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CHAPTER 17
Gambling Taxes

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Most politicians have an interest in increasing government tax revenues to support ever-growing government spending. This is one of the key motivations for the legalization and expansion of commercial gambling. Gambling is generally a state-level issue, with state governments being responsible for what types of gambling are legal in their respective states. The federal government is involved in regulating certain forms of gambling, for example, online betting, casinos, and poker.[1] Nevertheless, the great majority of industry revenue and tax revenue from legal gambling comes from state lotteries and commercial brick-and-mortar casinos.

What makes the gambling industry somewhat unique is that in many states, gambling is specifically banned either in the state's constitution, or through long-standing legislation. For example, the anti-gambling law in South Carolina dates back to 1802, and the police selectively enforce these laws.[2] Thus, an act of state government is usually required for the industry to exist legally in a state. With the existence of the gambling industry squarely in their hands, politicians may be expected to extract high rents from the industry.

This chapter discusses the expansion of legal gambling in the United States, with a focus on the taxes derived from lotteries and commercial casinos.

BACKGROUND

Legalized gambling began its modern expansion outside Nevada beginning with the introduction of the New Hampshire state lottery in 1964. Over the next few decades, other states would follow, and in 2016, all but five states operated a lottery.[3] The expansion of state lotteries was controversial, with a key argument against them being their regressive nature. Clotfelter and Cook (1991) provide a comprehensive discussion of the different issues surrounding lottery expansion, while Alm et al. (1993) and Jackson et al. (1994) provide econometric evidence on the factors explaining lottery expansion. Despite longstanding controversy over lotteries and state-sanctioned gambling in general, most state governments have apparently judged that the benefits from the lottery revenues outweigh the social costs of having the games. In many states that have more recently introduced lotteries, revenues have been earmarked for "good causes," such as scholarships for college students. Examples include the lotteries in Georgia and South Carolina. This earmarking has likely made lotteries more palatable for voters.

The present-day casino industry traces its roots back to 1931, when casinos were introduced in Nevada. Casinos were then legalized and opened in Atlantic City, NJ, in 1978. It was not until the 1987 *California v. Cabazon Band of Indians* (480 U.S. 202 (1987)) case in the US Supreme Court and the 1988 Indian Gaming Regulatory Act, which effectively relegated casino regulation to state governments, that tribal and commercial casinos began to spread across the United States. Currently more than 1,000 casinos operate in the United States.[4] The expansion of the casino industry has been the subject of much more controversy than lottery expansion was. This is likely because many people used to consider casino gambling "sinful" or a vice. During the early 1990s, concerns over the potential negative impacts of casinos were expressed with little or no supporting evidence by its staunchest opponents (e.g., see Goodman 1994). At the same time, empirical evidence in support of the positive economic impacts of casinos outside Nevada was limited. The lack of empirical evidence, combined with moral concerns about state-sponsored gambling, has fueled a long debate over the economic and social impacts of casinos.

Roughly half of US casinos are owned by sovereign Indian tribes. Tribal casinos come about after a process through which tribal lands are taken into trust by the Bureau of Indian Affairs (Department of the Interior) and a compact is signed between the tribe and the relevant state government.[5] Although tribal casinos do not pay taxes per se, in many states, tribes pay significant fees to maintain a monopoly in the state. For example, in Connecticut, the Mohegan Sun and Foxwoods casinos have agreed to pay 25 percent of their slot machine revenues to the state government in exchange for a guarantee that no commercial casinos will be approved in the state (Light and Rand 2005, 70). In some states, such as Alabama, Georgia, and South Carolina, Las Vegas–style table and slot machine games (Class III games) are not allowed. However, machine game manufacturers have been very clever in designing bingo games (Class II games), which are, from the customer's perspective, almost identical to Class III slot machines.[6] As a result, tribal casinos can effectively offer slot machines even in states where such machines are illegal. In the remainder of this chapter, discussion about casinos is limited to commercial casinos. This is because data on tribal casinos is generally not publicly available.[7]

Commercial casinos are those sanctioned and regulated by state governments. Such casinos have been legalized in more than fifteen states, beginning with South Dakota in 1989. Many Midwestern states adjacent to the Mississippi River legalized casinos in the early 1990s. The most recent wave of expansion has been in the Mid-Atlantic and Northeast, where Maryland, New York, and Massachusetts have recently legalized commercial casinos. As of early 2016, expansion is being considered in New Hampshire, Rhode Island, Connecticut, and New Jersey.

Although the expansion of lotteries and casino gambling could be attributed to an expanding appreciation for individual liberty or deference to consumer choice, empirical evidence suggests that fiscal stress has been a key determinant of lottery and casino legalization (Alm et al. 1993; Jackson et al. 1994; Calcagno et al. 2010). Interestingly, fiscal stress was not found to be a key determinant outside the United States (Richard 2010). However, it is clear that, in the United States, the potential revenues to governments remain a key catalyst for the expansion of legalized gambling.

TAX REVENUES

Although different states have legalized a variety of types of gambling—including pari-mutuel betting on horse and greyhound races—lotteries and casinos provide the vast majority of gambling tax revenues for state governments. For each $1 lottery ticket, approximately 20 percent goes to administrative costs and commissions to retailers, about 50 percent is returned to players in the form of prizes, and the remaining 30 percent is kept by the sponsoring state. This third allotment is called the "lottery tax." Empirical analysis has suggested that lotteries are generally designed to maximize revenues for the state (Garrett 2001).

Taxes on casino revenues vary greatly, from a low of around 6.75 percent in Nevada to 50 percent or more in such states as Illinois, New York, and Delaware. It is interesting to note that the casino tax rate is lower in larger, more established markets, including Nevada; Atlantic City, New Jersey; and Mississippi. Typically, taxes on casino revenues are applied to gross receipts, and most states have implemented complicated graduated tax schemes, so that larger casino properties with higher revenues will pay a higher percentage of their revenues than smaller casinos will. Even though taxes on commercial casinos and lottery sales are higher than on most other industries, legal gambling still contributes only a modest amount to state coffers. Walker and Jackson (2011) calculate state revenues due to gambling taxes to be less than 5 percent in most states. Recent evidence suggests that government revenues from the gambling industry have flattened, despite casino industry expansion (see Povich 2015).

Figures 1–4 present aggregate revenues from lotteries and casinos across all US states and the take by government, again aggregating across all states.[8]

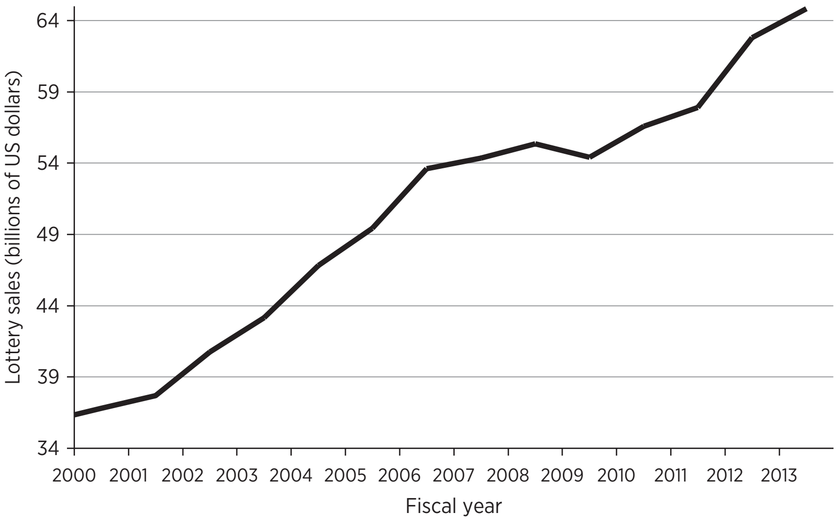
Figures 1 and 2 illustrate lottery sales and state revenues over the past 15 years. Sales have continued to climb at a healthy rate since 2000, with the exception of flat sales during the Great Recession. Lottery sales in fiscal year 2013 were more than $64 billion, with state governments retaining about $21 billion from lottery sales in that year.

Casino revenues in the United States have increased dramatically since 2001, to about $38 billion in 2014. (This amount does not include tribal casinos, which are probably about another $30 billion.) The government tax revenue in all states amounted to about $8 billion in 2011.

INTERINDUSTRY RELATIONSHIPS

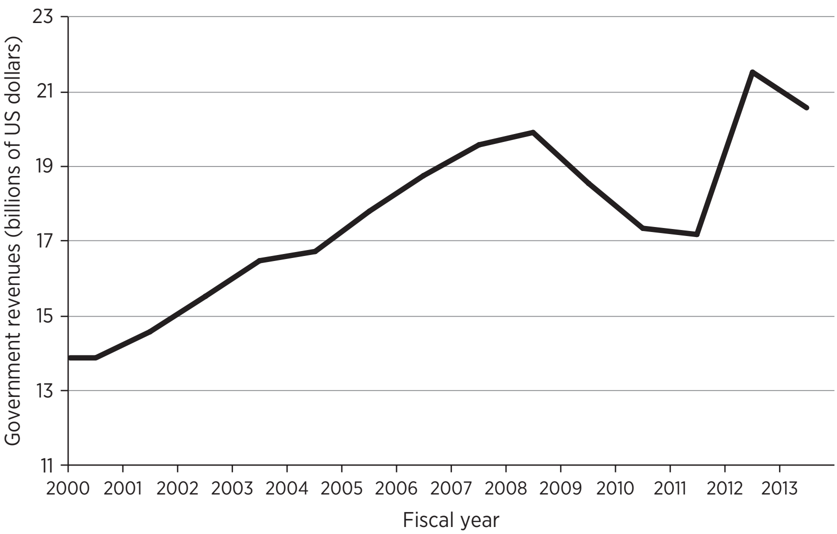
One common concern about the expansion of casino gambling has been that the industry may lead to the demise of other types of gambling or other nongambling industries. Such interindustry relationships are commonly called "industry cannibalization" in the gambling literature (Walker 2013, 26–28). Several studies have examined the relationships among different types of gambling. Most evidence suggests that casinos and lotteries are substitutes, and that these forms of gambling harm one another's revenues (see, e.g.,

Figure 1. Total Lottery Sales, All States, 2000–2013



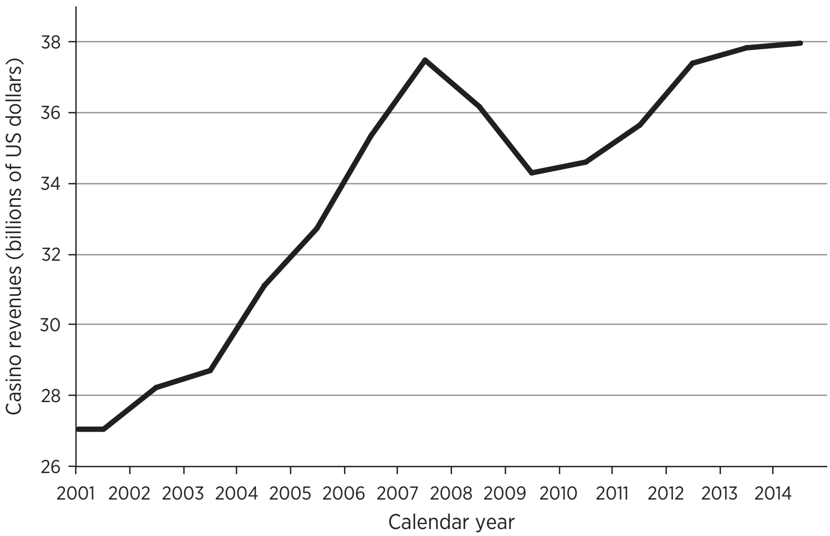
Source: LaFleur's Magazine, 2009–2013; *LaFleur's World Lottery Almanac* 17e, 1993–2008.

Figure 2. Total Government "Tax" Revenues from Lottery Sales, All States, 2000–2013



Source: LaFleur's Magazine, 2009–2013; *LaFleur's World Lottery Almanac* 17e, 1993–2008.

Figure 3. Total Casino Revenues, All States, 2001–2014



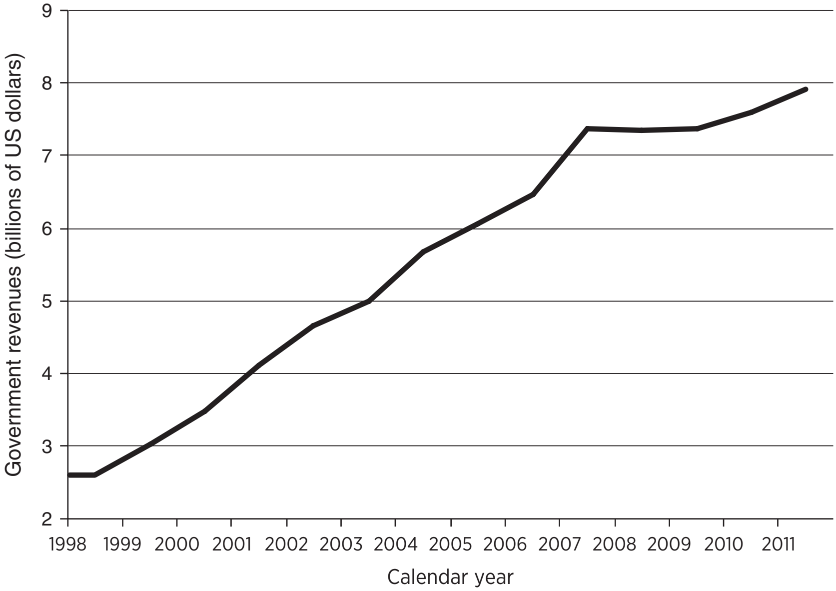
Source: University of Nevada, Las Vegas, Center for Gaming Research, Las Vegas, NV. http://gaming.unlv.edu/.

Note: Tribal casino revenues are not included in this figure.

Mobilia 1992; Anders et al. 1998; Ray 2001; Siegel and Anders 2001; Elliott and Navin 2002; Popp and Stehwien 2002; Kearney 2005).[9] However, there is no conclusive evidence from the literature that all types of gambling act as substitutes for one another. One comprehensive US study has found that certain types of gambling are complementary (Walker and Jackson 2008). For example, horse racing gambling revenues and casino revenues have been found to be complements, but this may stem from the development of "racinos" (racetrack casinos).

The relationships among different types of gambling are clearly important as a matter of politics. In some states, incumbent gambling industries staunchly oppose casinos. An example is the horse racing industry's opposition to casinos in Kentucky (see Hall 2014). In many states, the effect of casinos on lotteries has been an important concern. If casinos and lotteries are substitutes, for example, then the net benefit from casino taxes will be less than their gross tax receipts, as lottery tax receipts are likely to fall as a result of casino expansion. However, a recent study found that casinos had a negative impact on the lottery of only about 5 percent. This suggests that the net impact of casinos on aggregate gambling taxes are still overwhelmingly positive (Cummings et al. 2017).

Figure 4. Total State Government Revenues from Casino Taxes, All States, 1998–2011



Source: University of Nevada, Las Vegas, Center for Gaming Research, Las Vegas, NV. http://gaming.unlv.edu/.

Note: Tribal casino revenues are not included in this figure.

Much less is known about the relationship between gambling and nongambling industries and whether casinos significantly "cannibalize" other industries. Cannibalization might occur, for example, if people divert much of their entertainment spending away from sporting events or movies and concerts, for example, in order to gamble at casinos. The limited available evidence on property values in areas surrounding casinos suggests that the effect of casinos is probably positive on net (Phipps 2004; Wenz 2007; Wiley and Walker 2011). Cotti (2008) examines county-level employment and wage data in the United States, finding that casinos have had a modestly positive impact on employment, with a very slight positive effect on local wages. This evidence suggests that, at least at the county level, casinos likely have not hurt other industries. Even if they did, however, the tax rate applied to gambling is much higher than the tax rate typically applied to nongambling goods and services. Therefore, it seems safe to conclude that even considering interindustry relationships, casinos and lotteries have tended to increase net state revenues.

MARKET SATURATION

During the past few years there has been increasing concern, particularly among politicians in the northeastern United States, that the casino industry may be becoming saturated. The primary example of this is in Atlantic City, where four of the twelve casinos there closed during 2014.[10] Although the term "saturation" has not yet been clearly defined in the context of the casino industry, it loosely means that there are too many casinos for the market. Various stakeholders may adopt differing perspectives. For example, casino patrons may not think a market is saturated until there is at least one casino within a 15-minute drive from their house. Politicians may view market saturation to mean that a new casino opening does not increase overall casino tax revenues. The casino industry might define saturation as the point at which a new casino causes a decline in existing casinos' revenues or profits. Or it might simply be the point at which consumer spending at casinos reaches its maximum, regardless of new or additional supply of casino capacity. Almost no academic research has been done in this area.[11]

Only three published studies have focused on the saturation issue, with an emphasis on the impact of new casinos in the Northeast (McGowan 2009; Condliffe 2012; Barrow et al. 2016). Condliffe and McGowan focus on whether the introduction of casinos in Pennsylvania led to an increase or decrease in regional aggregate casino revenues. Findings from the studies are in conflict and use simplistic empirical analyses, limiting both the impact and generalizability of their results. Barrow et al. (2016) provides a framework for analyzing the degree to which the casino industry might be saturated. However one limitation of the proposed metrics is that they do not effectively deal with how tourism might affect the saturation measures. Despite the recent papers in this area, it remains one of the most seriously neglected areas of research on the economic impacts of gambling, as the issue has important implications for the stability of casino tax revenue streams.

SOCIAL ISSUES

Gambling can be thought of as a form of entertainment. Casino games and lotteries are entertaining to many people because of the rush of excitement they may create. For example, the consumption value of lottery tickets may simply be the enjoyment people have imagining what they would do if they won a multimillion dollar jackpot. Casino games can be exciting both because of the potential to win large sums of money and the social nature of the games. Similarly, playing daily fantasy sports games may be enjoyable largely because players have friends who are also playing, and they enjoy comparing their results.

Regardless of the consumer benefits from gambling, most politicians believe that the government has a role in regulating gambling. This perspective may have its roots in a moral concern over gambling, or the view that gambling is a vice that should be controlled. However, in recent decades the debate over lotteries and casinos has raised other concerns about the effects of legal gambling. As noted earlier, a key concern with lotteries has been their regressive nature. Nevertheless, state governments have expanded lotteries. Because lottery revenues are often earmarked for positive purposes, such as subsidizing college tuition, the regressive nature of lotteries has apparently not quelled their popularity.

Concerns over casino gambling center around social cost issues. The social costs of gambling have been debated in the literature and are still controversial (Walker 2013). The potential harms that stem from gambling are generally associated with problem gambling, which is akin to drug or alcohol addiction. Problem gambling is gambling to an extent that it negatively affects a person's professional or personal life.[12] Such problems are commonly manifest as financial problems and are thought to lead to increased rates of crime, divorce, and bankruptcy (Walker 2013). However, the degree to which gambling alone can be blamed for such problems is debatable, because most problem gamblers have other disorders, often involving excessive drug and alcohol use (for a discussion, see Petry et al. 2005; Kessler et al. 2008).

The fact that gambling has been linked to a variety of social problems has likely led to its unique status among industries. It is one of the most strictly regulated and highest taxed industries in the United States. Despite the potential for large tax revenues, many observers argue that the state should not be offering, sponsoring, or promoting gambling because of the potential public health harms. Such concerns seem to have been overwhelmed by the arguments in favor of expanded gambling, as no movement has succeeded in repealing casino or lottery legalization in any state.

PUBLIC CHOICE ISSUES

As already noted, empirical evidence suggests that state lotteries are designed to maximize the revenues of the sponsoring state governments. Casino legislation, too, seems to be drafted with an aim toward maximizing tax revenues. However, state governments do little to analyze the tax rates that should be applied to casino revenues to maximize government revenues. That the casino industry is allowed to exist by an act of government raises the potential for enormous rents to be captured by state governments.

Most states do not allow a free market in casinos, although Nevada is close. Typically, a strict limit is placed on the number of casinos allowed, as well as the number of gambling machines and table games (i.e., gambling positions) allowed in each casino. States do vary on the degree to which they control the sizes and number of casinos. States that have more recently legalized gambling commonly use a regional model, in which a single casino is allowed in each region of the state. Examples of this model appear in Kansas, Ohio, and Massachusetts. Obviously, when the state restricts the number of casinos, rent-seeking is likely to occur. This situation creates an opportunity for corrupt activities (Walker and Calcagno 2013).

One result of the special status of casinos is that the casino industry itself has a large hand in helping develop the regulations that will control it. This has resulted in regulatory changes over time that appear to be favorable to the casino industry (Calcagno and Walker 2016). For example, states such as Missouri that initially had regulated maximum bets no longer do. States that once allowed only riverboat casinos, such as Mississippi, now allow land-based casinos. Regardless of a trend toward more favorable regulations, the industry is still heavily taxed. However, given that casino taxes represent a relatively small part of state governments' budgets, why are casinos so hotly debated and promoted by politicians?

One answer to this question is that, although casinos do not make a big difference in most states' finances, casinos can help politically—at the margin (Walker 2013). Consider that many states have seen growing fiscal crises, particularly since the Great Recession. Politically, it is difficult to cut spending on popular (and even unpopular) government programs. It is also unpalatable to raise sales, property, or income taxes at the state level. This may help explain why politicians are so willing to consider the legalization and expansion of the gambling industry. This explanation is also consistent with the findings from the literature that fiscal stress is a key determinant of lottery and casino legalization.

TECHNOLOGY AND THE FUTURE OF GAMBLING

The landscape of legal gambling in the United States has changed dramatically since 1990. State lotteries exist in the majority of states, casino gambling is available in most states, and only two states currently ban all forms of gambling. Already widespread, lotteries and casinos are unlikely to see dramatic change in the near future. The key determinant of how the gambling industry will develop is technology. The ability of people to gamble over the Internet using their home computers or smartphones presents unimaginable possibilities for the expansion of gambling. For example, the popularity of daily fantasy sports, exemplified by Draft Kings and Fan Duel, exploded during the fall of 2015, along with a constant barrage of advertising. Both potential customers and regulators have taken note. A variety of state governments and the federal government are now studying this new activity. There is some debate over whether these activities constitute gambling and how the current laws will treat daily fantasy sports. Online poker and online lotteries have seen similar developments over the past few years, although they developed somewhat more slowly than daily fantasy sports (see Rose 2016).

It would be surprising if state governments and perhaps even the federal government did not decide to step in to regulate all forms of online gambling.[13] Although such regulations will be sold under the guise of consumer protection, it is likely that regulated online gambling would also come with heavy taxes.

CONCLUSION

Despite the view of some that gambling is a vice and should not be sanctioned or allowed by government, most US states have legalized gambling in one form or another. Lotteries have expanded to forty-five states since they were introduced in New Hampshire in 1964. Casinos began their spread outside Nevada and Atlantic City, New Jersey, beginning in 1989. Now more than 1,000 casinos operate in the United States, and gambling plays an important public finance function in many states. The overall contribution of the gambling industry to state budgets is still somewhat small, even though states impose higher taxes on gambling revenues than on many other goods or services.

Increased competition in the gambling industry across state lines has been a catalyst for reconsidering gambling policy in some markets. Some states, for example, have begun to consider lowering their casino tax rates. Other states have expanded the number of casinos allowed beyond what they allowed when casinos were first legalized. In still other states, completely new ideas are gaining attention. For example, some politicians in New Hampshire have even suggested that a free market in gambling might be the best model. It would certainly be unique and could operate better than highly regulated markets.

The most interesting developments in the gambling industry are certainly technology related. Little is known about the relationships between online forms of gambling and traditional lottery and brick-and-mortar casinos. Certainly, continuous technological advances pose a potential threat to the traditional gambling sectors, and, in turn, to state gambling tax revenues. As a result, we should not be surprised to see state governments, and even the federal government, taking aggressive steps to control and tax new types of gambling as technology allows their development. As a result, the US gambling industry will likely be very different 10 years from now.

NOTES

1. Online poker, sports betting, and daily fantasy sports are examples of games that the federal government has a role in defining and regulating. The legality and regulation of these industries have been controversial and are not settled matters at the time of this writing. As a result, and because revenues from these components of the gambling industry still represent a very small proportion of overall revenues, these issues are not addressed in this chapter.
2. See http://www.scstatehouse.gov/code/t16c019.php for the anti-gambling law in South Carolina, and Town of Mt. Pleasant v. Chimento et al., South Carolina Supreme Court Opinion No. 27197, November 21, 2012, for an example of a case near Charleston in which a home poker game was raided by police.
3. The exceptions are Alabama, Alaska, Hawaii, Nevada, and Mississippi.
4. The number includes tribal and commercial casinos, as well as racetrack casinos and card rooms. See www.casinocity.com for a list of casinos and other gambling venues in each state.
5. For more information, see http://www.indianaffairs.gov/WhatWeDo/ServiceOverview/Gaming/index.htm.
6. For example, at the Poarch Creek Indian tribe's Wind Creek Casino in Wetumpka, AL, the machines are identical to Class III slot machines with one minor detail. At one corner of the display screen, there is a small bingo card. Once the player hits the "play" button, a new bingo card appears, along with winning numbers. Then the slot machine display begins and shows the result of the slot machine play. This entire process takes about 2 seconds. Although it looks just like a Class III slot machine, it is technically and legally considered to be a bingo (Class II) machine.
7. Some aggregated tribal casino data are available in Meister (2015).
8. The data presented in figures 1–4 are the most recent publicly available data as of this writing. As mentioned earlier, tribal casino revenues are excluded, as are any so-called fees paid by tribal governments to state governments in which tribal casinos are located.
9. In this discussion, the terms "substitutes" and "complements" refer only to the relationship between revenues in different industries, not to the economic relationship between the demand for one product and changes in the price of another.
10. Recent data showing higher profits for the remaining Atlantic City casinos suggest that the closures in 2014 may have simply been a normal market correction. See Wayne Perry, Associated Press, "Atlantic Casino Profits Up 31 Percent," May 23, 2016, https://www.indystar.com/story/news/2016/05/23/ac-casino-profits-increase/32621749/.
11. The study by Walker and Nesbit (2014) examined the effect a new casino in Missouri would have on existing casinos' revenues, but this was not a direct test for industry saturation.
12. A growing literature in psychology and medicine is dedicated to understanding and treating gambling problems. Such problems are estimated to affect about 1 percent of the general population and a higher percentage of the adolescent population.

13. As of July 2017, it is unclear how the federal government may act toward expanded online gambling. This issue has become more complicated as US Attorney General Jeff Sessions has reportedly recused himself from making any decisions regarding online gambling (see Brody 2017).

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