

DISCUSSION DRAFT – DO NOT DISTRIBUTE – DISCUSSION DRAFT

Proposition 1C: California State Lottery

Staff Recommendation: **OPPOSE**

Issues Committee Recommendation: **OPPOSE**

Executive Committee Recommendation:

Board Action:

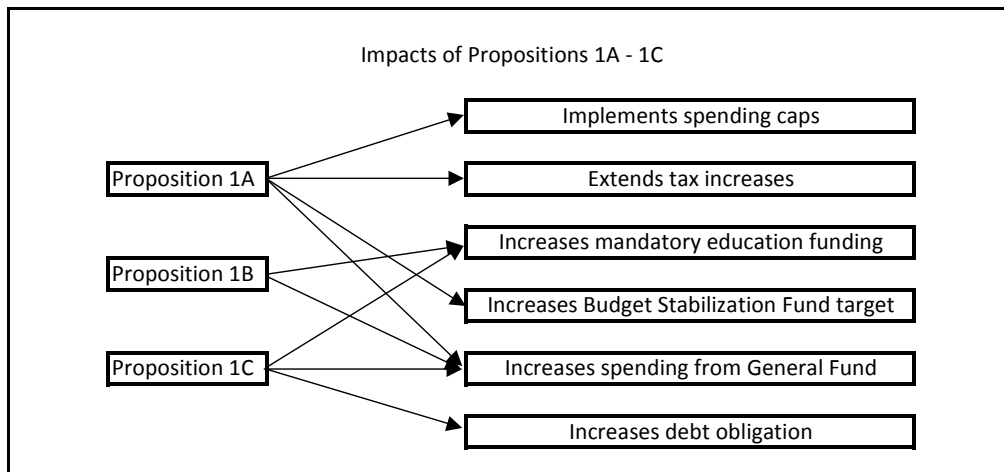
Rationale:

While passage of Proposition 1C would certainly play an important role in balancing the FY09-10 budget, it would do so by putting further strain on the State General Fund in future years by establishing permanent education funding obligations as well as increasing the amount of debt owed by the state.

Background:

In January 2009, it was projected that the state would face a \$40 billion shortfall over fiscal years 2008-09 and 2009-10 if no corrective actions were taken. In February, the Governor and the Legislature agreed on a package to balance the current years and FY09-10 budget. This package is anticipated to generate \$98 billion in revenue and spend approximately \$92 billion. The remaining \$6 billion will cover the FY08-09 deficit and build up reserves.

As part of the budget package, six propositions were placed on a special election ballot to be held on May 19th. The FY09-10 budget depends on access to \$6 billion outlined within these measures. If voters approve all of the measures, it is expected that the state will still face multi-billion-dollar budget shortfalls in the coming years.



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California State Lottery

The California State Lottery was created after voters approved Proposition 37, which authorized the establishment of a state-operated lottery run by the Governor-appointed California Lottery Commission. Of the total lottery revenues, Proposition 37 requires that 50% be returned as prizes, not more than 16% be used for expenses, and at least 34% used to fund K-12 districts, community colleges, and State colleges and universities¹. The 34% minimum of lottery revenues may go towards no other purpose than education.

During fiscal year 2007-2008, the California State Lottery contributed approximately \$1 billion to K-12 education². For reference, this is equal to roughly 1% of K-12 public schools' revenue in the State of California.

Proposition 98

Proposition 98 was an amendment to the State Constitution approved by voters in 1988 that sets a minimum payment out of the General Fund to fund K-12 education. Funding provided under Proposition 98 makes up approximately 75% of K-12 education budgets³.

Proposal:

The Proposition 1C ballot label will read:

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. Fiscal Impact: Allows \$5 billion of borrowing from future lottery profits to help balance the 2009-10 state budget. Debt-service payments on this borrowing and higher payments to education would likely make it more difficult to balance future state budgets.

Impacts on Current Lottery Laws

Proposition 1C is one of the most vital aspects of the six propositions that have been proposed to balance the State's budget. The most significant and unprecedented characteristic of this measure is the State, upon approval by voters, being able to borrow as much as \$5 billion from future lottery profits. Additionally, this measure would change the California State Lottery Act so that the lottery revenue that is currently

¹ Los Angeles Law Library. California Ballot Propositions 1980-1984. Accessed March 16, 2009. Available: <<http://lalaw.lib.ca.us/research/ballots/1980/1984.aspx>>

² California Lottery 2008 Report to the Public. Accessed March 16, 2008. Available: <<http://www.calottery.com/Media/Publications/AnnualReports/>>

³ California Legislative Analyst's Office. Accessed March 16, 2009. Available: <http://www.lao.ca.gov/ballot/2009/1C_05_2009.pdf>

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designated for public education would instead be used to repay the amount borrowed from future lottery profits with interest. Any lottery profits that are left over after paying back the borrowed amount with interest would go towards paying off General Fund budgetary obligations, infrastructure bond debts, and Economic Recovery Bonds. In order to make up for the decreased spending going towards public education, passage of Proposition 1C would require that the state increase its payment to public education equal to at least the amount of lottery payments towards education in FY07-08 and adjusted for enrollment growth and cost of living. This new spending requirement would begin in FY09-10.

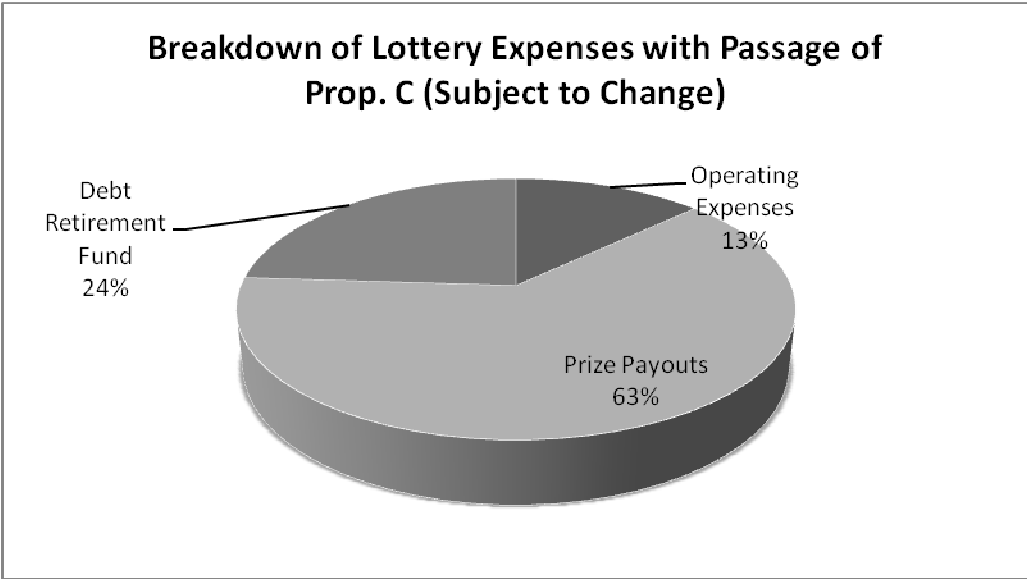
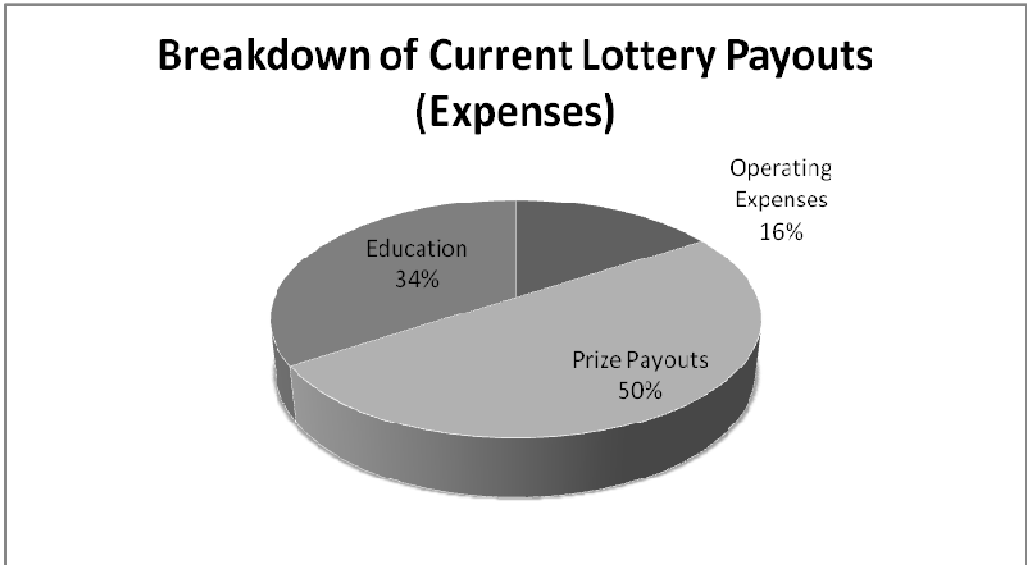
Increasing Lottery Revenues

The California Lottery Act would be further modified in an attempt to bring in higher revenues. Specifically, the passage of Proposition 1C would give the Lottery Commission the ability to change the percentages of lottery revenues given back to the public in cash prizes, as long as that figure is no less than 50% of total revenues. After reviewing the practices of other state lotteries, a trend was revealed which showed that higher prize payouts results in increased sales. Costs to administer the lottery would be given a stricter cap of 13% of total revenues.

Key Parts of Proposition 1C and How They Compare with Current Law		
	<i>Current Law</i>	<i>Proposition 1C</i>
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% 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.

Table courtesy of the California Legislative Analyst’s Report.

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Fiscal Impact:

Impacts of Voter Approval of 1C

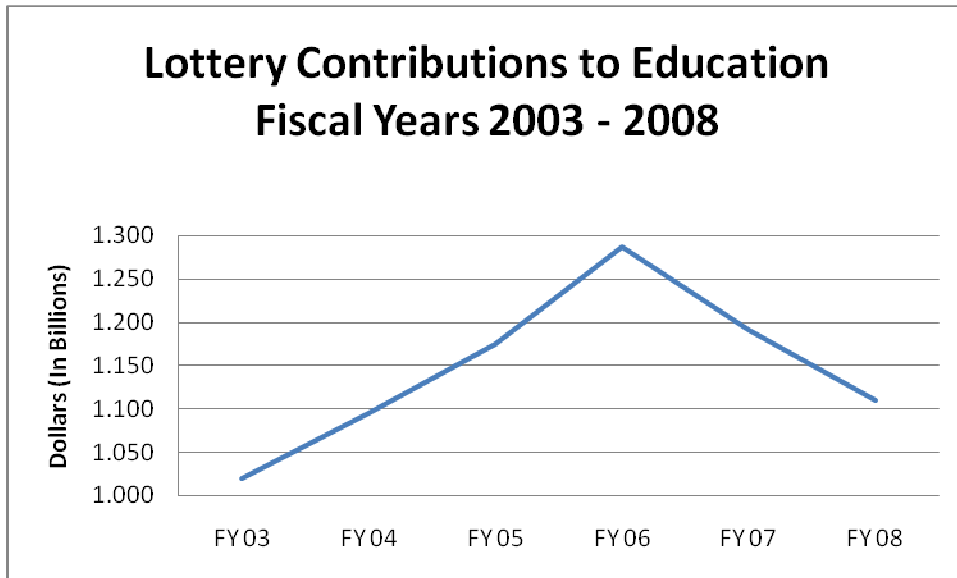
With the passage of Proposition 1C, the state would be allowed to borrow up to \$5 billion beginning in fiscal year 2009-10 from future lottery profits. Once the State has borrowed from future lottery profits, it would set up yearly debt payments using the current year’s lottery revenues to cover the payments. For example, if the state were to borrow \$5 billion during fiscal year 2009-10, the Legislative Analyst’s Office estimates that annual debt-service payments (with interest) would be between \$350 - \$450 million per year for 20 to 30 years. Any excess revenue (after payment of cash prizes, lottery operating

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expenses and debt-service on borrowing of future lottery revenue) would be dedicated to paying off other debt obligations. Such excess revenues would be transferred to the Debt Retirement Fund which would be established with the passage of Proposition 1A.

Funding for Education

When Proposition 37, the California State Lottery Act, was passed by voters in 1984, the state lottery was established under the expectation that less cash prizes and operating expenses, all lottery revenues would be used to fund public education. Because funds paid to education were based on revenue of ticket sales, annual payments varied widely. For example, contributions over the last eight years has a variance of approximately \$300 million (see figure below).



Source: California Lottery Financial Reports 2003 – 2008.

With the passage of Proposition 1C, those funds that were previously dedicated to public education would instead be used to pay off debt. In order to make up for this decrease in funding, the General Fund would be required to make payments of at least the amount paid by the lottery in FY 2007-08 (\$1.109 billion), adjusted for enrollment and cost of living adjustments. The obligation of the General Fund to pay this amount to education can only be repealed by a vote of the people. Essentially, those funds, which were previously variable when coming from lottery revenues, would steadily increase with enrollment and costs of living.

The idea is that the General Fund could support this additional funding obligation because some General Fund dollars would be freed from debt-service payments with the help of increased lottery revenue. However, lottery revenue (and therefore the amount of

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debt service lottery will be able to cover) will continue to fluctuate, while the funding obligations to education will continually increase. Additionally, the Lottery would have to achieve at least an additional \$1.109 billion in revenue after paying for cash prizes, administrative costs, and the debt service on borrowing from future lottery profits in order for there to be a net zero need for the General Fund to increase revenues. This revenue would have to increase annually to account for cost of living adjustments and enrollment growth. The passage of 1C would help balance the FY09-10 budget, but would set up future budgets higher obligations to fund education. Finally, it is important to note that the state could borrow from future lottery profits again, thereby further increasing debt-service costs.

Impacts of Failure of 1C to Pass

If voters ultimately vote against Proposition 1C, the process to balance the budget will be reopened. Even if Propositions 1A, 1B, 1D, 1E and 1F all pass, the budget would still be unbalanced by -\$5 billion.