A Re-examination of the Use(s) of Lottery Profits

Pursuant to the Virginia Public Building Authority Bill approved by the 1993 Special Session of the General Assembly (S.B. 2001, Chapter 1, 1993 Acts of Assembly, Special Session)

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INTRODUCTION

The 1987 session of the General Assembly authorized a referendum on November 3, 1987, on the question of establishing a state-operated lottery in Virginia. The referendum was successful, and the legislation providing for the lottery was effective December 1, 1987. Lottery ticket sales began on September 20, 1988.

The enabling legislation did not, and does not now, specify a particular use for lottery profits. Such profits are to be transferred to the general fund at the close of each fiscal year after the balances in the Lottery Fund are audited and certified by the Auditor of Public Accounts. Once transferred to the general fund, lottery profits are available for appropriation by the General Assembly for any purpose it chooses.

In 1989, the General Assembly passed an Act (Chapter 640, 1989 Acts of Assembly) to appropriate lottery profits to specified capital outlay projects. These projects were prioritized in rank order and could only be released (by the Governor) after lottery revenue in a sufficient amount was transferred to the general fund. The original priority order for releasing these capital projects was changed by legislation passed in the 1990 General Assembly session (Chapter 922, 1990 Acts of Assembly). This revised legislation authorized a total of $473.2 million for capital projects from the general fund, contingent on lottery receipts, over a three-year period: the fiscal years ended June 30, 1990, 1991, and 1992.

With the recurring revenue shortfalls from the official general fund forecast for fiscal year 1990 and the 1990-92 biennium, funding was withheld for capital outlay projects not under contract. As a result, lottery profits were used to finance general fund operating and capital programs approved by the General Assembly in the general Appropriation Act. Otherwise, further cuts would have been necessary in the general fund budget that finances, among other things, such high priority services as public education, higher education, corrections, health care, and mental health and mental retardation community services.

A capital outlay project, passed by the 1993 special session of the General Assembly, authorizes the Virginia Public Building Authority (VPBA) to issue bonds for $17 million plus amounts needed to fund issuance costs, for a new building at the corner of Ninth and Broad Streets in downtown Richmond. The new office building will be occupied by the Lottery Department and several other state agencies. In enacting this debt authorization, the 1993 General Assembly also asked that the policy governing the use of lottery transfers be revisited.

The fourteenth enactment clause of the VPBA legislation requires that the Governor develop a plan to address the following issues:

1. Detail when state lottery proceeds will no longer be needed to fund operating expenses of the Commonwealth and become available to pay the debt service on the bonds issued to finance the Ninth and Broad Street building (the building);

2. Detail the anticipated annual debt service, through their maturity, on the 1993 VPBA bonds used to finance the building; and

3. Detail the net proceeds estimated to be derived from the state lottery over the lifetime of the VPBA bonds used to finance the building;

4. Detail any changes necessary in the State Lottery Law to create an escrow fund mechanism by which sufficient amounts of state lottery net proceeds can be set aside annually to pay the annual debt service on the VPBA bonds used to finance the building.

The purpose of this study is to address the above issues. The issues are rearranged to facilitate readability of this report.

If lottery profits are to be earmarked for VPBA debt service costs, it is important to first determine the projected cost of debt service on the bonds in question, and then the anticipated amount of lottery receipts over the life of these bonds before exploring alternative uses of lottery funds.

Accordingly, this study will address the specified issues in the following order (Issues #2, #3, #4, and #1).

BACKGROUND, ASSUMPTIONS AND ANALYSIS

Issue #2 - DETAIL THE ANTICIPATED ANNUAL DEBT SERVICE, THROUGH THEIR MATURITY, ON THE VIRGINIA PUBLIC BUILDING AUTHORITY BONDS USED TO FINANCE THE BUILDING.

***Background*:** Internal Revenue Service regulations require that issuers of tax-exempt bonds comply with certain provisions concerning interest earned on bond proceeds prior to their being spent and the period of time over which the proceeds are spent. These regulations are intended to prevent issuers of tax-exempt bonds from abusing the tax-exempt status of the bonds by reinvesting bond proceeds over a long period of time at interest rates higher than the rates carried on the bonds, thereby earning "arbitrage" on the bond proceeds. The regulations require that bond proceeds be spent over a limited period of time, usually two years, with a prescribed schedule within the time period. If the proceeds are spent too slowly, the issuer is required to rebate all interest earnings in excess of the yield on the bonds to the federal government, or to pay a penalty. Therefore, bonds issued to fund construction which may occur over several years should be issued in such a manner as to meet the spending requirements required by the regulations, thus maximizing the interest which can be earned on the bond proceeds.

To maximize the potential interest earnings on the bond proceeds and thus minimize the size of the associated bond issues, the Department of Planning and Budget with assistance from the Department of General Services analyzed the cash drawdown requirements of the building project authorized in the VPBA bond issue.

***Assumptions*:** Based on requirements of the VPBA bond bill for a parking report and the $1 million contribution from the City of Richmond, the VPBA will be unable to issue bonds for the building until August 1994 and August 1995. The respective bond issues will fund or reimburse all project cash drawdown requirements through July 1995, and all remaining cash needs through the completion of the building in January 1996.

The Department of the Treasury assumes a 6.5 percent interest rate, and an additional 2 percent to cover costs of issuance ($335,000).

***Issue Conclusion*:** Under these assumptions, debt service on the bonds would amount to $1.6 million during the 1994-96 biennium. Following the 1994-96 biennium, the debt service costs average approximately $1.5 million in each fiscal year until the bonds are completely paid off in fiscal year 2015-16. The schedule of projected debt service costs over the life of the bonds is shown in Appendix Table 1.

Issue #3 - DETAIL THE NET PROCEEDS ESTIMATED TO BE DERIVED FROM THE STATE LOTTERY OVER THE LIFETIME OF THE VPBA BONDS USED TO FINANCE THE BUILDING.

***Background*:** The development of long-term projections is a precarious exercise. In the case of lottery profits, this is especially true. Not only will lottery revenue fluctuate from year to year based on changed economic conditions, it can also be influenced by the state of technology, competition, border states' enactment of lotteries, and pure chance.

The revenue projections contained in this report are the result of assumptions about how per capita spending, potential sales volume and competition may affect lottery operations in the future, taking into consideration the experiences of other states which have more mature lotteries. To the extent that these assumptions prove reliable, the projections are deemed to be reasonable expectations of results.

***Assumptions*:** Any projection of net lottery proceeds must be predicated on assumptions about how lottery sales will fare in the future. Moreover, within any given sales forecast, the level of net proceeds or profits can vary based on different assumptions concerning the percentage of sales devoted to prize payouts and operational expenses. Because of the inter-relationships that prizes and promotion can have on sales volume, these variables are hard to predict.

For this reason, this report presents two alternative forecasts. While both are based on sales projections developed by the Virginia Lottery, they differ in terms of assumed prize payouts and the assumed level of operational expenses. The forecasts are for 22 years which is the same period the VPBA bonds will be outstanding.

The 22 year sales projection prepared by the Virginia Lottery anticipates that lottery sales will grow from $2.53 per capita per week in fiscal year 1993 to $2.86 per capita per week by fiscal year 1996. The $2.86 per capita per week figure is the average sales level for those lotteries that: (1) are in the eastern United States; (2) have had a period of sales growth for at least several years after introduction of three major products - instant games, a daily 3-digit game, and a 6-digit large-jackpot game; and (3) since then, have experienced relatively level sales.

Sales increases after fiscal year 1996 are based on expected population growth. The Virginia Employment Commission's population projections were used for 1990, 2000, and 2010. Trends implicit in these estimates were extrapolated for other years.

In terms of operations, the first forecast alternative, as prepared by the Department of Planning and Budget, assumes that prizes and operational expenses will continue to remain at their projected 1993-94 level (65.3 percent of sales) over the next 22 years. Using this assumption, the projections for prizes, operating expenses and net revenue to the Commonwealth appear in Appendix Table 2.

The second alternative was prepared by the Virginia Lottery and assumes that certain changes will occur in the operations of the Lottery to maintain an appropriate level of promotional support for its products.

In this scenario, the prize percentage is increased from 53 percent to 58 percent of sales in fiscal year 1995. This would be a proactive move to prevent future degradation of sales, specifically, sales of instant tickets. In addition, operating expenses are increased to 10 percent of sales by fiscal year 1996 as the Lottery begins to replace fixed assets (e.g., computer systems). The long term forecast based on these assumptions is shown in Appendix Table 3.

However, it should be noted that the forecasts do not assume any adverse impact from the start-up of new lotteries, and they do not provide for any change in the retailer commission. The latter is held constant at 5.2 percent of sales throughout the forecast period. The start-up of a new lottery in a border state may cause a decline in Virginia Lottery sales and net revenue (e.g. a North Carolina lottery may cause an 8 percent decline in Virginia beginning in fiscal year 1996).

Issue Conclusion: Over the next 22 years, net proceeds from lottery sales to the Commonwealth will average between $286.5 million and $370.1 million per year based on these two alternative forecasts (neither forecast reflects the start-up of a new lottery in a border state). Either forecast will be sufficient to make debt service payments on the VPBA bonds used to finance the building.

Issue **#4** - DETAIL ANY CHANGES NECESSARY IN THE STATE LOTTERY LAW TO CREATE AN ESCROW FUND MECHANISM BY WHICH SUFFICIENT AMOUNTS OF STATE LOTTERY NET PROCEEDS CAN BE SET ASIDE ANNUALLY TO PAY THE ANNUAL DEBT SERVICE ON VPBA BONDS USED TO FINANCE THE BUILDING.

Background: As stated in the introduction of this report, lottery profits are not earmarked by law for any single purpose. They are available for appropriation by the General Assembly after the Auditor of Public Accounts certifies the amount transferred to the general fund.

The lottery statute (Section 58.1-4022, Code of Virginia) provides that appropriation of lottery revenue shall be made only upon actual and audited collections as transferred to the general fund and shall in no event be predicated upon an estimation of such revenues. While this language in the Code has not been changed, it has been overridden by Appropriation Act provisions to ensure that lottery revenue is available for appropriation in the year in which it is collected and prior to the final annual audit.

This override language is found in Section 3-1.01 I of the 1993 Appropriation Act (Chapter 994, 1993 Acts of Assembly). This provision states:

> *The Comptroller shall transfer to the general fund an amount estimated at $296,919,589 the first year and $308,365,000 the second year from the State Lottery Fund. The transfer for each shall be made in two parts: (1) on or before June 30 of each year, the Comptroller shall transfer balances of the State Lottery Fund for the fiscal year, based on an estimate determined by the State Lottery Department, and (2) no later than ten days after receipt of the annual audit report required by § 58.1-4023 of the Code of Virginia, the Comptroller shall transfer to the general fund the remaining audited balances of the State Lottery Fund for the prior fiscal year. If such annual audit discloses that the actual revenue is less than the estimate on which the transfer was based, the State Comptroller shall transfer the difference between the actual revenue and the estimate from the general fund to the State Lottery Fund. The Comptroller shall take all actions necessary to effect the transfers required by this paragraph, notwithstanding the provisions of § 58.1-4022 of the Code of Virginia.*

The override language is valid, however, only for the biennium in which it is included in the Appropriation Act (i.e., 1992-94 biennium). If this override provision is not reenacted, it will expire on June 30, 1994 and the Code provision will again become effective.

Another important issue of concern is the security for VPBA bonds. VPBA bonds are issued pursuant to Article X, Section 9(d) of the Constitution of Virginia. The VPBA bonds are secured by lease agreements between the Commonwealth and the VPBA, with lease payments made by the Commonwealth used by the VPBA as debt service on its bonds. Commonwealth lease payments are subject to appropriation by the General Assembly. Lease payments may be appropriated from both general and nongeneral funds. The constitutional foundation of VPBA debt requires that the lease payments be subject to appropriation and therefore not binding beyond the current budget period.

Analysis: On face value, it would not be difficult to create an escrow fund so that lottery profits are earmarked to pay the annual debt service costs on VPBA bonds. This could be done in one of two ways.

First, the language in Section 3-1.01 I of the 1993 Appropriation Act (Chapter 994, 1993 Acts of Assembly) could be amended to require the Comptroller to set up such a fund and to direct that a portion of each year's lottery profits be paid into that fund for debt service. The amount of the transfer would be specified in the Appropriation Act based on the projected debt service requirement for these bonds. After satisfying this requirement, any remaining lottery profits would be transferred to the general fund as now required by present law. (Sample language is shown in Appendix Table 4).

The advantage of this approach is that it is simple and the amounts set aside for debt service costs could be easily revised each year during budget development as actual debt service requirements become known. The major disadvantage is that the escrow fund would not be permanently established in statute. Any such provision would have to be reenacted in each succeeding Appropriation Act (i.e., every two years) over the life of the bonds.

The second way to establish an escrow account for this purpose would be to amend Section 3-1.01 I of the current Appropriation Act, as indicated above, and to also change the lottery statute. Under this approach, Section 58.1-4022 D., Code of Virginia, would have to be amended to eliminate the prohibition against the appropriation of lottery profits in advance of their receipt. This would be necessary to assure that sufficient lottery revenue was transferred to the escrow fund so that the first debt service payment on the VPBA bonds could be paid in February 1995. In addition, the same section of the Code would have to be amended to prescribe that an amount equal to the annual debt service cost for the VPBA bonds be transferred to the escrow fund before the required transfer of the remaining lottery profits are deposited in the general fund of the Commonwealth.

There is an obvious advantage in this second approach because it provides for the transfer of lottery profits into an escrow account for payment of VPBA debt service costs as a continuous part of law. However, this approach would fundamentally change the proposition that lottery profits are not predictable and thus, should not be permanently appropriated in advance of their receipt. A similar change in policy was rejected by the General Assembly as recently as the 1991 session (see House Bill 1580 and Senate Bill 625; Appendix pages 5 and 6).

Although the technical changes required to amend existing law are fairly straightforward, there are other complex issues that need to be addressed in terms of setting up a debt service escrow account for this purpose. These issues are both legal and practical in nature.

In this context, any effort to set up an escrow account for payment of VPBA debt service costs is of questionable legal value. While the effort could promote a sense of security in that projected lottery receipts are greater than projected debt service costs, as shown in the first part of this report, it is not clear how bond buyers would interpret this move, especially if it is legislated in statute. What is intended as a good faith effort to reserve funds for debt service costs could be interpreted by one bond purchaser as positive. Another investor may see it as an attempt to limit the liability of the Commonwealth for paying debt service costs. Either way, an explanation of the true nature of the escrow account would have to be disclosed in the bond issuance documents.

A final consideration in establishing an escrow account relates to the timing of lottery transfers. Under current law, lottery transfers are paid into the general fund at the end of each fiscal year. This procedure was established to ensure that the state lottery had sufficient reserves during the course of the year to meet all of its obligations (prizes, etc).

On the other hand, debt service payments on the VPBA bonds will be made twice a year. Thus, in order to have sufficient cash in the escrow account to pay debt service costs, it would be necessary to transfer lottery profits more frequently or increase the amount of lottery revenue placed in escrow at the end of the year to cover debt service payments which would have to be made prior to the next lottery transfer.

Both of these alternatives would have an impact on general fund revenue available for appropriation. If lottery profits are transferred more frequently, the lottery would lose interest income and consequently, the amount of profits available for transfer over the course of the year would decline. Moreover, the lottery would probably have to be audited more often, at least on a preliminary basis, to ensure that lottery profits at the time of each transfer exceed the required amount to be paid into the escrow account for debt service payments.

If the second alternative is chosen and the portion of lottery profits earmarked for the escrow account is increased at year end (to prepay scheduled debt service for the ensuing fiscal year), the net amount of lottery profits paid into the general fund would decline accordingly. The net effect of this action would be to accelerate debt service payments by one year in terms of the impact on the general fund. Over the life of the bonds, the amount available for appropriation from the general fund for any given biennium would be reduced by an average of $1.5 million.

In any alternative, the escrow fund should be established with certain restrictions including restricting the yield on the escrow to the yield on the bonds. However, this raises a credit concern for any VPBA bonds secured in whole or in part by such an escrow.

From a bondholder perspective, lease payments made from the escrowed funds would still need to be appropriated by the General Assembly to meet the "subject to appropriation" criteria for VPBA debt. However, the escrow mechanism would represent a different security structure for the bonds from that used for all other VPBA bonds. If the only source of funds for lease payments for the building is the escrow, a problem could arise if Lottery revenues are insufficient to completely fund the escrow. The General Assembly could still appropriate funds if revenues are insufficient, but the timing of such an appropriation in light of VPBA debt service payment dates could prove unworkable.

Given the complexity of these issues, another approach could be considered to accomplish the objective of earmarking lottery revenue for debt service costs. Language could be placed in Section 3-1.01 I of the Appropriation Act to clearly state that it is the intent of the General Assembly that the first payment (not to exceed debt service requirements) of lottery profits into the general fund each year shall be considered a reimbursement for general fund expenses incurred in servicing the VPBA bonds. This alternative would overcome all of the issues raised in this report and would clearly link lottery revenue as the funding source for the VPBA bond debt service payments.

Finally, there is an approach which does not fund an escrow account but which may follow the intent of the General Assembly. The intent of the General Assembly appears to have the portion of the lease payments for the building attributable to the State Lottery Department paid from Lottery revenues. A method to accomplish this is to make the Lottery portion of the lease payment payable from nongeneral funds. The fund source would be Lottery's operating budget. The lease payment would constitute an operating expense of the Lottery payable from their operating appropriation which is a percentage of Lottery revenues. Several other VPBA projects, such as the Department of Motor Vehicles Building, Main Street Station, and the State Corporation Commission Building projects, have large nongeneral fund lease payment components such as this.

Issue Conclusion: In summary, while it is possible to set up an escrow account in which lottery revenue would be reserved to pay VPBA bond debt service costs, there are several legal and financial issues that should be considered. Other approaches appear to have fewer legal and financial issues and may follow the intent of the General Assembly.

Issue #1 - DETAIL WHEN STATE LOTTERY PROCEEDS WILL NO LONGER BE NEEDED TO FUND OPERATING EXPENSES OF THE COMMONWEALTH AND BECOME AVAILABLE TO PAY THE DEBT SERVICE ON THE BONDS ISSUED TO FINANCE THE NINTH AND BROAD STREET BUILDING (THE BUILDING).

Background: After lottery sales began in September 1988, the 1989 General Assembly enacted appropriations for 82 capital projects totaling $291,145,000 from the general fund and $37,799,000 from nongeneral funds for a grand total of $328,944,000. The general fund share was to be funded from lottery revenues received during the three fiscal years ended June 30, 1989, June 30, 1990, and June 30, 1991.

The legislation directed the Governor to release general fund appropriations for lottery projects to the extent that the audited balances of the Lottery Fund transferred to the general fund were sufficient for that purpose. The projects were to be released in the priority order in which they were listed in Chapter 640, 1989 Acts of Assembly.

For the fiscal year ended June 30, 1989, the State Comptroller transferred $140,487,320 to the general fund from the audited balances of the Lottery Fund, less the required reserve. On August 26, 1989, the Governor released $138,125,000 of this amount for the first 37 projects listed in the 1989 legislation. The remaining $2,362,320 was retained by the general fund because this amount was not sufficient to totally fund the next capital outlay project on the list.

In the summer and early fall of 1989, a decline in general fund revenues from the amount on which 1988-90 appropriations were based became apparent. Accordingly, on December 1, 1989, Governor Baliles withheld unexpended and unobligated appropriations for certain non-lottery capital projects in the amount of $57,414,000. On January 10, 1990, he acted to withhold unexpended appropriations for lottery projects totaling $66,509,000.

Governor Baliles introduced a bill in the 1990 Session appropriating $444,638,647 from lottery revenues for 30 additional capital projects. The bill also appropriated $66,509,000 to fund the withheld lottery projects and $57,414,000 to fund the withheld non-lottery projects. This was done in the expectation that revenues would improve so as to permit these projects to go forward.

The General Assembly's final action was to appropriate $473,201,772 for 53 additional projects and $132,558,116 to fund the withheld projects. This money was to be available from transfers to the general fund from the Lottery Fund for the fiscal years ended June 30, 1990, June 30, 1991, and June 30, 1992. The priorities in Chapter 922, 1990 Acts of Assembly, replaced those in Chapter 640.

The Auditor of Public Accounts certified $156,484,607 to be transferred from the Lottery Fund to the general fund as of June 30, 1990. In August of 1990, Governor Wilder released $80,857,435 of this amount for certain capital projects. He also released and concurrently withheld appropriations for other capital projects, because of the continuing decline in general fund revenues during 1990. Therefore, of the original transferred amount, $75,627,172 was made available for operating expenses rather than capital projects.

The 1991 Appropriation Act repealed the two lottery appropriation acts enacted in 1989 and 1990. Language was included in that act to override the Code provision prohibiting appropriations of lottery revenues except on the basis of actual audited amounts and to allow lottery revenues to be available in the year when collected. Thereafter, all lottery profits have been retained in the general fund.

The 1992 Appropriation Act continued the override for the 1992-94 biennium and estimated that lottery revenues available for the general fund would be $305,075,000 for 1992-93 and $308,075,000 for 1993-94. These amounts were changed by the 1993 Appropriation Act to $296,919,589 for 1992-93 and $308,365,000 for 1993-94. In addition, in May 1993, the State Lottery Department reduced its forecast for the first year by $3.2 million. Finally, Lottery changed its estimate for the June 30, 1993 transfer to $297 million for the 1992-93 revenues available for the general fund.

Analysis: Although both lottery acts were permanently repealed in 1991, capital projects originally planned for this source of funding have not been completely deferred. In retrospect, it is not totally correct to say that lottery revenue has been simply transferred to the general fund in order to support operating expenditures. The relationship between the repeal of the lottery legislation and the shortfall of revenue in the general fund is much more complex than that, and an explanation is in order.

As previously noted, the 1987 enabling legislation for the state lottery did not earmark lottery profits for any single purpose. It did, however, prohibit the appropriation of these funds prior to their receipt. As such, lottery profits could not be used for either operating expenses or for capital outlay until they were audited and deposited into the general fund of the Commonwealth.

The 1989 and 1990 legislation appropriating lottery revenue for certain capital outlay projects recognized this fact. Provisions in both pieces of legislation authorized the Governor to release funds for the specified projects only when sufficient lottery revenue had been transferred to the general fund after the close of each fiscal year. The source of funding for all projects listed in the legislation was the "General Fund"; not the "Lottery Fund."

Moreover, the use of lottery revenue was not restricted to state capital outlay projects per se, according to a strict interpretation of the Appropriation Act (see Section 4-4.01.a.1., Chapter 972, 1990 Acts of Assembly). The second lottery act (Chapter 922, 1990 Acts of Assembly) contained appropriations for the Housing Partnership Revolving Loan Fund ($38.0 million), for the Virginia Water Facilities Revolving Fund ($19.0 million) and for local jail construction ($16.9 million). Although these projects were certainly capital in nature, they were not "state projects" in the sense that the Commonwealth either owned or operated the financed facilities. Previously, such projects had been financed by pass-through funds included in the operating side of the general fund budget.

As a result, when lottery projects were first deferred by Governor Baliles in 1990, the authority for the action was the general provisions of the Appropriation Act, then in effect. The provisions in question allowed the Governor to withhold general fund appropriations for capital outlay projects in the event of a general fund revenue shortfall to the extent that the projects were not legally under contract for architectural, engineering or construction work. This same authority was used by Governor Wilder in August 1990, in the face of another downward revision in the general fund revenue forecast. Within limits, each Governor was authorized by the general provisions to reduce capital outlay expenditures in order to balance the general fund budget.

In this context, it was not a major policy change when capital projects financed by lottery revenue had to be deferred. The authority for delaying them had been in the Appropriation Act for many years. The new feature was the language placed in the Appropriation Act for the first time in 1991 to override the prohibition against lottery revenue being appropriated before its receipt. This change meant that lottery revenue could be included in the projected general fund revenue stream that supported budgeted general fund appropriations in the Appropriation Act. It also meant that lottery revenue could be appropriated within the general fund budget during the fiscal year in which it was collected for any purpose approved by the General Assembly -- be that purpose operating or capital outlay appropriations.

While the above was indeed a significant policy change, it did not defer all capital outlay projects originally slated to be financed by lottery revenue. General fund appropriations approved by the General Assembly moved lottery projects forward on four fronts.

First, the 1992-94 Appropriation Act, as amended by the 1993 General Assembly, includes appropriations of $72.4 million from the general fund for capital outlay projects. More than half of this amount ($40.6 million, including the $10 million from the undesignated, unreserved general fund balance on June 30, 1993) is for maintenance reserve projects. Because the 1990 legislation made maintenance reserve projects the number one priority, it is reasonable to assume that these projects would have been included in any subsequent bill to appropriate lottery revenue for capital outlay projects.

In addition, at least some of the remaining $31.8 million from the general fund for capital outlay projects in the 1992-94 Appropriation Act can be traced to the original two pieces of lottery legislation. Given the serious fiscal situation that would have developed in the general fund in the absence of lottery revenue, it is probably safe to assume that all of these projects would have also been funded in subsequent lottery bills.

Second, the 1992-94 Appropriation Act, as amended by the 1993 General Assembly, contains $26.9 million in general fund appropriations within the operating budget that are for items formerly financed in the lottery bills. The items include: $15.0 million for the Housing Partnership Fund, $1.0 million for the Virginia Water Facilities Revolving Fund, and $10.9 million for the construction of local jail facilities.

In addition to these direct appropriations, certain other lottery projects have been initiated with financing provided by other bond issues through the VPBA. This Authority was established to undertake essential capital projects for the state. The VPBA finances these projects through bonds which it issues in its own behalf. The state then services this debt through lease payments which it pays to the Authority for the use of the facilities. These lease payments are appropriated to the Treasury Board and, for most projects, they are funded by general fund appropriations.

Over the course of the last several years, the VPBA has undertaken several projects that were contained in the lottery bills. For example, the construction of new correctional facilities was one of the top priorities in the 1989 lottery act. Priority number nine in Chapter 640, 1989 Acts of Assembly authorized $29.9 million for new prison construction. When this project was released, it was assumed that additional facilities would have to be constructed in the near future to relieve overcrowding of state prisoners in local jails.

With the subsequent revenue shortfalls and the deferral of lottery capital outlay projects, the VPBA has been the main source of financing for new prison construction. Since 1990, the VPBA has undertaken the construction of sixteen new correctional facilities. In addition, it has funded at least six other projects during this timeframe that had been authorized for construction from lottery profits.

The point is that much if not all of the lease payments associated with recent VPBA projects could have been avoided had the policy of earmarking lottery projects for capital outlay remained in effect. For the 1992-94 biennium, the Appropriation Act includes $28.7 million from the general fund to make these lease payments for projects financed by the VPBA since 1990.

Finally, the 1992-94 Appropriation Act contains $23.6 million for the debt service on the general obligation bonds authorized in the 1992 General Assembly session and approved by the voters in the referendum. Many of the projects included in this general obligation bond package can be found in one of the two previously enacted lottery acts.

Issue Conclusion: When all of the above items are added together, one can easily make the case that $151.6 million from the general fund during the 1992-94 biennium will go for items which otherwise would have been paid for by lottery revenue. From this perspective, about three-quarters ($453.8 million) of the $605.4 million to be transferred to the general fund from the Lottery Fund in the current biennium will be diverted to purposes other than those envisioned in the 1989 and 1990 lottery bills. (See Appendix Table 5.)

The foregoing analysis suggests that lottery proceeds are immediately available to pay the debt service on the proposed VPBA bonds because the debt service on these bonds is appropriated from the general fund and because lottery revenue is presently transferred to the general fund. However, it is more difficult to answer the question of when the $453.8 million above will no longer be needed to support general fund appropriations and become available to fund additional capital outlay projects.

Obviously, any effort to set apart lottery profits from the general fund in the near future would have serious consequences on general fund operations. The $453.8 million being used to support general fund appropriations for the 1992-94 biennium would be equivalent to another 15 percent reduction in the general fund budget. This would be on top of the 25 percent reduction ($842.8 million) that operating budgets of many state agencies have already sustained over the past several fiscal years.

There is no way that a reduction of this magnitude could be absorbed without an adverse effect on high priority general fund expenditures. One only needs to consider that five major programs account for 77.2 percent of the growth in the general fund budget from 1985 to 1994. These programs include medical services, corrections, programs for persons with mental disabilities, public education and higher education. Moreover, at the present time approximately 46.5 percent of the general fund budget goes to aid for localities.

To this end, it appears that the ability of the Commonwealth to use lottery proceeds strictly for capital outlay purposes will depend on the prospects for general fund revenue growth in the future and on the competing demands that will be placed on the use of any additional revenue as a result of this growth. For example, when lottery proceeds were first proposed to be used exclusively for capital outlay projects, revenue growth in fiscal year 1990 was projected to be 11.1 percent and for fiscal years 1992 and 1993, it was projected to be 6.1 percent and 7.9 percent, respectively. Under these conditions, it was anticipated that the Commonwealth could afford to earmark lottery proceeds for capital projects without hurting the operating side of the budget.

But actual revenue collections for fiscal year 1990 only grew by 0.2 percent and for fiscal year 1991, they actually declined by 0.4 percent before registering modest growth of 2.8 percent in fiscal year 1992. Preliminary collections for fiscal year 1993 show growth of 9.0 percent as of July 16, 1993. Because the severe contraction in Virginia's economy had brought revenue growth to a near standstill during this period, lottery profits could no longer be used solely for capital outlay projects without considerable reductions in ongoing services. Accordingly, the change in policy relating to the use of lottery revenue was one that was brought about by the weakening performance of revenue growth more than anything else.

As for the future, revenue growth in Virginia is expected to be slow during the remainder of the 1990s. It is now anticipated that Virginia will underperform the nation in employment growth beyond 1993 because:

- Virginia's labor force will grow at a slower rate;

- Net migration is expected to slow down; and

- Civilian and military defense cutbacks will continue.

As a result, the long term forecast released by the Department of Taxation last December calls for revenue growth averaging about 4.8 percent annually over the period from fiscal year 1995 to fiscal year 2000. This is below the average annual revenue growth of 7.8 percent that was experienced between fiscal years 1985 and 1990, but it is considerably better than the 0.8 percent growth averaged over fiscal years 1990 and 1992.

Whether this growth will actually allow lottery proceeds to be allocated for capital projects will depend to a large degree on how many competing demands for funding arise during this timeframe. However, as the Virginia economy undergoes its structural change and revenue growth improves, the need for debt financing to undertake capital projects should diminish. Similarly, the prospects for again allocating lottery revenue to capital projects should improve.

APPENDIX

APPENDIX TABLE 1

PROJECTED DEBT SERVICE COST FOR VIRGINIA PUBLIC BUILDING AUTHORITY BOND ISSUES TO FINANCE THE NINTH AND BROAD STREET BUILDING

Assumptions:
- 20 year bonds;
- Two issues of $11.6 million August 1994 and $5.7 million August 1995;
- Average effective interest rate for all issues equals 6.5 percent;
- Amount of bonds issued includes amounts needed for costs of issuance; and
- Debt service structured on a level debt service basis.

DEBT SERVICE SCHEDULE
$ MILLIONS

Fiscal Year	Principal Payment	Interest	Total Cost
1994-95	...	$ .375	$ .375
1995-96	.290	.929	1.219
1996-97	.455	1.093	1.548
1997-98	.485	1.062	1.547
1998-99	.520	1.030	1.550
1999-2000	.550	.995	1.545
2000-01	.590	.958	1.548
2001-02	.630	.918	1.548
2002-03	.675	.876	1.551
2003-04	.720	.831	1.551
2004-05	.765	.782	1.547
2005-06	.815	.731	1.546
2006-07	.875	.676	1.551
2007-08	.935	.617	1.552
2008-09	.990	.555	1.545
2009-10	1.065	.488	1.553
2010-11	1.130	.417	1.547
2011-12	1.210	.341	1.551
2012-13	1.290	.259	1.549
2013-14	1.375	.173	1.548
2014-15	1.470	.080	1.550
2015-16	.500	.016	.516
Total	$17.335	$14.205	$31.540

APPENDIX TABLE 2

LONG TERM LOTTERY 22 YEAR REVENUE PROJECTIONS
(For the same period the 1993 VPBA Bonds are outstanding.)
$ MILLIONS

Fiscal Year	Sales	Prize Expense	Operating Expense	Revenue to Commonwealth
1994-95	$ 960.5	$ 509.1	$ 118.1	$ 333.3
1995-96	983.1	521.0	120.9	341.1
1996-97	993.8	526.7	122.2	344.8
1997-98	1,004.7	532.5	123.6	348.6
1998-99	1,015.6	538.3	124.9	352.4
1999-2000	1,026.7	544.2	126.3	356.3
2000-01	1,034.7	548.4	127.3	359.0
2001-02	1,042.7	552.6	128.3	361.8
2002-03	1,050.8	556.9	129.2	364.6
2003-04	1,059.0	561.3	130.3	367.5
2004-05	1,067.2	565.6	131.3	370.3
2005-06	1,075.5	570.0	132.3	373.2
2006-07	1,083.8	574.4	133.3	376.1
2007-08	1,092.2	578.9	134.3	379.0
2008-09	1,100.7	583.4	135.4	381.9
2009-10	1,109.3	587.9	136.4	384.9
2010-11	1,114.4	590.6	137.1	386.7
2011-12	1,119.6	593.4	137.7	388.5
2012-13	1,124.8	596.1	138.4	390.3
2013-14	1,130.0	598.9	139.0	392.1
2014-15	1,135.2	601.7	139.6	393.9
2015-16	1,140.4	604.4	140.3	395.7

Sources: The long term sales projections above were prepared by the Virginia Lottery Department based on the assumption that sales would grow from $2.53 per capita per week in fiscal year 1993 to $2.86 per capita per week by fiscal year 1996 and thereafter sales would parallel projected population growth. Prize and operating expenses were projected by the Department of Planning and Budget assuming that these expenses would stay constant relative to sales at their projected 1993-94 level (65.3% of sales).

Department of Planning and Budget, June 1993

APPENDIX TABLE 3

VIRGINIA LOTTERY 22 YEAR REVENUE PROJECTIONS
(For the same period the 1993 VPBA Bonds are outstanding.)
$ MILLIONS

Fiscal Year	Sales	Prize Expense	Operating Expense	Revenue to Commonwealth
1994-95	$ 960.5	$ 557.1	$ 131.6	$ 271.8
1995-96	983.1	570.2	149.4	263.5
1996-97	993.8	576.4	151.1	266.3
1997-98	1,004.7	582.7	152.7	269.3
1998-99	1,015.6	589.1	154.4	272.2
1999-2000	1,026.7	595.5	156.1	275.2
2000-01	1,034.7	600.1	157.3	277.3
2001-02	1,042.7	604.8	158.5	279.4
2002-03	1,050.8	609.5	159.7	281.6
2003-04	1,059.0	614.2	161.0	283.8
2004-05	1,067.2	619.0	162.2	286.0
2005-06	1,075.5	623.8	163.5	288.2
2006-07	1,083.8	628.6	164.7	290.5
2007-08	1,092.2	633.5	166.0	292.7
2008-09	1,100.7	638.4	167.3	295.0
2009-10	1,109.3	643.4	168.6	297.3
2010-11	1,114.4	646.4	169.4	298.7
2011-12	1,119.6	649.4	170.2	300.0
2012-13	1,124.8	652.4	171.0	301.4
2013-14	1,130.0	655.4	171.8	302.8
2014-15	1,135.2	658.4	172.5	304.2
2015-16	1,140.4	561.5	173.3	305.6

Sources: The long term sales projections above were prepared by the Virginia Lottery Department based on the assumption that sales would grow from $2.53 per capita per week in fiscal year 1993 to $2.86 per capita per week by fiscal year 1996 and thereafter sales would parallel projected population growth. Prize and operating expenses were also projected by the Lottery Department assuming that prize payout percentage would increase from 53 percent to 58 percent of sales in fiscal year 1995 and that operating expenses would increase to 10 percent of sales by fiscal year 1996.

Virginia Lottery Department, June 1993

APPENDIX TABLE 4

Sample Language for Section 3-1.01 I
1993 Appropriation Act (Chapter 994, 1993 Acts of Assembly)

I.1. The Comptroller shall transfer an amount estimated at $296,919,589 the first year and $308,365,000 the second year from the State Lottery Fund. From the amounts so transferred, the Comptroller shall first deposit $xxx,xxx,xxx the first year and $xxx,xxx,xxx the second year into an escrow account which shall be used to pay the debt service costs contained in Item 285 of this Act for Virginia Public Building Authority bonds authorized by the 1993 General Assembly pursuant to Chapter 1, 1993 Acts of Assembly, Special Session. Such reimbursement shall not exceed the principal and interest payments required in each year. The remaining amounts estimated at $xxx,xxx,xxx the first year and $xxx,xxx,xxx the second year shall be deposited into the general fund.

2. The transfer specified in paragraph 1 of this item for each year of the biennium shall be made in two parts: (1) on or prior to June 30 of each year, the Comptroller shall transfer balances of the State Lottery Fund for the fiscal year, based on an estimate determined by the State Lottery Department, and (2) no later than ten days after receipt of the annual audit report required by §58.1-4023 of the Code of Virginia, the Comptroller shall transfer the remaining audited balances of the State Lottery Fund for the prior fiscal year. The Comptroller shall take all actions necessary to effect the transfers required by this paragraph, notwithstanding the provisions of §58.1-4022 of the Code of Virginia

LD5832308

HOUSE BILL NO. 1580

Offered January 21, 1991

A BILL to amend and reenact § 58.1-4022 of the Code of Virginia, relating to the State Lottery Fund.

Patrons—Diamonstein, Cranwell and Parker

Referred to the Committee on Finance

Be it enacted by the General Assembly of Virginia:

1. That § 58.1-4022 of the Code of Virginia is amended and reenacted as follows:

§ 58.1-4022. State Lottery Fund.—A. All moneys received from the sale of lottery tickets or shares, less payment for prizes and compensation of agents as authorized by regulation and any other revenues received under this chapter, shall be placed in a special fund known as the "State Lottery Fund." Notwithstanding any other provisions of law, interest earned from moneys in the State Lottery Fund shall accrue to the benefit of such Fund.

B. The total costs for the operation and administration of the lottery shall be funded from the State Lottery Fund and shall be in such amount as provided in the general appropriation act. Appropriations to the Department during any fiscal year beginning on and after July 1, 1989, exclusive of agent compensation, shall at no time exceed ten percent of the total annual estimated gross revenues to be generated from lottery sales. However, should it be anticipated at any time by the Director that such operational and administrative costs for a fiscal year will exceed the limitation provided herein, the Director shall immediately report such information to the Board, the Governor and the Chairmen of Senate Finance and House Appropriations Committees. From the moneys in the Fund, the Comptroller shall establish a special reserve fund in such amount as shall be provided by regulation of the Department for (i) operation of the lottery, or (ii) use if the game's pay-out liabilities exceed its cash on hand.

C. Any start-up sums appropriated from the general fund of the Commonwealth necessary to commence operation of a state lottery shall be repaid within the first twelve months of initial lottery sales.

D. ~~Appropriation of lottery revenues shall be made only upon actual and audited collections as transferred to the general fund and shall in no event be predicated upon an estimation of such revenues. No later than ten days after receipt of the audit report required by § 58.1-4023, the Comptroller shall transfer to the general fund, less the special reserve fund, the audited balances of the State Lottery Fund.~~ *The Comptroller shall transfer to the general fund, before the last day of each fiscal year, balances of the State Lottery Fund, for the first ten months of the fiscal year, less the special reserve fund, as certified by the Auditor of Public Accounts, based on the completion of interim audit procedures. No later than ten days after receipt of the annual audit report required by § 58.1-4023, the Comptroller shall transfer to the general fund the remaining audited balances of the State Lottery Fund, less the special reserve fund, for the prior fiscal year.*

E. As a function of the administration of this chapter, funds may be expended for the purposes of reasonably informing the public concerning (i) the facts embraced in the subjects contained in subdivisions 1 through 7 of subsection A of § 58.1-4007 and (ii) the fact that the net proceeds are paid into the general fund of the Commonwealth; but no funds shall be expended for the primary purpose of inducing persons to participate in the lottery.

2. That an emergency exists and this act is in force from its passage.

LD6035308

SENATE BILL NO. 625

Offered January 16, 1991

A BILL to amend and reenact § 58.1-4022 of the Code of Virginia, relating to the State Lottery Fund.

Patron—Holland, R.J.

Referred to the Committee on Finance

Be it enacted by the General Assembly of Virginia:

1. That § 58.1-4022 of the Code of Virginia is amended and reenacted as follows:

§ 58.1-4022. State Lottery Fund.—A. All moneys received from the sale of lottery tickets or shares, less payment for prizes and compensation of agents as authorized by regulation and any other revenues received under this chapter, shall be placed in a special fund known as the "State Lottery Fund." Notwithstanding any other provisions of law, interest earned from moneys in the State Lottery Fund shall accrue to the benefit of such Fund.

B. The total costs for the operation and administration of the lottery shall be funded from the State Lottery Fund and shall be in such amount as provided in the general appropriation act. Appropriations to the Department during any fiscal year beginning on and after July 1, 1989, exclusive of agent compensation, shall at no time exceed ten percent of the total annual estimated gross revenues to be generated from lottery sales. However, should it be anticipated at any time by the Director that such operational and administrative costs for a fiscal year will exceed the limitation provided herein, the Director shall immediately report such information to the Board, the Governor and the Chairmen of Senate Finance and House Appropriations Committees. From the moneys in the Fund, the Comptroller shall establish a special reserve fund in such amount as shall be provided by regulation of the Department for (i) operation of the lottery, or (ii) use if the game's pay-out liabilities exceed its cash on hand.

C. Any start-up sums appropriated from the general fund of the Commonwealth necessary to commence operation of a state lottery shall be repaid within the first twelve months of initial lottery sales.

D. ~~Appropriation of lottery revenues shall be made only upon actual and audited collections as transferred to the general fund and shall in no event be predicated upon an estimation of such revenues. No later than ten days after receipt of the audit report required by § 58.1-4023, the Comptroller shall transfer to the general fund, less the special reserve fund, the audited balances of the State Lottery Fund.~~ *The Comptroller shall transfer to the general fund, before the last day of each fiscal year, balances of the State Lottery Fund, for the first ten months of the fiscal year, less the special reserve fund, as certified by the Auditor of Public Accounts, based on the completion of interim audit procedures. No later than ten days after receipt of the annual audit report required by § 58.1-4023, the Comptroller shall transfer to the general fund the remaining audited balances of the State Lottery Fund, less the special reserve fund, for the prior fiscal year.*

E. As a function of the administration of this chapter, funds may be expended for the purposes of reasonably informing the public concerning (i) the facts embraced in the subjects contained in subdivisions 1 through 7 of subsection A of § 58.1-4007 and (ii) the fact that the net proceeds are paid into the general fund of the Commonwealth; but no funds shall be expended for the primary purpose of inducing persons to participate in the lottery.

2. That an emergency exists and this act is in force from its passage.

APPENDIX TABLE 5

INDIRECT SUPPORT FOR CAPITAL PROJECTS FROM LOTTERY PROCEEDS IN THE 1992-94 BUDGET (CHAPTER 994, 1993 ACTS OF ASSEMBLY)

Description	Item #	1992-93	1993-94	Total	Percent
		Millions of Dollars			
Total Lottery Transfers to the General Fund	3-1.00 I	297.0	308.4	605.4	100.0%
Less:					
Support for Operating Programs					
Housing Partnership Fund	86	2.0	13.0	15.0	2.5
Water Facilities Revolving Fund	417	....	1.0	1.0	.2
Local Jail Construction	462	10.9	....	10.9	1.8
Subtotal		12.9	14.0	26.9	4.5
Support for Debt Service					
VPBA Series 1991 A	285	4.1	4.5	8.6	1.4
VPBA Series 1992 C	285	3.8	14.5	18.3	3.0
GOB	285	2.8	20.8	23.6	3.9
Proposed VPBA Series 1993	285	....	1.8	1.8	.3
Subtotal		10.7	41.6	52.3	8.6
Support for Capital Outlay					
Maintenance Reserve	C-1	10.0	20.6	30.6	
Maintenance Reserve	C-1		10.0*	10.0	6.7
Other Capital Projects	Various	3.3	28.5	31.8	5.3
Subtotal		13.3	59.1	72.4	12.0
TOTAL INDIRECT SUPPORT	...	36.9	114.7	151.6	25.1
Net Lottery Transfers to General Fund	...	260.1	193.7	453.8	74.9

*Maintenance Reserve of $10 million from the undesignated, unreserved general fund balance on June 30, 1993 as required by the 1993 Appropriation Act.