How Pennsylvania Got it Right

STRATEGIES FOR THE SUCCESSFUL INTRODUCTION OF GAMING

By Jennifer Day and Emily Oliver

In the post-recession economy, many states are considering new or expanded gaming operations as an additional source of tax revenue and job creation. Policy-makers must balance these two distinct and at times conflicting objectives with the nuanced interests of regional stakeholders, such as local politicians, raceway and lottery operators, and the various governmental departments that stand to benefit from the allocation of gaming tax revenue.

Making this complex issue more difficult to address is the penchant for states to change goals and effective tax rates over time. This creates uncertainty and risk, and can lead to major casino operators passing on developments where the tax system is considered unstable.

One state that has successfully and efficiently met this challenge is the commonwealth of Pennsylvania. After legalizing slots in 2004, Pennsylvania's gaming industry experienced eight years of consecutive growth. The state includes 12 gaming facilities that generated over $3.1 billion in both slot and table game revenues in 2012 and account for $1.4 billion in tax proceeds to the state.

Through deliberate planning and informed decision-making, Pennsylvania met its goals of maximizing gaming tax revenue, supporting its racetracks, and stimulating development and employment. As the number of states with legal gaming grows, including those now considering online, so does the variety of existing licensing and tax structures. While each state has its own unique needs, an analysis of how Pennsylvania got it right can provide valuable insights for legislators in other states.

The Keystone State did not realize its annual $3 billion-plus gaming market by chance. Here's how they got it done.

GOALS FOR GAMING

Lawmakers considering gaming all tend to focus on economic growth, revenues, jobs, increasing revenues for the state and facilitating economic growth while meeting the needs of influential stakeholder groups. In Pennsylvania these overarching objectives manifested themselves as three specific goals.

1) Generate $1 billion in tax revenues to offset property tax burden:

The primary impetus behind Pennsylvania's 2004 Race Horse Development and Gaming Act was to reduce the property tax burden in the state. Under pressure to reduce the property tax rate, Pennsylvania legislators began to move toward gaming as an alternate revenue source in the early 2000s. Policy-makers identified that Pennsylvanians were actually generating significant tax revenues through gambling, but revenues were going to the neighboring states of New Jersey, West Virginia and Delaware, where Pennsylvania residents were contributing to over $4.4 billion in net revenue that could be taxed by surrounding jurisdictions.

The commonwealth determined that in order to provide tangible property tax relief to Pennsylvania homeowners, they would ideally need to generate $1 billion in annual gaming tax revenue. The legislature engaged in a study to determine the locations and tax rates necessary to reach this figure. Christopher Craig, current general counsel to the Pennsylvania Treasury and former counsel to the state Senate Democratic Appropriations Committee, observed, "While political support determined most of the locations of licenses, it was the in-depth study that showed legislators where best to locate the remainder and determine the proper size for the casinos for the state to realize the $1 billion in tax relief it had promised from the program. We had the guidance to establish a feasible tax rate, allowing facilities to flourish in the long run while providing immediate taxpayer relief. At the time there was a lot of skepticism as to the projection, but the naysayers were wrong. The estimates proved correct."

2003 Regional Competition for Pennsylvania

	Machine Revenues	Machines	Win per machine
Charles Town	$220,985,043	2,700	$224.24
Delaware Park	$268,209,000	2,000	$367.41
Dover Downs	$186,893,500	2,000	$256.02
Harrington	$110,807,400	1,339	$227.30
Atlantic City	$3,258,239,958	37,760	$236.41
Total	$4,419,015,113	50,389	$240.27

Source: Delaware Lottery Games, West Virginia Lottery, New Jersey Division of Gaming Enforcement, The Innovation Group

2) Bring a revenue base to the racetracks:

A secondary motivation behind Pennsylvania's gaming legislation was to bring a revenue base to the states' racetracks. Pennsylvania racetracks were losing revenue and horses to out-of-state competitors where slot machine revenue subsidized purses, making it increasingly difficult for Pennsylvania tracks to compete.

3) Incentivize development and job growth:

Tangential to the first two goals was the desire to stimulate the economy and create jobs.

DETAILS, DETAILS

In designing the Pennsylvania Gaming Act, legislators took a rational approach to meeting their primary goals. In 2003, the Senate Democratic Appropriations Committee commissioned a comprehensive gaming market analysis for the state, requiring: Seven of the state's 12 licenses will be assigned to racetrack locations, six of which had been predetermined. Of the five additional licenses (non-racino), two will be assigned to Philadelphia and one to Pittsburgh.

Given these parameters, the legislature needed to know three things—the most advantageous locations for the remaining three licenses, the maximally profitable size for all 12 facilities, and the tax rate needed to generate $1 billion in property tax relief.

The consultant team considered and analyzed multiple development scenarios, several of which brought in nearly $1 billion in annual tax revenues assuming approximately 30,000 machines and a 34 percent tax rate. In terms of the locations, it was recommended that of the additional three licenses, two be assigned to the Poconos region with the final license located near the Maryland-Pennsylvania border. This scenario had largely manifested itself by 2010 with one major exception; two of the 12 licenses in the above scenario have not been awarded, and therefore are not generating revenue.

Statewide Machine Revenues: 2003 Report vs. 2010 Actuals

	2006 Proj.	2010	Difference	Difference %
PARX	$307,763,421	$382,978,796*	$75,215,375	24.4%
Chester	$233,514,145	$287,176,968*	$53,662,823	23.0%
SugarHouse	$656,058,607	$166,416,527*	-$489,642,080	-74.6%
Philadelphia Area Subtotal	**$1,197,336,173**	**$836,572,290***	**-$360,763,883**	-30.1%
Penn National	$182,214,268	$253,403,976	$71,189,708	39.1%
Mohegan @ Pocono	$90,151,538	$224,762,570	$134,611,032	149.3%
Mt Airy	$92,715,175	$143,811,645	$51,096,470	55.1%
BethSands	$241,797,391	$258,735,860	$16,938,469	7.0%
Eastern Region Subtotal	**$1,804,214,545**	**$1,717,286,341**	**-$86,928,204**	-4.8%
The Meadows	$153,329,630	$249,131,455*	$95,801,825	62.5%
The Rivers	$369,184,791	$274,128,075*	-$95,056,716	-25.7%
Pittsburgh Area Subtotal	**$522,514,421**	**$523,259,530**	**$745,109**	0.1%
Presque Isle	$113,790,574	$170,387,248	$56,596,674	49.7%
Western Region Subtotal	**$636,304,995**	**$693,646,778**	**$57,341,783**	9.0%
Total	$2,440,519,540	$2,410,933,119	($29,586,421)	-1.2%

*Source: Pennsylvania Gaming Control Board; Innovation Group. *Note: Annualized based on most recent performance (Jan-April)*

The legislature embraced the 34 percent tax rate as the base rate necessary to raise $1 billion annually in tax rate relief. Additionally, Pennsylvania policy-makers allocated an additional 12 percent of gaming revenues to the horse-race industry.

While not the highest percentage share of slot revenues assigned to the horse industry from the racino/casino gaming business sector, the projected absolute dollar amount ranked first in the country. Revenues distributed to local governments and the Race Horse Development Fund brought the effective tax rate to 55 percent. At the time, this was the highest effective gaming tax rate of any state. Although these slots-only facilities proved to be highly successful, observers have noted that they were relatively lacking in amenities compared to facilities in neighboring states with lower tax rates. This provides a clear example that when effective tax rates reach these levels, amenities will be sacrificed to obtain a positive return on investment.

Despite the lack of a second Philadelphia facility and the economic downturn, gaming revenues were similar to what had been projected (excluding the final, unassigned license), as indicated in the table above. Pennsylvania's eastern market had seven facilities in operation in 2010, forming a veritable barrier to Atlantic City and Delaware, particularly in the Philadelphia area submarket. Even without the second Philadelphia license, the Philadelphia area facilities were on course to generate over $836 million through slot revenues alone in 2010.

The western market, including the Pittsburgh sub-area, was performing slightly better than anticipated, with its three facilities generating annualized slot-only revenues of nearly $700 million. The impact of these new facilities on the neighboring competition was apparent, with revenues in New Jersey declining by $1.6 billion and West Virginia experiencing a 1.6 percent average annual rate of decline between 2006 and 2010.

Although performing well, Pennsylvania was facing an increasingly dynamic competitive environment. In 2008, Maryland legalized video lottery terminals at five facilities. The first facility opened in Perryville—just 26 miles from the Pennsylvania border—in late 2010. Ohio followed suit in 2009, legalizing both slots and table games, opening the first of the four current facilities in May 2012.

While Pennsylvania's decision to locate casinos along state borders to encourage in-state gaming was rational, it also left Pennsylvania facilities vulnerable to out-of-state competition close to the border. As other states expand gaming operations, new casinos could pull from the existing Pennsylvania markets, especially among non-Pennsylvania residents of those states. Beyond staying competitive, job creation became a compelling goal in reaction to the recession.

As Christopher Craig noted, "It was necessary to convince state legislators that once on board with the program, they would be the single greatest stakeholder in the gaming industry, and the onus was on them to stay involved and to provide the industry with all the tools it needed to compete in order to protect this critical state revenue stream." This they did.

EXPANDING ECONOMIC IMPACT

In January 2010, Pennsylvania updated the Race Horse Development and Gaming Act to permit the sale of table game licenses. The impetus behind this change was twofold: First, policy-makers wanted to increase the attractiveness of the existing facilities to remain viable in an expanding competitive market. Second, the addition of table games would spur job growth. Both of these goals required that the operators retain a significant portion of the revenues generated by the table games.

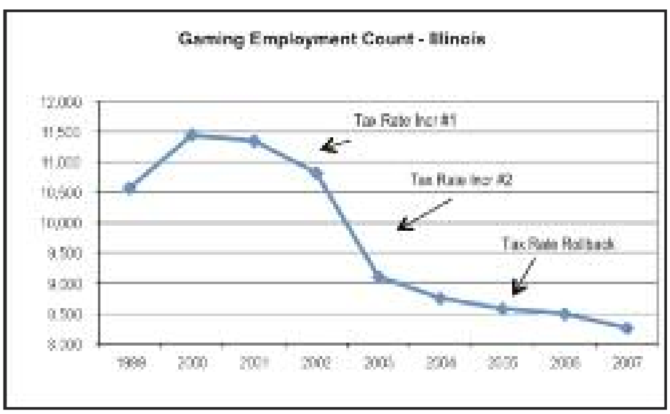
Labor-intensive table game operations provided the impetus for expanding facilities or adding job-creating amenities such as hotels and entertainment venues which in turn draw table game players. These amenities, coupled with the draw of the games themselves, can lead to a significant increase in visitation, revenues, and the overall economic footprint of the facility. Because table games are 10 times more labor-intensive than slots, operating costs are very high, and if taxed excessively, table games become a drain on an operator's budgets and can lead to a decline in services, quality and net revenues.

As such, the legislature made the contentious but astute decision to tax table game revenues at a significantly lower rate than slot revenues. Although facing pressure from the horse-racing industry to place an additional tax on table game revenues to further subsidize the racetrack and equine industries, legislators settled on a relatively low rate in which the majority of gaming tax revenues went to the Pennsylvania Budget General Fund. As indicated in the pie chart below, gaming facility operators in the state retain 86 percent of their table game revenue—nearly double the share they retain for slots.

Pennsylvania's bifurcated tax rate reflects the state's specific goals and the policy-makers' understanding of the gaming industry. The high tax rate placed on slot revenues is balanced by the relatively low tax rate applied to table game revenues.

Pennsylvania Senator Tim Solobay observed, "The decision to add table games came during the Great Recession when Pennsylvania, like many other states, was suffering from high unemployment. It was largely the study done on behalf of the operators that convinced legislators that by allowing table games we could create critically needed jobs and would help protect our existing casinos from external competition. Once again the estimates made in the study have been met and nearly 10,000 Pennsylvanians have benefited accordingly."

Tax rates in Pennsylvania have been stable. This consistency has allowed Pennsylvania to aggressively generate tax revenue while providing a predictable tax rate for investors. Although higher than some states, a stable rate encourages investors by removing uncertainty. The oft-cited case study of Illinois, which altered its tax rates three times between 2002 and 2005, shows the lasting negative impact that tax shifts can have on the economic footprint of the gaming industry.



At least one state has followed Pennsylvania's lead in terms of gaming tax policy. Maryland implemented an effective tax rate of 67 percent on slot revenues in 2008, but the legislation that legalized table games in 2012 applies a tax rate of 20 percent. However, the fact that these rates were higher resulted in less than desirable facilities and long delays in implementation.

As Pennsylvania was introducing table games, it also restructured the funds being allocated to the Race Horse Development Fund. As noted, the percentage of slot revenues committed to the horse racing industry is not the highest in the country; however, the absolute figures are quite substantial. Due to the success of the fund, in January 2010, 34 percent of the Pennsylvania Race Horse Development Fund was allocated outside of the racing industry and put in the General Fund.

GAMING IN PENNSYLVANIA TODAY

Pennsylvania has nearly met the original goals set for the establishment and eventual expansion of gaming by using a rational approach to set gaming tax rates and determine the proper number and location of gaming licenses. Total gaming revenue in 2012 reached over $3.1 billion, generating $1.4 billion in gaming taxes. Of that total gaming revenue, $2.4 billion was generated by slot machines, providing Pennsylvanians with $840 million in property tax relief. Although shy of the original goal of $1 billion, this goal is expected to be met as the remaining facilities open across the state.

Currently, 12 of the 14 designated licenses have been granted. Of the two remaining licenses, six applications are being reviewed for the second Philadelphia license and the remaining non-resort license has yet to be determined. Although the Pennsylvania Gaming Control Board hopes to award the Philadelphia license in 2014, there has been some opposition to the project. In July 2013, a group of investors in the Sugarhouse casino brought suit against the Pennsylvania Gaming Control Board challenging the ability of the board to re-issue the Philadelphia license. The original license was revoked in 2010, after the Foxwoods Development Company failed to secure financing by the deadline.

In addition to generating funds for property tax relief, gaming activities generated $7.6 billion for the Race Horse Development Fund from November 2006 to December 2012. This revenue has been used to increase purses, improve facilities and further incentivize the horse racing industry across the state, making Pennsylvania a leading state in the horse racing industry. Total purses paid have steadily increased in the last five years from $177.9 million in 2008 to over $218 million in 2012, making racing more competitive and exciting.

Although the primary goal of introducing gaming to Pennsylvania was the generation of tax revenue, the industry has also spurred economic development and the creation of jobs. According to the AGA's 2013 annual report, in 2012 casinos paid employees $339.77 million (including tips and benefits), while employing 10,162 people across the state. Pennsylvania casinos also generate additional spending on local goods and services, local taxes and charitable contributions.

Since entering the market, Pennsylvania has seen gaming revenues grow even as other states have seen dwindling numbers. Delaware, New Jersey and West Virginia all saw revenues decline throughout the past several years, with New Jersey also forced to deal with the impacts of Hurricane Sandy.

Gaming Revenue 2011-2012

	2011	2012	Change
Delaware	$552.37 million	$526.67 million	-4.7%
Maryland	$155.71 million	$377.81 million	142.6%
New Jersey	$3.32 billion	$3.05 billion	-8.0%
New York	$1.26 billion	$1.8 billion	43.1%
Ohio	N/A	$429.83 million	N/A
Pennsylvania	**$3.02 billion**	**$3.16 billion**	**4.6%**
West Virginia	$958.7 million	$948.81 million	-1.0%

Source: Gaming Revenue Boards, The Innovation Group

Nearby states are likely to continue to expand gaming activities, and Pennsylvania will need to continue to reassess goals and strategy along the way. The landscape continues to change; i-gaming is being explored by Pennsylvania and is already legalized in the nearby states of New Jersey and Delaware.

As Pennsylvania potentially moves into this channel, it can benefit by taking the same rational and intentional approach it has taken in the past. By doing so it will help protect its existing markets, develop expertise, drive customers from online offerings to land based casinos in the state, generate an additional revenue stream, and develop the skills necessary to compete nationally should that day come.

In a broader sense legislators in Pennsylvania (and indeed any state) should continue to view themselves as the primary stakeholders in the industry and should constantly be seeking ways to expand and protect this revenue stream.