Video Slot Gaming in Maryland: Weighing the Costs and Benefits

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Published by
The Maryland Public Policy Institute
P.O. Box 195
Germantown, Maryland 20875-0195
(240) 686-3510
www.mdpolicy.org

During his ultimately successful campaign for the Maryland governor's mansion, Robert L. Ehrlich repeatedly told voters that, if elected, he would push for the legalization of video slot machines in some of the state's horse tracks. The machines were necessary, Ehrlich said, both to boost the Old Line State's sagging horse racing industry and to bring new revenue into the state's severely deficient coffers. The latter result was especially important in light of his promise to increase state funding of primary and secondary education.

That motivation merits emphasis: Most slot proponents in the Ehrlich administration and the General Assembly do not simply believe that video slots should be allowed because a segment of Maryland's population wants to play them, a business sector wants to satisfy that demand, and – at least in the opinion of some proponents – slot machine gaming would provide a net benefit for Maryland. Instead, the politicians' motivation is to increase state revenues through licensing fees and a substantial tax on the machines' net proceeds. Likewise, the motivation of at least some slot opponents in the General Assembly is not that the machines would be bad for Maryland. Rather, those lawmakers have threatened to oppose the machines because the resulting revenue likely would not go directly to various pet projects and favored constituencies (though the fungibility of state money means that slot revenues would support all state functions to some degree).

Hence, the debate over legalizing video slots in Maryland revolves around two very different issues:

1. Do the games represent a net benefit or harm to Maryland society?
2. How much state revenue will the games produce?

To attempt to answer those questions, this report will examine the conclusions of various academic studies of the social costs of gaming in the United States. The report will then outline the various proposals for slot legalization in Maryland, and evaluate those proposals in light of experiences and research on gaming in neighboring states. Finally, this report will conclude with some policy recommendations for lawmakers to consider if they choose to legalize the machines in Maryland. An appendix presents an historical overview of legalized gaming in the United States, and is intended to offer context to some of the discussion contained in this report.

THE GAMING INDUSTRY IN AMERICA

"Gambling" can be defined as "putting something valuable at risk in a process the end of which cannot be known to those whose risk it is."[1] We can divide gambling activities into two categories: casino gaming (e.g., slot machines/video devices or table games such as bingo, keno, or poker) and betting (e.g., horses, dogs, jai alai, lotteries, or—in Nevada—sports events).

From a practical standpoint, casino-oriented gambling centers on a "game of chance" in which individual players have no way of knowing how cards, dice, wheels, etc., will fall and only goods in the form of cash are put at risk. The purpose of that commercial enterprise, often called "gaming," is to entertain the individuals engaged in the activities.

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1. *Blackwell Encyclopedic Dictionary of Business Ethics*.

America's quandary   An enduring problem associated with gambling (including legalized gaming) in America is that many people believe there is something inherently wrong with the activity. Yet it seems difficult to establish clearly what the "wrong" is; for most people, legalized gambling is a voluntary act that promotes their enjoyment and happiness.

Social and ethical issues involving religious conviction, compulsive gamblers, and the potential for organized crime to expand into a community through gaming all remain serious concerns for Americans. Until the last quarter of the twentieth century, those issues held sway in the public policy arena. More recently, however, the social consequences argument has lost ground to the belief that gaming is an individual rights issue and that the games represent a non-tax source of revenue for government to finance various programs and projects.

As summarized by researcher J.H. Frey in his 1998 article "Federal Involvement in U.S. Gaming Regulation,"[2] recent surveys show that the American public believes legalized gambling has positive impacts on their state and local economies, creates jobs and generates tax revenues, and provides additional money to support high-cost, government-supported programs such as education and transportation. Frey further notes that several studies reveal that the majority of Americans, including those who do not gamble, do not want the activity prohibited and feel that it should be legalized. Those attitudes are similar across employment, age, racial, and educational categories; the only consistent opposition is shown by those surveyed from the southern region of the United States and those who have fundamental religious beliefs that include the opposition to gambling.

SOCIAL IMPACTS

The social impacts or "costs" of gaming are traditionally viewed through the categories of crime, suicide, personal bankruptcy, and an increase in pathological gambling. In recent years, social science research has examined those societal issues carefully. The following data highlight the most important results from several studies and reports reviewed during the two-year period between 1997 and 1999 by the congressionally mandated National Gambling Impact Study Commission (NGISC).

Crime   The presence of legalized gaming has been alleged to increase the crime rate in the communities where casinos operate. But several recent studies have called that belief into question.

In a comprehensive review of available information on gaming and crime, former Illinois Inspector General and director of the Illinois State Police Jeremy Margolis found little documentation of a causal relationship between the two.[3] According to Margolis, the research shows that, when the increased population resulting from casino presence is properly accounted for, the pre- and post-casino periods reflect that communities with casinos are just as safe as communities that do not have casinos.

In a study commissioned by the Greater Baltimore Committee, researcher Peter Reuter analyzed available crime data on the experiences of approximately 20 communities that had established

2. "Federal Involvement in U.S. Gaming Regulation," by J.H. Frey. *The Annals of the American Academy of Political and Social Science*, No. 556 (1998).
3. *Casinos and Crime: An Analysis of the Evidence*, by Jeremy Margolis, 1997.

casinos since the mid-1980s. Reuter found no evidence that casinos had a major impact (e.g., an increase of one-quarter) on the crime rates of towns or metropolitan areas in which they are located.[4]

According to the National Opinion Research Center (NORC) at the University of Chicago, after compiling and examining data from 100 randomly selected communities as well as 10 communities within 50 miles of a casino, researchers found that casino proximity is not statistically significant for any crime outcome measures.[5] Similarly, in a report issued by the Public Sector Gaming Commission, commission members concluded that, after reviewing data collected in studies undertaken over the previous decade, there is no link between casino-style gambling and crime.[6]

Suicide While suicide ranks ninth among causes of death in the United States with some 30,000 fatalities annually, research has not conclusively shown a "cause-and-effect" relationship between casino gambling and suicide. According to recent study results released by the National Research Council, there appears to be a "strong association" in the research literature on suicide and pathological gambling.[7] Yet the study cautions that the general population is underrepresented in nearly all research studies of gambling-related suicide, thus weakening that connection from an etiological perspective. In a 2000 University of Nevada, Reno study of eight casino communities, the presence of a casino is associated with a statistically significant increase in per capita suicide, but the overall fit is somewhat low, i.e., 0.15 significance level (0.05 is the level of statistical significance generally employed in academic studies).[8]

Personal Bankruptcy Personal bankruptcy filings in the United States have topped one million on an annual basis over the last few years. However, the evidence for casino gaming contributing to personal bankruptcy is unconvincing. For example, of the 24 counties in the nation with the highest bankruptcy filing rates, none have casino gaming.[9] Furthermore, of the top 10 states with the highest bankruptcy rates, none have casino gaming operations. Finally, the above-cited NORC study found that casino proximity did not contribute to increased personal bankruptcy. Yet the above mentioned University of Nevada, Reno study results of eight communities in the United States that have recently adopted casino gambling reveal an increase in personal bankruptcy in seven of the eight communities evaluated.

Addiction Pathological gambling describes the clinical disorder characterized by a persistent and recurring failure to resist gambling behavior that is harmful to the individual and/or others. In

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4. *The Impact of Casinos on Crime and Other Social Problems: An Analysis of Recent Experience*, Report for the Greater Baltimore Commission, by Peter Reuter, January 1997.
5. *Overview of National Survey and Community Database Research on Gambling Behavior*, Report for the National Gambling Impact Study Commission, published by the National Opinion Research Center at the University of Chicago, February 1, 1999.
6. *Final Report of the Public Sector Gaming Study Commission*, published by the National Council of Legislators from Gambling States, March 31, 2000.
7. *Pathological Gambling: A Critical Review*, published by the National Research Council of the National Academy of Sciences, 1999.
8. *Suicide and Divorce as a Social Cost of Casino Gambling*, by M. Nichols, B.G. Stitt, and D. Giacopassi. University of Nevada, Reno, Institute for the Study of Gambling and Commercial Gaming, November 2000.
9. *The 1999 Industry Report: A Profile of America's Casino Gaming Industry*, written and compiled for the American Gaming Association.

1997, a meta-analysis of 120 different research studies by Harvard Medical School's Division on Addictions estimated that 1.29 percent of the U.S. adult population could be classified as suffering from a pathological addiction to gambling.[10] That is up slightly from 0.84 percent for the period between 1977 and 1993.

According to the 1999 NORC study cited above, a telephone survey of 2,400 adults resulted in a finding that 0.1 percent of the U.S. adult population suffers from serious gambling disorders. Moreover, in the above cited National Research Council report, researchers concluded that 0.9 percent of the U.S. adult population could be classified as pathological gamblers and that the estimated social costs are $900 per pathological gambler per year for a total of $5 to $6 billion annually.

Based on survey results contained in the NORC report, between five and 15 percent of gaming revenues are due to pathological gamblers. The report concluded that pathological gambling is quite rare and is not increasing in frequency.

ECONOMIC IMPACTS

A number of recent studies have attempted to determine the economic effects of the legal gaming industry. Several of those studies were conducted on behalf of the industry and their results should be treated with some degree of skepticism, but they do suggest that legalized gaming could have a significant positive economic impact on the local job market.[11]

Similarly, studies conducted by academics who were not under contract to the gaming industry have reported positive economic impacts from legalized gaming. As part of its work, the congressionally mandated National Gambling Impact Study Commission reviewed research and heard testimony indicating that legalized gaming produces overall financial benefits for the local community.[12]

GAMBLING IN THE OLD LINE STATE

Maryland presently oversees two forms of gambling: the Maryland Lottery and horse racing. The lottery, operated by state government since 1973, offers betting opportunities in the following lottery product categories: Pick 3, Pick 4, Lotto, Keno, Keno Bonus, Mega Millions, Scratch Off, Cash In Hand, and Bonus Match. Mega Millions is an interstate lottery that also involves the states of Michigan, Massachusetts, Virginia, New Jersey, New York, Illinois, Georgia, Ohio, and Washington.

Lottery revenues are deposited into Maryland's General Fund. FY02 Maryland Lottery sales totaled approximately $1.3 billion, with 55.7 percent ($728,245,672) going to prize expense, 6.53 percent ($85,358,927) to retailers, 33.9 percent ($443,381,814) to state programs, and 3.86

10. *Estimating the Prevalence of Disordered Gambling Behavior in the United States and Canada*, by H.J. Shaffer, et al. Harvard University Medical School, Division on Addictions, 1997.
11. See, e.g., *Economic Impacts of Casino Gaming in the United States,* Vol. I: Macro Study, produced by Arthur Andersen, 1996; *Gaming Industry Employee Impact Survey*, produced by Coopers & Lybrand, October 1997.
12. See, e.g., *Overview of National Survey and Community Database Research on Gambling Behavior*, Op. cit. Footnote 5; *Testimony Before the NGISC*, Adam Rose, Penn State University, September 11, 1998, pp.162-163.

percent ($50,370,000) to lottery operational expenses.[13] Proceeds from the designated scratch-off games and Mega Millions lottery benefit the Maryland Stadium Authority. In FY02, $27,230,000 was contributed to the Stadium Authority.

Horse Racing. The Maryland Racing Commission, formed in 1920 and presently operating within the Department of Labor, Licensing and Regulation, licenses all persons, associations, or corporations that hold any horse racing meet within Maryland where racing is permitted for any stake, purse, or reward. It also oversees Satellite Simulcast Betting and inter-track betting. The commission makes all regulations governing the races. Further, the commission officiates the races through its stewards and judges. It may also regulate the size of a purse, the price of admission, or the charge made for any article or service sold at the meets. The commission also conducts hearings on appeals, collects taxes and fees, distributes the taxes and fees to localities, collects and tests specimens from horses participating in the races, and oversees the administration of breeding enhancement programs.

In Maryland, there are three privately owned thoroughbred racetracks: Laurel Park in Laurel (one-mile track), Pimlico Race Course in Baltimore (one-mile track), and Timonium Race Course in Timonium (half-mile track). Another privately owned racetrack, Fair Hills Races in Elkton, is a steeplechase track. Pimlico Race Course is the home of the Preakness, the second leg of the Triple Crown. Maryland also is home to two privately owned harness or standardbred tracks, Rosecroft Raceway in Fort Washington and Delmarva Downs (Ocean Downs) in Berlin. Horse racing employs the pari-mutuel system in which betters wager against one another, instead of against the "house."

There are three Satellite Simulcast Betting facilities (also referred to as "Off-Track Betting") licensed by the Maryland Racing Commission: The Cracked Claw in Frederick, Northeast Racing and Sports Club in North East, and Riverboat on the Potomac in Colonial Beach, Virginia. Each Satellite Simulcast Betting facility must be operated under a contract negotiated with a thoroughbred or standardbred racetrack. There are no legal limits on the number of Satellite Simulcast Betting facilities that may operate in Maryland.

Maryland's Competition. Pari-mutuel horse racing, including off-track betting and inter-track wagering, is legal in 43 states and involves the racing of thoroughbreds, standardbreds, quarter-horses, and Arabians. There are approximately 175 racetracks in the United States. In 1997, approximately 40 million people attended the races, wagering over $15.2 billion.[14]

The "betting handle" is very important to the industry because it drives racing. With horse racing, the amount wagered has a direct effect on the involvement of additional owners in the industry and the economic effect it has. As betting increases, so does the purse money, the share of the betting handle that goes to horse owners at the track, and – of course – the revenue to the track itself.

Among the 43 states that offer horse racing, track attendance has declined in recent years. Industry experts point to the proliferation of quick-action, non-cerebral video slots in Indian and non-

13. All data in this paragraph are from the Maryland Lottery Commission.
14. All data in this paragraph are from the American Horse Council.

Indian casinos, riverboat casinos, and other gaming venues as the main draw for today's generation of gamblers. Horse tracks that lack slots have simply not kept pace as their customer base has aged and new players have failed to materialize.

Baltimore Sun columnist Michael Olesker noted the decline in action at Maryland tracks in a January 5, 2003 column:

> You walk into Pimlico on a normal day and a few thousand hardcore folks are there, many huddled in the shadows on little beach chairs, staring numbly at television simulcasts, oblivious to all around them, while outdoors there's a sea of about 14,000 empty seats.

Slots and Racetracks. One of the largest and most recent growth areas within the gaming industry is found in racetrack casinos, often referred to as "racinos." Racetrack casinos, which along with pari-mutuel facilities (that include horse tracks, dog tracks, and jai alai), have video slot machines on-site. Racinos presently operate in Delaware, Iowa, Louisiana, New Mexico, Rhode Island, and West Virginia. For 2001, 7,928 people were directly employed by this sector and taxes collected from video slot gaming totaled $577.9 million nationwide (excluding Louisiana) on revenues of $2.1 billion (excluding Louisiana).[15]

That revenue has provided a tremendous boost for the horse racing industry in states where the racinos operate. *Sun* columnist Olesker noted that in his January 5 column:

> In Delaware, and more recently in West Virginia, slot machines have rejuvenated the racing business and poured millions into civic projects. Last year, for example, gamblers spent $3.5 billion on slot machines at Delaware Park and two nearby harness tracks. Tens of millions in slot money have been funneled into that state's racing industry, and more into refurbished schools and expanded police efforts. Every day, they thank heaven for all those cars filling their racetrack parking lots – uncountable numbers of them with Maryland license plates.

Similarly, *Washington Times* writer Rick Snider in a May 18, 2002 article noted the positive impact of video slots on horse racing purses in Delaware and West Virginia. According to Snider, "Since slots arrived in 1995, daily purses have risen from $92,000 to $250,000 to leap past Maryland's by nearly $100,000." That leap leaves Old Line State horse racing in a worrisome position competitively, Snider notes:

> Maryland racing needs a major cash infusion not only to recapture its past glory but also to provide a future against mounting gaming competition. From multi-state lotteries to regional gaming, Maryland is being squeezed from its centuries-old mantle to the cusp of the minor leagues.

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15. *State of the States: The AGA Survey of Casino Entertainment 2002*, published by the American Gaming Association.

But not all horse racing industry observers believe that video slot gaming is the panacea for Maryland's ailing industry. Writes Andrew Beyer in the March 9, 2002 edition of the Washington Post, "Everyone in the racing industry – horsemen, breeders, track owners – is dazzled by the dollar signs associated with slot machines, and only a few question the merits of the devices." But, Beyer continues, there are two drawbacks to video slot gaming: the first, when racetracks get video slot machines, racing becomes a secondary concern at the tracks; the second, when one track benefits from video game slot machines, others suffer. Regarding the latter point, he writes:

> The purses have helped Charles Town [W.Va.] business, but they have simultaneously lured many horses from Maryland, denuding the lower-level races at Pimlico that used to draw full fields. Smaller fields have made the racing in Maryland less attractive (i.e., less wagering) and hurt its business, e.g., leading to revenue losses.

But, as quoted by Snider in his *Washington Times* article, former Pimlico and Laurel race tracks owner Joseph A. De Frances offers a strong argument on behalf of the industry as to why Maryland tracks must keep up with neighboring states and offer the machines: "If we get the same benefits Delaware and West Virginia have to provide funding to revitalize our facilities and make capital improvements, then Maryland racing can be at the head of the nation's elite." Without the games, De Frances claims that Maryland horse racing will fall behind: "If not, we can be successful, but we can't be successful employing the same business model of having two facilities running year-round." That last observation is particularly relevant for Maryland taxpayers who provide the industry with an annual subsidy of between $2 million to $10 million annually.

MARYLAND SLOTS PROPOSALS

In light of Gov. Ehrlich's call for allowing video slot gaming at Maryland horse tracks, a number of proposals have been floated concerning how many machines the state should permit, where they should be placed, and what revenues the state should collect from them. Below is a thumbnail sketch of some of the more prominent proposals:

Ehrlich Proposal. Faced with a looming (and historic) $1.2 billion budget deficit, Gov. Ehrlich has claimed a mandate for legalizing video slot machine gaming as a source of revenue to help offset the projected FY04 deficit. A new source of revenue is especially important for his administration because he has promised a significant increase in state funding for Maryland's public schools, but he has eschewed increasing the state's sales and income taxes.

The governor has proposed raising $350 million for the FY04 budget by selling video slot machine licenses to four of the state's horse racing tracks—Pimlico, Laurel, Rosecroft (each at $100 million) and a planned racetrack in Allegany County ($50 million). The duration of the licenses is to be 20 years. Under the proposal, a total of 10,500 machines would be licensed in Maryland, with 3,000 each at Pimlico, Laurel, and Rosecroft and 1,500 in Allegany County. The video slot gaming machines would be owned or leased by the state and monitored by a central computer owned and controlled by a new nine-member State Lottery and Racing Agency and Commission.

According to the Ehrlich proposal, the state would receive 63.9 percent of net proceeds, all of which would be earmarked for the Maryland Education Trust Fund (though, again, state revenues are fungible). The remaining net proceeds would be distributed as follows: 24.8 percent to racetrack owners, 5.8 percent for purse dedication, three percent to local governments as direct aid, 1.4 percent to the Maryland Bred and Standardbred Race Funds, 0.8 percent to the Maryland State Fair, 0.3 percent to Ocean Downs Racetrack, and $500,000 to gambling addiction services. The governor anticipates $45 million in gaming proceeds would go to the education trust fund in FY04, and that amount would rise to $800 million by 2006, when his administration projects total slot revenues could reach $1.3 billion.

It should be noted that, as this paper goes to print, the Ehrlich administration is reconsidering its proposal. Aides in the governor's office have indicated that a private research firm may be called in to research the industry and provide information to reshape the Ehrlich proposal.

Industry Proposal. At the request of Gov. Ehrlich, interested owners of the state's horse racing tracks offered their own proposal for slot legalization. Under their design, a total of 18,000 video slot gaming machines would be apportioned among five thoroughbred and harness racetracks at a combined initial licensing fee of $300 million. Gaming experts predict that this number of video slot gaming machines could generate upwards of $2 billion in revenue annually.

Four of the five racetracks that would have slots under the proposal are those that would also have slots under the Ehrlich plan; the fifth would be Ocean Downs, located in Berlin on the Eastern Shore. (Gov. Ehrlich is on record as opposing any video slot gaming on the Eastern Shore, as are legislators from that region of Maryland.) The Pimlico, Laurel Park, and Rosecroft Raceway tracks would be licensed for 4,500 video slot gaming machines under the industry plan; Ocean Downs and the new Allegany County racetrack would evenly split 4,500 slot machines (2,250 each). The racetrack owners also requested that the licensing fee be only an advance against net earnings, and that the advance would be deducted from the tracks' contributions to the state over a four-year period at $75 million per year.

The industry's proposal for dividing the net revenues is as follows: Approximately 45 percent of the profits would go to the five tracks as commissions for operating the video slot gaming machines; approximately 45 percent would go to the state of Maryland; and approximately 10 percent would be set aside for horse breeders, racing purses, and a variety of other interests, including the Maryland State Fair and the University of Maryland Animal Science Department.

The industry group has noted that, under its plan, the state would receive a higher percentage of revenues than other states allowing video slot gaming machines at racetracks. The racing industry proposal also suggests that the state reserve money to make improvements in the neighboring communities surrounding the racetracks.

Rawlings Proposal. Del. Howard Rawlings (D-Baltimore), chairman of the House Appropriations Committee, has circulated a draft bill that would authorize up to 10,000 video slot gaming machines at four of Maryland's racetracks. The bill would require racetrack owners to pay $500 million in licensing fees, and net proceeds would be divided up as follows: 50 percent to the state of Maryland; eight percent to local governments; eight percent for racing purses; and 34 percent to track owners.

Rawling's draft bill would open slot licenses to competitive bidding at any of the five commercial thoroughbred and harness racetracks, including Ocean Downs. A track could not actually begin to operate the machines until it receives a vote of approval from its resident county's lawmakers or from the local electorate through a countywide referendum.

ANALYSIS

To be sure, the legalization, licensing, and taxing of slots will generate significant income for the state of Maryland. Though not all of the money that players pump into the machines will represent new revenue (some will be entertainment money reallocated from other in-state activities), the higher percentage of net revenue from the machines going to the state vis-à-vis the taxes on other activities, the attraction of out-of-state players from Virginia, D.C., and Pennsylvania, and the retention of Marylanders who now go to Delaware and West Virginia to play video slots will all bring new money into state coffers.

Revenue Projections. But how much new money? Gov. Ehrlich's proposal envisions some $800 million dollars of state revenue generated per fiscal year. But an estimate by the Maryland General Assembly's fiscal experts forecasts that 10,000 video slot gaming machines would produce a total net revenue of between $870 million and $1.05 billion annually. Applying Governor Ehrlich's state tax of 63.9 percent to that forecast generates between $555.9 million and $642.2 million in annual state revenues, a revenue shortfall of between $244.1 million and $157.8 million annually. Legislative Services's Office of Policy Analysis director Warren G. Deschenaux has estimated that the state would need 13,500 video slot gaming machines to produce the revenue called for in Gov. Ehrlich's budget.

Delaware Comparison. The thoroughbred racetrack at Delaware Park Downs offers a relevant regional "real world" comparison. Delaware Park Downs, operating "coin in, coin out" video slot machines since August 1996, for FY02 had 2,000 machines in operation. The maximum bet allowable on each video slot gaming machine was $100 and the payout to winners was 92.4 percent of revenue. The machines were in operation for 363 days in FY02, during which the net proceeds averaged $135,527 per machine. In Delaware's case, the state collects 36 percent of the net revenues; that means that Delaware Park Downs generated roughly $100 million in state revenues in FY02. If 10,500 Maryland slots were to average similar returns then, with the state collecting 63.9 percent of the net revenue in accordance with the Ehrlich proposal, the machines would net the state more than $900 million—even better than the governor envisions.

However, the returns were not as good at Delaware's other two tracks that feature video slot machines—Dover Downs (2,000 machines) and Harrington Raceway (roughly 1,250 machines). It took the revenues from those two tracks together to roughly equal Delaware Park Downs' returns to the state, which means that Delaware's more-than-5,000 machines generated about $200 million in revenue for the state in FY02. If Maryland's machines were to offer similar returns then, under the Ehrlich plan with 63.9 percent of revenues going to the state, only a little more than $725 million a year would go to state coffers.

Pennsylvania Study Comparison. Another source of information for determining how much state revenue could be generated from the machines is an academic study that the owners of Pennsylvania's four thoroughbred and standardbred horse racing tracks contracted with Penn State University to produce. The Penn State researchers attempted to determine the combined economic impact if the state were to authorize 1,500 video gaming slot machines for each track. The study estimated that, if 6,000 machines were put into operation in Pennsylvania and if the Keystone State were to receive 25 percent of the net revenue, state proceeds would be $191 million dollars. The study[16] further projected that, if the number of video slot gaming machines increased to 2,500 per racetrack (for a total of 10,000), Pennsylvania's net proceeds would increase to $319 million. If the state's cut of the net proceeds would increase to 36 percent (as in the Delaware example), net proceeds for Pennsylvania would be $459 million. If video slots in Maryland would generate the same net revenue per machine as that projected for Pennsylvania in the Penn State study, then Maryland would receive about $850 million in revenue if it receives the 63.9 percent cut envisioned by Gov. Ehrlich.

The State's Cut. But, given that Delaware receives a 36 percent share of video slots' net revenue and West Virginia received a 38.5 percent share (FY02), is the Ehrlich proposal for a 63.9 percent state share of Maryland video slot net revenues realistic? Would the horse tracks agree to accept the machines if that large a portion of their revenue plus a hefty licensing fee would go to the state? And if the tracks do accept the machines, would they have to find other ways to earn profits from track visitors (e.g., higher food and drink prices, entrance fees, and other expenses) and lower track costs (e.g., cutbacks in staffing, capital improvements, services, amenities, etc., as well as setting the machines to a lower payback level to players) that could negatively affect slot revenues? That seems likely. Moreover, because of the high state cut of slot revenue, the horse racing industry in Maryland would remain at a severe competitive disadvantage with tracks in neighboring states—a disadvantage that the slots were supposed to alleviate.

Maryland probably could set its percentage share of the slot revenue at a level that would be competitive with other states and still achieve its annual revenue goal of $800 million. But to accomplish that, the state would have to authorize more machines than what the Ehrlich proposal would allow. Given similar parameters as Delaware (similar demographics, "coin in, coin out" machines, 363 operational days, $100 maximum bet, 92.4 percent payout, and a 36 percent state share of net proceeds), the numbers suggest that Maryland would have to license approximately 4,000 video slot gaming machines per track.

However, there is a very real concern that the Law of Diminishing Returns would trip up that calculation. Simply increasing the number of video slot gaming machines at a racetrack does not mean that revenue per machine will continue to be maintained. There will be declining revenue returns above a certain number of video slot gaming machines, although total revenues will continue to increase at a decreasing rate. Increasing the payout beyond 92.4 percent on video slot machines may modestly improve the annual net proceeds per machine; but unless the increase in payout is at least marginally offset by increases in revenue (from customer demand) per video slot machine, the overall impact may result in a decline in the state's share of net proceeds.

16. *The Economic Impact of Horse Racing on the Economy of Pennsylvania*, published by the Institute of State and Regional Affairs, Penn State University-Harrisburg, January 2002.

POLICY RECOMMENDATIONS

In light of the above discussion, it seems appropriate to offer several recommendations to the state of Maryland if lawmakers choose to authorize video slot machines. In order for the state to achieve desired revenue targets in a manner that benefits the gaming industry and enhances its competitiveness with other states, Maryland should consider the following:

- **Place slots at horse tracks only.** The concern of many Maryland residents with the proliferation of legalized gambling in their state is understandable, especially given the social problems that slot gaming wrought on Maryland in the post-World War II era. On the other hand, the state has had a horse racing industry (and legalized betting) since the 1920s. Furthermore, the state lottery has proven to be a successful source of state funding for Maryland government over the last 30 years.

  Because of its proximity to West Virginia and Delaware, many Maryland residents are presently spending their money in those states' racinos. Recapturing that lost revenue, as well as attracting the residents of the District of Columbia, northern Virginia, and southern Pennsylvania, is an attractive opportunity that Maryland has not seized up to this point in time.

  The looming budget deficit has brought that missed opportunity into focus. The social costs of expanded gambling opportunities always need to be considered; however, with similar gaming opportunities at adjacent state racinos already within an hour or two drive for Maryland residents, that concern carries much less weight. The economically embattled horse racing industry in Maryland, the recipient of annual multi-million dollar state subsidies, can become a greater contributor to the state's economy. In addition, because of the tracks' history of regulated gambling, no new facilities would be needed for the state to expand into video slot gaming if it goes the racino route. The case for expansion into racinos is compelling.

- **Set license fees to reflect auction pricing.** Gov. Ehrlich has suggested a total video slot license fee of approximately $350 million for four Maryland racetracks. Del. Rawlings wants $500 million in licensing fees from the four racetracks' owners. The state's horse racing industry has suggested $300 million for five racetracks, with that money then being deducted from the state's cut of net revenue.

  Those figures likely are an understatement of the market price for such proven, financially lucrative rights to "print money." An alternative would be to sell the licenses to racetrack owners at "shadow auction" prices (with no provision for repayment of fees to the industry), i.e., based on comparable selling prices at similar gaming venues in other states. The state of Maryland could contract with an independent economic consulting firm with a background in the gaming industry that could calculate the "shadow" auction price. That approach equitably benefits both the state's economically depressed horse racing industry and Maryland taxpayers.

- **Grant the industry a competitive percentage.** The issue of what percentage of net proceeds will be returned to the racetrack owners needs to be evaluated carefully. In Delaware, racetrack owners receive 49 percent of net proceeds. The horse racing industry in Maryland has suggested 45 percent, while Del. Rawlings uses a figure of 34 percent. The governor is offering only 24.8 percent to the racetracks, approximately half of what Delaware offers.

Will Gov. Ehrlich's offer to the racing industry attract much interest? Perhaps. However, the state of New York authorized video slot gaming machines in 2001 but has yet to attract industry interest because racetrack owners would receive only about 25 percent of net proceeds, which curiously is about what is being offered in Gov. Ehrlich's proposal. According to Maryland racetrack owners, they will be forced to spend as much as $200 million in capital expenditures to improve their respective facilities to attract gamblers. Also, with the state of Pennsylvania fertile grounds for racinos, the gaming attractiveness of Maryland could be reduced if the percentage of net proceeds to the industry falls below the 40 percent level.

The attractiveness of Maryland (including its proximity to the District of Columbia and northeastern Virginia) offers an opportunity for the state to negotiate a reduced industry net proceeds percentage. Some of the industry's concern can be offset by increasing the upper limit on the number of video slot gaming machines at each racetrack. Furthermore, a strong case can be made that reduced state licensing fees below the shadow auction price offsets a lower (i.e., below 40 percent) percentage of net proceeds offered to the industry.

- **Authorize 15,000 machines.** With an eventual target of $800 million in state net proceeds annually, a realistic approach to attaining that revenue goal is to allow for a maximum of 3,000 video slot gaming machines (a figure exceeding that found in Delaware and exceeding or equaling that found at West Virginia racinos) in the five thoroughbred and harness racetracks that have expressed interest. That approach would increase the geographic distribution of video slot gaming locations for Maryland residents and visitors while broadening economic assistance to the state's horse racing industry. Given that expansion, the five horse racing venues would have a combined 15,000 video slot gaming machines, creating a realistic opportunity of the state's net proceeds eventually approaching the governor's anticipated budget revenue figure (assuming an eventual 40 percent return to the Maryland Education Trust Fund, after deducting five percent for regulatory and operating expenses).

  The concern of some critics of expanding the maximum number of video slot gaming machines above 10,000 appears to be based on nothing other than a belief that more than 10,000 would somehow be excessive. Major casinos have between 2,000 and 4,000 video slot gaming machines, with an average of about 2,500. West Virginia presently allows 3,000 video slot gaming machines at its Mountaineer Park racino. The number of video slot gaming machines should be reflective of the best estimates of consumer demand. The question of limits on the number of video slot gaming machines needs to be negotiated between the state of Maryland and the industry. An arbitrary limit established on the basis of a "feeling" is ineffective public policy.

- **Realize that other states will compete for gaming dollars.** While the state of Maryland will, no doubt, benefit economically from expansion into racinos, its estimated share of net proceeds ($800 million annually) in future years needs to be re-evaluated. Pennsylvania's new governor has expressed a strong interest in authorizing racinos in his state, and West Virginia and Delaware likely will expand their offerings to include table games like blackjack and poker. If those changes occur, Maryland racinos will see a decrease in out-of-state traffic and more Marylanders will venture across state lines for gaming entertainment.

The "Arms Race." An additional point deserves elaboration here. It has been said that states are engaged in a sort of "arms race" in which each state has significant economic incentive to increase the number of gaming venues, expand the types of games offered, and boost the number of games at each venue. The states with the broadest assortment of legalized gaming opportunities will be positioned to capture the most revenue both for public coffers and private game operators. However, other states likely will move quickly to catch up to the gaming frontrunners.

There is, however, one very important difference between the nuclear arms race and the gaming race: It may not be a sensible strategy for states to refuse to participate in the gaming race. During the cold war, many nations abstained or were prohibited by treaty from developing and deploying nuclear weapons, or else only engaged in those activities to a small degree. As a result, those nations could redirect public and private money toward non-military purposes that potentially were more beneficial to the economy and the standard of living. But in the case of the gaming race, states that abstain from participating will not free up state revenue for other purposes; they will miss out on generating revenue that could then be used for beneficial and economy-expanding purposes. Unless the social costs of legalized gambling are far higher than the academic research discussed above has indicated, states that do not allow gaming will miss a significant opportunity, not avoid a spending quagmire.

CONCLUSION

Available data and academic research indicate that Maryland lawmakers face an historic opportunity: By authorizing video slot gaming at the state's horse tracks, Maryland could increase the entertainment offerings to consumers, provide new jobs, financially strengthen Maryland's horse racing industry, and create an important new source of state revenue.

Those gains may come at some social costs, but recent academic research indicates those costs would be modest (and Maryland gamblers already have access to legalized gambling both in the state—e.g., Lottery, horse tracks, and video slots that are already in place on the Eastern Shore—and across state lines at Delaware and West Virginia racinos and Atlantic City casinos). Some provisions should be made to control gaming appropriately; limiting the machines to state horse tracks where gambling already occurs seems to be one sensible provision. But there appears to be no persuasive reason for lawmakers to bypass this opportunity.

With that said, Maryland lawmakers must realize that the machines will not be the cash cow that they have sometimes been construed to be. The gaming industry—like most other industries—is highly competitive; if the state of Maryland attempts to take too large a share of the net revenue pie or too tightly regulate gaming activities, it will place Maryland tracks at a disadvantage to their out-of-state competitors. That, in turn, will diminish revenue for both the tracks and the state.

On the other hand, the licenses to operate the machines are valuable commodities, and Maryland should collect a licensing fee that reflects that value. To both ensure that the state receives the highest level of revenue that it can from the games and to nurture a healthy horse racing and gaming industry in the state, Maryland should study and position itself to better compete with the gaming industry of other states. In doing so, the Old Line State would better ensure that it maximizes the video gaming opportunity.

APPENDIX
HISTORY OF LEGALIZED GAMBLING IN AMERICA

The modern history of legalized gambling in the United States can be traced back to 1931 when the state of Nevada, its minerals-based economy in economic ruin, authorized virtually all forms of gaming (except lotteries) as a replacement for its exhausted mines.[17] The deepening depression of the 1930s forced many state governments across the country to search for new sources of revenue to replenish their treasuries. As a result, pari-mutuel betting (e.g., horse racing, dog racing, and jai alai) was legalized as a tax revenue source to help fund public services.

In 1963, New Hampshire authorized the first state lottery. The lottery trend swept the nation over the ensuing four decades and picked up steam as the twentieth century ended – the number of lottery states increased by over 50 percent between 1986 and 1996.[18] In recent years, those state lotteries have expanded to multi-state lottery pools.

For over four decades, Nevada remained the nation's only state authorizing casinos. But in 1977, New Jersey citizens voted to break that monopoly by authorizing the establishment of casinos in Atlantic City. The casino industry was touted as an urban redevelopment tool to assist in the economic regeneration of the once-proud beachfront community.

Between 1986 and 1996, the number of states authorizing casinos increased from two to 10, while the number of actual casinos outside of Nevada and New Jersey increased by over 300. Some of that rapid casino proliferation was a direct result of Congress passing the Indian Gaming Regulatory Act in 1988. As a practical result of the Act, gaming was authorized on Native American lands in 31 states. The heartland of America soon opened up to legalized gambling when, in 1989, Iowa authorized riverboat gambling. Illinois followed suit in 1990. By the onset of the new millennium, gambling firmly established itself as an accepted form of entertainment and commerce throughout most of the United States.

Overview of the Industry. In contrast to other countries, the U.S. government has had a long history of "benign" regulation of the gaming industry.[19] In general, gaming regulation has been left to the states, except where constitutional provisions prevail (e.g., Native American gaming activities), where there has been a concern for the involvement of organized crime (e.g., Gaming Devices Act of 1951, Crime Control Act of 1970), or where the federal government would have to settle a dispute between states (e.g., Professional and Amateur Sports Protection Act of 1992). Thus, gaming regulation has been viewed as most appropriate for state and local jurisdictions, with the federal government intervening only if there is an interstate matter of concern. It has maintained a neutral stance toward gambling and instituted a policy of non-enforcement, except

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17. Unless otherwise noted, the information in this section is drawn from the article "Gambling in the American Economy," by E.M. Christiansen. *The Annals of the American Academy of Political and Social Science*, No. 556 (1998).
18. "*Casinos de Juegos del Mundo*: A Survey of World Gambling," by W.N. Thompson. *The Annals of the American Academy of Political and Social Science*, No. 556 (1998).
19. This paragraph concerning federal regulation is drawn from Frey's 1998 article cited in footnote 2.

in the case of prohibiting the expansion of sports betting and restricting the transportation of gambling information or equipment across state lines.

Despite limited federal involvement, the gaming industry is one of the most heavily regulated of all industries in America. State regulation is designed to ensure the integrity of owners and operators of casinos through detailed background investigations and high standards of licensing control, and to preserve public confidence in the conduct of games through ongoing regulatory evaluation of operations.[20]

The extent of this regulatory control is highly dependent on the level and type of gaming permitted in a state, with regulatory oversight programs managed by an appointed commission typically having enforcement, investigation, audit and tax, and licensing divisions. The investigation division ensures the integrity of licensees, employees, and other parties who will be associated with casino operations. The enforcement and audit divisions are responsible for monitoring the proper operation of casino games. The enforcement division performs reviews of game supervision, surveillance, covert transactions, work card compliance, and also settles patron disputes. The audit function focuses on ensuring that casinos comply with required internal financial controls, while the tax function and licensing division collect taxes and fees and performs statistical analysis. The state attorney general's office traditionally functions as legal counsel to a state's gaming commission.

In 2001, 434 commercial casinos operated in 11 states—Colorado, Illinois, Indiana, Iowa, Louisiana, Michigan, Missouri, Mississippi, Nevada, New Jersey, and South Dakota. In addition, Native American-run casinos operated in 23 states. Approximately 365,000 people were directly employed by the commercial casino industry with wages totaling $11.5 billion; adjusted for Native American and racetrack casino employment, the 2001 jobs total rises to 577,000 directly employed nationwide.

Commercial casinos contributed state taxes of $3.6 billion in 2001, an increase of $147 million over 2000 revenue figures. Of additional interest, consumer spending on commercial casino gaming in 2001 was $25.7 billion, an increase of $1.2 billion over the 2000 figure. The increase can be attributed in part to new gambling opportunities in Michigan and Missouri and customer-friendly regulatory changes, such as the increase in the maximum bet in South Dakota.

20. This paragraph on state gaming regulation is drawn from Arthur Andersen's 1996 study *Economic Impacts of Casino Gaming in the United States*.

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