

# Findings



Dedicated to the  
Preservation of the Family.

## Is the Lottery a Tax?

### *Generating Revenue through State-Sponsored Gambling*

By Stephen Daniels



The merits of the lottery have been debated for many years in North Carolina and there is ample evidence to support the position that the lottery is bad public policy.<sup>1</sup> But regardless of one's position on the issue, there is one thing that everyone can agree on—the lottery is a way for the state to raise money.

The lottery has become a popular fiscal mechanism for state governments that are reluctant to push for increased taxes.<sup>2</sup> Lotteries offer an alternative means of raising revenue to pay for programs, particularly ones that are politically popular like education. During the debate over North Carolina's lottery, many state officials promoted the games as a way to help fund education without burdening the taxpayer.<sup>3</sup> Nonetheless, the lottery wasn't created as a form of entertainment. If this were the case, all of the net revenues left after taking out enough money to operate the lottery would be returned to players in the form of prizes. Instead, over a third of the total revenues are pocketed by the state to fund public programs.

Much has been made about whether the lottery involves a tax on players who purchase tickets. This question is central to a lawsuit, which claims that the General Assembly violated certain provisions in the North Carolina State Constitution when it passed the Lottery Act. Fundamental to that legal challenge is whether or not the lottery is a tax. If so, constitutional procedural requirements on the legislature that demand recorded votes on separate days would apply.<sup>4</sup>

If it is a tax, another significant public policy issue arises when examining the merits of the lottery. Lawmakers and

other government officials who support the lottery have endorsed state-sponsored gambling as a way to raise more money for the state. And even though the revenue generated by the lottery amounts to very little (lottery revenue would equal a meager two percent of the state's general fund budget),<sup>5</sup> the legislature has a responsibility to manage that money as carefully as it does any other tax revenue. After all, it is exacting hard-earned money from citizens who choose to play the games.

These observations raise the obvious question of whether there is any differ-

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ence between raising money for the state from the sale of lottery tickets and raising money for the state by other means. How does the lottery as a revenue-raising method really differ from other taxes? That is the question addressed in this paper. The evidence will show that the only difference between lottery profits and some other forms of taxation is the term used to describe them. In fact, the lottery is indeed a tax on players and should be characterized accordingly.

#### **Tax versus Profit**

Duke professors Charles Clotfelter and Philip Cook aptly described the purpose of the lottery when they wrote: "The states now offering lotteries do not simply make a product available in order to accommodate the widespread taste for buying a low-priced chance at a big prize. They seek to foster that taste. Lottery agencies are not merely acting out of a

liberal respect for consumer sovereignty. They are engaged in a well-focused quest for increased revenues."<sup>6</sup>

When the North Carolina General Assembly approved the Lottery Act in 2005, it changed state law to legalize this form of gambling (something that had long been prohibited in the Tar Heel State) and fashioned the lottery as a state-run monopoly. Thus the state of North Carolina alone can establish the product line, sell tickets, advertise lottery games, and reap the benefits of the "profits" generated by ticket sales. The clear intent of the legislature in enacting the lottery was to create an additional means of extracting money from the citizens of North Carolina—for the primary purpose of funding state programs.

The U.S. Census Bureau defines a tax as: "Compulsory contributions exacted by a government for public purposes."<sup>7</sup> *American Jurisprudence* defines taxation as "the power by which the sovereign raises revenue to defray the necessary expenses of government."<sup>8</sup> It is the lottery's function to raise money for public purposes that immediately sets it apart as a taxing mechanism. Interestingly, the U.S. Census Bureau classifies lottery profits as "general revenue."<sup>9</sup> But as the Tax Foundation's Alicia Hansen explains:

*"There is no reason to put any type of revenue in a miscellaneous catch-all category if it would fit better in a more clearly defined category. Lottery profits certainly fit the Census Bureau's definition of a tax... There is nothing in this definition that excludes lottery revenue. One example the Census Bureau provides in the tax category is pari-mutuel sales tax. Pari-mutuels include horse racing, dog racing and jai-alai, and there is no reason lottery proceeds could not be treated the same way the pari-mutuel gambling proceeds*

are treated; it would simply require legislators who are willing to call the lottery profit what it is—a tax.”<sup>10</sup>

There is no question that the North Carolina lottery was designed to raise money for “public purposes.” Consider the North Carolina Lottery Act’s “purpose and intent” section, which expressly states that the purpose of the lottery is to raise money for the state. That section reads as follows: “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.”<sup>11</sup> The Lottery Act also describes the North Carolina State Lottery Commission as “an independent, self-supporting, and revenue-raising agency of the State.”<sup>12</sup> The law also refers to monies raised by the lottery as “net revenues.”<sup>13</sup> Such descriptors clearly show that the state intends the lottery to be a moneymaking enterprise for the state, but nowhere does it refer to the revenue as a tax.

According to the Lottery Act, 50 percent of the gross revenue spent on the lottery is paid back to players in the form of prizes.<sup>14</sup> Fifteen percent of the gross revenue is used to cover administrative costs, with seven percent going to compensate retailers who sell tickets, seven percent going to the vendors who operate the lottery and other expenses, and one percent going toward advertising costs.<sup>15</sup> The remaining 35 percent is transferred into the North Carolina State Lottery Fund where it is used to pay for public programs designated by the General Assembly.<sup>16</sup>

The actual “value” of a lottery ticket is comprised of the portion of gross revenue that is related to the lottery—the amount of the ticket that is paid back toward prizes (50 percent) and the portion that covers administrative costs (15 percent). But the remaining 35 percent that goes into the Lottery Fund (the portion that is completely unrelated to the lottery itself) represents an implicit tax on the people of North Carolina.

When someone purchases a consumer good such as an article of clothing or electronics, he must also pay a tax that is added onto the cost of the product by the local and/or state government—a tax that is used to fund public programs. In much the same way, when the state of North Carolina sells a lottery ticket, it keeps 35 percent of the revenue paid toward the price of the product. In this case the product is a ticket that someone buys for a

chance to win a jackpot. The only difference is that the state itself produces the product and embeds the tax within the total price of the good.

Because the purpose of the North Carolina lottery is expressly to raise revenue for the state, and because a portion of the gross revenue is kept by the state to fund public programs, the lottery imposes a tax on any player who purchases a ticket. A recent analysis of lotteries by the Tax Foundation explains 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.”<sup>17</sup>*

According to the Lottery Act, the money raised by the lottery is designated to fund several education programs. The law 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.<sup>18</sup>

It is apparent that the only difference between lottery profits and other taxes is the terminology used to describe them. Lottery profits have not commonly been referred to as a tax, but that doesn’t make them any less of one. Lottery proponents have always promoted the lottery as an alternative to taxes and a painless way for the state to raise money—this is one reason lotteries have become so popular. Characterizing the lottery as a tax (even a voluntary one) would likely undermine support.

Even though states do not forthrightly refer to a lottery tax, some states come close by promoting their lottery as an

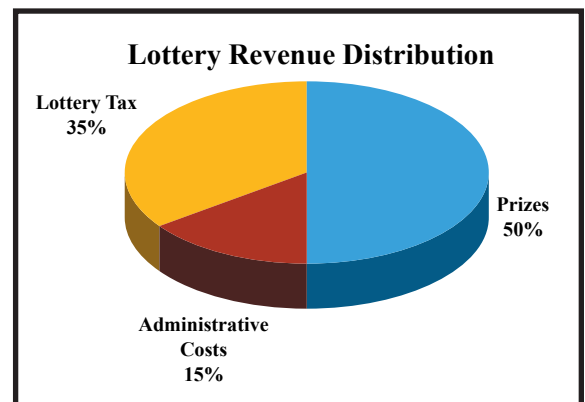
alternative to taxes. Wisconsin uses net lottery proceeds to provide property tax relief to state taxpayers, by sending lottery money directly to municipalities and crediting resident’s tax bill.<sup>19</sup> Minnesota characterizes a percentage of its sales as “in-lieu-of-sales tax.”<sup>20</sup>

Overseas, the National Lottery in the United Kingdom is much more up-front when identifying the portion of total sales that their citizens pay to the government. They simply refer to it as a “lottery duty.”<sup>21</sup> The term duty means tax.<sup>22</sup>

Another reason why lottery revenue has not been classified as a tax could be because doing so allows the lottery to avoid many of the rules, regulations and oversight imposed on other government agencies that collect taxes.<sup>23</sup> North Carolina, like other states, has created the North Carolina Lottery Commission as “an independent, self-supporting, and revenue-raising agency of the State,”<sup>24</sup> instead of placing it under the auspices of a state agency like the Department of Revenue or Commerce.

### Voluntary versus Mandatory

A common objection to the lottery-as-a-tax concept is the notion that a lottery ticket is a voluntary purchase and not mandated by the state. Therefore, the lottery cannot be considered a tax. However this claim fails to distinguish between the voluntary purchase of a lottery ticket and the mandatory payment of a portion of the ticket cost to the state. Consumers all across the state voluntarily purchase goods such as cigarettes, clothing, electronics and many others, but they are required by the state to pay a tax on each of these goods. The same is true of lottery tickets. No one is forced to play, but once the ticket is purchased, a mandatory 35 percent of the price is collected by the state in the form of an embedded tax. As the North Carolina Budget and Tax Center puts it, “an involuntary tax on a voluntary purchase is still a tax.”<sup>25</sup>



The only difference between the purchase of consumer goods and a lottery ticket is that the tax is included in the price of the lottery ticket instead of added on to the purchase price. And this hidden tax is easily accomplished because the state has a monopoly on the lottery. Unlike other industries that produce and market their merchandise before adding the tax at the point of sale, North Carolina exclusively produces the product (in this case a lottery ticket), sells the product to consumers through approved retailers, advertises the product, and is the sole beneficiary of revenues raised.

### **Tax versus Fee**

Some lottery supporters reject the lottery tax claim by saying that the net revenue constitutes a fee, not a tax. However, there is a difference between the two. The U.S. Census Bureau defines a fee as: “Amounts received from the public for performance of specific services which benefit the person charged and from sale of commodities or services other than utilities and liquor stores.”<sup>26</sup> Examples of fees include such things as postage sold by the United States Postal Service, payment for ferries, bridges, toll roads, public campgrounds and public parking, and even tuition at public universities.<sup>27</sup>

The fundamental difference between fees and taxes is the intent behind them and their use. Fees are collected and used for purposes closely related to the activity or regulation for which they are charged. This includes the cost of administrative and operational functions of the regulatory body or public agency. Taxes, on the other hand, are collected by a governmental entity and used to fund public programs that benefit the broader community, not just the activity for which they are imposed.

The North Carolina Supreme Court reinforced this distinction when it ruled that a toll paid on a toll road is not a tax, but a fee.<sup>28</sup> 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.<sup>29</sup> 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.

Conversely, the state lottery takes 35 percent of the gross revenue and directs it to education programs that are totally

unrelated to the operation of the lottery. Unlike someone who pays a fee and benefits from the related service, someone who purchases a lottery ticket may never directly benefit from the services it funds. Likewise, someone who never buys a lottery ticket may benefit from all of the services it funds. The only portion of lottery proceeds that may be considered a fee is the 15 percent of the gross revenues that pay for administrative costs to operate the lottery.

### **A Bad Tax**

Not only is the lottery a tax, it is not a very good one. To overcome public aversion to state-sponsored gambling as a revenue-raising method, states have linked funds from the lottery to some public good. Education is the most common beneficiary,<sup>30</sup> though some states have linked revenues to other popular programs such as helping wildlife<sup>31</sup> or benefiting senior

## **The tax rate on North Carolina’s lottery is almost 54 percent, making it among the highest of any lottery in the country.**

citizens.<sup>32</sup> Doing so shifts the debate away from the merits of gambling and places the focus on the presumed financial benefits that the lottery will provide (though the lottery’s financial contribution to education is not as significant as many in the public have been led to believe).<sup>33</sup> It is worth noting that the state’s willingness to link the lottery tax to a public good and to actively market the sale of tickets to the public sets this tax apart from any other.

As a tax, the lottery is highly regressive, meaning that it affects people with lower incomes disproportionately more than people with higher incomes. Clotfelter and Cook found that lottery players with annual household incomes under \$10,000 wagered nearly three times as much as those with annual household incomes over \$50,000.<sup>34</sup> Commenting to the National Gambling Impact Study Commission about the lottery, professor Cook said, “It’s astonishingly regressive. The tax that is built into the lottery is the most regressive tax we know.”<sup>35</sup> The North Carolina Budget and Tax Center determined that the lottery would, “impact the bottom 20 percent of income-earners approximately 40 times harder (as a share of income) than the state’s top 1 percent of

income-earners.”<sup>36</sup> And a study published in the *National Tax Journal* found that minorities who play the lottery “are bearing a disproportionately large share of the tax burden. The higher tax on lottery products has adverse horizontal equity implications among racial groups, even after accounting for all other measurable characteristics.”<sup>37</sup>

The tax rate on lottery tickets is also extraordinarily high. In fact, the implicit lottery tax is one of the highest tax rates imposed on any product in the state, meaning that the government’s take is greatly increased when lottery tickets are purchased instead of other goods.<sup>38</sup> Nationwide, the average tax rate on a lottery ticket is 45 percent. This is calculated by dividing the “profit” or net revenue per ticket kept by the state (the lottery tax) by the amount of each lottery ticket paid out in prizes plus the administrative costs (the “true” price of the ticket).<sup>39</sup> Using this equation and the current distribution of funds from a lottery ticket, the tax rate on North Carolina’s lottery is almost 54 percent,<sup>40</sup> making it among the highest of any lottery in the country.<sup>41</sup> This calculation does not take into account federal and state income taxes on winnings.

Additionally, as a form of tax revenue, the lottery is highly unstable and inefficient. States have seen fluctuating revenues and significant drops in lottery income over the years.<sup>42</sup> This is particularly troubling when the tax revenue has been promised to certain education programs that are dependent on the money.

Equally troubling is the lottery’s lack of neutrality as a tax. Good tax policy should not interfere with market choices on consumer products. Instead, it should remain neutral and let the market operate on its own.<sup>43</sup> The lottery violates this principle because the state actively entices citizens to play through advertising, thus encouraging people to spend their money on one product over another and effectively pushing consumers to pay the lottery tax.

### **Conclusion**

The lottery exists for one purpose and one purpose only—as a revenue-raising method for the state to generate funds for public purposes. It fits well within the definition of a tax, whether or not it is actually called a tax. Consumers who purchase a lottery ticket, despite doing so voluntarily, are required to give a portion of the cost to the government. The only difference between the tax on a consumer good and the lottery is that the state government has

a monopoly on the sale of lottery tickets and includes the tax in the total cost.

Lottery supporters have not traditionally referred to lottery “profits” as a tax. Doing so would most certainly undermine attempts to sell the games as a harmless alternative to raising taxes. But avoiding this term does not change reality. Consumers need to be aware that lottery purchases are taxed and that the lottery is nothing more than a highly regressive form of taxation. This gives players a clearer picture of the nature of the lottery and affords them a more informed decision when determining whether to spend their hard-earned dollars on the games. Lawmakers must not only consider lottery “profits” as tax revenue, but must also treat them as responsibly as they should any other taxes.

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## Endnotes

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13. N.C.G.S. §18C-164.
14. N.C.G.S. §18C-162(1).
15. N.C.G.S. §18C-162(3) and (4).
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