Privilege or Right

Gaming deserves predictable and reasonable taxation

by Robert Russell & Andrew Smith

"An economy hampered by restrictive tax rates will never produce enough revenues to balance our budget—just as it will never produce enough jobs or profits."
—John F. Kennedy

It is a universally accepted fact that the U.S. commercial casino gaming industry, which currently is authorized in 11 states, is a privilege industry authorized and governed by state government. The 1998 National Gambling Impact Study Commission Report stated that, "unlike other businesses in which the market is the principal determinant, the shape and operation of legalized gambling has been largely a product of government decisions."

On January 9, 2004, Frank J. Fahrenkopf, Jr., president and CEO, American Gaming Association, spoke to the National Council of Legislators from Gaming States, and reminded these important policy makers that they are "… for all intents and purposes our partners in a business enterprise." Fahrenkopf stated when state governments legalize casino gaming and license its operators, there is an implicit contract:

"We (commercial gaming) would be allowed to do business in their states in exchange for creating jobs, stimulating capital investment and, above all, generating tax revenue for various state governmental services and purposes."

Those involved with the commercial casino gaming industry are keenly aware of the states' regulatory role as it relates to licensing operators, employees, and suppliers, along with monitoring each layer of the business' activities. Persons not familiar with the strict regulatory constraints on the gaming industry are often shocked when they discover that casinos are required to work only with licensed suppliers and have state investigators review their financial records on a daily basis. In exchange for the unique gaming business license, many state governments also assess a "wagering tax," which is paid in addition to all other normal business taxes. This tax is often paid on gross revenue. It is this tax, and other unique fees paid by the commercial gaming industry, that most dramatically impacts the shape and success of a casino enterprise.

All businesses, whether authorized as a privilege or a free market industry, must conform to basic rules of economics. Consequently, as business expenses rise, the available financial resources to invest in capital improvements, expand employee hiring, and market a service or product become significantly compromised.

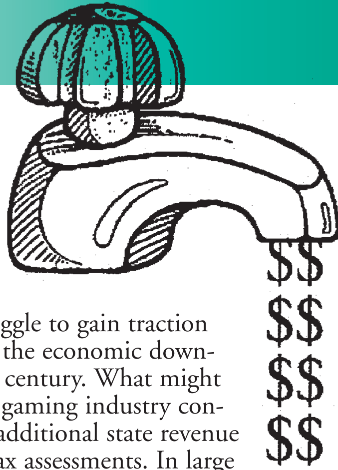
As a privilege industry, casino gaming is also charged with the responsibility of encouraging economic development within its host community. From Iowa, which legalized riverboat gaming in 1991, to Detroit, which authorized land-based casinos in 1996, the primary purpose for adding the industry to the local host economy was to create capital investment and jobs, and to attract tourists to the area. The economic success of the commercial casino gaming on host communities was documented by Adam Rose in "The Regional Economic Impact of Casino Gambling: Assessment of the Literature and Establishment of a Research Agenda" study, which was presented to the Federal Gambling Impact Study Commission in 1998. Rose notes in his study's conclusion that, "… a new casino of even limited attractiveness and placed in a market that is not already saturated, will yield positive economic benefits on a net to its host economy."

Economic Success: A Review of 2003 Numbers

Each year, the American Gaming Association ("AGA") compiles economic impact figures on the commercial casino gaming industry in its annual *State of the States Report*. The AGA's 2004 report, released in May, can be obtained on the AGA website (www.americangaming.com).

In 2003, there were 11 states that authorized commercial casino gaming in exchange for operators in these jurisdictions agreeing to pay a "wagering or privilege tax." These states include: Colorado, Illinois, Indiana, Iowa, Louisiana, Michigan, Mississippi, Missouri, Nevada, New Jersey and South Dakota. In total, 433 commercial casinos were licensed and in operation in 2002, with gross casino gaming revenue in excess of $27 billion. This figure represented a dramatic increase over revenues in 1992, when the industry generated $9.6 billion. This growth has largely been attributed to the expansion in the number of states authorizing commercial casino gaming. In 1992, only Nevada and New Jersey offered full-scale gaming, while the states of Colorado, Illinois, Iowa and South Dakota were just beginning to operate casinos.

According to the AGA's 2004 report, the gaming tax revenue paid to state and local governmental bodies was over $4.3 billion and the industry employed roughly 352,000 people with an industry payroll of $11.8 billion. Very few, if any, other U.S. industries, privileged or not, have had the success and provided the positive economic benefits the commercial casino gaming industry has during the last decade. During this same period, the industry has not only added jobs to the U.S. economy but invested tens of billions in capital investment in locations and areas that other businesses or industries would likely not have considered.



Gaming Taxes: Not All Are Equal

It is probably not a surprise to anyone reading this article that state coffers from Maine to California are strapped for cash, as the U.S. economy continues to struggle to gain traction following the post-9/11 fallout and the economic downturn which hit us at the turn of the century. What might be unexpected, however, is that the gaming industry continues to be targeted as a source of additional state revenue in the form of increased wagering tax assessments. In large part these increases have come with little, if any, relaxing of regulation or expanded businesses opportunities for the operating companies. Rather, these increased fees have cut directly into the existing business operation and operators' bottom lines.

I. Nelson Rose, professor and gaming law expert from Whittier Law School, stated in an article "Nothing Is Certain Except Death and More Taxes" that, "State legislators are playing a kind of Russian Roulette with gaming taxes. Only the victims are casino workers, investors, owners and their patrons, who did not even know they were playing the game."

In February of this year in Las Vegas, Fahrenkopf addressed industry leaders and reviewed the various wagering tax increases that were statutorily enacted in 2003. He stated that, "the past two years have brought a sea of change—or more like a tidal wave of change—for our industry." In this statement, Fahrenkopf was referring to the various tax increases that have been enacted by states across the nation that allow commercial casino gaming industry.

In reviewing those states that have approved commercial casino gaming, it is important to first acknowledge those that are being fiscally responsible to the industry. Mississippi Governor Haley Barbour told those in attendance last month at the Southern Gaming Summit that, "I'm against raising taxes, period." Governor Barbour, addressing the casino executives at the Summit, stated, "There are people in Jackson, Mississippi, who want to raise casino taxes, whiskey taxes, beer taxes, cigarette taxes. I'm against raising anyone's taxes." He went on to say that the state's 29 casinos are attracting "… tourists to the state who are in turn changing stereotypes of Mississippi and spurring economic development."

This, however, has not been the norm in other states with commercial casino gaming. In 2003, the most dramatic wagering tax increase occurred in the state of Illinois where the legislature and governor implemented a top tax rate of 70 percent. Illinois' wagering tax begins with a reasonable 15 percent levy on adjusted gross receipts up to $25 million, but increases to 37.5 percent on receipts of $50 million and incrementally inflates to 70 percent for receipts over $250 million. Illinois' wagering tax had held steady at a flat 20 percent until 1998, when the state began to tap the industry for added revenues and implemented massive tax hikes, first in 2002 (50 percent), followed by the more recent one (70 percent) a year later.

From the industry's perspective in Illinois, one might reasonably ask: What did we do to deserve such harsh fiscal treatment from our state government? The answer, if one consults the data, would appear to be nothing. In fact, the nine riverboat operators have more than delivered on their promises to the state. Consider the following table, which looks at state tax collections between 1998 and 2002, and judge for yourself whether or not Illinois gaming operators were following through on their end of the 'implicit contract' and deserving of yet another tax increase in 2003.

It is also worth noting that, despite the challenging economic climate (particularly visible in the industrial Midwest), riverboat casinos in Illinois increased employment levels by more than 10 percent during this five year period.

Illinois Gaming Taxes (1998-2002)

Year	Taxes Paid	Percentage Change
1998	$337 million	
1999	$419 million	24%
2000	$512 million	22%
2001	$555.2 million	8%
2002	$666.1 million	17%

The result of the Illinois tax increase has had the reverse affect on state revenues from the gaming industry. Tom Swoik, executive director of the Illinois Casino Gaming Association, provided testimony at the Illinois Gaming Control Board meeting on January 15, 2004, and stated "… in 2002, the casino industry in Illinois employed nearly 11,000 people and paid almost $365 million in salaries and fringe benefits." Swoik informed the Board that, as a result of the state's wagering tax increase, "In 2003, the casino industry laid off nearly 700 employees, and they are not filling close to 600 additional vacancies." Most shocking in Swoik's testimony was the fact that the adjusted gross receipts for the first six months of the current 2003-2004 fiscal year are down by over $88 million and admissions are down by over 18 percent.

In response to the negative impact on the industry, certain Illinois legislators are currently drafting legislation to roll back the inflated tax rates to 1998 levels. In addition, state representatives are drafting legislation to increase the number of authorized gaming positions at current Illinois riverboat casinos, allow electronic gaming devices simulating horse races and to possibly authorize up to three more casino gaming licenses.

It is important to note that Illinois' 2002 tax increase was not the first increase in taxes on casino operations where the result was an adverse economic impact on state revenues. In discussing Colorado, which opened limited-stakes casinos in three small mountain towns in October 1991, Professor Rose noted in his article that "by July 1992, the original 25 casinos had grown to 68." In response to the industry's success, the Colorado legislature raised taxes on casinos and, as Rose noted, within five months, 21 casinos had closed. Following the closure of these facilities and loss of economic activity, the legislature lowered the tax rate to a level at which the industry could operate successfully.

Despite these lessons learned in Illinois and the historical events surrounding jurisdictions like Colorado, certain elected officials continue to float radical tax increases on gaming industry revenues.

On May 12, the Michigan House of Representatives was the most recent to enter the arena of seeking to dramatically increase the state wagering tax on the state's commercial casino industry. The proposed legislation caught industry lobbyists and Wall Street analysts off guard, as Republican Representative Larry Julian introduced a proposal to increase Detroit's commercial casino tax from 18 percent to 36 percent on gross gaming revenues.

What is most shocking about the Michigan tax increase proposal, separate from the fact that no independent financial analysis was conducted to weigh the potential economic impact, is that the legislative proposal required a "supermajority" (3/4ths vote of the legislature) to amend the Michigan Gaming Revenue Act, and it was able to obtain this result in the House of Representatives.

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Most political observers in the state contend obtaining this 3/4ths majority is a virtually impossible feat.

The Michigan tax proposal was offered by Julian as a way to tax all of Michigan's gaming options equally, i.e. racinos, lottery, etc. However, what Julian's proposal mistakenly miscalculates is the level of economic investment made by Michigan's commercial casino industry compared to the state's proposed racino industry and existing Lottery business. Since the establishment of commercial gaming in Detroit, casino operators have invested $1.3 billion in capital investments and established a workforce of more than 8,000 employees. The operators also have entered into permanent casino development agreements with the city of Detroit, which, in addition to the 18 percent wagering tax shared by the state and city, will pay hundreds of millions of dollars to the city in additional fees, along with assisting in community and business development funds, including an expensive riverfront park project.

At the time this article went to print, it is unclear what the state government would ultimately decide to do with Detroit's wagering tax. However, any changes could impact the plans for the $1.5 billion in capital investment slated to be spent on the permanent Detroit casinos, along with the potential loss of jobs for Detroit residents.

Elected officials in New York state also have followed misguided fiscal policy with respect to their taxation of gaming operations. While enabling legislation was first passed back in 2001, progress in getting video lottery terminals (VLTs) up and running at the state's racetracks has been slowed both by court battles and revenue distribution formulas that many operators considered economically unviable. Essentially, as envisioned in the 2003 amendment to the state's tax laws, racetrack operators will receive roughly 20 percent of VLT revenue before capital expenditures and paying taxes, wages, benefits, etc. In later years, because of mandatory increases in distributions to racetrack purses and racehorse breeding programs, this distribution to racetrack operators drops to just over 17 percent of revenue (an effective tax rate of well over eighty percent)!

Longtime gaming industry analyst Eugene Christiansen, CEO of Christiansen Capital Advisors, makes a number of important observations with respect to this taxation phenomenon. Prior to the reworking of the last year VLT law, which gave racetrack operators a slightly higher percentage of gaming revenue, he noted, "New York is a case study in setting tax rates that frustrate development of any kind and therefore create no benefits at all." He goes on to add, "The VLT provision of New York's omnibus gambling law puts state fiscal needs too far ahead of the equally pressing needs of tracks and horsemen to be workable—and has made construction of racino facilities impossible to finance."

While New York's tax regime with regard to racetrack casinos may have improved slightly last year, it still remains far from ideal. Delaware North, owner/manager of three racetrack casinos in upstate New York, is spending $13 million at Saratoga Raceway, $10 million at Finger Lakes Race Track and $7.5 million at Buffalo Raceway to install and upgrade these facilities for VLT operations, according to *Buffalo Business First* newspaper. Undoubtedly even these levels of investments are welcome to the tracks and host communities, but they pale in comparison to what takes place in racetrack casino jurisdictions with more reasonable tax rates. For example, Wheeling Island, a Delaware North-owned dog track located in Wheeling, West Virginia, underwent an approximately $63 million expansion in recent years, a figure that is nearly double the company's initial capital expenditures at their three racetracks in New York.

What Does the Future Hold?

As the commercial casino industry continues to evolve, along with an increase in the number of jurisdictions that authorize some form of gaming, it is likely the debate over what state tax the industry should pay will continue. As this debate unfolds, it remains paramount that operators, suppliers and employees seek to better educate public officials on the positive impact that gaming has on host communities. The American Gaming Association and various state gaming associations have established a successful foundation for educating government, business and civic leaders that partner with commercial gaming when it is introduced in a new jurisdiction. As new unrealistic tax structures are proposed and become law, however, it underscores the reality there is more that can be done by the industry to educate the general public.

No business can survive in an environment with an unreasonable rate of taxation. In addition, basic "Economics 101" proves that businesses cannot risk capital by investing in markets that do not have a stable regulatory and tax environment.

Consequently, let us hope that, in the future, jurisdictions contemplating tax increases on commercial casino gaming operations examine relevant data and consider the critical lessons learned from Illinois, New York and Colorado. If the current wave of tax increases continue to occur, however, the industry must develop ways to structure legislative or legal agreements that establish a predictable gaming tax rate. Such assurances would ultimately lead to more comfort from Wall Street investors resulting in greater capital investment and, in turn, enhance revenues for those fiscally responsible states.

Finally, it would not seem an unrealistic request for an industry investing billions of dollars in capital investment, creating thousands of jobs, and spending billions on supplies annually to receive the assurance that its tax rate will be protected from unreasonable increases, even if it is a privilege industry.

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Russell would like to thank Doug Minke for his assistance in researching issues for this article.