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EUROPEAN UNION VALUE-ADDED TAXES ON INTERNATIONAL SALES OF DIGITAL PRODUCTS

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ABSTRACT

Value-added taxes (VAT) as assessed in European Union (EU) member countries are governed by a series of directives that function as tax enforcement laws. This paper discusses the governing directive that governs VAT collections on international sales of digital products to customers inside the EU. The paper also contrasts the EU position with that of U.S. states on sales taxes, which are similar to VATs as consumption tax levies.

INTRODUCTION

A VAT is a consumption tax levied on goods and services as they are sold from one stage of production into the subsequent one (Bagby and McCarty, 2002). To the purchaser, a VAT is a tax on the price paid for the good or service. The seller pays VAT to the government on the amount of the value the seller has added. The seller keeps the remaining amount of VAT collected on the entire purchase price from the seller as an offset to the taxes it paid on the goods and services acquired in the process of producing the product or providing the service (Tait, 1988). In 2002, the European Union (EU) issued its first directive requiring sellers to collect VAT on digital goods (De Rato Y Figaredo, 2002). The original directive, which was set to expire in 2008, has been extended (Meller, 2006) and is currently in force. Even non-EU companies that sell into the EU must register with EU tax authorities and levy, collect and remit VAT if their sales include digital goods delivered into the EU. This paper outlines the provisions of the EU directive, compares them to current sales tax rules on interstate transactions within the United States, and examines the implications for future laws relating to consumption taxes on cross-border commerce in digital goods.

ENFORCING THE EU VAT

The enforcement and collection of the EU VAT is normally straightforward. Because the tax occurs at the point of sale, tracking the occurrences of the economic events that trigger these taxes is much easier than calculating and collecting income-based taxes (Yang and Poon, 2002). A taxable transaction that involves a physical good results in a clear and visible event. Some form of product is moved from one location to another. International transactions involving physical goods have always been easy to track because the product being sold crosses an

international border and most international borders are controlled. By monitoring cross-border movements of physical products, EU member countries can enforce the collection of the VAT.

Digital Products

A major change occurred when virtual marketplaces opened online, allowing firms and individuals to place orders, confirm orders, and deliver digital products without any movement of a physical product. The overall visibility of transborder transactions diminished significantly and a lack of clarity regarding where income is earned, products are sold, or value is added became prevalent (IBLS, 2007). Existing laws and court decisions, which relied largely on the historical language of physical commerce to determine jurisdiction, became unclear and difficult to interpret in the online landscape (Jones and Basu, 2002).

Most consumption taxes were enacted many years ago, when it was reasonable to assume that most transactions would involve a buyer and a seller in the same jurisdiction. As mail order, telephone order, and more recently, online order businesses evolved, this assumption became less and less likely to be true. The inability of one jurisdiction to enforce collection of consumption taxes (at the point of sale) on items sold into its jurisdiction from outside its jurisdiction was, in most cases, nonexistent (Bagby and McCarty, 2003).

U.S. Sales Taxes on Digital Products

In the early days of online sales, there was a general consensus that imposing consumption tax collections on the nascent entities engaging in such sales would tend to stifle the development of online business activities (Barlas, 2003). However, in recent years, there has been a growing sentiment that online businesses can stand on their own without additional government subsidies in the form of non-enforcement of existing laws (Thibodeau, 2002).

Russell (2008) notes that the issue of nexus determination continues for interstate U.S. transactions. Pickart and Pessefall (2008) outline recent developments in the distinction between nontaxable services and taxable personal property in the enforcement of U.S. state sales taxes. Although the nexus issue has not been resolved, a number of major retailers have begun collecting U.S. sales taxes voluntarily on sales made online, even when they are not required to do so because they have a physical presence in the customer's jurisdiction (Krebs and Krim, 2003).

The combination of voluntary state enforcement cooperation and voluntary source collection by large retailers might combine to solve a large part of the problem in the United States. In other parts of the world, however, few initiatives have been undertaken by either government or private enterprise to address the collection of consumption taxes on international transactions. One exception to this lack of action are the EU rules that have been imposed on companies selling to EU-based purchasers.

DIMENSIONS OF VAT IN THE EU

VATs are the largest single source of tax revenue in most EU countries. The tax varies considerably from country to country within the EU. Countries such as Luxembourg (15%) and Madeira (12%) levy the lowest rates, while Denmark and Sweden levy the highest rate (25%). There are exceptions to each country's rates with specific reductions (derogations) authorized for particular economic reasons within each country (Ernst & Young, 2007).

In 2002, the European Union Council issued Directive 2002/38/EC (De Rato Y Figaredo, 2002) and accompanying Regulation 792/2002 that. The Directive and Regulation amended existing EU law to add specific provisions regarding the sale of broadcasting services and electronically supplied services; that is, digital products (Hamblen, 2003; Tedeschi, 2003). Under the law, companies that sell into EU countries must register with EU tax authorities and levy, collect, and remit VAT on digital products. The legislation includes not only digital products, but also "electronically supplied services," which encompasses a wide array of services, including the electronic supply of cultural, artistic, sporting, scientific, distance education, entertainment and similar services (De Rato Y Figaredo, 2002).

Digital products specifically subject to VAT include software, software upgrades or updates, computer games, digital music files, rights to access information databases, Internet access provision, Web site hosting, and both subscription and pay-per-download audio and video entertainment services. The list of digital products included in the law is expressly stated to be "illustrative," so the intent of the law is to include virtually all manner of goods and services that are delivered electronically. Thus, the list is comprehensive and it is reasonable to assume that it will be interpreted broadly in EU courts if challenged (Schneider, 2008).

Companies operating outside the EU but selling to users in the EU incur VAT. Under the rules, the location used to determine occurrence of sale will no longer be the jurisdiction in which the seller is established, but will instead be the jurisdiction in which the buyer is located. In an interesting and asymmetric tack, however, the rules provide that EU sellers are no longer required to levy VAT when selling digital products to customers outside the EU. Non-EU sellers must register with an EU country authority, but must pay the VAT rate of the country into which the digital product is shipped (Zee, 2008). EU sellers pay the VAT rate in effect in the country from which the digital products are shipped. Since most digital products and all digital services can be provided from almost any physical location, the strategy opportunities are obvious. These strategies are outlined in a later section of this paper.

The intent of the rules is to prevent non-EU sellers from avoiding VAT liability on EU sales while at the same time relieving EU sellers of the VAT burden on sales they make outside the EU. Europeans in favor of the laws argue that these two changes could help EU suppliers of digital products compete against foreign companies more effectively for both EU and non-EU business. EU sellers must register with the tax authority in their home country. Since they will remit VAT to their own tax authority, this allows them to create a fairly simple system for tracking sales and calculating the tax. If an EU seller is already conducting any sales at all, the company will have in place already a system adequate to track, report, and remit the VAT.

Non-EU sellers must register with an EU country tax authority. This authority can be in any EU country, so non-EU sellers do have some choice in the matter. However, this apparent help to non-EU sellers is nullified by provisions in the law that require non-EU sellers, no matter where registered, to assess the VAT at the rate in effect in the destination country.

This de facto imposes a greater burden on non-EU companies because they must track, report, and remit VATs computed using a variety of rates, one for each country into which they ship. Unfortunately, the underlying legal concept of equal protection under the law is not as well defined in the EU as it is in the United States. The law does provide for online registration by non-EU companies, so at least the registration requirement itself is not particularly onerous.

CONCLUDING OBSERVATIONS

The timing of the enactment of these tax enforcement measures is open to suspicion. Tedeschi (2003) reports survey results and other data from eMarketer (2003) that show that, at the time the EU directive was enacted, the number of Internet users in the EU exceeded that of the United States for the first time (221 million vs. 196 million). Schneider (2005) noted that the timing of the enactment suggests that Europeans might be untowardly opportunistic in their actions here.

The rules are unfair by design. They discriminate against non-EU companies that want to do business in the European market (Ivinson, 2007; Milchevia, 2007). One possibility that might arise in the future is that countries outside the EU might consider retaliating with similarly punitive tax laws or other regulations on sellers operating out of the EU.

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EXPORT CONTROL POLICY INITIATIVES UNDER THE OBAMA ADMINISTRATION

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The goal of the export control system is to deny adversaries access to U.S. defense technology while ensuring cooperation with allies and coalition partners and scrutinizing potential defense exports for their effect on regional stability. Yet restrictions on the sharing of research results and collaboration among scientists worldwide actually may undermine critical security goals (Kellman, 2009). Arguably, the current export control regime impedes the growth and development of the U.S. space program and threatens its future technological advancement, along with national security (Crook, 2009). Additionally, private sector-driven space industry companies, which are seeking to develop next-generation space habitats that utilize expandable technology, are crippled by export controls that treat commonly available and well-understood space-related technologies under the same regime as sensitive space systems with real military applications (Gold, 2008).

The complex licensing system and governmental review of transactions and compliance records complicate, and to a degree dissuade corporate transactions (Clark & Jayaram, 2005). Compliance is costly because of the expenses involved in inventorying the equipment and technology subject to the regulations, as well as in applying for export licenses (Findley, 2006). Sometimes compliance can be virtually unattainable; for example, if controlled technical data is stored on a single, company-wide computer system, then restricting access would necessitate the classification of all technical data to determine what is controlled, along with the implementation of a system-wide, password-controlled, access-control mechanism to restrict foreign nationals from accessing relevant technical data under deemed export rules (McGowan, 2008). Certainly outsourcing by U.S. companies is fraught with pitfalls, and requires assurance by an international partner that it will not subcontract any portion of the outsourced services to prohibited nations or entities, nor employ nationals of prohibited nations to provide services (Weiss & Azaran, 2007).

With respect to dual purpose exports, that is, those items with both civilian and military applications, the complex federal regulatory scheme puts American businesses at a competitive disadvantage with European businesses, which face less stringent controls and which can export goods more promptly (Broadbent, 1999). For example, an amendment to the EAR in 2007, informally called the *China Military Catch All Rule* provides that an exporter may not export, re-export, or transfer any of the approximately twenty specified products or associated technologies without a license if, at the time of the transaction, the exporter either possesses knowledge or has been informed by BIS that the item is intended for a military end-use in China. The regulation has been criticized as unnecessarily impeding collaboration and business partnerships with China by placing unilateral restrictions on dual-use goods that can easily be purchased from foreign competitors (Diamond, 2008). Similarly, the ITAR's regulation of the domestic communications satellite industry impedes global collaboration and reduces the market share of U.S.

manufacturers of satellites and their component parts, while countries of concern obtain and develop satellites and launching capabilities despite these licensing requirements (Allen, 2010).

Commentators also argue that in order to be competitive, U.S. firms must recruit talented, knowledgeable scientists and engineers from a global marketplace, and nonimmigrant foreign nationals help to fill that void (Leus, 2000). Much of this talent is needed for both university research programs and industries on the cutting edge of exactly what it is that export controls regulate, that is, high tech scientific advancements. In this race for global talent, the United States must compete to attract and retain successful high-skilled emigrants, and, for now at least, citizenship is an attractive incentive (Shachar, 2006). In fact, the premise upon which deemed exports restrictions are based (i.e., that the foreign national will return home resulting in an export of technology), may not be accurate given that a majority of these foreign nationals seek U.S. citizenship, in which case they would not be returning home (Martin, Lowell, & Martin, 2002).

In sum, the overly complex and burdensome export control system is in need of reform (Sievert, 2002; Bowman, 2004). Some commentators have argued that split enforcement and oversight authority between the departments of State and Commerce is unwieldy, and should be replaced by a system in which licensing responsibility and enforcement jurisdiction is centralized (Morehead & Dismuke, 1999; Lloyd, 2004). If current trends continue, more than 90% of all scientists and engineers soon will be living in Asia, a third of the world's R&D staff are already located in India and China, and a reliable study estimates that 75% of the new R&D sites planned over the next couple of years will be in India and China. Today's serious shortfall of qualified professionals in "STEM" (Science, Technology, Engineering and Mathematics) in the U.S. is exacerbated by deemed export licensing requirements, since realistically there is greater potential liability for regulatory violations under the ITAR and the EAR for the *inclusion* of foreign nationals in R & D, than under anti-discrimination laws for their *exclusion* (Sperino, 2008).

The Bush Administration recognized some deficiencies of the system, and either implemented or proposed remedial measures. For example, in 2007 a *Validated End User* program ("VEU") was established for China and India which recognizes trusted recipients of controlled U.S. products and technology in these countries, and is available for approved recipients of controlled U.S. products and technology in these countries (15 C.F.R. § 748.15 (2010)). To be eligible for the program, participants are vetted internally by BIS and then by the interagency End-Use Review Committee (composed of representatives of the Departments of Commerce, Defense, Energy, and State, and other appropriate agencies), which examines whether or not they have effective internal control programs to ensure that the products and technology will be used in accordance with the terms of their authorizations. Validated end-users must allow review of records, including on-site reviews and submit annual reports to BIS. There are currently only seven companies in China and one in India that have VEU status.

However, the Obama Administration seems committed to implement a more wholesale systemic reformation in the hopes of streamlining and interjecting more rationality into this critical control system, a system which must risk-manage security concerns while concurrently advancing the technology crucial to preserving the economic and political interests of U.S. and its allies. In 2008 the Obama Administration launched a comprehensive review by a joint task

force of export controls and defense trade processes. The President, in his State of the Union Address in January 2010 pledged to make export control reform a top priority, and in August 2010, the President proposed several reform initiatives.

First, the President proposed to have a single, tiered, positive list, which is designed to build higher walls around the export of the most sensitive items, while allowing the export of less critical ones under less restrictive conditions. A *positive list* is one that describes controlled items using objective criteria (e.g., technical parameters such as horsepower or microns) rather than broad, open-ended, subjective, catch-all, or design intent-based criteria. In conjunction with this three-tiered positive list, he proposed a single set of licensing policies that will apply to each tier of control, in an effort to bring clarity and consistency across the system. The tiers and their licensing requirements would be classified according to the following characteristics: 1) items in the highest tier provide a critical military or intelligence advantage and which are available almost exclusively from the United States, or items that are a weapon of mass destruction (license required); 2) items in the middle tier provide a substantial military or intelligence advantage and are available almost exclusively from multilateral partners and Allies (license exemptions or general authorizations for multilateral partners and Allies), and 3) items in the lowest tier provide a significant military or intelligence advantage, but are available more broadly (license not required). For items authorized to be exported without licenses, new controls will be imposed on the re-export of those items to prevent their diversion to unauthorized destinations. The plan is to merge the two lists (USML and CCL) into one list in the final stages of export reform.

The President also proposed to transition all agencies to a single IT system, making it easier for exporters to seek licenses, and for the government to share all the data efficiently so as to make informed decisions. Currently, the Department of the Defense is using the system, the State Department will be added in early 2011 and the Department of Commerce should be on board later in 2011, with other agencies will follow. When the IT consolidation is complete and the controlled lists are combined, a single system for license applications can replace the two current systems: *D-Trade* for USML items and *SNAP-R* for CCL items. Experts to date have examined one category of controls on the U.S. USML and the corresponding entries on the Commerce Control List, and have restructured USML Category VII (Tanks and Military Vehicles) into a positive, tiered list. Administrative officials report that the preliminary analysis indicates that about 74% of the 12,000 items licensed last year in this USML category will either be moved to the Commerce Control List or will be decontrolled altogether, while about 32% of the total may be decontrolled altogether. Of the 26% of items that remain on the USML, none were found to be in the highest tier, about 18% are in the middle tier, and the remaining 8% in the lowest tier.

Finally, the President announced plans for the creation of an *Export Enforcement Coordination Center* whose mission would be to strengthen enforcement efforts by eliminating gaps and duplication across all relevant departments and agencies. The President's initiatives are predicated on two principles: that the rules should be transparent and predictable, and that there should be streamlined processes and higher fences to control sensitive items appropriately while facilitating exports of less sensitive items to destinations and end users who do not pose

substantial national security, proliferation, or similar concerns. The plan relies on ultimately achieving four key reforms: a single export control list, a single licensing agency, a single enforcement coordination agency and a single information technology system. These reforms are proposed to be implemented in three phases. In the first phase, the executive branch will begin the transition toward the single list and single licensing agency, by making significant improvements to the current system, and by establishing criteria for a tiered control list. The second phase will complete the transition to a single IT structure, implement the tiered control list and make substantial progress toward a single licensing system. The final, third phase, which would necessitate Congressional action, would create a single licensing agency and single enforcement coordination agency.

Obama's proposed reforms, while ambitious, are well-designed to reduce the jurisdictional disputes that lead to slower, confusing, and often contradictory licensing decisions. Likewise, they are better tailored to protect the items, technology and data that are most sensitive, while permitting trade in those that, instead of treating a screw used in an F-18 the same as the aircraft itself, as do current regulations. The reforms also are designed to cut unnecessary governmental red-tape, such as the review of tens of thousands of license applications for export to European Union and NATO countries, of which well over 95% are approved for export. As a result, the White House says the plan would further Obama's goal of doubling U.S. exports in five years, to about $3.1 trillion.

The reform proposals are not a total panacea nor without controversy. Sorting through the USML likely will be cumbersome, and securing Congressional approval also may be challenging, as some members of Congress could object to some of the reform measures, such as the consolidation of oversight power into one agency and one agency head. Further, the recently proposed reforms do not specifically address the issues surrounding deemed export licenses; however, if more controlled items, technology and data are decontrolled, then there will be a concurrent reduction in the number of deemed export licenses required. Nevertheless, the Obama Administration is to be commended for recognizing that a band aid is no longer sufficient; surgery is needed.

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THE ROLE OF PRIVILEGE IN CORRUPTION AND ECONOMIC PERFORMANCE: A MODEL FOR EVALUATING AND IMPROVING STATE POLICIES

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ABSTRACT

Corruption acts as a key, common-denominator in studies of economic recovery, national economic growth, hindrance of economic development, social welfare and stability, and political stability/credibility. From a review of empirical studies on corruption (Lambsdorff, 2005) we create a model in which corruption serves as a central node in a pathway from independent variables such as free-press, independent judiciary and ease of market entry through mediating variables such as degrees of democracy, crime, and free markets to outcomes such as capital formation and quality of social welfare that directly influence economic growth. Analysis of the model shows that privileges act both directly and indirectly on the likely causes of corruption. The Harris-Twomey (2008) typology of privilege provides a structure for analyzing the link between various types of privileges and corruption and leads to policy proposals that might work to reduce corruption and facilitate developing stronger national economies and democracies.

INTRODUCTION

To paraphrase a proverb: corruption has always been with us. It corrodes our institutions, stifles economic activity, and degrades the human experience. Perceived levels of corruption have waxed and waned over the years, and, according to research conducted by Transparency International, we are in a wax-on cycle, with corruption expanding and growing more virulent across the globe. Between 2006 and 2009, 60 percent of the world population perceived an increase in corruption. North Americans and Europeans were above average in their pessimism: 67% and 73% of citizens in those respective areas perceived an increase in corruption. Who do world citizens hold in lowest regard as being most corrupt? Political parties (79%), public service employees (62%), and parliament or legislatures (60%).

If these perceptions of increased corruption are grounded in reality, it does not bode well for the world as we struggle to recover from the "Great Recession" that began in 2007. Perhaps the perception of increased corruption in the West flows from governments' preferred stimulus: granting special payments, opportunities, rights, or advantages to specific firms or industries – that is granting privileges. If the public perceives those privileges as a misuse of public power for private benefit, then those privileges fits the definition of corruption.(Transparency International, 2011)

At the U.S.A. federal level, we have at least the *appearance* that government has picked winners and losers and that those choices have involved some level of corruption; consider that the top officials of the U.S. Treasury Department and the Federal Reserve Bank Board of Governors are overwhelmingly alumni of Goldman-Sachs and that Goldman-Sachs was the single largest beneficiary of TARP money. This presents at least a *prima face* impression of corruption.

It is also likely that much of the economic problems that led to this great recession came from corruption and privilege. For example, the Office of Comptroller of the Currency regulations, based on interstate commerce laws, granted interstate banks the privilege of immunity from state laws regulating home mortgage lending (Bagley, 2008). As there were not sufficient resources at the federal level to monitor lending regulations, many firms engaged in corrupt behavior, breaking laws with regularity. The sub-prime mortgage bubble inflation and subsequent bursting was one of the fundamental triggers of this economic crisis.

This paper seeks to understand the relationship between privilege and corruption and to propose methods for dealing with both. We begin by reviewing empirical evidence regarding the causes of corruption and the effects of corruption on society. This review suggests to an integrated model of causes-corruption-outcomes. We then introduce the Harris-Twomey (2008) typology of privilege to expand the causal model. While proverbs and common knowledge tell us that privilege leads to corruption, but our model suggests specific ways that different kinds of privilege act on or through other concepts in causing corruption. With the general model explained, we suggest policies for dealing with state-granted privilege and the consequent corruption and unequal access to wealth and power.

CORRUPTION

In a survey of empirical research examining the consequences and causes of corruption at national levels, Lambsdorff (2005) concluded that although strongly correlated with corruption, the causal direction of relationships many suspect variables - low GDP, inequality of income, inflation, increased crime, policy distortions and lack of competition – was inconclusive. For example, Gupta, Davoodi and Alonso-Terme (2002), using data from a cross-section of 37 countries argued that corruption increases income inequality, as measured by the Gini coefficient. However, You and Khagram (2005) provided evidence for reverse causality, arguing that the poor are not able to monitor and hold the rich and the powerful accountable, enabling those to misuse their positions. Most likely there are reciprocal relationships creating a vicious reinforcing cycle.

Some well supported empirical findings had less ambiguous causal relationships (Lambsdorff, 2005); freedom of the press and independent judiciary and prosecutors appeared to be important elements in reducing corruption. Complicated regulation of market entry and tariffs, abundance of natural resources, distance to the major trading centers and cultural acceptance of hierarchy (power distance) each were causally related to increased corruption. Democracies with transparent electoral systems and high participation rates reduced corruption, but medium or weak levels of democracy appeared to increase corruption.

Consistent empiricism points to corruption lowering a country's attractiveness to international and domestic investors, reducing capital inflows and accumulation (Lambsdorff, 2005). Productivity of capital suffers from corruption. Evidence also suggests that corruption distorts government expenditures and reduces the quality of a wide variety of government services, such as public investment, health care, tax revenue and environmental control. In short, large welfare losses result from corruption.

In the traditional mode of thinking, these findings provide little in the way of guiding public policy. For example, the creating of strong democracies is a long-term program that requires cultural change as well as policy change. One cannot change natural resources, distance to markets, or cultural attitudes by decree. A nation may attack some of the variables of ambiguous cause-effect, but if corruption is already in place it may be difficult to work on any single variable.

To summarize, empiricism supports a model where freedom of the press, independent judiciary, and strong democracies act to decrease corruption. Barriers to free commerce, abundance of natural resources, distance to major trading centers, cultural acceptance of hierarchy, and weak democracies increase corruption. Low GDP, inequality of income, inflation, increased crime, policy distortions and lack of competition act reciprocally with corruptions. Increases in corruption lead to decreases in economic performance and social welfare.

PRIVILEGE

Experimental studies in psychology (e.g., Zimbardo, Maslach & Haney, 2000) have shown that, once an individual or group has been granted a privilege they quickly come to believe they deserve the privilege, they are entitled to extend or seek new privileges, and that they may treat un-privileged groups in prejudicial ways. In other words, granting privilege (in the experimental setting privilege was manipulated) almost immediately altered and corrupted the behavior of the privileged. Other studies (e.g., Powell, Branscombe & Schmitt, 2005) have shown that once privileged, it is difficult for the privilege holder to observe their own advantages or to empathize with the disadvantaged. These studies suggest there is a strong psychological impulse to leverage a privilege for more privilege and power and to engage in corrupt behavior (behavior outside the rules of the encounter/context) to achieve greater power and privilege.

Based on these studies it is tempting to say that we should simply outlaw all privilege. That, however, would be economically disastrous. A modern society needs a wide range of privileges to function efficiently. For example, few would make investments in buildings if they did not have the privilege of secure tenure in the land. Natural resources, such as the electromagnetic spectrum, require privileges for efficient economic exploitation; without exclusive use, our airways would be an unreliable shout-fest. We would not have broadcast television, radio, or cellular telephones. These privileges, while necessary for efficient resource use, create problems of general fairness for the whole of society.

Moreover, not all privileges *are* economically efficient. For example, regulations to limit market entry and tariffs are clearly formal privileges (based in law). Tariffs are generally

considered economically inefficient. Regulations that limit market entry aim to limit competition and therefore are likely to result in higher prices and deadweight losses – economic inefficiencies.

The Harris-Twomey typology of privilege (Harris & Twomey, 2008; Twomey & Harris, 2009) provides a system to distinguish these formal (state granted) privileges as "efficient" and "inefficient." They also make a distinction between formal (law/regulation/rule-defined) and informal (culturally or socially-defined) privileges. So, the state privilege that grants exclusive use of portions of the electromagnetic spectrum would be *formal* and *efficient* while subsidies to a particular company/industry would be *formal* and *inefficient*. (We will not address the informal privileges here, but many states make formal responses to these informal privileges and these should be explored for their efficacy in trading negative side-effects from formal privileges against the benefits of ameliorating the negative effects of informal privileges).

We illustrate how privilege can help us more deeply understand corruption's causes by exploring the relationship between privilege and two variables identified as causing corruption – ease of market entry and abundance of natural resources. This exploration will lead to suggestions for public policy.

Formal, efficient privileges and natural resources

As mentioned earlier, efficient exploitation of most natural resources requires formal privilege. There are two-fold problems with granting these privileges. The first is the psychological corruption mentioned earlier. The second is that the privilege holder has the opportunity to gain extraordinary wealth which adds to the power and likelihood of manipulating political systems to gain further advantages. Incorporating privilege in the corruption model suggests that it is not the abundance of natural resources *per se* that creates corruption, but it is the privileges associated with the exploitation of natural resource that are the source of corruption.

This challenge can best be addressed by charging fees for the use of the privilege that are equivalent to the opportunity cost and/or transfer costs borne by all who do not hold the privilege. Ideally, those fees would be variable, episodically updated reflecting the general understanding of costs. The collection of use (exploitation, access) fees would have to be transparent and deployed for public welfare, otherwise the substantial wealth so concentrated would be too tempting a plum for corrupt officials. In countries where the other forces resisting corruption are weak it may fall upon less corrupt trading partners to impose various taxes or tariffs and employing monitoring methods to ensure a less corrupt exploitation of the natural resources (as is being done with the monitoring of "blood diamonds").

Formal, inefficient privileges and market entry

Barriers to entry come from company efforts, access to raw materials, and legal constructs such regulations, tariffs, and intellectual property. Company efforts, such as producing higher quality goods, require no special attention here; they are not the subject of state defined

privileges. Access to raw materials would likely be less of a barrier if appropriate fees were charged for the privilege of exclusive access to the materials; it would be economically infeasible to hold an unexploited resource for long or to provide it to the market at ineffective prices.

This leaves the legal constructs. Many of these, such as tariffs and subsidies, are widely recognized as economically inefficient. The obvious public policy for this is to eliminate such privileges. Others, such as intellectual property, are subject to debate as to their economic efficiency. A test of this would be to charge a fee (on the same principle as fees on natural resources) and see what happens. If it is efficient for the economy to grant legal privileges, the state should collect the value of the efficiency for the benefit of all (or at least all who bear an opportunity cost of forgoing the privilege).

CONCLUSION

At the national level, there are multiple variables interacting with corruption. Some serve in feedback loop and others apparently act in a more direct, one-way causal relationship. Corruption decreases the amount of public and private investment and the effectiveness of both types of investment; corruption is strongly and inversely correlated with economic growth and stability.

Several variables that have been shown to cause corruption are related to various forms of privilege. Moreover, psychological studies have shown that privilege has the effect of increasing further privilege seeking, reducing sympathy and concern for less privileged, and generally increasing corrupting behavior (rule-breaking, assumption of power, arrogance and indifference). Because privileges come in a variety of forms and have differential effects on economic activity, the Harris-Twomey typology of privilege is used to distinguish formal (rule or law enforced) privileges from informal (culturally or socially enacted) and economically efficient (those needed to efficiently carry out economic activity) from economically inefficient (those that hinder economic activity). This allows analysis and treatment of various privileges rather than a general (and generally ineffective) treatment of all privileges as the same.

We propose treating many of the problems, especially the problem of corruption at the state level, by creating unique solutions for each category of privilege. For formal, economically efficient privileges, we would charge fees for the privilege equal to the opportunity cost or cost transfer borne by those who do not hold the privilege. For formal, economically inefficient privileges we would eliminate them. If there is a doubt about whether a formal privilege is efficient, then charge a privilege fee and see what happens. For informal privileges, our first choice is to let the effects of diminishing the power of formal privilege have a chance to work. There is some considerable evidence that greater access to natural resources and fewer barriers to market entry create economic conditions that diminish gaps in wealth distribution (and reduce corruption). Closing gaps in wealth distribution provides a context for reducing acceptance of power distance, another cause of corruption.

With these beneficial effects on corruption a more robust economy should emerge, further reinforcing the cycle of benefits. Without such change, we are likely to see more corruption and a slower economic recovery.

This analysis calls for public debate and action, but it also suggests opportunities for more in-depth research. We need to know more about the magnitude of the drag of corruption on developed economies, the ways various privileges motivate, and the limits (if any) to the interactions between privilege, corruption and economic activity. While there are many recommended methods for coming to an appropriate price for privileges (mostly variations on auctions), we need to study what has been effective and what might aid in better reaching prices so that acceptance of privilege-limiting policies is widespread. A catalogue of privileges of all kinds would also aid in more detailed analysis. For, example, sales taxes provide a form of privilege in most locales. Would we be better off eliminating all sales taxes or charging sales taxes on everything (in other papers we have suggested that all taxes on savings and production are inefficient, generally apply privileges in their application and therefore should be eliminated).

We hope this paper has provided a provocative view of the relationships between privilege, corruption and economic activity. There is much to be done in research and policy making, and the constructs here could provide a fresh view leading to innovative and effective new policies.

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THE ECONOMIC, LEGAL AND ETHICAL PHILOSOPHY OF FRÉDÉRIC BASTIAT

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ABSTRACT

Frederic Bastiat (1801-1850) was an economist and journalist. A member of the French Liberal School, he is best known for his free trade ideas and his philosophy of law. Mark Blaug ranks him as one of the 100 greatest economists before Keynes. Schumpeter called him a brilliant economic journalist. Haney devoted a chapter of his History of Economic Thought to Bastiat.

Although Bastiat is known for his work on free trade and the philosophy of law, he also wrote on other topics. To date, only one scholar has examined his views on ethics and that study discussed only two of Bastiat's essays and was less than five full pages. The purpose of this paper is to expand on that study.

INTRODUCTION

Frédéric Bastiat (1801-1850) was a French political economist and journalist. He was a member of the French Liberal School, also referred to as the Optimist School (Cossa, 1893, 376-382; Gide & Rist, 1948, 329-354). Skousen (2001, 59) compares him to Franklin and Voltaire for his integrity and purity and the elegance of his writing style. Hébert (1987, 205) considers him to be unrivaled in the way he exposes fallacies (Skousen, 2001, 59). Haney (1949) devoted a chapter to Bastiat in his *History of Economic Thought.* Blaug (1986) ranks him as one of the 100 greatest economists before Keynes. Schumpeter (1954, 500) considered him to be a brilliant economic journalist, although not a first-rate theoretician. He used the reductio ad absurdum technique to demolish his opponents.

Much of his work, in the original French, is now available on the internet (Bastiat, 1848, 1850, 1861, 1862a&b, 1864, 1870, 1873a, b & c). About one-third of his works have been translated into English (Audouin, 1991; Bastiat, 1964a, b & c; 1968; 2007; Garreau, 1926).
A few books (Bidet, 1906; DeFoville, 1889; Imbert, 1913; de Nouvion, 1905; Roche, 1971, 1993; Ronce, 1905; Russell, 1969; 1985) and dissertations have also been partially (Buccino, 1990) or fully (Hendrick, 1987; Russell, 1959) devoted to Bastiat, as well as several articles. Hazlitt (1946; 1979) and Russell (1985) have written books applying Bastiat's methodology to a range of twentieth century issues.

He was very much opposed to socialism, which he equated with a government that goes beyond its role of protecting life, liberty and property and ventures into the realm of redistribution. He debated the socialists of his time, most notably Proudhon, with whom he exchanged a series of letters (Bastiat, 1862a, Vol. V). Unfortunately, that debate has not been

discussed in the English literature to any great extent, although Imbert (1913, 57-66) and de Nouvion (1905, 256-269) discussed it in French and Mülberger (1896) wrote about it extensively in German.

Historians of economic thought cite Bastiat as being a leading proponent of the view that there is a harmony of interests between social classes (Screpanti & Zamagni, 1993, 94-95), a view that was diametrically opposed to the Marxist view of class conflict. However, the view that there was a universal harmony of class interests did not originate with Bastiat. Quesnay discussed the concept before Bastiat and several other political economists, including Say, Carey and Cantillon (1755), also discussed it (Schumpeter, 1954, 234).

Although best known for his views on protectionism (1850, 1862b, 1864, 1870, 1873a, b & c, 1964a&b, 2007) and the philosophy of law (1862a, 1968), Bastiat wrote on a number of other topics as well. Bastiat's ethical views have been mentioned in the literature, but only one article has focused specifically on his ethics, and that article examined only two of Bastiat's essays and was less than five full pages in length, which could not do full justice to his ethical views (O'Donnell, 1993). The purpose of the present paper is to expand on O'Donnell's article and discuss Bastiat's ethical positions in more depth.

Bastiat was both a utilitarian and a rights theorist. His utilitarianism was more complete and fully developed than that of many other utilitarian scholars, even by today's standards. His rights theory was based in religion but could just as easily be applied as a tool of ethical analysis by an atheist.

BASTIAT'S RIGHTS THEORY

Bastiat was a strong believer in the night watchman state (Bastiat, 1862a, IV, 342-393; 1968). Like Locke (1689) and Nozick (1974), he believed that the legitimate functions of government are limited to the protection of life, liberty and property (Chappell, 1994; Feser, 2004; Lacey, 2001; Paul, 1991; Schmidtz, 2002; Thomas, 1995; Wolfe, 1991). All three believed that individuals are unconditionally entitled to keep the fruits of their labor, unlike Rawls (1971, 2001), who believed individuals had a moral right to keep the fruits of their labor only if doing so benefited those at the bottom of the economic ladder (Freeman, 2003, 2007; Kukathas and Pettit, 1990).

For Bastiat, the role of government is to protect people, not to help them. Going beyond the basic protection function requires redistribution, which Bastiat considers to always be unethical. Stated alternatively, the state should have minimum functions, minimum taxes and maximum liberty ("Minimum de fonctions et minimum d'impôts avec maximum de liberté." Imbert, 1913, 97).

His most complete and comprehensive analysis of rights theory is in *La Loi* [The Law, 1968], which first appeared as a pamphlet in 1850 and was later reprinted in *Oeuvres Complètes de Frédéric Bastiat* (1862a, Vol. IV, pp. 342-393).

His theory begins with the premise that everyone has a natural right from God to defend their person, property and liberty (Bastiat, 1968, 6). Since all individuals have these rights, it follows that groups of individuals can organize and support a common force to protect these

rights. In other words, governments are formed to protect pre-existing rights. Rights do not come from government, as legal positivists would have us believe (Austin, 1869; Bentham, 1843, 1988; Fuller, 1969; Kramer, 2003; Marmor, 2001; Waldron, 1987). They are inherent.

The common force that protects these rights cannot have any rights that the individual members who formed the collective entity do not have and it cannot have any purpose other than that for which it was formed. It cannot be used to destroy the equal rights of others. Justice will reign to the extent that this common force protects these rights. Injustice will reign if the common force goes beyond these basic duties.

BASTIAT'S UTILITARIANISM

Bastiat was more than just a rights theorist. He was also a utilitarian. His utilitarianism was more comprehensive and complete than the utilitarianism of many other theorists and ethicists. His essay, *What Is Seen and What Is Not Seen* (1850; 1862a; 1964a; 2007, I) is perhaps his best and most comprehensive essay from a utilitarian perspective.

Bastiat begins the essay by stating the difference between a good economist and a bad economist.

There is only one difference between a bad economist and a good one: the bad economist confines himself to the *visible* effect; the good economist takes into account both the effect that can be seen and those effects that must be *foreseen*. (Bastiat, 1964a, 1)

Hazlitt (1946; 1979) states Bastiat's position somewhat differently. He says that a good economist considers the effect a policy has on all groups in both the short-run and the long-run whereas a bad economist ignores some groups or some timeframe.

…the whole of economics can be reduced to a single lesson, and that lesson can be reduced to a single sentence. *The art of economics consists in looking not merely at the immediate but at the longer effects of any act or policy; it consists in tracing the consequences of that policy not merely for one group but for all groups*. (Hazlitt, 1979, 17)

The Broken Window

If one wants to start with an example of his application of utilitarian ethics to a particular case, there is no better place to start than with his story of the broken window, which comprised the opening salvo of his classic essay, *What Is Seen and What Is Not Seen* (Bastiat, 1850; 1964a, 1-50; 2007, I, 1-48).

The story starts when an incorrigible son breaks a pane of glass, which the father must pay a glazier to replace. The crowd that has witnessed the spectacle discusses the event and concludes that the destruction has a bright side. Such accidents are good for the economy because they keep industry going. Without occasional broken windows, glaziers would disappear.

What is seen is an increase in business for glaziers. It appears that breaking windows is good for business. Some observers might even conclude that the incident was what economists might call a positive-sum game.

But such an analysis would be incomplete. What is seen is the extra business the glazier receives. What is not seen is that the father, who must pay the glazier six francs to replace the pane of glass, now has six francs less to spend on other things. Rather than having a window and six francs, the father now has just the window. Upon consideration of the father's loss, economists might conclude that breaking windows is a zero-sum game, since the glazier's gain is equal to the father's loss.

But this analysis is also incomplete because it does not consider the secondary effects of breaking the pane of glass. If the window had not been broken, the father could have bought a pair of shoes. He would have had both a window and a pair of shoes. The cobbler would also have gained, since his business would have increased by one pair of shoes. So there are really two losers because of the broken window, the father and the cobbler, whereas there is only one winner, the glazier, leading economists to conclude that breaking windows results in a negative-sum game because there are more losers than winners.

The main thrust of Bastiat's argument is that a law or policy produces both immediate effects, which can be seen, and other, secondary effects that take place later and that cannot so easily be seen or predicted. We are lucky if we can foresee these secondary effects. Sometimes policymakers cannot predict what these secondary effects will be. In modern economic terms, we might say that there are unintended consequences.

Examples of Faulty Utilitarian Analysis

Many economists and policy makers over the centuries have engaged in faulty utilitarian analysis because they failed to take into account the effect that a policy would have on all groups in both the long-run and short-run. Keynes is a prime example. He even boasted of the fact that he ignored the long-run in his statement, "In the long-run we are all dead," (Keynes 1924, 64-65), which many economists consider to be an affront to Bastiat (Skousen, 2001, 348).

The Keynesian multiplier theory is a classic case of the misapplication of utilitarian ethics. The Keynesian multiplier (Keynes, 1936) basically states that an injection of money into the economy will result in some multiple of increased economic activity. For example, if the multiplier is five and one billion dollars is injected into the economy, economic activity will increase by five billion dollars. Even Keynesian economists now point out that the theory does not work quite the way Keynes said it would because of "leakages." (Hansen 1953, 86-105). Some economists even give a detailed mathematical analysis to explain why the theory does not work the way it is theoretically supposed to work. However, it is not necessary to revert to complex mathematical analyses to explain why the Keynesian multiplier does not work the way Keynes said it would. All one need do is apply a little logic to the situation, which Bastiat did in the 1840s.

Bastiat might say, "What is seen is one billion dollars injected into the economy. What is not seen is where the billion dollars came from and where it might have gone if it had not been sucked out of one sector of the economy so that it could be injected into another part of the economy." In other words, in order for one billion dollars to be injected into one sector of the

economy, it must first be taken out of another sector of the economy. In order for one sector to expand by five billion dollars, other sectors must shrink by five billion dollars.

Bastiat discussed a similar situation in his essay, *What Is Seen and What Is Not Seen* (Bastiat, 1850, 1964a, 27-28). For every hundred-sou (a measure of French currency at the time) that is dropped into the economy, it will be like a stone that is thrown into a lake, causing an infinite number of concentric circles to radiate great distances in every direction (Bastiat, 1964a, 27). What is seen is the stone being thrown into the lake and the multitude of concentric circles that it causes. What is not seen is where the stone came from and the concentric circles that cannot now be made because the stone was thrown into the lake at Point B instead of Point A. "The stone is thrown in at one point in the lake only because it has been prohibited by law from being thrown in at another." (Bastiat, 1964a, 28).

In other words, total economic activity has not changed. It has merely been shifted. Rather than creating wealth, government intervention into the economy has merely caused wealth to be redistributed.

At this point one may stop and conclude that the result is what utilitarian economists would call a zero-sum game, since the gain of one sector of the economy has been exactly offset by the losses in other sectors of the economy. However, such a conclusion ignores opportunity cost and preference theory. If the law requires the stone to be thrown into the lake at point B instead of point A, it means that the former owners of those funds are precluded from using their funds to spend on the products and services that are at point A. The funds will necessarily be spent somewhere else that is lower on the economy's preference scale. Because of that, total utility has declined because the funds were not spent on the consumers' first choice.

Another example of the faulty use of utilitarian ethics – perhaps the most atrocious, actually – comes from the discipline of international relations. Scholar after scholar in this field make it a point of ignoring the effects a policy will have on all groups. They deliberately ignore some groups that can be easily identified and they make little or no attempt to consider the effect that a policy will have on groups that are not as easily identified.

Lopez (1999) and Gordon (1999a&b) are typical examples. These two scholars conducted a debate in the literature on the issue of whether economic sanctions are successful more often than not. However, their definition of success is more than a bit curious to an economist, because they define a successful sanction as one that persuades or forces the target of the sanction to change behavior in the direction advocated by those who impose the sanction. Hufbauer et al. (2007) have even gone so far as to attempt to measure the success of hundreds of sanctions on this basis.

International relations scholars do not look at sanctions from a positive-sum, negative-sum game perspective and they often totally ignore rights issues (Cortright and Lopez, 2000; Haass, 1998; Haass and O'Sullivan, 2000; O'Sullivan, 2003; Selden, 1999; Shambaugh, 1999), with some exceptions (Singleton and Griswold, 1999). It is quite common to ignore the fact that all sides lose from most sanctions, in the sense that both the sanctioning countries and the target countries lose trade opportunities. The secondary and tertiary effects of the sanctions and the effects the sanctions have on these groups are usually ignored as well.

Thus, Bastiat's approach to utilitarian ethics is superior to those of many economists and international relations theorists working today. Bastiat at least tried to identify all the groups and individuals who would be affected by a policy, in both the short-run and the long-run. His utilitarian ethics applied opportunity cost theory a generation before Carl Menger (1871) developed the theory.

CONCLUDING COMMENTS

Much of Bastiat's ethical insights had to do with rent seeking, the act of using government to do what could not otherwise be done without committing a crime. It is a form of legalized plunder, the forcible taking of property. Individuals who engage in the practice are acting unethically both from a utilitarian perspective and a rights perspective.

A DEMOGRAPHIC STUDY OF MALAYSIAN VIEWS ON THE ETHICS OF TAX EVASION

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ABSTRACT

A number of studies have examined the relationship between tax collection and various demographic variables. However, until recently most of those studies have involved a United States sample population. The Internal Revenue Service provides demographic data for researchers on a regular basis. The present study goes beyond those studies in several important ways. For one, it uses data on Malaysia taken from the World Values database. Not much work has been done on the Malaysian tax or public finance system. Thus, the present study expands on the very limited research done on Malaysian public finance.

The present study expands on existing literature in at least two other ways as well. For one, it examines how various demographics interact with attitudes toward tax evasion. Secondly, we examine several demographic variables that were not examined in prior studies.

One of the questions in the World Values database asked whether it would be justifiable to cheat on taxes if it were possible to do so. Respondents were asked to choose a number from 1 to 10 to indicate the extent of their support for tax evasion. This study examines those responses, both overall and through the prism of more than 20 demographic variables. A comparison is made with other ethical issues to determine the relative seriousness of tax evasion.

The study found that attitudes toward the justifiability of tax evasion often do vary by demographic variable. Tax evasion was found to be a less serious offense than homosexuality, prostitution, abortion, suicide, wife beating, accepting a bribe and euthanasia and more serious than divorce, avoiding a fare on public transport and claiming government benefits to which you are not entitled.

Although the present study focuses on Malaysia, the methodology used in the present study could serve as a template for research on other countries or regions.

INTRODUCTION

Most studies on taxation have taken a public finance perspective (Buchanan, 1967; Buchanan & Flowers, 1975; Hyman, 1999; Kaplow, 2008; Marlow, 1995; Musgrave, 1959, 1986; Musgrave & Musgrave, 1976; Rosen, 1999), sometimes with a Public Choice twist (Cullis & Jones, 1998). They discuss topics like cost and benefit, ability to pay versus benefits received, efficiency in tax collection, optimal taxation and even optimal tax evasion. David Ricardo (1817, 1996) was one of the first authors to devote a major section of a book to the topic. Musgrave and Peacock (1958) edited a book that reprinted some of the classic articles in the field.

Buchanan and Musgrave (2001) debated the role of public finance in a democratic state. Musgrave took the more statist position, that the state has the legitimate authority to enact any kind of tax system it chooses, and can extract whatever income it wants from the populace, in cases where the government is a functioning democracy. His rationale was that the people have chosen their representatives to make tax decisions for them, and thus they have consented to the tax system they have. Buchanan took the position that there are limits to state power even if the leaders come to power through the democratic process. He pointed out that the elected representatives might not always represent the will of the people because they sometimes have a different agenda.

Most studies on tax evasion have taken economic, psychological or sociological perspectives (Feld & Frey, 2010; Groenland & van Veldhoven, 1983; Kirchler, 2007). They focus on issues such as why people pay taxes, why they evade taxes and how tax evasion can be reduced (Alm, Martinez-Vazquez & Rider, 2006; Alm, Martinez-Vazquez & Torgler, 2010; Alm & Martinez-Vazquez, 2010; Bird, Martinez-Vazquez & Torgler, 2004; Frey & Torgler, 2007; Kirchler, 2007; Kirchler, Muehlbacher & Wahl, 2010; McGee, 2000; Torgler, 2003c; Torgler, Demir, Macintyre & Schaffner, 2008; Wallschutzky, 1984).

Some studies have examined demographic issues, such as gender, age, income levels, and so forth. Most of those studies have focused on the United States, since the Internal Revenue Service provides data to scholars on a regular basis (Internal Revenue Service, 1978, 1983; Bloomquist, 2003a&b; Ritsema, Thomas & Ferrier, 2003). In recent years a few studies have looked at demographics in other countries, including Armenia (McGee & Maranjyan, 2006, 2008), Austria (Torgler & Schneider, 2005), Costa Rica (Torgler, 2003d), Kazakhstan (McGee & Preobragenskaya, 2008; Russia (Alm, Martinez-Vazquez & Torgler, 2005, 2006), Spain (Martinez-Vazquez & Torgler, 2009), Sweden, (Vogel, 1974), Switzerland (Torgler, 2004a, 2007; Torgler & Schaltegger, 2006), transition countries (McGee & Gelman, 2008; Nasadyuk & McGee, 2006; Torgler, 2003b), Ukraine (Nasadyuk & McGee, 2006) and various Latin American countries (McGee & Gelman, 2009).

The present study focuses on attitudes toward tax evasion in Malaysia. Not many studies have been made of Malaysian public finance and even fewer of attitudes toward tax evasion in Malaysia. Yet Malaysia is a large and important Asian country. A former British colony, it gained independence in 1957. Geographically it is a little larger than the state of New Mexico. It has a population of more than 28 million, which places it 43rd in the world. Its people are young and predominantly Muslim, with large Buddhist, Christian and Hindu minorities. It has an above-average population growth rate (CIA, 2011).

THE PRESENT STUDY

The present study examines Malaysian attitudes on tax evasion. It examines more than 20 demographic variables. It is probably the most comprehensive study of tax evasion in Malaysia available in the English language. The sample size is about 1200, covering a wide demographic in terms of gender, age, occupation, marital status, religion, education, income level, etc.

METHODOLOGY

Groups of social scientists all over the world have been conducting coordinated surveys of the world's population since the 1980s. Some surveys have solicited the opinions of more than 200,000 people in more than 80 countries. The surveys included hundreds of questions on a wide range of subjects. One question in the most recent surveys addressed attitudes toward tax evasion:

Please tell me for each of the following statements whether you think it can always be justified, never be justified, or something in between: Cheating on taxes if you have a chance.

The range of responses used a 10-point Likert Scale where 1 = never justifiable and 10 = always justifiable. The surveys collected data on a number of demographic variables, including level of education, gender and age. The present study uses the data gathered in the most recent survey on Malaysia. The sample size was about 1200.

More that 20 demographic variables are examined using t-tests and ANOVAs to determine whether any differences are significant at the 5 percent level. The ANOVA was used to analyze mean score differences between groups as a whole. The ANOVA scores are reported in the "b" tables. T-tests were sometimes made to compare the mean scores of two particular groups. Those scores, where made, are reported in the "a" tables.

CONCLUDING COMMENTS

This study found several interesting relationships between attitude toward tax evasion and more than 20 demographic variables. It is perhaps the most comprehensive demographic study of Malaysian attitudes toward tax evasion done to date. The methodology used in this study can also serve as a template for studies of other countries and regions. Some of the demographic variables included in this study have not been used in prior studies, which break new ground and may serve as the basis for further research into these variables.

ARE PHARMACEUTICAL SALES REPRESENTATIVES OUTSIDE SALESMEN UNDER THE FAIR LABOR STANDARDS ACT OF 1938?

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ABSTRACT

Last fall a panel of the United States Court of Appeals for the Second Circuit ruled that pharmaceutical sales representatives (PSR) were not outside salesmen. This ruling held the PSRs were entitled to time and a half overtime pay for weekly hours worked in excess of forty hours. Traditionally, PSRs were not paid for overtime work because under the Fair Labor Standards Act of 1938 they were considered to be outside salesmen. This year, in a similar case before the United States Court of Appeals for the Ninth Circuit, a panel held that PSRs were outside salesmen and thus not entitled to overtime pay.

INTRODUCTION

That two separate panels of circuit court judges could reach the opposite conclusion on the same set of facts and questions of law should come as no surprise. But the surprise came recently when the United States Supreme Court denied a writ of certiorari to the Second Circuit case which occurred after the Ninth Circuit had issued its opinion (The American Lawyer, 2011). Perhaps the reason for the denial was that both cases arose from summary judgment decisions and the court wants the Second Circuit case to be tried.

IN RE NOVARTIS WAGE AND HOUR LITIGATION

This case was filed as a class action suit by 2,500 former and current pharmaceutical sales representatives (PSRs) claiming they were owed overtime pay by Novartis Pharmaceuticals Corporation (Novartis). The district court granted Novartis's motion for summary judgment denying their claims under the Fair Labor Standards Act (FLSA) on the grounds that they were outside salesmen and thus exempt from overtime pay. The PSRs appealed on the basis that the trial judge did not apply the exemption standards correctly as set out in regulations issued by the United States Department of Labor (DOL) and in its amicus curiae supporting the plaintiffs' position.

Under the United States Food and Drug Administration (FDA) regulations, drug manufacturers may not sell prescription drugs directly to patients or to their treating physicians. Novartis sells its prescription drugs to wholesalers which sell to pharmacies. Physicians write prescriptions for patients who can then purchase the drugs from pharmacies. The PSRs contented that because they cannot make sales contracts with physicians but only seek a non-binding

commitment by the physicians to write prescriptions for the drugs they are told by Novartis to present, they are not salesmen (Novartis, 5-6). The information the PSRs present to physicians is carefully developed by brand managers. The PSRs are also given written materials such as brochures, posters, laminated cards developed by marketing managers as well as samples of drugs for the physicians (Novartis, 8). The PSRs are not allowed to deviate from the core message prepared by the brand manager (Novartis. 9).

Although Novartis does not know how many prescriptions each physician writes for its product, it subscribes to services that give it information on when Novartis drugs are filled by pharmacies and also identifies the prescribing physician. Based on these figures PSRs receive up to a quarter of their pay as bonuses. Novartis sets sales projections for PSRs' assigned territory. When those projections are met or exceeded, Novartis pays PSRs a bonus (Novartis, 11-12). The entire drug industry treats its PSRs as exempt from overtime pay under the FLSA.

The Department of Labor amicus curiae in support of the PSRs noted that regulations issued under the FLSA on exemptions from overtime pay did not apply to PSRs because they could not make sales or receive orders, and could not exercise managerial discretion in formulating what they would say to the physicians they called on. The appellate panel concluded that because the DOL's interpretation of its regulation issued under the FLSA was entitled to deference, it would accept its stand that PSRs were neither outside salesmen nor managers (Novartis, 20).

CHRISTOPHER, BUCHANAN, ET AL. V. SMITHKLINE BEECHAM CORPORATION, DBA GLAXOSMITHKLINE

In this case, the district court in Arizona granted Glaxo's motion for summary judgment holding that PSRs were outside salesmen and thus not entitled to overtime pay under the FLSA from their defendant employer . On appeal, the Ninth Circuit panel affirmed the trial court. Like Novartis, Glaxo sells its prescription drugs to distributors or retail pharmacies. Glaxo's PSRs work in the same manner as those at Novartis. They call on physicians, present them with information and samples, and try to get them to commit to writing prescriptions for Glaxo products. The commitment is non-binding on the physician. PSRs are assigned a territory. Before calling on a doctor, Glaxo provides their PSRs with information about the doctor's prescribing habits and drug preferences, market volume of Glaxo products prescribed by the doctor versus volume of competing products (Glaxo, 5). The company also gives its PSRs core messages about its products, including benefits and risks, dosages, and types of patients for whom the products are suitable (Glaxo, 6-7).

PSRs receive two types of compensation, a salary and incentive pay. The incentive pay is based on Glaxo's increased market share of a drug in the PSRs' designated territory, or sales volume increases, sales revenue increases, or dose volume increases. The company aims to have a PSRs total compensation be 75% salary and 25% incentive pay (Glaxo, 8). There is an industry-wide code of conduct to regulate PSRs and their contact with physicians. The code also regulates how much a PSR can spend on meals and gifts to doctors (Glaxo, 12).

The appeals panel approved of the district court's treatment of the DOL's amicus curiae brief as not being entitled to deference because it was inconsistent with the language of FLSA and its prior interpretations of its regulations going back seventy years (Glaxo, 14).

The panel thought it was a no brainer that PSRs were engaged in sales because part of their compensation was based on incentive pay tied to the doctors in their assigned territory increasing the number of prescriptions for Glaxo products which they gave to patients who then had them filled at pharmacies (Glaxo, 35, 42).

CONCLUSION

In refusing to grant the writ of certiorari in the Novartis case, the Supreme Court has required the class action suit to proceed to trial. Since it is the Novartis case that seems out of line with the other circuits, why did the Supreme Court refuse the writ? Why would the court want such an anomaly having an impact within the Second Circuit?

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