Date: May 7, 2012
To: The Maryland General Assembly
From: Heather Ruby and Jordan Butler
Subject: Buying Lottery Tickets Online – A Bet Maryland Should Not Wager

I. Introduction

On March 25, 2012, Illinois became the first state to sell lottery tickets online. USA Today predicts: “It won’t be the last.” Will Maryland be the next, and more importantly, should it be the next? The Maryland State Lottery Agency (SLA) issued a report on December 15, 2011, stating that Maryland should expand its lottery sales to the Internet and mobile phone devices to achieve the SLA’s core mission of raising revenue. In April 2012 the Maryland General budget committees allocated $500,000 for the SLA to create the platform and the associated regulatory structure for selling tickets online tentatively to begin on January 1, 2013.

While expanding the lottery market will generate millions of dollars in revenue and broaden the market for lottery sales by targeting younger generations, it raises ethical questions of whether the state should market to specific generations, encourage addictive behavior, and undermine work ethics. Selling lottery tickets online also makes the lottery more easily and readily available to underage gamblers. We believe that the ethical considerations outweigh any potential financial gain of implementing an online lottery sales platform. Consequently, we recommend that Maryland should not expand its lottery sales to the Internet and mobile phone devices. If Maryland ultimately decides to adopt the SLA’s proposal, we provide recommendations to ameliorate the problems that a lottery expansion will bring.

II. Background

The Department of Justice released a memorandum in December 2011 stating, “Interstate transmissions of wire communications that do not relate to a ‘sporting event of contest’ fall outside the reach of the Wire Act” per the request of New York and Illinois for the Department

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of Justices’ opinion on the ability to sell lottery tickets to residents online. Three months later, Illinois became the first state to sell lottery tickets online on March 25, 2012. Currently, at least 21 states and the District of Columbia are considering online lotteries. I. Nelson Rose, a Whittier Law School professor, predicts “In less than 10 years, we’re going to see most of the states moving to Internet gambling.”

III. Economics and Taxes

A. Revenue

Lottery sales have generated a lot of money for Maryland. Among the states, Maryland ranked eighth for lottery revenue as a percentage of own-source revenue in fiscal year 2004 at 2.09 percent. Since its inception in 1973, Maryland lottery sales have topped $34.4 billion and raise over $12 billion in revenue. For fiscal year 2011, the Maryland Lottery ranked sixth in per capita sales out of the 43 states and District of Columbia that offer lotteries. Maryland’s per capita lottery sales have increased $56 from 2002 to 2011, and for the fourteenth year in a row, lottery sales revenue, as Table 1 and Table 2 in the Appendix illustrate.

However, in the last two years the rate of growth in lottery sales has stagnated to approximately 0.5 percent growth. Expanding the lottery market to electronic commerce (e-commerce) and mobile commerce (m-commerce) would increase the growth rate. Online and mobile lottery sales are projected to increase total sales by 12 percent to 18 percent as Internet selling initiatives reach maturity. This may be especially appealing to Maryland as it struggles to recover from the recent recession. Studies have shown a positive correlation between short-
term state debt and lottery adoption.\textsuperscript{10} Thus, it is not surprising that Maryland now considers whether to expand its lottery market to recoup revenue losses from the past recession.

Maryland projects to earn $2.2 million in revenue from online lottery sales, but we question whether this forecast is too optimistic due to Illinois’s less than stellar performance. Illinois projected having a million online customers, but they only had 80,000 customers register online and ticket sales have been less than $20,000 a day, which Illinois blames on a soft launch of not advertising online sales and the complexity of the registration process.\textsuperscript{11}

\textbf{B. Taxes}

Many people do not associate the lottery with tax policy, but the lottery has an implicit tax rate. The implicit tax rate is calculated by dividing state revenue (r) by the sum of the prizes awarded (p) and administrative costs (c): $t = \frac{r}{p + c}$. For 2011, with sales of $1,714,402,578, state revenue of $519,393,853, prizes awarded of $1,029,040,616, and administrative costs of $88,840,469, the implicit tax rate is 46.46 percent.\textsuperscript{12}

In regards to tax policy, lotteries fare poorly in terms of transparency and who bears the burden of the tax. With lottery sales, most taxpayers do not realize what is being taxed and at what tax rates. If the SLA needs to raise more tax revenue, they can introduce new games and products, increase the percentage of sales that goes to the state, or increase the ticket price. This flexibility gives state lottery agents the freedom to frequently change the implicit tax rate, thus decreasing tax transparency even more.

Lotteries are regressive, which means that low-income individuals spend a greater percentage of their income on lotteries than high-income individuals. A 1997 study found that households with incomes under $10,000 spend about three times as much as households with incomes over $50,000.\textsuperscript{13} Expanding lottery sales to the Internet and mobile phone devices would increase progressivity because it would target upper and middle-income households who tend to

use the Internet more often. However, there is a chance that expanding lottery sales online might increase lottery sales for low-income households even more than currently.

High-jackpot games may reduce the regressive nature of the lottery because high-income individuals tend to be better educated and therefore are likely to better understand the expected value of the lottery, so they only play when the expected value is high. Also, individuals may play the lottery for entertainment, which depends on how large the prize is relative to their wealth, so high income individuals have a higher threshold for entry.\(^\text{14}\) Oster found from out-of-sample extrapolation that as the jackpot increases, the lottery tax becomes less regressive as more middle- and high-income individuals play, and when the jackpot reaches approximately $806 million, the lottery becomes progressive.\(^\text{15}\) Expanding the lottery market to e-commerce and m-commerce is projected to increase lottery sales, which would increase the likelihood of high jackpots and make the lottery more progressive.

Although the majority of lottery revenue goes to Maryland’s general fund, some of the revenue is earmarked for the Maryland Stadium Authority. In 2011, $20 million was earmarked to the State of Maryland Stadium Authority. Siegfried and Zimbalist note, “The median income of all sports event ticket purchasers in 1994 was 84 percent above the overall median income level.”\(^\text{16}\) Although low-income individuals bear the most burden of the lottery tax, they do not receive as great of a benefit as high-income individuals when the lottery revenue is earmarked for sporting stadiums. While this does not change the regressivity of the lottery tax, it increases the regressivity of Maryland’s spending policies.

C. Brick-and mortar retailers

Brick-and-mortar retailers depend on revenue from lottery ticket sales. Maryland retailers earn 5 percent commissions on sales and an additional 3 percent commission for winnings cashed through lottery terminals.\(^\text{17}\) Maryland retailers earned $113.6 million from


lottery commissions in fiscal year 2011.\footnote{Maryland lottery - retailer corner. (n.d.). Retrieved from http://mdlottery.com/retailer-corner/} Retailers also depend on other purchases that lottery customers tend to make in their stores: Lottery customers spend $10.35 in purchases on average at convenience stores while non-lottery customers only spend $6.29.\footnote{Online lottery push faces strong opposition . (2012, April 27). NACS Online. Retrieved from http://www.nacsonline.com/NACS/News/Daily/Pages/ND0427121.aspx} Many retailers fear that competition from online lottery sales will reduce not only their commissions but also their non-Lottery products from fewer customers.

The SLA argues that online lottery sales will not harm retailers because Maryland is targeting new consumers who currently do not purchase lottery tickets. The SLA found that 85 percent of lottery customers are happy with the way that they purchase tickets and are unlikely to switch to online purchases.\footnote{Poinski, M. (2012, February 1). Online lottery ticket sales expected to start next year, boost sales”. The Maryland Reporter. Retrieved from http://marylandreporter.com/2012/02/01/online-lottery-ticket-sales-expected-to-start-next-year-boost-sales/} While there is no credible research that supports or denies the SLA’s claims, there will be no deadweight loss associated with expanding lottery sales to the Internet. A substitution effect may occur, that consumers may indeed switch from retailers to the Internet for purchasing lottery tickets, but consumer spending would simply be spent elsewhere.

IV. Social Policy

Despite the traditional policy and ethical concerns that a state lottery poses, the Maryland General Assembly is clearly comfortable with a state lottery in its current form. Since Maryland first began administering a statewide lottery nearly 40 years ago, the Maryland General Assembly has never seriously considered removing the lottery as a revenue stream for the state.

The SLA correctly argues that the rise of e-commerce and m-commerce in today’s economy would bode well for state lottery sales. Private firms, such as Starbucks, Verizon Wireless, and Southwest Airlines, already harness these new forms of commerce to expand consumer bases and increase sales. Making lottery tickets available for purchase on computers and mobile devices would expand the reach of Maryland’s lottery to younger consumers, a group who historically plays the lottery less often than older consumers.\footnote{Maryland State Lottery Agency, (2011). Report on plans for online sales of traditional lottery games. Retrieved from website: http://dlslibrary.state.md.us/publications/JCR/2011/2011_25.pdf}

Expanding Maryland’s lottery to the Internet and mobile phone devices, however, will exacerbate the problems already associated with the State’s current lottery structure.
A. Undermined work ethic

Greater accessibility to lottery tickets and a subsequent increase in lottery sales will further undermine a work ethic from which all of society benefits. In Maryland, the lottery is advertised as an easy and feasible vehicle to wealth, when in reality, the chances of winning a significant payout are nearly zero. These advertisements inculcate the message into Maryland residents that purchasing lottery tickets, not hard work, will lead to success.

“One can only speculate about the long term impact that such a message will have on the young,” Stearns and Borna writes. They continue, citing commentator Andy Rooney: “How can Americans who profess to believe in such classic virtues as honesty, thrift, hard work, and intelligent action allow any part of the government they formed to run a gambling operation?”

B. Underage gambling

Along these lines, a second problem is that online lottery sales will increase the prevalence of underage gambling in Maryland. Underage gambling is already a problem in the United States. Studies show that 80 percent of adolescents in North America have gambled at least once in their lifetimes and “that between 4 percent and 8 percent of adolescents between 12 and 17 have a very serious gambling problem, while another 10 percent to 15 percent are at-risk for developing a gambling problem.” Many academics surmise that the Internet’s accessibility and ability to be anonymous, along with the “visually enticing aspects of Internet gambling,” will appeal to adolescents more than traditional forms of gambling and compound current trends of underage gambling. Indeed, the prior reluctance of state legislatures to adopt online lottery sales is in part because of underage gambling concerns. While the SLA reports that it would enforce “responsible gambling” by implementing mechanisms to block adolescents from purchasing lottery tickets online, in the last decade industry experts and scholars have expressed


skepticism, including Alan Feldman of MGM Resorts International and casino tycoon Sheldon Adelson.25 26

C. Risk of increased gambling addiction

A third problem is that the Internet and mobile phones will allow individuals with gambling problems to purchase lottery tickets faster, easier, and at a moment’s notice. Recent research that explores the demographics and behavior of online gamblers, particularly poker players, suggest that the “frequency of play, spending, and gambling time are significantly greater among online gamblers” compared with offline gamblers.27 28 Additionally, the SLA reports that advertising directed at online gamblers in Maryland would be more targeted, sophisticated, and interconnected. An ethical issue is raised whether the SLA’s proposed advertising is appropriate for a subset of players who are especially susceptible to gambling problems. From the SLA’s report:

An ecommerce platform would, for the first time, give the SLA a full understanding of our players’ consumer behaviors through a robust player database…With this information, the SLA would be able to make stronger business decisions through targeted, relevant marketing and sales efforts that are incorporated into our overall business plan with the underlying goal of attracting non-players, bringing back latent players, and turning everyday players into strong brand ambassadors.29

An additional ethical issue is raised whether the SLA’s proposed advertising is too aggressive in marketing a product that does not serve the best interests of Maryland citizens.

D. Privacy and security

A fourth concern relates to whether it is appropriate for a state entity to gather players’ personal information and gambling activities. Legal questions arise whether the SLA’s aforementioned “robust player database” would overstep individuals’ constitutional expectations of privacy. For instance, would the Freedom of Information Act mandate that the State provide players’ information upon request? Similarly, while the SLA has not provided details regarding a registration system for selling lottery tickets online, the State of Illinois allows players to enter credit card information to purchase tickets, and it also requires players to provide their Social Security numbers in an effort to reduce underage gambling.\textsuperscript{30} If the SLA follows this practice, online security will become an issue, namely that hackers could gain access to the SLA’s online platform and compromise the sensitive data of hundreds of thousands of players.

V. Recommendations

Maryland should not sell lottery tickets online. While the main motivation for selling lottery tickets online is to increase lottery revenue, it is uncertain how much revenue will actually be generated given Illinois’s dismal start. The lottery is not a good tax policy because it lacks transparency to consumers. Selling lottery tickets online would also likely worsen the problems already associated with the lottery, such as an undermined work ethic, underage gambling, and gambling addiction. The SLA’s intent to gather information on its players could set a dangerous precedent for consumer privacy.

If the State of Maryland ultimately decides to follow in Illinois’ footsteps, the State must adopt practices to ameliorate the economic, taxation, and social problems that will follow. First, the State should be cautious about relying too heavily on a lottery for revenue because of the lottery’s regressivity and lack of transparency. Second, the State should implement mechanisms that limit the number of online lottery tickets an individual can purchase per week and that restrict minors from participating in the lottery, perhaps by forcing new registrants to provide identification at brick-and-mortar retailers. Finally, the State should protect consumer privacy and reduce the likelihood of online gambling addiction by limiting its information gathering and its promotion of e-coupons, promotional codes, and player loyalty programs.

Appendix

Table 1.

Table 2.