PROPOSITION

1C LOTTERY MODERNIZATION ACT.

OFFICIAL TITLE AND SUMMARY

LOTTERY MODERNIZATION ACT.

- Allows the state lottery to be modernized to improve its performance with increased payouts, improved marketing, and effective management.
- Requires the state to maintain ownership of the lottery and authorizes additional accountability measures.
- Protects funding levels for schools currently provided by lottery revenues.
- Increased lottery revenues will be used to address current budget deficit and reduce the need for additional tax increases and cuts to state programs.

Summary of Legislative Analyst's Estimate of Net State and Local Government Fiscal Impact:

- Impact on 2009–10 State Budget: Allows $5 billion of borrowing from future lottery profits to help balance the 2009–10 state budget.
- Impact on Future State Budgets: Debt-service payments on the lottery borrowing and higher payments to education would likely make it more difficult to balance future state budgets. This impact would be lessened by potentially higher lottery profits. Additional lottery borrowing would be allowed.

FINAL VOTES CAST BY THE LEGISLATURE ON AB 12 (PROPOSITION 1C)

Senate:	Ayes 30	Noes 8
Assembly:	Ayes 70	Noes 8

FINAL VOTES CAST BY THE LEGISLATURE ON SCA 12 (PROPOSITION 1C)

Senate:	Ayes 27	Noes 9
Assembly:	Ayes 63	Noes 14

ANALYSIS BY THE LEGISLATIVE ANALYST

OVERVIEW OF THE PROPOSAL

Measure Allows State to Borrow From Lottery Profits. As discussed in the "Overview of the State Budget" section, this measure is one of the major components of the plan approved by the Legislature and the Governor in February 2009 to balance the state budget. The measure makes major changes to the 1984 voter initiative that created the California Lottery. These changes could increase lottery ticket sales and allow the state to borrow $5 billion in the 2009–10 fiscal year from future lottery profits. In addition to borrowing this $5 billion, the state also could borrow more from lottery profits in future years. Under the measure, lottery profits now dedicated to schools and colleges would be used to pay back the borrowing. The measure would increase state payments to education from the state General Fund to make up for the loss of these lottery payments. (See the nearby box for definitions of terms used in this analysis.)

BACKGROUND

Existing Lottery Laws

Lottery Created by a Voter-Approved Measure. California voters approved Proposition 37 in 1984. Proposition 37 authorized creation of the lottery and dedicated lottery profits to education. It created the California State Lottery Commission (commission), which consists of five persons appointed by the Governor and confirmed by the State Senate. The commission oversees the approximately 600-person state department that administers the lottery.

Laws Governing Use of Lottery Funds. Proposition 37 directs the use of funds generated from sales of lottery tickets. It requires that 50 percent of these funds be returned to lottery players as prizes. (This means that, on average, a lottery player in California claims about 50 cents in prizes for every dollar spent on tickets.) Currently, the lottery may spend no more than 16 percent of its ticket sales on lottery operating expenses. The law dedicates lottery profits—the funds remaining after payment of prizes and lottery operating expenses—to educational institutions. These payments to educational institutions must equal at least 34 percent of the funds generated from lottery ticket sales each year.

Under Current Law, Lottery Funds Benefit Education. Currently, state officials have no ability to use lottery funds to help balance the General Fund budget. As described below, lottery profits currently benefit educational institutions and are paid directly to schools, community colleges, and universities. The state now has no ability to borrow from future lottery profits.

Current Lottery Funding for Education

Lottery Payments Are a Small Part of Education Funding. In the 2007–08 fiscal year, the lottery sold over $3 billion of tickets, paid out $1.6 billion in prizes, and spent $380 million on operating expenses. This left about $1.1 billion in lottery profits, which were distributed to public educational entities based on their number of students. This amount represents only a small part of the overall budget of California's public educational institutions. For kindergarten through twelfth grade (K–12) schools, for example, lottery funds made up just over 1 percent of all revenues in 2007–08. In recent years, lottery payments to education have grown slowly. Between 1997–98 and 2007–08, these payments grew at an average rate of 2.8 percent per year—slightly less than the rate of inflation. In addition, as shown in Figure 1, lottery payments to education have gone up and down over time, including drops in each of the last two fiscal years. By contrast, funding provided under Proposition 98—which makes up about three-fourths of K–12 education budgets—grew at an average rate of 5.6 percent per year between 1997–98 and 2007–08. Prior to the current fiscal year, Proposition 98 funding had increased every year during the last decade.

PROPOSAL

This measure modifies both the State Constitution and other state laws. It makes major changes in lottery operations and the allowed uses of lottery funds. These changes also would allow the state to borrow from future lottery profits. These changes also would affect both the funding of educational institutions and the state General Fund. Figure 2 summarizes key parts of this measure and how they compare with existing law.

Changes to Lottery Operations

More Flexibility for Lottery in Its Prize Payouts. This measure gives the lottery the flexibility to increase the percentage of lottery funds returned to players as prizes. Higher prize payouts can attract more spending for lottery tickets and increase lottery profits. Under this measure, the lottery commission could set prize payouts above 50 percent of lottery sales—at the level it determines will produce the maximum amount of lottery profits each year.

Selected Terms Used in This Analysis

Borrowing. The type of state borrowing allowed under this measure involves selling an asset to investors through a bond transaction. The asset—in this case, future lottery profits—then pays back the investors, with interest, over time. Through this borrowing, the state can receive benefit from future lottery profits "upfront"—by converting a stream of future annual payments into a large, "lump sum" amount realized now. This type of borrowing—referred to as securitization—is somewhat different from most other types of state borrowing in that it involves no legal commitment to use General Fund tax revenues to pay investors.

Educational Institutions. These are the public educational entities that now receive payments from the lottery, including kindergarten through twelfth grade (K–12) school districts, community college districts, the California State University system, and the University of California system.

General Fund. The state government's main operating account, the General Fund, now receives over $90 billion per year in taxes and other revenues. Its funds can be used by the Legislature for any purpose.

Lottery Operating Expenses. These are the costs to run the lottery. Currently, most of these expenses are sales commissions, bonuses, and other payments to retailers that sell lottery tickets—such as convenience stores, liquor stores, and supermarkets.

Lottery Profits. These are the lottery revenues that remain after payment of (1) prizes and (2) lottery operating expenses. They are currently about one-third of total sales.

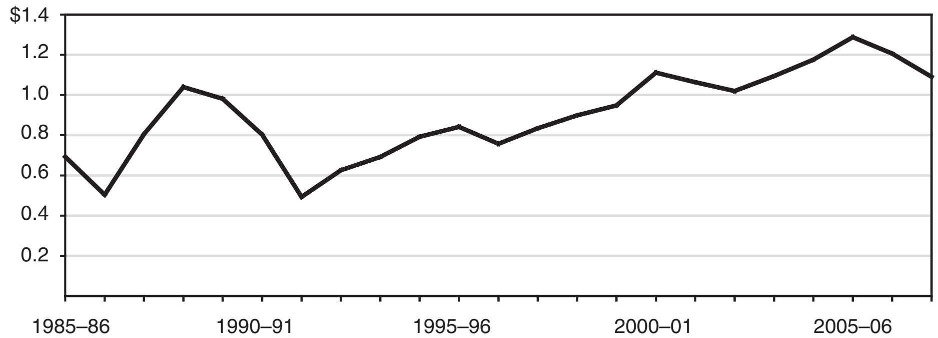
Proposition 98. Approved by voters in 1988, Proposition 98 provides a minimum level of guaranteed funding each year to K–12 school districts and community college districts. This funding level, which is supported by the state General Fund and local property taxes, makes up about three-quarters of total revenues for these districts.

For text of Proposition 1C, see page 48.

Figure 1

Annual Lottery Payments to Education Have Gone Up and Down Over Time

(In Billions)



More Flexibility for Lottery Operating Expenses. Existing laws give the lottery more flexibility than most other state departments to spend funds for operating expenses, including contracts with private entities. Proposition 1C expands this flexibility in some ways. For instance, the measure further limits the number of contracts with private entities that the commission must submit for competitive bidding. The measure also reduces the maximum amount of lottery operating expenses from 16 percent of lottery funds each year to 13 percent of these funds. (Since the lottery currently spends under 13 percent of lottery funds—less than the maximum now allowed—on its expenses, this change probably would have no immediate effect on lottery operations.) The measure, however, gives the lottery new flexibility to carry over unused operating funds to a future year.

No Changes to Laws on Lottery Games and Devices or State Operation of the Lottery. This measure includes no changes to existing laws about the types of technologies the lottery may use in its games or the machines it may use to dispense lottery tickets. In addition, this measure continues to require the lottery to be conducted by the state and not by a private company.

Use of Lottery Profits

Profits Would No Longer Be Dedicated to Education. Under Proposition 1C, lottery profits no longer would be paid to educational institutions beginning in 2009–10. Instead, as described below, payments to educational institutions from the state General Fund would increase to make up for the loss of the lottery payments.

Borrowing From Future Lottery Profits. If voters approve this measure, the state would be able to borrow from future lottery profits and receive a large payment or payments now from investors. The state budget plan for 2009–10—approved by the Legislature and the Governor in February 2009—relies on the state receiving $5 billion from such a borrowing. Future lottery profits would be used to repay the investors—with interest—over time. There is no limit in the measure on how much state officials may borrow in 2009–10 and future years.

Profits Would Be Available for State Debt Payments or Budget Obligations. Under this measure, lottery profits not needed to pay off lottery borrowing would be transferred to a new state government account called the Debt Retirement Fund (DRF). Funds in the DRF could be used by the Legislature to pay the following state expenses:

- Debt-service costs on bonds issued by the state to fund roads, schools, prisons, and other infrastructure projects.
- Debt-service costs on Economic Recovery Bonds (ERBs). (The ERBs were approved by voters in Proposition 57 in 2004 to address state budget deficits from earlier in this decade.)
- Other debts incurred by the General Fund (such as amounts borrowed from other state funds) to help address budgetary shortfalls, as well as other General Fund budgetary obligations.

Payments for Problem Gambling Programs. The measure requires the lottery to direct $1 million of its funds each year to the state's existing Office of Problem Gambling for its awareness and treatment programs. Currently, the lottery commits about $250,000 per year to this office to help pay for the state's 1-800-GAMBLER problem gambling telephone line.

Funding for Educational Institutions

Increased State General Fund Payments. This measure requires the state to increase payments to educational institutions from the General Fund beginning in 2009–10. This would make up for the loss of lottery payments to education. Specifically, the measure requires the General Fund to make payments to educational institutions in 2009–10 equal to (1) the amount of lottery profits paid to these institutions in 2008–09 plus (2) an adjustment for growth in the number of students and the cost of living. For K–12 schools and community colleges, the measure states that these General Fund payments in 2009–10 are in addition to those already required under the Proposition 98 funding guarantee. In future years, the new General Fund payments for K–12 schools and community colleges would become part of their annual Proposition 98 funding. Future General Fund payments to educational institutions would continue to be adjusted each year for growth in the number of students, as well as cost of living. Like the payments under the existing lottery law, these General Fund payments would be distributed to educational institutions based on their number of students.

Future Amendments

Legislature Would Have More Flexibility to Amend the Law Later. Currently, two-thirds of Members in each house of the Legislature can vote to amend the lottery law to further the purposes of Proposition 37, the original lottery law passed in 1984. This measure gives the Legislature (with a two-thirds vote) more flexibility to amend the lottery law in the future. For example, such amendments could authorize new operating rules, games, or devices that increase the lottery's ability to generate profits for public purposes. The Legislature, however, would not be able to amend the parts of this measure that increase state General Fund payments to educational institutions without approval of the voters.

FISCAL EFFECTS

This measure would affect the finances of (1) the state General Fund, (2) the lottery, and (3) educational institutions.

Fiscal Effects on the General Fund

Lottery Borrowing Is a Key Part of the State's 2009–10 Budget Plan. In February 2009, the Legislature and the Governor approved major spending reductions and revenue increases to address the state General Fund shortfall. This budget plan assumed that the state would receive $5 billion from future lottery profits in 2009–10. Under current revenue forecasts, the $5 billion is necessary in order for the 2009–10 budget to be in balance. Therefore, if voters reject Proposition 1C, the Legislature and the Governor probably will have to agree to billions of dollars of additional spending cuts, tax increases, and/or other solutions in order to balance the 2009–10 state budget.

Lottery Profits Would Pay Off the Borrowing and Cover Some General Fund Costs. If the state successfully borrows about $5 billion from future lottery profits in 2009–10, annual debt-service payments to investors could total between $350 million and $450 million each year for 20 to 30 years. Lottery profits first would go to make these debt-service payments. Any remaining lottery profits then would be deposited to the DRF for use in paying various General Fund expenses. Accordingly, lottery profits not needed to pay debt-service costs would benefit the General Fund.

Figure 2

Key Parts of Proposition 1C and How They Compare With Current Law

	Current Law	Proposition 1C
State borrowing from future lottery profits	Not allowed.	Allows $5 billion in borrowing to help balance the state's 2009–10 budget. Additional borrowing allowed in the future. Repayment from future lottery profits.
Lottery prize payouts	Fixed at 50 percent of lottery sales.	Flexibility given to California State Lottery Commission to set prizes at a level above 50 percent that generates the most profits.
Use of lottery profits	Paid to public schools, community colleges, and universities.	Not paid to educational institutions. Proceeds instead are used first to repay state borrowing described above. Remaining profits would be available to benefit the state General Fund by paying state debts and budgetary obligations.
School and community college district funding	Annual minimum funding guarantee established by Proposition 98.	An increased Proposition 98 guarantee to make up for districts' loss of payments from lottery profits.

For text of Proposition 1C, see page 48.

Future Strain on the General Fund. Proposition 1C requires increased General Fund payments to education. As described below, this measure's changes to lottery operations probably would allow the lottery to grow its sales and profits above what they would be under existing law. Nevertheless, after the increased lottery profits are used to make debt-service payments to investors, the remaining profits probably would not be enough to cover the General Fund's higher payments to education for most of the next 20 to 30 years. In the years after the $5 billion borrowing, the Legislature would probably have to identify hundreds of millions of dollars per year in revenue increases or spending decreases to cover these costs.

Future Lottery Borrowing Also Could Affect the General Fund. While the Legislature and the Governor have assumed the state will borrow $5 billion in 2009–10, the measure allows the state to borrow more from future lottery profits at any time in the future. If officials decided to do this, the state General Fund would benefit from the borrowing in a future year—just as the General Fund would benefit from the $5 billion borrowing in 2009–10. Additional borrowings, however, would increase debt-service costs even more. These increased costs would reduce further the portion of lottery profits available to cover the General Fund's higher payments to education. Accordingly, if state officials decide to borrow more than $5 billion from future lottery profits, budgetary decisions of the Legislature could be more difficult in the years after that borrowing.

Financial Crisis Creates Near-Term Uncertainty About the $5 Billion Borrowing. In 2008, the steep fall of the housing market led to insolvency or other fiscal troubles for many major financial institutions. This led to a global "credit crunch" that reduced the ability and willingness of investors to lend money to many individuals, companies, and governments, including the state. The credit crunch has eased in recent months. At the time this analysis was prepared, however, there remained a possibility that California would not be able to achieve all of the planned $5 billion lottery borrowing in 2009–10.

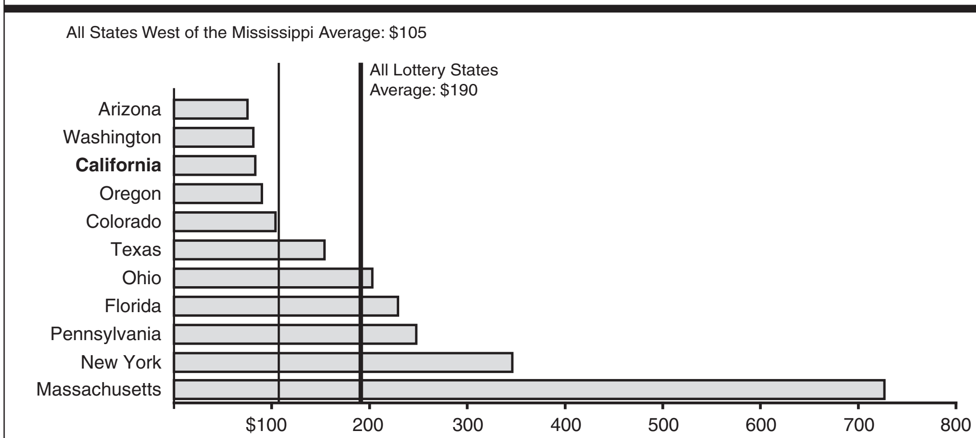
Fiscal Effects if State Never Borrows From Lottery Profits. While the state budget plan assumes $5 billion of lottery borrowing in 2009–10, this measure does not require the state to undertake such a borrowing. In the event no lottery borrowing ever takes place, voter approval of Proposition 1C would allow the other changes to lottery operations, the uses of lottery funds, and funding for educational institutions discussed in this analysis to go into effect. In other words, if voters approve Proposition 1C and the state never borrows from future lottery profits, all lottery profits would flow to the DRF and be available to cover General Fund costs, including the required payments to education under this measure. In this case, it is possible that increased lottery profits under this measure would roughly offset the General Fund's increased payments to education over the long term.

Fiscal Effects on the Lottery

Increased Prize Payouts Are Likely to Increase Lottery Sales and Profits. Each Californian currently spends an average of $83 each year on lottery tickets—considerably less than the average resident of other states with a lottery, as shown in Figure 3. There are probably many reasons why this is so, including the other entertainment and gambling options available for residents here. California's relatively low lottery prize

Figure 3

2007–08 Lottery Sales Per Resident in Selected States



Excludes video lottery terminal sales.

payouts (about 50 cents in prizes for every dollar spent on lottery tickets) likely also contributes to the lottery's relatively weak sales. Higher prize payouts appear to attract more players and greater spending for lottery tickets. For example, the Massachusetts State Lottery—one of the leading lotteries in sales per resident—returns over 70 percent of its funds to players as prizes. In 2002, the Florida Legislature authorized that state's lottery to grow its prize payouts. Within five years, Florida Lottery sales grew substantially. Based on the evidence from other states, we conclude that if voters approve this measure, sales and profits of the California Lottery could grow significantly compared to how much they would grow under existing law. This growth could result in future lottery sales being somewhere between 30 percent and 80 percent higher. Because a greater share of lottery funds would be given back to players as prizes, lottery *profits* would grow by a smaller percentage. We estimate that lottery profits would increase by hundreds of millions of dollars per year compared to what they would be under current law.

Choices by Consumers, Lottery Officials, and Legislators Would Affect Growth. While lottery sales and profits could grow substantially if this proposal is approved, the precise effects of this measure cannot be predicted. The amount of sales and profit growth would depend on how California consumers react to the products offered by the lottery in the future. In addition, the lottery's financial performance would depend on many decisions made by the commission and lottery staff. They would decide, among other things, the level of lottery prize payouts, how lottery games will be marketed to the public, and how lottery retailers throughout California will be encouraged to sell lottery tickets. The Legislature also would be able to pass additional changes to the lottery law to further increase lottery profits.

Fiscal Effects for Educational Institutions

State General Fund Payments to Make Up for Loss of Lottery Funds. Currently, educational institutions are the only entities that receive lottery profits. These profits totaled $1.1 billion in 2007–08 and appear likely to be somewhat lower in 2008–09 based on recent lottery sales trends in California and other states (due in part to the recession). Under this measure, the lottery payments to schools, community colleges, and universities would stop at the end of the 2008–09 fiscal year. Beginning in 2009–10, payments from the state General Fund would increase to make up for the loss of lottery payments. These payments would grow each year in line with the growth of students and the cost of living. For K–12 schools and community college districts, the payments would become a part of their Proposition 98 funding. Over the long term, these General Fund payments to educational institutions likely would grow faster and more consistently than the payments that the schools now receive from the lottery.

Other Fiscal Effects

Effects on Other Governmental Revenues and Expenditures. Under this measure, it is likely that California consumers would spend more of their income on the lottery. This means that Californians would spend less on other goods and services, including, perhaps, other gambling activities. State and local governments receive revenues as a result of consumer spending in these areas. Increases in lottery sales, therefore, would be partially offset by declines in other state and local revenues. The projected increase in lottery gambling activity also may contribute to more Californians having gambling problems. This could result in increased demands for services from publicly funded health and social services programs.

Summary of Fiscal Effects

This measure would affect finances of the state General Fund, the lottery, and educational institutions:

- ***State General Fund.*** This measure would allow the state to borrow $5 billion from future lottery profits in 2009–10 to help balance the 2009–10 state budget. The measure also would allow more borrowing from lottery profits in the future. While the General Fund would benefit in the future from lottery profits not needed to pay off the borrowing, these lottery profits probably would not be enough to cover higher payments to education required by this proposition. This means the state would have to identify new revenues or spending reductions to make these higher payments to education in the future.
- ***Lottery.*** If voters approve this measure, lottery profits probably would increase by hundreds of millions of dollars per year compared to what they would be under current law.
- ***Educational Institutions.*** Schools, community colleges, and universities would no longer receive payments from the lottery. Instead, these institutions would receive higher payments from the state General Fund. These payments would grow over time—likely faster and in a more consistent way than the schools' existing lottery payments.

For text of Proposition 1C, see page 48.