Fiscal and Economic Benefits of Legalizing Internet Poker in California

Summary

We estimate that legalizing internet intrastate poker in California as proposed by SB 51 and SB 678 would result in additional state revenues over the first five years of $845 million. In 2015 it would also increase California's total economic output by $334 million and add 1,952 jobs, with annual amounts growing in subsequent years. Our estimate is based in part on our review of previous estimates of proposals to legalize internet poker in California and in part on new data provided by industry experts that take into account the changes in the illegal internet poker market since "Black Friday".

SB 51 and SB 678

Senate Bills 51 and 678, pending in the Legislature, each legalize internet poker, place a 10-percent tax on gaming revenues and allow any firm to seek authorization to operate a site that is subject to specific regulation. Both bills stipulate that operates of such sites must maintain the physical plant and the employees inside the state and serve only players located within the state's boundaries.

Background

Poker has been a popular game in America since the early 1800's, but this popularity was mostly confined to casual gamblers in homes and social clubs. By 1970, for example, there were still only 50 poker tables in the entire city of Las Vegas. That changed dramatically with the television debut of the World Series of Poker (WSOP) in 1973. The WSOP and its emulators fostered a boom in casino-based poker playing.

With the emergence of the internet, poker went on-line in the early 2000's. But poker did not really take off as a popular on-line gaming option until 2003 when a then unknown -- Chris Moneymaker -- won a chair at the WSOP through a $40 round on PokerStars.com and went on to beat out 838 other contestants and win $2.5 million.

In 2006, Congress enacted the Unlawful Internet Gambling Enforcement Act (UIGEA), which made internet gambling illegal in the USA. However, the federal government did not undertake any significant enforcement actions to shut down offshore sites that accepted US players until "Black Friday" -- April 15, 2011. See the nearby box for a history of UIGEA and Black Friday. After Black Friday, internet poker play in the USA came to a virtual halt.

UIGEA and Black Friday

Congress enacted the Unlawful Internet Gambling Enforcement Act (UIGEA) in 2006, presumably in reaction to the rapid growth of internet gambling during the first half of the decade. UIGEA defines unlawful internet gambling as "to place, receive, or otherwise knowingly transmit a bet or wager by any means which involves the use, at least in part, of the Internet where such bet or wager is unlawful under any applicable Federal or State law in the State or Tribal lands in which the bet or wager is initiated, received, or otherwise made." However, UIGEA and the implementing Regulations, jointly issued by the Federal Reserve and the Department of the Treasury, provide for an intrastate exemption. The exemption requires that the bet or wager be initiated and received or otherwise made exclusively within a single State and certain other conditions are met (primarily that the bet is otherwise legal in the state).

Initially, the federal government did not enforce UIGEA in any substantial way. As a result, after an initial sharp reduction, the internet poker market soon rebounded. However, on April 15, 2011 -- now known in gaming circles as "Black Friday" -- the Department of Justice issued indictments against the founders of PokerStars, Full Tilt Poker, and Absolute Poker as well as entities involved in the transfer of funds to those sites. The elimination of these sites, which were the largest US-facing sites, accounting for over 90 percent of all on-line poker gaming, virtually eliminated the illegal internet poker market in the USA, although a few small sites continue to provide illegal real-money poker play.

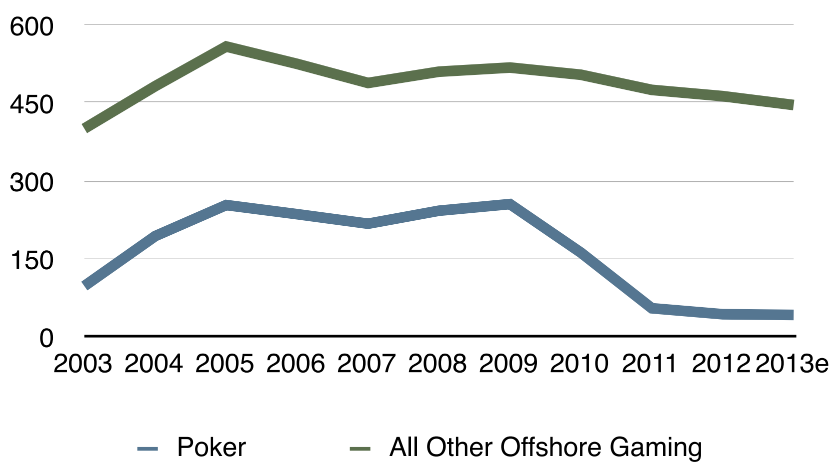
Figure 1 displays the history of offshore internet gaming by Californians in terms of Gross Gambling Revenues[1] (GGR) for poker and for all other gaming (sports betting, casino games, bingo, etc.). The figure shows the rapid rise in internet gaming by Californians in the early part of the last decade and the slight decline as UIGEA was enacted. More than likely, the slight increase in poker in particular from 2007 to 2009 resulted from players realizing that the federal government was not making significant efforts to enforce UIGEA. The chart also shows that after black Friday, poker play dropped off precipitously, while other gaming only declined slightly. The fact that players on the three major poker sites that were shut down by the DOJ lost $175 million in deposits and the fear that such actions could eventually extend to other internet real-money games probably accounts for the reduction in non-poker offshore gaming.

Figure 1

California Offshore Gaming

Gross Gambling Revenues

(dollars in millions)



Previous Estimates of Internet Poker Volume and Tax Revenues

There have been several studies of proposals to allow legalized intrastate internet poker in California. As Figure 2 illustrates, these studies have produced a substantial range of estimates regarding the volume of play, the revenue to be generated by a tax on GGR and by the increased economic activity generated by the legalized sites.

Offshore Play Estimates

The estimates of the volume of play on offshore sites vary significantly for several reasons. Genest Consulting[2] and Blue Sky both used projections for off-shore GGR in 2011, while LECG used projections for 2012. Genest Consulting's projections were provided by Global Betting and

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[1] Gross Gambling Revenue (GGR) is the most common measurement of the volume of internet gaming. It consists of the "rake" (a percentage of each winner's pot taken by the site, usually 1 or 2 percent) for "ring" games (cash) and the entry fee for tournaments. The data shown on the table reflect estimates by H2 Gaming Capital. All of the legalization proposals for California have proposed to impose a tax as a percent of GGR.

[2] Genest Consulting was the precursor to Capitol Matrix Consulting, the author of the current report.

Gaming Consultants (GBGC) while LECG's were "derived from" estimates provided by H2 Gaming Capital[3]. These are the two leading firms worldwide that track and project the activity of internet gaming sites. While Blue Sky relied on GBGC for some per-player dollar figures, they also used the results of direct surveys of Californians to project the numbers of players.[4] Each of these approaches is reasonable and the range of projections they provide simply reflects the fact that there will always be significant uncertainty in estimating the volume of any illegal activity. Moreover, as LECG stated in its report: "a strong case can be made that a legal California system will be able to recapture much of this activity, but until the system is in place, the ultimate share of business that returns to California is unknown."

Figure 2

Comparison of Previous Studies of Impacts of Legalizing Intrastate Internet Poker in California

	Before Black Friday			Post-Black Friday
	Genest Consulting	**LECG**	**Blue Sky Consulting I**	**Blue Sky Consulting II**
Estimated GGR of California Players on Offshore Sites	$536 m	$825 m	$316 m	No Estimate
Proposed Market Structure for Legalized Intrastate Sites	One monopoly site	Up to 3 Hubs multiple sites	Not Specified	Not Specified
Estimated First-year GGR of proposed, legalized, intrastate site	< $50 m	$370 m to $704 m	$452 m	$624 m
Proposed GGR Tax Rate	10.0%	20.0%	10.0%	10.0%
Tax Revenue on GGR	< $5 m	$74 m to $141 m	$45.2 m	$62.4m
Other State Revenues	Minimal	$130 m to $256 m	$36.3 m	$54.2 m
Impact of Exclusivity Violation on State's Indian Gaming Revenues	-$350 m	No estimate	No estimate	No estimate

Estimating GGR and Gaming Tax Revenues In A Legal Intrastate Market

Players in a newly legalized market would be of two types, those switching from the illegal, offshore market and those who begin playing internet poker only after it is legalized[5]. The LECG study indicates that the former would be serious players, gambling more money over longer times, while the latter would be casual. Each study used a different approach to estimating the "recapture rate" of those playing on offshore sites:

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[3] H2 advises us that it did not directly provide the $825 million estimate and that it "sounds high" for a 2012 estimate. H2 also notes that a tax rate of 20 percent would cause them to reduce their estimate substantially.

[4] Such a survey essentially relies on contacted individuals to honestly report their own illegal activity. It is possible that this accounts for Blue Sky's significantly lower estimate of GGR on the offshore sites.

[5] These could include players who stopped playing after Black Friday but return upon legalization.

- Genest Consulting assumed that there would be only minimal transfer from offshore sites for two reasons. First, the specific proposal analyzed called for a one-site monopoly. Industry experts advised Genest Consulting that such a monopolistic site would not have succeeded in attracting customers away from the established offshore sites in the pre-Black Friday environment. Second, players moving from the illegal sites to the legal sites would have to report their earnings for income tax purposes. This would reduce their chances to (illegally) avoid taxation and would make playing on the legal site much less attractive.
- LECG assumed a range of recapture rates, from a low of a flat 25 percent to a high of 80 percent growing to 100 percent over time. LECG based these ranges on H2's analysis of the transfer rates in other countries that have legalized internet gaming and on the testimony of industry experts. The proposal that LECG was analyzing would have created a more competitive, and therefore a more attractive gambling environment by allowing up to three hubs with multiple sites potentially operating on each hub. However, it should be noted that it would still have suffered from a substantial income reporting disincentive. In addition, the proposal analyzed by LECG did not specify the tax rate, so they provided separate estimates for 20, 30 and 40-percent rates. Industry experts advise us that a tax rates above 10 percent or so would make it financially difficult for operators to invest sufficiently in player recruitment and retention and thereby seriously reduce the volume of play.
- Blue Sky's first report relied on surveys of Californians to determine the recapture rate. While this has the advantage of being California specific, a survey-based estimate should be viewed with caution. It is unclear how honestly respondents would answer a question that, in essence, asks whether they would cease playing illegally if a legal alternative were available. In addition, Blue Sky's reports did not analyze a specific proposal, so a key condition of creating a strong poker market, competition, is not addressed.
- Blue Sky's second report came a month after Black Friday. While the exact impact of Black Friday was not yet known at that time, Blue Sky correctly assumed that the closure of the three largest offshore sites would shift far more play into a legalized market. Accordingly, they increased their estimated GGR in a legal market by 38 percent.

With regard to new players being attracted to the newly legalized market, the approaches of each report also differed:

- Genest Consulting did not think the monopolistic site proposal it analyzed would draw significant numbers of new players into the internet poker arena.
- LECG relied on estimates from H2 Gaming and Capital. Both H2 and GBGC in general rely on data gleaned from monitoring internet play worldwide and they use the experience in other countries to model the growth rates of play and the effects of legalization on the volume of play in specific markets.
- In both of its reports, Blue Sky uses its survey methodology to project the impact of legalization on current non-players.

Of course, once the GGR estimates are complete, the revenue to be expected from taxing that GGR is simply a function of the tax rate. It is worth noting, however, that LECG modeled several different tax rates and correctly assumed that higher tax rates would result in lower GGR levels, in part because they would make it more difficult for firms to invest in player recruitment and retention, which is both costly and necessary to maximize the volume of play. H2 advises us that a tax rate of 10 percent would not create a significant disincentive, but rates much higher than that level would tend to have significantly deleterious effects on the volume of play in the market.

Estimating The Other State Revenues

Legalizing intrastate internet poker would create, at least in theory, four other sources of increased revenue to the state beyond the tax on internet gaming itself: (1) corporate profit taxes on the companies operating the legal sites, (2) personal income tax on players' winnings, (3) personal income tax on the earnings of employees working on the sites, and (4) increased income and sales tax from the increase in the state's economy that could result from legalization.

Genest Consulting indicated that these other revenues would be minimal because of the nature of the specific proposal that they analyzed. By creating an intrastate monopoly in an environment where there was a thriving and competitive, albeit illegal, offshore market, that proposal would have attracted only minimal activity and the other revenues associated with it would have been insignificant.

LEGC and Blue Sky used quite different and detailed methodologies to arrive at their estimates of corporate profits and personal income tax paid on winnings.[6] But, both used standard econometric modeling to estimate the increases in overall economic activity that would result from moving gaming from offshore to legalized sites. Figure 3 displays the estimates of these revenues as computed by both LEGC (for both their low and high recapture rates) and Blue Sky in both its first and second reports. We do not regard the difference in the results -- 15 to 16 percent of GGR for LECG and 8 to 9 percent of GGR for Blue Sky -- as significant, especially in light of the many unknowns inherent in estimating the impacts of legalization.

Figure 3
Comparison of Market Size and Revenue
(dollars in millions)

	LECG			
	Low Recapture	High Recapture	Blue Sky I	Blue Sky II
Total California GGR	$371	$704	$450	$620
Tax Rate	20.0%	20.0%	10.0%	10.0%
Direct Revenues from GGR Tax	$74	$141	$45	$62
Other Revenues	$56	$115	$36	$54
Other Revenues as a Percent of GGR	15%	16%	8%	9%

The Special Case of Exclusivity

Genest Consulting relied on legal advice from its client to the effect that legalizing internet poker would violate the exclusivity clauses in existing Indian Gaming compacts. To the extent that exclusivity is violated, it would automatically free up the gaming tribes to cease making the payments to the state that the compacts require. In 2010-11 those payments totaled $365 million. Obviously, the potential loss of that amount of revenue would have dwarfed any state revenue gain from legalization. However, a more recent legal opinion provided to us by our client indicates that internet poker would not violate the exclusivity clauses in the compacts. While exclusivity remains an issue for further legislative consideration, given the most recent legal

[6] While Blue Sky displayed all sources of revenue in detail in its report, LEGC did not display its results disaggregated into the various specific indirect sources.

opinion, we do not assume in this analysis that SB 51 or SB 678 would result in any revenue losses to the state.

The Fiscal Effects of SB 51 and SB 678

These bills (virtually identical to each other) allow any provider to apply to become a licensed intrastate internet operator in California. Applicants would have to deposit $15 million with the new licensing entity created by the bills, but the deposit would be credited against future payments of the 10-percent GGR tax.[7]

While the bills require that the companies and facilities operating the sites and all the players on the sites be located only inside the state of California, consistent with UIGEA, we do not regard this as a significant barrier to competition. As LEGC noted in its study, the potential player pool in California is large enough to create competition among prospective providers and the amounts of money potentially in play would allow providers to make the investments in player retention and recruitment bonuses and advertising that are essential to the successful operation of a poker site.

Our estimate of the fiscal effects of these bills draws from the previous estimates of similar proposals discussed above, but recognizes that the environment in which these bills would be enacted is materially different from the environment in which previous proposals would have been enacted. Specifically, after Black Friday there is only minimal offshore competition for internet poker players (although, as we discuss in more detail below, there remains a substantial, albeit illegal, offshore market for other forms of internet gaming such as casino games and sports betting).

This has two important implications for estimating the fiscal effects of these bills. First, the concerns raised in the Genest Consulting report -- that few players would use the new legal sites due to the lack of competition in an intrastate monopolistic site and the disincentive of automatic income reporting and withholding -- do not apply. We are comfortable therefore using H2's most recent 5-year forecast of the potential, legalized California market in our GGR estimates.

Second, and on the other hand, the absence of a significant offshore market means that we have to carefully consider from where the new legal market will draw players. This is important because some of the fiscal effects of legalization are attributable *only* to that portion of the market that represents a net increase in economic activity, discounting that portion of the market that represents redirection of spending already occurring inside California.

GGR and Revenues From the 10-percent Tax

Figure 4 display's H2's most recent projection of the size of a legalized intrastate internet poker market in California, assuming legalization takes effect in 2015. The revenue that the state would collect from the proposed 10-percent tax is also displayed.

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[7] The bills refer to this as a fee, but for constitutional purposes it would likely be treated as a General Fund tax, meaning it would be counted in the Proposition 98 school funding guarantee calculations, among other things. While tribal governments are generally not subject to state taxation, the payment of this particular tax also would be a condition of operating a legal poker site, so it would be on the order of an entry fee. We suggest that the authors consider explicitly clarifying this language. For this analysis we are assuming that the tax/fee applies to tribal governments but the revenues would be treated as a tax. As discussed below, we do not believe that the corporate profits of a tribal government operating such a site would be subject to the state's corporate profit tax.

Figure 4
Projections of a Legal Intrastate, Internet Market in California and the State Revenue from a 10-percent Tax [8]
(dollars in millions)

	2015	2016	2017	2018	2019
GGR	$729	$867	$992	$1,149	$1,292
State Revenue from the 10-percent GGR Tax	$73	$87	$99	$115	$129

The methodology that H2 used to make these projections is quite similar to how it made the projections for the earlier LEGC study, essentially modeling what has happened in other countries after legalization and using the current worldwide volume of play as an indicator of market potential. In fact, the market volumes are similar, adjusting for growth to the year 2015, to H2's earlier estimates of the volume of the offshore market that existed prior to Black Friday.

H2 advises, there is no definitive data on what California online poker players did after Black Friday, but that they probably fall into one of several categories:

- Some may have continued to play on the few remaining offshore real-money poker sites. In fact, H2 estimates that in 2014, these sites will have a GGR from California players of about $38 million.
- Some switched to free-play, social gaming or subscription poker sites.
- Some switched to real-money sites that offer games other than poker and which have yet to be effectively shut down by the DOJ.
- Some ceased play altogether.
- Some moved outside the USA. Very likely, the professionals who had been earning substantial incomes, often in the hundreds of thousands of dollars annual, are in this category.
- Some moved their gaming to brick and mortar casinos or card clubs in California or other states.

As a result of these uncertainties, H2 advises that at least in the initial years of legalization the projections of GGR should be regarded as an upper bound. Industry experts, however, advise us that over time, the California market has the potential to far exceed these projections.

Other Revenues

These revenues fall into two categories: (1) those that are a direct function of the volume of play, such as corporate profit tax revenues and the personal income tax revenues from winners' income, and (2) the revenues that come from net gains in economic activity that result from moving income and jobs into the state from outside its borders, which includes the personal income tax resulting from incremental employment gains and the tax revenues associated with the indirect increases in economic activity (i.e., the multiplier effect).

[8] SB 51 and SB 678 require substantial deposits of sites that register to operate internet poker. The deposits would be used to pay the GGR tax until they are depleted. Figure 4 does not attempt to model this cash-flow because it would depend on the numbers of sites and it would not affect state revenues in total.

Corporate Profits Tax Revenues. We reviewed the annual statements of eleven large, international internet gaming companies and found that profits before taxes and gaming fees averaged 22 percent of GGR. This level, which we use in our calculations, is substantially higher than the 13.3 percent cited in Blue Sky's first report.

H2 also advises that profits in this industry are very dependent on the costs of acquiring and retaining players and that in the highly competitive market that would arise in California under SB 51 or SB 678, companies would initially invest substantial amounts to capture as large a market share as possible. We therefore assumed that there would be no profits in the first year and a reduced level of profits in the second year. We also assumed, as did Blue Sky, that half of the market would be captured by tribal governments and therefore would be exempted from California's corporate tax.

Finally, we subtracted the 10-percent GGR tax from the profits and then applied California's 8.84 corporate tax rate to the resulting net profits. The results are displayed on Figure 5.

Figure 5
Corporate Profits Tax Revenue
(dollars in millions)

	2015	2016	2017	2018	2019
GGR	$729	$867	$992	$1,149	$1,292
Estimated Corporate Profits	$0	$172	$196	$227	$256
Corporate Tax Revenues	$0	$4	$9	$10	$11

PIT Revenues on Winner's Earnings. LECG and Blue Sky used different methods to compute the amount of winnings and the effective state tax rates of those winnings. Both approaches are plausible and data-driven, but they result in quite different estimates of state revenues, with LECG's revenue estimate equating to 1.95 percent of GGR and Blue Sky's equating to 5.3 percent of GGR. We use the simple average of these two estimates -- 3.63 percent -- to develop the estimates shown on Figure 6.

Figure 6
Personal Income Tax on Winners' Earnings
(dollars in millions)

	2015	2016	2017	2018	2019
PIT Revenue On Winners' Earnings	$27	$32	$36	$42	$47

Revenues From Net Gains in Economic Activity. LECG and Blue Sky both base their revenue estimates from earnings of employees of the new, legal sites and from the indirect economic impact (i.e., the multiplier effect) on *net, not gross* new activity. By net, we mean only the portion of new internet poker GGR of the new, legal sites that is redirected from outside of California, i.e., from illegal, offshore sites. In its report, Blue Sky stated: "If California were to legalize online poker, a sizable fraction of the revenue currently flowing to off-shore poker website operators would instead be collected by California poker websites and spent on employee wages and supplier purchases in California. This recaptured revenue and the indirect and induced economic activity that results constitutes new economic activity for California." Conversely, gambling activity that is redirected from other expenditures within California has limited, if any, net impacts on the aggregate state economy.

There is really no way to predict what percent of current offshore or out-of-state gaming would transfer into the newly legalized sites. Industry experts advise us that the recapture rate could be substantial, especially since SB 51 and SB 678 create the framework for a competitive market, with relatively low gaming tax rates. We believe a recapture rate of 40 percent is a reasonable, conservative guess. While this percentage is similar to the ratio implied by the Blue Sky study, it is applied against the much reduced post-Black Friday volume of offshore gaming. It also falls in the range of the two scenarios prepared by LECG (one using a 25-percent recapture rate and the other using an up-to 100 percent recapture rate). Under this assumption, the amount of net new spending in California would be $182 million, or about 25 percent of the $782 million total California GSR in 2015.

Figure 7 displays our estimate of the net increase in spending within California that this represents, as well as our estimate of the associated increase in jobs, output, and state revenues.[9]

Figure 7
Projections of a Increased Economic Output, Jobs and Other Revenue
(dollars in millions)

	2015	2016	2017	2018	2019
GGR	$729	$867	$992	$1,149	$1,292
Amount Redirected from Off Shore	$182	$217	$248	$287	$323
Less Profits	--	-$24	-$55	-$63	-$71
Balance Spent In CA	$182	$192	$193	$224	$252
Economic and Revenue Impacts:					
Increased Jobs	1,952	2,053	2,063	2,375	2,657
Increased Output	$334	$352	$354	$410	$460
Indirect State Revenue*	$21.7	$22.8	$23.0	$26.6	$29.9

* Includes taxes on employee wages (about $1 million in 2015) and taxes associated with indirect and induced effects of net new spending in the state (about $20.7 million in 2015).

Bottom Line

Figure 8 summarizes our estimate of total revenues that can be expected under SB 51 or SB 678. It is noteworthy that our estimate of increased 'other" revenues equates to about 7 percent of GGR, as compared to LEGC's 15 to 16 percent and Blue Sky's 8 to 9 percent. The major reason for our lower estimate is the impact of Black Friday on offshore, illegal internet gaming. The effect has been to significantly reduce the relative amount of offshore spending available to be recaptured, thereby limiting the relative amount of indirect revenues associated with legalization of internet poker.

[9] We estimate new jobs and output resulting from the GGR redirected from offshore gaming sites. The estimates include the direct, indirect, and induced impacts of the associated spending by internet poker sites on employee wages and purchases for advertising, web hosting, and administrative services. The estimates are based on multipliers derived from the IMPLAN input-output model. The indirect revenues are based on our estimate of increased output and the current ratio of state revenues to California Gross State Product (about 6.5 percent).

Figure 8
Total Revenues from a Legal Intrastate Internet Market in California
(dollars in millions)

	2015	2016	2017	2018	2019	5-year Totals
Direct State Revenues from GGR Tax	$73	$87	$99	$115	$129	$503
Other State Revenues						
Corporate Profits Tax	--	(4)	(9)	(10)	(11)	(33)
PIT On Winners' Earnings	(27)	(32)	(36)	(42)	(47)	(184)
Indirect Revenues	(22)	(23)	(23)	(27)	(30)	(125)
Subtotals, Other State Revenues	$48	$58	$68	$78	$88	$342
Ratio of "other" to GGR	6.61%	6.69%	6.85%	6.82%	6.84%	6.80%
Totals	$121	$145	$167	$193	$217	$845