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WHY WE ARE OUTRAGED: AN ECONOMIC ANALYSIS OF INTERNET GAMBLING

*Frank Vandall**

While domestic casinos and lotteries take in about \$84.7 billion a year; internet gambling is worth about \$12 billion. By comparison, movies bring in about \$23.24 billion a year.¹ Fifty-two percent of the population gambles.² Although all but two states (Utah and Hawaii) permit gambling of some sort, none license internet gambling.³ It is therefore illegal in all 50 states. Estimates suggest that only 1% of the population engages in internet gambling.⁴

Melissa Shettini Kearney argues that internet gambling is inexpensive as compared to casinos.⁵ What she means by this is that you do not have to fly or drive to a casino.⁶ Further, the gambler does not have to stay overnight, and thus pay for lodging. Internet gambling is also private, meaning it can be done in the gamblers' home or at the office.

Standing casinos in Nevada and other locales, give back to the community in the form of wages and expenditures for services such as airfare, gas, rooms and food. They also employ hundreds of thousands of persons and pay taxes, which also stimulates the local economy.⁷ By contrast, internet gambling sites keep it all. Indeed, they pay little for a license and hire few employees.⁸

The core problem with regulating internet gambling is that the large number of sites are located in foreign countries such as England,

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¹ Ryan S. Landes, *Layovers and Cargo Ships: The Prohibition of Internet Gambling and a Proposed System of Regulation*, 82 N.Y.U. L. REV. 913, 917 (2007).

² *Id.* at 916-17; *see id.* at 926.

³ Melissa Shettini Kearney, *The Economic Winners and Losers of Legalized Gambling*, 58 NAT'L TAX J. 4 (2005); *id.* at 282 (stating that "[l]egalized gambling reached a record high of \$78.6 billion in 2003").

⁴ *Id.* at 298.

⁵ *Id.*

⁶ *Id.*

⁷ *See* Kearney, *supra* note 3, at 285; *see also* Landes, *supra* note 1, at 917, 920.

⁸ Landes, *supra* note 1, at 917 ("Casinos employed 354,921 people in 2005, paying them a total of \$12.6 billion in wages.").

Costa Rica, and Gibraltar.⁹ The United States has no jurisdiction over them and, at present, they are largely free to do as they wish.¹⁰ Having no jurisdiction over internet sites means that the United States can do little to regulate them. Although the 2006 Act allows for prosecution of site operators, this is largely meaningless because they cannot be arrested or prosecuted in their home countries.¹¹

The main thrust of the Safe Port Act of 2006 (2006 Act) is to cut off the flow of funds from financial institutions to sites and to permit prosecution of the internet gambling executives.¹² Ryan Landes argues that numerous detours have been constructed around the U.S. credit card companies so that imaginative U.S. residents are still able to gamble on the internet.¹³ Thus, in spite of the 2006 Act, internet gambling continues.¹⁴

Why are we outraged? The United States is outraged because no taxes are paid on the \$6 billion that is shipped abroad.¹⁵ The misery and expenses, however, that follow internet gambling are distributed among the various states.¹⁶

The social cost of internet gambling is widespread: divorce, loss of homes (that were put up as collateral), bankruptcies, gambling by children, and suicides.¹⁷ Melissa Shettini Kearney largely agrees.¹⁸ John Kindt looks further and argues that internet gambling will eventually disrupt foreign financial institutions and will likely cause destabilization of developing countries.¹⁹

⁹ Kearney, *supra* note 3, at 297 (numbering 1,800 foreign internet gambling sites); John W. Kindt & Stephen W. Joy, *Internet Gambling and the Destabilization of National and International Economies*, 80 DENV. U. L. REV. 111, 113 (2002) (pointing to twenty-five foreign sites); Landes, *supra* note 1, at 930.

¹⁰ Kindt, *supra* note 9, at 111.

¹¹ *See id.* at 113 (stating that internet gambling is legal in the numerous sites where they are licensed).

¹² Nelson Rose, *Gambling and the Law: The Unlawful Internet Gambling Enforcement Act of 2006 Analyzed*, 11 UNLV GAMING RESEARCH AND REVIEW J. 2, 3, (2007), available at http://www.gamblingandthelaw.com/columns/2006_act.htm.

¹³ Landes, *supra* note 1, at 934.

¹⁴ *Id.* at 935-36.

¹⁵ *Id.* at 943; Kindt *supra* note 9, at 126, 129, 130.

¹⁶ Landes, *supra* note 1, at 927.

¹⁷ Landes, *supra* note 1, at n. 49; see Frank Vandall, *Winning at Craps: Are Casinos Vulnerable to State Suits for Social Costs? A Further Analysis of Causation, Assumption of Risk and Sovereign Immunity*, available at <http://ssrn.com/abstract=448920> (stating that the social cost to the state is very similar to the costs incurred because of casinos).

¹⁸ Kearney, *supra* note 3, at 14.

¹⁹ Kindt, *supra* note 9, at 116.

Addictive personalities are drawn to internet gambling perhaps more than standard casinos.²⁰ These addicts are likely to lose big and this will lead to bankruptcy and divorce in some cases.²¹ We are further outraged that the costs of internet gambling are imposed on the gamblers' home state with no contribution from the internet foreign site.²²

The literature also decries the loss of control.²³ Careful reading suggests, however, that the essential problem is that six billion dollars leaves the United States and none returns in the form of taxes.²⁴ My thesis is that if internet gambling could be somehow taxed, a portion of the money could be spread among the states to help defray the costs of the social services expended on gamblers and their families. The operative mechanism is that internet gambling executives, such as site owners and operators, like to visit the United States.²⁵ This has not been previously explored as a lever to obtain taxes.

Several internet gambling industry executives have been arrested and prosecuted when they entered the United States.²⁶ This proves several things: first, the internet gambling executives like to visit the United States, second, they are tracked by the U.S. government, and third, it is thought desirable to arrest and prosecute them.

Several solutions to the lack of jurisdiction over internet gambling sites have been proposed. First, the 2006 Act forbids internet sites from receiving money from U.S. financial institutions and forbids U.S. financial institutions from sending payments to foreign sites.²⁷ Second, Ryan Landes proposes a voluntary regulation of foreign sites, who agree to reduce underage gambling and fraud, as well as pay taxes.²⁸ Landes argues that these are the key problems with internet gambling.²⁹ His proposal reads like a wish list for existing "bricks and mortar" casinos as it would permit them to own internet gambling sites.³⁰ My proposal is related, but different.

²⁰ See *id.* at 114-15; Landes, *supra* note 1, at 919.

²¹ See Kindt, *supra* note 9, at 116, 121.

²² See Landes, *supra* note 1, at 927; see also Kindt, *supra* note 9, at 113, 153.

²³ Kindt, *supra* note 9, at 127 (stating that the "main policy concern is that we lose control"); see also Landes, *supra* note 1, at 926.

²⁴ Kindt, *supra* note 9, at 126, 129; Landes, *supra* note 1, at 943.

²⁵ See Landes, *supra* note 1, at 914, 935.

²⁶ *Id.* at 914.

²⁷ See Rose, *supra* note 12; Landes, *supra* note 1, at 932-36.

²⁸ See Landes, *supra* note 1, at 937-43.

²⁹ *Id.*

³⁰ Landes, *supra* note 1, at 938 ("American casinos, currently out of the market entirely, would gladly choose certification and regulation over outright exclusion from the market.").

I argue that, if the foreign site agrees to pay taxes and will work to reduce underage gambling and fraud, we will allow their “designated employees” to visit the United States.³¹ Pointedly, I do not open the door to American casinos to operate internet gambling sites, nor propose a new agency. In the final analysis, the costs of gambling may exceed its benefits.³²

The fear of underage gambling seems to be essentially concerned with gambling by college students (under twenty-one) or children who steal their parents’ credit cards. However, are these an overreaction to a limited problem? College students make a large number of mistakes and gambling on the internet seems like another one. College has always carried a risk of suicide, to be sure. The fraud mentioned in the literature appears to be that the internet site may begin with high payouts and then shift to lower payouts and finally, not payout at all.³³ All of this is without notice to the gambler.³⁴ There are at least two replies, first, the “market works” regardless of less than perfect knowledge, and if rates worsen or if sites refuse to pay, gamblers will move to another, more favorable site. Second, perhaps fraud is part of the thrill: “new site, high payout rates, I bet.” Economically speaking, I would think that internet gamblers would discount for fraud and chancy payouts. It seems to be similar to buying a used car which carries a large number of risks. If a site cheats, it will lose business.

There are two major proposals for change. First, Landes argues for a new agency that will bring all internet gambling under one roof. Reading between the lines, Landes seems to be arguing for a mega-solution that will encourage internet gambling to grow by allowing the huge, lucrative state casinos into the internet game:

At the core of the system is the Internet Gambling Regulation Commission (IGRC), which would be created to certify gambling websites that meet certain qualifications. Among these would be an effective method for excluding underage users, full disclosure of website and financial operations (to protect against any kind of fraud), the payment of a licensing fee or tax, and the refusal to transact with financial service providers that also transact with noncertified casinos. Operation of a gambling website in the United States without IGRC certification would be illegal as would fund transfers to

³¹ At present, once they enter the United States, they are subject to prosecution and arrest. See Landes, *supra* note 1, at 914, 935.

³² Kearney, *supra* note 3, at 299.

³³ See Kindt, *supra* note 9, at 114, 134; Landes, *supra* note 1, at 925.

³⁴ See Landes, *supra* note 1, at 925.

any such site. Since offshore casinos and financial institutions are not subject to American laws, the only way to control them is to have them voluntarily abide by the regulations. I will describe how each component of the regulatory system would work and why users, foreign online casinos, and foreign financial institutions would voluntarily opt into the scheme.

• • •

There are a number of ways for the IGRC to generate revenue. It could charge an issuance fee for certification, an annual license fee, a tax on revenues, or any combination thereof. Domestic casinos would surely give up a portion of their potential profits for the chance to enter the online market. Faced with new competition and the prospect of an expanded user base, foreign casinos would likely follow suit. Even a very modest tax rate would likely be more than enough to fund the IGRC's entire operation. Additional funds could go to educational programs, problem gambling treatment, cooperative foreign governments, and the several states.³⁵

The second solution is the Safe Port Act of 2006. It has had some success, but has been extensively critiqued by others.³⁶

The clear benefits of my proposal are that it is voluntary, cheap to administer and will open a dialogue with the foreign internet operators. My proposal expressly excludes the licensing of internet gambling sites in the various states. Licensing would remain a power left to the states, in coordination with the federal governments. This issue will be addressed in a later article. It also holds the promise of a few billion dollars in taxes. It could begin tomorrow with a simple announcement from the U.S. Attorney General.

A substantial benefit from my modest proposal is it may save the government huge amounts in damages. The United States is being sued by Antigua in the World Trade Organization for restraint of trade.³⁷ The core of Antigua's complaint is that because of our restric-

³⁵ *Id.* at 937, 942.

³⁶ *Id.* at 934; Rose, *supra* note 12.

³⁷ Antigua, along with Barbuda and Costa Rica, sued in the World Trade Organization for damages that flowed from the U.S. decision in May, 2007 to ban online gambling in the United States. These three countries won before an arbitration panel, Antigua is now seeking \$2 billion in damages. Daniel Pruzin, *Antigua, Costa Rica Request Arbitration on Compensation in U.S. Gambling Dispute*, 25 BNA INT'L TRADE REPORTER No. 5 (2008). "Antigua [claimed] the dozens of online casinos based there are important to the islands' economy as its second-largest employer." James Kanter & Gary Rivlin, *Ruling Lets Antigua Be Pirate To Punish U.S. in Trade Fight*, N.Y. TIMES, Dec. 22, 2007, at C3, available at 2007 WLNR

tive laws in regard to online gambling, Antigua's sites are losing money.

The good news is that the United States may be able to argue my tax program as a partial defense. With my program in place, the United States will be able to claim that as long as online gambling sites in Antigua pay taxes, C.E.O's from Antigua will not be prosecuted. Thus my suggestion could result in the avoidance of as much as two billion dollars in damage awards by the World Trade Organization.

My solution is cheap in that it only requires the name of the site, the name of its chief officers and the amount of taxes paid in proportion to the revenue from U.S. gamblers. A part time college student working in the Attorney General's office could keep the tally. After she receives a letter from the foreign site containing relevant information, such as a list of "designated executives," the number of U.S. players for the tax year, profits from the U.S. players and a certified check for the appropriate taxes, she would then send a note to the A.G. informing him of the internet "designated executives" who are now entitled to "visit" the United States.³⁸

A final benefit is that my proposal will offer competition for standard casinos in Nevada, on the reservations and elsewhere. Competition, as always, should help the market to work and prices to fall.

2526871. I thank Andrew Woods, Harvard Business School, for suggesting this argument.

³⁸ Specific details of my "proposal" will be the subject of a second paper. Comments and suggestions are appreciated.