

The Economics of Gaming Regulation

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Atlantic City's saga, we are told, is of regulation that smothered the golden goose. Reports on Colorado say excessive taxation makes doing business impossible. While states regulate gaming for social reasons, these situations show the impact regulation can have on profitability.

Nevada and the other casino states face a major challenge. Twenty years ago, Nevada was the only state with legal casinos. Having a geographic monopoly accelerated Nevada's growth. In the late 1970s, the monopoly eroded with the legalization of casino gaming in Atlantic City. The flood came when the United States Congress decided to legalize casino gaming in many states that have Native American tribal lands. Tribes in Minnesota, Connecticut, and Wisconsin opened full casinos on Indian reservations although non-Indians in the same states could not open casinos off the reservation. Congressional action caused many states to legalize gaming to realize revenues from the gaming activities of their citizens. Nine states now have legal non-Indian casinos. The prospect exists for a dozen other states legalizing casino gaming in the next few years. Both Indian and state-sanctioned casinos throughout the United States compete for the same consumer dollar.

Unlike other industries in the United States that are highly regulated, gaming is either virtually unregulated, as are many Indian casinos, or regulated by the state government. The federal government has almost no involvement. Every state either has different rules or applies its rules differently.

This article discusses how the differences in regulatory policy between states can affect the economics of a state's gaming industry. These differences can make one state's gaming industry more competitive than another. Seven major areas of casino regulation can have the greatest impact. These are: (1) cost of regulatory compliance, including fines and assessments; (2) regulatory price controls; (3) ease of entry; (4) taxation; (5) advertising; (6) credit policy; and (7) economic controls.

Cost of Regulatory Compliance

Each state that allows gaming has some regulation. The two basic types of regulation are economic and social. Economic regulation attempts to rectify imperfections in a free market for the public benefit to ensure that consumers receive quality service at competitive prices. Industries typically perceived to have market imperfections are those with relatively large fixed costs (e.g., shipping), where the existence of several large firms serving a community would entail the wasteful duplication of costly capital facilities (electricity or gas) or where there is a finite supply to be distributed (radio or television airwaves.) Examples of agencies regulating such industries include the Interstate Commerce Commission, Federal Communications Commission, and Federal Energy Regulatory Commission.

Absent government interference, the gambling industry in America is not subject to natural market imperfections. With relatively little cash outlay, a person can operate a gambling game. A table and three cards are enough to play three card monte, and a pair of dice and an alley are sufficient to play craps.

Government involvement in gaming is based on the concept of social regulation, *i.e.*, the impact of the industry's product on society. Social regulation usually concerns the public health or safety. Examples include the Occupational Safety and Health Administration, the Consumer Products Safety Commission, and the Environmental Protection Agency. Gaming control, however, is a unique subset of social regulation that involves protecting the public from the non-health-related detriments of a vice.

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Nevada was the only state with legal casino gaming between 1931 and 1978. Nevada began regulating gaming in the late 1950s primarily to keep criminals out of the gaming industry. The initial reason for regulation was fear that the federal government would outlaw casino gaming if organized crime could use Nevada-based operations to finance, or conceal profits from, other illegal activities.¹ Subsequently, other rationales for keeping the criminal element out of the gaming industry were proffered, including beliefs that the perception that the casino industry is dishonest would impair the development of the industry;² that preventing criminal influence would assure honesty of the games;³ and that keeping the criminal element out would assure proper accounting for tax revenues.⁴ From the premise that the State should keep criminals out of the gaming industry, an entire system of regulatory control over the gaming industry evolved. Other states that subsequently legalized gaming adopted many components of the Nevada system, but all parrot the same basic goals.

Because every state has a different regulatory system, casinos' cost of complying varies between states. Regulatory costs are a mixture of fixed and variable costs that the casinos attempt to pass on to patrons through higher costs. In the gaming business, the pricing of the gaming experience is not as simple as other businesses where the price of the product goes up if the cost of producing the product increases. Casinos provide games for patrons to play. Casinos make money by winning it from patrons. The amount won results from the slight advantage the casino has in the odds of the game, as little as about 1 percent in craps and blackjack. To make more money in a given transaction, the casino must raise its "prices," usually by increasing its odds at the gaming tables and slots. As the costs rise, however, demand for the product decreases. If every competitor has the same fixed regulatory costs, they must compete on another basis. Now, however, the cost of doing business in New Jersey is higher than Nevada, and Nevada is higher than other places. Thus, all other things being equal, Nevada casinos can offer better odds to patrons than New Jersey casinos can and still make the same income from a given game. Better odds will influence price-sensitive players to choose Nevada over Atlantic City. The higher the regulatory costs, the smaller the market for the casino product will become.

For many of the reasons stated above, regulation is needed to maintain the integrity of the industry. On the other hand, high regulatory costs could burden or destroy the competitiveness of the state's industry. A challenge facing all casino jurisdictions is to maintain a high standard of regulatory control at the lowest cost. This may place some states at a competitive disadvantage with other states having little or no regulatory control, but those states face a greater downside if their lack of controls causes scandal, disenchantment with gaming, and the demise of the industry.

Economic Controls

Market forces are powerful. Consumers respond to new products that provide value for their money. On the other hand, they resist poor quality and overpriced items. The consumers force producers to make better products to stay competitive. These forces continue to improve the general quality of the market, often dramatically.

The same principles apply to a competitive casino industry. The product is the casino experience. Successful casinos find a market among potential patrons, and serve that market by providing good value. Not all casinos need to be Caesars Palace or The Mirage. Just as all people are not attracted to the same automobile, they are not attracted to the same casino. Some people like the luxury of Caesars Palace and are willing to pay for it. Others want a bargain and may choose the Lady Luck. What do Caesars and Lady Luck have in common? Both know their patrons' desires, cater to those desires and offer exceptional value for the money. They are also successful.

Unsuccessful casinos share common traits. They either do not find a market niche or cannot compete against other casinos for the same market segment because they offer an inferior product or a similar product at higher costs. It is also why Nevada is likely to see some major casino-resorts fail in the next five years. New products, such as MGM Grand and Trea-

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sure Island, will grab significant market share. Casinos serving the same market segments but offering inferior products will fail.

A misconception is that all casino closures hurt the local economy. The opposite is often true. Suppose a market can only support five resorts when there are six. This results in an excess supply of games and devices. The least profitable hotel has some market share. With the sixth and least profitable hotel open, the other five resorts are less healthy because they earn less. They are also less attractive to lenders and investors. When the sixth resort closes, the other resorts quickly absorb its customers and become healthier. The resort that fails often is the least competitive because it has an inferior product or is overpriced.

Another misconception is that a casino opening may hurt the local economy. Suppose a new mega-resort opens in a casino market. This new resort will create greater competition for patrons. Initially, this may lower the profits of existing casinos that lose patrons to the new resort. Two alternative conclusions may result. The first is that the market will be strong enough or will grow to accommodate the expansion. The second is that the weakest casino will fail. In either case, the market is better off. The first case is obviously good for the local economy because it is in an expansion mode. In the latter case, the quality of the remaining properties is better than before the expansion. With this better stock, the community maintains an edge in competition with casinos and other recreational products in other areas.

Regulatory agencies charged with maintaining the integrity of a gaming industry may confuse their role with that of agencies designed to regulate imperfect markets. The gaming regulators may see many casino closures and feel compelled to intervene to protect creditors and employees. They also may feel they can predict which projects will succeed and which will fail and make licensing decisions on that basis.

Government should not attempt to alter market forces. It should not help a struggling casino remain open nor sentence it to a premature death. Keeping an ailing casino open promotes oversupply and hurts the entire market. Government's only obligation is to help the displaced workers until they can find new employment. Likewise, the state should not refuse to license a new casino operation because of questions about its economic viability. The market is the best judge of viability. If government assumes this role, the market may lose a potential competitor that could succeed by introducing innovations or creating new markets.

Regulators that question the viability of an operation may have legitimate concerns. For example, will the operator go to an unsuitable source to get money if times turn tough? Will it try to create profits by cheating patrons? Careful monitoring of the operator and requiring submission of periodic reports can address these concerns.

Likewise, regulators should not require casino operators to comply with economic conditions that are not related to social goals of casino regulation. For example, suppose a regulatory agency questions the financial viability of a proposed casino. The agency may have a concern that if the casino fails it will not be able to pay its trade creditors. The agency may be sensitive to this possibility because other casino failures resulted in hardships to local trade creditors. The regulatory agency may consider requiring the casino to establish reserves to pay creditors even though other businesses or casinos in the community do not have to comply with similar requirements. This should be avoided. First, it takes discretion away from the business operator to use its funds where it believes the money could best be put to use. If that money could be used for promotion, but is unavailable, the property is now at a competitive disadvantage and may fail. Second, these requirements do not advance the real purpose of gaming control — to ensure that organized crime is not involved, that games are honest, and that the state receives its fair share of taxes. Having lay commissions act as economic directors in an otherwise competitive market is not effective. Third, the bankruptcy laws already protect trade creditors, and the bankruptcy courts are responsible for ensuring that all creditors are treated fairly. Gaming regulators should not accord special privileges to artificially chosen classes of creditors. Fourth, trade creditors must assume responsibility for their actions. If a person is in the business of providing goods or services, he needs to be responsible for decisions such as allowing a customer to buy on credit. If that customer is a struggling hotel, the supplier can either require cash up-front or not accept the business.

Taxation

Casinos exist in three types of markets: monopolies, oligopolies, and competitive markets. Windsor, Ontario, is an example of a monopoly. The province has announced that only

one casino will be allowed in Windsor. It may not always be a monopoly, however, because Detroit may have legal casinos in the future. In the monopoly models, the taxes that casinos can pay the state can be much higher in most circumstances. In a monopoly, the casino usually will set odds more favorable to the house than in a competitive market. This pricing is a function of how many games the casino can offer before the cost of adding one additional game exceeds the revenues that can be derived from the additional game. This point is reached at different times in a monopoly and a competitive model. In a perfect competitive model, the marginal revenue curve is the same as the demand curve. This means that a competitive casino cannot increase prices — worsen the odds customers receive — without losing customers and, hence, money. In a monopoly, on the other hand, the marginal revenue curve intersects the marginal cost curve at a lower output and a higher price. This means that the monopoly casino can provide fewer games at worse odds or increase prices of other casino products without sacrificing earnings.

Because a monopoly casino's margins are much higher, it can afford to pay higher taxes. For example, Splash, in Tunica, Mississippi, was the only casino in the Memphis area. It charged patrons for parking and to enter the casino, but still had four-hour lines just to enter the casino. Other casino operators were attracted to the area and eventually obtained the licenses needed to open. No longer a monopoly, Splash had to alter its pricing structure. Few patrons would be willing to pay for admission not charged by its competitors. Because it has few casinos, the Memphis area is not a perfect competitive model. Instead, it mirrors an oligopoly model where the profit maximizing price lies somewhere between that of the perfect competitive model and the monopoly model.

When setting a tax structure, government dictates output. In the casino industry, output equates to the number of games and devices that the casinos offer the public. The number of games and devices offered drives other areas such as the number of employees, capital investment, and ancillary and complementary industries. All industries have demand curves for their product. Usually, the higher the cost, the lower the demand for the product. Taxation can be either a fixed or variable cost. In either case, it increases the cost of the product. The more the government taxes casino gaming, the lower the demand for the product. Conceivably, the government could tax the industry so heavily that patrons will go to other jurisdictions or will gamble with illegal operators.

A government's tax policy should be consistent with the purposes for which it legalized gaming. If the purpose is to promote a gaming industry, encourage entrants, and maximize employment, then it is counterproductive to charge higher taxes. Perhaps most dangerous is to change tax policies on an established industry. Suppose you have a competitive industry that reached an equilibrium based on a tax rate of 10 percent. If you raise the tax rate to 20 percent, the industry needs to raise prices to stay profitable, which reduces demand. The lower demand results in an oversupply and the closure of some producers. The best example was when Colorado raised its gaming taxes from 15 percent to 20 percent of gross gaming revenues. This raised the fixed costs for the casinos, making it unprofitable for many casinos to operate, and resulted in multiple closures.

Barriers to Entry

Of all factors necessary to support a free market model, a key is the absence of barriers to entries.⁵ Barriers to entry discourage potential competitors and thus allow the established firms to earn supernormal profits. How a market becomes a monopoly, oligopoly, or competitive can result from explicit regulation. For example, state law may dictate that there be only one casino or fifteen riverboats. Sometimes natural occurrences shape markets. For example, the Pacific island Tinian can physically hold, at most, only a few casinos. More often, the law will not dictate the number of casinos, but will influence whether a given market becomes a monopoly, oligopoly, or competitive. An example is where only a few sites in a state qualify under criteria limiting where an operator may place a casino. Another example is where the government requires substantial investment to qualify for a license. This may make investment attractive for the first entrant, who can make monopoly profits and, perhaps, for a few more

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entrants. At some point, however, potential competitors will not be willing to enter the market because the potential profits do not justify the capital costs.

Finally, the licensing system employed by a state will influence the number of competitors. In a perfect competitive system, competitors will enter the market if the existing entrants are making extraordinary profits. How quickly or easily they can enter the market is greatly influenced by licensing. Obviously, existing competitors will have an advantage if the licensing process creates an enormous barrier.

Licensing can create barriers to entry in four major ways. First, it can add uncertainty and risk to the decision to enter a market if regulators regularly deny licenses to applicants. All things being equal, a company will devote its resources to a market where it is more likely to obtain a license. Second, the length of time that a licensing investigation takes may create a barrier. Companies that want to enter a market do so based on the current economics of that market. If licensing takes a substantial amount of time, the company must forecast the economics for when it may obtain its license. This adds risk to the decision to enter the market. Third is the cost of licensing. A potential entrant will consider the cost of licensing to decide if its money will generate a higher return in this market or business as opposed to another. Finally, the licensing process may cause social stigma and embarrassment to a potential entrant. This may discourage some companies, especially diversified companies where embarrassing news could hurt its other businesses.

Governments should understand that the laws promoting barriers to entry affect competitive markets and have economic costs. Monopoly and oligopoly markets result in higher cost to the consumer and lower output. In the casino industry, lower output means higher net profits on lower gross revenues. It also means lower employment and fewer games and devices.

Regulatory Price Controls

In most industries, regulatory price controls means the government sets prices for services. For example, a state public service commission may fix basic telephone rates. In the casino industry, government sets rates by dictating the odds of the games. For example, Colorado requires casinos to offer no more than double odds on craps and to have both "0" and "00" on their roulette tables, requirements that increase or help preserve the casinos' edge. These regulations set prices in the gaming industry. So do requirements that a casino use multiple decks in blackjack, another edge-preserving rule.

Price setting disrupts a competitive market. Often price setting helps established firms because it eliminates competitive pricing. If the industry's market is only local residents, price setting may be good for casinos that do not have to compete based on price, if the price set is above market price. This is bad for patrons, however, who will not get the lowest prices. If the market is national or regional, price setting may harm both the patrons and the casinos. A problem in these jurisdictions is that serious players do not like the rigidity of fixed odds. They prefer to play at casinos that compete based on odds because they get a better deal. Patrons benefit from price setting only in systems, such as monopolies, where the casino could and would give worse odds if the law did not mandate better odds.

A similar consideration is regulatory flexibility in adapting to market conditions. In other words, does the casino have business discretion to change game rules and procedures, game mix, and to introduce new games? If it does, the casino industry can adopt new trends and technologies very quickly. For example, if a new game becomes popular, can the casino expose it for play or does it need to go through a laborious approval process? Businesses that can adapt quickly have a better chance of surviving.

Advertising

Whether to allow casinos to advertise is a policy decision based on the potential negative impact of gaming on a community. Proponents of a ban on casino advertising argue that it encourages people who would otherwise not gamble to use nondiscretionary funds for gaming purposes: Instead of buying books, appliances, or food, they spend their money on slot machines. Thus, society as a whole will suffer because the general standard of living will decrease. Some states, however, confuse their goals and policies. On one hand, they want casinos to provide jobs and taxes but on the other wish to discourage gambling by banning advertising.

Banning casino advertising but allowing casino gaming can be consistent. In societies that permit legal gaming and have rational policies underlying their regulatory structure, two distinct systems exist. In the first model, society does not restrict the gaming industries' ability to stimulate demand for its product. In this model, a casino can advertise, offer inducements to patrons, provide entertainment, and do other activities that increase patronage.

In the second model, called unstimulated demand, society allows at least some casinos, but prohibits them from activities that stimulate demand for their product. In these societies, casinos cannot advertise, offer entertainment, sponsor junkets, or conduct other activities that stimulate interest in casino gaming. Great Britain is the purest form of the unstimulated demand model. The government will grant a casino license only if the applicant proves that the area where it proposes to operate the casino has a substantial unstimulated demand for casino gaming and no other gaming facilities are available. Moreover, British casinos cannot provide live entertainment. Outside signs cannot encourage people to enter the casino. Potential players must wait forty-eight hours before obtaining membership allowing them to gamble. British casinos also may not issue credit.

Underlying the British system is not a belief that gaming is immoral. The system is built on rational social policy. Prohibiting gaming is unsatisfactory, according to the proponents of this model, who view gambling as inevitable. If gambling is illegal, some citizens will gamble with illegal operators. This allows criminals to finance other illegal activities and encourages police corruption. Moreover, the government cannot ensure that the illegal operators will treat players fairly and not engage in abusive collection practices. On the other hand, the proponents of the British system believe that allowing casinos to stimulate demand for casino gaming is also undesirable. They reason that gaming creates social burdens, particularly compulsive gambling and gaming by those who cannot afford it. They assert that compulsive gambling can devastate families and individuals. Likewise, encouraging gambling may result in nondiscretionary dollars going to gaming instead of food, clothing, education, and health care. As a result, either the standard of living goes down or the government must provide additional services. Consequently, Great Britain prevents casinos from stimulating demand for its product.

Hybrid models, which borrow elements of the stimulated or unstimulated demand models, also exist. Puerto Rico, for example, allows casinos to stimulate demand outside Puerto Rico to attract tourism, but does not allow casinos to advertise within the Commonwealth. Other jurisdictions allow casinos to stimulate demand outside their borders, but prohibit their own population from engaging in gaming.

Adopting an unstimulated demand model is acceptable public policy if government understands the potential consequences of such a decision. A component of the unstimulated demand model is the ban on advertising. In a competitive market, consumers can make rational decisions on where to spend their money only if they have information about the rates charged and the products offered by competitors. A common method of acquiring such information is through advertising. While advertising is often an imperfect source of information, it is better than no information at all. In the casino industry, casinos frequently advertise straight pricing information that consumers would find of the greatest value. For example, some casinos will advertise that their blackjack games have single decks or their craps games offer ten-times odds.

Like price setting, a ban on advertising disrupts a competitive market. Often this disruption helps established firms, but also can hurt the entire industry. In a closed market, the ban may benefit existing casinos as it prevents consumers from making rational decisions on where to bet and promotes oligopoly pricing. If the market is close to another market that allows advertising, it may be counterproductive because the other market can use advertising to draw price-conscious consumers. In all instances, a ban on advertising burdens the patron, who has greater difficulty obtaining pricing information.

Credit Play

Credit play is the process of allowing patrons to gamble on credit by signing credit instruments that the casino can negotiate through normal banking channels. Public policy debates over whether the government should allow casinos to grant credit address collection methods, effect on patrons, and competitiveness. Three principal arguments against casino credit are that allowing credit (1) will allow casinos to engage in undesirable methods of

collection, (2) could result in casinos skimming funds through the writing off gaming debts or not reporting paid debts, and (3) would result in patrons losing more than they can afford.

The first concern is historical rather than real. Illegal gaming, by definition, is operated by criminals. Because of their willingness to ignore criminal statutes and engage in illegal gambling, they also have little regard for other laws, including debt collection procedures. In stark contrast, legal gaming operators undergo rigorous licensing examinations, including whether they conducted their businesses in strict compliance with all laws. The public still confuses prior illegal gaming operators with the legal gaming operators. The perception of organized crime accomplices collecting gaming debts is confused with the professional and ethical enforcement of credit found today. Engaging in any illegal or tortious collection practices would jeopardize a gaming operator's license. Federal laws also govern abusive collection practices that give substantial rights to debtors. In recent times, no Nevada gaming operator has been charged with any crimes related to debt collection or been successfully sued for such.

Good regulation can prevent the skimming of funds through the credit process. Casinos can abuse the credit process in two ways. Most states tax gross revenues, which is all money the casino retains as its winnings, less all money the casino pays out as losses. This allows the first method of skimming: A person in association with a casino obtains cash or chips by opening a credit line, does not gamble, and converts the chips to cash. The casino, in turn, makes no collection effort and writes the debt off. The net effect is that the funds go to a third party, are not legitimate gaming debts, and the casino pays no taxes. In the second method, a casino employee or owner collects a debt from a patron, does not report its collection, and records the debt as uncollectible. Both situations are adequately addressed by regulation and proper enforcement. Licensees must maintain extensive records on all credit players and must

follow detailed internal controls in issuing and collecting gaming credit. These procedures ensure that one or two casino employees cannot work with a third party to defraud the casino. Enforcement procedures allow the regulators to verify the accuracy of the information contained in the records.

The final issue concerns whether the extension of credit encourages pa-

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trons to gamble beyond their means. Good long-range casino planning dictates that the casinos not allow patrons to lose more than they can afford. Casinos want to retain a patron's business over many years. Casinos do this by keeping patrons within their means. If a patron exceeds his limits, the casino risks losing the patron's business and reducing the likelihood of collection. Nevertheless, some patrons and casinos do abuse the credit process. Patrons often do this by obtaining credit at many casinos, the cumulative effect of which is to exceed their means. Casinos try to avoid this by using credit reporting services but are not always successful. If a jurisdiction finds that some casinos are recklessly granting credit, a regulation capping the percentage of credit that can be written off as uncollectible may limit this problem.

Given that the percentage of players and casino that abuse the credit process is extremely small, the issue is whether government should prohibit all credit. This debate centers on the effectiveness and role of government. First, will prohibiting credit reduce the incidence of patrons losing more money than they can afford? Second, even if it does, should government dictate to its citizens what legal activities they may and may not borrow money to engage in? Third, will the banning of credit play have a greater negative effect on the gaming industry and those associated with it than any benefit that may be derived? Fourth, are there less burdensome alternatives than a total ban? The latter two issues address the economic effect on a jurisdiction's gaming industry resulting from the loss of the ability to grant credit.

Banning credit can have a substantial economic effect if an area's casino industry competes with another jurisdiction that allows credit. Many patrons who gamble well within their means prefer to gamble on credit so that they do not need to carry large amounts of cash. These patrons are more likely to gamble in jurisdictions that allow credit. The federal government also created an artificial demand for gaming credit play by adopting cash reporting requirements. Under federal law, casinos must file reports on patrons who lose more than \$10,000 in cash, but need not make similar reports for patrons who gamble on credit and pay with a check.

Patrons who are offended by government intrusion into their personal spending habits also prefer to gamble on credit.

Conclusion

What can a state do to help its casino industry? First, it can make the cost of doing business cheaper. There are two ways to do this: Reduce the cost of regulation, and reduce taxes. If it is cheaper to do business in one state, then its casino industry can offer its product at a lower price and better compete against other casinos and recreational opportunities in other states. Reducing taxes on the casino industry is difficult in tight financial times. The worst scenario, given increasing competition in other states, is to raise gaming taxes.

The second avenue is to reduce the cost of regulation. This includes repealing regulations that cost money to comply with but that have little or no regulatory value. This requires cost analysis of regulation. Another vehicle is to reduce regulatory costs by building better mouse traps, that is, by finding ways to accomplish regulatory goals at lower cost.

States with established regulatory systems should regularly solicit comments from the industry about how regulation can work better and cheaper. Old regulations need to be examined regularly from a cost-benefit analysis. States implementing gaming and regulations should not blindly adopt laws of other states without examining cost and benefit in light of their own circumstances, capabilities, and goals.

The third avenue is to make rational decisions on the degree, cost, and duration of the licensing process, credit policy, price controls, and advertising.

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⁵These barriers can take on many forms. Barriers to entry include:

- a. Extreme or significant capital requirements resulting from scale effects.
- b. The existence of patents or copyrights.
- c. Scarcity of or control over a necessary resource.
- d. Excessive skill or knowledge requirements.
- e. Social, cultural, or religious taboos.
- f. Absolute cost advantages, *i.e.*, advantages possessed by established firms who are able to sustain a lower average total cost than new entrants irrespective of size of output.
- g. Large initial capital requirements.
- h. Product differentiation, either natural or artificial, such as advertising.
- i. Retaliation or pre-emptive actions.
- j. Vertical integration, *i.e.*, requiring entry at two or more levels.
- k. Governmental restraints.