

ADVICE TO AINSWORTH NOMINEES PTY LIMITED ON THE GOVERNMENT'S PROPOSALS FOR A DUTY BASED ON TURNOVER ON POKER MACHINES IN N.S.W.

SUMMARY

The Ainsworth Group has asked me to prepare a paper dealing with the issue of a duty based on poker machine turnover which I believe will be proposed for N.S.W. clubs.

This document outlines the background to the development of the Government's proposals for a turnover based duty on poker machines in N.S.W.

It also canvasses my views about why the Government is pursuing a turnover (credits played) based tax and possible arguments which the club and poker machine industries should advance to counter this move.

In spite of the apparent nonchalance of the club movement to the seriousness of the Government's proposal, I believe that the Chief Secretary's Department is adamant that the tax system must change and that its preferred option is a duty on credits played as distinct from net revenue.

BACKGROUND

- A tax on poker machine turnover has been under consideration for many years. To my knowledge, the tax was first considered in the early 1980's by the former Treasury Poker Machine Branch. Statistical models were considered at that stage when it was discovered that a tax on turnover (credits played) would have given many clubs the benefit of a considerable reduction in tax liability but would have severely penalised other clubs.
- The reasons for this disparity were that clubs differed in their player return percentages, the amount of bonus prizes given in addition to machine prizes and the amount of annual tax they paid because of various denomination mix preferences.
- Because of those problems the proposal was put in the "too-hard-basket".
- The subject arose again after the Liquor Administration Board took over the Treasury Poker Machine Branch. Again, no progress was made because it was believed that the potential problems far outweighed the merits of any such change to the tax system.

- When the Greiner/Murray Government came to power in March 1988 the matter was raised again - but this time with a firm commitment to deal with the matter positively. The issue became part of the Green Paper proposals issued in June 1988 when it was intermingled with a number of "sweeteners" for clubs.

- The decision to proceed with the proposal was due mainly to the new Department Head's zeal to show that he was committed to fulfil initiatives which had been the subject of procrastination under the Treasury Poker Machine Branch and the L.A.B.

This was at a time when the Mr McGregor had to prove himself to the new Government because he was on its "hit list" of the former Government's Departmental Heads and was dumped as head of the Health Department as soon as Greiner won power.

- The dangers of a duty on credits played were never really considered by clubs at that stage, in spite of a clear indication from the Government that it was likely to be proposed.

- Later, Roger Cowan presented a paper to the Club Industry Advisory Council addressing some of the problems of a turnover tax.

- The package proposed by the Government included an amendment to the Registered Clubs Act to permit a new taxation system for poker machines to be introduced by regulation. This perhaps unprecedented move which defies convention (i.e. that the people, as represented by the Parliament, should be given the opportunity to reject a proposed tax) was deviously slipped through Cabinet and the Parliament to enable the new tax system to be implemented by regulation with haste, if necessary.

Traditionally, all proposals for changes to taxation rates or systems must be brought before the Parliament for debate and ultimate determination by the peoples' representatives before enactment. This is done by proposed amendments to the relevant Act rather than by regulations. Regulations may be introduced by the Minister without prior reference to Parliament. However, the Regulation must be placed on the table of the House within 14 sitting days of publication of the Regulation in the Government Gazette, following which Parliament, by majority, may disallow the Regulation.

- The proposal to enact the new tax by regulation was claimed to be justified because the present tax has been in place for so long and flexibility was needed to make quick changes if the need arose (due to unforeseen cases of hardship or if the new scheme didn't achieve the desired result).

- The representatives of the Registered Clubs Association were made aware of these proposals but were hood-winked by the Department in accepting the stated reasons for requiring Regulatory change rather than insisting on conventional change after full Parliamentary debate.
- The Registered Clubs Act was suitably amended by Schedule 4 of the Registered Clubs (Amendment) Act 1988 to give effect to the proposal.
- I believe that the issue to change the tax structure was motivated by the new administration wanting to show the new Government how progressive and innovative it can be.
- Similar amendments to the Liquor Act were made to introduce a tax on credits played on approved amusement devices which after much discussion and argument was accepted by the A.H.A.

STATED REASONS FOR REQUIRING A DUTY ON CREDITS PLAYED

The Department has stated that a new system of tax for poker machines is needed to achieve uniformity, simplicity, efficiency and equity.

Critical examination of the stated reasons for a change to the tax scheme and a credits played tax rather than a profits based tax need to be undertaken by the industry as a matter of urgency.

UNIFORMITY

It is true that other forms of State gaming taxation are based on turnover (amounts staked by wagerers).

However, there are several differences between those other forms of gambling and poker machine gambling:-

1. Poker machine gambling is much more rapid - players reinvest their winnings time and time again, almost immediately. Poker machines are played by many, including the elderly, as a pastime to while away the hours as a form of entertainment.

This is not the case with most other forms of gambling where -

- the events are sparse;
- the permissible stakes and prize-money are greater;
- the lure of large prizes is the main attraction;
- the entertainment value is very much less than poker machines, and
- relatively little gambling winnings are reinvested by players immediately after winning.

The time span between wagering events on poker machines is measured in seconds whereas other gaming timespans between wagers is measured usually in hours or days (e.g. lotteries, racing, lotto etc.).

2. Most other forms of gaming involve gamblers wagering by contributing to a pool of money out of which taxes and the house edge are deducted before prize dividends are distributed from the residue of the pool.

Examples of this are lotto, lotteries and T.A.B. betting. Those forms of gambling guarantee both taxation to the Government and a profit to the operator on each wagering "event".

Not so with poker machine gambling!

A turnover based tax on poker machines would guarantee a fee from every wager to be paid to the Government.

However, every "event" (each play of a poker machine) does not have a built-in profit margin to the operator (in this case, clubs) because poker machines - with the exception of linked jackpot systems - do not involve "pooled gambling". Each and every play of a poker machine is a transaction between the player and the club, the result of which is determined instantaneously by a machine. Neither the club nor the player (except where player intervention is allowed) can affect the outcome.

It is often the case that over long periods, machines can operate to the club's disadvantage by giving prizes in excess of expected, which diminish club returns.

Of course, the opposite can occur which provides the club with more revenue from a machine than expected.

However, experience shows that machines are more likely to operate against the club for reasons unknown to clubs, manufacturers and the Government.

A tax on credits played will penalise the club further, through no fault of its own.

This situation is quite different from pooled racing, football and lotto because the tax and the operator's profit from the pool are certain percentages of the pool - the unknown factor is the prize ultimately paid to the gambler.

Draw lotteries is slightly different because the gambler knows what the prizes will be - but, there is no draw until all tickets are sold. Therefore, the gambler must wait for accumulation of the total pool so that the Government gets its tax and the operator gets its profit.

3. Most other forms of gambling have a fixed edge to the operator and at any particular time there is usually only one operator of the game (i.e. off-course race-betting -- T.A.B.; on-course race-betting -- racing clubs (tote); lotto; lotteries and football pools -- State Lotteries Office).

There is a virtual monopoly given to those institutions.

- e.g. - There is only one T.A.B.
- There is only one race meeting of its type allowed in the immediate vicinity of the Sydney Metropolitan area on a particular day, for instance.
 - There is only one State Lotteries Office.

Therefore, no competition is necessary - a fixed percentage of return to the player is acceptable and a tax on turnover is acceptable.

This is not the case with poker machines!

- Poker machines are not operated by the Government.
 - They are operated by separate and distinct entities.
 - Competition is prevalent and healthy.
 - Clubs have the freedom to determine the percentage of turnover they wish to retain as profit (max. 15%).
 - All the risks are taken by clubs.
 - All operating costs are assumed by clubs.
4. Poker machine gambling involves players wagering on the outcome of an event which is determined by a device over which the operator, by law, has no control.

Unlike bookmakers, clubs cannot:-

- adjust the odds against the wagerer
 - lay-off bets to eliminate or reduce their risk
 - refuse to take a bet
5. The "house edge" for most other gaming forms in N.S.W. is fixed by Regulation or statute and is taken out of the subscription pool BEFORE prizes are declared.

- THE HOUSE CANNOT LOSE !

6. The introduction of a turnover based duty for hotel draw poker machines was for entirely different reasons than for poker machines:-

- the Government wanted to increase the taxes on hotel machines (this is stated not to be the case for club machines);
- the pre-existing tax scheme for hotel machines was inappropriate and inequitable (it had no relationship to profits as does the existing club tax scheme);
- it would be easier to administer and more secure for the Government than a profits based tax because -
 - the Government may have less trust in hotels than in clubs to fully declare profits;
 - hotels do not have a regulated and secure system of controlling and accounting for machine clearances and payouts (clubs do have such controls);
 - in the final negotiating stages, the rate of duty - not the method of assessing it - was the only matter under consideration (for clubs, the reverse is the case - the duty is to be revenue neutral - the method of assessment is in dispute).
- hotel draw poker machines, by nature, are different to club poker machines making a turnover tax on hotel machines of less significance because -

- they are less volatile than club machines with a rigid prize structure, smaller stakes and smaller prizes, even after taking into account the marginal increased return the player may achieve through use of skill, and
- they service a clientele which is less discerning than club patrons in terms of requirements for entertainment value.

SIMPLICITY

The argument that a duty based on straight turnover would be more simple than the present system of poker machine taxation is difficult to deny.

The present system is cumbersome and unwieldy with three types of taxes and several complicated concessions, exemptions and rebates.

There is merit in simplifying poker machine taxation for the benefit of both Government and industry. The present system has several undesirable features and the club industry should take the opportunity to correct them (see page 18).

However, simplification may inadvertently entail a reduction in equity of the tax system. This is because to achieve equity it seems there must be a progressive taxation structure to preserve the principle that the more affluent must pay a higher rate of tax than those that can least afford it (like income tax).

EFFICIENCY

This criterion seems to be linked with the concept of achieving a simplified system of poker machine taxation.

Naturally, simplifying a system should achieve more efficiency in handling the system.

However, there is no evidence that the club industry is not competently handling the present system. The accuracy of poker machine taxation returns are confirmed both by a Club's management and its auditor.

Even if discrepancies occur between a Club's return and the L.A.B.'s records, investigations by the L.A.B. and a review of the Club's records seem to resolve the problem efficiently.

EQUITY

This criterion is perhaps the most controversial reason put forward for a change to the existing system.

The Greiner/Murray Government purports to support entrepreneurial flair in business and the free-enterprise system where competition is acknowledged as being healthy and for the betterment of industry and the community.

Yet, this poker machine tax policy has been formulated to effect a "Robin Hood" approach to the ideal of taxation reform.

Once again, this initiative is thrust upon the club industry under the guise of assisting small clubs. However, history has repeated itself time and time again by other such initiatives failing to provide real help to small clubs.

The Chief Secretary's Department has stated that its best model developed so far will result in -

- 375 clubs paying more tax;
- 1,113 clubs paying less tax; and
- 542 clubs will pay no tax at all.

I find it hard to justify why small clubs should be exempted totally from paying poker machine taxation. Under the present scheme all clubs pay tax, albeit a small amount in the case of some 600 clubs. I fail to understand how the granting of total exemptions for those clubs under a new system would be equitable.

The Department appears to be selling the proposal for a change to the taxation structure solely on the basis that a redistribution of the tax burden is necessary, i.e. that big clubs will have to subsidise the small clubs, with the effect of keeping small clubs in existence.

That approach is not a genuine attempt at achieving equity - it is political grandstanding aimed at convincing the majority of clubs that a turnover tax will be good for them.

COUNTER ARGUMENTS THE CLUB INDUSTRY SHOULD PURSUE

- patrons can detect a machine's payback percentage.
- a high payback percentage is essential to satisfy players, particularly for \$1 and \$2 machines and \$10 stakes.
- poker machines are designed partly to enable patrons to "buy time" as well as to make a profit.
- high payback returns are essential to future game innovation, i.e. high stakes casino type games like blackjack, roulette, baccarat, etc.
- poker machines must provide player appeal and this is dependent on providing high player returns.

Note: The industry must present a qualified argument about these theories.

It is my view that the industry cannot win the arguments against a turnover tax solely on the basis of unproven theories such as:-

- the players can detect a machine's percentage return;
- the players can tell the difference between a 92% machine and a 95% machine;
- players want more time in which to play machines, etc.

These statements may well be true. However, unless the industry can prove to the Government that these statements are factual, which is unlikely in the short term, it seems pointless arguing the case. If the industry is intent on arguing the case it must qualify the points precisely and avoid making sweeping statements, like it has recently.

- the criterion of "uniformity" is falacious, e.g. hotel draw poker machines, lotteries, T.A.B.
- the tax will be counter-productive to giving clubs the incentive to promote and market their businesses by trade competitions, bonus prize schemes etc. because it is likely that tax deductions will be denied.
- it will adversely affect the ability for clubs to distribute funds in aid of charity and community projects.
- it will adversely affect the ability of clubs to provide affordable services and facilities.
- it will adversely affect the ability of clubs to offer employment.
- it will stifle initiative and discourage professional management of poker machine operations which Government and industry have strived to achieve over recent years.
- it will place less emphasis from Government on control of poker machine revenue because Government revenue will not be reduced by poor management, incompetence nor malpractice.
- the effective rate of turnover tax on hotel draw poker machines is much less than the stated 3% for the first \$2 million turnover and 4% thereafter because, technically, a vast amount of turnover on hotel machines is not counted (i.e. all turnover (credits played) in the "double-up" game feature is not counted by the turnover meter). Poker machines on the other hand record ALL turnover.

This will put clubs at a distinct disadvantage which cannot be denied - the effect will be that clubs will pay a much higher rate of tax than will hotels - a scenario which the Government would surely be against.

In actual fact, whichever system is decided upon hotels will still be better off than clubs because of the non-counting of "double-up" credits played.

- if clubs are forced to reduce their machine player returns, that will involve a massive cost burden necessary for program changes and perhaps new program development by manufacturers.
- this is more difficult since the L.A.B. only permits a limited number of variations of machine models.
- the volatility of modern machines is such that clubs (particularly small clubs) will be penalised if machines operate at a severely reduced profit rate for considerable periods, which is not uncommon.

Small clubs will not be able to risk operating highly volatile machines which offer large prizes. Irrespective of a machine's profit, they will still have to pay the appropriate rate of turnover tax - adversely affecting the clubs' cash flows.

- the reward in the form of tax rebates for expenditure by a club on approved welfare schemes will be jeopardised or lost entirely by the industry.

WHAT'S WRONG WITH THE PRESENT SYSTEM?

There are several good reasons to change the present scheme of taxation on poker machines -

1. Annual tax

It seems there is universal support for abolition of the annual tax component of the existing tax scheme because:-

- the tax rates for various machine classes (minimum cost of operation - 5 cent, 10 cent and 20 cent) are illogical and have no relationship to profit or turnover;
- the tax unnecessarily plays a part in a club's assessment of the optimal denomination mix of its machines.
- the tax inhibits the freedom to change the machine denomination mix of a club at its convenience;
- the tax discourages ready and optimal changes to machine holdings to take advantage of peak or seasonal operating periods.
- the tax discriminates against 5 cent and 10 cent machine classes by not allowing rebates to clubs which cease using those denominations, like it does with the 20 cent class.

- except for half-year rates, there is no fair pro rata application of the tax when clubs wish to increase their machines during the taxation period.

2. Supplementary tax threshold

Although there is an exemption from supplementary tax if a club's net revenue does not exceed \$100,000 - once it does there is a supplementary tax of 90 cents for each \$1 earned in excess of \$100,000 to \$120,000 - an outrageous amount of tax in anyone's language.

The scale provides little incentive for a club which is on the verge of exceeding \$100,000 per annum net revenue from machines to boost its profit beyond \$100,000.

3. Supplementary and Additional Supplementary Taxes

The liability for both supplementary and additional supplementary taxes now starts at \$100,000.

Additional supplementary tax was presumably designed to create an extra graduated impost on the more affluent clubs - \$100,000 being the start of the more affluent class.

This level has been unchanged for many years and no account of inflation has been taken into account to increase the threshold.

Therefore, the threshold is no longer relevant because all clubs which pay supplementary tax also pay additional supplementary tax.

Recent amendments to lift the exemption threshold for supplementary tax from \$50,000 to \$100,000 (without similar changes to higher additional supplementary tax brackets) has meant that the system has changed from a 3 tier revenue tax scale of exemption, supplementary tax and additional supplementary tax categories to only two classes of revenue tax liability for clubs:-

1. those that are exempt from supplementary and additional supplementary taxes and pay only annual tax; and
2. those that pay all 3 categories of annual tax, supplementary tax and additional supplementary tax.

MAJOR CONCERNS OF THE GOVERNMENT ABOUT THE EXISTING SYSTEM

It is my view that the Government's primary concerns with the present scheme are:-

1. Over recent years, the Government's share of poker machine turnover in taxation has been declining because of the increasing trend of clubs to operate machines with higher player returns and because of more tax deductions for bonus schemes. Although Government revenue has increased in absolute terms, Treasury believes its tax revenue could be greater if the Government curbed the freedom of clubs to vary machine percentages and prizes in favour of the player.
2. The Government believes a turnover tax of, say, 3% will help to achieve that goal.

While it will not stop a club from giving higher returns to players, it will act as a disincentive because the proportion of tax payable to gross profit will be greater for those clubs that do so.

3. The Canberra system achieves that principle in a more direct way because the Government does not permit machine percentages to range outside of approximately 86% - 88%.

If a turnover tax is not pursued, I believe the Government may wish to limit the allowable return to player on machines to, say, 90%.

4. The Government believes that the actions of clubs in offering high player returns and benefits represents unfair competition which adversely affects small clubs.
5. The Government is concerned that where bad management, machine malfunction or theft affects poker machine revenue, the Government tax revenue is also directly affected because of the assessment of tax on actual revenue retained by clubs.

6. The Chief Secretary's Department has a theory that poker machine manufacturers have an interest in promoting higher player returns because:-

- the increased turnover that results from higher player return machines gives the impression that the machine has more player appeal than competitors' machines - thereby enabling false claims to be made about a machine's earning potential; and
- the "queue theory" operates to enable more machines to be sold to clubs - the principle being that if players spend more time at machines, then more players will be waiting (queueing up) to play - thereby creating justification for the purchase of more machines.

7. The Government wants to overcome the complications and inequities of the existing system mentioned in this paper.

I trust this report is found to be informative and raises some issues about the poker machine turnover tax debate which may not have been considered to date.

I would welcome further discussions as considered appropriate.

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