

A Tale of Two Lotteries: California and Massachusetts

California has been in the lottery business since 1984 when 58 percent of the state's electorate approved Proposition 37, The California State Lottery Act (the Act). The primary purpose of the California State Lottery is to provide additional, supplemental revenue for public education. In fact, the Act specifically states that the lottery shall be run in a manner that makes the most money for education.¹ In other words, the mandate of the voters is for the lottery to operate at maximum profitability. However, that mandate has yet to be fully realized, even after two decades of operation. The general consensus among national lottery experts is that California operates an under-producing lottery which currently grosses approximately \$3 billion in annual revenues, when it should be earning at least twice that much (or \$6 billion annually).

Why isn't the California lottery performing at the optimum level? To answer this question it is essential to understand what differentiates California's lottery from the more successful lotteries in the country. One of the most successful is the Massachusetts state lottery. It was established in 1971 by the legislature and is one of the oldest lotteries in the country, as well as one of the most profitable per capita. With a population of 6.4 million people, the Massachusetts lottery currently raises over \$652 in per capita sales, while California, with a population of 35 million people, produces only \$82 in per capita sales.² However, the Massachusetts lottery was not always as successful as it is today. It went through its share of growing pains on its path toward becoming a booming enterprise. It is worth examining the ways in which the Massachusetts lottery was able to transform itself from a sluggish business in its early years into the revenue driving machine it is today. Several of the ingredients of its success can be applied to the California State Lottery. Consider the following:

Lottery Commission Authority

The Massachusetts State Lottery Commission has almost unmitigated authority to do whatever it deems necessary to run the lottery as a profitable business. The Massachusetts lottery commission was given almost *carte blanche* authority by its state legislature and has subsequently functioned independent of the legislature when determining such operational details as game themes, the variety and quantity of games available to consumers at any given time, or prize payout percentages. The Massachusetts lottery commission was given its independent decision making authority because, for the most part, the concept of running and promoting a successful state lottery has been consistently and enthusiastically supported by both lawmakers and governors alike.³

¹ The California State Lottery is the only for-profit business run by the state. It is totally self-sustaining and does not rely on the state's General Fund (i.e., tax) dollars for any of its functions. All its revenues are derived from the sale of lottery tickets.

² The comparison in "Total Revenues" and "Revenue to the State" is staggering. With a population of only 6.4 million people (compared to California's population of 35 million people), Massachusetts out-produced California in 2002 in Total Revenues by approximately \$1.3 billion and came very close to matching California in net Revenue to the State (i.e., \$900 million for Massachusetts to California's \$1 billion).

³ One other point that should be made is that when Massachusetts began its lottery 32 years ago, it did not have to contend with the same anti-gaming sentiments that we have faced here in California. In fact, it is a

And, there appears to be an attitude among Massachusetts government leaders that the daily business of the lottery is no business of the legislature.⁴ In contrast, because California's state lottery was established through the initiative process, the state legislature has never taken any real ownership of the concept. Likewise, the state's last three governors have all shown less than enthusiastic support for, or even interest in, the lottery's growth and success. Essentially, the state lottery has been treated as an ugly stepchild of state government by California's lawmakers and chief executives since its inception.

Like Massachusetts, California's state lottery is also governed by a five member commission. However, the similarity stops there. Unlike Massachusetts, California has been hobbled with a series of restrictions that can only be changed through legislation or the enactment of a subsequent initiative. Where, for example, the Massachusetts lottery commission can change the payout percentages on the prizes of individual games, California's prize payout percentages are fixed in the Act and can only be changed through legislation. Similarly, there are game theme restrictions in the California Penal Code that have been in the books long before the passage of Proposition 37, but effectively prevent the state lottery commission from having a free hand in establishing the kind of games (i.e., lottery ticket themes) that can be presented to the playing public.⁵ In order to change the Act, or any law affecting the Act, the Act itself specially states that such changes require a two-thirds vote of the legislature and can only be made if they are "in the furtherance of the Act." In other words, any changes must promote the mission of the lottery, which is to maximize the amount of money provided to public education. Frankly, the most productive solution, though not the most politically realistic, would be for the legislature to grant the same level of authority and freedom to the California lottery commission as was granted to the Massachusetts lottery commission since its inception.

Increased Prize Payout

The most successful state lotteries in the country have one major thing in common, a prize payout of at least 60 percent. There are 39 state lotteries, 36 of which pay 60 percent or more of ticket sales to prizes. Two of the poorest performing state lotteries, California and Louisiana, have a limited prize payout of only 50 percent of ticket sales to prizes.⁶ It is a proven principle in state run lotteries that the larger the pot,

generally agreed upon principle that state run lotteries have succeeded as well as they have in the Northeastern part of the country because of a preexisting attitude easterners have traditionally held in favor of gaming and the gaming culture. A perfect example of this is the old "numbers games" played on street corners and in taverns throughout the Northeast for decades.

⁴ In fairness to California, it must be noted that three of the five members of the Massachusetts lottery commission are state office holders – i.e., the State Treasurer (who serves as Chairperson), the Secretary of Public Safety, and the State Comptroller. The two remaining members of the commission are appointees of the governor.

⁵ Since all of its sales are derived from the sale of lottery tickets, the state lottery has to constantly come up with new products (i.e., games) in order to increase the amount of revenue it raises in the marketplace.

⁶ Please note that the prize payout percentage reported for "Instant Revenues" under Tab 4A of this compilation is 60%. This percentage was the result of an experiment by the California state lottery in which administrative funds were diverted to the prize pool in order to increase the prize pool payout

the more tickets will be sold. Massachusetts is a prime illustration of such a principle. Not only is their payout greater than 50 percent of the available pot, but they employ a tiered structure of payout in which the prize available to the ticket purchaser is directly proportional to the amount he or she bets. For example, Massachusetts has offered instant games in which \$1 games have a payout of 60 percent of the pot, while the \$5 games pay 70 percent, and the \$10 games pay 79 percent. According to industry experts, the primary incentive for people to make the big bets is the chance of winning from a larger prize pool. California has nothing like this. The California state lottery conservatively estimates that by increasing the percentage payout for prizes from 50 to 60 percent of total sales, the state lottery will increase the annual revenues for education from between \$175 to \$250 million.

Instant Ticket Games

Massachusetts is the most successful state lottery in the category of Instant Ticket Games. When Instant Ticket Games were first introduced in Massachusetts, they were not particularly profitable, averaging \$30 million per year. However, Instant Ticket Games currently average \$60 million per *week* in sales. According to a Massachusetts Lottery expert with whom we spoke, the primary reason for such a dramatic increase in sales is the nature and number of games presented to consumers. Maximum profitability is a result of game themes that gamblers understand, primarily those related to *casino* or *sports* themes. The other factor is the variety of games available to the consumer. Massachusetts has an average of 35 games in circulation at any given time. (Please refer to Tab 6 of this compilation for an exhaustive review of Massachusetts's instant game themes, practices, and so forth.) The most substantial variables in the successful sale of Instant Ticket Games are the types of game themes and the variety of games available at one time. As stated above, California (unlike Massachusetts) is restricted in the type of themes its can employ because of general gaming restrictions set forth in its Penal Code.⁷ Consequently, it makes sense to exempt the state lottery from all such game restrictions, which would then allow the lottery commission to develop and employ whatever *ticket* game themes are most successful in the gaming marketplace, as well as which varieties work most productively in tandem. The lottery is a for-profit business, and when the state unnecessarily limits the kind of themes and the variety of games it can offer, it hinders the lottery's ability to operate effectively, and thus impedes its profitability.

Fixed Prize Payout

There is a maxim in the lottery industry that a fixed prize payout invariably results in more gaming activity, because people who buy lottery tickets like to know how much they can win. Fixed prize payout games, unlike pari-mutuel games, operate as banked games in which the game operator (or "the house") guarantees a certain payout regardless

percentage, thus resulting in increased sales. It was informally known as the "Bridge Project." The 60% figure is proof that increased prize payout does, in fact, increase sales.

⁷ The California legislature has exempted the state lottery from some game theme restrictions in the past, such as "horseracing." However, why a general exemption was not granted to all such theme restrictions is unclear.

of how much money is entered into the pot. Pari-mutuel games, on the other hand, payout proportionately to how much money is bet (or put into the pot, so to say) so one never knows how much he has the potential to win. All current lottery games offered by the state are operated on a pari-mutuel basis. Fixed prize payout games, however, are preferable from a business standpoint because of the increased gambling traffic they draw. California did have a successful fixed prize payout game in the past called Keno. It was taken out of circulation due to the Western Telcon Decision, in which the court determined that a banked game was in violation of the Lottery Act. In reality, the real reason the issue was raised in the first place was because the California Indian tribes wanted to install slot machines (a banked game) on their reservation properties, but could only do so if they could show that the state lottery also offered banked, or fixed prize payout, games.⁸ Consequently, Keno became the poster child of the issue and was subsequently held to violate the Act. Regardless, Keno went by the wayside, and that was unfortunate because of its popularity and immense profitability. The irony of it all is that the Indian tribes now have slot machines, and the state no longer has Keno. After the Western Telcon Decision, Governor Davis pretty much gave away the store to the Indian tribes and negotiated subsequent gaming compacts which allowed for slots in Indian Casinos throughout the state.

Keno is a considerable money maker for Massachusetts and every other state that offers it. (It should be noted that Keno is the one game in Massachusetts that did require passage by the legislature.) When the California lottery offered Keno as a fixed prize payout game, it earned \$8 million per week. In contrast, the most recent incarnation of Keno in California, as a pari-mutuel game called Hot Spot, brings in only \$3.5 million per week. This is a clear illustration of how much more popular and profitable the same game can be when offered with a fixed prize payout. (Please refer to Tab 5 of this compilation.)

Political Realities

There appears to be a sea change in the prevailing attitude toward the lottery under the current administration. And, such a change in attitude is absolutely necessary for the California state lottery to maximize its potential and to achieve its greatest profitability.⁹ Unfortunately, as discussed above, there are still several members of both houses of the state legislature who do not like gaming, generally, and the lottery, more specifically. This, in conjunction with the two-thirds vote requirement for any legislation that would amend the Act, along with possible intermeddling by competitive interests (i.e., the Indian casinos, the horse racing industry and, to a lesser extent, the card rooms) or stakeholders, such as the CTA, makes any move toward change a substantial

⁸ Under federal law, the Indians can only offer games on their tribal properties that are allowed in the state where the property is located.

⁹ Unlike Massachusetts, all five members of the California lottery commission are appointed by the governor and serve term appointments. Likewise, the lottery director is also appointed by the governor, but serves at his pleasure. In other words, the director essentially has two bosses, the commission and the governor. Thus, the California governor does have a significant amount of influence on the daily operation of the lottery and the type of person who shall run it.

challenge. However, notwithstanding the aforementioned, meaningful legislation is definitely achievable considering the state's current fiscal crisis.