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**LIBERALISING GAMBLING MARKETS:
LESSONS FROM NETWORK INDUSTRIES?#**

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ABSTRACT

This paper, based on my concluding remarks at the “Colloquium on the Economic Aspects of Gambling Regulation: EU and US Perspectives” held at Tilburg in November 2006, discusses the question why, in Europe, some service sectors (such as network industries) are liberalised, while others (like the gambling sector) are not. In both, the discussion appears to be one-sided. In the former, the focus is on consumer benefits, where in the latter, only the possible consumer harm associated with liberalisation is discussed. A proper balancing of costs and benefits can, and should, be subsumed under the ECJ’s proportionality test, as formulated in *Gambelli*. If this more economic approach is taken, the result might very well be less restrictive policy towards gambling and games of chance.

JEL Codes: L51, L83, L88

Key words: Gambling, market liberalisation, EU internal market

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1. INTRODUCTION

In some service industries, the European Commission has been following a vigorous policy of opening up the European markets to competition, a process that is also known as market liberalisation. This policy has been and is pursued especially in the so-called network industries (post, transport, energy and telecommunications), in which the services are delivered over networks that frequently have the character of a natural monopoly. Traditionally monopolistic suppliers, frequently operated by the state itself, offered these services but, over the last 25 years or so, a wave of structural reform has swept these industries. The industries were restructured, with the monopolistic bottlenecks separated from the competitive segments, and the resulting markets being opened for competition, also by competitors from abroad. In the process, state owned companies were frequently privatised. Along the way, public interest objectives were, and are still guaranteed by regulation rather than by means of government provision.

In other service sectors, the gambling industry being a prominent example, we have not (yet) seen such drastic structural changes. These industries (with the possible exception of lotteries, where network effects might be important) are not natural monopolies, but legal monopolies, with entry being prohibited by government regulation. For sure, the national monopolies have been challenged; sometimes by firms that are monopolies in other markets, but these attacks have not yet led to actual market entry, as most governments have been unwilling to give up the monopoly rights. In the gambling industry, the European Commission has been remarkably cautious. For example, in the Press Release IP/06/436, in which the Commission announced that it had taken the first step in an infringement procedure under Article 226 of the EC Treaty against seven Member States, the responsible Commissioner McCreevy states “I don’t underestimate the sensitivities that exist in many Member States on the question of gambling. In sending these letters [officially requesting information on restrictive national legislation regarding the supply of sport betting services, EvD], we are not seeking to liberalise the market in any way. Rather, we are seeking reassurance that whatever measures Member

States have in place are fully compatible with existing EU Law, or have been brought fully into line.” (European Commission, 2006). Subsequent press releases on this topic, such as IP/06/1362 and IP/07/909 have used similarly cautious language.

In this brief contribution we describe the difference in treatment and ask what might explain the difference. While in network industries, the benefits of competition, subject to appropriate regulation, are being emphasized, it seems that in the discussion of the liberalisation of the gambling sector, the focus is on the cost associated with competition. One wonders about the asymmetric treatment and whether, from an economic point of view, such asymmetry is justified. As we will see, in both policy areas, a more balanced approach would be desirable.

2. LIBERALISATION: NETWORK INDUSTRIES

The Competition website of the European Commission contains a section “Liberalisation” that describes, in broad terms, the advantages of market liberalisation, the powers of the European Commission in this domain, the way network industries have been liberalised, and the side measures that have to be taken - the additional regulation required- in order to make market liberalisation into a success.

In describing the powers of the Commission in this domain, the web site links the term liberalisation to Article 3 of the EC Treaty, which states that the Commission shall ensure that competition in the internal market is not distorted, and to Article 86 (3) of the EU Treaty, which entrusts the Commission with a specific surveillance duty with respect to public undertakings and undertakings to which Member States grant special or exclusive rights. It is stated that “The Commission must where necessary, address appropriate directives or decisions to Member States which enact or maintain in force any measure contrary to the rules contained in the Treaty, in particular to these rules provided for in Article 12 and in Articles 81 to 89”. There is also reference to the more limited powers in the context of services of general economic interest, that is economic (or market) activities that warrant special public intervention. For these services, Article 86.2 of the

Treaty is relevant: providers of services of general economic interest are subject to the rules contained in the Treaty, in particular to the rules on competition, in so far as the application of these rules does not obstruct the performance of the particular tasks assigned to them. In particular, “the development of trade must not be effected to such an extent as would be contrary to the interests of the Community”.

With respect to liberalisation, the Commission stresses the advantages for consumers: “By opening up these markets to international competition, consumers can now choose from alternative service providers and products. Opening up these markets to competition has also allowed consumers to benefit from lower prices and new services, which are usually more efficient and consumer-friendly than before”. There is also a link between liberalisation and the competitiveness of the European economy: not only final consumers, but also industry consumes the products of the network industries, so that lower priced, or higher quality services “helps to make our economy more competitive”. In various progress reports, the Commission has indeed documented these gains, but it should be stated, and is also admitted by the Commission, that they are larger in some sectors than in others. Part of the explanation comes from the fact that there are considerable differences between the various network industries and that this was not adequately reflected in the recipe that was used for reforming them, but this is not the place to discuss these issues. In any case, the Commission rightly notes: “Opening up new markets requires additional regulation to ensure that public services continue to be provided and that the consumer is not adversely affected”.

It is, hence, simple to summarize the policy: liberalisation brings consumer benefits; there are certain risks as well, but these can be handled by appropriate regulation. Competition is the rule, not the exception.

3. LACK OF LIBERALISATION: THE GAMBLING INDUSTRY

In most EU Member States, suppliers of gambling services, of whatever form, need to have a license. Frequently, only a limited number of licenses is given out and in several

countries only one license is available for certain forms of gambling, such as operating a casino, or organizing a lottery. In addition, this exclusive license may be in the hands of a state-owned company. For a detailed overview of the legal regimes governing gambling and games of chance in the European Union, we refer to the extensive survey of the Swiss Institute of Comparative Law that is available on the web site of the DG Internal Market and Services of the European Commission; see http://ec.europa.eu/internal_market/services/gambling_en.htm.) Competition, therefore, is restricted, and in some cases, severely so, with trade being limited as a consequence. Even though the general arguments mentioned in the previous Section apply, as do the articles from the Treaty mentioned there, the gambling services have not been subject to liberalisation policies and the DG Competition has not played a very active role. The lead has been taken, not by the Commissioner for Competition, but by Internal Market and Services Commissioner Charlie McCreevy, who, as shown in the Introduction, has acted in a very cautious way. There is no harmonisation of legislation and no market liberalisation. Competition is not the rule, but the exception.

In several Member States that maintain a limited licensing regime, potential entrants have challenged the system. They have claimed that the system would violate in particular the Articles 43 and 49 of the EC Treaty that guarantee the freedom of establishment and the freedom to provide services. The case law of the European Court of Justice has clarified under what conditions a restrictive licensing regime for gambling would not violate these articles and what type of restrictions would be justified in this case. As these issues were extensively discussed during the previous Tilburg Symposium on Gambling (see Littler, 2007), there is no need to repeat that discussion here. For my purposes, it suffices to recall the main elements of the Gambelli judgment of the European Court of Justice (Case C-243/01):

“in order to be justified, the restrictions on freedom of establishment and on freedom to provide services must (...) be justified by imperative requirements in the general interest, be suitable for achieving the objective which they pursue and not go beyond what is necessary in order to attain it. They must in

any event be applied without discrimination.” (*Gambelli*, paragraphs 64 and 65.)

The ECJ has given guidance on what might qualify as “imperative requirements in the general interest”. In particular, the Court has indicated that frequently invoked arguments, such as the preservation of public order, protection against gambling addiction, and the prevention of fraud and money laundering, might qualify. The Court has made clear that national authorities have a margin of appreciation in determining what consumer protection and the preservation of public order require, but that policy to achieve the goals, the restrictions imposed, must be “consistent and systematic”: a Member State cannot ban certain private providers while at the same time strongly encouraging citizens to gamble in state casinos. Furthermore, the ECJ has stated that it is for the national authorities to decide whether the conditions listed in the above quotation (justifiability, suitability, proportionality and non-discrimination) are satisfied. In the more recent *Placanica* case (C-360/04), the Court has further explained that, in order for a monopoly regime to be really effective in combating illegal gambling, it may be necessary for that monopoly to provide a sufficiently attractive service, and to advertise that service in an appropriate way; see *Placanica*, paragraph 55. Consequently, balancing is required: a modest amount of advertising by a monopoly state casino is allowed, but not too much.

The Netherlands is an example of a country with a restrictive licensing regime. For example, Holland Casino, a state owned company, has been given an exclusive license to operate casinos in the Netherlands. The monopoly has been challenged by a French company and on 14 March 2007 the Raad van State (the highest administrative court in the country) ruled on whether the monopoly provision in the Dutch Gambling Law was compatible with Article 49 of the EC Treaty; see Decision in Case LJV BA0670. The Court reached its decision by using the *Gambelli* criteria mentioned above, and by also taking into account the additional insights offered by *Placanica*. It came to the conclusion that the above-mentioned goals (which were also the ones invoked by the Dutch government and by Holland Casino) were of imperative public interest and that the

monopoly was an effective and proportional measure. In the Council's view, the Gambelli criteria were satisfied.

Although the motivation of the Raad van State (Council of State) was brief, it touched on issues of competition. In the Council's view, competition between providers of gambling services would induce each of these to offer better deals to consumers, such in an attempt to attract as many costumers as possible, and this having the possible consequence of leading to more gambling addicts. As such, competition would be undesirable; see the Decision in Case LJM BA0670 at paragraph 2.6.4.) It should be remarked, however, that the Council did not really discuss the proportionality requirement, that is, the requirement that the monopoly does not go beyond what is necessary in order to attain the policy aims. It satisfied itself by remarking that a monopoly was effective and that the complainant had only argued that there are other effective instruments.

In this respect, the Council sides with the Dutch State, that had earlier made similar arguments in response to the official request for information that the European Commission had sent to the Netherlands on 4 April 2006 (Tweede Kamer, 2006). In the letter of 12 July 2006, The Dutch Minister of Justice explains the Dutch policy with respect to gambling and its goals, and how these have evolved over time, and he argues that, in his view, the Dutch Gambling Law is in Agreement with the criteria from *Gambelli* and, hence, does not violate any European Law. The Section of the letter that deals with the proportionality requirement (the first and third paragraph on page 11) is, however, very brief: there are only a few remarks, in essence stating only that this belongs to the margin of discretion of a Member State. Strictly speaking, proving that the restrictions do "not go beyond what is necessary in order to attain the goals" would seem to require a comparison with other measures that would also attain the goals, but that would possibly be less intrusive. No comparisons are, however, made.

The latest development is quite recent. On 2 August 2007, the responsible minister of Justice sent a bill for a new Dutch Gambling Law to parliament, in which the restrictive licensing regime is maintained. In the explanatory memorandum to the Law (available at

http://www.minjus.nl/images/Memorie%20van%20toelichting_tcm34-80692.pdf), it is remarked that the previous court decisions have shown that monopoly regime does not violate the EC Treaty; no new arguments are being offered. Again, there are very few remarks about proportionality. Strictly speaking, as far as the proportionality requirement is concerned, it has not been proved that the proportionality requirement is satisfied. It is just that plaintiffs have not been able to show that it is violated. From an economic point of view, there are the prior questions about how to make the proportionality requirement operational and how to translate it in economic language. As far as I have been able to verify, the case law does not provide any guidance on these issues. As I will argue below, if a translation is made in terms of Pareto improvements, or potential Pareto improvements, which appears natural, the proportionality requirement might very well not be satisfied. In short, it seems likely that alternative, less restrictive, measures exist, that are associated with higher economic welfare.

Of course, the reader will have noticed the asymmetry with respect to the arguments given in the previous section. There the discussion was dominated by the gains in consumer surplus that could be obtained and it was argued that the possible negative side effects should be dealt with by regulation. In the case of gambling, the negative side effects (which are only possible and not quantified) dominate the discussion; the possible gains in consumer surplus are only mentioned in passing, if at all, and they are not discussed. In effect, they are not taken into account.

4. ECONOMIC ASPECTS AND ARGUMENTS

From a technical and economic perspective, the network industries, of course, are very different from the gambling industries. In the language of economics, there are different types of market failures that characterize these industries. In the former, there are segments that can be classified as natural monopolies, hence, costs are minimized whenever there is just one supplier. In addition, costs may be large and sunk, hence, even though competition may be feasible, there is the risk of cut-throat competition, hence, entering into such a segment is risky. In short, monopolies arise naturally. In this context,

regulation also arises naturally, to curb the market power associated with the monopoly and to protect the interests of the consumers.

In contrast, in the gambling industries, monopolies are not natural, but artificial. They arise as a result of regulation that limits competition. (It should be noted that an exception should, perhaps, be made for lotteries: if gamblers prefer, everything else equal, larger main prizes, then a lottery with more participants will be able to offer a better deal, and a monopoly might arise endogenously. In short, there may be network effects, and a monopoly may have an advantage on the demand side, instead of lower cost.) Nevertheless, this is not to say that regulation is unnatural. The public interest concerns mentioned in the previous section are real and may very well give rise to regulation. In the language of economics: the gambling industry is associated with (negative) externalities, while, perhaps, also the usual assumption of full consumer rationality may be problematic. (The standard economic approach assumes that consumers act rationally, hence, they do what they most prefer. The act of gambling thus is evidence that the consumer prefers this activity to something else. Clearly, consumers may not always be as rational as the standard model assumes, but in this respect there may not be that much difference between gambling and the purchasing of electricity; see Waddams and Wilson (2007).

Large as the differences between these sectors may be, there are also similarities. In both, competition may have positive as well as negative aspects; in neither is the picture one-sided. Nevertheless, it seems that in each of them, only one side of the picture is stressed.

Within Europe, the liberalisation of the network industries plays a major role in the Lisbon strategy, which aims to make the European economy more competitive. Firms that have lower input cost, or that can use inputs of higher quality, will be more competitive, hence, here we see a difference between network services and gambling services; the latter are consumed almost exclusively by final consumers, the former also provide inputs to firms. Consequently, there will be more pressure on network firms to deliver value for money than there will be on gambling firms. Be that as it may, let us

look at the arguments used by policy makers for why liberalisation would yield benefits. In European Commission (2005), a representative paper in this area, three general types of benefits are being mentioned: liberalisation will lead to lower cost (increased productive efficiency), lower prices (increased allocative efficiency) and more innovation (enhanced dynamic efficient efficiency). The arguments in that paper are rather general and, it has to be admitted, not always backed up by careful empirical studies, or convincing theoretical models. For sure, the intuition goes in the direction of enhanced efficiency, and there are studies that confirm this intuition (and there are more and more of these), but scientific proof seems to follow policy, rather than the other way around.

There is no reason why the three types of beneficial effects of market liberalisation would also not be present in the gambling industry. Competition generally forces firms to pay more attention to cost and to offer customers a better deal. Indeed, the Dutch Council of State, in the decision referred to above, explicitly acknowledged the latter effect. Furthermore, the presentation of Professor Eadington at this conference illustrated that jurisdictions that treat gambling in a more liberal way do indeed see more innovation. Consequently, although liberalising the gambling markets may be associated with negative side effects, there are positive effects as well.

A problem is that, at the moment, such positive effects are not always recognized. The discussion in Europe is dominated by the legal criteria developed by the European Court of Justice and these do not explicitly refer to the joy (utility) of gambling experienced by the regular (non-problem) gamblers. At least in the Dutch case referred to above, when applying the criteria from *Gambelli*, neither the Dutch Council of State, nor the Dutch Government did take the interests of these gamblers into account. The same remark applies to the Decision of the Supreme Court of the Netherlands in Case C03/306HR (LJN: AR4841) concerning De Lotto and Ladbrokes. As also noted in the contribution of Prof. Forrest to this symposium, existing research on the consumer surplus associated with gambling is scarce, but the results that do exist (for example Farrell and Walker, 1999) clearly suggests that the effects may be rather large, and, hence, cannot be neglected. (The authors estimate the consumer surplus associated with the UK market for

lottery tickets to be just below £1 billion per annum – the same order of magnitude as reducing the rate of income tax by 0.5%.) As non-problem gamblers benefit from increased competition in a variety of ways, as indicated above, the gains in consumer welfare associated with market liberalisation should also not be underestimated; at least they should be recognized.

From an economic point of view, the interests of the “regular” gamblers should be taken into account in the proportionality test. If two measures would be equally effective in dealing with the imperative requirements of general interest, but measure A would be associated with lower cost (or higher utility) to regular gamblers than measure B, then measure A would be preferred. This corresponds to the usual criterion of Pareto efficiency from welfare economics. More generally, if A would be somewhat less effective, but the “regular” gamblers would gain so much that they could compensate those that lose as a result of A being adopted instead of B, measure A might still be the preferred one. Again, this is the standard approach in welfare economics.

In cases where market liberalisation is associated with both gains and losses, cost benefit analysis (CBA) provides a structural framework to identify all gains and losses and to trade these off against each other. In his contribution to this Symposium, Prof. Walker has indicated some of the fundamental problems involved in doing such analysis in the gambling sector. In his contribution, Tom Coryn has illustrated some of the difficulties, involved, as well as the possibility to abuse the method in practice. While the difficulties can be acknowledged, it should be noted that these also exist in other industries, such as network industries. In fact, the electricity industry may illustrate the usefulness of doing such a CBA. We have referred above to the general benefits that are expected to be associated with the liberalisation of network industries: consumers are expected to gain from lower prices, while the incumbent producer would be expected to lose. Experience however, show that who gains and who loses may depend on how the sector is liberalised and restructured. For the special case of the UK, it has been shown in Newbery and Pollit (1977) that in contrast to expectations, and its contrast to what the restructuring was supposed to achieve, the restructuring of Britain’s Central Electricity Generation Board

yielded producer gains and consumer losses. The authors performed the CBA *ex post*; had it been done *ex ante*, it could probably have discovered some flaws into the design, and, hence, could have led to higher welfare gains. Similarly, in the gambling industry, a CBA could lead to a more informal discussion and, hopefully, better decisions.

In order to motivate the regulation of gambling and games of chance, at least in the Netherlands, the government no longer invokes moral arguments; instead reference is made to the preservation of public order, protection against gambling addiction, and the prevention of fraud and money laundering. In effect, these are all negative externalities associated with gambling. During this Symposium, Prof. Walker has argued that one of the major problems associated with doing a CBA related to gambling regulation revolves around the notion of social cost. In his path-breaking paper on social cost (Coase, 1960), Ronald Coase has taught us that we should not look at externalities as being one-sided: if the regular gambler imposes a negative externality on the problem gambler, then, vice versa, the latter imposes a negative externality on the former. Without both types of gamblers being present, there would not be an externality. As the externalities are wide spread, contracting cannot be relied upon to provide an efficient solution, and there is a role for the government. That government, however, should not take a one-sided approach, it should trade-off the right of the problem gambler to be protected against the right of the regular consumer to enjoy gambling services. The proportionality requirement from *Gambelli* provides a way for doing this, but it has not yet been interpreted in this way. Doing so would seem to be desirable and this might very well lead to conclusions different from the ones obtained thus far.

5. CONCLUSION

The gambling industries are very different from the network industries, but these two sectors seem to share the property that policy with respect to them is guided more by prior beliefs, or preconceptions, than by a careful balancing of the pros and cons associated with the various policy options. Interestingly, while the liberalisation of network industries is guided foremost by the consumer benefits that can be obtained, and

seems to have little attention for the risks involved and the costs associated with certain aspects of the proposals, the discussions in the gambling sector seem to be dominated by the possible negative side-effects associated with liberalisation. In both cases, a more balanced approach seems called for. In the context of gambling, this requires more attention to be paid to the consumer surplus of non-problem gamblers. This consumer surplus could, and should, be taken into account in the proportionality test that has been proposed by the ECJ in *Gambelli*: in order to see whether a measure does not go beyond what is necessary to achieve the specified policy aims, the external effects on consumers not explicitly mentioned in these policy aims should not be neglected. After all, the general interest is broader than the particular interests of those that could become addicted to gambling. There is thus a need to balance the costs and the benefits. Cost benefit analysis may provide a framework that helps in taking such a more balanced approach. A Coasean perspective suggests that, in the absence of transaction costs, consumers would negotiate a more liberal regime with respect to gambling, hence, that government policy should be less restrictive as well.

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