Memorandum
To: New Jersey State Governor Chris Christie, State Legislatures and Interested Parties
CC: Professor J. Yinger
From: Miss Alicia Swartz
Subject: Privatization of New Jersey's State Lottery
Date: Wednesday, March 27, 2013

I do not recommend privatizing the sales and marketing of the State of New Jersey Lottery. There is not sufficient evidence that privately managed lotteries are in the best interest of the state (i.e., promoting cost savings for the state of New Jersey thereby increasing state revenue without the use of dishonest advertising and exploiting the states vulnerable population). The State of New Jersey's legislators have already taken action to prevent Governor Chris Christie from entering a contract with a private firm, but since the Governor has the final word regarding the approval of the bill, the legislative action may be ineffective. In this economic downturn, the contract could come at a great cost to both the state (if the contractor is unable increase profits) and to the state's most vulnerable population (if targeted by the contractor while attempting to raise revenue). This would result in the state canceling the contract and reestablishing a state-run lottery.

I. Defining the Policy Problem

The purpose of this Policy Analysis is to determine if privatizing the management of New Jersey's State Lottery is in the best interest of the State: the question is whether it will promote cost savings—thereby increasing state revenue—without the use of dishonest advertising and exploiting the state's vulnerable population.

II. Background

The New Jersey Lottery is the state's fourth leading revenue grosser. In 2012, the New Jersey State Lottery received over $2.7 billion in revenue sales at the expense of consumers. Of that figure, 34.43% of sales (approximately $930 million) were dedicated to programs that benefited millions of New Jersey residents. The New Jersey State Lottery benefits many education and institutions, such as state community colleges, universities, the Department of Human Services, the Department of Military and Veterans Affairs, the state's School Nutrition Program, and the School for the Deaf. Additionally, the State Lottery supports local and small businesses by providing retailers with a five percent commission per lotto ticket sale. The state's 6,500 lottery retailers earned $153 million in 2012 (5.57% of New Jersey State Lottery earnings). The remaining amount of sales earnings went toward prizes at 58.63%, contractor fees at 1.34%, and administrative expenses at 1.33%. (State of New Jersey, Department of Treasury, Division of State Lottery, 2012)

The 2010 New Jersey Privatization Task Force Report to Governor Christie mentioned the privatization of the State Lottery. The task force concluded that privatizing the management of the state-run lottery would bring "lower costs, improvements in the quality of public services, and access to private-sector capital and professional expertise." (The New Jersey Privatization Task Force, 2010) Governor Christie contracted Macquarie Capital to study whether the State Lottery should be privatized. Macquarie Capital recommended privatization of the state's lottery, predicting a cost savings to the state and an increase in revenue for lottery sales. (Macquarie

Capital, 2012) The report has not been made public. On August 10, 2012, the New Jersey Department of Treasury, under the direction of Governor Chris Christie, requested for lottery companies to submit bids to privately manage the State Lottery. When the bid closed in December 2012, the state received one bid proposal, from Northstar Lottery Group, a partnership between GTECH and Scientific Games. The Department of Treasury is responsible for assessing the bid; however, under New Jersey state law, the governor has the power to sign a contractual agreement with a private party without the state legislature's approval. On January 29, 2013, the New Jersey State Assembly passed a measure that requires the state's governor to obtain approval from the state's legislature to privatize the state's lottery. (Hutchins, 2013) On March 18, 2013, the New Jersey State Senate passed an identical bill; however, to become law, the bill requires the governor's approval, which is unlikely to occur. An override of a veto is not possible in the State of New Jersey, therefore if the Governor does not approve a bill, it does not become law. On April 12, 2013, the New Jersey's Treasury Department announced plans to award a sales and marketing contract for the state lottery to Northstar. There is a waiting period—to allow the public to protest—before the contract will be formally executed and become a public document. (State of New Jersey Department of the Treasury, 2013) According to state treasurer, the contract was factored into the state's fiscal year 2013 budget several months ago. (Linhorst, Northstar New Jersey will be awarded 15-year state lottery contract, 2013)

III. Policy Analysis

Financially-pressed states faced with shrinking resources are starting to turn to private companies to manage their state-run lotteries (e.g., Illinois and Indiana). This trend has initiated the debate on whether the privatization of State Lotteries is in the best interest of the state (i.e., by increasing state revenue without exploiting the state's vulnerable population).

Under New Jersey's proposal to privatize the state lottery, the state would continue to own the lottery and a private contractor—in this case, Northstar—would manage the sales and marketing of the lottery for a portion of the revenue earned. Other tasks will remain with the state, including licensing, auditing, payment of prizes, and security. A state lottery commission will oversee the contract. (Katz, Christie privatizes big chunk of New Jersey Lottery, 2013) The 15-year contract requires the contractor to meet certain revenue targets; the contractor would pay a penalty if revenue goals were missed, and could keep up to five percent of the revenue if it generated a surplus. Additionally, the contractor is required to pay the state $120 million upfront. If the contractor does not increase revenue, the state has the right to cancel the contract. The contract is predicted to begin in April 2013 and will last until 2029. New Jersey predicts that the prospective contractor could earn more than $1 billion over the total life of the contract. (Linhorst, N.J.'s lottery adviser worked for firms bidding to take games over, 2013)

Arguments in Favor of Privatization of New Jersey State's Lottery:

The general consensus is that the benefits (e.g., funding for state programs) outweigh the costs (e.g., gambling, addiction, and increased crime). Thirty percent of the New Jersey State Lottery is earmarked to fund state education programs and institutions. Therefore, an increase in revenue would generate an increase in funding to the state's earmarks, but could lead to cuts in other revenue sources (e.g., income tax, property tax, sales tax, etc.). The state predicts that privatization of the states lottery would bring in $1 billion in revenue over the 15-year contact, and expenses would drop to $13 million per year. The current yearly cost to run the State Lottery is $37 million. (The Associated Press, 2012) By contracting out the state's monopoly on its lottery, an increase in competition could lead to the lottery process being more efficient. Additionally privatization could offer greater resources and expertise that could lead to quicker response to “customer preferences and apply new technology and more individualized support to help lottery retailers boost their profitability and efficiency.” (Katz, Christie privatizes big chunk of New Jersey Lottery, 2013)

Privatization could work well since performance objectives can be clearly specified in the contract, (such as requirements to meet certain revenue targets), the contractor’s performance can be monitored (such as audits of revenue earned), and financial rewards and/or penalties can be written into the contract (for example, the contractor would pay a penalty if revenue goals were missed, and could keep up to five percent of revenue if a surplus is generated). Issues concerning gambling addiction (i.e., expansion maximizes the social costs of lottery addiction) and marketing to vulnerable groups could prove to be difficult to monitor, but objectives must be specified in the contract (e.g., limit vendor expansion in low income areas and maintain the states Responsible Play Initiatives: provide information encouraging responsible play on all state lottery tickets, the lottery website and advertising materials and provide information regarding an individuals chance of winning the lottery, which the state currently does not provide on all tickets sold). (New Jersey Lottery, 2013) Finally, private firms must answer to the disciple of the contract; in this case if the contractor does not return a profit for the state within two years, the state has the right to cancel the contract.

Arguments Against the Privatization of New Jersey State’s Lottery:

The market for privatization of state lotteries is not competitive. The state only received one bid and currently only two other states have private lotteries. Bidding is possible and open to anyone in the market, but the risk is great for private firms. This decreases the number of firms willing to take on such risk, thereby decreasing bids. While New Jersey has defined performance objectives for Northstar, those objectives are currently being negotiated and the contract could change dramatically from what the state initially advertised when announcing the bid. Currently there is no evidence that privatization of state lotteries leads to an increase in revenue or cost savings. In January 2011, Illinois entered into a contract privatizing the State Lottery with Northstar, but the state did not see an increase in revenue in fiscal year 2012. Northstar’s net income target for fiscal year 12 was $851.2 million. An Illinois State Audit found that the lottery only generated $757 million in net income, which means the contractor fell $94 million short of meeting its contract target—and is now liable to pay the State of Illinois $20 million. Northstar generate $89 million more in net income in 2012 than the state administered lottery did in the pervious year. Illinois’ State Lottery’s net income has been increasing since 2009, by 2.3% a year, with projected income earnings at $683 million in 2012. The privately-run lottery did increase net income in 2012 in comparison to the state projected increase, but it is too soon to tell how sales were increased, and whether it was at the expense of vulnerable groups. (Illinois State Lottery, 2013) While it has only been one year, the state’s only comparable example of another state contracting out its lottery failed to increase revenue to meet the contracted agreement. It is also worth noting that New Jersey would be contracting with the same company as Illinois. (Leonard Gilroy et. al, 2011)

The greatest risk New Jersey takes on by contracting out its State Lottery is the increased risk that the contractor would target vulnerable groups, such as the state’s low-income population and “lottery addicts.” Companies make money by increasing customer base. Lottery taxes are very regressive (that is, the tax takes a larger percentage from low-income people than from high-income people, therefore lower-income individuals are hit harder). (Investopedia, 2013) “The poor and the middle class pay a far higher percentage of their annual income for gambling than do wealthy individuals (i.e., lotteries profit at the expense of the poor).” (Brunori, 2011) A 1999 Duke University study, titled State Lotteries at the Turn of the Century, found that communities of color, and those who were poorer or less-educated, spent the most on the lottery. The average player spends $313 per year on the lottery. African Americans spent on average $998 on lottery tickets compared to $210 for whites. Households with incomes less than $25,000 spent an average of $600 a year on lottery tickets, while those from household earning more than $100,000 spent about $289 year. College dropouts spent $700 a year on lottery tickets, while graduates spent $178. (Charles T. Clotfelter, et.al., 1999) A 2004 study, titled Hitting the Jackpot or Hitting the Skids: Entertainment, Poverty, and the Demand for State Lotteries, by Garrick Blalock, et.al., attempts to explain why lotteries are extremely popular among the poor and why they spend a disproportionate amount of their income on the lottery. The study found that low-income consumers play the lottery at greater rates because of an “ill-conceived belief that participation will improve their financial well being.” Additionally, “lottery participation is the greatest among those in poverty who seemingly have the greatest chance of escaping poverty.” (Garrick Blalock, et. al., 2004) According to a 2008 study, Subjective Relative Income Lottery Ticket Purchases, by Emily Haisley, et. al., low-income consumers are disproportionately driven to purchase lottery tickets due to their economic status for two reasons. First, “lotteries are more alluring for poor people because they provide an opportunity to correct for low-income status. Second, lotteries are one of the few opportunities available to poor for a sudden increase in wealth.” (Emily Haisley, et.al., 2008) Therefore, the easiest way for a contractor to raise revenue is to target the vulnerable population by establishing aggressive advertising and misleading the public about their odds of winning. Aware of this disparity, the State of Illinois wrote performance objectives in its contract with Northstar limiting the expansion of lottery sales in stores located in low-income areas. Results from 2012 showed a decrease of retailers offering lottery tickets in Illinois’ poor neighborhoods; this does not, however, indicate that the purchase of lottery tickets by the poor is down. (Indianapolis AP, 2013)

Privatization of the lottery will not increase jobs—rather, it displaces them. Even though the majority of the state’s lottery jobs are contracted out, the state employs 135 public employees to coordinate administrative office functions such as management, marketing, and sales. If the lottery was privatized, these employees would lose their jobs, be transferred within the state government (unlikely), or may be hired by the private company (highly unlikely). (Katz, New Jersey joins a list of states considering privatizing their lotteries, 2012) Additionally, a study by the Asian American Retailers Association argues that the privatization of the state lottery would impact small businesses and eliminate jobs in the state, reasoning that the contractor could expand to chain stores and the Internet in order to increase sales. The association claims that a total of 7,000 jobs could be lost. (Celock, 2013) The net losses for the state could include loss of tax revenue generated from small businesses, increased unemployment burden, and increased costs associated with laying off state employees (e.g., severance packages).

There have been increasing concerns over conflict of interest. Macquarie, who recommend for the state of New Jersey to privatize their lottery, previously worked with GTECH and Scientific Games, which make up the joint venture Northstar. GTECH is known for wielding its political influences. For example, the company has made a total of $4.1 million in campaign donations since 1991. (Katz, New Jersey joins a list of states considering privatizing their lotteries, 2012) Additionally, GTECH has “doubled its lobbying expenditures in the state over the last two years, retaining a law firm founded by David Samson, the chief of Governor Christie's transition team, and a public affairs firm headed in the state by Christie's top campaign strategist, Mike DuHaime." (Linhorst, N.J.'s lottery adviser worked for firms bidding to take games over, 2013) In 2001, Scientific Games donated $37,000 to the New Jersey Democratic State Committee. Scientific Games' contract to manage the state's instant games started nine days later. (Katz, New Jersey joins a list of states considering privatizing their lotteries, 2012) It appears that GTECH and Scientific Games have been using campaign donations and lobbying to influence the State of New Jersey decision to privatize the state-run lottery, and to award the contract to Northstar.

IV. Conclusions and Recommendations

Richard McGowan, a Boston College finance professor and expert on state-run lotteries, stated that "even though a company's goal is to make money, given the social cost, lotteries is not an industry where you want to maximize profits." (Katz, New Jersey joins a list of states considering privatizing their lotteries, 2012) Privatizing the New Jersey State Lottery is not in the best interest of the state. There is no evidence that privatization promote cost savings, and no evidence it would increase state revenue. Additionally, there is not sufficient evidence that performance objectives can be written into a contract to prevent a contractor from dishonestly advertising or otherwise exploiting and taking advantage of the state's vulnerable population. Based on this policy analysis, I do not recommend for the State of New Jersey to privatize the sales and marketing of its state-run lottery.

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