

Internet Gambling Regulation in the United States:
A Policy Comparison

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December 2010

Undergraduate Honors Thesis
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Abstract

This thesis compares two competing alternatives for internet gambling regulation in the United States: prohibition as dictated by the Unlawful Internet Gambling Enforcement Act of 2006 (the status quo), and legalization as proposed by the Internet Gambling Regulation, Consumer Protection, and Enforcement Act and its companion bill, the Internet Gambling Regulation and Tax Enforcement Act of 2010. The analysis assesses the two policy alternatives using 6 criteria: youth gambling, problem gambling, defraudment by site operators, money laundering susceptibility, tax revenue, and effect on other forms of gambling. The research indicates that under the legalization bills, youth and problem gambling rates would increase slightly compared with the status quo, while money laundering susceptibility and other forms of gambling would be unaffected. Legalization would also increase player protections against defraudment and generate more than \$10 billion of new tax revenue over the next ten years. This thesis recommends adoption of the legalization bill contingent on specific regulatory requirements, as the tax revenue and benefits to consumers greatly outweigh the costs of the marginal increases to youth and problem gambling.

Introduction

Internet gambling has been a thriving and rapidly growing industry for United States citizens since its development over 15 years ago. Current estimates attribute more than half of the \$16 billion in online gambling revenue worldwide to U.S. players (Vandall 2008). With such high stakes, lawmakers have debated how to most effectively regulate internet gambling. For years, the legality of online gambling remained ambiguous. Beginning in 1998, the Department of Justice had mixed success charging sports betting site owners with violations of the Wire Act of 1961, which outlawed wagers placed over the telephone (Leitzel 2008). In 2002, the U.S. Court of Appeals for the Fifth Circuit ruled that the law does prohibit sports betting over the internet, but does not ban games of chance (*Thompson v. Mastercard*). Meanwhile, there were numerous unsuccessful attempts in Congress to ban internet gambling, beginning with the Internet Gambling Prohibition Act of 1997. Despite such efforts, the industry continued to grow, as little action was taken to deter online gamblers from wagering through offshore sites. Congress took its first clear legislative stance with the passage of the Unlawful Internet Gambling Enforcement Act of 2006 (UIGEA). This bill prohibited U.S. financial organizations from transmitting payments to and from gambling site operators, essentially banning internet gambling for U.S. citizens who lack an offshore bank account.

The passage of UIGEA has not ended discussion over the proper way to regulate internet gambling. In May of 2009, House Financial Services Committee Chairman Barney Frank (D-MA) reintroduced a bill to legalize and regulate online gambling, H.R. 2267: The Internet Gambling Regulation, Consumer Protection, and Enforcement Act. With the issue receiving increased attention during the second half of 2009, Frank's committee held a hearing to discuss the bill on December 3, 2009. Representative Jim McDermott (D-WA) followed in March of

2010 by introducing a complement bill, H.R. 4976: Internet Gambling Regulation and Tax Enforcement Act of 2010, which provides specific tax laws for internet gambling. Following an additional House Financial Services hearing on H.R. 2267 in July of 2010, the committee held a markup on the bill and voted 41-22-1 to advance the legislation. As of December 1, 2010, neither the full House nor the Senate had taken up the bill.

Unfortunately, there are very few unbiased academic works informing lawmakers about the legalization of internet gambling. Thus, this paper intends to provide impartial information that could aide legislators in forming their stances on internet gambling legalization. Even if the current bill fails to proceed any further, internet gambling will undoubtedly return as a controversial issue in the future.

This thesis compared two different approaches to online gambling regulation: legalization with a regulatory regime and the status quo of prohibition as dictated by UIGEA. More specifically, the legalization alternative was based upon the proposed House bills, H.R. 2267 and H.R. 4976. The former would grant regulators within the Department of the Treasury jurisdiction over internet gambling, requiring any site accepting U.S. customers to obtain an operating license. Regulators would require licensees to demonstrate satisfactory measures to prevent youth gambling, participation by compulsive gamblers, cheating, and money laundering. The idea of the licenses is to align incentives such that gamblers will only want to wager on sites regulated by Treasury, and thus all sites will strive to meet the requirements for a license. H.R. 4976 would establish both federal and state taxes on licensed site holders as well as reporting requirements on player transactions.

The status quo alternative was the form of prohibition created in 2006 by UIGEA. Under this law, financial institutions are banned from transmitting payments to and from gambling site

operators. While prohibition could certainly take many forms (as demonstrated by the variety of proposals over the years), it makes the most sense to use the policy currently in place. Thus, the analysis examined the most likely (and only truly realistic legalization alternative) with the actual status quo.

These two policy alternatives were measured against six different criteria. For each of the options, I explored the consequences (or expected consequences) on youth gambling, problem gambling, defraudment by site operators, money laundering susceptibility, tax revenue, and other forms of commercial gambling. I relied on statistics, studies, and anecdotes from recent years to evaluate the consequences of UIGEA. Predictions about legalization were based upon regulation of other gambling forms in the United States as well as the United Kingdom's legalization of internet gambling in 2005.

In making a final policy recommendation within the conclusion, I utilized a cost-benefit perspective. This analysis rejected the point of view that gambling should be illegal simply because the activity is immoral. Instead, the societal benefits of legalization were weighed against the expected negative externalities. In this analysis, I took a perspective based upon John Stuart Mill's Harm Principle, which states "That the only purpose for which power can be rightfully exercised over any member of a civilized community, against his will, is to prevent harm to others" (Mill 1869).¹ Applied to this debate, the Harm Principle indicates that the government has the right to restrict gambling when the activity causes harm (negative externalities) to other citizens. Thus, the final outcome of this policy analysis depended greatly on the youth and problem gambling rates because increases to these figures would result in

¹ Note that Mill makes what is essentially an exception for children, "that this doctrine is meant to apply only to human beings in the maturity of their faculties" (Mill 1869).

elevated social costs, as discussed more extensively in the *social cost* and *youth gambling* sections.

The cost-benefit analysis placed value on consumer sovereignty, deciding that consumer actions are indicative of their true preferences.² Thus, the decision by millions of Americans to gamble online indicates that the activity creates enjoyment for many people. Even if they lose money, this consumer sovereignty approach led me to conclude that a legalized gambling industry would create benefit for many American citizens.

Ultimately, I recommend that lawmakers pass H.R. 2267 and H.R. 4976 to legalize, regulate, and tax internet gambling. The analysis indicated that passage of these bills would likely result in small increases to the youth and problem gambling rates. However, legalization would also generate more than \$10 billion in new tax revenue over the next ten years as well as consumer surplus from the newly available internet gambling opportunities. These benefits would greatly outweigh the additional social costs created by the increased number of problem and youth gamblers.

Past Arguments For and Against Legalized Gambling

Gambling first appeared in the United States during the Colonial Period. Since that time, citizens and politicians have debated the proper role of the government in the industry. As popular opinion and the political and economic climate have changed, gambling has gone through many stages of prohibition and legalization. Yet, even as new forms of gambling emerged, the arguments for and against legalization have remained remarkably consistent.

² This assumption is based on the idea that gambling is a rational economic choice from which people receive entertainment in addition to the chance to win money. See: Marfels, Christian. "Is Gambling Rational? The Utility Aspect of Gambling." *Gaming Law Review* 5.5 (2001): 459-66.

Ethical Arguments

Opponents of legalized gambling have often used two moral arguments. First, they argue that the government should not be encouraging a vice through state-sponsored gambling, such as lotteries (Tyrrell 1996). Secondly, some Christian denominations believe gambling is a sin that the government should work to eradicate (Zipperer 1994). This explains the strong involvement that many Christian interest groups have had in lobbying against legalized gambling. On the opposite side of the issue, some people take a libertarian approach to gambling regulation, arguing that adults should have the freedom to gamble if they choose. They further contend that the small minority of people who may become addicts is not sufficient to justify a ban on gambling, as there are citizens addicted to just about every activity imaginable (Gillespie 1996). Congressman Frank repeatedly used this argument to support legalization of internet gambling in the December 3, 2009 hearing (*Reasonable Prudence Hearing* 2009).

Problem Gambling

The remaining issues of debate regarding legalized gambling center on more tangible effects of the industry. Opponents of legalization argue that the availability of more gambling options will result in higher rates of problem gambling (Hoffmann 2009). The National Council on Problem Gambling (NCPG) uses the term to broadly describe “gambling behavior which causes disruptions in any major area of life” (“What Is Problem Gambling” 2010). Individuals exhibiting the most severe symptoms can be diagnosed with pathological gambling, an impulse control disorder. Studies conducted over the past decade, such as one by John Welte, have found a positive correlation between gambling availability and problem gambling rates (2009). As previously discussed, many legalization proponents trying to counter this argument say that the actions of a small minority do not justify bans on gambling. Richard Vatz and Lee Weinberg

made an argument that compulsive gambling is a psychological myth that gives reckless gamblers an excuse for their behavior (1993). They noted that there is no evidence of any neurochemical or neurophysical status linked to heavy gambling.

Social Costs of Gambling

Central to discussions over the government's right to ban adults from gambling has been the concept of social cost. John Hoffmann noted that although criminologists have generally classified gambling as a "victimless crime," problem gambling does impose heavy costs on both the family and society at large (2009). The National Gambling Impact Study (NGIC) found that "compulsive gambling introduces a greatly heightened level of stress and tension into marriages and families, often culminating in divorce and other manifestations of familial disharmony" (*National Gambling Impact Study*, 1999). In the National Opinion Research Center's report to the NGIC, respondents representing 2 million Americans identified a spouse's gambling as a significant factor in a past divorce (Gerstein et al. 1999). The NGIC also presented extensive anecdotal evidence of children who were neglected and/or abused as a result of a parent's gambling problem (*National Gambling Impact Study*, 1999).

As for problem gamblers' effect on society as a whole, researchers have used many different mechanisms to approximate the social costs of problem gambling, resulting in a wide range of estimates.³ Yet, most works have found the social cost per gambler to be around \$1000 annually. The NGIC estimated the annual societal cost per problem gambler and pathological gambler to be \$715 and \$1200, respectively (*National Gambling Impact Study*). Demonstrating the wide variance in past research, a 1997 piece in *Gaming Law Review* approximated the annual social cost per serious problem gambler to be \$9,469 (Thompson et al. 1997). Douglas Walker

³ Past literature generally falls under one of three categories: cost of illness studies (common in drug and alcohol abuse research), economic approach, or public health approach.

recently performed a cost-benefit analysis in which he excluded transfers of wealth (e.g. theft) and internalized costs (e.g. getting fired from work) that he claims had dramatically inflated previous estimates, such as the Thompson study. Ultimately, he calculated the total social cost per problem gambler (comprised mostly of civil court costs, criminal justice system costs, and costs of treatment) to be about \$881 annually (Walker 2007).

Crime/Money Laundering

Crime has long been an issue tied to legalized gambling and the main justification for three waves of anti-gambling legislation from 1950-1970⁴ (Blakey 1984). Earl Grinols and David Mustard ran an econometric analysis on crime rates in every United States County from 1977-1996, comparing areas with legal casinos to neighboring counties without legal gambling options. After controlling for potential confounding variables such as economic trends, the authors concluded that casinos significantly increase the rate of serious crime in their county (Grinols and Mustard 2006). During the first year of operation, new casinos often hire additional police forces that temporarily reduce the crime rate. However, by year five, there are usually large jumps in burglary, aggravated assault, auto theft, and other crimes (Grinols and Mustard 2006). Conversely, some have argued that studies linking legalized gambling to crime fail to account for the tourism effect on these areas. Following up on research relating tourism to increased crime, Ronald Ochrym studied crime rates in five New Jersey cities. He found that the crime rate in Atlantic City was comparable to that of the study's two non-gambling tourist cities (Ochrym 1990). In addition, the three tourism destinations all had higher crime rates than the

⁴ This is in contrast with the moral arguments that dominated the previous legalized gambling debates in America. These three waves resulted from the Kefauver Committee investigations of 1950-1951, Attorney General Robert F. Kennedy's program against organized crime in 1961-1962, and the Nixon administration's anti-crime efforts of 1969-1970 (Blakey 1984). With a primary focus of reducing organized crime, these efforts included the Gambling Devices Act of 1951, the Wire Act of 1961 and the Organized Crime Control Act of 1970, among many other bills restricting the gambling industry (Blakey 1984).

two non-tourist urban centers, further supporting the notion that visitors may account for the crime spikes in areas with legalized gambling (Ochrym 1990).

Money laundering has also been an issue central to debates over legalized gambling. People on both sides of the argument agree that the cash-intensive nature of gambling institutions makes the industry attractive to money launderers (Chaikin 1991). The question then becomes whether the crime is more prevalent in a legalized system or during a prohibition. Joseph Kelly and Mark Clayton found that money laundering has not been a notable problem in well-regulated land casinos, while it has been far more prevalent in illegal gambling and less-regulated legal gambling operations (Kelly and Clayton 2010). This research appears to support the argument that lawmakers can best prevent money laundering through legalization and strict regulatory controls.

Economic Impact

Another large area of debate revolves around the economic impact of legalized gambling opportunities. *The Nation* contributing editor Marc Cooper argued that legalized gambling exploits lower class citizens and depresses already struggling communities (1996). He noted that the poor are likely to spend 2.5 times the percentage of their income gambling as the middle class (1996). Charles Clotfelter and Philip Cook looked at lotteries in particular, finding that without exception, the implicit tax on lotteries is heavily regressive (1989). Furthermore, John Kindt found that gambling-related bankruptcies soared in South Dakota during the early 1990's, directly following liberalization of the state's gambling laws (1994). Despite these findings, many legalization proponents have argued that gambling is an attractive revenue source because the activity provides entertainment and is purely voluntary (Mikesell and Zorn 1986). Thomas

Jefferson made this very same argument in 1826, writing that revenue from lotteries is preferable to traditional taxes because they involve only willing participants (1826).

Beyond the morality issues of legalized gambling revenue, many have debated whether the industry actually has a positive or negative economic effect. Some proponents of legalization have argued that new forms of commercial gambling spark economic growth in their area. One Arthur Andersen study explored the economic impact of casinos in Shreveport, Louisiana; Biloxi, Mississippi; and Joliet, Illinois. Conducted approximately five years after these casinos opened, the report concluded that in all three cases, the new casinos led to thousands of new jobs, tax revenue for the government, and a boost to other local businesses (*Economic Impacts of Casino Gaming*, 1997). Robert Goodman disagreed, arguing that gambling institutions divert money away from other local products and services (1994). As one example, he stated that South Dakota clothing stores, recreation services, business services, and auto dealers all saw significant declines after the state legalized Indian casinos and gambling machines throughout the state (1994). Beyond the ill effects to the businesses themselves, this substitution away from other products and services reduces sales taxes, ultimately diminishing the net benefit of newly legalized gambling options.

Others have argued that this “cannibalization” should be viewed no differently than any other new product or service that competes for business because gambling is a rational and productive activity in which people willingly pay for the utility they receive. David Steele wrote that even the purchase of an unfair bet (e.g. a \$1 dollar lottery ticket with a 1 in 1,000,000 chance to win \$700,000) can be perfectly rational in that the gambler is willing to pay the additional money beyond the expected value of the ticket for the excitement and ability to dream about incredible wealth (1997). Christian Marfels incorporated the complimentaries offered by modern

casinos into this analysis, demonstrating how casino guests often receive discounts on meals, entertainment, and lodging that offset their potential losses (2001). This perspective further supports the assertion that people make rational economic decisions to gamble.

Effects on Other Forms of Gambling

With past legalization debates, the effect that liberalization would have on other forms of gambling was a critical issue. Existing commercial gambling interests became very involved in legalization discussions, a trend that has continued with internet gambling. For example, established gambling companies have often fought to prevent the introduction of state lotteries, fearing that consumers would reduce spending at their institutions to begin playing the new lottery (Clotfelter and Cook 1989). Yet, past research has failed to find a consistent substitution effect between different forms of gambling. On one side, studies have found that newly introduced casinos take proceeds away from pre-existing state lotteries (Walker and Jackson 2008; Elliott and Navin 2002). Conversely, Clotfelter and Cook concluded that newly introduced state lotteries appeared to have no negative effect on existing gambling establishments (1989). Thus, the effect of legalization on other gambling forms appears to vary by individual circumstances, although casino revenue appears relatively stable. Clotfelter and Cook note that a small number of established gaming interests have actually supported liberalization measures, believing that new forms of gambling may increase overall gambling participation, aiding their businesses (1989).

Issues Specific to Internet Gambling

In addition to the areas of disagreement listed above, the unique nature of internet gambling creates new issues critical to the debate over its legalization. Most notably, the ability or lack thereof to exclude youths from online gambling has become a hotly debated issue. In the

aforementioned December 2009 Congressional hearing, opponents of H.R. 2267 repeatedly focused their attacks on how legalization would affect American youths (*Reasonable Prudence Hearing* 2009). Ryan Landes noted that online gambling sites lack the ability to reliably verify age as in a traditional casino (2007). He stated that essentially any minor with a credit card can access online gambling sites. However, it is unclear whether legalization will make youth gambling easier or more difficult. While many argue that legalization will make online gambling more available to youths, others have said that a legalization/licensing regime will allow authorities to require stricter youth gambling controls.

Defraudment by site operators is an additional issue unique to internet gambling. Users are forced to provide their credit card or bank information before they can play on the internet sites. Thus, in the current environment of offshore unregulated sites, there is nothing to prevent operators from disappearing with players' money (Landes 2007). Similarly, no legislation currently exists to ensure that site operators maintain fair sites with odds and payouts as advertised. Many proponents of legalization have argued that a regulatory regime will allow U.S. authorities to prevent these fraudulent activities, by requiring sites to meet strict fairness standards in order to receive and maintain a license.

Representatives on both sides of the issue have the same goals. Everybody involved wants reductions in youth gambling, problem gambling, money laundering, and defraudment by site operators. This thesis then explores the consequences of two competing policy alternatives for online gambling legislation and their respective effects on these four problem areas, tax revenue, and other gambling interests.

Comparing the Two Policies

1) Youth Gambling

The inherent anonymity of internet gambling makes it significantly more difficult to exclude underage players than in traditional land casinos. In bricks and mortar casinos, security guards check identification upon entry and can easily spot those who are underage. A 14-year-old who would never make it past the front door of a land casino could easily gamble on his/her older sibling's internet account without detection. Given existing research indicating that early gambling initiation is associated with future gambling problems, effective youth internet gambling prevention is critical to the success of any regulatory policy (Volberg 1996; Winter et al. 2002). Thus, policymakers have been working to find the best solution to prevent underage gambling over the internet.

Under the Status Quo

The passage of UIGEA in 2006 profoundly changed the internet gambling industry, and youth gambling rates in the United States as a result. Although regulations for the bill did not go into effect until June 1, 2010, many gambling operators chose to begin preemptively excluding U.S. customers in 2006. With popular sites like PartyPoker, SportingBet, and ParadisePoker no longer accepting U.S. deposits, the level of American participation in the industry appeared to decline (Whyte 2009).

A study by Dan Romer of the Annenberg Public Policy Center at the University of Pennsylvania concluded that this sudden decline in participation extended to American adolescents. Romer found that both weekly and monthly adolescent internet gambling rates steadily rose up until 2006, when they reached their peak, before sharply falling off in 2007

(2008). For example, the percentage of male adolescents gambling online at least once a month sharply declined to 2.4% in 2007 after peaking at 6.6% in 2006 (2008).

Table 1. Percentages of Respondents Reporting Different Gambling Activities at Least Once a Month from 2004 to 2008.

	Age Group										Total Sample				
	14-17					18-22									
	2004	2005	2006	2007	2008	2004	2005	2006	2007	2008	2004	2005	2006	2007	2008
Card Playing	17.0	20.6	18.0	13.8	14.4	23.8	29.5	24.2	20.8	19.3	20.7	25.7	21.4	17.0	16.9
Male	23.9	33.8	26.7	21.7	20.1	33.1	38.5	39.4	31.4	31.6	28.8	36.4	33.1	26.0	25.6
Female	9.9	5.9	8.2	5.2	8.5	14.4	20.4	9.7	10.5	6.5	12.3	14.2	9.3	7.7	7.8
Internet	2.3	2.3	3.1	1.4	1.6	2.6	3.7	5.0	2.2	2.2	2.4	3.1	4.1	1.8	1.9
Male	2.2	3.4	4.1	2.0	2.7	3.5	5.8	8.9	2.9	4.4	2.9	4.7	6.6	2.4	3.3
Female	2.3	0.5	2.1	0.9	0.5	1.5	2.0	1.2	1.4	0.0	1.9	1.4	1.6	1.1	0.5

(Romer 2008)

This trend was very much the same across different age subgroupings and for different frequencies of internet gambling.⁵

It certainly appears that UIGEA has succeeded in its goal of reducing youth gambling rates on the Internet. The legislation seems to have led to a decline in the number of U.S. adults gambling online. As predicted by numerous studies that demonstrate a strong correlation between youth gambling and parents who gamble, this reduction in adult participation had a trickle-down effect on adolescents (Delfabbro and Thrupp 2003; Gupta and Derevensky 1997). With fewer parents and older siblings gambling online, fewer youths were exposed to internet gaming. Further, as many of the most popular and well-known sites chose to preemptively cut off U.S. business, underage gamblers presumably found it harder to find sites accepting American players, adding an additional deterrent.

While youth gambling rates have decreased since UIGEA, payment processing companies that disguise the true nature of gambling transactions have allowed U.S. citizens (including adolescents) to evade the law relatively easily. Furthermore, UIGEA focuses solely

⁵ For full data from study, see:

<http://www.annenbergpublicpolicycenter.org/Downloads/Releases/Release_Romer_gambling_nov25_2008/Card%20Playing%202008%20Release%20nov%2025.pdf>

on financial institutions and makes no requirements of gambling operators. Without any real oversight, the popular offshore websites that continue to attract U.S. play have maintained less than satisfactory standards for excluding underage participants. In one 2004 study (prior to the UK's Gambling Act of 2005), a 16-year-old girl attempted to register with 37 UK-owned gambling sites by using her own debit card and simply lying about her birthday. Thirty of the 37 sites allowed her to register (Smeaton and Griffiths 2004). While these particular sites are now regulated by the UK's Gambling Commission, similarly unregulated operations from around the world are still thriving and accepting underage U.S. customers. UIGEA has succeeded greatly in reducing underage participation but has not addressed this concern that U.S. teenagers can relatively easily register with offshore websites. However, given that there is no feasible policy to block access to these sites, UIGEA's profound effect on reducing overall youth gambling rates must be seen as a success.

Under Proposed Legalization Bills

The youth gambling provisions of H.R. 2267 are purposefully broad, leaving the creation of specific requirements for the regulation stage, should the bill become law. The legislation does require as a minimum that:

“Any application for a license shall include a submission to the Secretary or qualified State or tribal regulatory body setting forth a comprehensive program that is intended—1) to verify the identity and age of each customer; and 2) to ensure that no customers under the legal age as defined by State or tribal law, as applicable, may initiate or otherwise make any bets or wagers... (H.R. 2267, Sec. 5384)

Beyond that, the regulators would be tasked with determining what an acceptable standard is and who should receive licenses. This lack of specificity will allow regulators at the Department of the Treasury to adapt youth gambling requirements as technology advances.

Potential Requirements

An examination of youth gambling controls internationally reveals what requirements would likely be implemented under H.R. 2267. Gambling sites in Alderney (a UK crown dependency in the Channel Islands) have largely succeeded in preventing youth participation, as demonstrated when the UK's Gamcare attempted unsuccessfully to register underage gamblers on Alderney-based websites. Alderney Gambling Control Commission CEO André Wilsenach attributes this success to the large majority of licensed sites using third-party identity verification software (Wilsenach 2007). In the Isle of Man, players are required to use a PIN number mailed to the customer's physical address in order to withdraw funds (Williams 2007). This technique of preventing underage withdrawal of money largely eliminates the financial incentive to gamble for the minors.

Since its Gambling Act of 2005 to legalize and regulate internet gambling, the UK has required site operators, at a minimum, to: warn users that underage gambling is illegal; require customers to affirm they are of legal age; regularly review their age verification systems; ensure staff are trained in the use of age verification tools (particularly using secondary forms of identification to confirm age); and allow sites to work with internet parental blocking tools (*Conditions and Codes of Practice*, 2009). Much like the proposed bill in the United States, regulators are tasked with evaluating the individual age verification techniques when an operator applies for a license. Interestingly, the use of a credit card is considered additional proof that the

gambler is of age. However, if the player attempts to deposit with any other form of payment, the operators are instructed to require further verification, such as checking against credit databases (*Conditions and Codes of Practice*, 2009).

In 2009, the British Gambling Commission conducted unannounced tests of licensees' youth gambling controls. The commission had underage volunteers attempt to gamble on and withdraw funds from UK-licensed websites using their own bank accounts but lying about their birth years. The report found that although many of the smaller sites had potential weaknesses, 95% of active customers were registered with operators that had no identified weaknesses (*Online Mystery Shopping Programme*, 2009). Essentially, the most popular, highest grossing sites all had satisfactory youth gambling controls.

Internet liquor stores in the U.S. provide further examples of age controls that could be applied to gambling websites. Many of these stores crosscheck customer information with public records, such as credit bureau databases, to ensure the customer's name, social security number, birth date, and credit card all match (Reznikov 2007). A minor attempting to circumvent this check would need to obtain not only a parent or other adult's social security number, but their credit card as well. One company, IDology, takes things even further by using public records to ask questions only the individual would know. For instance, "the system could instantaneously ask the consumer different questions, such as what car they drove in a certain year and where they lived at that time" (Reznikov 2007). IDology has already been approved by the Michigan Liquor Control Commission as an age-verification tool.

There is clearly technology in place to largely prevent underage gambling on licensed sites. Should H.R. 2267 pass, the critical issue will be the extent to which regulators require the licensees to adopt these techniques. If use of data verification databases and other protections

become a prerequisite for obtaining a license, then it appears internet gambling would remain difficult for adolescents. However, legalization without the proper requirements would likely result in youth gambling returning to its pre-UIGEA levels or higher.

The Effects of Increased Availability

Even with strong controls in place, the question remains whether they will be effective enough to offset the consequences of increased availability. Studies have found that the number of legal gambling options in an adolescent's state is positively related to the odds of current gambling, current frequent gambling, and current problem gambling (Welte et al. 2009). The United States very much witnessed this effect in reverse when UIGEA (essentially reducing the number of legal gambling options) caused a drop in youth gambling rates. Legalization would lead to significantly more adults wagering on the internet and the advertising that comes with a newly introduced legal market. It certainly makes intuitive sense that, as the Welte study predicts, this increased exposure would lead to elevated youth gambling rates.

The increased number of adults gambling online would also lead to yet another effect on youths that is often overlooked. With "legitimization" of the industry, one might expect to see more adults allowing teenagers to play on their accounts. While this does occur to some extent under the status quo, the problem would likely escalate if online gambling were to become a legal, heavily marketed industry.⁶

Implications

As previously noted, the net effect on youth gambling rates would depend entirely on the strictness of regulations. Legalization will naturally put upward pressure on youth gambling

⁶ There is no mention of marketing restrictions in H.R. 2267.

rates. Legitimizing the industry without tough regulations would likely cause rates to reach new highs. Yet, legalization and regulation provide the opportunity to require all the most popular and trusted operators to implement strict age verification standards. If Treasury required operators to use verification tools like those discussed above, I would expect youth gambling rates to increase slightly, yet remain below the pre-UIGEA rates.

2) Problem Gambling

Many people fear that internet gambling has the potential to drive gambling addictions to a record high level. Experts have cited internet gambling's anonymity, convenience, isolation, and rapid speed of play as risk factors for problem gambling (Whyte 2009). As previously noted, a sharp rise in gambling addictions could be quite detrimental to society in the form of related social costs. In evaluating online gambling policies, lawmakers must determine how each alternative will affect problem gamblers.

Under the Status Quo

The lack of a single definition for problem gambling makes tracking its prevalence over time quite difficult. Instead, there is mostly medical research estimating problem gambling at a specific point in time, given the specific definition researchers chose to use. These studies, based on the traditional medical model, determine whether gambling is problematic based on how it affects a person's emotions and life responsibilities. The most recent such study estimated pathological gambling at 0.6% and problem gambling at 2.3% (Kessler et al. 2008). Current statistics from the National Council on Problem Gambling (NCPG) are quite similar, estimating that about 2 million Americans (1%) suffer from pathological gambling while another 4-6

million adults (2-3%) show less severe but still serious symptoms of problem gambling (Whyte 2009).

One study by researchers at the Harvard Medical School Center on Addictions performed a meta-analysis on 119 different prevalence studies conducted over a 20 year period. The authors concluded that the prevalence of gambling disorders among adults in the general population increased between 1974 and 1997 (Shaffer, Hall and Bilt 1999). It certainly appears that the widespread trend towards increased legal gambling options during this period resulted in the increasing problem gambling rates. The National Gambling Impact and Behavior Study further supported the association between gambling availability and gambling problems, finding that citizens who lived within 50 miles of a casino had double the rate of problem gambling of those living between 50 and 250 miles from a casino (Gerstein et al. 1999). It should be noted that conclusions based upon this study rely on the assumption that those with existing gambling problems did not move to be closer to a casino, creating a selection bias in the data.

Beyond the medical model of problem gambling, the issue can be viewed as a personal finance problem. Essentially, gambling becomes problematic when a person is endangering his/her financial standing and that of their family. Thus, measuring the percentage of gamblers wagering over 10% of their income, for instance, or tracking the incidence of gambling-related bankruptcies provides an additional way of evaluating the prevalence of problematic gambling behavior. Unfortunately, there is insufficient data to utilize this approach to problem gambling as it relates to UIGEA. Certainly, future research should look to use this personal finance perspective to corroborate the findings of medical problem gambling statistics.

Relying on what data is available, there are no indications that the problem gambling rate has decreased since UIGEA passed. In his written testimony to the House Financial Services

Committee, NCPG Executive Director Keith Whyte noted, “While participation in internet gambling by U.S. residents appeared to decline after the passage of Unlawful Internet Gambling Enforcement Act (UIEGA), we did not see a decrease in indicators of gambling problems, such as helpline calls” (Whyte 2009). Unfortunately, there simply has not been a sufficient period of time to assess the problem gambling effects of the bill. Gambling problems take time to develop, so there will be a natural lag time between implementation of a liberalization measure and any noticeable consequences. Future analysis on UIGEA should explore whether this upward trend predicted by past literature does in fact occur.

Under Proposed Legalization Bills

Congressman Frank’s legalization bill would require license applicants to make available upon request problem gambling materials as well as personalized gambling options such as deposit limits, loss limits, and session time limits (H.R. 2267, Sec. 5384). The bill would also grant citizens the ability to self-exclude from all licensed websites, preventing themselves from registering and making deposits (H.R. 2267, Sec. 5384). These uniform requirements would provide an improvement over the current problem gambling controls featured on offshore sites, which vary greatly from one operator to another. While some sites already offer self-exclusions, deposit limits, and links to problem gambling help, others have no controls at all.

Examples from Abroad

The best available way to predict how legalization and regulation of internet gambling might affect problem gambling rates in the United States is to look at examples from abroad.

Specifically, the UK Gambling Act of 2005 is similar enough to H.R. 2267 to allow for useful problem gambling comparisons.

The British Gambling Prevalence Survey of 2007 presented detailed reports on the state of problem gambling in the UK. The survey used two different criteria to measure problem gambling, one based upon the Diagnostic and Statistical Manual for Mental Disorders, Edition IV (DSM IV) and the other from the Canadian Problem Gambling Severity Index (PGSI). Most importantly, the DSM IV screen in 2007 was identical to that used in the British Gambling Prevalence Survey of 2000 (*Prevalence Survey 2007*). The result is a useful tool to gauge what effect the 2005 legalization of internet gambling had on problem gambling rates.

The 2007 survey found problem gambling rates to be nearly identical in every category as they had been in 2000. Using the DSM IV screen, overall current problem gambling prevalence was 0.6% in both studies (*Prevalence Survey 2007*). Breaking these results down by gender, the male prevalence rate rose slightly from 0.9% to 1% while the female rate fell from 0.3% to 0.2%, although these changes are within the margin of error (*Prevalence Survey 2007*).

There are a number of possible explanations for the disparity between these findings and the overwhelming majority of past studies on the connection between legal availability and gambling problems. First, it is difficult to measure small population percentages of any sort using surveys. The difference of a small number of participants can appear as a dramatic percentage shift when compared with previous studies. Furthermore, as with UIGEA, there was not enough time between the passage of the Gambling Act of 2005 and the Gambling Prevalence Survey of 2007 to allow for the necessary lag time. Future research, such as the Gambling Prevalence Study of 2010, to be released in February of 2011, will be far more effective in relating the Gambling Act of 2005 to problem gambling rates in the UK.

Unfortunately, the British Gambling Prevalence Survey of 2007 also did not include sufficient data to calculate gambling losses as a percentage of income. Moreover, the presence of confounding variables such as the 2008 financial crisis makes it nearly impossible to draw problem gambling conclusions from bankruptcy data. Thus, as is the case with UIGEA, there is insufficient information to track problem gambling from a personal finance perspective. Future prevalence surveys should relate data on gambling losses to the survey participants' annual incomes.

Implications

Research on gambling prevalence draws a clear association between disordered gambling and legal availability. While the UK did not see any effects of its Gambling Act of 2005 in the year immediately following its passage, there is no way to predict what consequences may manifest themselves in the future. H.R. 2267 makes strict problem gambling prevention requirements of licensees that would greatly improve upon the controls that many of the offshore sites currently utilize. Yet, even with strict controls in place, legalization and its resulting surge in legal gambling options would likely lead to slightly higher rates of problem gambling.

3) Defraudment By Site Operators

Online gambling creates the opportunity for scam artists to cheat unsuspecting players out of their money. Whether by credit card or direct bank transfer, customers are required to pay before they begin playing. Unfortunately, players often have little idea to whom they are sending their money. Hiding behind the anonymity of the internet, criminals have the

opportunity to steal money through a variety of techniques. An ideal policy towards online gambling will protect consumers from such acts of fraud.

Under the Status Quo

Under UIGEA, the millions of Americans that continue to gamble online have no list of approved, reliable sites to reference. Rather, these players take their chances on websites operated by offshore ownership under little or no true regulation. As a result, American customers have become victims of fraudulent practices by various gambling providers.

The first and most simple form of fraud occurs when site operators steal a player's deposits or withhold winnings. Numerous players have fallen victim to phantom sites that appear legitimate to customers. The site operators direct player deposits to their personal accounts and then shut the site down without warning, disappearing with the money (McMullan and Rege 2010). Other operators, such as GlobalSportsNet, Fallons, and BingoWorld, maintained actual gambling websites but shorted customers on withdrawals or withheld the money altogether (McMullan and Rege 2010).

The second form of defraudment occurs when individual employees use their status at an operating company to steal from players. Such cheating scandals have recently struck AbsolutePoker and UltimateBet, two of the most popular poker sites on the Internet, accounting for millions of dollars in illegitimate winnings. Both websites are headquartered in the Kahnawake Mohawk Territory, a common license provider to online gambling operators.

In the case of the 2007 AbsolutePoker scandal, Marco Johnson of Las Vegas requested a hand history from the website after suspecting the user "Potripper" of cheating in a tournament. Whether sent mistakenly or by a whistleblower at the company, Johnson received a history

complete with IP addresses and e-mail addresses (Goldman 2007). This information revealed that another user was always present at “Potripper’s” table as a “spectator.” This spectator had breached the security system, gaining the ability to view the hole cards of every player at the table (McMullan and Rege 2010). The spectator then passed this information along to his partner, “Potripper,” taking all guesswork out of the poker game. Later investigations linked the IP address of the spectator to company part-owner Scott Tom and “Potripper” to former director of operations AJ Ripper (Goldman 2007). During six weeks of undetected cheating, “Potripper” stole between \$500,000 and \$1 million from customers on AbsolutePoker (McMullan and Rege 2010).

An even larger and more complicated scandal struck UltimateBet in 2008 when players suspected cheating on the popular site. As with the AbsolutePoker situation, players and not the “regulators” from the Kahnawake Mohawk Territory uncovered the cheating (Brunker 2008). A mathematical examination of the hand histories revealed that the user “NioNio” won at a rate 10 standard deviations above the mean (Moses 2008). It is unclear exactly what individuals were involved, but the cheaters used software created by former employees to view other player’s cards (Brunker 2008). During an estimated three-year-long scam involving numerous different usernames, the cheaters stole tens of millions of dollars from other players (McMullan and Rege 2010; Brunker 2008).

When news of the scandal emerged in January 2008, the Kahnawake Gaming Commission ordered the website to refund all players who were cheated out of money, fined UltimateBet \$1.5 million dollars, and threatened to revoke the site’s license if it did not comply (Moses 2008). The owners of UltimateBet refunded some players and promised to refund any other players found to have suffered from the cheating once investigations were complete.

Nonetheless, countless players who believed they were victims of the scheme had yet to receive any compensation as of September 2008 and feared they likely never would (Brunker 2008).

These scenarios highlight two key weaknesses in the current approach to online gambling policy. First, most of the websites currently lack adequate regulatory audits of site security and fairness. The licensing agencies “operate as pay-as-you-go boutiques, generating millions of dollars in fees while showing little interest in policing rogue sites” (Gaul 2008). Players simply hope for the best, generally assuming that the most popular sites are also the fairest. Unfortunately, the scandals at AbsolutePoker and UltimateBet revealed this to be an uncorroborated assumption.

Secondly, without a regulatory structure in place, there is no protocol for players to air grievances against site operators. The victims had no ability to file legal claims against the sites responsible for the security lapses. Further, the actual criminals were less hesitant to cheat on these websites, given the complicated legal statuses and jurisdictional issues were they to get caught.

Certainly, many do not view this as a problem because internet gambling is illegal to begin with. However, the fact that Congress chose to ban internet gambling in 2006 does not automatically determine whether online gamblers warrant greater protections. Internet gambling’s legality is the overarching question of this policy analysis. Thus, its current legal status should not be cited as inherent support or opposition to a policy.

Under Proposed Legalization Bills

H.R. 2267 would require proof of fair games and anti-cheating protections, both during the application stage and in regular audits thereafter (H.R. 2267, Sec. 5383). The legislation also

has strict requirements for what individuals are eligible to earn licenses as site operators (H.R. 2267, Sec. 5383). Further, the bill would establish cheating on licensed sites as a crime subject to litigation in the U.S. court system (H.R. 2267, Sec. 5390).

Examples of Current Defraudment Controls

The system for maintaining fair games under the proposed legalization bills would likely resemble that of other regulatory systems, both for land casinos and for internet gambling internationally. In the United States, state regulatory agencies like the Nevada Gaming Commission are responsible for auditing bricks and mortar casinos. These agencies regularly run tests on casino equipment and inspect all games to ensure there is no cheating. Meanwhile, internet gambling regulators in countries like Tasmania and Gibraltar set specific technical standards and regularly subject the operators to independent integrity testing (*Internet Gaming Technical Requirements, 2009; Code of Practice for the Gambling Industry, 2009*)

Beyond game fairness, regulation would likely implement standards to ensure complete and timely payouts to online gamblers. Internet gambling regulators abroad have implemented various controls to protect player deposits. In the UK, site operators must tell customers whether deposits are protected in the case of company insolvency and if so how (*Conditions and Codes of Practice, 2009*). Antigua and Barbuda's regulators require operators to maintain "investments that have a market value... of not less than the aggregate amount of all its outstanding prizes and monies held on account for players" (*Interactive Gaming and Interactive Wagering Regulations, 2007*). As with bank regulations, such mandates protect player accounts from any sort of financial shock to the operator.

Implications

A strong regulatory system will succeed in aligning the interests of site operators and consumers. Under such a system, players would only have incentive to wager on the licensed sites. These websites have received the Treasury seal of approval that the games are fair, the system is secure, and player deposits are safe. Consumers would no longer have any reason to risk defraudment by wagering on poorly regulated offshore sites. Meanwhile, licensees would strive to maintain the utmost fairness standards to protect their license. Operators will understand the importance of the regulatory seal of approval for business, and will respond by emphasizing fairness standards. Assuming the regulatory audits are both strict and frequent, players would finally have confidence in the integrity of online gambling sites.

There is no question that the proposed legalization bills would be a large improvement over the status quo in protecting players from fraudulent operators. As noted previously, the issue then becomes whether those participating in online gambling have standing on the issue and warrant consideration. Should policymakers decide to value the protection of American internet gamblers, then the legalization bills certainly present a better approach than UIGEA.

4) Money Laundering Susceptibility

Money laundering is the process of hiding the location and origin of funds gained through illegal activity. Given its cash-intensive nature, the gambling industry has long been an attractive method for criminals to launder money (Chaikin 1991). Many people fear that the international, anonymous nature of online casinos makes internet sites even more susceptible to money laundering operations. An effective policy towards internet gambling should restrict the ability for criminals to move illicit money through the betting sites.

Under the Status Quo

UIGEA attempted to limit internet gambling's susceptibility to money laundering by banning U.S. financial institutions from processing transactions to and from gambling websites. While this would seem to eliminate any potential for the crime, numerous methods of bypassing the law have arisen. The very same payment processing companies that allow millions of Americans to continue gambling online have made money laundering a concern once again. Thus, the worries that officials raised prior to UIGEA are very much still relevant today.

A 2002 GAO report on internet gambling found mixed opinions on the industry's susceptibility to money laundering. On one side, banking and gaming regulatory officials did not believe that internet gambling sites were any more susceptible to money laundering than other electronic commerce businesses (2002). Conversely, numerous law enforcement officials stated that the volume, speed, and geographical reach of internet gambling make the sites an ideal target for the layering stage (moving illegal funds through different financial institutions) of money laundering (2002; Rhodes and Palastrand 2004). The various law enforcement agencies held this view despite the lack of adjudicated cases. Treasury Enforcement noted that the industry is particularly vulnerable because the "gambling sites are frequently located in areas with weak or nonexistent supervisory regimes" (2002). The report further included a hypothetical situation where a criminal would deposit a large sum of illicit money into a gambling account, make small hedging wagers, and then withdraw the money.⁷ The transaction would appear as a legitimate internet gambling transaction, effectively "cleaning" the illegally earned money (2002).

⁷ With a hedging wager, the launderer makes certain that one bet will win. For example, they could bet \$1 million on the Redskins to beat the Cowboys and then wager \$1 million on a different site that the Cowboys defeat the Redskins. They guarantee a large victorious wager, losing only the small betting fees.

Since the report was published in 2002, these officials' concerns have remained hypothetical. While there have been a small number of money laundering cases related to the industry, none of these cases have involved criminals using internet gambling websites to launder money earned illegally from other activities. Rather, law enforcement officials have used money laundering laws as the simplest way to prosecute gambling site operators and payment processors.

The most notable of these cases charged the two former directors of NETeller, a large money transfer company, with money laundering for transferring funds to promote illegal gambling (Verrinder 2007). In a similarly high publicity case in late 2008, federal prosecutors charged Edward Courdy and Michael Garone with money laundering for processing payments on behalf of internet gambling giant Bodog (Smith 2008). Thus, money laundering has been a vehicle to target those supporting internet gambling, but internet gambling has yet to become a platform for money laundering.

Under Proposed Legalization Bills

H.R. 2267 is again quite broad in its requirements regarding money laundering prevention. The legislation simply states that licensees must have “appropriate safeguards to combat fraud, money laundering, and terrorist finance” (H.R. 2267, Sec. 5383). Regulators would be responsible for determining what constitutes “appropriate safeguards.”

Examples of Current Money Laundering Controls

Money laundering requirements under H.R. 2267 would likely reflect current anti-money laundering regulations for land casinos. The Bank Secrecy Act of 1970 requires bricks and

mortar casinos to report any large and/or suspicious currency transactions. Specifically, casinos are required to file a Currency Transaction Report for any cash transaction (excluding jackpots) exceeding \$10,000 (*Money Laundering Fact Sheet*). Gambling institutions must also file a Suspicious Activity Report when a transaction over \$5,000 meets specific criteria for potentially illegal activity (*Money Laundering Fact Sheet*).

Looking abroad, licensed internet gambling operators in the UK have specific requirements for prevention of money laundering, as dictated by the Money Laundering Regulations of 2007. The regulations grant primary supervisory responsibilities to the Gambling Commission while also requiring operators to verify the identity of any customer wagering more than 2,000€ in a 24 hour period (*Money Laundering Regulations 2007, Section 10, 23*). The Gambling Commission makes numerous additional requirements of licensed sites, including that they: maintain adequate customer records, utilize effective systems for customer identity verification, train staff in money laundering prevention, develop controls appropriate to their specific company, and report suspicious activity to law enforcement bodies (*The Prevention of Money Laundering and Combating the Financing of Terrorism, 2007*).

Implications

Under a legalized internet gambling system, it would be quite simple for regulators to require similar controls of U.S. licensees. Further, the internet gambling industry is in a better position to fight money laundering than its bricks and mortar counterparts. With all transactions occurring electronically, there is an automatic paper trail often absent in the cash-dominated land casino industry. An effective regulatory system would require licensees to maintain detailed financial records in addition to filing the mandated transaction reports. Further, site operators

should be required to have systems in place to identify suspicious money-laundering behaviors such as numerous withdrawals just under the Suspicious Activity Report cutoff or a gambler who makes hedge wagers.

With the regulations that would likely accompany the passage of H.R. 2267, licensed internet gambling sites would become an undesirable platform for money laundering. With so many unregulated gambling operations on the internet, there would be no reason for a criminal to launder money on the more closely-watched U.S. regulated websites. The U.S. would certainly be doing its part to prevent money laundering, particularly through American sites. Yet, looking at the whole problem, H.R. 2267 would really do nothing to alter internet gambling's liability to money laundering. According to Treasury Enforcement, money launderers always seek out and exploit the least effective regulatory regimes (2002). Improving a small percentage of websites will do nothing, as criminals will continue to look for the lowest regulatory standard.

In sum, internet gambling operators' susceptibility to money laundering is a question in and of itself. Without any adjudicated cases, it does not appear that this issue needs to be a central point of discussion in the policy debate. Furthermore, there is no policy the U.S. can adopt to truly alter the ability for criminals to launder money on internet gambling sites. As long as there are even a small number of poorly regulated websites anywhere in the world, criminals will have the opportunity to launder money.

5) Tax Revenue

Proponents of H.R. 2267 have cited government revenue as a primary motivation for the legislation. With a national debt of \$13.8 trillion as of December 1, 2010, policymakers are looking for any possible way to raise money ("The Debt to the Penny and Who Holds It" 2010).

As with any other policy comparison, the economic effects of respective alternatives must be an important consideration in the debate.

Under the Status Quo

UIGEA is essentially an economically neutral bill, with little discernable effect on government revenue. The law requires financial institutions, rather than law enforcement officials or regulators, to determine which transactions are intended for internet gambling. Thus, the only money the government spends related to UIGEA is to prosecute the minimal number of cases against operators and payment processors that law enforcement officials pursue each year. Relative to the size of the federal deficit, this cost is small enough to disregard.

Turning to financial benefits, UIGEA bans internet gambling by Americans, eliminating the potential for numerous revenue sources. Online gamblers are legally required to pay taxes on their winnings (*McClanahan v. United States*). Yet, most are under the impression that internet gambling is not taxed because the websites are illegal and based in other countries (Humphrey 2010). Further, the IRS has a very difficult time identifying those who do not declare their internet gambling winnings due to the lax and inconsistent regulatory structure of the industry. While land casinos are required to issue W-2G forms and report to the IRS winnings above a certain level,⁸ there is no comparable mandate for the offshore gambling websites. Thus, under the status quo, both federal and state governments lose out on player gambling taxes that they are legally owed. Beyond player income taxes, the government's decision to ban internet gambling eliminates the opportunity to tax site operators. Thus, while the overall accounting profit of UIGEA may be neutral, there are enormous opportunity costs to the law.

⁸ The cutoff for reporting varies based on the gambling activity. Currently, management must issue W-2G forms for winnings of \$600 or more from state lotteries, dog/horse racing, or jai alai; \$1200 or more from bingo or slot machines; and \$1500 or more from Keno (*Information Returns Filing Chart*, 2010).

Under Proposed Legalization Bills

H.R. 2267 and H.R. 4976 together propose a clearly defined taxation system for internet gambling. H.R. 2267 broadly requires Treasury to assess sufficient licensing fees from operators to cover the regulatory costs of the bill (H.R. 2267, Sec. 5383). H.R. 4976 expands upon this legislation, adding specifics for licensing fees and other taxes. This bill would require licensees to pay a monthly federal licensing fee equal to 2% of all money deposited into player accounts during each previous month (H.R. 4976, Sec. 4491). The other major provision of the proposed law would require licensees to pay State/Indian tribal governments an additional 6% fee on all deposits (H.R. 4976, Sec. 4493).

Under the proposed legalization bills, Treasury would acquire new regulatory responsibilities. It would need to hire and train new employees to publish regulations, review license applications, regularly audit the operations of license holders, and conduct all other regulatory actions. Using the costs of similar programs as a baseline, the Congressional Budget Office (CBO) estimated that this operation would cost Treasury approximately \$85 million annually (Pickford et al. 2010). Accounting for a growth period prior to reaching full output size, the CBO estimated the total governmental cost of the bill from 2011-2020 at \$670 million (Pickford et al. 2010).

It appears that the revenue from licensing fees and other taxes would greatly outweigh the added costs to Treasury. The Joint Committee on Taxation prepared an economic analysis of H.R. 2268, a predecessor bill to H.R. 4976 that was nearly identical except it did not include the 6% fee to state and tribal governments. In this report, the estimated revenue from legalization depended largely on whether states had the ability to opt-out of legalized internet gambling. The revenue estimates which included the potential for state opt-outs ranged from \$10-13 billion over

the next 10 years, while the report estimated revenue of \$41.8 billion if no states opt-out⁹ (Barthold, 2009).

A 2008 Pricewaterhouse Coopers report similarly estimated federal revenue from the versions of the Frank and McDermott bills introduced during the 110th Congress. The only notable difference in the previous forms of the bills was that the taxation bill, as with H.R. 2268, included only the 2% federal tax and not the 6% additional state tax included in the most recent iteration, H.R. 4976. The numbers in this report very closely reflected the estimates made a year later by the Joint Committee on Taxation. The Pricewaterhouse Coopers analysis calculated revenue from wagering and corporate income taxes (which already exist for land casinos), the new 2% federal license fee, and individual income taxes. The report estimated 10-year revenue of \$10.9 billion with high state opt-out, \$21.4 billion with low state opt-out, and \$40 billion with no state opt-out¹⁰ (*Estimate of Federal Revenue Effect*, 2008).

The addition of the 6% state tax included in H.R. 4976 provides states with enormous incentive to allow internet gambling in their territories. Based off the estimates for the 2% license fees, it appears the state tax would generate upwards of \$10 billion dollars collectively for state governments. Given this financial incentive, one would expect only a small number of strongly anti-gambling state governments to opt-out of legalized internet gambling. Therefore, the updated taxation legislation, H.R. 4976, would likely result in federal revenue increases closer to the low state opt-out estimates.

⁹ The version of H.R. 2267 passed by the House Financial Services Committee on July 28, 2010 included a revised state opt-out provision. Under an approved amendment by Rep. Brad Sherman (D-CA), state legislatures are given one full general legislative session to opt-out of legalization in their state rather than a 90 day period as originally proposed.

¹⁰ The low state opt-out scenario assumed that states would allow online versions of any land-based games that were legal in the state. The high opt-out scenario assumed that 10 states with some form of legalized land gambling would opt-out of legalizing internet gambling.

In addition to the taxes on operators, the legalization regime would also increase the amount of income taxes paid on internet gambling winnings. H.R. 4976 requires all licensed operators to provide the government with detailed accounting records for all customers, including: name, address, taxpayer identification number, gross winnings, gross wagers, gross loses, net winnings, amount of tax withholdings, beginning and end of year account balances, and amount withdrawn/deposited (H.R. 4976, Sec. 4492). With such detailed records, gamblers on the licensed sites would have no choice but to begin paying taxes on their winnings.

Certainly, this creates an apparent incentive for Americans to continue gambling with offshore providers, to avoid paying taxes on the winnings. Yet, it appears that most internet gamblers fail to pay taxes due to a misunderstanding of the tax code and not out of an intentional disregard for the law (Humphrey 2010). While those who intentionally break the tax law now may continue to do so under the legalization system by using illegal sites, I expect the positive incentives of the regulated companies to outweigh the costs of taxation for the vast majority of gamblers. Bricks and mortar casinos automatically report winnings beyond a certain threshold and yet this has not resulted in any substantial proliferation of underground gambling establishments.

Implications

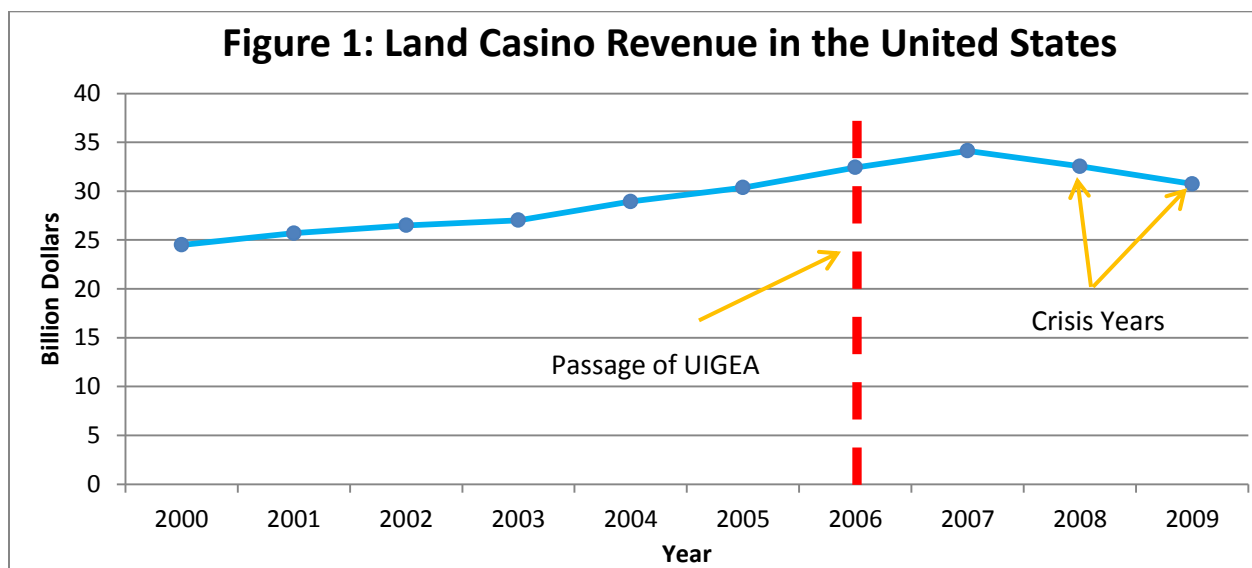
The number of states and territories that elect to opt-out will certainly affect the revenue figures from legalized internet gambling. Regardless, legitimization of this new industry would generate billions of dollars in new tax revenue. Instead of allowing enormous sums of money to flow to offshore operators each year, the government would finally have the authority to profit off this lucrative industry. From a purely economic standpoint, there is no question that legalization makes more sense than the status quo.

6) Effects on Other Forms of Gambling

The way legalization would affect existing forms of gambling is a critical issue for lawmakers deciding on an optimal policy. Members of Congress who believe legalized internet gambling will harm the existing gambling industry in their state/district have strong incentive to vote against the proposed bills. Beyond their responsibility to protect businesses in their community, politicians have an individual motivation to appease the gambling companies in order to continue receiving their political contributions. Thus, a comprehensive policy analysis must compare the proposed legalization bills' effect on existing gambling interests with that of UIGEA.

Under the Status Quo

UIGEA's passage in 2006 did not appear to noticeably benefit land gambling operations in the United States. In 2007, commercial casino revenue continued on a similar rate of growth to what had occurred in the years leading up to UIGEA (*Gaming Revenue 2010*).



From 2006 to 2007, the legal gambling industry as a whole¹¹ actually had its lowest growth rate of the decade, increasing just \$1.4 billion compared with a 2000-2006 average annual growth of \$4.9 billion. Unfortunately, the financial crisis of 2008 greatly impacted gambling revenue in 2008 and 2009, making it nearly impossible at this point to accurately assess UIGEA's effect on the land gambling industry. However, the one pre-crisis year after UIGEA was passed did not demonstrate any notable spikes in gambling revenue resulting from the new prohibition.

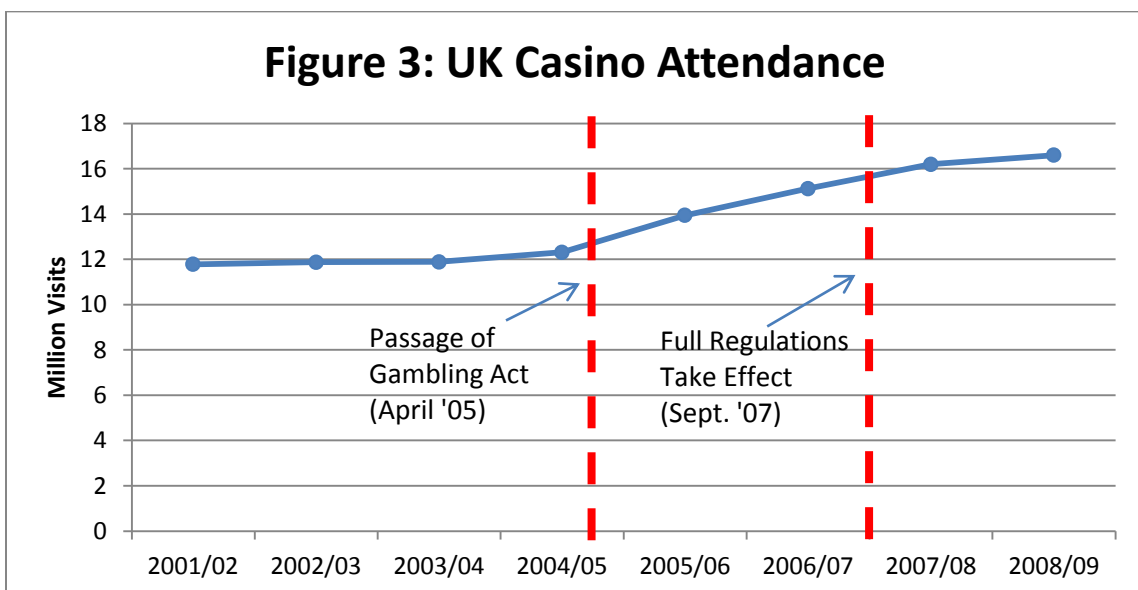
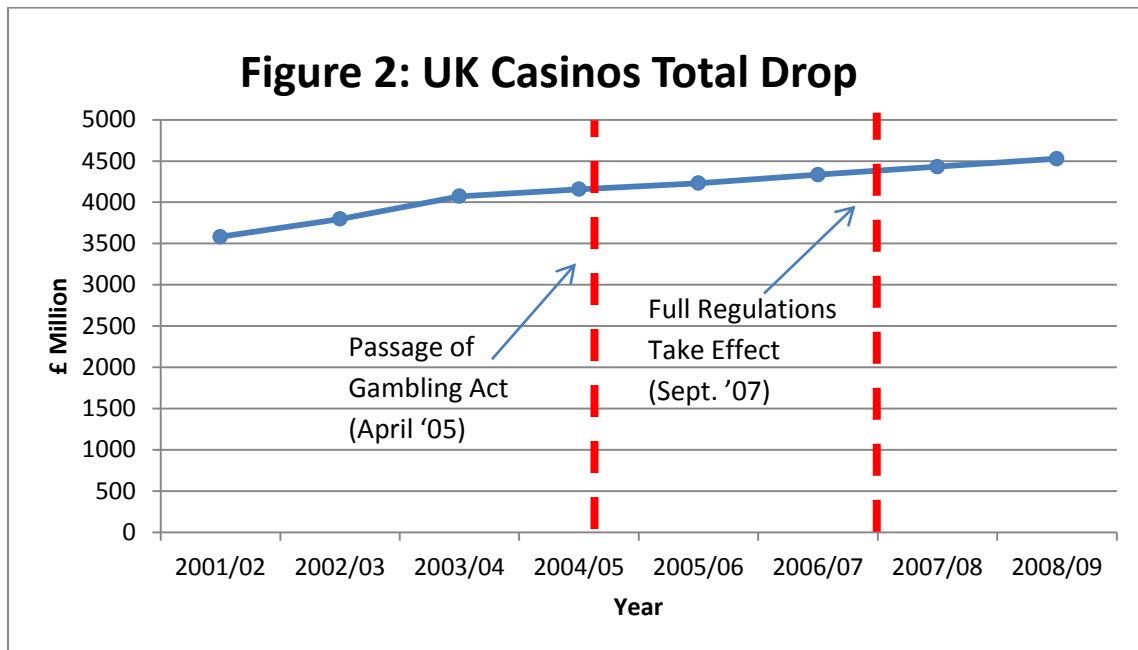
Under the Proposed Legalization Bills

Past liberalizations in the United States are useful for determining whether different types of gambling are substitutes or complements. It appears that the substitutability between two forms of gambling depends on their individual characteristics. On one side, various econometric studies have determined that the introduction of legalized casino gambling within a state cannibalizes revenue from its already existent lottery (Walker and Jackson 2008; Elliott and Navin 2002). Interestingly, Clotfelter and Cook did not find a similar effect when the order was reversed and new state lotteries were introduced after the other gambling establishments. Using a multivariate analysis on data from the National Study of Gambling, the authors concluded that, "The prevalence and level of betting on all other forms of commercial gambling combined were not affected by the lottery" (1989). It therefore appears that: (1) there is no consistent model for the substitutability of different gambling forms, and (2) casino revenue is more stable than lottery revenue.

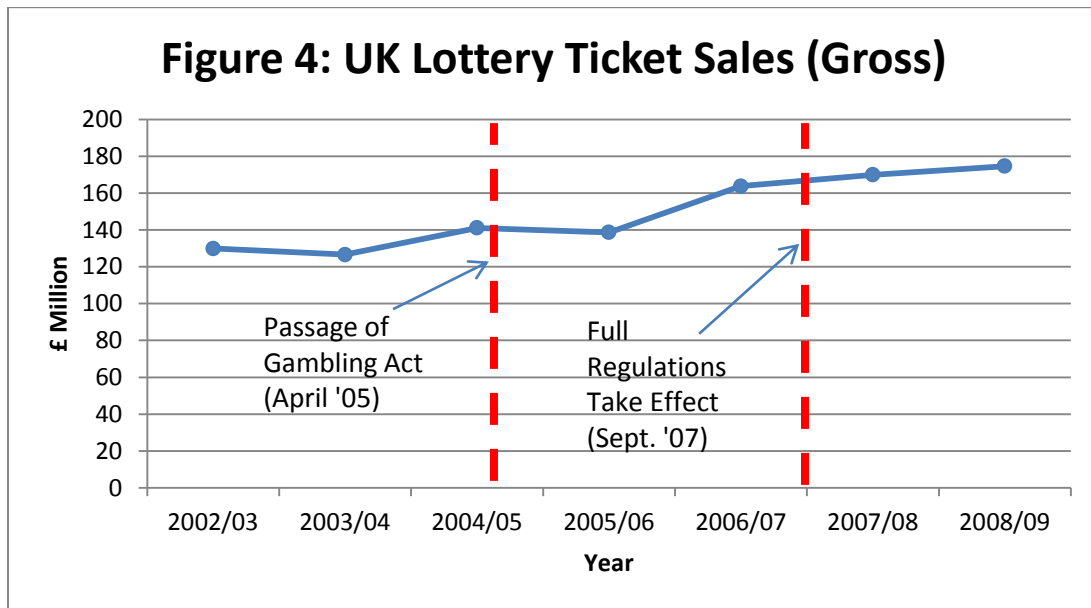
The legalization of internet gambling in the UK provides a useful way to reconcile these findings and determine how newly legalized internet gambling affects pre-existing forms of

¹¹ This includes pari-mutuel wagering, lotteries, casinos, legal bookmaking, charitable gaming and bingo, Indian reservations, and card rooms.

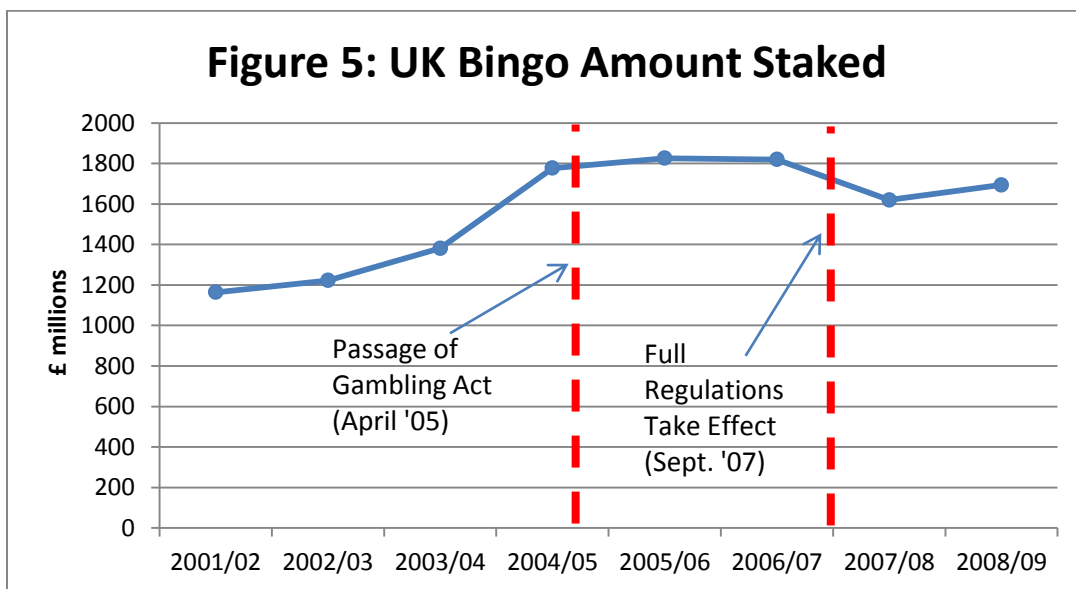
gambling. Figures 2-5 show the annual casino drop, casino attendance, lottery ticket sale proceeds, and bingo amount staked in the UK from 2002-2009. Casino drop and attendance, the best indicators for the land gambling industry as a whole, have continued on their upward trends since the Gambling Act was passed in 2005 and fully implemented in 2007 (*Industry Statistics 2006-2007; Industry Statistics 2008-2009*). Casino attendance actually grew at the fastest rate in the two years following passage of the legislation and has continued to rise in recent years.



Similarly, after alternating years of growth and decline prior to the Gambling Act, lottery ticket sales have been increasing at a rapid rate since 2006 (*Industry Statistics 2008-2009*).



On the other hand, the bingo industry saw a mild declining trend from 2005 to early 2008. Then, the amount of money staked increased from the 2007-2008 reporting year to the 2008-2009 reporting year (*Industry Statistics 2008-2009*).



Thus, the bingo industry took a downward turn after the legislation passed but most recently had a growth year directly following its official implementation date on September 1st, 2007. Without a longer period of data collection, it is difficult to decipher exactly how the legalization of internet gambling affected this particular sector. There is always the possibility that the temporary drop arose from factors other than the legalization bill, such as the Scottish smoking ban implemented in early 2006 (*Industry Statistics 2006-2007*).

Implications

Based upon the recent example in the UK, it appears that legalized internet gambling will not harm pre-existing gambling interests. Policymakers need not worry about ill effects to these businesses when forming their stance on H.R. 2267. Moreover, the legislation provides established American gambling companies the opportunity to actually profit from internet gambling. Major gambling corporations like Harrah's Entertainment have lobbied in favor of H.R. 2267, knowing that they could increase profits if given the opportunity to expand to the internet. In sum, legalized internet gambling will likely have no negative effect on most established gambling interests, while providing a growth opportunity for those attempting to enter the new market.

Conclusions

The debate over H.R. 2267 simplifies to a relatively straightforward trade-off. Lawmakers no longer need to incorporate vulnerability to money laundering into their decision on the bill. Without any real examples so far, the websites do not appear to be the attractive money laundering tool that law enforcement officials previously feared. Furthermore, money

launderers will find the lowest level of regulation available and take advantage, rendering the United States' decision on H.R. 2267 meaningless for that particular issue.¹² Similarly, legislators can ignore any worries that legalizing internet gambling will harm existing gambling interests, a claim that has been proven false in the United Kingdom since 2005. Turning to defraudment by site operators, H.R. 2267 will greatly protect players from dishonest sites. Thus, legislators will have to decide whether greater consumer protection and the increase in revenue outweigh the likely increases in youth gambling and problem gambling.

Taking a cost-benefit perspective, the benefits of legalization appear to overwhelmingly offset the negative externalities (costs). Legalization will essentially create a new consumer product, producing consumer surplus in the form of convenient and trustworthy gambling opportunities. Many people enjoy gambling and will receive benefit from these newly available alternatives. Further, as noted previously, the state and federal license fees are each expected to generate more than \$10 billion in new tax revenue over the next ten years. While taxes are normally treated as a wealth transfer for cost-benefit analyses, the new revenue in this case is a benefit because internet gambling will be a newly legalized industry. Money that would have otherwise gone to international site owners will now be directed to the government to provide services and/or reduce the national deficit.

These benefits must be balanced against the social costs created by legalizing internet gambling. It appears that passage of H.R. 2267 would result in slight increases to the problem gambling and youth gambling rates. As noted earlier, problem gamblers impose societal costs, particularly through legal and treatment expenses. Increased underage gambling will likely lead to more adult problem gamblers in the future and the social costs that they create (Volberg 1996;

¹² Treasury should certainly still write strong anti-money laundering regulations, making reporting and identity verification requirements as discussed in the earlier analysis.

Winter et al. 2002). Yet with properly written regulations, Treasury can greatly limit the extent to which legalization affects these rates. In the end, the tremendous benefits of the legalization bills will outweigh the social costs created by the small number of additional problem gamblers.

Thus, I recommend passage of H.R. 2267 and H.R. 4976 conditional on specific provisions being included during the regulations stage (discussed further below). The following requirements must be included in regulations to supplement those already made by the two legalization bills:

1. All licensees must supplement their own age verification systems with the tools used by online liquor stores in which customer information is crosschecked against public records to ensure that underage gamblers cannot simply lie about their birth year to gain access. As the single most effective widely available way of combatting underage play, Treasury must specifically require all sites to invest in this service.
2. Regulators must periodically conduct unannounced tests of underage exclusion systems, like the UK's Mystery Shopping Programme, levying penalties on any operators that allow underage players to register during the test. Penalties should include fines as well as suspension/removal of license for those operators who have glaring problems or repeated infractions. These punishments must be strict enough so that licensees will have incentive to combat underage gambling to the best of their ability.
3. Regulations must consider all licensed websites as a single entity for deposit, loss, and time limits. A gambler who reaches his/her loss limit on one site should not be able to deposit on another site to "chase their losses."
4. Treasury must dedicate 1% of annual internet gambling tax revenue to programs that prevent and treat problem gamblers; allocate an additional 1% of internet gambling

revenue to youth gambling prevention programs in high schools that stress the importance of financial responsibility.

With the above controls in place, it appears that the benefits of H.R. 2267 would greatly outweigh the costs caused by likely increases in problem and youth gambling. The debate undoubtedly involves countless other issues that will shape how the legislation moves through Congress. With a Republican controlled House of Representatives for the 112th Congress, supporters of the legalization bills will face an uphill battle. Yet, from a policy standpoint, H.R. 2267 and H.R. 4976 would present a clear improvement over the status quo under UIGEA.

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