

**Submission to Productivity Commission Inquiry into Gambling**

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## **Introduction and summary**

Gambling policy in Australia is riddled with contradictions. Governments which established monopoly powers over gambling so as to control the social evils it causes are now doing their best to promote those evils. At the same time as the scope of competition policy is being extended more widely than ever before, the ancient abuse of the sale of monopoly privileges is being revived on a large scale.

The central theme of this submission is that existing policies are both economically irrational and socially damaging. Regressive and arbitrary gambling taxes, and the implicit taxes associated with monopoly exacerbate the social damage caused by excessive gambling.

The main conclusion is that gambling monopolies should be abolished and that policies should be developed to minimise problem gambling through restrictions on advertising and the design and operation of gambling services and venues.

## **Historical background**

Fifty years ago, most forms of gambling were illegal in Australia. The main exception, on-track betting on horse racing, was inaccessible to the majority of ordinary people. All other forms of gambling were prohibited on the basis of 'moral' arguments that gambling was inherently wrong, or on the basis of 'paternalist' arguments that gamblers needed to be protected from themselves. The exemption for racetrack betting reflected the traditional policy of suppressing the vices of the poor but not those of the rich. Not surprisingly illegal forms of gambling such as SP (starting price) betting flourished. A series of changes in government policy have fundamentally changed this situation.

First, governments concluded that the prohibitionist policy was unsustainable and decided to offer strictly controlled legal gambling. A typical instance was the change in policy in South Australia which, under the Playford government had followed some of the most restrictive gambling policies in Australia. The South Australian Totalisator Agency Board (TAB) and the South Australian Lotteries Commission (SA Lotteries) were established in 1967. To minimise opposition, surpluses derived SA Lotteries were hypothecated to the State's Hospitals Fund. Similarly, 50 per cent of surpluses from TAB were paid to the racing industry.

Initially, the behavior of the monopoly gambling enterprises was consistent with the paternalist rationale under which they had been established. Gambling was not advertised and few attempts were made to expand the market. Moreover, having provided legal outlets for gambling, in the form of a public monopoly, governments were fairly effective in suppressing illegal alternatives. Thus, the policy change was generally seen as successful.

However, the income stream associated with these monopoly enterprises has proved irresistible and has been exploited both to extract steadily increasing amounts of revenue from gamblers and to confer a variety of political favours. Constraints on advertising were abandoned and new forms of gambling were introduced, not to suppress illegal alternatives, but to increase the total flow of revenue. The general trend towards corporatisation further tended to focus the management of publicly owned gambling enterprises on the objective of maximising profits, without regard to social consequences.

The final stage of this process has been privatisation. Governments have sought to convert cash flows into lump sums by selling their monopoly powers to private individuals and corporations. Although there has been long-standing private involvement

in the provision of lotteries, the process has been accelerated with the sale of TAB enterprises in several states.

### **General observations on the sale of monopolies and taxes**

The sale of monopoly privileges to raise government revenue has a long and tawdry history. The Stuart kings of England, James I and Charles I, used the sale of monopolies on such items as soap, glass and playing cards as a way of raising revenue without parliamentary approval. Parliamentary objections to these and similar financial expedients were the main cause of the Civil War which led to the execution of Charles I. The grant of monopolies was subsequently confined to the patent system to reward inventors and monopoly trading privileges granted to groups such as the East India Company.

The Bourbon monarchs of France went one step further, selling the right to collect taxes to private individuals and companies. As in England, the consequences were dire. The abuses practised by the 'tax farmers' who bought these right to collect taxes were among the causes of the French revolution.

Economists from Adam Smith onwards condemned the practise of creating and selling such artificial monopolies. Analysis showed that a legal monopoly was equivalent, in economic terms, to the right to collect a tax. However, whereas most taxes were designed to achieve a balance between the objective of raising revenue and the desirability of minimising the burden of taxation, monopoly prices were set with the sole objective of maximising revenue.

This analysis led economists to be highly critical of monopolies. Gradually, however, it was recognised that some industries were 'natural monopolies' in which efficiency was maximised if the entire market was served by a single firm. The first recognised example of a natural monopoly was the railway industry and the analysis was

later extended to infrastructure industries such as electricity and telecommunications. By contrast, monopolies created by restrictive legislation, or by the creation of barriers to entry may be regarded as ‘artificial monopolies’. Australian governments in the 1990s have broken up natural monopoly industries in the interests of competition. Simultaneously, they have created and sold artificial monopolies in the gambling sector to raise revenue. This contradictory policy is, in part, a historical accident and in part the result of a lack of understanding of the economics of the gambling industry.

### **The case against sale of artificial monopolies**

The case against the sale of artificial monopolies and rights to collect taxes has a number of main elements

\_ Artificial monopolies are undesirable *per se*

\_ The sale of monopolies creates contractual obligations which improperly bind the hands of future governments

\_ Corruption and misuse of monopoly power is encouraged and the possibility of redress through democratic monopoly processes is removed

*Artificial monopolies are undesirable*

Most economists favour an approach to taxation in which taxes on goods and services are levied at a uniform rate, except where considerations of equity or practicality create a need for special treatment. The creation of artificial monopolies, or rights to collect revenue-maximising taxes, is inconsistent with this policy objective. The effective tax rate on goods or services subject to artificial monopolies is much higher than the rate applied to other goods. For example, as will be shown below, the effective rate of tax on lottery and totalisator gambling services is more than 100 per cent, whereas existing indirect taxes on most goods and services amount to less than 20 per cent of the retail

price and a uniform goods and services tax would probably be levied at a rate of around 10 per cent. Such variations in effective tax rates are inefficient.

Historically, artificial monopolies have most commonly been applied to items that are widely consumed, even if they may be stigmatised, in puritanical terms as unnecessary luxuries. The resulting taxes are therefore highly regressive. Poor households spend about as much on lottery and totalisator gambling in absolute terms as rich households, and a much higher proportion relative to their income. On the other hand, forms of gambling favoured by high-income groups such as speculative investments on share and futures markets are subject to little or no tax.

#### *Binding the hands of government*

Regardless of the rationale for high taxes on gambling the structure of taxation of is in serious need of reform. The taxation of gambling in its various forms is a crazy quilt, with a mixture of explicit taxes, public monopolies and the allocation of private monopoly rights in forms of gambling such as poker machines. There is no attempt to achieve any consistent definition of the tax base or equalisation of tax rates across different forms of gambling.

The effect of selling monopoly rights is to set these policies in concrete. Even if a future government wishes to reform the taxation of gambling, it will be bound by the contractual agreements undertaken when the monopoly was sold. Hence, governments will have little choice but to allow bad taxes to remain in place.

The anti-competitive aspects of gambling monopolies are under investigation by the Industry Commission and the Australian Competition and Consumer Council. It is unlikely that the breach of competition principles inherent in these monopolies will be found to have a social justification.

Governments which sell monopoly privileges are therefore subjecting their successors to potentially contradictory obligations — contractual commitments to private

monopolists and to the requirements of the Competition Principles Agreement. Retention of monopoly privileges may make the state liable for the loss of financial assistance grants under the Competition Principles Agreement, while removal of monopoly privileges may leave the government liable to pay compensation to monopolists or face legal action for breach of contract. In most cases, the costs of compensation for breach of contract will be greater than the value of the stream of monopoly profits that have been sold.

Even if the existing structure of gambling taxes and monopolies were defensible, it is anti-democratic to bind the hands of future governments through the creation of long-lived monopoly privileges.

#### *Corruption and misuse of monopoly powers*

The sale of monopoly privileges creates powerful financial interests entirely dependent on government protection for their income. This is a recipe for bad government. The consequences have been seen most evidently in the Kennett government's dealings with Crown Casino, but have also emerged in a number of other cases.

#### **Social harm associated with gambling**

The majority of Australians engage in some form of moderate gambling without suffering any harm. At the levels of expenditure typical undertaken most Australians, gambling is a fairly low-cost recreational activity. However, a significant minority of people gamble to the extent that they encounter significant financial difficulties as a result of their losses. The distribution of gambling expenditure is illustrated by Figures ... taken from a study of Queensland casino patrons (McMillan, Quiggin and Ryan 1996)

As can be seen, only 2 per cent of respondents spent more than \$1000 on machines and only 13 per cent spent more than \$1000 on table games in a 12 month period. Thus, only a small minority of casino patrons could be regarded as potential ‘problem gamblers’.

However, this small minority is crucial to the profitability of the gambling enterprise. The 2 per cent of gamblers spending more than \$1000 on machines account for more than 25 per cent of the casino's total income from machines. The 13 per cent of gamblers spending more than \$1000 account on table games for more than 50 per cent of total income from table games.

It follows that casinos and other providers of gambling services would face significant revenue losses in the absence of the minority of heavy gamblers, including problem gamblers. In the absence of deliberate policies to curb heavy gambling, market forces will lead to the adoption of advertising and design policies conducive to heavy gambling.

A number of features of the standard design of casinos illustrate this point. Casinos are typically windowless rooms with no clocks or natural light. This is clearly designed to create a 'timeless' atmosphere in which patrons will be encouraged to gamble continuously, to seek to maintain ‘lucky breaks’ and to recoup the money lost in ‘bad runs’. Broadly similar features apply in other venues with large-scale machine gambling, such as the larger licensed clubs.

More generally, it is clear that the advertising undertaken by the providers of gambling services seeks to encourage and promote the irresponsible attitude characteristic of heavy gamblers. The slogan used by Queensland PubTAB ‘How do you expect to get rich if you just drink and watch TV?’ is a striking, but not atypical example.



In summary, gambling causes significant social damage, and existing gambling institutions tend to exacerbate that damage.

### **Gambling taxes are an inappropriate way of reducing the social harm associated with gambling**

Many countries have imposed heavy taxes on gambling. Several different rationales have been proposed for such taxes, including

- (i) the idea of ‘sin taxes’;
- (ii) a paternalist argument that people need to be protected from themselves;
- (iii) the argument that these activities generate negative externalities for the community as a whole; and
- (iv) an efficiency-based argument based on the claim that goods and services for which demand is inelastic should be heavily taxed.

The arguments for and against heavy taxes on goods for which demand is inelastic are discussed by Quiggin (1998). Any putative efficiency advantages of a tax policy of this kind are more than offset by the equity costs associated with the fact that low price elasticity of demand is normally associated with low income elasticity of demand. Hence, taxes on inelastically demanded goods and services are usually regressive.

Attention will focus, therefore, on the first three rationales.

In its pure form, the idea of sin taxes must be rejected as incompatible with the basic principle of liberal democracy that, provided they do not harm others, or irrationally harm themselves, people should be free to do as they choose. Even if the principles of liberal democracy are not regarded as binding, the idea that gambling should be punished by the use of sin taxes is . The majority of Australians do not regard smoking, drinking and gambling as morally wrong. Most people accept and engage in moderate gambling and regard heavy gambling as foolish rather than immoral.

Moreover, the actions of Australian governments have completely undermined the 'sin tax' rationale for gambling. Whereas some attempts are made by governments to discourage smoking and excessive drinking, gambling has been enthusiastically promoted by governments seeking to maximise the revenue that can be generated from this source.

The paternalist rationale for taxation of gambling is subtly different from the sin tax rationale. Paternalists may accept the basic idea that individuals should be free to pursue their own preferences, but argue that with respect to certain addictive activities, individuals cannot accurately determine their own best interests. Hence taxation may be justified on the basis that individuals are discouraged from participating in these activities, or from participating to excess.

Two difficulties arise with a paternalist defence of gambling taxes. The first is that, as already observed, the imposition of paternalist taxes on an activity is not consistent with active promotion of that activity. Governments must either stop encouraging gambling or abandon the paternalist rationale for taxation.

The second problem is more subtle. The object of a paternalist tax is to prevent individuals from harming themselves. In the case of taxes on tobacco and alcohol, it may be argued that the high rate of taxation reduces consumption of dangerous drugs and therefore reduces health damage. In the case of gambling, however, the principle source of damage is the financial loss associated with excessive consumption of gambling services. If, as is generally assumed, the demand for gambling services is price-inelastic, particularly for 'problem' gamblers, the imposition of a tax will lead to an increase in net losses and therefore to an increase in the damage suffered by gamblers. Gambling taxes are not appropriate instruments for a paternalist policy. At most, such taxes might play the supportive role of providing funding for services aimed at controlling excessive

gambling. In the absence of any significant public provision of such services, the issue is moot.

Economists are generally unsympathetic to the ideas of sin taxes and paternalist taxes. Where taxation is aimed at changing behaviour, economists generally seek to analyse the justification of such taxation in terms of (negative) externalities, that is, adverse effects of the behavior of one person on the welfare of others. Taxes on the consumption of alcohol and tobacco may also be justified in terms of externalities. Consumption of these goods generates some classic Pigovian externalities. Second-hand smoke creates both discomfort and health risk for bystanders. The consumption of alcohol is associated with dangerous driving and with generally antisocial public behavior.

An externality rationale for gambling taxes is hard to justify. People who gamble heavily reduce the amount they have available to spend on other goods and services. Other members of the gambler's household are also likely to be adversely affected. But, unless gamblers incur bankruptcy, or steal to finance gambling, there is no negative external effect on anyone outside the household. There are externalities within the household, but taxes will make these worse, not better.

Regardless of the rationale for high taxes on gambling and alcohol, the structure of taxation is in serious need of reform. The taxation of gambling in its various forms is a crazy quilt, with a mixture of explicit taxes, public monopolies and the allocation of private monopoly rights in forms of gambling such as poker machines. There is no attempt to achieve any sort of consistent definition of the tax base or equalisation of tax rates across different forms of gambling.

## **Policy recommendations**

The main policy recommendations to follow from the analysis presented above are straightforward.

- \_ Monopolies and high taxes are an inappropriate way of controlling the social damage caused by gambling

- \_ Existing gambling monopolies should be abolished as anti-competitive.

- \_ In line with the general principles of competition policy, the holders of private monopoly rights should not be compensated for their abolition

- \_ The tax component of existing monopolies should be made explicit

- \_ Taxes on gambling should be harmonised and, over time, reduced to levels comparable with those applicable to other services

- \_ Providers of gambling services should be required to act in a way which minimises problem gambling. In particular,

- \_ advertising of gambling services should be prohibited

- \_ lottery games should be designed to promote small rather than large bets

- \_ opening hours of gaming venues should be restricted, and casinos should be required to display clocks and where possible to admit natural light

- \_ existing and new forms of gaming should be subject to social impact tests.

Gaming forms that encourage moderate betting should be encouraged and others discouraged

- \_ similar restrictions should apply to new and existing gaming machines

- \_ services to assist problem gamblers should be expanded and financed from gambling taxes

Because of the excessive dependence of state governments on revenue from gambling taxes and monopolies, it will be difficult to introduce all of these recommendations immediately. However, the abolition of private gambling monopolies should be a first step. A situation where long-established institutions are being abolished

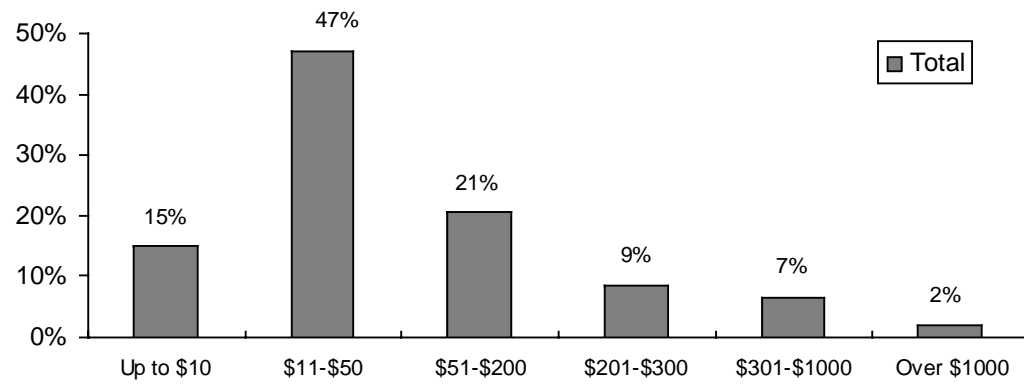
as anti-competitive, without compensation or effective consultation, while large corporations profit from newly established monopolies, is politically and morally unacceptable.

## **References**

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### \$ Spent at Casinos on Machines in Past Twelve Months



### \$Spent at Casinos on Table Games Past Twelve Months

