

Findings



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Lottery Lawsuit

Insuring the Integrity of the Legislative Process

By John Rustin and Tami Fitzgerald



On August 31, 2005, North Carolina Governor Mike Easley penned his signature on House Bill 1023, enacting into law a bill authorizing the establishment of a lottery in the Tar Heel State. This action not only made North Carolina the last on the East coast to join the throng of states that profit from monopolized state-sponsored gambling, it also seemingly brought to a close a 23-year legislative battle over the lottery in North Carolina. However, in their haste to finally get a lottery bill to the governor's desk, legislative leaders likely made a critical error—ignoring the North Carolina Constitution and its directive to the legislature on the process required for voting on bills that raise revenue.

Article II, Section 23 of the North Carolina Constitution states:

“Revenue bills.

No law shall be enacted to raise money on the credit of the State, or to pledge the faith of the State directly or indirectly for the payment of any debt, or to impose any tax upon the people of the State, or to allow the counties, cities, or towns to do so, unless the bill for the purpose shall have been read three several times in each house of the General Assembly and passed three several readings, which readings shall have been on three different days, and shall have been agreed to by each house respectively, and unless the yeas and nays on the second and third readings of the bill shall have been entered on the journal.”

Despite significant evidence to the contrary, legislative leaders in both the House and Senate decided not to treat

House Bill 1023 as a “revenue bill” and found it unnecessary to confine themselves to the requirements of Article II, Section 23 when seeking passage of the lottery. Ironically, this conclusion—while proving to be politically expedient and greatly aiding the passage of the lottery in both chambers—has exposed the Lottery Act to legal action that could result in its undoing.

On December 15, 2005, the North Carolina Institute for Constitutional Law, led by former State Supreme Court

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Justice Bob Orr, filed a complaint in Wake County Superior Court asking the court to find the Lottery Act unconstitutional and to enjoin the N.C. State Lottery Commission from taking any further action to establish a lottery in North Carolina.¹ As the North Carolina Family Policy Council is a plaintiff in the case, the purpose of this paper is to explore the basis of the lawsuit in order to help the citizens of the state understand why it is important.

Three Readings in Each Chamber

As a matter of procedural explanation, all bills (except certain House and Senate resolutions) must receive three “readings” in both the House and Senate before they can be enacted into law. The first reading of the title of the bill takes place on the chamber floor when the bill is initially introduced. The bill is then assigned to committee for consideration, and if the

bill passes through the committee structure, it returns to the chamber floor for a second reading vote and, if successful, a third reading vote. The entire chamber votes on bills during the second and third readings. If the bill passes the third reading, it is then sent to the other chamber where it follows a similar process.

More often than not, the second and third reading votes on bills that do not involve state finances take place on the same day. Typically, the second reading vote will be conducted as an electronic recorded vote in which members register their votes by pressing the “Aye” or “No” button on electronic voting devices at their chamber desks. The Principle Clerk registers the vote and enters it into the official record, or journal. Usually, if a bill passes second reading by a significant margin (and at times even if the margin is quite slim) the presiding officer will call for a third reading voice vote immediately after the second reading vote has been taken. If voted in this way, the third reading vote is not electronically recorded, but instead the presiding officer makes a determination of the voice vote (almost always mirroring the recorded vote) and announces the outcome.

Revenue Bills

Because the framers of North Carolina's Constitution deemed the imposition of taxes upon the people of the state or the extension of the credit of the state to be such a significant act, they required “revenue bills,” or those bills meeting the terms of Article II, Section 23, to meet a higher level of scrutiny than most other pieces of legislation. In 1897, the North Carolina Supreme Court spoke to the intent behind this constitutional provision:

“It [Article II, § 14, the predecessor to § 23] is the protection which the people, in convention, have thrown

around themselves for the benefit of the minority as well as of the majority. The object of the provision was to prevent hasty and ill-advised legislation, by means of which the people might be deprived of their property, not for the ordinary expenses of government, but, by special taxation, for enterprises ostensibly in the name of the public good, but which might prove sources of individual injustice and injury. When indebtedness of the kind mentioned in the provision is sought to be incurred, the people have said in that provision that their legislative body, whenever considering the propriety of authorizing it, shall be not only careful, but deliberate...”²

Accordingly, Article II, Section 23 requires that revenue bills be read on three separate days in both chambers and that the second and third reading votes may not occur on the same day. In addition, the “yeas” and “nays” on both second and third readings must be recorded and entered into the journal. In other words, a voice vote on the second or third reading of a revenue bill is insufficient to comply with the Constitution. This is a practical protection put in place for the benefit of the citizens of the state and one intended to ensure that the passage of revenue bills is deliberate and well thought out.

Requiring revenue bills to be read on three separate days and to be voted on two separate days opens up the legislative process. This affords the public an extra opportunity to become aware of what the legislature is considering and to engage their elected representatives on the matter. In contrast, non-revenue bills can move through the General Assembly in a single day and be signed into law even before the public knows what has happened. Also, by requiring revenue bills to be voted on two different days, this provision allows legislators to “sleep on” their decisions and be absolutely sure of their final vote. In addition, it serves to protect the integrity of the legislature by slowing down the legislative process and limiting opportunities for abuse and political shenanigans, such as calling for a surprise vote on a tax bill or rushing a revenue bill through the House or Senate while members are absent from the chamber.

Furthermore, by requiring the second and third reading votes to be recorded in the journal, Article II, Section 23 provides greater accountability for legislators. The journal is a public document open for public inspection, and citizens, at any time,

may review the recorded votes of state lawmakers.

History of House Bill 1023

It is indisputable that the process the General Assembly used to gain passage of House Bill 1023 did not conform to the constitutional directive of Article II, Section 23.

On April 6, 2005, the North Carolina House passed HB 1023 on second reading by a recorded vote of 61 to 59.³ It is important to note that if one member had changed his or her vote from “Aye” to “No,” the bill would have been defeated for failure to obtain a majority. Following the second reading vote, and ignoring objections by numerous members of the House, Speaker Jim Black (D-Mecklenburg) immediately called for a third reading voice vote on the bill, which he then determined was in favor of passage. Clearly, the second and third reading votes on HB 1023 did not take place on separate days in the House, nor were the yeas and nays on the third reading vote recorded in the journal.

Similarly, in the North Carolina Senate, both votes on HB 1023 occurred on the same day—August 30, 2005. The second reading vote culminated in a 24 to 24 deadlock, with Lieutenant Governor Beverly Perdue breaking the tie when she voted in favor of the bill.⁴ Immediately thereafter, amidst objections, the Lt. Governor, who presides over the Senate, called for a third reading voice vote and ruled that the bill had passed its final step. All this took place with two declared lottery opponents absent from the chamber. Once again, both second and third reading votes on HB 1023 were taken on the same day, the third reading vote was taken by voice, and the yeas and nays on third reading were not recorded in the journal.

As further evidence that legislative leaders were intent on avoiding any additional votes on the lottery, they devised a scheme to modify HB 1023 without having to return the bill to the House for another vote. Instead of making amendments directly to HB 1023—which would have required the bill to return to the House for a vote on the Senate’s changes—the Senate included its changes in a completely separate bill—the 2005 budget bill, Senate Bill 622 that had previously passed. These provisions were written in such a way that they had no effect unless HB 1023 was enacted into law. In fact, all of the lottery provisions in the budget were preceded by the statement, “If House Bill 1023, 2005 Regular Session, becomes law, then

[relevant section of HB 1023], as enacted by that act, reads as rewritten....”⁵

Amending HB 1023 in this way, as well as taking recorded votes just on the second reading in both the House and Senate, allowed the Lottery Act to pass the North Carolina General Assembly with a total of only two recorded votes. Considering the controversial nature of the legislation, the highly contentious 23-year debate in the General Assembly over the issue, and the fact that lottery proponents anticipate ticket sales to generate annual revenues of \$1.2 billion from the pockets of taxpayers, the purposeful avoidance of legislative votes resulted in a process that was neither “careful” nor “deliberate.” This is particularly true when one considers the mountains of research demonstrating that the lottery is often established “ostensibly in the name of the public good,” but which ultimately proves to be, at least for some, a source “of individual injustice and injury,” to borrow the language of the 1897 Supreme Court.⁶ It appears that the General Assembly’s hasty passage of HB 1023 was exactly the type of action Article II, Section 23 was intended to prevent.

House Bill 1023 is a Revenue Bill

With it clearly established that HB 1023 was not approved in a manner consistent with Article II, Section 23, the next question that must be answered is whether HB 1023 is a “revenue bill” and thus subject to this provision of the Constitution. A closer look at the fundamental structure of the Lottery Act exposes the fact that it creates both an implicit and an explicit tax.

One clarification that needs to be made at this point is the difference between taxes and fees, because state courts have determined that fees generally are not subject to Article II, Section 23.⁷ Typically, fees are “imposed by an administrative agency upon only those persons, or entities, subject to its regulation for regulatory purposes, or to raise ‘money placed in a special fund to defray the agency’s regulation-related expenses.’”⁸ In other words, fees are collected and used for purposes closely related to the activity or regulation for which the fee is charged. This includes the cost of administrative and operational functions of the regulatory body or public agency.

According to the Lottery Act, 15 percent of the gross revenue from the lottery may be used to cover administrative costs—including seven percent to compensate retailers for selling the tickets, one percent for advertising, and seven percent to pay for contracts with lottery

vendors to operate the games, as well as other expenses.⁹ These are the funds used to generate and collect lottery revenues and this is the only portion of the lottery that might be considered a fee. Because the promotion and sale of lottery tickets demand more of the state than do traditional forms of tax collection, the operational costs for the lottery are significantly higher than the typical cost the state incurs to collect revenue.

Fifty percent of the gross revenue is to be returned to lottery ticket purchasers in the form of prizes,¹⁰ while the remaining 35 percent is to be withheld by the state and transferred to the North Carolina State Lottery Fund to be allocated to a variety of public programs as determined by the General Assembly.¹¹

The clear objective of the Lottery Act is set out in its “purpose and intent” statement, which reads: “The General Assembly declares that the purpose of this Chapter is to establish a State-operated lottery to generate funds for the public purposes described in this Chapter.”¹² The bill establishes the role of the North Carolina State Lottery Commission as “an independent, self-supporting, and revenue-raising agency of the State,”¹³ and speaks of the money generated for public purposes from the sale of lottery tickets in terms of “net revenues.”¹⁴ The act dictates how lottery revenues are to be allocated or spent—35 percent of which are to go to fund education-related programs, public programs that have nothing at all to do with the lottery other than being designated as a recipient of lottery funds.¹⁵ It is the generation and collection of this 35 percent “net revenue” for the broad public purpose of education that comprises the lottery tax.

A recent analysis of lotteries by the Washington, DC-based Tax Foundation put it this way:

“If the amount of revenue generated is more than the amount needed to provide the good or service, and if the revenue is used to fund unrelated government activities, courts are likely to consider it a tax rather than a fee. This is certainly the case with lotteries. Operating costs (including vendor commissions) in Fiscal Year 2003 accounted for only 27 percent of the take-out from traditional...lottery games; the rest was kept by state governments as “profit” —really tax revenue—and used to fund projects that were, for the most part, entirely unrelated to lotteries.”¹⁶

An article in *The Tax Lawyer*, a publication of the American Bar Association, reinforces these conclusions: “State lotteries are ‘implicit taxes.’ The revenues derived by states from lotteries are equivalent to tax revenues.... The state’s takeout rate (*i.e.*, what percentage is left after prizes and operational and administrative expenses are deducted) is the state’s lottery tax revenue.”¹⁷

Who Pays and Who Benefits?

Further evidence that “net” lottery revenues constitute a tax and not a fee can be found in how the revenue is spent and who benefits. As mentioned above, fee revenues cover the cost to provide the particular good or service for which the fee is charged, while tax revenues are collected by the state and used to fund unrelated public purposes.

Consider the North Carolina Supreme Court’s determination that tolls paid on toll roads are not a tax, but instead are a fee.¹⁸ The court made this determination based on the fact that toll revenues are used to pay administrative costs to collect the toll, as well as to fund the maintenance of the roadway on which the toll is collected.¹⁹ While the tolls collected may exceed the cost of administration, the excess is used for a purpose closely related to the activity—the maintenance of the roadway. As a result, only those who choose to use the toll road pay the toll, and conversely, only those who pay the toll benefit directly from the service.

In contrast, the Lottery Act directs the state to automatically skim 35 percent of the revenues off of the top and use those revenues for public purposes unrelated to the lottery—in this case education (although state lawmakers could redirect the funds to other purposes at any time.) The Lottery Act directs “net revenues” to the Education Lottery Fund to be used in the following ways: 50 percent to reduce public school class size “in early grades,” and “to support academic prekindergarten programs for at-risk four-year-olds;” 40 percent to the Public School Building Capital Fund; and 10 percent to the State Educational Assistance Authority to fund college and university scholarships for low-income students.²⁰

Clearly the educational programs funded by the lottery are intended to serve not only those who participate in the lottery, but the state as a whole. In fact, the purchaser of a lottery ticket may never benefit from any of these services, while someone who has never spent a dollar to buy a lottery ticket may utilize all of them.

Although some may see this as a laudable way to generate additional state revenue, it in essence represents an embedded tax of 35 cents on every dollar spent to purchase a lottery ticket.

A Voluntary Tax?

Some individuals claim that the purchase of a lottery ticket is completely voluntary and therefore the lottery is not a tax. This is flawed reasoning. As with a lottery ticket, the purchase of cigarettes, candy, clothing, or any other commodity is *voluntary*, but once the purchase is made, the payment of the related tax is *mandatory*. If you exercise your choice to purchase a pack of cigarettes, you then have no option but to pay the related taxes on that product. Likewise, if you purchase candy or clothes, you are obligated to pay the state sales tax. The only difference with the lottery is that the tax is embedded in the price of the product, not added on to the purchase price.

Explicit Taxation

If this were not enough to convince one that the lottery is a tax, the Lottery Act also explicitly establishes a new income tax withholding on lottery winnings. In order to accomplish this, the act directs the State Lottery Commission to deduct and withhold income taxes of seven percent from the payment on winnings that are reportable to the Internal Revenue Service (typically prizes over \$600).²¹ The act also authorizes the state to tax the winnings of out-of-state lottery players.²²

Extension of the Credit of the State

In addition to creating new explicit and implicit taxes, the Lottery Act also “raises money on the credit of the state for the payment of lottery winnings” and “pledges the faith of the state for the payment of a debt” in violation of Article II, Section 23.²³ One must assume the State is ultimately responsible for the payment of any debt created by the lottery, including covering the cost of prizes and other lottery-related liabilities such as employee and vendor contracts. While many believe the income generated from the lottery will exceed expenses and liabilities, this is not the case during the start-up phase of the lottery, due to the fact that the state expends significant dollars and enters into multi-year contract obligations well before the first lottery ticket is ever sold. This is made possible by the Lottery Act, which authorizes the Lottery Commission to borrow up to \$10 million from the State Treasury—obviously an extension of the credit of the state for the purposes

of raising money.²⁴ Additionally, if for some reason the lottery agency was unable to fulfill its obligation to pay off jackpot winnings or defaults on a contract or other agreement after lottery tickets begin to sell, the state presumably would have to step in and satisfy the debt.

A recent example of such a possibility is a December 2005 lawsuit charging the South Carolina Education Lottery with fraud over the continued sale of scratch-off lottery tickets after the top prize had been won.²⁵ A news report indicates that the plaintiff would like the case to become a class-action suit and has asked for a preliminary injunction to stop the sale of scratch-off tickets in South Carolina until the matter is resolved.²⁶ If successful, such an action (especially if it becomes a class-action suit) could cost the lottery millions of dollars, expose the state to significant liability, and damage public confidence in the lottery, reducing ticket sales and lottery revenues.

Drawing of Public Money

Finally, the Lottery Act violates Article V, Section 7 of the North Carolina Constitution, which states: “No money shall be drawn from the State treasury but in consequence of appropriations made by law, and an accurate account of the receipts and expenditures of State funds shall be published annually.”²⁷ As mentioned above, the Lottery Act authorizes the State Treasurer to lend \$10 million to the State Lottery Commission “to cover initial operating expenses of the Commission” and specifies that those funds “shall be available for expenditure...without further action by the General Assembly.” The lending of these funds to the State Lottery Commission constitutes a drawing of money from the State treasury but does so without a direct appropriation by the North Carolina General Assembly.

Legislative Precedent

Another compelling piece of evidence in this case is the legislative history set over the last two decades by the General Assembly. Since 1983, six lottery bills have passed second reading in the North Carolina Senate.²⁸ In every case—except one—the third reading of these bills was held on a separate day, and if a third read-

ing vote was taken, that vote was recorded in the journal. The one exception was in 1992 when the Senate took a House bill seeking to increase salaries and benefits for state employees and added a provision to it calling for a statewide referendum on the lottery.²⁹ When that bill passed the Senate and returned to the House, the House refused to accept it, and it was sent back to the Senate where it died. Until 2005, no lottery bill had passed the North Carolina House. Legislative history sets a strong precedent for considering the lottery to be a revenue bill and holding the second and third readings on two separate days.

Conclusion

The Lottery Act is a “revenue bill” and the General Assembly should have followed the requirements of Article II, Section 23 when they sought to pass it. In addition, the manner in which lawmakers provided start-up funds for the lottery also appears to have been unlawful. It is quite possible that House Bill 1023 would not have made it to the Governor’s desk if the North Carolina House and Senate had followed the mandate of the North Carolina Constitution and conducted recorded votes on the lottery on separate days. Instead, legislative leaders gambled by taking a path that offered the greatest—and possibly the only—chance for the passage of the lottery in 2005.

In cases where the N.C. Supreme Court has determined that the General Assembly violated Article II, Section 23, the remedy has been to rule the unconstitutionally passed laws null and void.³⁰ For the benefit of the state and its taxpayers, and for the integrity of the Constitution and the institution of the North Carolina General Assembly, our state’s high court should provide a similar remedy for House Bill 1023.

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Endnotes

1. *Heatherly v. N.C.*, Complaint, Case No. 05 CVO 17197 (December 15, 2005).
2. *Commissioners of Stanly County v.*

3. *Snuggs*, 121 N.C. 394; 28 S.E. 539 (1897). North Carolina House of Representatives, Roll Call vote on the Second Reading of House Bill 1023, HCS, Seq. # 107, April 6, 2005.
4. North Carolina Senate, Recorded Vote on the Second Reading of House Bill 1023, CS 2nd Edition, Seq. 1057/8, August 30, 2005.
5. North Carolina Session Law 2005-276, Section 31.1.
6. *Commissioners of Stanly County v. Snuggs*, supra.
7. See, *N.C. Turnpike Authority v. Pine Island, Inc.*, 265 N.C. 109. 143 S.E.2d 319 (1965), and *N.C. Association of ABC Boards v. Hunt*, 76 N.C. App. 290, 332 S.E.2d 693 (1985).
8. *Club Association of West Virginia, Inc. v. Wise*, 156 F. Supp. 2d 599; 2001 U.S. Dist. LEXIS 13580. (S.D.W.V. 2001).
9. N.C.G.S. §18C-162(3) and (4).
10. N.C.G.S. §18C-162(1).
11. N.C.G.S. §18C-164.
12. N.C.G.S. §18C-102.
13. N.C.G.S. §18C-110.
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15. N.C.G.S. §18C-162.
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18. *N.C. Turnpike Authority v. Pine Island, Inc.*, 265 N.C. 109; 143 S.E.2d 319 (1965).
19. *Ibid.*
20. N.C.G.S. §18C-164.
21. N.C.G.S. §105-163.2B.
22. N.C.G.S. §105-134.5(b).
23. *Heatherly v. N.C.*, Complaint, Counts One and Two, Case No. 05 CVO 17197 (December 15, 2005).
24. North Carolina Session Law 2005-344, Section 15.
25. Kropf, Schuyler. “Man sues lottery for fraud; Scratch-off tickets sold after big prizes gone, audit found.” *The Post and Courier*. December 29, 2005.
26. *Ibid.*
27. North Carolina Constitution, Article V, Section 7(1).
28. North Carolina General Assembly, 1983 Session, Senate Bill 275; 1985 Session, Senate Bill 532; 1989 Session, Senate Bill 4; 1991 Session, Senate Bill 2; 1991 Session, House Bill 1514; 1993 Session, Senate Bill 11.
29. North Carolina General Assembly, 1991 Session, House Bill 1514.
30. See, *Debnam v. Chitty*, 131 N.C. 657, 43 S.E. 3 (1902); *Commissioners of Stanly County v. Snuggs*, supra; *Commissioners of Wilkes County v. Call*, 123 N.C. 308, 31 S.E. 481 (1998).

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