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An examination of the claimed and likely cost of poker machine reform in Australia

Policy Brief No. 33
January 2012
ISSN 1836-9014

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TAI

Policy Brief

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Acknowledgement

This research paper was commissioned by the Stop the Loss Coalition. Founding Coalition members include GetUp, UnitingCare, Anglicare, the Gambling Impact Society, PokieACT and the Free Yourself Program.

Introduction

Poker machines play a major role in redistributing income away from those with the least and towards those with the most. According to the Productivity Commission the social cost of poker machines is approximately $4.7 billion per year. Perversely, those who profit most from this most inequitable of income distribution devices often justify the existing regulatory regime on the basis that a small portion of the money lost in poker machines is spent on building sporting and community facilities in some areas. Just why the money lost by problem gamblers should be the primary source of revenue for improving sporting ovals is, however, typically left unsaid.

A number of inquiries have recommended reform to the way poker machines are regulated in Australia in recent years however the election of the minority Gillard Government in 2010 gave impetus to such calls for change with Senator Nick Xenophon, Andrew Wilkie and Senator Richard Di Natale all supporting specific reform proposals.

Perhaps unsurprisingly, the gambling industry has responded more critically to proposals to reduce the money lost in poker machines than the representatives of the disadvantaged communities that the machines are alleged to contribute to. Indeed, the gambling industry has suggested that the introduction of reforms such as ‘mandatory pre-commitment’ technology or setting a maximum poker machine bet a $1 would cost between $2.5 and $5 billion to implement.

This paper argues that such estimates, when linked to the actual reforms being proposed, are so exaggerated as to be fanciful.

The paper begins with a brief overview of the poker machine market in Australia. The second section of the paper outlines the methodology on which the $5 billion cost estimate is based. The third section provides a critique of the method used by supporters of the gambling industry to generate their $5 billion estimate. The final section provides new estimates of the likely cost of the proposed poker machine reforms and concludes that the likely cost of policy reform would be around one tenth of that being suggested by some opponents of gambling reform.

The paper also makes the observation that if the cost of poker machine reform was anything like the $5 billion being suggested by the Australian Hotels Association then the volume of software and hardware modifications involved would actually create tens of thousands of skilled jobs. But, that said, the main conclusion of the paper is that the costs of reform will be nothing like the $5 billion suggested by opponents of reform.

The estimated reform costs from this paper are much smaller than those preferred by the Australian Hotels Association because they are based on the reforms under proposal rather than a hypothetical requirement to modify all poker machines simultaneously and immediately.

Another major reason for the disparity is that the estimates provided below do not attribute the full replacement cost of decade old poker machines to the introduction of new regulation. That is, all commercial equipment has a commercial life and over the course of that life assets are typically 'depreciated' in value by their owners. The $5 billion estimate, on the other hand, attributes the full cost of replacing a ten year old poker machine to the introduction of new policy. The estimates developed in this paper, on the other hand, make the more traditional assumption that all machines would eventually be replaced as they ended their commercial life and that the 'cost' of policy reform should only include the residual depreciated value of poker machines that have been replaced earlier than they might have otherwise been.

What the gambling industry says

The gambling industry has repeatedly claimed that the introduction of mandatory pre commitment technology will cost the industry up to $5 billion, a claim that has in turn been repeated regularly by journalists and commentators.[1][2]

For example, Des Crowe of the Australian Hotels Association testified to the Joint Select Committee on Gambling Reform that:

> *"...the full pre-commitment solution signed off in the Wilkie-Gillard agreement will require 25 per cent of Australia's electronic gaming machines to have a software upgrade costing around $3,000 to $4,000 per machine, 25 per cent of Australia's electronic gaming machines to have a software and hardware upgrade costing around $9,000 to $12,000 per machine and 50 per cent of Australia's electronic gaming machines to be replaced at a cost between $18,000 to $25,000 per electronic gaming machine. Therefore the AHA strongly believes it is not appropriate to rush through this new technology without extensive research and trialling, particularly when implementation cost estimates range from $2.5 billion to $5 billion."*[3]

Indeed, Clubs Australia executive director Anthony Ball has even claimed the cost could be higher, stating in July 2011:

> *"Today we have an independent, internationally recognised financial institution confirming that the Wilkie deal will cost the industry up to $6.5 billion each year and another $5 billion just to set up."*[4]

Interestingly, the Deutsche Bank report on which the $5 billion claim is based actually suggests that the potential cost of policy reform is in the range of $400 million and $5 billion. The gambling industry has focussed almost exclusively on the upper bound of what is already an extraordinarily broad range of estimated cost.[5]

[1] Dusevic, T 2011.'Gaming industry's rubbery figures behind 'Armageddon' claims', *The Australian*. October 28.

[2] Livingstone, C 2011. 'Pokies reform: Clubs Australia, Deutsche Bank and Peter Garrett', *Crikey,* July 28.

[3] Parliamentary Joint Select Committee on Gambling Reform 2011. *First Report: The design and implementation of a mandatory pre-commitment system for electronic gaming machines*, May, p. 175.

[4] Dusevic, T 2011.'Gaming industry's rubbery figures behind 'Armageddon' claims'

[5] Wilson, M. and Pi, D 2011. *COAG Gambling Reform Council meeting.* Deutsche Bank. 30 May. Available online: <http://www.clubsnsw.com.au/Files/DeutscheBank-2011.pdf> Accessed January 18 2012.

An overview of the poker machine Industry in Australia

Australia has more poker machines per capita than any other country in the world and, in turn, Australians are the world's most prolific gamblers spending an average of $1,200 per capita every year on wagers.[6] Of the $19 billion gambled by Australians every year, 60 per cent is lost in the 'pokies'.[7]

Australia has more than 200,000 poker machines, around half of which can be found in New South Wales. Interestingly, while there are no poker machines in Western Australia (outside of casinos) there is no widespread perception of any lack of sporting or community services in that state.

While around 600,000 Australians play poker machines weekly it is estimated that 15 per cent of those gamblers account for around 40 per cent of all of the losses. This concentration of losses among 'problem gamblers' is a major contributor to the social cost of poker machine gambling which, as discussed above, has been estimated by the productivity Commission to be in the order of $4.7 billion per year.[8]

The problems associated with problem gambling on poker machines in Australia has long been recognised in Australia and a number of national inquiries[9][10][11] have recommended significant regulatory reforms to help curb the losses and, in turn, reduce the social costs of problem gambling.

For example, recommendations from the 2010 Productivity Commission examination of the poker machine industry included, among other things:

- That low intensity machines be offered (loss rates of about $120/hour), with $1 bet limits and a $20 load-up maximum
- Mandatory pre-commitment for high-intensity machines whereby users specify a loss limit before gambling on poker machines and have that limit enforced via technological measures.

Similarly, the Joint Select Committee on Gambling Reform conducted an inquiry into the introduction of mandatory pre-commitment technology. The Committee's recommendations were consistent with those of the Productivity Commission finding that:

- High intensity machines with the possibility of large, but infrequent wins have taken the gambling experience far away from the low risk recreational activity it used to be.[12]
- $1 limit on bets would help mitigate the consequences of poker machines for problem gamblers without reducing the enjoyment of recreational gamblers.[13]

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[6] €902 ($1208.75) per year according to *The Economist*, reported in: Kruger, C 2011. 'It's a sure thing: Australians are far ahead in the gambling world'. *Sydney Morning Herald*, May 21.

[7] Productivity Commission 2010. *Gambling*, vol. 1, Commonwealth of Australia p. 2.

[8] Productivity Commission 2010. *Gambling*, vol. 1, Commonwealth of Australia p. 2.

[9] Productivity Commission 1999. *Australia's Gambling Industries*, Commonwealth of Australia

[10] Productivity Commission, *Gambling*, vol. 1, Commonwealth of Australia

[11] See also: <http://www.aph.gov.au/senate/committee/gamblingreform_ctte/completed_inquires/index.htm>

[12] Parliamentary Joint Select Committee on Gambling Reform 2011. *First Report: The design and implementation of a mandatory pre-commitment system for electronic gaming machines*, May p. 165

[13] "The committee is satisfied that reducing the bet limit will reduce harms to problem gamblers, but will not adversely affect the enjoyment of recreational gamblers, who typically play with lower bet amounts. The committee agrees with expert advice that a bet limit of $1 per game on low intensity machines would

It is important to note that both the proposal by Andrew Wilkie and that of Senator Richard Di Natale propose significant phase-in periods in addition to the fact that the intention to introduce reform has been on the public record since 2010. The significance of these notice and phase-in periods, as will be made clear below, is that in estimating the potential cost of reform the gambling industry has been wilfully blind to these phase-in features. The consequence of this decision is that it helps to exaggerate the cost of reform.

appropriately target problem gamblers without diminishing the enjoyment of low level, recreational gamblers." Committee report, p. 165.

How to exaggerate the cost of poker machine reform

As discussed above, there are around 200,000 poker machines in Australia and if they were all replaced tomorrow the cost of replacing them, at an assumed cost of $25,000 per machine would be around $5 billion.

The claim that 200,000 times $25,000 equals $5 billion is as true as it is irrelevant. No one is actually proposing that all poker machines comply with new regulations immediately, and even the industry concedes that the cost of upgrading the software of the 50,000 newest machines would be far less than $25,000 cost of replacing whole machines. Leaving these fundamental flaws with the $5 billion cost estimate aside, it would be physically impossible to replace 200,000 machines in one year.

Bizarrely, while the gambling industry is at pains to talk about the pragmatic difficulties of upgrading the oldest poker machines it is willing to abandon all such notions of pragmatism when 'estimating' the cost of proposed policy change.

Interestingly, even the lower estimate of $2.5 billion used by the gambling industry appears to be exaggerated based on their own analysis. In the words of Des Crowe of the Australian Hotels Association when testifying to the Joint Select Committee on Gambling Reform:

> *"...the full pre-commitment solution signed off in the Wilkie-Gillard agreement will require 25 per cent of Australia's electronic gaming machines to have a software upgrade costing around $3,000 to $4,000 per machine, 25 per cent of Australia's electronic gaming machines to have a software and hardware upgrade costing around $9,000 to $12,000 per machine and 50 per cent of Australia's electronic gaming machines to be replaced at a cost between $18,000 to $25,000 per electronic gaming machine. Therefore the AHA strongly believes it is not appropriate to rush through this new technology without extensive research and trialling, particularly when implementation cost estimates range from $2.5 billion to $5 billion."*[14]

However, if the AHA's lower range cost estimates of $3,000, $9,000 and $18,000 are applied for the cost of software, software/hardware and replacement then the cost would be $2.4 billion, not $2.5 billion. Nor does using the upper range get near to $5 billion, rather it comes in at $3.3 billion.

[14] Parliamentary Joint Select Committee on Gambling Reform 2011. *First Report: The design and implementation of a mandatory pre-commitment system for electronic gaming machines*, May, p. 175.

How the Gambling industry should estimate the cost of poker machine reform

The $5 billion estimate used by the gambling industry is clearly fanciful and bears no relationship to the policy proposals currently being considered by the government. There are three main reasons that the $5 billion cost estimate so significantly exaggerates the potential cost of reform:

1. They have ignored the phase-in provisions proposed by both Andrew Wilkie and Senator Di Natale. The significance of this omission is that it ignores the natural rate of poker machine replacement that occurs each year. Indeed, if new poker machines were not replacing old poker machines each year then the only way for poker machine manufacturers to sell their product would be to further increase the number of poker machines in Australia each year.

2. The second way that the gambling industry is inflating the potential cost of poker machine reform is by valuing the oldest poker machines, the ones the industry says cannot be upgraded to suit the new regulations, at the full replacement cost of those machines rather than the depreciated value of those machines. That is, it is entirely misleading to link the full replacement cost of a 10 year old poker machine which was purchased for $10,000 ten years ago to the introduction of a new policy. Such machines will inevitably be replaced and, to that end, the owner of the machines will have been recording the ‘depreciation’ of those machines in the cost of operating their enterprise. Some machines might need to be replaced slightly earlier than scheduled as a result of the introduction of new poker machine regulations but, to the extent that this is the case, the ‘cost’ to the owners of the machine would be the depreciated value of the old machines, not the full replacement cost.

   Consider the following example. Imagine if the government introduced new noise and pollution standards for all passenger cars and a 20 year old, poorly maintained car which was purchased for $20,000 and was now worth $1,000 failed to meet those new standards. Now imagine the owner of the unroadworthy car purchased a $30,000 new car to replace her old car. Should the ‘cost’ of the new policy be described as $30,000, $1,000, or zero? Those arguing that the cost of poker machine reform is $5 billion are effectively arguing that the cost of such noise and pollution standards should be estimated at $30,000.

3. The gambling industry has ignored the reduction in the social harm associated with the introduction of the poker machine reforms.

   As discussed above, the Productivity Commission has estimated that problem gambling costs the Australian community around $4.7 billion per year. While the gambling industry has been at pains to include all of the potential costs to their industry associated with reducing the amount of money lost by problem gamblers, they have been careful to exclude any of the benefits to the community of such a change.

   That is, the gambling industry is conducting what economists call ‘partial equilibrium analysis’ in that they are focussing on the impact of a change on one small part of the economy and assuming that all other parts of the economy remain unchanged. In the case of the proposed poker machine reforms, however, such an approach is clearly misleading.

   In addition to ignoring the benefits to problem gamblers, their families and their communities of reducing their losses the gambling industry is also ignoring the potential job creation associated with building and retrofitting a large number of poker machines.

Indeed, if the task of retrofitting and replacing poker machines to ensure compliance with proposed new regulations is anywhere near as large as has been suggested by the gambling industry then the expenditure of $5 billion on software and hardware upgrades will be a major source of job creation in the software and manufacturing industries.

Using the relevant employment multipliers implied in the Australian Bureau of Statistics for the ‘Computer and Electronic Equipment Manufacturing’ and ‘Computer systems design and related services’ industries, an expenditure of the magnitude suggested by the AHA would create 5,422 direct and indirect jobs in the software industry and 23,800 direct and indirect jobs in skilled manufacturing.[15]

Of course it is more likely that the cost of retrofitting poker machines will be far less than has been claimed by gambling industry. That said, the fact remains that the larger the cost of poker machine reform the greater the employment creation in the manufacturing, maintenance and software industries will be.

[15] TAI calculations based on data from ABS (2011) *Australian national accounts: Input-output tables – Electronic publication, 2007-08 Final*, Cat no 5209.0.55.001, 25 October.

The likely cost of poker machine reform to the owners of poker machines

According to the Australian Tax Office the economic life of a poker machine is seven years when maintained normally. This implies that around one seventh of a poker machine is 'used up' each year which in turn means that after seven years the depreciated value of a poker machine is zero. It is possible that the actual life of poker machines is longer than the seven years assumed by the Australian Tax Office, to the extent this is true then the existence of such 'accelerated depreciation' provisions should be considered as a tax concession to the gambling industry. Alternatively older machines can be kept going longer but with higher maintenance costs. Those additional costs are saved if the older machines have to be scrapped as a result of the new policy.

The proposals to introduce both mandatory pre commitment technology and $1 maximum bets are based on the provision of phase-in periods for new machines and phase-out periods for existing machines. Such provisions have been explicitly designed to reduce the chance that brand new machines with relatively long lives will need to be expensively upgraded as a result of new regulations and that older machines, the machines the industry say cannot be upgraded, will need to be prematurely scrapped. These proposed reforms to the poker machine industry have been on the public record since Andrew Wilkie announced his support for the Gillard Government in 2010. Additionally, Senator Di Natale's proposal would not require new machines to be compliant with the new regulations until 2013 and would not apply to existing machines until 2017.

Assuming then that the industry has chosen to ignore the announcement in 2010 of impending reform and is waiting until legislation passes later this year before making any preparations for potential new regulations, they might still be purchasing machines in 2012 that would require a software upgrade in 2017, an upgrade that the industry estimates would cost between $3,000 and $4,000.

Given that the economic life of poker machines is seven years then most of the machines already installed in 2012 would have been fully depreciated and replaced on schedule before a 2017 cut-off date for non-complaint machines. However it is possible that 2/7ths of the machines that have not reached the end of their economic life by 2017 may need a software upgrade estimated by the gambling industry at between $3,000 and $4,000.

- If 2/7ths of machines needed to be upgraded at a cost of $3000 per machine the total cost of upgrading machines would be $171 million.
- More conservatively, if 3/7ths of machines needed to be upgraded in 2017 at a cost of $4,000 per machine then the total cost of upgrading machines would be $342 million.

To summarise, even if the gambling industry has done nothing to prepare for impending reforms and has continued to install machines that would be expensive to make compliant with the proposed regulations then, at worst, the cost of upgrading poker machines would be less than $350 million

Even though the figure of $350 million is less than one tenth of the cost of reform being suggested by the industry it is still likely to be a significant exaggeration for a number of reasons:[16]

[16] It is important to note the gambling industry's admission that the most modern quarter of existing machines would only require a software upgrade and that only the oldest half of machines would need to be fully replaced. The significance of this is that, by 2017, the only machines that would not have reached the end of their economic life would be the ones currently described as 'modern'. In turn, there would be no poker

1. less than 3/7ths of the machines in operation in 2017 will actually require any upgrade. As discussed above a more likely worst case figure would be 2/7ths of machines, and even this figure assumes that none of the machines purchased since 2010 could be easily made compliant with the foreshadowed regulatory changes.

2. The cost of software upgrades is likely to be significantly less than $4,000 per machine claimed by the industry.

3. The costs to the industry should not be conflated with the cost to the economy more generally. Any costs to the industry associated with modifying their machines will create new jobs in the software and manufacturing industry

4. The costs to the industry should not be conflated with costs to society as they ignore the reduction in social harm associated with reducing problem gambling, harm estimated to cost the community $4.7 billion per year.

machines operating in 2017 that had not been fully depreciated that would require full replacement rather than simply a software upgrade.

Conclusion

The assertion that the cost of poker machine reform is anything like $5 billion can only be described as fanciful. Indeed, such an estimate appears to be based on a reform proposal that no one is proposing and, were it to be proposed, would be impossible to implement.

The existence of a notice period for reform stretching back to 2010, combined with proposals to phase-in poker machine reforms mean that the actual cost of reform will be a small fraction of the costs being suggested by the AHA. When the natural attrition of existing poker machines is combined with those phase-in periods and the capacity to reprogram the more modern poker machines remotely is taken into account then the costs fall further still.

Finally, if the exaggerated cost estimates relied upon by the AHA were to be realised then the expenditure of $5 billion on updating and replacing poker machines would create more than 20,000 jobs in the manufacturing and software industry. Such employment would negate the claimed employment impacts that opponents of poker machine reform seem so concerned about.

In summary, proposals to restrict the losses on poker machines by problem gamblers will benefit the community while imposing small costs on the industry. To the extent that the exaggerated claims about costs were true they should be seen in the context of the social harm that can be avoided by reforming poker machines, the profitability of the existing gambling industry and the capacity to create significant employment should retrofitting poker machines be nearly as hard as the gambling industry has been suggesting.

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