



Ideas in Action is a public forum to present discussion in vital issues affecting the economy, public policy and concerns that touch the lives of many Floridians. The opinions expressed in this Ideas in Action do not necessarily reflect those held by the members, staff or the distinguished Board of Trustees of Florida TaxWatch.

April 2005

The State Legislature May Leave \$4.5 Billion on the Table by Not Setting a Fair State Gaming Tax

By: Jeffrey C. Hooke, Maryland Tax Education Foundation and Thomas A. Firey, Maryland Policy Institute

In a March 8, 2005 referendum, the citizens of Broward County, Fla. voted to permit three county racetracks and one jai-lai fronton to operate slot machine gaming. The referendum obligates the state of Florida to allow the so-called “racinos,” but the state has the authority to set limits on the number of machines that can be installed, the rate at which the machines are taxed, operating hours, and other gaming parameters. State policymakers are currently considering several different proposals for those parameters.

Before Florida adopts any proposal, state leaders should give careful scrutiny to the financial aftermath of Pennsylvania lawmakers’ recent decision to legalize slot gaming. Under Pennsylvania law, eight designated horse tracks and four non-track locations can receive a permit to operate slots gaming in exchange for paying a \$100 million licensing fee to the state and accepting a 52% gaming tax on slot revenues. In the months following passage of the Pennsylvania law, two racino license holders sold their rights to operate the machines to major casino operators who will, in compliance with the law, run the games at the tracks. The average sales price of the two transactions—\$460 million—gives a strong indication of how dramatically Pennsylvania lawmakers underpriced the licensing fees and gaming taxes. Altogether, Pennsylvania gave up more than \$3 billion in revenue that it could have received in exchange for creating a valuable and economically viable slots oligopoly.

The Florida legislature should not repeat Pennsylvania’s mistake of establishing an extremely lucrative oligopoly that creates windfall profits for a small group of politically favored businesses. The Sunshine State should instead charge a far more appropriate effective gaming tax¹ that generates revenue for tax relief and the funding of state services.

Based on this report’s analysis, the appropriate gaming tax for four racinos operating in the Miami-Fort Lauderdale metropolitan area is 74% of the net revenue from Class III slot machines (68% for a Class II). The remaining 26% is allocated to the Florida racino owners. That share provides them a healthy 20% annual return on their investment.

¹ The effective tax rate includes state and local gaming taxes, administrative charges, and mandated purses.

A 74% tax may seem extremely burdensome, but it is comparable to the effective 73% rate paid by Rhode Island racinos. Those racinos make so much money that they repeatedly petition the Rhode Island legislature for permission to operate more machines.

Based on our projections involving a combined racino- and Indian-operated slots market of 13,500 machines in the Miami-Fort Lauderdale area, a gaming tax of 74% would provide approximately \$ 770 million in state revenues annually. In contrast, the 30% tax that Broward racetrack owners are advocating would provide revenues of only \$315 million annually. If Florida lawmakers adopt the lower tax rate, track owners would be enriched by \$4.5 billion at the expense of Florida taxpayers.

Research Assumptions and Methodology

To calculate the appropriate gaming tax rate and the resulting revenues for slots operations in Broward County, we first made several assumptions about the slots gaming market that would emerge in the Miami-Fort Lauderdale metropolitan area after the opening of racino operations. We then fed those assumptions into a model that we constructed for analyzing slot markets in other locations—a model that has proved effective in predicting market revenues and optimal tax rates in other markets.

Below is a list of the relevant assumptions we made and a description of our methodology.

- A. Market Population: The Miami-Fort Lauderdale metro area had 3.9 million citizens as of April 1, 2000, according to the U.S. Census. Between 1990 and 2000, the area's population grew by 21%. Given those data, we assume the area's population has grown by an additional 10% as of 2005, for a total current population of 4.3 million.

Palm Beach County had 1.3 million residents in 2000, which suggests that the current population is close to 1.5 million residents. Because of the county's proximity to future racinos, we include two-thirds of that population in the racinos' overall local market base, for a total of 5.3 million.

Unlike several of the comparative markets, Southeast Florida has a high percentage of retirees and a substantial number of recreational tourists. Those two groups have an above-average consumption of slot gaming relative to other markets. Accordingly, we assign a 15% premium to the population base, bringing the effective market base to 6.1 million.

- B. Maximum Number of Machines: The Miami-Fort Lauderdale metro area has three existing Indian casinos that, together, operate approximately 4,000 slots. The Indian casinos have no numerical limits on slots, and it is expected that they will add up to 4,000 machines in the near future, depending on the outcome of state compacts.

The Broward County racinos will have a state-established limit on the number of allowed machines. For this report, we assume the state will set the limit at 3,000 machines per racino, which is a reasonable limit given the configuration of racinos

in other states. Added to the current and anticipated Indian machines, our assumption about the racinos' limit indicates the maximum number of machines that will be operating in the southeastern Florida market will be 20,000. All machines are assumed to be Class III. See paragraph P for a discussion of Class II machines.

- C. WPD Per Machine: The evidence from slot operations in other locations indicates that operators must reach a certain level of machine density (i.e., market base divided by number of operating slot machines) in order to profit-maximize (Table 1). After that point, the win per day (“WPD”) per machine declines as the market reaches saturation (Table 2)—as the number of residents per machine declines, the average WPD per machine drops. The “total market revenue” increases with diminishing results, as line (6) of Table 1 indicates. Rational slots operators will adjust the number of machines they operate (within parameters set by law) so as to maximize profits.

Table 1: Total Market Revenues Example

Market of 1 Million People
Machine Density/WPD/Total Market Revenue

(1) Per Capita Residents per Machine	600	450	300
(2) Number of Machines	1,667	2,222	3,333
(3) WPD per Machine	\$450	\$350	\$240
(4) Market WPD per Machine	\$750,000	\$778,000	\$800,000
(5) % Increase in Machines	-	33.3%	50.0%
(6) % Increase in Total Market WPD	-	3.7%	2.8%

Table 2: Comparative Metro Areas with Slot Machines

<u>Metro Area</u>	<u>Population per Slot Machine^(a)</u>	<u>Average WPD per Slot Machine</u>
Chicago	600	\$450
Detroit	450	350
St. Louis	300	240
Southeast Florida ^(b)	300	240(estimated)

(a) Legal slot machines registered with state gaming authorities.

(b) At a maximum of 20,000 machines, Southeast Florida will have one machine for every 305 residents, as defined herein.

We estimate the WPD per machine at \$240 at the maximum of 20,000. The WPD is similar to Detroit.

- D. Daily Cash Operating Cost per Slot Machine: In this report, the daily cash operating cost for a Florida racino is set at \$60 per day per machine, including machine leasing costs. This figure is consistent with results observed in Delaware, West Virginia, and Rhode Island racinos.²

² For additional details involving the cost of building and operating a racino, see “Legalizing Video Slot Gaming in Maryland: A Business Analysis” by Jeffrey C. Hooke and Thomas A Firey, published by Maryland Tax Education Foundation and Maryland Public Policy Institute, 2003.

- E. Racino Facility Construction Costs: Given the experience of slot gaming operations elsewhere in the United States, we assume that the cost for constructing a racino slots building and the related infrastructure is \$25,000 per machine. Thus, a racino slots parlor housing 3,000 machines costs \$75 million to build, and a parlor with 2,000 machines costs \$50 million.

This figure is consistent with observed data from Delaware, West Virginia, and New York, and with interviews conducted with gaming industry executives. Note that hotels, shopping arcades, and conference venues generate their own revenues, apart from slots; and thus, the construction costs of such amenities are not included in this \$25,000 per machine amount.

- F. Depreciation Expense: The \$25,000 per machine facility investment is depreciated over 10 years, or \$2,500 in depreciation expense per year per machine. This amount equates to \$7 per day per machine.
- G. Fair Rate of Return to Racino Operator: This report assumes the operator requires a 20% after-tax return on its facility investment every year. This rate-of-return target is consistent with observed objectives for publicly traded corporations. Thus, the operator must earn \$5,000 annually per machine in “net income after tax” to realize a 20% annual return. The daily net income required per machine is thus \$14.
- H. Income Tax Rates: Our report assumes a combined 40% federal and state income tax rate for racino operators. Thus, the operator must generate \$23 in pre-tax income for every \$14 in net income. The \$9 difference is the income tax expense. Note that “gaming taxes” are paid by the racino operators “off the top,” before pre-tax income is determined.
- I. Required Racino Operator Revenue to Earn an Adequate Profit: The racino operator requires \$90 in revenue per day per machine in order to make a 20% annual return on its investment, as indicated in Table 3. Florida should claim most of the revenues in excess of \$90 per day per machine, because the state is creating the slots business at no charge to the racino owners.

Table 3: Revenue and Cost per Slot Machine per Day

Cash Operating Costs	\$60
Depreciation of Facility	7
Income Taxes	9
Net Income after Income Taxes	<u>14</u>
Total Revenue Required by Racino Operator	\$90

- J. Hypothetical State Gaming Tax Rates: Slots operators that achieve a higher WPD should pay a higher tax rate to the state. Table 4 offers one possible “excess revenue” tax scheme that extracts all of the rents.

Table 4: Gaming Tax Rates at Different WPD

WPD Per Machine	\$450	\$350	\$240
Less: \$90 Required by Operator	<u>(90)</u>	<u>(90)</u>	<u>(90)</u>
Excess Profit Retained by State	\$360	\$260	\$150
Appropriate Gaming Tax Rate for the State of Florida	80%	74%	63%

K. Annual Tax Revenues to State: In Table 5, we calculate Florida's share of the WPD if the state wants to permit slot operators to generate a fair 20% annual return on their investments. For comparative purposes, the table examines three different market configurations.

Table 5: Florida's Share of Revenue Under Three Scenarios

	<u>10,000 Machines</u>	<u>13,500 Machines</u>	<u>20,000 Machines</u>
(1) Number of Racino Machines	6,000	8,100	12,000
(2) Number of Indian Machines	<u>4,000</u>	<u>5,400</u>	<u>8,000</u>
(3) Total Number of Machines	10,000	13,500	20,000
(4) Effective Market Base (million)	6.1	6.1	6.1
(5) Residents per Machine	600	450	300
(6) WPD per Machine	\$450	\$350	\$240
(7) Operators' Share of WPD	<u>(90)</u>	<u>(90)</u>	<u>(90)</u>
(8) State's Share of WPD	\$360	\$260	\$150
(9) State Gaming Tax Rate	80%	74%	63%

L. Total State Gaming Taxes per Year in (millions): Table 6 calculates the total state gaming taxes per year under the three scenarios.

Table 6: Projected Gaming Taxes Per Year in Florida Under These Scenarios

(In Millions)	<u>10,000 Machines</u>	<u>13,500 Machines</u>	<u>20,000 Machines</u>
A. (2) x (6) x 365 days	\$1,314	\$1,281	\$1,095
B. Exclude 40% for Indian slots	<u>(526)</u>	<u>(512)</u>	<u>(438)</u>
C. Projected Gaming Taxes Per Year	\$788	\$769	\$657

By limiting the number of racino machines to 8,100 and the number of total machines to 13,500, Florida would collect \$769 million in taxes per year at a flat gaming tax of 74%. We recommend this option.

If the state can negotiate tribal compacts that include gaming taxes on Indian Casinos, the tax revenue will increase.

- M. Flat Gaming Tax: Instead of having a graduated tax rate that would extract all excess rents from slot gaming, we recommend that Florida adopt a flat tax of 74%. Because of the flat tax, slot operators will have a strong incentive to increase WPD per machine beyond the projected WPD of \$350. Each extra dollar of win provides 26 cents of extra revenue, most of which will be pure profit to the operators.
- N. Expected Scenario: With the exception of the state of New York, which has an effective tax rate of 80% (including state taxes, system administrative costs and horse purses), all the states that have legalized non-Indian, casino-style gaming (post Nevada) have (i) given away gambling licenses, either for free or for pennies on the dollar; and (ii) charged gaming tax rates that are sufficiently low to ensure excess rents to the license holders.

The assessment of such a high tax rate does seem counter to conventional wisdom about slot taxes and operators' financial viability. For example, Florida state economist Amy Baker recently testified that a 30% tax was the most the racino industry could afford.¹ But her assertion does not jibe with Pennsylvania's recent experience, as the above-mentioned sales of the two slots licenses attest. As indicated by Table 7, if Florida does enact the 30% tax rate for 20,000 machines instead of the 74% tax for 13,500 machines that this study recommends, the state would forego considerable revenue that could be used for tax relief for Florida taxpayers.

Table 7: Projected Revenue under Two Market Regimes and Tax Rates

	<u>20,000 Machines</u>	<u>13,500 Machines</u>	
	30% Tax Rate Supported by Gambling Interests⁴	Recommended Scenario Set Forth Herein	<u>Difference</u>
State Gaming Tax Proceeds Per Year	\$315 million	\$769 million	\$454 million

- O. What Happens to Excess Slot Machine Revenue Not Taxed by the State of Florida?
Lower gaming taxes increase the net worth of racino owners by handing them an unnecessarily large cut of the windfall profits from a heavily constrained Florida slots market. If Florida is determined to have a constrained slots market, then more of that windfall should be captured by state taxes and redirected to tax relief for Florida taxpayers.

The \$454 million that would have been captured under the market design and tax regime recommended in this paper would instead becomes excess "income before federal income taxes" for the racino owners. Assuming the four racinos divide the \$454 million "income before federal income taxes" equally, each racino would

¹ See Miami Herald on March 11, 2005.

⁴ The calculation is as follows: (20,000 slot machines x \$240 win per day x 365 days x 30% gaming tax rate x 60% non-Indian-portion equals \$315 million per year).

receive \$114 million per year over and above the required 20% return on investment.

The values of gaming stocks are heavily dependent on earnings, and publicly traded stocks are frequently quoted on their price-earnings ratios and EBITDA-enterprise value ratios.⁵ Thus, if a firm’s stock trades at a 10x EBITDA ratio, and EBITDA increases by \$114 million, the firm’s total stock market value climbs by \$1.14 billion. The likely effects of this increased value on the Isle of Capri and Magna—the publicly traded firms that own two of the Broward racinos that are set to receive slots—are indicated in Table 8.

Table 8: Likely Increase in Stock Market Values when Florida Legislature Allows Excess Profits to Racino Owners

<u>(In Millions, except stock price)</u>	<u>Isle of Capri</u>	<u>Magna</u>
Current Market Value	\$830	\$620
Add: Excess Value	1,140	1,140
Post Giveaway Value	1,970	1,760
Current Stock Price	28.00	6.00
Post-Giveaway	66.10	16.45

As mentioned, the \$454 million in excess increase for federal income taxes would be multiplied by 10 to determine the new market value of the gaming oligopoly. The resultant value at a low 30% tax is \$4.5 billion.

- P. Class II Slot Machines vs. Class III: The legislature is presently considering the use of Class II machines at the four sites instead of Class III machines. The latter are typically considered to be “true” slot machines.

A reasonable rule-of-thumb is that Class II machines will produce 80% of the revenue of Class III machines, as long as there are no competing Class III machines in a given market.

If there are 13,500 Class II machines (instead of Class III), the recommended gaming tax would be 68% instead of 74%. With those Class II machines, Florida would collect \$561 million in taxes per year.

The Class II machines will provide \$208 million less per year in gaming taxes than the Class III machines. See paragraphs L and M.

⁵ EBITDA is an abbreviation for “earnings before interest, income tax, depreciation and amortization.”

Conclusion

Florida lawmakers are obligated by both the Broward County referendum and an earlier statewide referendum to allow slot gaming at four “racinos” in Southeast Florida. They must fulfill this duty—and do so in a way that promises the slot operators a fair return on investment in the games. At the same time, the lawmakers have a fiduciary duty to Florida taxpayers to extract excess rents from the games for public use—especially for tax relief.

For obvious reasons, it is in the racino owners’ best interests to encourage Florida lawmakers to adopt a low tax rate on the games—and they are doing so. This study is offered to counter those efforts and to benefit Sunshine State taxpayers.

Many government officials are unaware of the extremely high profit margins and overall revenues of slot gaming. This report is intended to convey that information and to encourage Florida lawmakers to capture much of that revenue for use in providing tax relief to taxpayers.

Gaming Tax Rate on Racinos¹

	<u>Tax Rate</u>	<u>Number of Racinos Going Bankrupt Because of Gaming Tax Rate</u> ²
New York	80%	0
Rhode Island	73	0
West Virginia	55	0
Delaware	51	0
New Mexico	45	0
Iowa	36	0
Louisiana	36	0

Note that the Canadian provinces tax slot machines at racetracks at rates of 75% to 90% of net win. None of the tracks have shut their operations.

¹ Including state taxes, local taxes, administrative costs and purse contributions

² Vernon Downs in New York is presently in bankruptcy proceedings; however, its insolvency problems predate the introduction of slots in New York State

About the Authors

Jeffrey C. Hooke is managing director of Hooke Associates, LLC, an investment bank based in McLean, Virginia. His volunteer work includes being chairman of the Maryland Tax Education Foundation (www.marylandtaxeducation.org). Previously, Hooke was a director of Emerging Markets Partnership (a \$5 billion private equity partnership), a principal investment officer of the World Bank Group, and an investment banker with Lehman Brothers and Schroder Wertheim, respectively, two prominent securities firms based in New York.

Hooke is the author of three books: *The Emerging Markets* (2001), *Security Analysis o Wall Street* (1998), and *M&A: A Practical Guide to Doing the Deal* (1996), published by John Wiley & Sons of New York. His studies on casino-style gaming have lead to testimony on the value of gaming licenses and the prospective revenues from state-sanctioned gaming expansion before the legislatures of Maryland, Pennsylvania, and Texas. His views on state-sanctioned gaming expansion have been referenced in numerous publications, including the *New York Times*, *Forbes*, *Washington Post*, *Chicago Sun Times*, *Philadelphia Inquirer*, *Houston Chronicle*, *Baltimore Sun*, *Dallas Morning Post*, *Cleveland Plain Dealer* and *Pittsburgh Post Gazette*.

Thomas A. Firey is the managing editor of *Regulation* magazine, a publication of the Cato Institute (www.cato.org), and also is a senior fellow of The Maryland Policy Institute (www.mdpolicy.org).

Hooke and Firey co-authored the August 2003 report “Legalizing Video Slot Gaming in Maryland: A Business Analysis,” which was published jointly by the Maryland Tax Education Foundation and The Maryland Public Policy Institute.

For a copy of the report, please call:
(850) 222-5052

OR

Write TaxWatch at: P.O. Box 10209
Tallahassee, FL 32302

OR

Access and download the report at:
www.floridataxwatch.org where this *Ideas In Action* was
initially released before being printed in hardcopy format.

Barney Barnett, Chairman; Dominic M. Calabro, President, Publisher and Editor.
Steve Evans, Chief Operating Officer
Florida TaxWatch Research Institute, Inc.

© Copyright Florida TaxWatch, April 2005

About Florida TaxWatch

Florida TaxWatch is a private, non-profit, non-partisan research institute that over its 25 year history has become widely recognized as the watchdog of citizens' hard-earned tax dollars. Its mission is to provide the citizens of Florida and public officials with high quality, independent research and education on government revenues, expenditures, taxation, public policies and programs and to increase the productivity and accountability of Florida Government.

Florida TaxWatch's empirically sound research recommends productivity enhancements and explains the statewide impact of economic and tax and spend policies and practices on citizens and businesses. Florida TaxWatch has worked diligently and effectively to help state government shape responsible fiscal and public policy that adds value and benefit taxpayers.

This diligence has yielded impressive results: since 1979, policy makers and government employees have implemented three-fourths of Florida TaxWatch's cost-saving recommendations, saving the taxpayers of Florida more than \$6.2 billion--approximately \$1,067 in added value for every Florida family.

The organization enjoys a credible reputation and statewide exposure with the television, radio and newspaper media, which regularly report on its research and recommendations.

Florida TaxWatch has a historical understanding of state government, public policy issues, and the battles fought in the past necessary to structure effective solutions for today and the future. It's the only statewide organization devoted entirely to Florida taxing and spending issues.

Supported by voluntary, tax-deductible memberships and grants, Florida TaxWatch is open to any organization or individual interested in helping to make Florida competitive, healthy and economically prosperous by supporting a credible research effort that promotes constructive taxpayer improvements. Members, through their loyal support, help Florida TaxWatch to bring about a more effective, responsive government that is accountable to the citizens it serves.

Florida TaxWatch is supported by all types of taxpayers -- homeowners, small businesses, large corporations, philanthropic foundations, professionals, associations, labor organizations, retirees--simply stated, the taxpayers of Florida. The officers, Board of Trustees and members of Florida TaxWatch are respected leaders and citizens from across Florida, committed to improving the health and prosperity of Florida.

With your help, Florida TaxWatch will continue our diligence to make certain your tax investments are fair and beneficial to you, the taxpaying customer who supports Florida's government. Florida TaxWatch is ever present to ensure that taxes are equitable, not excessive, that their public benefits and costs are weighed, and that government agencies are more responsive and productive in the use of your hard-earned tax dollars.

The Florida TaxWatch Board of Trustees is responsible for the general direction and oversight of the research institute and safeguarding the independence of the organization's work. In his capacity as chief executive officer, the president is responsible for formulating and coordinating policies, projects, publications and selecting the professional staff. As an independent research institute and taxpayer watchdog, the research findings and recommendations of Florida TaxWatch do not necessarily reflect the view of its members, staff or distinguished Board of Trustees, or Executive Committee and are not influenced by the positions of the individuals or organizations who directly or indirectly support the research.

Florida TaxWatch Values:

◆ *Integrity* ◆ *Productivity* ◆ *Accountability* ◆ *Independence* ◆ *Quality Research*



106 N. Bronough St.
P.O. Box 10209
Tallahassee, FL 32302

NON-PROFIT ORG.
U.S. POSTAGE
PAID
TALLAHASSEE, FL
Permit No. 409