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# JOURNAL OF LEGAL, ETHICAL AND REGULATORY ISSUES

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## EDITORIAL REVIEW BOARD

## TABLE OF CONTENTS

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# ACHIEVING THE GOAL OF "CREDIBLE" REGULATORY OVERSIGHT

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## ABSTRACT

*Much of the current financial crisis is attributed to the failure of "credible" regulatory oversight. This article addresses the difficult and unresolved question of how to achieve credible regulatory oversight that provides meaningful control of the nations' financial infrastructure and at the same time preserves self-regulation, innovation and growth in the marketplace. The oversight question is generally framed in terms of identifying a corporate or market disaster and then reflecting upon what is needed to make oversight work, without any real understanding of the boundaries of regulatory authority and the systemic problems impacting the probable success of regulatory oversight. While a valuable exercise in scholarship, its shortcoming is that it is like trying to fix a watch without first understanding all of the moving parts. The article undertakes a comprehensive examination of the current regulatory status quo, including the recent changes made by the Wall Street Reform and Consumer Act legislation. Newly compiled regulatory agency data is compared and analyzed to provide a clear understanding of "how" things work before trying to figure out "why" the regulatory oversight mechanism periodically breaks down. In navigating a possible solution to achieving the goal of credible regulatory oversight, the analysis also takes into account certain powerful externalities including legal, private sector, political, and market forces that frequently overtake oversight authority and directly impact the probability that regulators will succeed in competently performing their function in conformity with legislative models.*

*Key words: credible oversight; self-regulation; regulatory supervision; Wall Street Reform and Consumer Act*

> "We regulators are often perceived as constraining excessive risk-taking more effectively than is demonstrably possible in practice. Except where market discipline is undermined by moral hazard, owing, for example, to federal guarantees of private debt, private regulation generally is far better at constraining excessive risk-taking than is government regulation. The very modest credit losses that have appeared in derivatives portfolios at U.S. banks are a testament to the effectiveness of market discipline in this area" (Greenspan, 2003).

## INTRODUCTION

### Understanding the Problem

Much of the continuing financial crisis is attributed to the failure of "credible" regulatory oversight. Indeed, the Securities and Exchange Commission publicly repents almost daily in the media for its failure to have averted whatever industry or corporate debacle unfolds as current front page news. Congress continues its quest, now closing in on a decade, to identify the reasons that the oversight infrastructure in both the public and private sectors collapsed at the most critical moments. Most recently, Congress responded to the problem with the expansion of federal financial regulation by passing the Wall Street Reform and Consumer Protection Act (Reform Act), signed into law on July 21, 2010. Its predecessor, the Sarbanes-Oxley Act (SOX), was signed into law in 2002. Both pieces of major legislation mark a decade of legislative frustration over the inability to achieve financial stability in the marketplace.

This article focuses on the difficult and unresolved question of how to achieve credible regulatory oversight that provides meaningful control of the nations' financial infrastructure and at the same time preserves innovation and growth in the marketplace.

The current public debate on this issue has failed to culminate in a general consensus. Many argue that more regulation is needed to resolve the oversight crisis; as if there aren't enough rules already and that promulgating more rules will somehow solve the problem. The most notable recent convert is the Federal Reserve Bank (FRB). Its previously hardnosed self-regulatory philosophy, characteristic of the Greenspan era, has given way to a new strict adherence to the power of a super regulator, the Financial Services Oversight Council (FSOC), the new systemic risk overseer of Wall Street and the banking industry. Yet, others point to the lack of adequate agency resources from the federal government; as if throwing more money at the regulators to encourage them to read the massive annual corporate regulatory filings will lead to prevention. Still, others blame the private sector "watchdogs," including bankers, appraisers, lawyers, accountants, money managers, stock analysts, and others, for their failure to avert conflict of interest and simply do the right thing. Arguably, SOX has failed to legislatively resolve Congress' "barking watchdog" problem. Finally, the private sector digs in its heels demanding the true resurgence of managerial capitalism based upon a self-regulatory model supportive of innovation and growth untainted by risk-averse regulation. Once, the most powerful logic in the marketplace, the private sector argument has increasingly lost its patina in regulatory circles and with the investing public. Indeed, the recent report issued by the Financial Crisis Inquiry Commission ascribes some measure of blame for the current financial crisis to the self-regulatory model (FCIC Report, 2011).

The debate nonetheless well describes the contours of the problem. Yet, it seems that no matter how often the problems are reviewed, digested, and regurgitated in the literature, the solution to achieving credible oversight in the context of the regulatory debate remains unsettled.

"Credible" is the operative word here. In order to tackle this difficult policy question, the article examines only the public sector component of the hybrid public/private sector regulatory oversight model; namely, the host of federal regulatory agencies anointed with the task of financial industry oversight. The framework of the current regulatory oversight model is described more fully in section II below.

**Tackling the Tough Unanswered Questions**

Why is the examination of the regulatory infrastructure so critical to resolving the oversight question? First, the current literature does not include an actual survey of the scope of regulatory oversight authority or an explanation of the federal regulatory infrastructure other than in a summary fashion. The oversight question is generally framed in terms of identifying a corporate or market disaster and then reflecting upon what is needed to make oversight work, without any real understanding of the boundaries of regulatory authority and the systemic problems impacting the probable success of oversight. While a valuable exercise in scholarship, its shortcoming is that it is like trying to fix a watch without first understanding all of the moving parts. Second, this article adds to the scholarship by examining the debate between the need for expanded regulation on one hand and the desire for a self-regulatory model on the other through a comprehensive examination of the current regulatory status quo, including the recent Reform Act legislation. It provides a clear understanding of "how" things work before trying to figure out "why" the mechanism periodically breaks down. Third, this causal analysis also takes into account certain powerful outside forces that frequently overtake oversight authority and directly impact the ability of regulators to function in conformity with legislative models. Certainly, failure can be attributable to inadequate supervision but it may also be attributable to a different cause; namely, outside interference with oversight. Andrew Ross Sorkin eloquently illustrates that entity size alone may insulate market participants from effective supervision in his recent book, "Too Big To Fail" (Sorkin, 2009).

Specifically, the review of the federal financial regulatory infrastructure begins by answering some basic questions: What is regulatory oversight? How does regulation work? What is the actual legal jurisdiction of the regulatory agencies in the financial sector? What is the standard for determining whether the oversight exercised by a particular federal agency is "credible"? Who decides that question in the government, if anyone? Given the current absence of enabling regulations, does the new Reform Act signal real change in financial oversight?

Concededly, answering the ultimate question of whether the goal of credible oversight can be achieved in the marketplace requires a big picture analysis of both components of the oversight model, the public and private sectors. However, to date, much of the scholarly literature has addressed the private sector "barking watchdog" problem with little attention being paid to the actual mechanics of the public regulatory side of the paradigm. This paper adds to the scholarship by considering the relatively unexamined public sector part of the hybrid model through data collection and analysis. The intent is to open a more well-informed avenue for future debate on the ultimate question of how best to achieve credible regulatory oversight.

## Research Methodology

The research methodology includes the selection of seven federal agencies responsible for supervising some material aspect of financial transactions in the securities and banking sectors in the marketplace, including the: Securities and Exchange Commission (SEC); Public Corporation Accounting Oversight Board (PCAOB); the Commodities Futures Trading Commission (CFTC); Federal Reserve Board (FRB); Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC); and the Office of Thrift Supervision (OTS), which has now been merged into the OCC by passage of the Reform Act. The article also addresses several important changes made by the Reform Act, including the creation of the FSOC to monitor the existing regulatory agencies, with the important caveat that the real parameters of the Reform Act will remain relatively unknown until the regulatory agencies, authorized by Congress to pass enabling regulations, have the opportunity to deliberate and draft regulations. That process is expected to take several years (latimes, 2010). Indeed, the Act sets some deadlines more than a decade from now.

The compiled data is organized in the appendices by the process of mapping information into spreadsheets, referred to here as "regulatory maps," which provide a framework for comparison and evaluation. The process is similar to the OED (Office of Evaluation Department of the World Bank) methodology used by Huther and Shah in evaluating whether government programs have the potential to achieve their objectives, consistent with a country's current priorities and corporate goals, given a country's existing institutional and policy environment (Huther and Shah, 2000). The regulatory maps are organized to: identify the statute(s) that create the federal agency and its powers; identify the current enabling regulations which authorize the actual oversight rules; review and catalogue current case law that interprets the expanse of the regulatory agency authority; provide agency policy pronouncements which offer insight into the regulatory philosophy of the agency; and, catalogue recent Office of the Inspector General (OIG) audit reports of specific agency operations. The article then compares the agency regulatory model with the audit results to determine if a particular agency has operated in compliance with its congressional mandate. Finally, several conclusions about oversight are provided based upon the relative success or failure of a particular agency's oversight activities.

Achieving the goal of credible oversight is complicated and cannot be cured simply by piling on more rules and regulations. Even achieving a baseline of credible supervision may not necessarily result in credible oversight. As the article explains, inadequate regulatory oversight embraces a multitude of external causes including lack of resources, agency lack of focus, pressure from outside political forces, legal and policy limitations on agency authority, regulatory gaps created by policy decision, and concealment of dishonest business practices in the private sector. These externalities directly impact oversight effectiveness.

Why is "Credible Oversight" Important? Credible oversight is a central component in achieving the goal of good corporate governance. Behavioral finance literature, applying "rational choice theory," explains that lure becomes criminal opportunity where the corporate criminal perceives the absence of "credible oversight" (Shover and Hochstetler, 2006). Credible oversight increases the risk for the criminally predisposed and, concomitantly, decreases the risk of unlawful conduct (Grabosky and Shover, 2010). Congress, in the recent Enron hearings, credited the absence of credible oversight as one of the principle causes of the corporate debacle. It concluded that both the regulators and the traditional "corporate watchdogs" in the private sector "failed to bark" (Enron Report, 2002). The FCIC Report echoes the same sentiment, noting that the regulators were simply not "at their posts" (FCIC Report, 2011).

Credible oversight is also important in its breach. Particularly where markets lack transparency or are otherwise unregulated, as with derivatives and hedge funds, such unregulated, unsupervised financial markets can all too easily suffer catastrophic failure. If a market center gains a reputation as having lax oversight and surveillance, that market will suffer the consequences. Those consequences include "the harsh reality that where there is no market, there is no value" (Bodine and Nagel, 2008). The recent collapse of capital markets resulting from inadequate or absent credible oversight underscores the real importance of the discussion.

Despite all of the rhetoric about the importance of credible oversight, there is almost nothing in the literature to explain exactly what *it* is. The failure to define credible oversight leaves a substantial gap in understanding how oversight should operate in the corporate environment and whether conclusions based upon failed expectations about the quality of oversight are reasonable.

## DEFINING "CREDIBLE" REGULATORY OVERSIGHT

Credible regulatory oversight is at least a function of whether the agency is doing the job that it is authorized by law to do. In 1993, Congress passed the Government Performance and Results Act (GPRA) to "improve the confidence of the American people in the capability of the Federal Government, by systematically holding Federal agencies accountable for achieving program results." The Government Accounting Office (GAO) is responsible for the implementation of the GPRA. The GAO typically examines the overall effectiveness of the entire federal apparatus and/or its various parts (GPRA, 1993).

Additionally, the Inspector General Act of 1978 was enacted to conduct and supervise audits and investigations relating to programs and operations of the Department of Agriculture, the Department of Commerce, the Department of Housing and Urban Development, the Department of the Interior, the Department of Labor, the Department of Transportation, the Community Services Administration, the Environmental Protection Agency, the General

Services Administration, the National Aeronautics and Space Administration, the Small Business Administration, and the Veterans' Administration (IGA, 1978). Thus, several federal agencies covered by the GPRA also have an Inspector General (IG) assigned to audit and review the activities of that particular agency regulator, as in the cases of the SEC and the CFTC.

Functionally, the IG focuses on the operations of a specific agency whereas the GAO examines the overall effectiveness of the regulatory apparatus, or some part thereof, in connection with a particular systemic issue or problem. To facilitate the audit process, under the GPRA, the head of each federal agency is required by law to prepare and submit to the President and the Congress, a report on program performance for the previous fiscal year. Each program performance report must identify performance indicators established in the agency performance plan along with the actual program performance achieved compared with the performance goals expressed in the plan for that fiscal year.

Ideally, when the audit results reveal that the agency has satisfied its congressional mandate, it acts credibly. When the agency does not, it fails. The problem is that averting crisis through adequate supervision is often difficult to document. When something doesn't go wrong it is hard to prove that the system is working because the regulators are doing their respective jobs. Thus, credible oversight does not mean that oversight is credible only when it demonstrably prevents disaster.

At a minimum, however, credible oversight requires that the agency is doing the job it is responsible to do under the law on a relatively continuous basis over time. The agency must exhibit clear focus on the task before it. Of course, that does not always happen as illustrated by the SEC's failure to follow its legislatively imposed mandate to regularly review filings submitted by corporations like Enron during the three year review period immediately preceding its demise (Enron Report, 2002).

## EXTERNALITIES IMPACTING CREDIBLE REGULATORY OVERSIGHT

Oversight may also be credible in the sense that it satisfies its congressional mandate but may still be unable to prevent corporate misconduct where the circumstances are beyond the regulator's sphere of control. In short, credible supervision may not necessarily result in credible oversight where outside forces prevent or interfere with the regulatory oversight function.

First, even assuming that the regulatory agency is functioning according to its legal mandate, the congressionally authorized degree of supervision may be inadequate to detect and prevent corporate and financial misconduct. Thus, the agency may be doing precisely what it is authorized to do but lacks congressional authority to prevent the problem. Case in point: the CFTC, though it's former chair Brooksley Born, requested and was refused the congressional authority to regulate derivatives (CFTC Report, 1998; Frontline, 2009).

Even more problematic are those policy decisions made outside of the control of a particular regulatory agency that may impact the agency's ability to control the consequences in the marketplace. Indeed, John Taylor of Stanford University makes a compelling argument that government intervention and conscious economic policy decisions designed to protect consumers actually created, worsened, and prolonged the current financial crisis (Taylor, 2009). Also, not to be forgotten is the wave of deregulation during the Reagan era, referred to as “the cure that killed” and crippled regulatory oversight (Calavita and Pontell, 1990).

Next, market innovations may simply outpace regulatory control. Henry Hu demonstrated, in his landmark article in 1993, that the very design of a financial product can impede regulatory oversight and control (Hu, 1993, 2009). Hu’s point is aptly illustrated by Thomas Donaldon’s example of unregulated hedge funds, which he argues are, by design, made up of “intractable conflicts that cannot be resolved through government regulation” (Donaldson, 2008).

Additionally, concealed fraudulent behavior may impede oversight. For example, the fraudulent use of earnings management is typically invisible to the naked regulatory eye even upon audit of the books and records (Weismann, 2009). The resulting collapse of trust, described by Greenspan as the cornerstone of the marketplace, some argue cannot be repaired by regulation at all (Greenspan, 2003). Indeed, some financial behaviors are just “bad to the bone” and cannot be fixed until some form of internal corporate governance addresses the inherent conflicts of interest inbred in corporate culture (Donaldson, 2008). Thus, the problem may not be one of failed credible regulatory oversight but instead, one caused by other outside forces, externalities, that can overtake the oversight function and control the outcome.

Inevitably, the responsibility for oversight failure must be shared with the private sector which has strenuously insisted on preserving a self-regulatory model. As part of that self-regulatory model, the private sector has certain delineated oversight duties to the public, such as those performed by self-regulatory organizations (SROs). At its most basic level, self-regulation is the manner in which all firms self-police their own activities to ensure that they are meeting all fiduciary and other duties to their clients. In fact, the old "Shingle Theory" was founded on the principle that, if you hold yourself out to the public as offering to do business, you are implicitly representing that you will do so in a fair and honest manner (Richards, 2000). In many instances, the private sector has failed to live up to its part of the bargain as envisioned by Congress. Thus, the current oversight model is clearly a shared function in the marketplace where the federal regulatory infrastructure does not and is not intended to unilaterally control all aspects of oversight. Indeed, as history has shown, the private sector must frequently be held accountable by regulation infused with financial disincentives to avoid the failure to credibly self-regulate (Acharya, Pedersen, Phillippon and Richardson, 2008).

Finally, the passage of the new Reform Act signals some attempt by Congress to deal with a bigger problem; namely, the desperately needed overhaul of an outdated regulatory infrastructure that is ill-suited to the task of financial regulatory oversight (GAO Report, 2009). Achieving credible regulatory oversight is less likely where the adeptness of federal agencies anointed with supervisory responsibility critically lags behind innovative financial products and activities in the marketplace.

## UNDERSTANDING THE REGULATORY INFRASTRUCTURE

### The Current Regulatory Oversight Model

The current regulatory oversight model in the securities and futures financial marketplace can best be described as a hybrid of government and private sector governance. Federal agencies, authorized to regulate within legal boundaries set by Congress, are bound in a governance partnership with private sector organizations including SROs (self-regulatory organizations), which ostensibly operate in lockstep with government regulation. Congress crafted this hybrid model of financial oversight with the passage of the 1934 Securities and Exchange Act. The original SEA regulatory model was aptly described by former SEC Chair Arthur Leavitt: "Our securities markets operate under a 'self-regulatory' system. Markets serve an important public interest, and deserve public oversight; but markets are also innovative and fast moving, and easily stifled by the heavy hand of government. So Congress arrived at a formula in which the industry polices itself, with SEC oversight. This keeps us out of most day-to-day affairs, and allows us to keep our hands off, but our eyes open. And on those rare occasions when self-regulation goes off track, the SEC must act in the public interest"(Richards, 2000).

FRB Chairman Bernanke recently observed, regarding the relative benefits of this model, that "both regulation and market discipline have important roles to play in constraining risk-taking in financial markets; the best outcomes are achieved when these two forms of oversight work effectively together" (Squam Lake Conference, 2010).

But some see the model as a century old tug of war between increased regulatory supervision and the need for unimpeded growth in the capital markets. It is viewed operationally as a paradigm of cyclical business failures followed by a burst of regulatory activity which then dissipates as the markets settle back into what is perceived as stable monetary growth. Yet, both sides of the debate are constrained to agree that the current regulatory infrastructure remains critically outdated and unable to keep pace with private sector innovations in modern finance. Whether the Reform Act repairs the model sufficiently to overcome this imbalance is questionable and in large measure will remain an unknown until the implementing regulations have been formulated.

Another characteristic of the oversight model is the concept of functionality. The regulatory system for financial services which embraces both the banking sector and the securities and futures sector assigns supervisory authority based upon "functional" operations. Thus, financial products or activities are regulated and supervised according to their function, no matter who offers the product or participates in the activity. This also means that more than one federal agency may be responsible for supervision at the same time. Broker-dealer activities, for instance, are generally subject to SEC's jurisdiction, whether the broker-dealer is a subsidiary of a bank holding company subject to Federal Reserve supervision or a subsidiary of an investment bank. According to the GAO, "the functional regulator approach is intended to provide consistency in regulation, focus regulatory restrictions on the relevant functions area, and avoid the potential need for regulatory agencies to develop expertise in all aspects of financial regulation" (GAO Report 08-32, 2007).

The relative benefits of the functionality model are described as two-fold: First, specialization by regulators allows them to better understand the risks associated with particular activities or products. Second, competition among regulators helps to account for regulatory innovation, providing businesses with a method to move to regulators whose approaches better match businesses' operations (Id). However, the Federal Reserve has been constrained to admit that the model is ineffective in its "execution," although not in its design. It has resulted in an "institution-by-institution supervisory approach" which fails to identify overall systemic instability (Annual Meeting of the American Economic Association, 2010). The solution to this problem is somewhat addressed by the Reform Act through the implementation of the FSOC and its new role in bringing together the functional regulators to supervise big picture systemic risk posed by Wall Street and the banking industry. The functionality characteristic of the oversight model, however, remains in place.

## OVERVIEW: WHO DOES WHAT TO WHOM?

The two primary and intrinsically interrelated financial sectors include the banking industry and the securities and futures markets. With some new additions and modifications created by the Reform Act, the federal regulatory structure is as follows. In the banking sector, multiple federal and state agencies may regulate the same entity based upon the functionality model described above. However, the primary supervisor of a domestic banking institution is determined by the type of institution and the regulator responsible to license its operations. In the banking industry, that regulatory configuration depends on the type of charter under which the banking institution operates. Types of bank charters include: commercial banks; thrifts, which include savings banks, savings associations, and savings and loans, originally created to serve the needs, particularly the mortgage needs, of those not serviced by commercial banks; credit unions, which are member-owned cooperatives run by member-elected boards; and industrial loan companies (ILCs), also known as industrial banks, which are state-chartered financial institutions that have grown from small, limited-purpose institutions to a diverse industry that includes some of the nation's largest and more complex financial institutions (GAO Report 08-32, 2007).

These charters may be obtained at the state or national level for all except ILCs, which are only chartered at the state level. State regulators charter institutions and participate in the oversight of those institutions; however, all of these institutions have a primary federal regulator if they offer federal deposit insurance. The supervisory function of each federal regulator is briefly summarized as follows. The Office of the Comptroller of the Currency (OCC) charters and supervises national banks. The Federal Reserve (FRB) serves as the regulator for state-chartered banks that opt to be members of the Federal Reserve System. The Federal Deposit Insurance Corporation (FDIC) supervises all other state-chartered commercial banks with federally insured deposits, as well as federally insured state savings banks. In addition, the FDIC has certain backup supervisory authority for federally insured banks and savings institutions. The Office of Thrift Supervision (OTS), now merged with the OCC under the Reform Act, previously chartered and supervised federally chartered savings institutions. The National Credit Union Administration (NCUA) charters and supervises federally chartered credit unions. Additional unique responsibilities and regulatory authority of each of these agencies is described in more detail in the following sections devoted to each agency.

Additionally, these federal regulators establish capital requirements for the depository institutions, supervise, conduct onsite examinations and offsite monitoring to assess an institution's financial condition, and monitor and enforce compliance with banking and consumer laws. The regulators issue regulations, take enforcement actions, and close institutions determined to be insolvent.

The other primary financial sector, the securities and futures sector, is regulated under a combination of SRO's, subject to oversight of the appropriate federal regulator, and direct oversight by the Securities and Exchange Commission and/or the Commodity Futures Trading Commission. SROs, such as the New York Stock Exchange and the AMEX, have responsibility for oversight of the securities markets and their participants by establishing the standards for their members; monitoring business conduct; and bringing disciplinary actions against their members for violating applicable federal statutes, SEC's rules, and SRO rules. The SEC supervises SROs by inspecting their operations, reviewing rule proposals and appeals of final disciplinary proceedings. In the futures industry, SROs include the futures exchanges and the National Futures Association. Futures SROs are responsible for establishing and enforcing rules governing member conduct and trading; providing for the prevention of market manipulation, including monitoring trading activity; ensuring that futures industry professionals meet qualifications; and examining members for financial strength and other regulatory purposes. The CFTC independently monitors, among other things, exchange trading activity, large trader positions, and certain market participants' financial conditions (GAO Report 08-32, 2007).

## UNDERSTANDING THE REGULATORS

### The Source and Limits of Regulatory Oversight Authority

Regulatory agencies have limited powers. The Supreme Court has made clear that regulatory authority to act must always be based on a specific grant of congressional power.[1] Regardless of how serious the problem an administrative agency seeks to address, it may not exercise its authority "in a manner that is inconsistent with the administrative structure that Congress enacted into law."

There are also legal limitations on the acceptable breadth of agency interpretations of statutes in the course of drafting implementing regulations. The power of an administrative agency to administer a congressionally created program necessarily requires the formulation of policy and rule-making to fill any gap left, implicitly or explicitly, by Congress.[2] If Congress has explicitly left a gap for the agency to fill, there is an express delegation of authority to the agency to implement a specific provision of the statute by regulation. The courts will accord such legislative regulations "controlling weight" unless they are "arbitrary, capricious, or manifestly contrary to the statute."[3] In short, regulators do not have carte blanche to regulate to prevent harm even if the result is desirable to protect the health, safety, and welfare of the public. Nor can an agency create corporate governance standards for business or pass regulations that result in a substantial economic impact in the marketplace unless Congress accords the rule and policy making authority to that agency through legislative grant. The agency also has no independent power to detect and prevent wrongdoing. Here, credible oversight is restricted to Congressional will and not agency whim.

For example, in 1984, General Motors proposed to issue shares of second class common stock with only one-half vote per share. The issuance was in direct violation of the NYSE rule requiring at least one vote per share on the issuance of common stock. However, the NYSE was unwilling to enforce its own internal rule and sought relaxation of the voting disenfranchisement policy from the SEC. The SEC refused, citing the importance of shareholder voting rights in the management of the corporation. To that end, the SEC passed a new regulation mandating voting powers among various classes of shareholders to prevent results that "decrease the welfare of the voting community." The private sector sued, claiming that the SEC had exceeded its regulatory authority to ensure conformity with Rule 19c-4, which required SROs to fairly administer their rules and act in conformity with the requirements of the 1934 Securities and Exchange Act (SEA).

The court agreed.[4] The ruling made clear that the SEA "does not provide the Commission carte blanche to adopt federal corporate governance standards through the back door by mandating uniform listing standards." In short, as the case demonstrates, the SEC has no independent enabling power to establish a comprehensive federal corporations act, it may only demand full and fair corporate disclosure in conformity with the legislative history and philosophy behind the passage of the SEA. Regulation of corporate policy with regard to the number of directors, voting shares, and other matters concerning corporate governance are matters to be regulated by state law. If Congress wishes to expand an agency's authority, it may do so but the agency may not act on its own accord.

Nor may the agency regulate where its actions result in unintended economic consequences that impact an entire industry. Simply put, an agency cannot create economic policy. Again, it may only act to enable the express will of Congress as set forth in the statute. For example, the Food and Drug Administration (FDA) sought to regulate the distribution of tobacco to minors under its legislative grant to regulate "drugs and devices." The FDA promulgated regulations governing tobacco products' promotion, labeling, and accessibility to children and adolescents based upon studies showing that tobacco use was the leading cause of premature death, resulting in more than 400,000 deaths annually, and that the majority of adult smokers began smoking when they were minors. The regulations, therefore, attempted to reduce tobacco use by minors so as to substantially reduce the prevalence of addiction in future generations, and thus, the incidence of tobacco-related death and disease. The tobacco companies sued, claiming that the FDA had exceeded its regulatory authority. The Supreme Court agreed. Despite the FDA's well intentioned regulation aimed at a serious health and safety issue, Congress had enacted several tobacco-specific statutes fully cognizant of the FDA's position and had likewise considered and rejected many bills that would have given the agency this authority. The Court concluded that Congress had not given the FDA the authority to regulate tobacco products as customarily marketed. Also key to the decision was the pragmatic "common sense" analysis adopted by the Court to consider whether Congress "is likely to delegate a policy decision of such economic and political magnitude to an administrative agency." Here, the FDA had asserted "jurisdiction to regulate an industry constituting a significant portion of the American economy." In doing so, the agency exceeded its oversight authority.

Thus, the first step in this analysis examines the enabling legislation to determine the scope of each agency's powers in their respective oversight roles. The analysis also reviews the seminal court cases that restrict the boundaries of agency authority under the congressional mandate. Returning to the definition of credible oversight, this data illustrates that the operation of the regulatory infrastructure is at least a function of whether the regulatory agency is doing the job that it is authorized by law to do. The agency may be doing precisely what it is authorized to do by law but may still lack the real authority to prevent a particular problem. Concomitantly, policy decisions made outside of the control of a particular regulatory agency may impact the agency's ability to control the consequences in the marketplace. Both situations may interfere with agency supervision and the attainment of credible oversight.

## THE FINANCIAL SERVICES OVERSIGHT COUNCIL

Notably, the Reform Act does not change this model of investing and limiting agency regulatory authority despite the creation of the new systemic risk overseer, the FSOC (Reform Act, 2010, Title I, Subtitle A, Section 1001). The FSOC is made up of ten voting members including, nine federal financial regulatory agencies and an independent member with insurance expertise and five nonvoting members. The voting federal regulatory agencies include: the Secretary of the Treasury, who serves as the Chairperson of the FSOC, the Chairman of the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Director of the newly created Consumer Financial Protection Bureau, the Chairman of the Securities and Exchange Commission, the Chairperson of the Federal Deposit Insurance Corporation, the Chairperson of the Commodity Futures Trading Commission, the Director of the Federal Housing Finance Agency (FHFA), the Chairman of the National Credit Union Administration Board (NCUA), and an independent member with insurance expertise that is appointed by the President and confirmed by the Senate for a six-year term. The FHFA was added by the Reform Act to replace the now dissolved OTS. Nonvoting regulatory members are selected from various state agencies and serve only in an advisory capacity. The state nonvoting members have two-year terms.

In enacting the Reform Act, Congress recognized that the then existing regulatory structure focused regulators narrowly on individual institutions and markets, which allowed supervisory gaps to grow and regulatory inconsistencies to emerge—in turn, allowing arbitrage and weakened standards. No single entity had responsibility for monitoring and addressing risks to financial stability posed by different types of financial firms operating in and across multiple markets. As a result, important parts of the system were left unregulated. The analysis of the federal regulatory agencies selected in this article will aptly illustrate this point.

As Chairman Ben Bernanke explained, the purpose of the FSOC is to provide a forum for agencies with differing responsibilities and perspectives to share information and approaches, and facilitate identification and mitigation of emerging threats to financial stability. It is intended "that the lines of accountability for systemic oversight be clearly drawn, [but that] the council should not be directly involved in rule-writing and supervision. Rather, those functions should remain with the relevant supervisors, with the council in a coordinating role" (Squam Lake Conference, 2010). See, Reform Act, 2010, Title I, Subtitle B, Section 1107. In short, the current supervisory system will remain relatively intact.

Thus, the FSOC can be characterized as more of a "looker" rather than a "doer" with a significant exception where the marketplace is "imperiled," a situation still to be defined by implementing regulations. However, Congress has now authorized the FSOC and the FRB to "break up" firms that have failed to respond to earlier measures and pose an immediate threat to the market. This power must be coordinated with Article II of the Reform Act which is intended to replace bailouts or bankruptcies with an alternative "orderly liquidation process" to dismantle companies on the verge of collapse. The FSOC's power is subject to judicial review under Section 1103, so it will not be the sole determinative authority. Again, the devil is in the details which remain relatively unknown until the implementing regulations are in place. Until then, the authority of the new super regulator will be the subject of speculation and most assuredly the topic of political debate.

As an additional measure to address the failings of intra-agency co-operation and systemic risk assessment, the Reform Act not only creates the FSOC but also authorizes the federal financial regulatory agencies to engage in increased oversight in response to FSOC recommendations (Title I, Subtitle B, Section 1102). However, that power is not unlimited. A company may still have both the right to seek judicial review where more strenuous standards are imposed and the right to seek abolition of the strenuous standards once the crisis is resolved (Section 1103). While the Reform Act ostensibly provides regulators with more, and as of yet undefined oversight authority, their actions will remain subject to judicial scrutiny.

Finally, the Reform Act also creates the Council of Inspectors General on Financial Oversight (CIGFO) which consists of all of the IGs assigned to audit the performance of the federal regulators serving on the FSOC. The regulators are now ostensibly more highly regulated.

## THE SECURITIES AND EXCHANGE COMMISSION (SEC)

### Regulatory model and authority

With the creation of the SEC in 1934, pursuant to the Securities and Exchange Act, a conscious policy decision was made about the character of oversight that the new regulatory body was to exercise over issuers in the marketplace. The model was premised on self-regulation by issuers, through a system of self-reporting under the supervision of the regulator. Here, supervision did not vest responsibility in the regulator to perform internal corporate auditing functions or other "hands-on" supervision. It was never intended that the SEC would become the issuer's accountant. Instead, it was the job of the issuer to hire credible third party professionals, such as accountants and lawyers, to perform audits, issue opinion letters, and assist in full and fair disclosure through a system of documentary reporting to the SEC (Weismann, 2009).

Simply, the regulator was to review and inspect only the issuer's mandated disclosures, to confirm that it was abiding by the rules (15 U.S.C. Sections 78(m) and (q)). Critical to the model of self-regulation was trust. The regulator was supposed to be able to rely upon the reporting disclosures of the issuer. That model also required the regulator to actually look at the materials being submitted by the issuer at least every three years to make such a determination. Credible oversight in this context meant a hands-off approach to issuers with, as former SEC Chairman and Supreme Court Justice, William O. Douglas described, the "shotgun behind the door," in the event an issuer engaged in improper or unlawful behavior. The SEC intended barebones agency regulation to avoid interference with natural market forces. The notion that respected third party professionals would not maintain their independence was not accorded much weight. In this way, private sector issuers were burdened with the obligation to provide corporate transparency and the regulator was entitled to rely on the watchful eye of third party professionals ensuring that the issuer satisfied his burden. These third party professionals were thought of as part of a class of “corporate watchdogs,” providing actual review and oversight. Indeed, the belief was that the marketplace had a pack of such watchdogs, including not only accountants and lawyers, but also the self-regulatory organizations (SRO’s) such as the stock exchanges, investment advisors, banks and market appraisers. Assuming each watchdog performed its functions in a conflict-free environment, the risk or opportunity for corporate wrongdoing would diminish. Indeed, the code of federal regulations (CFR) contained a specific proviso requiring auditors to maintain independence in the audit process (17CFR §240.10a-2).

There was nothing in this legislative model that contemplated anything more than a supervisory role played by regulators with reliance on information supplied by the issuer, combined with the reactive power to punish in the event of a breach of trust (17 CFR §§240.13a-1, and 13a-11). The federal agencies were bound in a governance partnership with the private sector. This regulatory philosophy is echoed in the agency philosophy espoused on its website: “The SEC facilitates the exchange of reliable and necessary information to enable investors to make informed investment choices.”

Periodically, Congress considered increasing the powers of the SEC and various statutes were added to the arsenal of regulatory enforcement tools. Yet, the SEC and Congress have steadfastly remained at a respectful distance to avoid undue interference in the marketplace. That philosophy is embedded in the federal regulations which require the SEC to consider, in addition to protection of the investors, whether the proposed regulatory action will promote efficiency, competition, and capital formation in the market (15 USC §78c(f)). The model creates a need for the SEC to serve two masters in the marketplace, investors and an efficient market. However, those interests do not always coincide.

Thus, the regulator is intended to supervise a system of self-regulation and enforce reactively in response to self-regulatory failure. This model of “credible oversight” was created by Congress based upon a myriad of policy considerations and political interests. Indeed, trust as the cornerstone of marketplace regulation, is still urged as the best regulatory model today (Donaldson, 2008).

**Recent oversight initiatives**

In October 2001, shortly before the failure of Enron, the SEC issued a report known as the "Seaboard Report," announcing a new thirteen point policy directive concerning its increased enforcement activities in the private sector (Seaboard Report, 2001). This itemized nonexhaustive list of criteria considered by the SEC in evaluating whether and how much to credit self-policing, self-reporting, and remediation includes: the egregiousness and duration of the misconduct; the extent to which a lax corporate culture led to the misconduct; the extent of "front-office" responsibility; the extent of investor harm; the extent to which internal corporate controls failed to detect the misconduct; the promptness and effectiveness of the company's response upon discovering misconduct; the promptness and thoroughness of the company's internal investigation of the misconduct; the effectiveness of the remedial measures to prevent recurrence; and, the extent to which the company cooperated with the SEC in its investigation. Before the new policy could be fully implemented and tested, the SEC was blind-sided by the Enron failure and a string of massive corporate debacles that were to follow in rapid succession.

In the wake of the Enron debacle, the SEC was severely chastised for its failure to have provided credible oversight. However, given the legislative model under which it operated, was the SEC remiss in its oversight duties? Was the expectation that the SEC should have caught the various fraudulent schemes through credible oversight a fair one?

There is no question that the SEC failed at least in its obligation to review the Enron disclosure documents in a timely fashion. In Congress' view, the SEC's stubborn deference to industry self-regulation, which parenthetically is the model that Congress created, produced a reactive and untimely response to the recent crisis. Congress observes: "[i]n short, the SEC's interactions with Enron reveal the downside to the Commission's largely reactive approach to market regulation. . . it has been less than proactive in attempting to address fraud at an earlier stage, before it becomes a corporate calamity." Not only did the SEC fail to look at Enron's Form 10-Ks for 1998-2000, the SEC staff conceded to Congress that "Enron's 2000 Form 10K would not even have been flagged for review" under the SEC screening criteria (Enron Report, 2002).

In response, Congress enacted several new oversight provisions in SOX increasing both the supervisory powers and responsibilities of the SEC and the disclosure obligations of the private sector, including: 1) annual reports to the SEC must include an assessment of management's internal controls and must be attested to by the auditing firm (15 USC §7262); 2) the SEC must conduct enhanced review of certain issuer disclosures in periodic reports issued on a regular and systematic basis for protection of investors (15 USC §7266); and, 3) directors and officers must certify financial information contained in their own periodic reports submitted to the SEC (18 USC §1350).

Was this change in oversight initiatives perceived as enough to fix the problem? There is no unified response to that question. Instead, there exists a difference of opinion among the concerned stakeholders about how to define the real problem in the first instance. For example, the SEC insists that the new regulations continue to miss the mark because the changes don't directly address the problem. According to the SEC, the real cause of the trouble resulted from inadequate human and financial resources to enable it to act as a policing authority regardless of the expanse of its legal oversight authority. Current SEC Chair Shapiro testified before the

Senate Subcommittee on Financial Services and General Government in 2009 that "…the recent reductions in the SEC's staff seriously undermined the agency's ability to effectively oversee the markets and pursue violations of the securities laws." Lori Richards, Director of the SEC Office of Compliance Inspections and Examinations, defending the SEC's failure to uncover the Bernard Madoff financial fraud scheme, in testimony before the Senate Committee on Banking, Housing and Urban Affairs in 2009, argued that the SEC's examination program was simply not to blame. Instead, the "growth of advisor registrants outstripped the Staff's ability to examine every firm on a regular basis. The staff had to prioritize the firms subject to an examination by relying on a risk based program that targeted those firms most at risk of having an adverse impact on investors." In short, the regulators argue they are overworked and underpaid.

However, Lynn Turner, former SEC chief auditor, saw the problem differently. He concluded that current unbridled lending practices contributing to the mortgage crisis reflected a failure of all of the operative parts of the hybrid regulatory model. In a statement before the Senate Committee on Banking, Housing and Urban Affairs on Enhancing Investor Protection and Regulation of the Securities Markets in 2009, Turner concluded: "While lenders were making bad loans in exchange for an upfront fee, and gatekeepers were falling down on the job, federal government agencies were failing to supervise or regulate those under their oversight, as well as failing to enforce the law." He notes also that the lack of regulation of new products also contributed to the failure. For Turner, however, the problem is not solved necessarily by promulgating more rules. Instead, the problem is solved by getting the stakeholders to comply with existing rules.

Finally, some observers question whether the regulatory partnership model has any validity at all and view its hybrid nature with great cynicism. They argue that the hybrid partnership model of self-regulation breeds an incestuous relationship between government regulators and the private sector which dilutes credible oversight. There is no set of rules designed to fix this public perception. For example, the proposed SEC settlement with Bank of America over charges brought by the SEC against the bank arising out of false statements made to obtain investor approval of the bank's merger with Merrill Lynch in 2008, engendered the Court's anger and disgust. In a somewhat atypical decision, the judge rejected the negotiated settlement between the parties. The Court observed: "The proposed Consent Judgment in this case suggests a rather cynical relationship between the parties: the S.E.C. gets to claim that it is exposing wrongdoing on the part of the Bank of America in a high-profile merger; the Bank's management gets to claim that they have been coerced into an onerous settlement by overzealous regulators. And all this is done at the expense, not only of the shareholders, but also of the truth."[5]

A further illustration of the point was the failure to expose the Bernard Madoff scam despite repeated notifications to the SEC of Madoff trading irregularities by financial expert Harry Markopolis. As noted above, the SEC defended this failure based upon its limited staffing resources which precluded better prioritization of examinations under the SEC risk-based examination programs. However, while Markopolis was endeavoring to get the SEC to pay attention to reported trading irregularities over at least a five year period, Madoff's niece married a former regulator from the SEC, Madoff sat as an advisory member on several SEC committees and he was the former head of NASDAQ. While sounding incestuous at best, the OIG found after its investigation of the SEC that there was no conflict of interest. Yet, many in the marketplace view the regulators' relationships with the private sector as a major flaw in the model. Robert Rubin (former treasury secretary in the Clinton administration) and Henry Paulson (former treasury secretary in the Bush II administration) were both top executives at Goldman Sachs, now the subject of federal investigation. Rubin served for several years as the chairman of the Goldman's board. Rubin was also Citigroup's director and executive committee chair and supported the very financial decisions that occasioned the Citigroup bailout. Rubin's protégé, Timothy Geithner, now serves as President Obama's Treasury Secretary. This apparently seamless movement between government regulator and private sector mogul has created at least the appearance of impropriety in the hybrid regulatory model and has bred real cynicism that Congress' oversight initiatives, which fail to address the appearance of impropriety in regulatory governance, offer any hope of leading to credible oversight.

**Evaluating the regulator**

It is worth revisiting SEC Director Richard's argument that risk-based examination programs were in place and suitable to prevent and detect fraud during the most critical periods of economic failure. Was the SEC's voluntary risk-based oversight program, developed post-Enron, a success or part of a failed oversight paradigm? Concededly, the programs missed Madoff but they did manage to "catch" Bear Sterns. However, the 2008 Report issued by the OIG, in connection with the SEC oversight of Bear Sterns under the Consolidated Supervised Entity (CSE) Program, questioned the real efficacy of CSE program in view of the fact that Bear Stearns was found to be in compliance with most of the regulations but still became insolvent. The SEC had the regulations, Bear Stearns complied with the regulations, and Bear Stearns failed.

A second OIG report addressing SEC oversight of Bear Stearns under the Broker-Dealer Risk Assessment Program concluded that the SEC's Division of Trading and Markets was not fulfilling its oversight obligations under the program and that concerns raised by the OIG's audit of the program in 2002 had not been adequately addressed by the SEC. Nearly one third of the firms under the Broker-Dealer Risk Assessment program had not even filed the required documents. The division had not adequately reviewed the filings made by others. The OIG concluded that the failure to carry out the purpose and goals of the broker-dealer risk assessment program "hinders the commission's ability to foresee or respond to weaknesses in the financial markets." However, these conclusions fueled not only a difference of opinion but precipitated an angry outburst by the SEC.

In response to the OIG criticism, then SEC Chairman, Christopher Cox, conceded that the CSE program, created in 2004 in response to the lobbying efforts from the investment banking industry, was "fundamentally flawed from the very beginning" because investment banks could opt in or out of supervision voluntarily. But Cox blamed Congress for the failure of the program. The fact that investment bank holding companies were intentionally excluded from regulation by Congress, allowing them to withdraw from voluntary supervision at their discretion, diminished the perceived mandate of the program and weakened its effectiveness. Subsequently, Cox disbanded the CSE program but only after the demise or reorganization of the five biggest Wall Street firms, including Bear Stearns, Lehman Brothers, Merrill Lynch, Morgan Stanley and Goldman Sachs.

Cox's view that the supervisory debacle was the direct result of a "regulatory gap" created by Congress has support in the legislative history of deregulation. Some hindsight is useful here. In 1999, Congress passed the Gramm-Leach-Bliley Act (GLBA) reversing the earlier restrictions between investment banks and commercial bank activities. The law authorized the SEC to regulate only the securities and brokerage operations of the investment banks, but not their holding companies. A gaping regulatory loophole hampered the SEC's ability to control holding company financial activities. In 2002, the European Union, sensing an impending crisis in the unregulated holding company arena, sought to impose its own rules on unregulated holding companies unless they were otherwise regulated domestically. To avoid being subjected to the reach of European Union oversight, the investment banks lobbied the SEC to promulgate the voluntary CSE program (GAO Report-09-216, 2009). The program was arguably a sham designed to protect the political interests of the investment banking community and avoid government regulation where there was otherwise no clear intention to self-regulate.

While disbanding the CSE program, Cox publicly warned that the same regulatory gap existed in the unregulated credit default swap industry (SEC Release, 2008-230). Later, in testimony before Congress, then FDIC Chair Born recommended that Congress close the same regulatory gap. Both warnings were preceded by the earlier efforts of the GAO which reported that the large financial interconnections between derivatives dealers posed risk to the financial system and recommended that Congress and financial regulators take action to ensure that the largest firms participating in the OTC derivatives markets be subject to regulatory oversight (GAO/GGD 94-133 Report, 1994). Those repeated agency demands were vehemently opposed by Alan Greenspan, then FRB chairman, Lawrence Summers, and Robert Rubin in testimony before Congress (Frontline, 2009). The argument of the "Greenspan bloc" was straightforward: policymakers need to ensure that systemic regulation is balanced with other national goals, including facilitating capital raising and fostering innovation. With booming prosperity, came Congressional agreement with Greenspan. Now, the massive market failure has bred increased suspicion of an incestuous relationship between government regulators and the private sector.

The sustained but unheeded efforts of the SEC, the FDIC and the GAO also aptly illustrate that the agency may be doing precisely what it is authorized to do but may still lack the real authority to prevent the problem by virtue of regulatory gaps existing in the regulatory framework. The agency may not unilaterally act beyond the scope of its legislative grant of authority to solve an obvious and dangerous problem. Concomitantly, policy decisions made outside of the control of these regulatory agencies; namely, Congressional deference to the "Greenspan bloc," clearly impacted the agencies' ability to control the consequences in the marketplace (FCIC Report, 2011). In this instance, was credible oversight defeated by outside forces beyond the control of the agencies? Where the regulatory system is designed to operate on trust with a protective regulatory layer of independent professionals between the agency and the private sector, a regulatory gap may create a certain level of instability. For whatever combination of reasons, having been stripped of this protective layer through the non-regulation of bank holding companies, the regulatory model of credible oversight was severely crippled. The same frustrating inability of the SEC to regulate hedge fund advisors after numerous attempts is likewise addressed in the Commodities Futures Trading Commission section, below.

## REFORM ACT REMEDIATION

In an effort to remediate the problem, the Reform Act has added two oversight "loop closing" features for previously unregulated derivatives and hedge funds, both under Title IV. First, private equity and hedge funds with assets of $150 million dollars or more must register with the SEC. Venture capital funds remain exempt from full registration. Second, the "Volcker rule" bars proprietary trading unrelated to customer's needs at banks which are government backed. Additionally, credit exposure to banks from derivative transactions must now be added to banks' lending limits.

Does the loop closing feature requiring private and equity hedge funds with assets of $150 million or more to register with the SEC forecast an improvement in regulatory oversight? Again, the discussion recognizes that without implementing regulations, it is hard to predict but the question is worth exploring particularly in view of the failed attempts at oversight that preceded the current Reform Act. Almost 70 years ago, Congress exempted from registration hedge funds comprised of one hundred or fewer beneficial owners and which do not offer their securities to the public or because the investors fit the category of "qualified" high net worth individuals or institutions (Investment Company Act of 1940, §80a-3(c)(1), (3)(c)(7)). There is also a private investment advisor exemption that exempts funds from registration where the investment advisor, during the preceding 12 month period, has had fewer than 15 clients and does not hold himself out to the public as an investment advisor (Investment Company Act of 1940, §80b-3(b)(3)). These exemptions permit hedge funds to engage in unique investment behavior not available to other products, such as mutual funds. Hedge funds can remain secretive about their positions and strategies even with respect to disclosure to their own investors. Additionally, most domestic hedge funds are structured as limited partnerships to sever ownership from management (SEC Staff Report, 2003). As noted in an earlier Supreme Court decision,[6] the Advisor's Act is mainly a registration and anti-fraud statute from which most hedge funds are exempt.

The SEC did make an heroic attempt to make an end run around the exemptions by creating the Hedge Fund Rules in 2004 (69 Fed. Reg. 72,054 (December 10, 2004)). The SEC was motivated by the unbridled growth of the hedge fund industry. Hedge fund assets grew by 260 percent from 1999 to 2004 (Id. at 72,055). The SEC attempted to capitalize on two ambiguities in the statute. First, it is difficult if not impossible to define the terminology "hedge fund." The definition is usually expressed in terms of what a hedge fund is not. Second, the statute does not define "client" for purposes of calculating the number of clients under the private investment advisor exemption. So, the SEC redefined "client" to include shareholders, limited partners, members or beneficiaries of the fund (15 U.S.C. §275.203(b)(3)-2(a)). The effect of the rule would have required most hedge funds to register. However, the Court later struck down the rule finding that the SEC's interpretation contradicted Congress' express intention of exempting from registration advisers "whose activities were not sufficiently large or national in scope."[7] Nonetheless, the Court appeared to agree with the SEC and questioned the wisdom of the statutory rule exempting registration based upon the number of investors versus the dollar volume of the fund, correctly pointing out that "[i]t is the volume of assets under management or the extent of indebtedness of a hedge fund or other such financial metrics that determines a fund's importance to national markets" (Id). The Reform Act appears to incorporate the advice from the court's decision by tailoring the new registration requirement to include private equity and hedge funds with assets of $150 million dollars or more.

## PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD (PCAOB)

### Regulatory model and authority

The Sarbanes-Oxley Act of 2002 (SOX) created the Public Company Accounting Oversight Board (PCAOB) to implement the new oversight mandates given to the SEC by the legislation. The SEC charged the PCAOB with establishing auditing and related attestation standards; quality control standards; ethics standards, and independence standards. The organizational structure of the PCAOB is unique. It is technically not a regulatory agency of the federal government. Instead, it is a private sector, nonprofit corporation created by SOX which reports to the SEC. Its constitutional existence has been tested and sustained by the courts. However, the Supreme Court recently declared unconstitutional the method by which members of the PCAOB are selected to serve.[8] Until this problem is fixed, the Board is allowed to continue in its functions but appointment of the members must be made with the advice and consent of the President.

What the PCAOB does not do, however, is regulate accounting or disclosures by public companies. Its role is merely to enhance the quality of the audits of public company financial statements by auditors. Thus, the post-Enron model of credible regulatory oversight of auditors was somewhat overhauled by the passage of SOX. The creation of the PCAOB to implement major reform added a stronger regulatory presence in terms of a rule-making authority to ensure quality compliance by auditing professionals. It is a quality improvement approach to regulation. Yet, it still leaves the SEC dependent upon the layer of third party professionals hired by the issuer to provide accounting, financial, and legal information. The SEC remains a reviewer in a self-regulatory environment, perhaps with stricter rules, but still kept at a distance to avoid market interference.

In 2003, William J. McDonough became Chairman of the PCAOB, after serving for 10 years as the President and Chief Executive Officer of the Federal Reserve Bank of New York. McDonough's stated regulatory philosophy was that the quickest way for the professions to restore public confidence and trust shattered by recent corporate failures was for accountants to ensure their actions remain consistent with moral principles. He emphasized that the centerpiece of the new regulatory system was predicated upon trust and morality…and a lot of new rules.

**Recent oversight initiatives**

The PCAOB's first action on standards was to adopt the existing AICPA standards as interim standards, pending review of those standards. The Board determined not to designate a professional group of accountants to formulate auditing standards for the Board's ultimate approval. Instead, it formed its own staff of expert accountants to develop auditing and related professional practice standards at the PCAOB's direction. The staff was selected from a variety of backgrounds, including academia, professional practice and government. It was initially composed of 30 individuals with experience in auditing, financial statement preparation, corporate governance and investing, as well as other relevant fields. As part of its formal procedure, the PCAOB staff submitted proposed standards to the SEC for approval in accordance with SOX mandates. Then, the standards were released for public review and comment.

While SOX affirmatively requires auditors to follow PCAOB auditing standards only when they are performing public company audits, the hope was that, as with FASB's accounting standards, accountants will do the same for non-public companies as a "safe harbor" audit methodology. The PCAOB notes that while some public companies do go private, in many more cases, private companies go public. In addition, stakeholders other than public investors, such as lenders are now requiring auditors for non-public companies to provide audit reports according to issuer standards.

Specifically, the most significant revised auditing standards passed by the PCAOB include:

> Auditing Standard No. 1: requires that audits of publicly traded companies be conducted in compliance with the standards of the PCAOB, replacing the previous reference to generally accepted auditing standards, or GAAS.
>
> Auditing Standard No. 2: deals with auditors' responsibilities to audit a company's internal control over financial reporting. SOX required the PCAOB to develop this standard to complement the Act's requirement that company management assess the quality of the company's internal controls.
>
> Auditing Standard No. 3: deals with auditor document retention. This standard is important not just because it is expressly required by SOX, (18 U.S.C. Section1520), but it was also perceived as an integral piece in restoring investor confidence in the audit process. The PCAOB determined from a policy standpoint that good documentation is a critical component of an effective audit. The auditors' work papers are central to accounting firms' quality control over their audit engagements. Investors rely on more than just the words of the audit report, which are standard. They also rely on the name and signature on the report. A firm's reputation for quality auditing is the most important asset it has, and its audit documentation defends that reputation.

Firms and regulators, including PCAOB inspectors, test quality control by examining audit work papers to determine whether, in fact, audits meet the standard of quality for which the firm's name stands. Inadequate work papers are thus an early warning sign that audits may not be worthy of the firm's name, or investors' reliance. Work papers must be sufficiently specific to enable reviewers to understand the audit work performed, who performed and reviewed the work, and the nature of the audit evidence examined. In fact, the PCAOB determined that it was not enough to simply ask auditors to attest to and report on management's assessment of a company's internal controls. In its view, SOX clearly required more; that auditors self-determine that the internal controls are adequate to support reliable financial statements. The standards further require that auditors should make note of the effectiveness of the corporation's audit committee, including whether the committee is independent of management.

In response to the current financial crisis, ostensibly undetected by SOX reforms, the PCAOB announced seven new proposed standards cracking down further on audit risk (PCAOB, 2008). The Board describes audit risk as one where the auditor violates his obligation of independence in the audit process and "issues an inappropriate opinion when the financial statements are materially misstated." The new standards are aimed at reforming the protective layer of third party professionals between the issuer and the SEC to prevent corrupt participation by the auditor in the company's scheme. Thus, the cure is directed at the specific failure in the regulatory apparatus in the private sector, the failure of the auditor "watchdogs" to engage in independent audit review. There is some consensus that the regulations are designed to repair that part of the failed self-regulatory model.

**Evaluating the regulator**

The OIG does not audit the PCAOB as it does with other federal regulatory agencies to evaluate performance. While the PCAOB is relatively new to the regulatory stage, the preliminary reviews of its performance by the SEC have been positive. However, it has been the subject of public criticism which in large measure fueled the recent court case that ended in a pyrrhic constitutional victory for its critics. The critics claimed that the board members were simply not accountable to the government which is not surprising as the PCAOB is technically a private sector entity by design. For example, during 2008, PCAOB Chairman Mark Olson received a salary of $654,406 and each of the four other members received salaries of $531,995. The President of the United States, by contrast, earns $400,000 a year. The PCAOB salaries also exceed the cap of $500,000 set by the Obama administration for chief executives of banks taking federal bailout dollars.

The other frontal attack on the PCAOB is rooted in the belief that its lack of an accountable structure, other than perfunctory reporting to the SEC, allows it to formulate economic policy, a privilege denied to regulatory agencies without express congressional mandate. There is also discontent with the increased costs to the private sector resulting from compliance efforts with SOX and PCAOB rules. A Brookings-American Enterprise Institute study found that SOX has cost the U.S. economy more than $1 trillion in direct and indirect enforcement costs (Butler and Ribstein, 2006). While the regulatory oversight model is intended to operate through a partnership between the regulators and the private sector, there has been some dissension where the PCAOB is concerned.

## REFORM ACT REMEDIATION

In an apparent effort to rein in the agency, the Reform Act requires the Comptroller of the Currency to evaluate the costs and benefits of compliance with SOX (Section 7415). To increase PCAOB accountability, the Act also requires the SEC and the PCAOB to testify annually for the next five years before the Committee on Financial Services of the House of Representatives regarding efforts to reduce the complexity in financial reporting in order to provide more accurate and clear financial information to investors (Section 7407).

Despite the criticism, the PCAOB hails the Reform Act as a tool authorizing broader supervisory powers. In a public statement following its passage, the PCAOB acknowledged that the Reform Act expands its authority to oversee auditors of brokers and dealers. Previously under SOX, auditors of brokers and dealers were merely required to register with the Board. That was the limited extent of PCAOB authority, creating another regulatory gap. However, the Reform Act now provides the PCAOB with standard-setting, inspection and disciplinary authority regarding broker-dealer audits (PCAOB, 2010).

## COMMODITIES FUTURES TRADING COMMISSION (CFTC)

### Regulatory model and authority

Under the Grain Futures Act of 1922, trading of futures contracts was supervised by Department of Agriculture through the Grain Futures Administration. As part of the legislative fix to the financial crisis resulting in the "Great Depression," Congress passed the Commodity Exchange Act (CEA) in 1936 and created the Commodity Exchange Commission (CEC). The CEC established the Grain Futures Administration. More than 40 years passed until 1974 when Congress reorganized the CEC into the modern day Commodities Futures Trading Commission under the Commodities Futures Trading Act (CFTA). The CFTA is generally crafted to regulate futures trading. Futures contracts allow purchasers to buy or sell a specific quantity of a commodity for delivery in the future. While traders are required to register with the CFTC and maintain certain minimum capital requirements, the registration functions were delegated to the National Futures Association, a SRO, by regulation (17 CFR §3.2).

The CFTC regulatory oversight model tracks the SEC model. The regulations are crafted to protect the public interest through a system of "effective self-regulation" of trading facilities, clearing systems, market participants and market professionals under the CFTC oversight. The CFTA requires, before promulgating any regulation, that the CFTC engage in a "cost-benefits" analysis to determine the probable impact of the regulation on the protection and efficiency of the markets and other public considerations (7 USC §19).

The CFTC has jurisdiction over most futures and options contracts, whether traded on an exchange or over the counter (OTC trading). The authority to regulate the securities markets has been divided between the SEC and the CFTC in conformity with the functionality model described above. The SEC regulates the functions of the securities and securities options markets. The CFTC regulates the functions of most other markets (CFTC, 1998). However, there are numerous regulatory gaps created by law in regard to the OTC regulatory function. The CEA excludes from CFTC regulatory oversight most over the counter (OTC) financial derivatives, including credit default swaps. In 2000, the Commodities Futures Modernization Act "clarified" that some off-exchange trading would be permitted and remain largely unregulated, including hedge funds (7 USC §6(a)). Both forms of trading, now excoriated as the culprits of the current financial crisis, were thus intentionally excluded from regulatory oversight by Congress. The CFTC was denied the authority by Congress to supervise these financial products. This statutory model has been amended in some measure by recent changes made by the Reform Act. However, the meaning of those changes remains unknown until the enabling regulations are in place.

Section 3 of the CFTA authorizes three supervisory activities under the CFTC regulatory structure: 1) to protect the price discovery function; 2) to prevent the manipulation of commodities through trading schemes; and, 3) to assure an effective vehicle for risk transference.

While the financial futures market includes both sophisticated and unsophisticated investors, the OTC market is comprised mostly of professional broker dealers and institutional investors. Also, the oversight challenge of regulating financial future is considered functionally different than regulating metals futures, energy futures or agricultural futures. So, the agency has been required to reject a "one-size fits all" regulatory approach in its oversight function (Rainer, 1999).

**Recent oversight initiatives**

In 1998, the CFTC attempted to regulate derivatives. Under the leadership of its Chair, Brooksley Born, the CFTC issued a "Concept Release" aimed at market reform through the regulation and oversight of the OTC derivatives market (Concept Release, 1998). The Concept Release describes OTC derivatives as contracts executed outside of the regulated exchange environment used by market participants to perform a wide variety of important risk management functions. Born believed that this unregulated "dark market" could pose grave dangers to the economy. The attempt at regulation was opposed in testimony before Congress by Alan Greenspan, Robert Rubin and Larry Summers (Frontline, 2009). The Greenspan bloc was successful in derailing regulatory efforts with the passage of the Commodities Future Modernization Act passed in 2000. The CFMA which exempted most OTC derivatives from regulation, often referred to as the "Enron loophole," is now also blamed for the current financial crisis.

Significantly, the explosive growth of trading in unregulated hedge fund portfolios and OTC derivatives during the period 1999-2004 was preceded by the near catastrophic failure of Long Term Capital Management (LTCM). In fact, the LTCM failure proved that Born had accurately predicted the crisis. LTCM experienced large losses related to its $100 billion trading position in hedge funds (GAO Report, 1999). It entered into enormous positions in exchange traded and OTC derivatives. Viewed as a precursor to a global meltdown, the Clinton administration and the FRB pressured the financial institutions with large exposure to the hedge funds to provide $3.6 billion as a cushion until the fund could be liquidated in an orderly fashion. Despite the attempts of Born, the SEC's Christopher Cox and others, the regulatory gap has persisted until the recent passage of the Reform Act. The meltdown that was predicted, experienced in the LTCM debacle, experienced in the energy trades conducted by Enron, and repeated by Bear Sterns, Lehman Brothers, Goldman Sachs, most major U.S. and foreign financial institutions, and many others, is a main contributor to the current financial crisis. In short, Federal Reserve Bank economic policy, supported by Congress, directly impacted the regulator's ability to engage in credible regulatory oversight of an entirely unregulated dark market creating risk exposure in the trillions. This was directly contrary to the original agency oversight purposes envisioned by Congress under the CFTA.

## Evaluating the regulator

The OIG issued an audit report covering the period October 2009-March 2010 evaluating the performance of the CFTC (OIG Semiannual Report of the CFTC, 2010). The OIG identified three "most serious" management challenges: Congressional demand that the CFTC and SEC harmonize their regulation of overlapping financial products; a decision on the CFTC's regulatory model for the swaps derivatives market; and expansion of CFTC's regulatory responsibilities over the potential carbon emission trading markets.

Yet, neither the OIG nor the GAO has much to say about the CFTC. The agency's struggle over the last 20 years to take its place in the formal regulatory structure was effectively extinguished in 2000 with the passage of the Commodities Futures Modernization Act permitting off-exchange trading that would remain largely unregulated. The CFTC's struggle underscores the potency of externality impact on credible oversight. It also illustrates the point that where markets lack transparency or are otherwise unregulated, as with derivatives and hedge funds, such unregulated, unsupervised financial markets can all too easily suffer catastrophic failure. The emasculation of the CFTC by the CFMA provides supporting data for the conclusion that if a market center gains a reputation as having lax oversight and surveillance, that market will suffer the consequences.

Thus, the events that have contributed to the current collapse of the capital markets, including the debacle in the unregulated derivatives and hedge fund markets did not directly result from the failure of regulatory supervision. Instead, the culprit is arguably Congress. Not only did Congress refuse to heed the CFTC's warning, it passed affirmative legislation shutting the door on any regulation at all. It was arguably the direct result of economic policy and the will of the Greenspan bloc as evidenced by their direct testimony before Congress which criticized then CFTC Chair Brooksley Born who was demanding authority from Congress to regulate (Frontline, 2009). Even the demonstrable failure of LTCM would not budge lawmakers. Parenthetically, the Congressional Budget Office estimates that up to 235 additional employees may now be needed by the CFTC by fiscal year 2011 to regulate central counterparty clearing of swaps. This estimate would require a 40% increase over existing staffing levels. The estimate provides a window into the sheer magnitude of the agency's new regulatory role under the Reform Act.

## Reform Act remediation

The Reform Act authorizes the SEC and the CFTC to form a joint commission to identify emergency issues and regulatory risks, assess their implications for market participants and recommend solutions (Section 7307). Modernization of the regulatory infrastructure has begun with the expansion of CFTC regulatory authority under Title III of the Reform Act, also known as "Derivative Markets Transparency and Accountability Act of 2009." Under section 3001, along with the SEC, the CFTC is authorized to commence rulemaking with regard swaps and the swap related entities and participants. Under Section 3005, regulatory changes will be recommended to Congress for implementation in the derivatives market. Under Section 3006, the agencies will also recommend legislative changes to federal insolvency laws. Subtitle A of the Act further extends the CFTC's authority to regulate derivatives and repeals numerous legislative prohibitions.

Most significantly, subtitle B repeals the Gramm-Leach-Bliley Act prohibition against the regulation of security based swap agreements. Subtitle C provides for "Improved Financial and Commodity Oversight and Accountability" and authorizes the CFTC to define terms like "commercial risk," "operating risk," and "balance sheet risk."

The CFTC initiated the rule making process by dividing 30 proposed topic areas into eight groups including comprehensive regulation of swap dealers and major swap participants; clearing; trading; enforcement; position limits; and, others (CFTC Rulemaking Areas, 2010).

## FEDERAL RESERVE BOARD (FRB)

### Regulatory model and authority

In 1913, the Federal Reserve System, which serves as the nation's central bank, was created by Federal law (12 U.S.C.A. §241). There is a board of governors comprised of seven members appointed by the president with the advice and consent of the senate. The Secretary of the Treasury and the Comptroller of the Currency are also members. By law, the FRB must report on at least an annual basis to Congress. The law provides a list of specific responsibilities which includes: the formulation of monetary policy; setting the discount rate; regulating and supervising member banks; suspending, liquidating or restructuring troubled banking institutions; and setting standards for reserve requirements and worthless assets (12 U.S.C.A. §248).

The Federal Reserve shares functional supervisory and regulatory responsibilities for domestic banking institutions with the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision, now merged into the OCC. Banks are often owned or controlled by bank holding companies. Here, the FRB has supervisory authority for all bank holding companies, regardless of whether the subsidiary bank of the holding company is a national bank, state member bank, or state nonmember bank.

Although the terms "bank supervision" and "bank regulation" are often used interchangeably, they actually refer to distinct, but complementary, activities. Bank supervision involves the monitoring, inspecting, and examining of banking organizations to assess their condition and their compliance with relevant laws and regulations. When a banking organization within the Federal Reserve's supervisory jurisdiction is found to be noncompliant or to have other problems, the Federal Reserve may use its supervisory authority to take formal or informal action to have the organization correct the problems. Bank regulation entails issuing specific regulations and guidelines governing the operations, activities, and acquisitions of banking organizations.

The history of the FRB rule making authority illustrates the point made earlier that the regulatory authority of federal agencies is limited to the investiture of express powers by Congress and where the agency attempts to expand its supervisory power, even in the interests of preventing a societal harm caused by increased systemic risk, it will be prohibited from doing so. This may result in a regulatory gap that hinders credible regulatory oversight. Case in point. In 1986, the Supreme Court struck down a federal regulation promulgated under the Bank Holding Company Act of 1956 by the FRB, which gave the Board regulatory authority to supervise nonbank financial institutions offering the "functional equivalent" of banking services provided to customers by banks.[9] The Court observed that the Act gave a simple and broad definition of a bank as "any national banking association or any State bank, savings bank, or trust company" and exempted from regulation *all* institutions that did not engage in the business of making commercial loans. The message was clear: all other nonbank financial institutions not included in the statutory definition were simply outside of the FRB's rule making authority. Thus, insurance institutions providing functionally equivalent banking services, like AIG, escaped FRB oversight. The FRB presented argument to the Court describing the inherent dangers created by the regulatory gap, including the regulatory concerns that the proliferation of nonbank banks threatened the structure established by Congress for limiting the association of banking and commercial enterprises and that holding company acquisitions could be made without prior state regulatory approval. The Court rejected these regulatory concerns, repeating the legal maxim that circumscribes agency regulatory oversight: "If the Bank Holding Company Act falls short of providing safeguards desirable or necessary to protect the public interest that is a problem for Congress, and not the Board or the courts, to address." The statute was not expanded to permit nonbank financial companies to come within the regulatory purview of the FRB until after the AIG debacle by virtue of the passage of the Reform Act.

In this instance, the agency was willing to supervise and regulate, however, Congress chose to exclude from oversight the worst culprits in the current financial crisis. The powerlessness of the FRB under these circumstances aptly illustrates the point that an agency may be doing precisely what it is organized to do but may still lack any real authority to prevent the problem by virtue of regulatory gaps built into the regulatory oversight paradigm.

## Recent oversight initiatives

In the wake of the recent financial crisis, the FRB implemented in 2009 the Supervisory Capital Assessment Program, (SCAP), also known as the banks stress test (Conference on Bank Structure and Competition, 2010). The purpose of SCAP was to test the "health" of the largest U.S. banking institutions. As such, it was not a solvency test but instead an oversight initiative to determine if banks would have sufficient capital to keep lending if their respective losses exceed expectations. The examination focused not just on levels of capital but also on the composition of capital. The idea was to come up with a figure that the banks would need to collectively raise through private investment within a six month period in order to avert failure. If those private sources were not forthcoming, government capital would be provided to the banks. According to the FRB, the oversight measure was designed in large measure to "restore confidence in the stability of our banking system." Id.

FRB Chairman Bernanke has repeatedly emphasized that financial regulation and supervision are not ineffective at controlling risk (American Economic Association, 2010). Instead, he identifies the problem as one of "execution." His solution, facilitated by the creation of the new FSOC, is to move from an institution-by-institution supervisory approach to one that is "attentive to the stability of the financial system as a whole." Id. Leverage and liquidity and the analysis of the interactions between firms and the markets now require big picture oversight.

Finally, transparency has become an issue. The FRB publicized the SCAP financial institution results over industry objection that transparency might "back-fire" and scare public investors. Bernanke conceded that the traditional supervisory view is that confidentiality enhances the willingness of institutions to cooperate with supervisors and reduces the risk that a limited set of adverse findings might be over-interpreted by market participants. That traditional thinking has now been abandoned by the Board in favor of disclosure about the status of both individual banks and of the banking system as a whole in the belief that the result will be 'confidence-enhancing" in the marketplace.

**Evaluating the regulator**

The FRB was one of the federal agencies not technically subject to the audit and reporting requirements of the GPRA. Nonetheless, it has chosen to voluntarily comply with the Act. In any case, the Reform Act now requires special audit by the GAO of "FRB governance." Specifically, the auditors must determine the extent to which FRB governance adequately represents the public and whether there are any conflicts of interest when member banks elect the members of the FRB (1109(b)(1)(B)). Additionally, an Inspector General of the Board of the Federal Reserve has also been named in conformity with new amendments to the Inspector General Act. However, there has been some controversy over the new IG appointee who was unable to answer even the most basic questions about the operations of the FRB at a recent congressional hearing (Grayson, 2009).

The most recent IG Report for the period April 1, 2010 through September 30, 2010 omits any reference to public criticism that FRB economic policy that may have fueled the current economic crisis (OIG Semiannual Report of the CFTC, 2010). Yet, many others have criticized the Board, including the FCIC, for facilitating the credit crisis through its promulgation of loose monetary policy and low interest rates in the period post 9/11, which was characterized by the undetected corporate failures of Enron and WorldCom. As a consequence, the financial system was flooded with available cash. Banks, mortgage companies, institutional investors and the unregulated hedge funds, engaged in increased risk to generate ever higher returns in a weak dollar/low interest rate/cheap asset environment (Bodine and Nagel, 2008). Notably, the Board also opposed regulation of derivatives in opposition to the demands of another federal agency, the CFTC. Thus, lax economic policy combined with limited regulatory authority over nonbank financial institutions has fueled the claim that the Board failed to act in the public interest. More recently, the Financial Crisis Inquiry Commission Report, released on January 27, 2011 targets the FRB for its failure to avert the crisis: "The prime example is the Federal Reserve's pivotal failure to stem the flow of toxic mortgages, which it could have done by setting prudent mortgage-lending standards. The Federal Reserve was the one entity empowered to do so and it did not" (FCIC Report, 2011 at xvii).

In response to those accusations, Chairman Bernanke stands firm that interest rates were appropriately low and justified the loose flow of cash: "Stronger regulation and supervision aimed at problems with underwriting practices and lenders' risk management would have been a more effective and surgical approach to constraining the housing bubble than a general increase in interest rates" (Rampell, 2009). Ironically, Bernanke now criticizes the lack of regulatory authority from Congress to enable the FRB to do its job and identified the gap in regulatory authority as the root cause for the regulatory failure. However, Bernanke's strategy in defending the FRB may appear disingenuous in view of the staunch opposition to greater regulatory oversight of the financial markets that characterized the Greenspan era (Frontline, 2009).

The GAO report issued in January 2009 provides a different twist regarding the perceived failure of financial regulatory oversight. It is not so much a critique of the FRB, or any other federal regulator for that matter, but instead focuses on the absence of coordination between regulatory agencies and the externalities that impede credible regulatory oversight (GAO-09-216, 2009). Those externalities include the "too big to fail" scenario that characterized the collapse of AIG; the demise of the investment bank model where investment banks utilized publicly traded holding companies with broker-dealer subsidiaries dealing in largely unregulated markets due to the regulatory gaps created by the GLBA; and, the failure of the private sector to self-regulate and exercise restraint. In short, the GAO report describes a runaway market not subject to sound regulation and able to evade oversight.

**Reform Act remediation**

During congressional hearings in 2008, FRB officials acknowledged a failure of big picture regulatory supervision. It observed that under the pre-Reform Act regulatory structure consisting of multiple agencies, difficulties can arise in assessing risk profiles of large, complex financial institutions which operate across financial sectors, particularly given the increased use of sophisticated financial products that can generate risk across various entities (Senate Hearing, 2008). In addition to the creation of the FSOC under the Reform Act to coordinate agency supervision, a newly created position of Vice-President of Supervision has been added to the regulatory infrastructure requiring the FRB to make recommendations to Congress regarding the supervision and regulation of financial institutions (§§1108(a) and (c)).

Likewise, the solution to the "too big to fail problem," where the very size and nature of the nonbank financial institutions insulated them from regulatory oversight and market discipline, may now be a function of government regulation. Under the Reform Act, the FSOC may subject a "US nonbank financial company" to FRB supervision and to "prudential standards" if the FSOC determines by a two-thirds vote, including an affirmative vote by the Chairperson, that "material financial distress" exists at the nonbank financial company, or the "nature, scope, size, scale, concentration, interconnectedness, or mix of the activities" could pose a threat to U.S. financial stability. Section 113(a)(2) lists factors that the FSOC must consider in making this determination, including the leverage, size and interconnectedness of the company, as well as the importance of the company as a source of credit for households, businesses, and state and local governments, and as a source of liquidity for the financial system as a whole. It is important to note that nonbank financial companies still remain effectively outside of regulatory supervision unless the FSOC exercises its discretion as provided for under the Act. It remains to be seen whether this model will effectively remediate the regulatory gap.

The FRB is also required to issue regulations, in consultation with the FSOC, establishing criteria for exempting "certain types of classes" of nonbank financial companies from supervision by the FRB. In order to be a "US nonbank financial company" susceptible to FRB supervision, a company must be: 1) organized under the laws of the United States or any state; 2) not a BHC; or 3) a subsidiary of a BHC "predominantly engaged" in financial activities. A nonbank financial company is predominantly engaged in financial activities if 85 % or more of the consolidated annual gross revenues or consolidated assets of the company are attributable to activities that are "financial in nature" and if applicable, from ownership of an insured depository institution. Activities that are "financial in nature" include: all kinds of lending and other forms of financing; underwriting, dealing in and brokering securities; derivatives activities; investment management; and insurance activities.

The Reform Act may close the regulatory gap created by Congress' previous intransigence in excluding from FRB oversight large nonbank financial institutions, including insurance companies like AIG, even if they have no bank or thrift subsidiary. Here, the impact of externalities, namely Congress and economic policy, undoubtedly impacted credible regulatory oversight. The FRB argues that it was doing its job according to its legal mandate. It simply lacked the authority to effectively supervise systemic risk.

## FEDERAL DEPOSIT INSURANCE CORPORATION (FDIC)

### Regulatory model and authority

The Banking Act of 1933 created the FDIC to administer a federal program insuring bank deposits of participating banks. As such the FDIC was another regulatory brainchild of the Great Depression. In 1989, with the abolition of the Federal Savings and Loan Corporation (FSLIC), the FDIC assumed FSLIC's regulatory function over thrifts. Thrifts are savings and loan financial institutions, primarily engaged in the home mortgage business. The FDIC provides two oversight functions referred to as primary and "backup" or secondary oversight. The FDIC is responsible for primary oversight of any state-chartered bank that is not a member of the Federal Reserve System. In this capacity, it serves as the primary federal regulator for over 5,200 state-chartered institutions. Similar to other insurers, the FDIC monitors and assesses risks at all insured financial institutions and determines each institution's insurance risk category and premium rate. The FDIC regulations then assign each risk category a specific insurance assessment rate that is used to compute an institution's insurance premium which is added to the Deposit Insurance Fund (DIF).

The FDIC Improvement Act of 1991 (FDICIA) required the FDIC to establish a risk-based assessment system. A risk-based system is one based on an institution's probability of causing a loss to the DIF due to the composition and concentration of the institution's assets and liabilities, the amount of loss given failure, and the revenue needs of the fund.

To implement that requirement, the FDIC categorized institutions into risk categories based on two regulatory criterion: (1) capital levels; and, (2) supervisory ratings as calculated by the primary regulatory agency sharing functional oversight of the institution. With the passage of the Federal Deposit Insurance Reform Act of 2005 and the Federal Deposit Insurance Reform Act Conforming Amendments of 2005, the FDIC was statutorily required to set institutional risk assessments semiannually. The new provisions continued to require that the assessment system be risk-based, however, risk was more broadly defined. Yet, the integrity of the FDIC's oversight evaluation still rested upon the supervisory ratings calculated by the primary regulatory agency.

The focus here is on the secondary or backup examination and enforcement authority of the FDIC over all of the institutions it insures in order to prevent or mitigate losses to deposit insurance funds. It here where the FDIC's regulatory authority has been most limited and this explains in large measure the reasons that the FDIC was unable to effectively prevent major bank failures during the recent financial crisis as a result of these regulatory restrictions. As the word back-up implies the bank in question has a primary regulator other than the FDIC in charge of examination and supervision. Along with the primary regulator, the FDIC as the insurer has authority to perform its own examination of a federally insured bank and impose enforcement actions to protect the DIF, provided statutory and regulatory procedures are followed. Section 10(b)(3) of the Federal Deposit Insurance Act grants the FDIC special examination authority, or back-up authority, to make any special examination of any insured depository whenever the FDIC Board of Directors determines it is necessary to determine the condition of the institution for insurance purposes. Also, under the regulations, if the FDIC determines that the primary regulator is not doing its job by taking appropriate actions, the FDIC has enforcement powers to act. The FDIC's statutory authorization to engage in back-up enforcement action is under Section 8(t) of the Federal Deposit Insurance Act. However, the FDIC must follow certain procedural steps necessary to take such action.

One feature of the procedure requires the FDIC to follow the interagency agreement in place between itself and the primary regulator. In January 2002, the FDIC's Board of Directors approved an interagency agreement establishing guidelines for examination authority for those institutions that present "heightened risk" to the DIF.

Parenthetically, the interagency agreement was intended to balance the needs of FDIC against the regulatory burden on an institution of having two regulators duplicating examinations. Another critical aspect of the interagency agreement is that the FDIC must rely, "to the fullest extent possible," on the work of the primary regulator. Additionally, the terms of the interagency agreement governing information sharing and back-up examinations require that FDIC "prove a requisite level of risk at an institution – heightened risk, material deteriorating conditions, or adverse developments" in order for the primary regulator to grant FDIC access to the institution's information. Accordingly, where the primary regulator is not doing its job, the FDIC must still establish the requisite level of risk to obtain access to critical internal information. Strangely, that access is limited to the audit results of the primary regulator who has failed to do its job in the first instance.

To initiate its back-up examination, the FDIC must recommend in writing that an institution's primary regulator engage in a range of authorized enforcement action. The recommendation must also be accompanied by a written explanation of the concerns giving rise to the recommendation. If, within 60 days of the recommendation, the institution's primary regulator does not take the enforcement action recommended by FDIC or provide an acceptable substitute action plan, the FDIC may petition the FDIC Board to authorize the recommended enforcement action. The FDIC cannot take any enforcement action without Board approval. However, the composition of the FDIC Board includes the Director of OTS and the Comptroller of the Currency, and essentially puts the enforcement decision back into the hands of the primary regulator that failed to take the recommended actions in the first instance.

This regulatory paradigm was reviewed in detail by the Office of the Inspector General during its audit of the FDIC and the OTS in its "evaluation of the federal regulatory oversight" immediately preceding the failure of Washington Mutual Bank (WaMu). The OIG concluded that the procedures governing the FDIC's backup authority were unduly restrictive and prevented the FDIC from adequately performing its regulatory function (Eval 10-002, April 2010).

**Recent oversight initiatives**

The story of the failure of Washington Mutual (WaMu) perhaps best illustrates the failure of FDIC oversight initiatives and supports the OIG's conclusion that the FDIC's hands were tied by regulations which prevented it from effectively doing its job of credible regulatory oversight and preventing WaMu's downfall.

WaMu's primary federal regulator was the OTS. As such, OTS was responsible for conducting full-scope examinations to assess WaMu's safety and soundness and compliance with consumer protection laws. Unfortunately, OTS relied in large measure on WaMu's own internal audit system to track the thrift's progress. Parenthetically, the reliance on the private sector's own judgment effectively replaced the independent role of the primary regulator. Later facts revealed that WaMu's management pursued an unreasonably high-risk lending strategy to enable it to compete with its main competitor, Countrywide Mortgage, one of the first major lenders to fail in the string of mortgage company failures to follow. WaMu's strategy included liberal underwriting standards and inadequate risk controls. That high-risk strategy, combined with the housing and mortgage market collapse in mid-2007, left WaMu with loan losses, borrowing capacity limitations, and a falling stock price. To compound the problems, in fall 2008, depositors made a run on the bank and withdrew significant funds after WaMu's problems were made public. Thereafter, WaMu was unable to raise capital to cover depositor withdrawals, forcing OTS to close the institution on September 25, 2008.

WaMu was one of the eight largest institutions insured by FDIC. At the time it failed, the estimated cost to liquidate WaMu would have been approximately $41.5 billion. That amount would have depleted the entire balance of the DIF at the time. Fortunately, the FDIC resolved the WaMu crisis with no loss to the DIF through WaMu's subsequent acquisition by J.P.Morgan Chase & Co.

The OIG concluded that the FDIC properly conducted its required monitoring of WaMu from 2003 to 2008. As a result of this monitoring, the FDIC identified risks with WaMu's lending strategy and internal controls. However, the risks noted in the FDIC's monitoring reports did not result in an increase in WaMu's deposit insurance premium payments. This discrepancy occurred because the deposit insurance regulations rely on the safety and soundness ratings and regulatory capital levels determined by the primary regulator to gauge risk and assess related deposit insurance premiums, in this case the OTS. Since the OTS examination results were satisfactory, based upon OTS' misguided reliance on WaMu's own tracking system, increases in deposit insurance premiums were not triggered.

Nonetheless, the FDIC challenged OTS' safety and soundness ratings of WaMu in 2008. However, OTS was reluctant to lower its rating of WaMu to comport with the FDIC's assessment of risk. Ironically, the OTS and FDIC resolved the 2008 safety and soundness ratings disagreement seven days prior to WaMu's failure, when OTS lowered its rating to agree with

FDIC's. By that time, the rating downgrade had no impact on WaMu's insurance premium assessments and payments.

While the FDIC had enforcement powers to act when a primary regulator, such as OTS fails to take action, it did not use those powers for WaMu because of the significant procedural burden involved in taking any such action. Specifically, the coordination between the FDIC and OTS was problematic because of the terms of the interagency agreement governing information sharing and back-up examination authority, and the inherent tension between the roles of the primary regulator and the insurer. Under the terms of the interagency agreement, the FDIC needed to request permission from the OTS to allow FDIC examiners to review information on-site at WaMu in order to better assess WaMu's risk to the DIF. The OIG reported that the OTS viewed the FDIC's initial request as an intrusion and an unreasonable affront to OTS authority. Further, under the terms of the interagency agreement, the FDIC had to show that a high level of risk existed for the OTS to grant FDIC access to critical information to enable it to complete a full risk assessment. The OTS resisted providing FDIC examiners greater on-site access to WaMu information because they did not believe that the FDIC met the requisite need for that information according to the terms of the interagency agreement and believed FDIC should rely on the work performed by OTS as required by the regulations. Eventually, OTS did grant the FDIC greater access at WaMu but still limited the FDIC's review of WaMu's residential loan files. The OIG observes: "The logic of the interagency agreement is circular – FDIC must show a high level of risk to receive access, but FDIC needs access to information to determine an institution's risk to the DIF" (Eval 10-002, April 2010).

**Evaluating the regulator**

The OIG concluded that the interagency agreement did not provide the FDIC with the access to information that it needed to assess WaMu's risk to the DIF. Additionally, it found that the interagency agreement then in effect did not allow the FDIC sufficient flexibility to obtain information necessary to assess risk in order to protect the DIF. Finally, the OIG also concluded that FDIC deposit insurance regulations are too restrictive in prescribing the information used to assign an institution's insurance category and premium rate.

The OIG also found that this incident was not an aberration but part of a pattern repeated by the Indy-Mac Bank F.S.B. failure which depleted 24% of the DIF. In short, the regulatory paradigm designed by Congress failed to achieve the intended goal of credible regulatory oversight.

**Reform Act remediation**

The OTS was merged into the Office of the Comptroller of the Currency and no longer serves the function as a primary regulator. Additionally, the Reform Act now includes the

Dissolution Authority for Large, Interconnected Companies Act of 2009 (Subtitle G-Enhanced Dissolution Authority). Under this Act, the FDIC is authorized to make a written recommendation regarding systemic risk to U.S. economic stability posed by a financial institution in default or in danger of default. At that point, the FDIC may be appointed as a receiver of a financial institution for a one year period to take "certain discretionary actions to stabilize or dissolve the institution" (Section 1603). The FDIC may also commence involuntary bankruptcy proceedings against a failing institution and be appointed the trustee in bankruptcy (Section 1612).

## OFFICE OF THE COMPTROLLER OF THE CURRENCY (OCC) AND THE OFFICE OF THRIFT SUPERVISION (OTS)

### Regulatory model and authority

At the end of 2008, the Office of Thrift Supervision supervised 810 savings associations with total assets of $1.2 trillion and 463 holding company enterprises with approximately $6.1 trillion in U.S. domiciled consolidated assets (Polakoff, 2009). The OTS was merged into the Office of the Comptroller of the Currency by the Reform Act (Subtitle C, Section 1202). The OCC is in the process of creating a separate office to deal with thrift matters. Under the Reform Act, all functions and rulemaking authority of the OTS relating to Federal savings associations have been transferred to the OCC. The OTS's function of supervising thrift holding companies has been transferred to the Federal Reserve Board, which already has similar responsibilities over bank holding companies. State-chartered thrifts continue to be supervised by the states and the FDIC. The Reform Act mandates completion of the agency merger by July 2011.

As required by law, OTS regulatory oversight of risk management included conducting full-scope, on-site examinations of insured depository institutions with assets over $500 million dollars. OTS used the "CAMELS rating system" to evaluate a thrift's overall condition and performance by assessing six rating components: capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk. The regulator would then assign to each institution a composite rating based on the examiner's assessment of its overall condition and level of supervisory concern. OTS was authorized to use informal and formal enforcement tools to carry out its supervisory and enforcement responsibilities; to address violations of laws and regulations, conditions imposed in writing and written agreement with the agency; and to address unsafe and unsound practices. Specifically, OTS could engage in informal enforcement actions when a thrift's overall condition was sound, but it was necessary to obtain a strong commitment from the board of directors or management to ensure remediation of identified problems and weaknesses. Informal enforcement actions are not made public and so, there is no transparency in this process. The effectiveness of informal actions depends on the willingness and ability of the thrift to correct deficiencies. If the thrift violates or refuses to comply, OTS was unable enforce compliance in federal court or assess civil money penalties.

A formal enforcement action differs because it is both written and enforceable. Formal actions are appropriate when a thrift has significant problems, especially when there is a threat of harm to the thrift, depositors, or the public. The supervision of federal thrifts will now be merged into the supervision of the national banking system.

The OCC is part of the Department of the Treasury and is the Administrator of National Banks. It was created by the National Bank Act of 1863 which also provided for the issuance of a single national currency. The OCC was to oversee the national currency and improve banking efficiency by granting banks national charters to operate and conduct regulatory oversight to ensure sound management of the banks. In describing its own regulatory philosophy, the OCC adopts a "supervision-by-risk approach" (OCC Report, 1997). That is, the OCC supervises all national banks by engaging in bank supervision directed at identifying material problems, or emerging problems, in individual banks or the banking system, and ensuring that such problems are appropriately corrected. Because banking is essentially a business of accepting risk, the regulatory focus is centered on evaluating risks. The OCC applies that philosophy in all supervisory activities that it conducts. The OCC is a non-appropriated federal agency that continues to be funded largely from assessments on national banks and thrifts.

To achieve its supervisory objectives, the OCC develops and implements policy guidance and regulations and conducts on-site examinations and off-site monitoring of banks to assess compliance with regulatory standards and identify emerging risks or trends. When deficiencies are observed in bank policies and operations, the OCC much like the OTS uses formal and informal enforcement tools to achieve corrective action (OCC Annual Report, 2010).

Specifically, the OCC addresses operating deficiencies, violations of laws and regulations, including violations of consumer protection standards and unsafe or unsound practices at national banks through the use of supervisory actions and civil enforcement powers and tools. National banks and their operating subsidiaries are subject to comprehensive, ongoing supervision which may include on-site presence at national banks. The key focus of the enforcement policy is to address problems or weaknesses before they develop into more serious issues that adversely affect the bank's financial condition. In the event that problems or weaknesses are identified and communicated to the bank by the OCC, management and the board of directors are expected to correct them promptly. Management's response to addressing problems is an important factor in determining if the OCC will take enforcement action, and if so, the severity of that action. Thus, most bank problems have been resolved through the supervisory process, without having to resort to an enforcement action (OCC Bulletin 2002-38, 2002).

Supervisory actions include the issuance of comprehensive Reports of Examination, supervisory directives, and Matters Requiring Attention ("MRA") tailored to the specific problems. During the period from 2004 through 2007, the OCC issued 123 MRAs requiring corrective actions in connection with national banks' residential mortgage lending activities. By the end of 2008, the OCC had determined that satisfactory corrective action had been taken with respect to 109 (88.6%) of those MRAs, and they were closed (Dugan, 2009).

When the normal supervisory process is insufficient or inappropriate to effect bank compliance with law and the correction of unsafe and unsound practices, the OCC has numerous enforcement tools. For less serious problems, the OCC begins at one end of this enforcement spectrum with informal enforcement actions. However, in situations where the bank's capital is impaired, the OCC may also require the bank to submit an acceptable Capital Restoration Plan, or establish an Individual Minimum Capital Ratio ("IMCR") requiring the bank to achieve and maintain capital levels higher than regulatory minimums. The OCC's authority is limited to administrative enforcement only. Fraud and other possible criminal violations must be referred to the Department of Justice.

**Recent oversight initiatives**

In 2010, the OCC issued new policy guidance in four areas: incentive compensation; interest rate risk; off balance sheet risk; and, liquidity risk management. The guidance appears to be a mixture of self-regulation and increased regulatory risk management. For example, interest rate risk increased as a result of the low cost funding environment created by the FRB. The OCC has no authority to regulate monetary policy or curb increased rate risk by controlling the FRB. Instead, to address the increased lending risks, the OCC issued an advisory requiring banking institution to have in place control systems and procedures to match the amount of risk that they undertake (OCC Advisory, 2010). However, the OCC makes clear that a bank's tolerance for interest rate risk is a business decision and not one made by the regulator.

Here, the OCC oversight policy is tempered by externalities such as the FRB which determines economic policy having a direct impact on financial institution risk. Additionally, the relationship between the OCC and the national banks represents a delicate balance between the need for regulation and the private sector demand for self-regulation. That regulatory philosophy favoring self-regulation is embedded in the regulator's own mission statement: "the OCC seeks to promote an environment where risk is prudently managed by banks and appropriately monitored by the OCC, without imposing unnecessary regulatory burdens that undermine the ability of banks to operate efficiently, compete vigorously, and provide credit and other financial products and services to the public" (OCC Report, 1997).

In August 2010, the OCC published its 16th annual "Survey of Credit Underwriting Practices" to identify trends in lending standards and credit risk for the most common types of commercial and retail credit offered by national banks. The survey addresses the factors that may be affecting banks' pricing and underwriting policies and provides the OCC's view on whether the inherent credit risks in bank portfolios are increasing or decreasing. The OCC monitors risk but is not alone in monitoring capacity. It is joined by the FRB, the SEC and the FDIC. Again, while it can identify risk, it does not necessarily have the authority to regulate the activity resulting in increased risk. Many of those activities come under the supervisory authority of other federal regulators as illustrated below in the case of hedge funds.

**Evaluating the regulator**

Despite broad supervisory oversight, 30 national banks failed in 2010, compared with 13 in 2009. According to the OCC, the increase in bank failures reflected the adverse economic conditions that especially affected financial institutions with excessive asset concentrations particularly in commercial real estate. However, the increase in the bank failure rate has not been attributed to a failure of regulatory oversight by the OCC. Instead, the failure has been attributed to the failure of Congress to regulate certain high risk activity. Case in point-hedge funds. In 2005 and 2006, the OCC conducted an examination of hedge fund-related activities–mainly counterparty credit risk management practices such as due diligence of their hedge fund customer's business at the three large U.S. banks. The OCC generally found the overall risk management practices of these banks to be satisfactory. However, examiners identified concerns in the lack of transparency in the banks' hedge fund review processes and issued remedial recommendations. For example, examiners found in certain banks a lack of adequate credit review policies that clearly outline risk assessment criteria for levels of leverage, risk strategies and concentrations, and other key parameters and documentation to support accuracy of a bank's credit analysis and risk rating system (GAO 08-200, 2008). However, because hedge funds were exempt from regulation, the OCC was without authority to limit the activity and enforce its recommendations, although it did report its findings to Congress.

Additionally, the OCC has had to grapple with an outdated regulatory system unable to meet the challenge of new banking products and technology that creates a regulation gap. The problem is complicated by externalities in the global marketplace. Specifically, the 1988 Basel Accord, Basel I, established a framework for risk-based capital adequacy standards for the largest banks which was adopted by most banking regulators around the world. The federal regulatory agencies promulgated rules based on Basel I and applied these rules to all U.S. insured depository institutions. Although Basel I facilitated raising capital levels across the banking industry, it became increasingly apparent to the regulators that there were growing weaknesses in Basel I. The relatively simple framework for risk assessment under Basel I became incompatible with the increased scope and complexity of the banking activities of the largest banking institutions. Simply, the risk-weighting mechanisms of Basel I bore little resemblance to the complex risk profiles and risk management strategies that larger banks were capable of pursuing. This misspecification of risk under Basel I created inappropriate incentives and arbitrage opportunities that undercut supervisory objectives. The OCC found it was dealing with outdated and mismatched regulatory requirements, also costly to the banks being regulated (Dugan, 2006).

In response to these issues, the Basel Committee revised its strategy and selected a more risk-sensitive capital assessment approach, resulting in the publication of the Basel II Framework. The advanced approach of the Basel II Framework ameliorated the problem by implementing both an advanced internal ratings-based approach (IRB) for credit risk and the advanced measurement approach (AMA) for operational risk. The Basel II Framework continues to undergo global refinements.

However, in terms of evaluating regulatory performance, the perceived regulatory culprit here is the OTS and its punishment was dissolution and merger under the Reform Act. The GAO issued numerous reports highly critical of OTS' failure to remediate known internal weaknesses in several of the financial institutions which collapsed, including Washington Mutual Bank (WaMu). The IG followed with a scathing report on IndyMac Bank, FSB. The IndyMac crisis is perhaps the clearest case of failed regulatory oversight where the federal regulator simply did not do its job. The Material Loss Review of OTS conducted by the Inspector General revealed that "OTS's supervision of IndyMac failed to prevent a material loss to the Deposit Insurance Fund. Though OTS conducted regular examinations of the thrift, OTS examiners did not identify or sufficiently address the core weaknesses that ultimately caused the thrift to fail until it was too late -- causes such as aggressive growth without sufficient controls, poor loan underwriting, and reliance on volatile funding sources and FHLB advances. Even when examiners identified problems, OTS did not always report these to the thrift in the Reports of Examination" (OIG-09-0302, 2009). After successive blistering assessments such as this, many commentators predicted that the demise of OTS was inevitable.

The OIG audits point to OTS' failed strategy to resolve major institutional weaknesses through informal measures aimed at promoting self-regulation and self-remediation of the problems as the major defect in its regulatory approach. As noted above, informal resolution did not provide OTS an opportunity to enforce its recommendations when the financial institutions, focused on profitability and competition, failed to undertake the suggested remediation and ultimately failed.

### Reform Act remediation

The OTS was merged into the OCC by the Reform Act (Subtitle C, Section 1202). Now, the OCC is in the process of absorbing the OTS function into its own agency. The contours of the new OCC plan for regulatory supervision are in process.

## CONCLUSION: BEST PRACTICES

As a preliminary observation, the data indicates that some of the federal regulatory agencies do better than others in achieving credible regulatory oversight. The failure in detecting gross corporate misconduct appears to be, at least in part, a failure of adequate supervision as opposed to an inadequate arsenal of rules to enable the agencies to act, with some exceptions as in the cases of unregulated derivatives and hedge funds. Thus, more stringent rules are not needed to fix most of the problems where the rules already exist. However, in an area like derivatives where there are no rules at all, additional regulation is critical. Likewise, the now outdated regulatory infrastructure has simply failed to keep pace with financial product innovations.

The Financial Crisis Inquiry Commission Report provides a more scathing assessment of the current failure of credible regulatory oversight: "We conclude widespread failures in financial regulation and supervision proved devastating to the stability of the nation's financial markets. The sentries were not at their posts, in no small part due to the widely accepted faith in the self-correcting nature of the markets and the ability of financial institutions to effectively police themselves. More than 30 years of deregulation and reliance on self-regulation by financial institutions, championed by former Federal Reserve chairman Alan Greenspan and others, supported by successive administrations and Congresses, and actively pushed by the powerful financial industry at every turn, had stripped away key safeguards, which could have helped avoid catastrophe. This approach had opened up gaps in oversight of critical areas with trillions of dollars at risk, such as the shadow banking system and over-the-counter derivatives markets. In addition, the government permitted financial firms to pick their preferred regulators in what became a race to the weakest supervisor" (FCIC Report, 2011 at xviii).

In large measure, the FCIC attack is focused upon the model of self-regulation which is the legislative bedrock of the securities markets and the banking industry. While it is unlikely that the infrastructure grounded in self-regulation will change anytime soon, the most effective step may be to close regulatory gaps, intentionally left open by law makers, which have been repeatedly identified over at least the last decade.

As one commentator put it, the FCIC is perhaps too late and adds nothing to what has already been known for quite some time (Wagner and Gordon, 2011). There may be some merit to that assessment as the GAO has reported since at least January, 2009 that the "existing regulatory system failed to adequately address problems associated with less-regulated entities that played significant roles in the U.S. Financial System" (GAO Report- 09-216, 2009). The message could likewise not have been missed in the testimony of then CFTC Chair Born before Congress in 1999 that the failure to regulate the "black box" derivatives market was like leaving a ticking time bomb in the marketplace.

In short, it is fair to conclude that law makers, regulators and the private sector, ostensibly in partnership with the regulators, must all accept responsibility for the current state of the financial markets. However, this should not become just an exercise in assessing blame. Instead, the goal should be to focus on accountability for the failure of the regulatory system to identify systemic risk. The Reform Act, like SOX before it, is reactive legislation enacted not only to solve this nagging problem of achieving financial stability in the marketplace but also to send a remedial message in the hope of coaxing "gun-shy" investors back into the markets.

While the regulatory agencies are now facing the task of implementing regulations under the Reform Act, this article suggests some "best practices" guidelines to be followed in drafting regulations designed to ameliorate the problems. First, the regulations should include clearly defined regulatory goals. Clarity and focus permits the regulators to carry out their assigned tasks and allows for greater agency accountability. Second, the regulations need to be comprehensive in the sense that they should cover those activities that pose risk. That also requires providing standards of risk based criteria for determining the appropriate level of oversight for financial activities. Not all financial activities or entities require the same level of supervision. Accordingly, the criteria cannot be a "one size fits all" approach to risk assessment.

Further, in order to address the outdated regulatory infrastructure currently in place, some flexibility needs to be given to regulators to enable a quick response to market product innovation and changes. At the same time, regulators should be obliged to work in partnership with the financial industry to take into account the need for innovation and growth.

Fourth, consumer and investor protection should be made an important part of the regulatory mission. It is not enough to worry about growth and innovation in the marketplace. Due consideration must be given to the protection of the investing public prone to being victimized by the conduct and then having to pay for the consequences.

Regulatory independence is a more difficult goal both to define and to achieve through regulation. As this article has illustrated, outside externalities directly impact the probability of regulatory oversight success. Curing the "too big to fail" phenomenon by requiring mandatory entity registration and reporting and forcing transparency into black box markets like derivatives and hedge funds should contribute to the ability of regulators to overcome previous roadblocks, even those roadblocks created by their own questionable wisdom.

Finally, the real key to credible oversight is predictability in supervision and enforcement. Each regulatory agency must at least do the job that the law requires them to do over a consistent period of time. The regulators need to implement available safeguards to prevent systemic crises to minimize the opportunity for moral hazard and those safeguards must be enforced with regularity.

> And then there is the advice of Mark Twain: "What we need now is not more rules, what we need is sanity."

## EDITORS' NOTE

Due to space limitations, the Editors' were unable to include a number of highly detailed Appendices which expand on the *Statutory Creation, Oversight and Rulemaking Authority, Oversight Rules, Stated Regulatory Philosophy, Judicial Interpretation of Agency's Regulatory Authority, Congressional Hearings, Inspector General Reports*, and *Media Accounts* for each of the seven Federal Agencies examined in this manuscript. We encourage interested readers to contact the Author to obtain copies of these Appendices.

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# EXPORT CONTROL POLICY INITIATIVES UNDER THE OBAMA ADMINISTRATION

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## ABSTRACT

*The primary international framework for export controls of weapons and associated technology is the Wassenaar Arrangement by which participating countries agreed to maintain export controls on listed items as implemented by national legislation. In the United States, the agencies responsible for implementing and managing export control laws are the Department of State through its International Traffic in Arms Regulations and the Department of Commerce through its Export Administration Regulations. The goal of the export control system is to deny adversaries access to defense technology while ensuring cooperation with allies and coalition partners, and scrutinizing potential defense exports for their effect on regional stability. While predictably export licenses are required for the traditional transfer of defense and dual-use (civilian and military) articles, less intuitive is the fact that licenses also are required for the disclosure of technical data to foreign nationals in the United States or abroad. The U.S. regulations also control re-exports of defense and dual-use items. For example, if technical data is exported to a U.S. subsidiary in Germany, and that technology is shared in Germany with a foreign national from China, who works for the subsidiary, then a subsequent license for that disclosure of data might be needed, depending upon its classification.*

*Restrictions on the sharing of research results and collaboration among scientists world-wide actually may undermine critical security goals by thwarting the collaboration needed for high-tech scientific advancements in both university research programs and industries. The Department of Commerce under President Obama proposes 1) to revise the deemed export regulations to validate foreign end-users in order to encourage collaborative exchange, 2) to develop a process for systematic review of the list of controlled dual-use items, 3) to revise controls on encryption products, and 4) to review re-export controls.*

*This paper examines the complexity of the pre-Obama regulations which thwarted compliance efforts, frustrated technological developments and hindered cooperation among global partners. It also analyzes proposed changes to that policy, which are designed to enhance innovation, realize global economic gains, and facilitate trade to reliable foreign customers, while concurrently denying access to sensitive technologies to proliferators, international terrorists, and other foreign parties acting contrary to policy interests of the United States and its allies.*

## EXPORT CONTROLS GENERALLY

Formal international and domestic export restrictions for both weaponry and technology with the potential for military applications have been in place for decades (Swan, 1993). The United States is a party to several multilateral nonproliferation regimes (Luo, 2007), such as the:

- *Nuclear Suppliers Group*---39 member states seeking to curb the proliferation of nuclear weapons through the implementation of guidelines to control nuclear and nuclear-related exports,
- *Missile Technology Control Regime*---34 partners applying a common export policy to a common list of controlled items, including all key equipment and technology needed for missile development, production, and operation, and
- *The Australia Group*---38 participating countries agreeing though their export policies to thwart the acquisition of chemical and/or biological weapons by certain states and terrorists desiring that capability.

However, the primary international framework for controlling the export of technology with military application is the Wassenaar Arrangement ("WA"). The WA is an association of forty participating states established in 1996 to:

- Contribute to regional and international security and stability,
- Promote transparency and greater responsibility in transfers of conventional arms and dual-use goods and technologies,
- Complement and reinforce the existing control regimes for weapons of mass destruction and their delivery systems and
- Use export controls as a means to combat terrorism.

While the decision to transfer or deny transfer of any item is the responsibility of participating states, they agreed to:

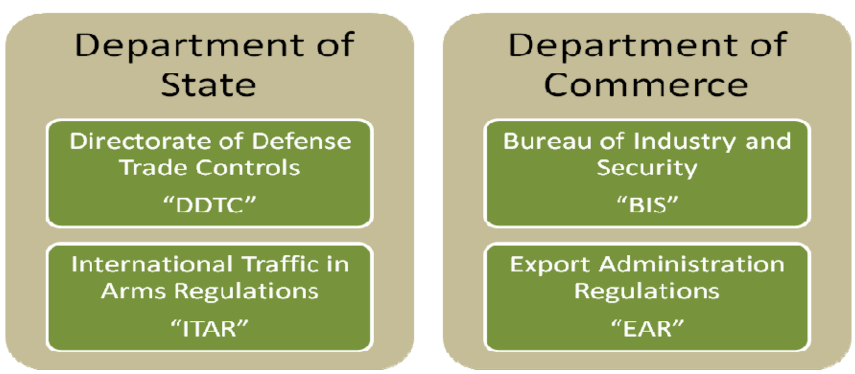
- Maintain national export controls on listed items as implemented by national legislation,
- Be guided by agreed upon best practices, guidelines or elements as established by the WA,
- Report on transfers and denials of specified controlled items to destinations outside the WA, and
- Exchange information on sensitive dual-use goods and technologies.

The WA is the successor to the former Coordinating Committee on Export Controls ("CoCom") the export control regime of the Cold War Era which disbanded after the fall of the Soviet Union. In light of new risks to regional and international security and stability, which involved not only conventional weapons but also dual-use technologies, former members of CoCom began exploring the feasibility of establishing a new multilateral arrangement, which eventually culminated in the WA (Durshy, 1997). Unlike CoCom, which required the review and approval of restricted exports, the Wassenaar Arrangement defers such a judgment to the participating states, and arguably is less effective as a result (Badway, 2005; Klaus, 2003). While these international accords collectively strive to impede the availability to rogue states and terrorists of weapons, as well as technology with potential military applications, this goal cannot be accomplished without vigilance being exercised independently by individual nations.

The control of arms sales to foreign parties is an integral part of the ability of the United States and its allies to safeguard national security and further foreign policy objectives (Dhooge, 1999). While the U.S. government historically has treated the enforcement of international trade and security restrictions seriously, the war on terrorism, coupled with the strengthening and commensurate enforcement of corporate ethics and liability laws, are responsible for an increased intensity of monitoring efforts. Federal regulations, which are enforced by federal agencies, specify the covered items and services which must be licensed for export, provide key definitions, such as what constitutes an export, and enumerate what transfers are exempt from licensing requirements (Liebman & Lombardo, 2006; Doornaert, 2005; Meagher, 2002).

## FEDERAL REGULATIONS AND OVERSIGHT

The primary agencies responsible for implementing and managing the current export control laws, which apply to the transfer of physical items, information, and services, are the Department of State through its International Traffic in Arms Regulations ("ITAR") administered by its Directorate of Defense Trade Controls ("DDTC"), and the Department of Commerce through its Export Administration Regulations ("EAR"), administered by its Bureau of Industry and Security ("BIS").



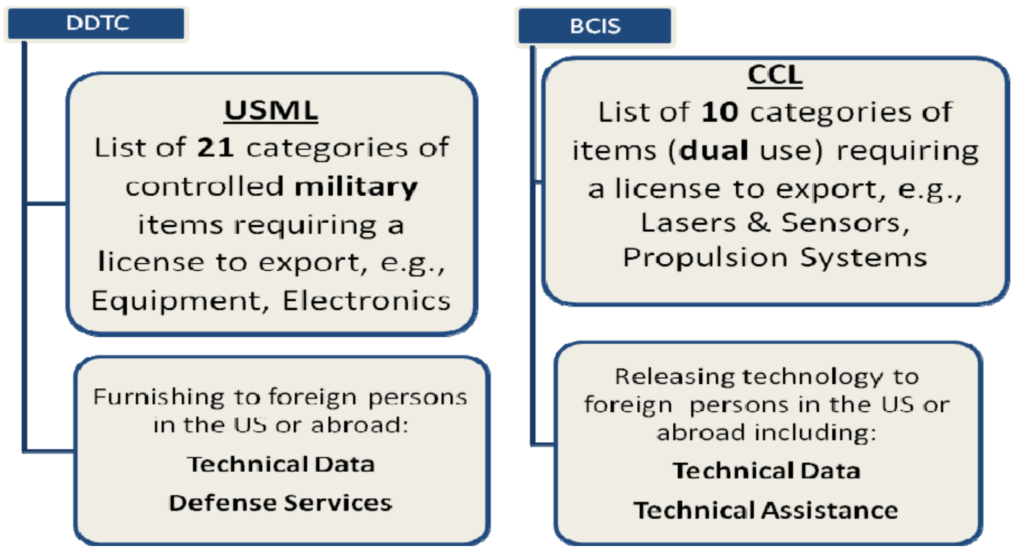
The ITAR primarily address the importation and exportation of defense related trade and technology transfers (22 C.F.R. §§ 120-133 & Supplements, 2010). The DDTC oversees the United States Munitions List ("USML"), a list of controlled items, which require a license prior to exportation. Since it is the technology that necessitates control, the inclusion of an item on the list is based upon the capability of the product to be used for military purposes, and not whether or not the intended use of the article after export is for military or civilian purposes. For example, brake pads on a M1A1 tank under current rules are subject to restrictions, even though they are almost identical to pads for fire trucks that can be exported without a license.

The USML is similar to the control lists of other significant arms exporting countries, but it also contains some items that other countries do not generally control as defense articles, such as commercial communications satellites, their parts, components and technology. The twenty-one categories items on the USML are inherently military in character, and include equipment, software, and military electronics, as well as chemical and biological agents. There is also a catch-all category, *Miscellaneous Articles,* for items that are not specifically enumerated in the other categories, but which have substantial military application and have been designed or modified for military purposes, including technical data and defense services that are directly related to the defense articles listed.

Although the decision to place a category of items on the USML is not subject to judicial review, courts are not necessarily prohibited from considering whether or not a particular item properly falls within a category of items designated by the USML (United States v. Pulungan, 2009). And while all prohibited items may not be named with complete specificity, the statute and its implementing regulations, with their scienter requirement, have withstood Constitutional challenges for vagueness (United States v. Lee, 1999; United States v. Sun, 2002; United States v. You-Tsai Hsu, 2004).

Unlike the ITAR, which only regulates articles, technology and services related to defense, the EAR are concerned with *dual use* items (15 C.F.R. §§ 730-744 & Supplements, 2010). Dual use items are goods and technology, which are primarily commercial and not military in nature, but which may have a dual militaristic use, such as mirror lasers (United States v. Spawr Optical Research, Inc., 1988). One of the more controversial of the regulations concerns encryption software, and was challenged unsuccessfully on First Amendment grounds as an unconstitutional infringement of free speech (Crain, 1999).

Comparable to the USML, the EAR provide a list of items and technology subject to control, the *Commerce Control List* ("CCL"), which BIS administers along with the licensing program. Items on the CCL are given a number based on their category and product group, which describes the particular item or type of item, and shows the controls placed on that item. This number along with the country to which the item is to be exported determines whether or not a license is needed for exportation. Like the ITAR, the EAR also have a catch-all category, EAR99, under which the item may not require a license, depending on its use. For example, bullet-proof windshield glass exported separately from a vehicle is on the CCL if it is for vehicles designed or modified for non-combat military use, but it is classified as EAR99 if it is for civil automobiles designed for the transportation of passengers and marketed through civilian channels.




Both the EAR and the ITAR necessarily are concerned with end use and end users, that is, with persons abroad who receive and ultimately use the exported or re-exported items. BIS's Office of Export Enforcement investigates end-users of controlled commodities to determine compliance with license conditions. To this end, BIS maintains several lists of prohibited parties that should be consulted, such as the *Denied Persons List*, consisting of parties denied export privileges, and the *Unverified List*, including names and countries of foreign persons previously parties to a transaction to which BIS could not conduct a pre-license check or a post-shipment verification.

The DDTC monitors the end use of defense articles and defense services, and if the end user is located in select countries (e.g., Cuba, Iran, Libya, North Korea, Syria) the license application will be denied. DDTC's Blue Lantern Program monitors the end-use of commercially exported defense articles, services, and related technical data subject to licensing in an effort to deter diversions to unauthorized end-users, to aid in the disruption of illicit supply networks, to make informed licensing decisions, and to ensure compliance. Persons engaged in the business of brokering activities with respect to the manufacture, export, import, or transfer of USML articles and services also are subject to registration and licensing requirements (Keppler, 2001).

The maintenance of compliance programs by exporters is essential in order to insure, not only that their exports are properly licensed, but also that controlled items, technologies and software are not diverted to prohibited end users or end uses. Risk assessment plans are particularly essential for entities involved in the defense trade or its support services because a failure to obtain the appropriate license can result in the loss of exporting privileges, debarment from government contracts, and substantial criminal penalties, as well (Dunn, 2005). Companies such as Lockheed Martin, Boeing, ITT Corporation and Northrop Grumman Corporation each have paid millions of dollars to settle alleged violations of export controls (Joiner & Joye, 2008).

One high profile criminal case involved plasma physicist J. Reece Roth, a retired 70-year-old University of Tennessee professor, who was convicted of eight counts of conspiracy, fraud and violating the Arms Export Control Act for exporting controlled technical data (Johnson, 2008). Roth had worked on U.S. Air Force contracts with a Knoxville technology company, Atmospheric Glow Technologies, to develop plasma-based guidance systems for unmanned surveillance vehicles (drones). Roth improperly shared sensitive information with his students from China and Iran, traveled overseas with electronic versions of that material on his computer, and had one report e-mailed to him in China through a Chinese professor's Internet connection. He was sentenced to four years in prison and two years probation. On appeal, Roth argued that the jury should have been instructed that he could only be convicted if he was aware that the controlled technology was on the USML. The Sixth Circuit rejected this contention and held that the lower court properly instructed the jury that Roth could be convicted if he was aware that his conduct was unlawful (United States v. Roth, 2011).

In criminal proceedings, such as Roth’s case, the government will usually consider whether or not there was a deliberate effort to conceal the violation in determining a settlement amount or penalty, along with the provision of any useful information during the audit, investigation, or penalty proceeding (Wray & Hur, 2006). Also, to deter fraudulent corporate restructuring to avoid prosecution, the doctrine of successor liability applies in some situations to hold corporate asset purchasers liable for past violations of export control regulations by the asset seller (Fellmeth, 2006). The administrative determination of sanctions is usually final, as there is limited judicial review of the imposition of civil penalties and the denial of export privileges (Pinkert & Blanford, 2001).

## THE MECHANICS OF EXPORT CONTROL REGULATIONS

Under the ITAR, *export* is defined as 1) sending or taking a defense article out of the United States in any manner, 2) transferring registration, control or ownership, 3) disclosing (including oral or visual disclosure) or transferring technical data to a foreign person, whether in the United States or abroad, or 4) performing a defense service for a foreign person, whether in the United States or abroad. Thus, in addition to the physical exportation of a defense article, the ITAR cover the performance of a defense service, such as furnishing of assistance or training to foreign persons either abroad or in the United States, or the provision of controlled *technical data* to foreign persons either abroad or in the United States. Technical data includes classified information relating to defense articles, certain software, as well as information required for the design, manufacture, repair, testing, or modification, for example, of defense articles.

Under the EAR, export means an actual shipment or transmission of items out of the United States, as well as the release of controlled technology or software to a foreign national in the United States. The release of technology or software can occur through visual inspection by foreign nationals of equipment and facilities, oral exchanges of information in the United States or abroad, or the application of personal knowledge or technical experience acquired in the United States to situations abroad. Technology is defined as the specific information necessary for the development, production, or use of a product, and can include the embodiment of that information (such as blueprints, plans, diagrams, models, formulae, specifications, etc.), as well as *technical assistance* (for example, instruction, skills training, working knowledge, consulting services) by which technical data is transferred.

In addition to requiring a license for the original exportation of technical data, the ITAR also prohibit the *re-export* of technical data without DDTC approval, defined as transferring defense articles or defense services to an end use, end user or destination not previously authorized under the license. The EAR also control re-exports of items, technology and software subject to the EAR's licensing requirements, defined as actually shipping or transmitting controlled items from one foreign country to another foreign country, or releasing technology or software subject to the EAR to a foreign national outside the United States. For example, if controlled technical data, e.g., a blue-print, is released to a foreign national (e.g., Chinese national) working overseas, who is not a national of the country for which the release of the information has been obtained (e.g., Germany), under the re-export rules, another license would be required before the foreign national may access the controlled technology in that country to which the information was legally exported (Germany).

While predictably export licenses are required for the actual transfer of defense articles, less intuitive is the fact that licenses are also required under the ITAR and the EAR for the disclosure of technical data to a foreign person, or for the performance of a defense service for a foreign person in the United States, under the *deemed export* rule, which treats the disclosure of controlled technical data to a foreign person (such as a foreign national engineer) in the course of the person's employment as an export, for which a license first must be obtained. For example, a foreign national witnessing any demonstration or briefing, or using controlled equipment in a corporate research laboratory constitutes a deemed export for which a license could be required (Rege, 2006). The deemed export rule is premised upon the assumption that ultimately the foreign national will return to the home country, and then the information will be *deemed* to be exported.

A foreign person means any natural person who is not a citizen, a lawful permanent resident (green card holder), a refugee or alien granted asylum, as well any foreign corporation, business association, partnership, trust, society or any other entity not incorporated or organized to do business in the United States. As such, the category includes lawfully admitted workers and students on approved visas. Full-time employees of U.S. institutions of higher learning, however, are exempt from ITAR licensing providing they are not foreign nationals of countries to which exports are prohibited (e.g., Belarus, Cuba, Iran, Libya, North Korea, Syria, Vietnam, Burma, China, Haiti, Liberia, Somalia, and Sudan).

Under the EAR, the license granted is not a blanket one, but rather only for the controlled technologies specified. If the foreign national's responsibilities should then require access to controlled technologies other than those authorized by the initial license, another export license application would be required. On the other hand, not all interactions by foreign nationals with EAR controlled items, technology and software will require a license. The deemed export rule does not regulate the operation of the controlled equipment by a foreign national, but rather the release of specific information to a foreign national of export-controlled *use* technology. The technology necessary merely to operate the export controlled equipment is not a release of *use* technology; therefore, no deemed export license is required.

| Export: ITAR | Export : EAR | Re-Export |
|---|---|---|
| • Sending or taking a defense article out of the U.S.<br>• Transferring registration, control or ownership<br>• Disclosing or transferring technical data to a foreign person ("DEEMED EXPORT"),<br>• Performing a defense service for a foreign person ("DEEMED EXPORT") | • Actual shipment or transmission of items outside the U.S<br>• Release of technology or software to a foreign national in the United States or abroad ("DEEMED EXPORT") | • **ITAR:** Transfer of defense articles or defense services to an end use, end user or destination not previously authorized ( *Deemed Re-Export*)<br>• **EAR:** Actual shipment or transmission of items from one foreign country to another foreign country; or release of technology or software to a foreign national outside the United States (*Deemed Re-Export*) |

The ITAR exempts certain transactions from the licensing requirement. For example, the *official use* and *foreign assistance* exemptions provide that a license is unnecessary for the temporary export of defense articles, including technical data or the performance of a defense service, for official use by a U.S. government department or agency, or for carrying out authorized foreign assistance or sales programs. This exemption was proffered unsuccessfully as a defense in the Iran-Contra controversy, which involved alleged covert governmental arms sales to Iran, for which no bill of lading was obtained from the government, in violation of export control laws (United States v. Durrani, 1987).

Another significant exception applies to technical data that is already in the *public domain*, which if not exempted from licensing requirements would raise significant policy issues concerning the government regulation of intellectual property (Lee, 2003). *Public domain* under the ITAR means information which is published *and* which is generally accessible or available to the public by one of several listed means, such as through, for example, at newsstands and bookstores, subscriptions, public libraries, patents, distributions at conferences, tradeshows or exhibitions accessible to the public, and *fundamental research* in science and engineering at accredited institutions of higher learning in the U.S. where the resulting information is ordinarily published and shared broadly in the scientific community. The public domain exemption, however, does not apply to actual shipments of USML items, which will always require a license. For example, the shipment of night vision devices without an export license to the People's Republic of China violates the law, even though such devices are readily available to the public in the United States (United States v. Wu, 1995).

More specifically, the ITAR distinguishes basic and applied research in science and engineering, which culminates in the results being published and shared broadly within the scientific community, from research, the results of which are restricted for proprietary reasons, or in accordance with specific U.S. government access and dissemination controls. In other words, if the research results are proprietary or subject to restrictions on dissemination, then a license is required for export, including, of course, disclosure to a foreign national as a deemed export. The regulations provide that university research will not be considered fundamental research (and exempt from licensing requirements), if the university or its researchers accept restrictions on the publication of scientific and technical information resulting from the project or activity, or if the research is funded by the government and specific access and dissemination controls protecting information apply. For example, if a laser manufacturer reviews research prior to publication in order to ensure that patent and other proprietary rights will not be compromised, or reserves the right to withhold publication if the results are undesirable, then the research no longer qualifies for the fundamental research exception under the ITAR (Rege, 2006). As such, if foreign nationals are working on the laser project, then export licenses must be obtained in order for pertinent technical data to be disclosed to them.

The EAR contain several exceptions to licensing requirements, as well. No license is required for the export of information that is public, or a part of the public domain, for example, published and generally accessible to the interested public in any form. Examples are similar to those in the ITAR and include information in periodicals, books, print, electronic, or any other media available for general distribution to any member of the public, information available at public libraries, patents and information released at open conferences, meetings, seminars, trade shows, or other open gatherings. Educational information used for instruction in catalog courses and associated teaching laboratories of academic institutions, as well as some publicly available educational technology and software, also may be considered information in the public domain, and not subject to licensing requirements.

There are many similarities between the EAR's exceptions and ITAR's exemptions, including an exception for fundamental research. In the ITAR fundamental research is included under the public domain exception, and is not a distinct category, as in the EAR. Fundamental research qualifying for this exception may occur at universities, federal agencies or in corporate settings. Fundamental research is defined under the EAR as basic and applied research in science and engineering, where the resulting information is ordinarily published and shared broadly within the scientific community, as distinguished from non-public research, the results of which would be restricted for proprietary or specific national security reasons. In contrast to the ITAR, the EAR permit limited prepublication review by a sponsor to insure that the publication would not inadvertently divulge proprietary information or to ensure that publication would not compromise patent rights.

University based research normally will be considered fundamental research unless the research results are subject to pre-publication review, but will not be considered fundamental research if the university or its researchers accept restrictions on publication of the information resulting from the project or activity. Similarly, research conducted by scientists or engineers in a business setting will be considered fundamental research so long as the researchers are free to make the scientific and technical research results publicly available without restrictions based upon proprietary concerns or national security controls. In sum, as long as research results are not shielded from public access in either the university or corporate setting, it will not be subject to the EAR's licensing requirements, and foreign national employees need not be licensed prior to the release of such information to them. On the other hand, much research in business will be of a proprietary nature, and thus subject to licensing requirements. Foreign national employees engaged in such endeavors would be subject to deemed export license requirements.

**ITAR EXEMPTIONS**

- **Fundamental Research :** the results are not proprietary & there is no restriction on access or its dissemination
- **Official use:** the temporary export of defense articles, including technical data or the performance of a defense service, for official use by U.S. government
- **Public domain:** information which is published *and* which is generally accessible or available to the public (applies to *technical data*, not to items such as firearms on the Munitions List)

**EAR EXEMPTIONS**

- **Public information:** includes ***fundamental research*** if it is a part of the public domain, e.g., published and generally accessible to the interested public in any form
- **Fundamental research:** to qualify for the exemption, results cannot be shielded from public access or of a proprietary nature. Researchers may NOT accept restrictions on publication of scientific and technical information resulting from the project or activity (no pre-publication review)

## CRITICISMS OF THE EXPORT CONTROL SYSTEMS

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; Damast, 2010). 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; Sundahl, 2010 ).

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 has reduced the market share of U.S. manufacturers of satellites and their component parts, while countries of concern continue to obtain and develop satellites and launching capabilities despite these licensing requirements (Allen, 2010).

Moreover, evidence suggests that exporters fail to comply with the regulations, particularly deemed export licensing requirements. Consider that 53.4% of the approved applications for HB-1 visas in 2009 were for employment in computer-related occupations and occupations in architecture, engineering, and surveying. Most of the beneficiaries of these visas that year were from India (48.1%) and China (9.7%), with HB-1 visas either initially approved or continued for 20,855 Chinese nationals. Yet in 2009 BIS only granted 750 deemed export licenses for Chinese nationals. These statistics seem somewhat inconsistent, unless an overwhelming number of the individuals employed are either working in non-technical, non-scientific areas (which is unlikely since educational qualifications or specific expertise is required for the visa), or they are working on materials subject to the fundamental research or public domain exceptions to the regulations. Another plausible explanation, however, could be that employers simply do not comply with the licensing requirements, which necessarily undermines the goal of advancing national security through the protection of sensitive technology.

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).

However, instead of initiating policy designed to compete more aggressively in the market for foreign talent, the Department of Commerce considered revising its policy to expand the coverage of application requirements for deemed export licenses. In 2005 BIS sought comment in a proposed rulemaking that would have impacted deemed export applications by changing the definition of the *use* of technology to include operation aspects, and to require a license of foreign nationals who operate controlled equipment, if the export of the equipment to their country of citizenship would require a license, even if the foreign national was engaged in fundamental research, which is exempt. Because of a record number of comments concerning the potential adverse effect these changes would have on the ability to recruit and retain foreign students and researchers vital to the success of U.S. based research programs, BIS suspended the rulemaking process and formed the *Deemed Export Advisory Committee* to evaluate the proposal and make recommendations to the Secretary of Commerce.

The Advisory Committee issued its report in December 2007, rejected the proposed rule, and recommended instead an overall revamping of the deemed export regulatory regime. The report acknowledged that academic and industrial organizations appeared either to be unaware of the rules or successfully conducted their affairs without being in compliance. It endorsed the establishment of a category of *Trusted Entities* involving both academia and industry, which could voluntarily elect to qualify for special, streamlined treatment in the processing of deemed export license applications by meeting specified criteria. It also urged that the deemed export regulations be more targeted to identify the critical aspects of technologies that could produce truly major threats, while protecting contemporary, pivotal technological breakthroughs. In addition to its general recommendations, the Advisory Committee proposed a 7-step decision process for the employment of persons working with controlled technology or data, which still may be too restrictive for industry and academia to be able to hire and collaborate with foreign nationals (Templin, 2009).

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 (Mancuso, 2008). 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).

## RECENT REFORMS AND INITIATIVES

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 (General Electric India) that have VEU status. In practice, the VEU program in China has had problems with establishing clear and transparent procedures for VEU-specific end-use checks, in conjunction with a commensurate need for a more thorough VEU authorization process (Feldman, 2010-11).

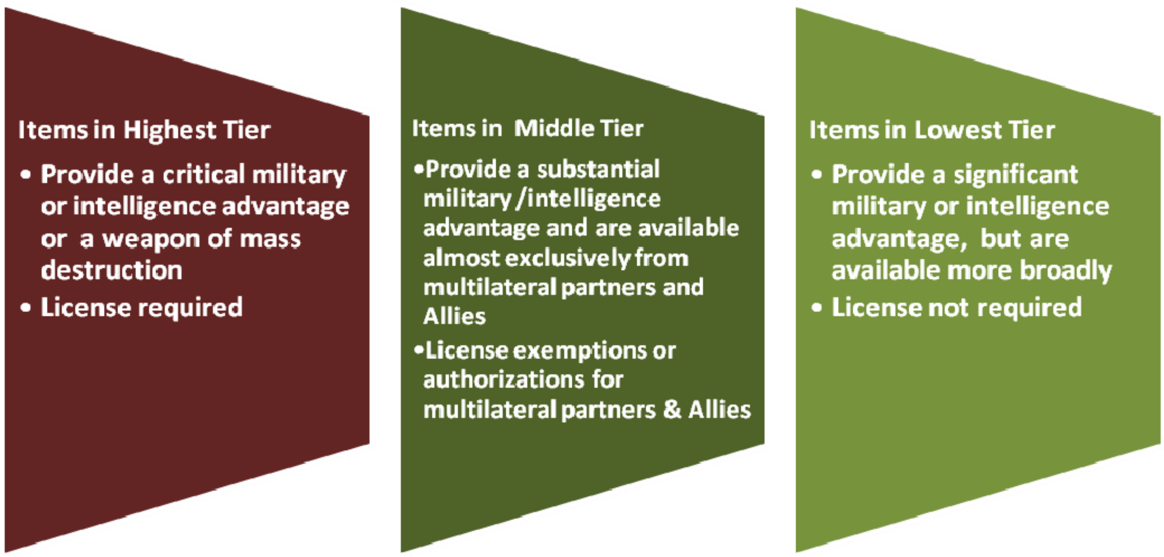
Also in response to the December 2007 Report of the Task Force, BIS established the Emerging Technologies and Research Technical Advisory Committee, the membership of which represented research universities, federal laboratories and relevant industries, to advise on regulatory reforms dealing with deemed exports and related issues. On January 22, 2008, President Bush signed Nation Security Presidential Directive 56, which mandated a series of reforms in the way defense trade is executed by the executive branch to enhance transparency, timeliness and predictability for industry, which included process and management improvements. For example, the Administration proposed a new intra-company transfer license exception, which would authorize companies with effective internal compliance systems to ship within their corporate families a wide range of products and technology for their internal use. This proposal was designed to simplify licensing issues, including deemed exports, for entities with global R&D and manufacturing operations, while concurrently permitting BIS to focus on transactions that pose a greater risk. Although the proposal is still pending, it is unlikely to ever take effect given the comprehensive reforms recently put forward by the Obama administration.

The Obama Administration seems committed to implement a wholesale systemic reformation of export controls in the hopes of streamlining and interjecting more rationality into this critical 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 the words of Secretary of Defense Robert Gates, “Tinkering around -- tinkering around the edges of the current system will not do” (Gates, 2010). 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 (President Obama Lays Foundation, 2010).

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.

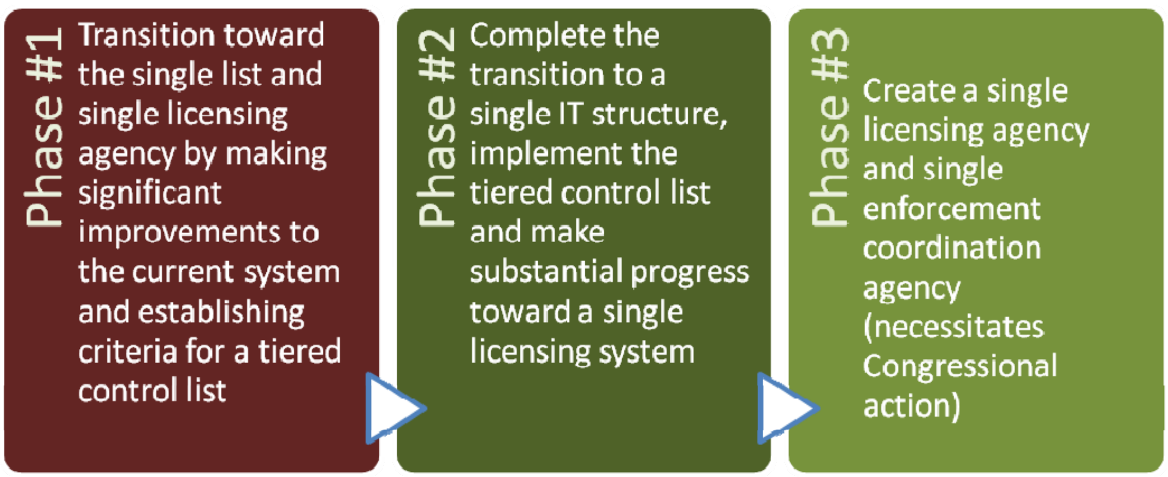
The President also proposed to transition all agencies to a single IT system, making it easier for exporters to seek licenses, and for the government to share all the data efficiently so as to make informed decisions. Currently, the Department of the Defense is using the system, the State Department will be added in early 2011 and the Department of Commerce should be on board later in 2011, with other agencies will follow (Gates, 2010). 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 (Hirschhorn, 2010).

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.

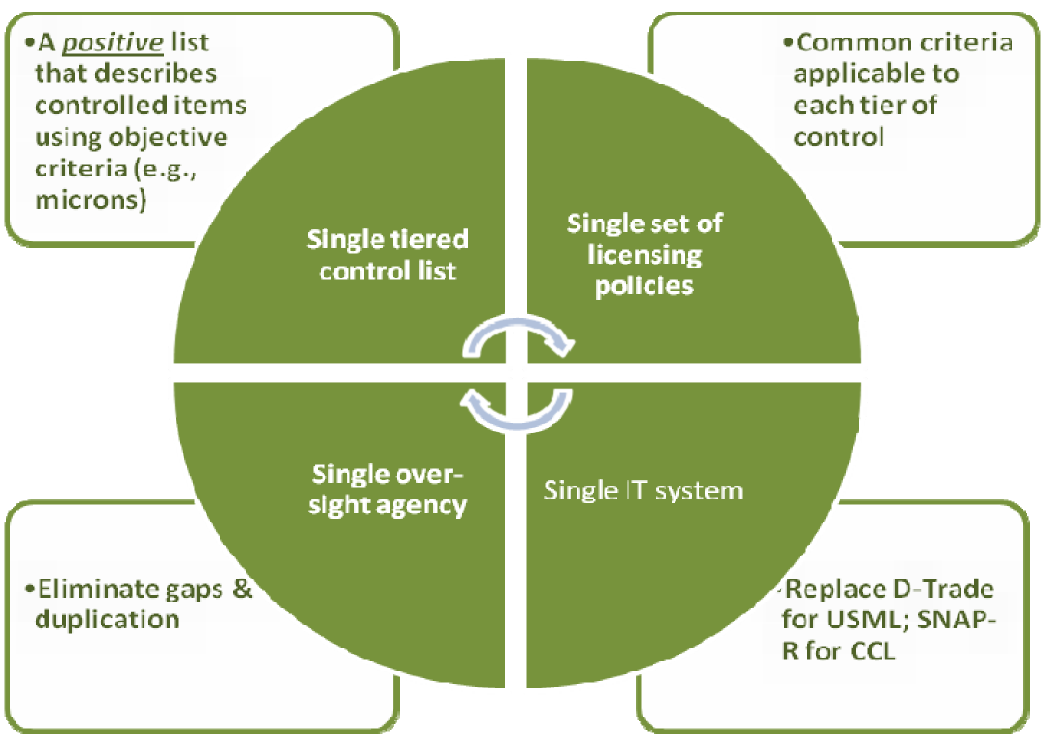



Obama's proposed reforms, while ambitious, are well-designed to reduce the jurisdictional disputes that lead to slower, confusing, and often contradictory licensing decisions (Spring, 2010). Likewise, they are better tailored to protect the items, technology and data that are most sensitive, while permitting 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 (Nichols & Ratnam, 2010).

The 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 (Palmer, 2010). Moreover, some military analysts note that the reform of the export control system is an exceedingly complex and multifaceted one, accompanied by a multitude of open questions and a decided lack of empirical data on the claims concerning our alleged antiquated, anti-competitive current system, which, given that the nation's security is arguably at stake, counsels a more conservative approach to reform than a radical approach (Burris, 2010).

There are also gaps in the recently proposed reforms, as well. For example, they do not specifically address the issues surrounding deemed export licenses; however, if more controlled items, technology and data are de-controlled, then there likely will be a concurrent reduction in the number of deemed export licenses required. Nevertheless, the Obama Administration is to be commended for recognizing that the export control system must be examined in a critical fashion with an eye toward a twenty-first century solution, which recognizes the increasing global importance of both India and China to strategic U.S. interests.

**Four Key Reforms**



## CONCLUSION

As the pace of technological progress accelerates exponentially, it is crucial that the U.S. and its Allies remain at the cutting edge of research and development. An efficient and effective system of export controls, which protect sensitive items, information and technology while allowing trade, collaboration, and technological advancement, is critical. The current regulatory system arguably undermines national security, and compromises competitiveness in scientific and engineering endeavors. Many of the reforms proposed by the Obama administration incorporate what critics and the Deemed Export Advisory Committee previously recommended: the consolidation of administration for the export control system into a single regulatory authority, and the development of a plan to build high walls around small fields, rather than around the entire U.S. scientific and technologic communities. While there are significant risks in a plan to consolidate governmental bureaucracies and their separate procedures and personnel, most notably, that nothing falls through the cracks during the phased transition, the risk of a failure to change is greater than the risk of change.

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# THE EFFECTS OF PERCEIVED LEGAL AND ECONOMIC FACTORS ON MANAGEMENT ACCOUNTANTS' COMPLIANCE WITH THEIR CODE OF ETHICS

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## ABSTRACT

*Management accountants are engaged in a struggle to gain acceptance as professionals within American Society. Management accountants have been largely insulated from liability concerns. One liability concern management accountants do potentially face is in connection with the required federal payroll withholding taxes. This study reviews that source of liability and tests its effect, along with economic factors, on management accountants' intent to follow their code of ethics. A within-subject experiment was conducted on members of local chapters of the Institute of Management Accountants. Each subject answered questions related to four scenarios depicting ethical conflicts. The scenarios differed on the combination of liability or no liability, and a favorable or unfavorable job market. The questions traced the course of action for resolution of an ethical conflict by the IMA Statement of Ethical Professional Practice. The results of this study indicate that the intention to follow the code is affected by both the liability aspect and the favorability of the job market. When liability is introduced, the code is more likely to be followed. When the job market becomes unfavorable the code is more likely to be followed in the early stages of resolution of the conflict, but less likely in the later stages and resignation from the organization becomes less likely. These results do not demonstrate the kind of ethical intentions which will gain the public's confidence. In addition, the results demonstrate the need for the ethics counseling services provided by the IMA to its members.*

## INTRODUCTION

Management accountants are engaged in a struggle to gain acceptance as professionals within American Society. A significant step taken in that direction was the adoption of Statement No. 1C, Standards of Ethical Conduct, by the National Association of Accountants (NAA, 1983). The NAA has since changed its name to the Institute of Management Accountants and their ethical code is now called the *Statement of Ethical Professional Practice.* Recognition of a responsibility to the public and the potential for legal liability are facts of professional life. Management accountants in the USA, however, have been largely insulated from liability concerns. Their liability had primarily stemmed from association with their companies' state and federal tax returns until passage of the Sarbanes-Oxley Act of 2002 which requires the Chief Executive Officer and Chief Financial Officer of publicly traded firms to certify in writing that their financial statements fairly represent the results of operations.

Recognition of the ethical principles which govern conduct is a widely accepted distinguishing mark of a profession (Custis, 1933). The public accounting profession in America achieved the status of a profession during the 20th century. This status is largely the result of the formulation, adherence to, and updating of its own code of ethics (AICPA, 2010). The public and business community have noted these actions, and now regard Certified Public Accountants as professionals. Management accountants must continue to follow the same course of action.

A professional code of ethics is a voluntary assumption of self-discipline above and beyond the requirement of law (Carey and Doherty, 1966). In order to gain acceptance as a profession, management accountants must not only adopt a code of ethics, but must also demonstrate a willingness to adhere to a level of practice which calls for actions which are based on ethical principles rather than on potential liability. By behaving in a way consistent with their code of ethics, professionals earn the public's trust.

This study examines: (1) the requirements in the *Statement of Ethical Professional Practice* for resolution of an ethical conflict, (2) the legal liability of management accountants regarding their companies' federal tax returns, (3) the moral decision process, and (4) ethical bases used for making decisions. A survey instrument using four different scenarios was designed to test the effect of potential legal liability and a situational factor (the favorability of the job market) on the intent of management accountants to follow their code of ethics.

## RESOLUTION OF AN ETHICAL CONFLICT

In the *Statement of Ethical Professional Practice* the procedures for the resolution of a significant ethical conflict are outlined in broad terms. The first step is to follow established policies of the organization toward the resolution of the conflict. Should these procedures not resolve the ethical conflict, the management accountant should consider the following courses of action (IMA, 2010):

> Discuss with the immediate supervisor except when it appears the supervisor is involved. In that case, present the issue to the next level. If still unresolved, submit to the next management level. If the supervisor is the CEO or equivalent, the acceptable reviewing authority may be the audit committee, executive committee, board of directors, board of trustees or owners. Contact with higher levels should be initiated only with the supervisor's knowledge, assuming they are not involved. Communication outside the organization is not appropriate unless you believe there is a clear violation of law.

Clarify relevant ethical issues by initiating a confidential discussion with an IMA ethics counselor or impartial advisor to better understand possible courses of action.

Consult your own attorney as to the legal obligations and rights concerning the ethical conflict.

## LEGAL LIABILITY OF MANAGEMENT ACCOUNTANTS

Management accountants generally are not subject to legal liability in association with their firm's financial statements and tax returns. A new source of legal liability arose under the Sarbanes-Oxley Act of 2002. Those management accountants who rise to the level of CEO or CFO within their firms face possible jail time for signing off on financial statements known to be false. This paper focuses, however, on the more traditional source of legal liability for management accountants—taxes. Management accountants who rise to the level of controller are subject to liability concerns regarding the payroll tax returns they are required to file and sign.

### Statutory Tax Requirements

Employers have a duty under the withholding system established by Internal Revenue Code Section 3401 to collect both income and Federal Insurance Contribution Act (FICA) taxes from their employees. Sums collected for these employment taxes are commonly referred to as "trust funds" because Internal Revenue Code Section 7501(a) provides that they are deemed to be a "special fund held in trust for the United States."

Once net wages are paid to the employee, the taxes withheld are credited to the employee regardless of whether they are later actually paid by the employer. Employers who fail to pay taxes withheld from their employees' wages are liable, under Internal Revenue Code Section 3403, for the taxes which should have been paid. The officer or employee of a corporation who is responsible for the collection of employment taxes from the pay due an employee may be assessed a penalty equal to the amount of the taxes if he willfully fails to account for and pay over the amount due to the United States.

Internal Revenue Code Section 6672(a) provides in part that:

> "Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat such tax or the payment thereof shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded or not collected, or not accounted for and paid over…"

Thus, a controller may be deemed to be the person responsible for the collection and payment of withholding taxes if he has authority to direct the payment of corporate funds. Furthermore, in order to be liable, his failure to comply with the statute must be willful.

**The Hochstein Case**

In *Hochstein v. United States* (1990), Hochstein was the controller of a manufacturing business. The issue was whether he was a responsible person under IRC section 6672 and would be held personally liable for tax payments that his former employer failed to make. He was not a shareholder, director or an officer of the company at any time. His responsibility as controller was to oversee the finances of the corporation, including the preparation of the payroll and the filing of the payroll tax returns. The company experienced severe financial problems and entered into a financing agreement to secure operating funds. Hochstein had no input into the decision to enter into the agreement nor did he negotiate it. Hochstein, however, was the one who dealt directly with the finance company in requesting the funds.

As the financial condition of the company deteriorated, the finance company refused to fund continuing operations. During the liquidation period the work force was greatly reduced and Hochstein could only secure enough money from the finance company to cover net wages. The withholding payments were not made from the fourth week in January, 1981 until operations ceased in the second week of May, 1981.

Hochstein was held liable for the failure to make the withholding tax payments. He was deemed to be a "responsible person" because he did exercise significant control over the company's finances: he had check-signing authority, made initial determination of the order in which large bills were paid, and had the discretion to pay smaller bills. His actions were willful violations, because the court suggested that his duty in the situation was to prorate the available funds between the Government and the employees.

**The Hanshaw Case**

In *Hanshaw v. United States* (1988), the controller of a coal mining company was held liable for civil penalties under Internal Revenue Code section 6672. The issue was whether the IRS could meet its burden of proof that Hanshaw was in fact a "responsible person" under section 6672 even though Hanshaw was not an officer or director and whether Hanshaw could meet his burden of proof that he lacked "willfulness" necessary to be held liable under section 6672. The company failed to remit the withholding taxes when experiencing financial difficulties prior to its ultimate collapse. Other operating expenses and creditors were paid during this time. Hanshaw alone managed the financial side of the operations and prepared and signed the state and federal tax returns.

The Bankruptcy Court held that he was a "responsible person" because of his position in the corporate structure. Hanshaw argued that his superiors ordered him not to make the required withholding payments, and he was therefore not responsible. He also argued that his action was not willful because he would have been fired if he had disobeyed orders. The court rejected these arguments, ruling that the fact that he might have been fired does not make him any less responsible for the payment of the taxes.

## THE MORAL JUDGMENT PROCESS

### The Kohlberg Model

The most widely recognized researcher in the area of moral development is Lawrence Kohlberg, who identified six successive stages of moral development (Kohlberg, 1984). These six stages are categorizations of individual thinking in making moral judgments. The motivation behind the judgments varies from stage to stage. Kohlberg grouped his stages into three levels.

The first two stages are referred to as the preconventional level. The motives at this level are fear of punishment or of authorities and self-gratification. The next two stages are the conventional level. Motives here include approval from others and adherence to moral codes or codes of law. The final two stages are referred to the principled level. The motives here are a concern for others, a concern for broader social welfare, and finally a concern for moral principle. In the last stage individuals are aware of a variety of values and are motivated to do what is right simply for the sake of doing what is right.

### The Rest Model

James Rest has also contributed significantly to research dealing with the moral decision process. Rest (1979) views the process as having four major components and refines Kohlberg's stage concept. He focuses, rather, on the conditions under which a way of thinking is demonstrated and to what extent it is demonstrated.

The first component of the moral decision process is to determine how one's actions will affect the welfare of others in the situation. Second, one determines the moral ideal and formulates a moral course of action. Third, one selects among the alternatives—either to fulfill the moral ideal or to fulfill a competing value outcome. Fourth, one executes his intentions.

### Ethical Bases for Decisions

Philosophy literature has identified two major foundations for ethical behavior. The first, Utilitarianism, is characterized by the belief that the value of an action is determined by the extent of its benefits (Smart and Williams, 1973). The second, Deontologism, is characterized by the belief that an action is ordained by moral obligation or duty (Kant, 1981).

Utilitarianism may take one of two forms. Act-utilitarianism, the strongest form, occupies the position that an act may be judged right or wrong based on its consequences—whether good or bad. Rule-utilitarianism, the weaker form, holds that the action should be judged based on the goodness of the rule being followed. When confronted with a situation in which abiding by a code would work against the maximization of good consequences, the rule-utilitarian would modify the rule.

Deontologism, alternatively, holds that an action is right, independent of its consequences. The morally correct action in any situation is to do one's duty. This basis is rooted in religious directives, but also has considerable philosophical support. For example, William D. Ross (1930) identified seven intuitive duties which he suggested should be adhered to regardless of the resulting consequences one foresees.

## PURPOSE OF THE STUDY

This study is designed to examine the compliance of members of the Institute of Management Accountants with their code of ethics. Specifically, the study attempts to determine the effect of two variables (legal liability consequences and the competitiveness of the job market) on a management accountant's decision to follow the procedures outlined by the *Statement of Ethical Professional Practice* for the resolution of an ethical conflict. The study also attempts to determine the ethical basis used by the participants in their decision process.

The following hypotheses are proposed and tested in this study:

*H1: Legal liability will have no effect on a management accountant's compliance with the code.*

*H2: The favorability of the job market will have no effect on a management accountant's compliance with the code.*

*H3: Management accountants with a deontological basis for their ethical decisions will be more likely to follow the code.*

*H4: Management accountants with a utilitarian basis for their ethical decisions will be more likely to deviate from the code.*

## METHODOLOGY

### Population and Sample

The population of interest is comprised of management accountants who are members of the IMA and are currently employed in industry. The sample consisted of IMA members in selected chapters from Texas, Arkansas, Mississippi, Louisiana, and Alabama. Three hundred research instruments were distributed to chapter members at chapter meetings and the instruments were returned via mail upon completion. Usable responses received totaled 126 for a 42 per cent response rate. The average age of the subjects was 48. Their ages ranged from 24 to 69. There were 82 males and 44 females participating in the study. Eighty-five subjects were Certified Management Accountants, 19 subjects were Certified Public Accountants and 16 subjects were Certified Internal Auditors.

### Research Instrument

The research instrument consisted of three separate sections. The first section was a reproduction of the procedures for the resolution of a significant ethical conflict taken from the *Statement of Ethical Professional Practice*. These procedures were followed by several questions designed to determine the subject's feelings toward codes of ethics. This section appeared first to remind the subjects of the ethical code they have adopted. The second section collected the demographic data.

The third section consisted of four scenarios depicting a different ethical conflict. Each was followed by a series of questions based on the procedures for the resolution of a significant ethical conflict from the *Statement of Ethical Professional Practice*. These questions were designed to trace how closely the subjects would follow the actions outlined by the code of conduct. The final question determined their feelings toward resignation from the organization. In each scenario the subject was asked by a superior to stop making tax withholding payments.

The scenarios differed on the combination of two factors—legal liability and the favorability of the job market. In the first scenario the subject was not liable and the job market was favorable. In the second scenario the subject was not liable and the job market was unfavorable. In the third scenario the subject was liable and the job market was favorable. In the fourth scenario the subject was liable and the job market was unfavorable.

## RESULTS

Hypotheses 1 and 2 were tested by examining the responses to the questions following the four scenarios. Data was analyzed by conducting a series of matched-pair *t*-tests on the appropriate combinations of scenarios. The results of these *t*-tests are summarized in Table 1 and Table 2 below.

Hypothesis 1, that legal liability will have no effect on the decision to follow the code, was rejected after examining the results of the *t*-tests on scenarios 1 and 3 (favorable job market) and examining the results of the *t*-tests on scenarios 2 and 4 (unfavorable job market). Table 1 summarizes the results of these tests. In the favorable job market, there was a significant shift by the subjects toward consulting with an attorney and toward resignation from the organization when legal liability was introduced. In the unfavorable job market significant differences were also found when legal liability was introduced. The subjects were more likely to seek out a confidential advisor and were more likely to resign from the organization. In summary, legal liability tended to shift behavior toward behavior identified as appropriate by the code of ethics.

**Table 1**
**RESULTS OF MATCHED-PAIR *t*-tests COMPARING MEAN RESPONSES IN FAVORABLE AND UNFAVORABLE JOB MARKETS WHEN LIABILITY IS INTRODUCED**

| | Favorable Market | | | Unfavorable Market | | |
|---|---|---|---|---|---|---|
| | No Liab. | Liability | | No Liab. | Liability | |
| | Mean | Mean | *t* | Mean | Mean | *t* |
| I would:** | Scen.1 | Scen.3 | prob. | Scen.2 | Scen.4 | prob. |
| Consult my organization's established policies on resolution of an ethical conflict | 4.09 | 4.17 | .569 | 3.89 | 4.23 | .087 |
| Submit the matter to the next level of management | 3.86 | 3.95 | .613 | 3.64 | 3.73 | .745 |
| Clarify relevant issues by confidential discussion with IMA ethics counselor or other impartial observer | 3.69 | 3.75 | .874 | 3.26 | 3.82 | .043* |
| Consult an attorney as to legal rights and obligations | 2.42 | 4.23 | .000* | 2.18 | 2.47 | .098 |
| Resign from the organization | 3.17 | 3.96 | .013* | 1.64 | 2.73 | .008* |

Scenario 1: No Liability/Favorable Job Market
Scenario 3: Liability/Favorable Job Market
Scenario 2: No Liability/Unfavorable Job Market
Scenario 4: Liability/Unfavorable Job Market

*Significant at $p < .05$
** Measured on a 5 point scale where 1 = Strongly Disagree and 5 = Strongly Agree

Hypothesis 2, that the favorability of the job market will have no effect on the decision to follow the code, was also rejected after examining the results of the *t*-tests on scenarios 1 and 2 (no liability involved) and examining the results of the *t*-tests on scenarios 3 and 4 (liability involved). Table 2 summarizes the results of these tests. In the scenarios with no liability, there were significant differences after the job market became unfavorable. Subjects were less likely to seek out a confidential advisor, which is contrary to the recommendation of the code. Subjects were also less likely to consider resigning from the organization when the job market became unfavorable. In the scenarios with liability as a factor, there were also significant differences after the job market became unfavorable. Subjects were less likely to consult with an attorney and less likely to resign from the organization.

**Table 2**
**RESULTS OF MATCHED-PAIR *t*-tests COMPARING MEAN RESPONSES IN NO LIABILITY AND LIABILITY SITUATIONS WHEN AN UNFAVORABLE JOB MARKET IS INTRODUCED**

| | No Liability Present | | | Liability Present | | |
|---|---|---|---|---|---|---|
| | Fav Mkt. | Unfav Mkt | | Fav Mkt | Unfav Mkt | |
| | Mean | Mean | *t* | Mean | Mean | *t* |
| I would:** | Scen.1 | Scen.3 | prob. | Scen.2 | Scen.4 | prob. |
| Consult my organization's established policies on resolution of an ethical conflict | 4.09 | 3.89 | .091 | 4.17 | 4.23 | .845 |
| Submit the matter to the next level of management | 3.86 | 3.64 | .126 | 3.95 | 3.73 | .117 |
| Clarify relevant issues by confidential discussion with IMA ethics counselor or other impartial observer | 3.69 | 3.26 | .047* | 3.75 | 3.82 | .798 |
| Consult an attorney as to legal rights and obligations | 2.42 | 2.18 | .085 | 4.23 | 2.47 | .001* |
| Resign from the organization | 3.17 | 1.64 | .004* | 3.96 | 2.73 | .017* |

Scenario 1: No Liability/Favorable Job Market
Scenario 3: No Liability/UnFavorable Job Market
Scenario 2: Liability/Favorable Job Market
Scenario 4: Liability/Unfavorable Job Market

*Significant at $p < .05$
** Measured on a 5 point scale where 1 = Strongly Disagree and 5 = Strongly Agree

Hypotheses 3 and 4 were tested by using the response to the statement "Situational factors affect whether a code of ethics should be followed" as a surrogate measure for the ethical basis used for decision making. Respondents who agreed with the statement were classified as utilitarian and those who did not agree were classified as deontological. A series of ANOVA's were run using the responses to the questions following the four scenarios as dependent variables and the utilitarian versus deontological classification as the independent variable. Because the ANOVA's revealed no significant differences between the two groups, hypotheses 3 and 4 were not supported.

## SUMMARY AND CONCLUSIONS

In order for management accountants to be accepted as professionals in our society the public must perceive them as having an ethical standard which is self-imposed and goes beyond compliance with the law. Their code of ethics, therefore, should be followed in the resolution of ethical conflicts regardless of the legal liability involved. In practice, management accountants may be held liable as persons responsible for the collection and payment of withholding taxes as well as being held liable for the fairness of the presentation within the financial statements. The proper handling of these aspects of their jobs is therefore an opportunity to gain public confidence.

The results of this study indicate that the intention to follow the code is affected by both the liability aspect and the favorability of the job market. When liability is introduced, the code is more likely to be followed. When the job market becomes unfavorable the code is more likely to be followed in the early stages of resolution of the conflict, but less likely in the later stages and resignation from the organization becomes less likely.

These results do not demonstrate the kind of ethical intentions which will gain the public's confidence. They do suggest that continued and improved coverage of ethical considerations in the business and accounting curriculum is necessary. In addition, the results demonstrate the need for the ethics counseling services provided by the IMA to its members. Those who provide these services may need to focus their efforts toward attaining greater compliance with the code of ethics regardless of whether personal legal liability is present or whether economic conditions are favorable or unfavorable. This support system may go a long way in promoting Waters' (1990) suggestion that ethics and excellence for management accountants go hand in hand.

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# DO CONSEQUENCES MATTER? SURVEY V. EXPERIMENTAL RESULTS IN A TAX SETTING

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## ABSTRACT

*This study examines whether the presence of consequences from participants' self-reported tax policy preferences affect such preferences. Prior research examining tax policy preference has been largely survey-based and reported mixed results. In a non-tax setting, prior research has found that survey responses about what participants would do in a situation do not necessarily reflect what they actually will do when consequences are attached to their choices. We examine this issue by soliciting participants' preferences for tax progressivity under both a no-consequences (survey) and a consequences (experimental) setting. Our results indicate that participants' self-reported tax progressivity preferences more strongly reflect self-interest when there are consequences. This suggests that researchers using surveys to study tax policy preferences should follow up with experimental studies that attach consequences to participants' responses.*

## INTRODUCTION

Survey research is a popular, relatively inexpensive way to gather public opinion. Indeed, Graetz (1997) claims that "public polls serve as the guide to policymaking." With respect to public opinion on tax policy issues, most prior research has used surveys to better understand the public's preference regarding tax progressivity (e.g., Hite and Roberts, 1992), the taxation of married couples (Hulse and Wartick, 1998), and the taxation of different family compositions (Christensen, Hite, and Roberts, 2000). However, Keene (1983) noted that "[a]ll of us who have worked with survey research know that different questions' wording can produce different results," and Roberts, Hite, and Bradley (1994) report evidence that this is true in a tax progressivity setting.

We contend that another shortcoming of survey research is that it does not result in consequences for its participants. That is, due to self-interest, participants' self-reported public policy preferences when there are no consequences may change when there are consequences. If so, survey results provide an incomplete, and perhaps inaccurate, picture of the public's policy preferences in an actual, real-world setting. If not, surveys provide results that are a reasonable proxy for the results obtained using experiments with consequences, but they provide them at a lower cost.

We examine this issue in the context of tax progressivity. The extent to which the tax rate should increase as income increases has been the focus of public policy debate for several decades, with some arguing that this increase should be relatively large and others arguing that it should be relatively small. Prior research has surveyed the public to ascertain what its preferences are regarding tax progressivity. We extend this research by having some of our participants self-report their tax progressivity preferences in a no-consequences setting, similar to prior research, and having the other participants do so in a consequences setting, where their self-reported preferences affect their chance to win a cash prize. In both settings, we randomly assign participants to either a low-income or high-income condition. Our results indicate that, in the no-consequences setting, participants had a slight preference for a tax system with greater progressivity. However, in the consequences setting, tax progressivity preferences were much higher for the low-income participants than for the high-income participants. This suggests that researchers should follow surveys of tax progressivity preferences, as well as tax policy and other public policy preferences more generally, with experimental studies that attach consequences to participants' responses so as to provide a more complete picture.

## LITERATURE REVIEW

A tax is progressive if the tax rate increases with income. Since taxpayers are theoretically taxing themselves in a democratic society, it is important to understand taxpayers' opinions on tax rate structure. Most taxpayers express a desire for a tax system that is "fair." What is fair generates an ongoing debate, but comes down to subjective opinions on how to split the tax bill (Slemrod and Bakija, 2008, Chapter 3). Likewise the popular press frequently debates the preferred degree of progressivity.

Part of the problem with understanding tax policy preferences is that a taxpayer may have an ideal tax system in mind that balances social desirability and preferences, but when faced with their own tax bill may favor one that benefits them. Researchers have made many creative attempts to disentangle these motivations. For example Milliron, Watkins, and Karlinsky (1989) find that three constructs explain a significant portion of the variance in the responses they received: equity (about 26 percent), simplicity (about 13 percent), and some combination of self-interest and perceived fairness (about 12 percent).

World-wide, participants tend to have a taste for mild progressivity. Hite and Roberts (1991) concluded that, in the U.S., "respondents prefer a mildly progressive tax system." Traub (1999) found that about two-third of the German workers surveyed preferred progressivity to a flat, proportional, or regressive tax. More recently, Richardson (2005) surveyed perceptions of tax fairness and tax noncompliance behavior. His Australian participants preferred some degree of progressivity more than did Hong Kong participants (a jurisdiction with a nearly flat tax).

Christensen, Hite, and Roberts (2000) showed that participants believe that taxpayers with dependent children should pay lower taxes and that taxes should not differ between married couples and singles with the same income. Participants thought married couples with a child should pay more than singles with a child, though. However, it is worth noting that none of these studies had any consequences attached.

Studies of preferences regarding other tax policies also have not had any consequences for their participants. Kinsey, Grasmick, and Smith (1991) surveyed taxpayers in person and found, among other things, that high income participants reported more tax avoidance strategies. Hulse and Wartick (1998) asked participants to judge how much tax two households of married couples should pay relative to each other and to households of single taxpayers. They forced participants to choose between horizontal equity (i.e., taxing equally married couples with the same combined income, regardless of how much of that income is earned by each spouse) and marriage neutrality (i.e., two individuals' aggregate tax is the same whether they are married to each other or not). Two thirds of their participants showed a preference for horizontal equity over marriage neutrality. Higher income taxpayers, those 35 or older, those with a bachelor's degree or more, and those who are married were more likely to favor horizontal equity. These studies indicate that self-interest can play a role in participants' choices, even when there are not consequences from those choices.

Experimental research has shown different presentation can cause participants to think about tax policy differently. For example, Roberts, Hite, and Bradley (1994) found that addressing a tax policy in concrete versus abstract terms could cause policy reversals between a preference for progressivity and proportionality. Wartick (1994) found that if the participants were personally affected by the policies in question, those policies were regarded as less fair. Bobek and Hatfield (2001) found participants thought economic goals but not social goals to be important in a tax system, and that a "flat tax" would be simpler and have fewer loopholes. Self-interest was shown to influence which system a participant thought was better. McCaffery and Baron (2004) also found a reversal of position based on framing and that some people were biased against taxes as opposed to fees even though the economics were the same. Again, though, it should be noted that these studies had no consequences since the participants' choices in these experiments did not affect their personal economic outcomes.

In a non-tax setting, Kachelmeier and Towry (2002) found that what people claimed they would do in questionnaires did not reflect what happened when consequences were attached to those choices. When there were consequences, subjects tended to behave in a manner more in line with the economic model of self-interest. In one tax-related experiment in which there were consequences (Ackert et al., 2007), participants were put in anonymous groups of five and asked to make decisions on 13 pairs of tax structures. One round would be randomly drawn for payout and the majority decision was imposed on the group. Each of the five participants in each group had different endowed income levels and Tax 1 in each of the 13 scenarios was a flat tax. There were 110 participants making for 1,430 observable votes. Tax language was specifically used so participants would frame the decision in a tax context. Only five of 110 participants behaved in a purely selfish manner in all 13 decisions. Eighty percent of the observed votes could be explain by selfish behavior; however, 17 percent were consistent with altruism.

Our research extends these prior research findings in several ways. Most importantly, we used a method that asked some participants to self-report their tax progressivity preferences in a no-consequences setting and the others in a setting with consequences. With one exception, prior research has examined tax progressivity preferences in settings without consequences. Although the research setting of Ackert et al. (2007) included consequences, it did not include a control group to see how participants would have responded without consequences. Second, in our research setting, we present the tax information using dollars and percentages simultaneously. Prior research has found that participants may make different decisions when using dollars versus percentages (c.f., Roberts and Hite, 1994), but Ackert et al. (2007) presented their tax amounts in dollar terms only. Finally, we used only one round in which participants in a consequences setting could vote for a particular degree of tax progressivity (which followed a training round so participants would better understand what they were doing), so participants were forced to make that one vote count. Ackert et al. (2007) used 13 rounds of voting and chose only one that counted for the prize, which means that participants knew that each round had only a 1-in-13 chance of "counting."

## RESEARCH HYPOTHESES

We base the first hypothesis on prior, survey-based research on tax progressivity preferences. If participants self-report their preferences in a self-interested way, even if there are no resultant consequences, we would expect participants to prefer the tax progressivity that leads to lower tax liabilities. This leads to the first hypothesis:

*H1: For the no-consequences sessions, participants in the high-income condition will choose tax tables that are less progressive than the tax tables chosen by participants in the low-income condition.*

Some prior research suggests that taxpayers will self-report their tax policy preferences in a more self-interested way when there are consequences that may result from it (Kachelmeier and Towry, 2002; Ackert et al., 2007). These results lead to our second hypothesis:

*H2: Participants in the consequences sessions will choose tax tables that result in less tax than participants in the no-consequences sessions.*

That is, H2 posits that participants will self-report in a more self-interested manner when there are consequences than when there are no consequences. This leads to specific predictions for the participants randomly assigned to the low-income versus high-income condition (discussed more fully below):

> *H2a: For the low-income condition, participants in the consequences setting will choose tax tables that are more progressive than the tax tables chosen by participants in the no-consequences setting.*

> *H2b: For the high-income condition, participants in the consequences setting will choose tax tables that are less progressive than the tax tables chosen by participants in the no-consequences setting.*

## METHODOLOGY

The study's participants were 102 undergraduate students at a large, public US university. The potential participants chose between two types of sessions. The session descriptions explained that one of the session types would take one hour and they would have a chance at winning a $50 prize ("consequences" sessions). The other session type would take a half-hour and that there would be no prize ("no-consequences" sessions).[1] As will be discussed in more detail below, participants in both types of sessions completed an exercise through which they expressed their tax progressivity preferences. The expressed preferences had no consequences for the no-consequences participants, but they did have consequences for the consequences participants as described below. We imposed a limit of 30 participants per consequences session so as not to dilute the effect of the participants' expressed preferences too much. There was no limit on the number of participants in each no-consequences session. There were 48 participants in the no-consequences sessions and 54 participants in the consequences sessions.

The no-consequences participants completed an exercise in which they had to choose one of three tax tables as being the most fair. The participants were to assume that about one-third of the population has $22,000 of income, about one-half of the population has income of $42,000, and about one-sixth of the population has $75,000 of income. Table 1, Panel A displays the three tax tables the participants could choose. One of the tables was proportional, with all of the population paying a tax equal to 20% of their income. Another of the tables we denote as mildly progressive, with tax rates ranging from 10% to 26% of income. The other tax table we denote as highly progressive, with tax rates ranging from 0% to 32%.[2] We designed the tax rate tables to each collect about the same tax revenue from the population, and so informed the participants.

Roberts and Hite (1994) and McCaffery and Baron (2004) found that participants generally assign higher tax burdens when using percents instead of dollars. Also, Roberts and Hite (1994) found that participants prefered progressive taxes when using words instead of numbers, but a third chose the proportional tax when choosing tax tables. Therefore, we used both dollars and percents and labelled the tax tables as "Tax Table A," etc. rather than using loaded words such as "progressive," "flat," or "proportional."

We randomly assigned these participants to a low-income or high-income condition. We instructed them to "imagine yourself as having an income of $22,000 [$75,000 if high-income] per year for the foreseeable future." These incomes correspond to the poorest one-third and richest one-sixth of the population in the tax tables they were given. The instructions directed the participants to choose the tax table "that appears to be the most fair" and to "choose the one that you would vote for if you could, knowing that the results of the vote would affect you, as well as other taxpayers." We used this language in the no-consequences sessions, so that the sessions' instructions would be more comparable to the consequences sessions discussed below. Finally, the participants answered some demographic questions.[3]

**Table 1**
**Tax Tables Available to Participants** [a]

| *Panel A* | | | | *Panel B* | | |
|---|---|---|---|---|---|---|
| Proportional Tax Table | | | | Number of Tickets [b] | | |
| Income | Tax % | Tax $ | Net Income | Before-tax | Tax | After-tax |
| $22,000 | 20% | $ 4,400 | $17,600 | 8 | 2 | 6 |
| $42,000 | 20% | $ 8,400 | $33,600 | 14 | 3 | 11 |
| $75,000 | 20% | $15,000 | $60,000 | 25 | 5 | 20 |
| Mildly Progressive Tax Table | | | | Number of Tickets [b] | | |
| Income | Tax % | Tax $ | Net Income | Before-tax | Tax | After-tax |
| $22,000 | 10% | $ 2,200 | $19,800 | 8 | 1 | 7 |
| $42,000 | 20% | $ 8,400 | $33,600 | 14 | 3 | 11 |
| $75,000 | 26% | $19,500 | $55,500 | 25 | 7 | 18 |
| Highly Progressive Tax Table | | | | Number of Tickets [b] | | |
| Income | Tax % | Tax $ | Net Income | Before-tax | Tax | After-tax |
| $22,000 | 0% | $ 0 | $22,000 | 8 | 0 | 8 |
| $42,000 | 20% | $ 8,400 | $33,600 | 14 | 3 | 11 |
| $75,000 | 32% | $24,000 | $51,000 | 25 | 8 | 17 |

[a] Participants were told to assume that about one-third of the population has $22,000 of income, about one-half has $42,000 of income, and about one-sixth has $75,000 of income. We told participants in the sessions with no consequences to imagine that they had $22,000 (or $75,000) of income and to choose the tax table that appears to be the most fair. Participants in the sessions with consequences were endowed with the number of tickets corresponding to $22,000 (or $75,000) of income, were told to choose the tax table that appears to be the most fair, and paid taxes in the form of tickets based on the most frequently chosen tax table in the participant's particular consequences session. All dollar amounts are US dollars.
[b] For participants in the sessions with consequences, income and taxes were converted to a number of tickets at a 3,000:1 conversion rate, with any fractional ticket rounded up to a whole ticket.

We gave the consequences sessions' participants an exercise similar to the other participants. However, the participants' expressed progressivity preferences in these sessions had consequences for them by affecting their probabilities for winning the $50 prize. The instructions endowed half of the participants with an experimental "income" of $22,000 and half with $75,000. They received the income in the form of tickets at a rate of one ticket for each $3,000 of income (rounded up to the next highest integer).[4] The participants received the same three tax tables as were used in the no-consequences sessions (see Table 1, Panels A and B), and the instructions stated: "Now, imagine yourself as having an income of $22,000 [$75,000 if high-income] per year for the foreseeable future and choose the tax table that appears to be the most fair. Specifically, choose the one that you would vote for if you could, knowing that the results of the vote would affect other taxpayers as well." We tallied the participants' votes to determine the one that received the most votes, while the participants answered some demographic questions. We then announced the winning tax table to the participants. The participants paid their taxes based on their income endowment and the winning tax table by remitting the number of tickets into which their tax dollars were converted.[5] Finally, we collected the participants' remaining tickets, shuffled them, and had one of the tickets randomly chosen by a participant to determine the winner of the $50 cash prize.

The methodology here involves two experimental manipulations. First, we manipulated the presence or absence of consequences resulting from participants' expressed progressivity preferences. In the no-consequences sessions, there was no prize, so the outcome for a participant was unaffected by his or her choice of tax table. In the consequences sessions, a participant's choice of tax table affected his or her chance of winning a $50 prize. More specifically, a participant endowed with $22,000 of income could increase his or her chances of winning the prize by choosing a more progressive tax table because he or she would pay fewer tickets in tax with greater progressivity, and a participant endowed with $75,000 of income could increase his or her chances of winning the prize by choosing a less progressive tax table because he or she would pay fewer tickets in tax with lesser progressivity. Second, we manipulated income level by randomly assigning subjects to a low or high income condition in both the no-consequences and the consequences sessions.

The no-consequences sessions are comparable to most prior research on progressivity preferences which has consisted mainly of surveys. By comparing their responses to those of the participants in the consequences sessions, we are able to identify the effect of the addition of consequences. If the effect is large, it suggests that surveys (i.e., free of consequences) poorly represent taxpayers' preferences for progressivity and other attributes regarding actual tax systems. If the effect is small, it suggests that surveys are a reasonable representation of their preferences.

## RESULTS

Table 2 provides demographic information for the study's participants. Some of the demographic statistics reflect the fact that our participants were undergraduate students. Ninety-five percent of them are 25 years old or younger, and a majority of them report having a family income of less than $15,000. While this suggests caution in generalizing the results to a broader population, the concern should be lessened because our research focuses on the effect of consequences on participants' expressed progressivity preferences and not the particular degree of progressivity expressed.

**Table 2: Demographic Information About Participants**

| Demographic characteristic | | Number of participants | Percentage of participants [a] |
|---|---|---|---|
| Sex: | Female | 46 | 45.1% |
| | Male | 55 | 53.9% |
| Income tax return filing: | Usually file one and get a refund | 66 | 64.7% |
| | Usually file one and owe more tax | 6 | 5.9% |
| | Usually do not file one | 24 | 23.5% |
| Family income: (in US dollars) | $0 – $15,000 | 58 | 56.9% |
| | $15,000 – $25,000 | 7 | 6.9% |
| | $25,000 – $50,000 | 8 | 7.8% |
| | $50,000 – $100,000 | 16 | 15.7% |
| | More than $100,000 | 11 | 10.8% |
| Age: | 16 – 21 | 74 | 72.5% |
| | 22 – 25 | 23 | 22.5% |
| | 26 – 34 | 2 | 2.0% |
| | 35 and older | 1 | 1.0% |
| University year: | Second year | 28 | 27.5% |
| | Third year | 55 | 53.9% |
| | Fourth year | 18 | 17.6% |
| Major area of study: | Management | 15 | 14.7% |
| | Accounting | 5 | 4.9% |
| | Finance | 9 | 8.8% |
| | Marketing | 15 | 14.7% |
| | Business – other | 14 | 13.7% |
| | Nonbusiness | 14 | 13.7% |
| | Undeclared | 1 | 1.0% |
| | Communications | 28 | 27.5% |

[a] The percentages to not sum to 100% because a few of the 102 participants did not answer all of the demographic questions.

A slight majority of the participants are male. About two-thirds of the participants usually file an income tax return and receive a tax refund, and about one-quarter do not usually file an income tax return. Approximately one-quarter of the participants are in their second year of university, about one-half are in their third year, and about one-sixth are in their fourth year. Fifty-seven percent of the participants have a major area of study for the university degree in an area related to business and economics.

Table 3, Panel A, reports the number and percentage of participants in each of the four experimental conditions choosing each of the three available tax tables. For example, of the 23 participants assigned to the low-income condition in the no-consequences sessions, five (22%) chose the proportional tax table, 17 (74%) chose the mildly progressive tax table, and one (4%) chose the highly progressive tax table. Figure 1 is a graphical representation of those results. Comparison across the four experimental conditions shows substantial differences in the tax table chosen. A majority of participants in the high-income conditions (with and without consequences) chose the proportional tax table, but less than one-quarter of participants in the low-income conditions did so.

**Table 3: Tax Table Chosen by Participants [a]**

| | Low-income condition | | | | High-income condition | | | |
|---|---|---|---|---|---|---|---|---|
| | No conseq. | | Consequences | | No conseq. | | Consequences | |
| | # | % | # | % | # | % | # | % |
| *Panel A: Number and percentage of participants choosing each tax table* | | | | | | | | |
| Proportional | 5 | 21.7% | 3 | 11.1% | 15 | 60.0% | 20 | 74.1% |
| Mildly progressive | 17 | 73.9% | 10 | 37.0% | 9 | 36.0% | 7 | 25.9% |
| Highly progressive | 1 | 4.3% | 14 | 51.9% | 1 | 4.0% | 0 | 0.0% |
| | 23 | 100.0% | 27 | 100.0% | 25 | 100.0% | 27 | 100.0% |
| *Panel B: Cumulative number and percentage of participants choosing each tax table* | | | | | | | | |
| Proportional | 5 | 21.7% | 3 | 11.1% | 15 | 60.0% | 20 | 74.1% |
| Mildly progressive | 22 | 95.7% | 13 | 48.1% | 24 | 96.0% | 27 | 100.0% |
| Highly progressive | 23 | 100.0% | 27 | 100.0% | 25 | 100.0% | 27 | 100.0% |

[a] See Table 1 for the three tax tables available for the participants to choose.
[b] This reports the number and percentage of participants in each experimental condition choosing a tax table or one less progressive than it.

The presence or absence of consequences also affects the tax tables chosen. The high-income participants' tax table choices skew more strongly towards the proportional tax table and the low-income participants' choices skew more strongly towards the highly progressive tax table in the consequences sessions compared to those in the no-consequences sessions. These results are consistent with the presence of consequences causing participants to more frequently prefer the tax table that is most beneficial for them.

This effect becomes more obvious when examining the cumulative number and percent of participants choosing a particular tax table. For example, Table 3, Panel B, shows that, of the 23 participants assigned to the low-income condition in the no-consequences sessions, five (22%) chose a tax table that was not more progressive than proportionality, 22 (96%) chose a tax table that was not more than mildly progressive (i.e., proportional or mildly progressive), and 23 (100%) chose a tax table that was not more than highly progressive (i.e., any of the tables).

**Figure 1**
**Tax Table Chosen**

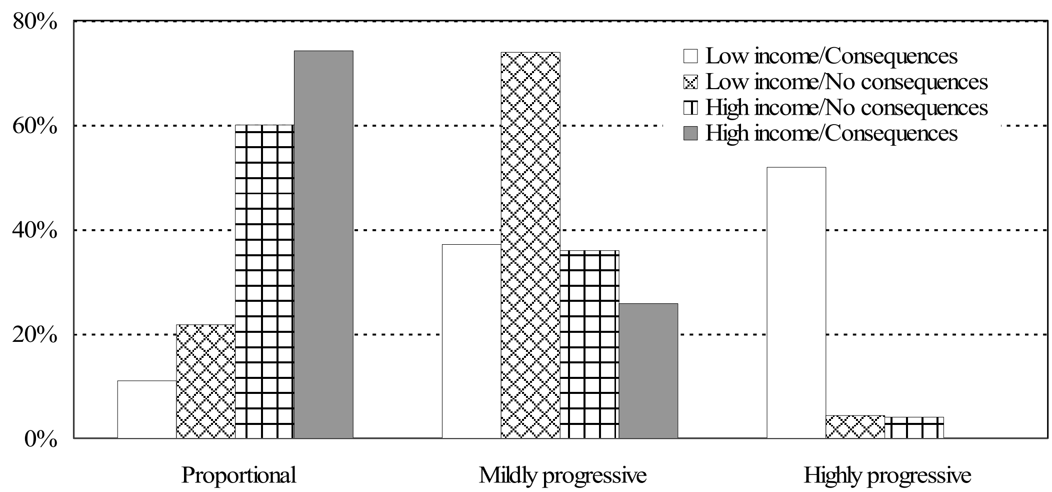


**Figure 2**
**Tax Table Chosen -- Cumulative Percentage**

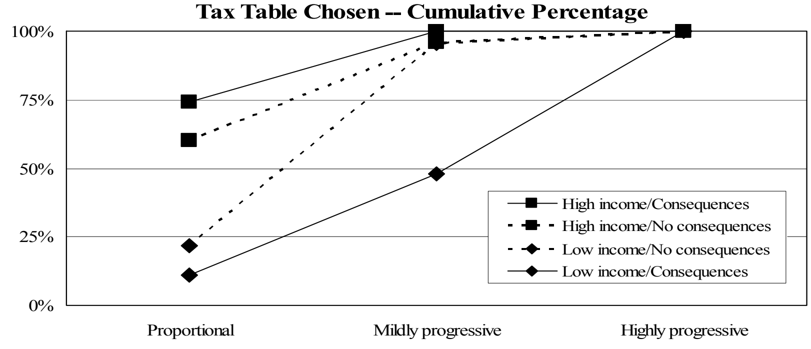

Figure 2 depicts the cumulative percentages reported in Table 3, Panel B. In Figure 2, a line that is higher indicates that the participants in that condition tend to prefer less progressivity since the cumulative percentage is more concentrated towards the left side of the figure (and a line that is lower indicates preferences that tend towards more progressivity). Examination of the figure shows interesting results. The dashed lines show that participants who are merely told to imagine that they have a high income tended to prefer less progressivity than those told to imagine that they have a low income, even though there were no consequences in these experimental conditions. When participants' choices had consequences (i.e., the solid lines), the spread between the high-income and low-income lines widens, indicating that the introduction of consequences had an effect.

To assess the statistical significance of the results reported in Table 3, Panel B (which are depicted in Figure 2), an ordinal logistic regression was estimated. This type of statistical analysis is appropriate when the dependent variable is categorical but the categories can be ordered (Agresti, 2002). This is the situation here, where the three tax tables participants could choose are categorical but the tables can be ordered according to their progressivity. The independent variables were an indicator variable for the presence or absence of consequences (one if the participant was in a consequences session and zero if the participant was in a no-consequences session), an indicator variable for the income condition assigned to the participant (one if high-income and zero if low-income), and an interaction of the two indicator variables.

The overall regression model was statistically significant ($\alpha < .0001$), and the coefficients for the consequences indicator variable ($\alpha = 0.0015$), the high-income indicator variable ($\alpha = 0.0203$) and the interaction term ($\alpha = 0.0020$) were all significantly different from zero. Further statistical testing compared the four experimental conditions, which can be interpreted as comparing the groups' lines in Figure 2. For the no-consequences sessions, the low-income participants' tax table choices differed significantly from those of the high-income participants ($\alpha = 0.0203$), which confirms hypothesis H1. For the low-income conditions, the tax table choices of participants in the consequences sessions differed significantly from those in the no-consequences sessions ($\alpha = 0.0015$), confirming hypothesis H2a. However, for the high-income conditions, the participants' tax table choices did not differ significantly between the consequences and no-consequences sessions ($\alpha = 0.2532$), failing to confirm H2b. Finally, for the consequences sessions, the low-income participants' tax table choices differed significantly from those of the high-income participants ($\alpha < .0001$), which confirms hypothesis H3.

To check the robustness of the results, we also estimated an ordinary least-squares regression. For this analysis, the dependent variable equaled zero if the participant chose the highly progressive tax table, one for the mildly progressive tax table, and two for the proportional tax table. The results were qualitatively similar to the ordinal logistic regression results. As additional checks of the robustness of the results, we re-estimated the ordinal logistic regression several times, each time including variables for one of the demographic characteristics reported in Table 2. The results were qualitatively similar to the results reported in the preceding paragraph.

As with all research ours has limitations. First, there might have been self-selection in terms of which treatment the students chose; however, we found no significant demographic differences between the two groups. Second, despite our efforts to make this a “tax-based” experiment, it is possible the participants took it as merely a game and “played” to maximize their chances of winning. Our debriefing conversations with participants make us believe this was not the case. Third, our use of student participants may limit the generalizability of our results. Similarly, our focus on a single tax policy issue may limit the generalizability of our results to other tax policy contexts. However, our finding that the presence of consequences can affect one’s stated tax policy preferences likely extends to other types of participants and richer policy contexts.

## CONCLUSION

Based on our findings, we believe that having consequences directly attached to a tax policy choice can affect the choice itself. When taxpayers are thinking about a policy choice in the abstract (i.e. during a time when it doesn’t directly relate to them), they may choose a more socially acceptable or more middle of the road approach. However, when there are consequences, they tend to choose a policy more in alignment with their own self- interest. Whether or not policy should be decided by abstract discussion or by self-interested votes is a matter for other research to explore. However, policymakers need to be aware that framing and context effects, as found in prior research, as well as the effects of consequences found in this research, can affect the choices taxpayers make when evaluating public policy decisions.

Future research could examine this issue with other populations and other policy issues to see whether the results here are, in fact, more generalizable. Specifically, it would be useful to know if the effect of self-interest varies with respect to age, economic and cultural settings, and the type of policy question at hand.

## ENDNOTES

1 It is possible that selection bias affects the research results, where the factors that led participants to sign up for a half-hour versus one-hour session affected participants’ expressed tax progressivity preferences. In sensitivity analyses discussed below, we control for various demographic characteristics and find no significant effect on the results.

2 Our designation of two of the tables as mildly progressive and highly progressive describes the progressivity of these tables relative to each other. We did not intend to describe the tables’ progressivity in an absolute sense. For example, one could consider the highly progressive tax tables’ maximum tax rate of 32% as only moderately progressive, and some countries have maximum tax rates that are substantially greater than 32%.

[3] Because of concern that the order of the three tax tables presented to the participants might bias their responses, we randomly assigned each participant one of three orderings of the tax tables in both the no-consequences and the consequences sessions. In sensitivity analyses discussed below, we control for this ordering and find no significant effect on the results.

[4] The $22,000 and $75,000 incomes are the same amounts as the low-income and high-income treatments in the half-hour sessions. We gave the consequences sessions' participants a worksheet for calculating the number of tickets corresponding to an amount of income to eliminate the need for calculators. They also participated in a short exercise similar to the experimental exercise, but prior to it, to practice the income-to-tickets conversion to better ensure that they understood it.

[5] A research administrator checked the participants' tax calculation to ensure that the number of tickets paid was correct.

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# IS THERE A "DIGITAL DIVIDE" IN THE PROVISION OF E-GOVERNMENT SERVICES AT THE COUNTY LEVEL IN THE UNITED STATES?

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## ABSTRACT

*This study examines whether e-government services provided at the county level in the United States (U.S.) are provided equally to citizens across income and poverty levels. A sample of 344 randomly selected counties was evaluated to assess whether or not they had a web presence. In addition, each county was evaluated based on the presence or absence of 12 e-services factors. The results indicate that counties with lower median incomes and higher poverty percentages were less likely to have a web presence as of January 2010. Results also showed that counties with lower median incomes and those with higher poverty percentages are less likely to offer any of the 12 e-services. These results indicate that efforts to reduce the "digital divide" in terms of citizen access to the Internet may not guarantee equal access to government services. Rather, a different type of "digital divide" may continue to exist if counties with less wealthy citizens cannot find ways to overcome barriers to increasing their level of e-government service offerings.*

## INTRODUCTION

E-government is defined by Holden et al. (2003) as "the delivery of government services and information electronically 24 hours per day, seven days per week." Since the passage of the E-government Act of 2002, governments at all levels in the United States have been engaged in the development of e-services. This act was specifically designed to make government more transparent and accountable, enhance access to government information and services, reduce costs while improving efficiency and effectiveness of government service delivery, and increase opportunities for citizen participation in government (U.S. Gov., 2002). In order for this goal to be achieved at the local government level, assuming such governments are committed to providing those services through an e-platform, the governments must have the resources and expertise necessary to implement and maintain e-government systems and the local citizenry must have affordable access to the Internet to make use of the government web-based resources. There have been impediments to both of those conditions. Local governments have cited a lack of resources and expertise as primary factors limiting the expansion of the e-government services

(Holden et al., 2003), while the "digital divide" has left many segments of the population without affordable access to the Internet (see, for example, Edmiston, 2002; Moon, 2002; Aerschot & Rodousakis, 2008; Belanger & Carter, 2009). In March 2009, with the goal of reducing this "digital divide", the United States Congress requested that the Federal Communications Commission (FCC) develop a plan that would provide affordable broadband service to all U.S. citizens. In 2010, the FCC responded with a plan that would provide access through third parties, with wireless broadband that could reach even the most remote locations in the U.S. (FCC, 2010). For governments, this access would mean that they can improve services to their residents regardless of how far the citizens live from a major metropolitan area. This plan, if implemented, creates real opportunities previously only imagined in remote communities, such as the ability of rural residents to participate in town meetings via web presence, to view commissioner meetings from remote locations, or provide immediate visual information of damage in rural areas. Rural residents could have the convenience of completing transactions online, such as paying taxes, renewing licenses, or registering to vote. Of course, an increased web presence and ease of access for citizens also provides the opportunity for governments to increase methods of collecting revenue, such as posting delinquent property taxes and pending auctions that would allow otherwise obscure properties to be sold to anyone in the country (or world). Even if governments have a web presence and affordable Internet access exists, there is a potential that not all segments of the population will be reached with the same effectiveness. Thomas and Streib (2003) provided evidence that in the state of Georgia, citizens accessing government websites as compared to Internet users in general were more educated, more likely to be Caucasian, and had higher incomes. In a European and Middle Eastern study, Aerschot and Rodousakis (2008) found that age and educational level had an effect on Internet usage. They also found that income level had an effect on Internet usage, but the difference was not as great as it was with age and educational level.

Several papers have been published regarding fully functional e-government and methods by which to quantify it. Layne and Lee (2001) wrote one of the first articles in an attempt to provide some measures by which any government could measure its progress. Layne and Lee did not attempt to measure how successful actual government entities were but rather presented a four stage model for measuring progress. The four stages were cataloguing, online transactions, vertical integration and horizontal integration. Reddick (2004) created one of the first empirical models to measure the growth of e-government. He used both the Layne and Lee model and the Hiller and Belanger (2001) model as a foundation and then gathered information from 4,123 chief administrative officers of municipalities or counties via a survey. In his survey instrument, Reddick noted several government to citizen, government to business and government to government factors. Within his findings, Reddick concluded that many municipalities had progressed to a stage of providing some interaction with citizens, but few had progressed to a point of true citizen interaction or customization.

The current study is similar to the previous studies as it is an attempt to analyze e-government growth. However, it differs from Reddick's study in that this is a focus specifically on county level government. County governments primarily serve the rural communities. Unlike people who live in cities and towns, most rural citizens do not have access to a public transportation system to get them to local services for voting, voting registration, county meetings or for even more mundane services such as paying taxes. While many government services can be handled through the mail, the ability to use online technologies can reduce anxiety of concerns such as "did it get there?" and "did it get there on time?" An increased level of e-government can benefit the citizenry in terms of both increased convenience (online payments for utilities and taxes, for example) and expanded opportunities for involvement (for example, being able to email your elected officials) via an increased level of e-democracy.

The current study is also different from previous e-government studies in that, instead of relying on survey data, we collected data directly from government websites as a direct measure of the level of information and interaction made available to the citizenry. We searched the Internet to locate websites of 344 U.S. counties that were randomly selected from the 3,140 existing counties or parishes. Data were gathered independently by three people to ascertain if the county had a website and, if so, what types of information or transactions were made available to the citizenry through the website.

We specifically examined whether higher poverty levels in a county correspond to lower levels of information or interaction available on the county's website. In other words, does a "digital divide" exist in the realm of e-government services for citizens in U.S. counties? County governments were selected because they often tend to manage rural areas that are not served by municipal governments. Providing citizens in rural communities access to services and to local officials can be even more critical than in urban areas. Citizens in rural areas have less access to public transportation and have increased commuting costs to travel to local government offices, making government access less available to them without e-government. Theoretically, this study attempts to contribute to existing literature on the adoption of Information and Communication Technology (ICT) to organizations with a specific focus on e-government. Specifically, we focus on e-government at the county level in the U.S. and the association of income and poverty levels with the services provided.

## RESEARCH STUDY AND METHODOLOGY

The purpose of this study is compare types of online government interactions available for citizens of rural counties in the United States to determine if those levels are associated with the poverty levels of the counties. We utilized, with some adjustments, the "government to citizen" e-government transaction factors from the Reddick (2004) study. The Reddick study was selected because it enumerated specific types of transactions that managers thought were important for e-government implementations. However, three factors from the Reddick study were omitted for this study: online reservation of recreational facilities, online utility payments, and online registration of property such as bicycles. These items were omitted because these services, online or not online, were not generally provided by county level governments. Therefore, those factors pertain to municipalities, but not to the county governments in our sample. One other adjustment was made to the Reddick list. To provide additional data about the types of information presented on a basic website, our factor list includes two items not specifically listed on Reddick's list: "provides general news and information to the public" and "provides economic development information to the public."

In order to establish a representative sample of the 3,140 county governments in the United States, a target number was determined using a confidence level of 95%. The resulting target number was 342. To meet the target number, 344 counties were randomly selected from the list of 3,140 counties listed by the US Census Bureau. The online presence of the counties in the sample was analyzed using the factors listed in Table 1. All websites were evaluated January 30 – 31, 2010 to ensure consistency of data viewed. The assumption was that few, if any, major upgrades or changes would occur during a weekend. Additionally, if changes or upgrades were made during that time, the website would consistently be down for all evaluators at the same time.

| **Table 1: E-Government "Government to Citizen" Factors Used in This Study** |
|---|
| Online payment of taxes |
| Online payment of fines/fees |
| Online completion and submission of permit applications |
| Online completion and submission of business license applications/renewals |
| Online requests for local government records |
| Online delivery of local government's records to the requestor |
| Online requests for services, such as pothole repair |
| Online voter registration |
| Forms can be downloaded for manual completion |
| Online communication with individual elected and appointed officials |
| Provide general news and information to the public |
| Provides economic development information to the public |

All of the factors were rated in a categorical manner, with a county either offering the type of transaction online (coded as a 1) or not offering it (coded as a 0). No attempt was made to measure the level or quality of each type of transaction. For example, regardless of whether a county had online meeting minutes or video streaming of meetings, the "provide general information to the public" factor was coded as a "1". Data for each county were examined by three individuals. To ensure that the three evaluators were rating the items consistently, the three individuals were all provided with specific examples explaining what would constitute a web presence for each item. For example, for a county to be credited with providing online communication with elected or appointed officials, it had to provide an email address for either elected or appointed officials, though not necessarily both. Providing online access to government records could include any one of a number of types of records, such as property records, criminal records, or civil records. In addition to the data obtained from the county websites, the US Census Bureau (www.census.gov) was utilized to obtain data on poverty levels and median income.

Our initial question is whether counties with more poverty, as measured by median household income (MHI) and poverty percent (PP), will be less likely to have a web presence than counties with wealthier citizens. A county is considered to have a web presence if it has as little as a basic webpage with information posted, even if there are no transactional applications available. If county governments have poorer constituents, it follows that they may have a smaller tax base and therefore may have fewer resources to devote to website development or technology staff. They may also have fewer constituents who currently have access to the Internet, making development of a website seem less important. Therefore, our first hypothesis is:

*H1a: Counties with a Web presence will have statistically higher MHI than counties without a Web presence.*

*H1b: Counties with a Web presence will have a statistically lower PP than counties without a Web presence.*

Next, we look specifically at the 12 e-government factors identified earlier to see whether the counties with lower MHIs and those with higher PPs have as many opportunities to participate in their local governments as their wealthier counterparts. Because we would expect that the less-affluent counties would be less likely to have a web presence at all, and if they do have a website it might be less sophisticated than that of the wealthier counties, we posit that those counties will have lower instances of providing each one of the factors than their wealthier counterparts. Therefore, hypothesis two is:

*H2a: Counties offering each of the 12 e-government factors will have a higher mean MHI than counties not offering those factors.*

*H2b: Counties offering each of the 12 e-government factors will have a lower PP than counties not offering those factors.*

For the second hypothesis, counties not having any web presence at all would have a "0" coded for all 12 factors, because they offer none of those services to their constituents.

Therefore, we get a complete picture of who is and who is not receiving each one of the services. However, a further question of interest is, for the counties that do have a web presence, do the services offered differ by poverty percent and median household income? We posit that, even when examining just the counties that have a web presence, those that have wealthier citizens will offer more of the 12 e-government factors on their websites. The third hypothesis is:

> *H3a: For counties having a web presence, counties offering each of the 12 e-government factors will have a higher mean MHI than counties not offering those factors.*

> *H3b: For counties having a web presence, counties offering each of the 12 e-government factors will have a lower PP than counties not offering those factors.*

## RESULTS

Table 2 describes the selected counties in terms of web presence, poverty level and median income. This table shows that, regardless of the poverty level, the majority of the counties (75 percent) have some type of web presence. However, the median income in counties with a web presence was $44,940 compared to only $37,308 for counties not having a web presence. The poverty percentage for counties having a web presence was only 14.53 compared to 18.43 percent for counties with no web presence. It is important to note that a high MHI represents more wealth and a lower PP represents more wealth. To test Hypothesis 1a, a t-test was performed to determine if the median household income differed significantly between the counties with the web presence and those without. As Table 2 indicates, that difference was statistically significant (p=.000). Therefore, Hypothesis 1a is supported. A similar procedure was performed for Hypothesis H1b with poverty percentage as the dependent variable. As shown in Table 2, the difference in poverty percentage between the counties with a web presence and those without was significant at the .000 level. Therefore, Hypothesis 1b is supported.

To test the second set of hypotheses, we used independent samples t-tests on each e-service factor to compare the counties without the factor to the counties with a factor on both MHI and PP. First, we tested to determine if there was a significant difference in MHI (Hypothesis 2a). These results are summarized in Table 3. As this table illustrates, for each one of the 12 factors, the counties with the factors had significantly higher MHIs than counties not offering those services (p=.000 for all 12 factors). This shows that, across the board, counties with less wealthy citizens are offering fewer e-government services than what is available to their counterparts with higher incomes. Therefore, Hypothesis 2a is supported.

| Table 2: Statistical Results for Hypothesis 1 | | | | | | | |
|---|---|---|---|---|---|---|---|
| | Have Website | N | Mean | Std. Deviation | Std. Error Mean | t | 2-tailed sig. |
| Median Household Income | No | 85 | 37308 | 8580.263 | 930.660 | 6.097 | .000 |
| | Yes | 259 | 44940 | 10440.063 | 648.714 | | |
| Poverty Percent All Ages | No | 85 | 18.43 | 6.3479 | .6885 | 5.148 | .000 |
| | Yes | 259 | 14.53 | 5.0574 | .3143 | | |

**Table 3: Tests of Hypothesis 2a**
T-tests of Differences in MHI Between Counties With E-Governance Factors and Counties Without

| E-Government Factor | Mean MHI: Counties with Factor | Mean MHI: Counties w/o Factor | 2-tailed Significance |
|---|---|---|---|
| Online payment of taxes | $48,825.69 | $40,884.46 | .000 |
| Online payment of fines/fees | $48,343.04 | $41,654.53 | .000 |
| Online completion and submission of permit applications | $48,346.79 | $41,725.83 | .000 |
| Online completion and submission of business license applications/renewals | $48,888.80 | $41,695.19 | .000 |
| Online requests for local government records | $48,793.53 | $40,392.49 | .000 |
| Online delivery of local government's records to the requestor | $48,786.67 | $40,403.61 | .000 |
| Online requests for services, such as pothole repair | $53,975.40 | $42,556.53 | .000 |
| Online voter registration | $51,596.32 | $41,898.62 | .000 |
| Forms can be downloaded for manual completion | $47,262.84 | $39,394.98 | .000 |
| Online communication with individual elected and appointed officials | $47,044.51 | $39,419.07 | .000 |
| Provide general news and information to the public | $46,380.06 | $39,318.27 | .000 |
| Provides economic development information to the public | $48,312.08 | $40,237.87 | .000 |

Next, we performed a similar analysis using the PP as the dependent variable. As shown in Table 4, all of the t-tests were significant at the .01 level. In every case, the mean poverty percentage is lower for the counties offering that service than for the counties not offering that service. Therefore, the counties with more poverty are receiving fewer e-government services. Therefore, Hypothesis 2b is supported.

| Table 4" Tests of Hypothesis 2b<br>T-tests of Differences in PP Between Counties With E-Governance Factors and Counties Without | | | |
|---|---|---|---|
| | Mean Poverty Percentage (PP) | | 2-tailed Significance |
| E-Government Factor | Counties with Factor | Counties w/o Factor | |
| Online payment of taxes | 13.452 | 16.266 | .000 |
| Online payment of fines/fees | 13.686 | 15.976 | .000 |
| Online completion and submission of permit applications | 13.874 | 15.904 | .002 |
| Online completion and submission of business license applications/renewals | 13.606 | 15.937 | .000 |
| Online requests for local government records | 13.348 | 16.494 | .000 |
| Online delivery of local government's records to the requestor | 13.373 | 16.489 | .000 |
| Online requests for services, such as pothole repair | 11.500 | 15.679 | .005 |
| Online voter registration | 13.127 | 15.817 | .004 |
| Forms can be downloaded for manual completion | 13.550 | 17.190 | .000 |
| Online communication with individual elected and appointed officials | 13.871 | 16.978 | .000 |
| Provide general news and information to the public | 14.329 | 16.809 | .000 |
| Provides economic development information to the public | 13.902 | 16.351 | .000 |

Next we examine whether differences exist within a subsample of the counties by looking at only those counties that have a web presence. Those counties with a web presence have at least put some investment into e-government services, even if it is only to present basic information to their constituents. We posit that, since the counties with more poverty and lower median incomes are likely to have lower revenues and, therefore, fewer resources, they are more likely to have more basic websites than the counties with wealthier residents. Therefore, we expect that the MHI for counties offering each of the e-services will be higher than those not offering the services. The results of independent samples t-tests for Hypothesis 3a are shown in Table 5. These results show that the between-group differences are all significant at the .01 level and that in each instance the MHI is higher for the counties offering the e-service. Therefore, Hypothesis 3a is supported.

To test Hypothesis 3b, t-tests were performed for each factor with PP as the dependent variable. These results are summarized in Table 6. In each case, the poverty levels were lower in the counties that offered the e-service. However, not all of the between group differences were statistically significant. The groups differed significantly on five of the 12 factors at the .01 level. An additional five factors showed significant differences at the .10 level. Poverty levels did not seem to differ significantly for counties offering general information to the public and online submission of permit applications. Therefore, Hypothesis 3b is only partially supported.

**Table 5: Tests of Hypothesis 3a**
T-tests of Differences in MHI Between Counties With E-Governance Factors and Counties Without Companies with a Web Presence Only

| E-Government Factor | Mean MHI | | 2-tailed Significance |
|---|---|---|---|
| | Counties with Factor | Counties w/o Factor | |
| Online payment of taxes | $48,825.69 | $42,726.93 | .000 |
| Online payment of fines/fees | $48,343.04 | $43,630.27 | .001 |
| Online completion and submission of permit applications | $48,349.67 | $43,702.27 | .001 |
| Online completion and submission of business license applications/renewals | $48,888.80 | $43,617.46 | .000 |
| Online requests for local government records | $48,793.53 | $42,140.43 | .000 |
| Online delivery of local government's records to the requestor | $48,786.67 | $42,146.23 | .000 |
| Online requests for services, such as pothole repair | $47,044.51 | $41,308.00 | .000 |
| Online voter registration | $53,975.40 | $44,384.95 | .000 |
| Forms can be downloaded for manual completion | $47,262.84 | $41,186.91 | .000 |
| Online communication with individual elected and appointed officials | $51,596.32 | $43,688.58 | .000 |
| Provide general news and information to the public | $46,380.06 | $41,537.51 | .000 |
| Provides economic development information to the public | $48,312.08 | $42,029.57 | .000 |

## CONCLUSIONS AND NEXT STEPS

This study revealed that a vast majority of the counties sampled had some type of web presence as of January 2010. So it does seem that most county governments believe that an online presence is worthwhile. Such a presence can save the government time and money since staff is oftentimes consumed with answering basic questions about government services and procedures. Having a well-designed web presence reduces the workload of government employees because it, in essence, allows the offices to be open 24 hours a day, seven days a week (Fountain, 2001).

| **Table 6: Tests of Hypothesis 3b**<br>T-tests of Differences in PP Between Counties With E-Governance Factors and Counties Without Companies with a Web Presence Only | | | |
|---|---|---|---|
| | Mean Poverty Percentage (PP) | | 2-tailed Significance |
| E-Government Factor | Counties with Factor | Counties w/o Factor | |
| Online payment of taxes | 13.452 | 15.150 | .009 |
| Online payment of fines/fees | 13.686 | 14.860 | .094 |
| Online completion and submission of permit applications | 13.874 | 14.774 | .206 |
| Online completion and submission of business license applications/renewals | 13.606 | 14.845 | .087 |
| Online requests for local government records | 13.348 | 15.396 | .001 |
| Online delivery of local government's records to the requestor | 13.373 | 15.395 | .001 |
| Online requests for services, such as pothole repair | 13.871 | 15.679 | .009 |
| Online voter registration | 11.500 | 14.720 | .016 |
| Forms can be downloaded for manual completion | 13.550 | 16.124 | .000 |
| Online communication with individual elected and appointed officials | 13.127 | 14.799 | .052 |
| Provide general news and information to the public | 14.329 | 15.019 | .316 |
| Provides economic development information to the public | 13.902 | 15.080 | .061 |

Our results indicate that citizens in counties with lower incomes and higher poverty levels have significantly less available to them in terms of e-government services at the county level. County governments that had some type of web presence had significantly higher median incomes and lower poverty percentages than counties that did not have any web presence. As a result, citizens in the more disadvantaged counties had less access to convenience services such as online payment of taxes or the ability to apply for permits or download forms online. In addition, these same citizens had less opportunity to interact with the government officials through email or receive information online about government activities. Recent actions have been taken at the federal level to attempt to reduce the "digital divide" in terms of providing affordable Internet service to all citizens, so that the citizens with lower incomes and rural citizens will have access to the Internet equal to what their wealthier and more urban counterparts enjoy. However, unless the local governments representing those citizens ramp up their e-government efforts, a different type of digital divide will remain wherein the poorer and more rural populations will not have the same access to local government services or be as able to participate in local governance to the same extent as more wealthy citizens and citizens in more urban areas.

In order to reduce this divide, local governments must find a way to overcome the barriers to increasing their e-government offerings. A common barrier cited in the literature is lack of financial resources (Reddick, 2004). This barrier may be the most difficult to overcome since a government's revenue stream is driven by the wealth and income of its constituents. It stands to reason, then, that in counties in which the citizens are less wealthy and have lower incomes, their county government will also be less wealthy and bring in less income than other counties. Other common barriers cited that could be income-related or geographically influenced are a lack of technology expertise and a shortage of technology staff (Reddick, 2004). Concerns about data security are also cited as barriers to e-government implementation (Reddick, 2004). Finding ways to fund and staff technology services at the county government level would likely go a long way to ensuring equal opportunity for all citizens in regard to e-government services.

Our next step is to examine the e-governance factors from the standpoint of their contribution to an e-democracy and to create some type of measure that would provide a better sense of how to weigh the factors, how to include more significant factors, and how to evaluate which factors are more important to achieving a fully functioning e-government and e-democracy. Further, we need to analyze municipal websites as well as equivalent level foreign web presences to determine if what we learned about the United States is consistent across developed, developing, undeveloped or underdeveloped countries. Lastly, it is equally important that we analyze implementations across population size as well as re-analyze the county implementations as technology and implementations change quickly.

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# THE ETHICS OF TAX EVASION: AN INVESTIGATION INTO DEMOGRAPHIC DIFFERENCES

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## ABSTRACT

*The concept of tax evasion is the primary focus of the study. Data is gathered from a survey of approximately eleven hundred individuals across six countries. An eighteen-item scale is presented, analyzed, and discussed. Findings suggest that tax evasion has three overall perceptual dimensions across the items tested: (1) fairness, as related to the positive use of the money, (2) tax system, as related to the tax rates and negative use of the money, and (3) discrimination, as related to avoidance under certain conditions.*

## INTRODUCTION

Many articles have been written about tax evasion. Most of them have appeared in the accounting, economics and public finance literature. The usual thrust of these articles is to discuss technical aspects of tax evasion. Practitioner journals address legal aspects and evasion techniques. Scholarly journals focus on lost tax revenues or reasons why collections are not more efficient. Ethics is seldom discussed, or when it is discussed, it is usually done superficially. Oftentimes the discussion begins with the premise that what is illegal is also unethical.

The present paper is different. This paper begins with an overview of the ethical literature that has been published on tax evasion and proceeds to present the results of an empirical study that solicited views on the ethics of tax evasion from participants in six countries. This study had several goals. One goal was to rank the main arguments that have been used to justify tax evasion on ethical grounds over the last 500 years. Another goal was to determine which categories of arguments drew the most support from a wide range of cultures.

## BACKGROUND ON TAX EVASION

Tax evasion has a long and distinguished history. Adams (1982, 1993) and Webber and Wildavsky (1986) trace the history of taxation and tax evasion back 5,000 years to ancient Egypt. Baldwin (1967), Beito (1989), Larson (1973), Rabushka and Ryan (1982) and Valentine (2005) have written about tax revolts while Greenwood (2007) and Holmes and Sunstein (1999) give us reasons why taxpayers should not revolt. Chodorov (1954), Cowell (1990), Graetz and Shapiro (2005), Gross (1995), Johnston (2003, 2007), Lewis and Allison (2002), Myddelton (1994) and Shughart (1997) tell us what is wrong with the current system. Hall and Rabushka (1985) have argued in favor of a flat tax to increase fairness whereas McCaffery (2002) argues that the flat tax is not fair. Others have argued that the income tax must be abolished altogether (Curry, 1982; Hultberg, 1996; Sabrin, 1995). Alm, Martinez-Vazquez and Rider (2006), Edwards and Mitchell (2008) and Mutti (2003) have examined tax competition and the effect it has on economic reform and foreign direct investment.

David Ricardo (1817; 1996) wrote the first classic treatise on taxation. Musgrave and Peacock (1958) collected and reprinted a number of other classic treatises on taxation and public finance. Musgrave made a number of other contributions to the literature of public finance (Musgrave, 1959, 1986; Musgrave and Musgrave, 1976) and participated in a scholarly debate with Nobelaureate James Buchanan on the proper role of taxation in society (Buchanan and Musgrave, 2001). James Buchanan and others have examined public finance theory from the perspective of public choice theory (Buchanan, 1967; Buchanan and Flowers, 1975; Cullis and Jones, 1988).

The most comprehensive literary survey of tax evasion in the twentieth century was done by Martin Crowe (1944), who examined the Christian (mostly Catholic) tax evasion literature over the prior 500 years, much of which was in Latin. He brought this literature to the attention of English speaking scholars. McGee (1994, 1998a, 1999a, 2006) used the Crowe study as the basis for several theoretical and empirical studies of tax evasion. Torgler (2003) conducted a comprehensive, multi-country study of tax morale that expanded on the Crowe and McGee studies.

A number of country studies have focused on various aspects of tax evasion. McGee (1999b) found that Armenians evade taxes because there is no mechanism in place to collect taxes and because they do not feel any moral obligation to pay taxes to a corrupt government that gives them nothing in return for their taxes, reasons that are also present in a number of other former Soviet republics and Soviet bloc countries as well as in Asia, Africa and Latin America.

Ballas and Tsoukas (1998) examined cultural aspects of tax evasion in Greece. Theoretical and empirical studies of tax evasion have also been conducted for Argentina (McGee and Rossi, 2006), Armenia (McGee, 2008d; McGee and Maranjyan, 2008), Bosnia (McGee, Basic and Tyler, 2008), Bulgaria (Pashev, 2008a&b; Smatrakalev, 1998, 2008), China (McGee and An, 2008), Estonia (McGee, Alver and Alver, 2008), Guatemala (McGee and Lingle, 2005, 2008), Poland (McGee and Bernal, 2006), Kazakhstan, (McGee and Preobragenskaya, 2008), Mali (McGee and M'Zali, 2008), Romania (McGee, 2005b; McGee, Basic and Tyler, 2008), Russia (Vaguine, 1998; Turley, 2008), Slovakia (McGee and Tusan, 2008), Thailand (McGee, 2008b), Ukraine (Nasadyuk and McGee, 2008) and Vietnam (McGee, 2008c).

Some multicountry studies of tax evasion have also been done. Examples include Asia (McGee, 2008a) and four Latin American countries (McGee and Paláu, 2008). Inglehart et al.

(2004) supervised a study that collected data on dozens of countries, including some data on tax evasion.

Other studies have focused on religious literature or religious views. Cohn (1998) and Tamari (1998) examined the Jewish literature and concluded that tax evasion is almost never justified, whereas an empirical study of Orthodox Jewish students found that there is slightly more flexibility within the Jewish community (McGee and Cohn, 2007, 2008). Theoretical studies of the Baha'i (DeMoville, 1998) and Mormon (Smith and Kimball, 1998) concluded that tax evasion is always unethical, with no exceptions.

Some of the Christian literature justifies tax evasion in certain circumstances, such as when the ruler is corrupt, when the tax system is unfair, where the tax burden is excessive or exceeds the ability to pay or where tax proceeds are used to support an unjust war. The Crowe (1944) study listed all of these reasons as being present in the Christian literature. McGee (1994, 1998c, 1999c) reviewed the Crowe study and expanded upon it.

Gronbacher (1998) examined the Catholic literature from the perspective of classical liberalism and concluded that tax evasion is sometimes justifiable on moral grounds. Pennock (1998) examined the view that evasion can be justified as a means of war resistance. Schansberg (1998) examined the Biblical view that taxpayers are morally obligated to render unto Caesar what is Caesar's and concluded that Caesar is not entitled to all of a taxpayer's income.

McGee (1997, 1998b) examined the Muslim literature and found that some Islamic scholars would justify tax evasion in cases where the tax increases the price of goods, such as in the case of sales taxes and tariffs. Those Muslim scholars would also justify tax evasion where the tax is on income.

Some philosophical studies have examined the justification for taxation or tax evasion. Block (1989, 1993) examined the public finance literature but could not find an adequate justification for taxation. He found that public finance authors did not address this question but rather began with the assumption that taxation is justified. Spooner (1870) did not address tax evasion in particular but concluded that the government of the United States is illegitimate, which might lead one to conclude that there is no moral duty to pay any taxes ever.

Leiker (1998) speculated on what Jean Jacques Rousseau would have said about the ethics of tax evasion, basing his opinion of various Rousseau works. Morales (1998) presents a sociological perspective in his examination of Mexican workers and concludes that the need to provide for the family may at times take precedence over the duty to pay taxes. Oliva (1998) discusses some of the conflicts that tax practitioners face when dealing with the tax law and clients.

## DATA COLLECTION & MEASUREMENT

Business school graduate students, undergraduate students and faculty from several countries were selected to participate in the survey, which was distributed in paper format.

Respondents were then asked to complete a survey comprised of eighteen items described in the following text. Statement topics were selected based on the reasons Crowe (1944) identified to justify tax evasion over the last 500 years. Three additional reasons were added to reflect more recent justifications based on human rights abuses. The respondents were asked to indicate their agreement or disagreement with each of the items by circling a number from (1) strong agreement to (7) strong disagreement. Thus, low scores indicate an acceptance of tax evasion, while higher scores indicate a disagreement with the practice of tax evasion. This procedure resulted in eleven hundred usable surveys.

From the literature review presented above, eighteen items are developed which reflect the various aspects under discussion in the area of tax evasion. These items are the following:

(v1) tax evasion is ethical if tax rates are too high,
(v2) tax evasion is ethical even if tax rates are not too high,
(v3) tax evasion is ethical if the tax system is unfair,
(v4) tax evasion is ethical if a large proportion of the money collected is wasted,
(v5) tax evasion is ethical even if most of the money collected is spent wisely,
(v6) tax evasion is ethical if a large proportion of the money collected is spent on projects, of which I morally approve,
(v7) tax evasion is ethical even if a large proportion of the money collected is spent on worthy projects,
(v8) tax evasion is ethical if a large proportion of the money collected is spent on projects which do not benefit me,
(v9) tax evasion is ethical if a large proportion of the money collected is spent on projects which do benefit me,
(v10) tax evasion is ethical if everyone is doing it,
(v11) tax evasion is ethical if a significant proportion of the money collected winds up in the pockets of corrupt politicians or their friends and family,
(v12) tax evasion is ethical if the probability of getting caught is low,
(v13) tax evasion is ethical if some of the proceeds go to support a war that I consider to be unjust,
(v14) tax evasion is ethical if I cannot afford to pay,
(v15) tax evasion is ethical even if it means that if I pay less, then others will have to pay more,
(v16) tax evasion would be ethical if I were a Jew living in Nazi Germany in 1940,
(v17) tax evasion is ethical if the government discriminates against me because of my religion, race, or ethnic background, and
(v18) tax evasion is ethical if the government imprisons people for their political opinions.

Also included in the study are three demographic variables used as predictors of respondents' perceptions of the ethics of tax evasion: (i) gender, (ii) country, and (iii) education levels. Data are collected on the same questionnaire for the gender and education items with respondents checking the appropriate box. For gender, this leads to male and female categories. For education, this leads to undergraduate, graduate, and faculty categories. The country variable is added afterwards and represents the country where the respondents answered the questionnaires. The respondents are from six parts of the world: the United States, the United Kingdom, Argentina, Romania, Poland, and Guatemala.

## ANALYSES & RESULTS

In order to determine the underlying dimensionality of the items measured, the data is subjected to principal axis factoring. The output of the initial factor analysis is then rotated using a varimax rotation with Kaiser Normalization. Only those dimensions with eigenvalues greater than one are included in the rotation. An inspection of these initial rotated loadings leads us to eliminate variables V13 and V14 due to low or indiscriminate loadings across the rotated dimensions. The procedure is then repeated, including only the remaining sixteen items. This results again in three dimensions which explain 55.87% of the common variance. The percentage of the explained common variance attributed to each factor is the following: factor one – 27.61%, factor two – 15.24%, and factor three – 12.87%. The final sum of squared loadings for the rotation is presented in Table 1.

**Table 1: Rotated factor Loadings**

| Variable | Factor 1 | Factor 2 | Factor 3 |
|---|---|---|---|
| V1 | .423 | .562 | .204 |
| V2 | .705 | .255 | .044 |
| V3 | .255 | .725 | .203 |
| V4 | .203 | .752 | .221 |
| V5 | .785 | .062 | .008 |
| V6 | .322 | .436 | .290 |
| V7 | .738 | .096 | .035 |
| V8 | .728 | .268 | .106 |
| V9 | .822 | .091 | .035 |
| V10 | .583 | .189 | .078 |
| V11 | .083 | .610 | .340 |
| V12 | .625 | .263 | .123 |
| V15 | .621 | .203 | .184 |
| V16 | -.028 | .221 | .636 |
| V17 | .087 | .281 | .837 |
| V18 | .181 | .197 | .743 |

As is shown in Table 1, the variables generally load highly on one dimension and not on others. If we look at the highest few loadings for each dimension, then it is possible to name the three dimensions. Factor one is correlated the highest with V9, V8, V7, V5, and V2. Those highly loading questions indicate that factor one is most likely a *fairness* dimension. Specifically, fairness appears to include the worthiness of how the money is spent and how that relates to the beneficiaries. Factor two is correlated the highest with V1, V3, V4, and V11. Those highly loading questions indicate that factor two is most likely a *tax system* dimension. Specifically, the tax system seems to indicate the rate of tax levies and possibly any corruption in the system. Factor three is correlated most highly with V16, V17, and V18. Those highly loading questions indicate that factor three is most likely a *discrimination* dimension.

Specifically, the discrimination seems to indicate the ethics of taxing people who are not treated as equal under the system.

Next, factor scores are derived from the loadings of all the sixteen variables within each of the three factors. This is accomplished by regressing, for each factor, the loadings with the original variables and summing them to arrive at the overall factor scores for each respondent. Note that this procedure creates standardized variables with an expected mean of zero and standard deviation of one. For instance, factor score one (fairness) for respondent one is derived in the following manner:

$$FS_{11}=.423V1+.705V2+.255V3+.203V4+.785V5+.322V6+.738V7+.728V8+.822V9+.583V10+.083V11+.625V12+.621V15-.028V16+.087V17+.181V18$$

The factor scores are then tested for mean differences across three demographic variables: gender, country, and education. Again, note that higher scores indicate a disagreement with the ethics of tax evasion, while the lower scores indicate an agreement with tax evasion.

The general descriptive statistics and the statistical test results of the mean comparisons for the factors are shown in Table 2 for the genders. As shown in the table, the three statistical tests indicated significant mean differences between men and women: fairness (p=.017), tax system (p=.001), and discrimination (p=.025). Men more than women seem to think tax evasion is less ethical when fairness is the issue, while women more than men seem to think tax evasion is less ethical when tax systems and discrimination are the issues.

**Table 2: Descriptive Statistics, Test Statistics: Gender**

| Factor | Demographic Group | N | Mean | Standard Deviation | 't' | 'p' | Finding |
|---|---|---|---|---|---|---|---|
| Fairness | Females | 385 | -0.0835 | .980 | 2.391 | .017 | M>F |
| | Males | 522 | 0.0687 | .903 | | | |
| Tax System | Females | 385 | 0.1017 | .855 | 3.250 | .001 | F>M |
| | Males | 522 | -0.0876 | .876 | | | |
| Discrimination | Females | 385 | 0.0752 | .916 | 2.252 | .025 | F>M |
| | Males | 522 | -0.0607 | .885 | | | |

The general descriptive statistics and the statistical test results of the mean comparisons for the factors are shown in Table 3 for the country. As shown in the table, the three statistical tests indicated significant mean differences across countries: fairness (p=.000), tax system (p=.000), and discrimination (p=.000). For fairness, it appears that the Argentineans and the Guatemalans are the most likely to think tax evasion is unethical, while the Romanians and the people of the United Kingdom are the least likely to reject tax evasion. The United States and Polish respondents were in the middle of these two polar groups. For the tax system, the people from the United States are the most likely to reject tax evasion, while the people of Poland and the United Kingdom are the least likely to reject tax evasion. The Argentineans, the Romanians, and the Guatemalans are in the middle regarding the ethics of tax evasion. Regarding discrimination, again the people from the United States are the most likely to think tax evasion is unethical, while the Polish are the least likely to reject tax evasion. The Argentineans Guatemalans, Romanians, and those people from the United Kingdom exhibit middle level means on discrimination.

**Table 3: Descriptive Statistics, Test Statistics: Countries**

| Factor | Demographic Group | N | Mean | Standard Deviation | 'F' | 'p' | Finding |
|---|---|---|---|---|---|---|---|
| Fairness | Argentina | 198 | 0.4920 | .612 | 42.63 | .000 | A,G>US,P>R,UK |
| | Guatemala | 115 | 0.3591 | .708 | | | |
| | Poland | 265 | -0.0192 | .835 | | | |
| | Romania | 124 | -0.5483 | 1.078 | | | |
| | UK | 120 | -0.6622 | 1.056 | | | |
| | USA | 101 | 0.1370 | .860 | | | |
| Tax System | Argentina | 198 | 0.0582 | .868 | 10.69 | .000 | US>A,R,G>P,UK |
| | Guatemala | 115 | 0.0245 | .941 | | | |
| | Poland | 265 | -0.1727 | .791 | | | |
| | Romania | 124 | 0.0573 | .861 | | | |
| | UK | 120 | -0.2114 | .891 | | | |
| | USA | 101 | 0.4918 | .809 | | | |
| Discrimination | Argentina | 198 | 0.1502 | .920 | 5.47 | .000 | US>R,G,UK,P |
| | Guatemala | 115 | 0.0099 | .974 | | | A>UK,P |
| | Poland | 265 | -0.1906 | .824 | | | R,G>P |
| | Romania | 124 | 0.0166 | .895 | | | |
| | UK | 120 | -0.0736 | .866 | | | |
| | USA | 101 | 0.2614 | .921 | | | |

**Table 4: Descriptive Statistics, Test Statistics: Education**

| Factor | Demographic Group | N | Mean | Standard Deviation | 'F' | 'p' | Finding |
|---|---|---|---|---|---|---|---|
| Fairness | Undergrad | 302 | -0.3045 | 1.056 | 27.93 | .000 | F>G>UG |
| | Graduate | 228 | 0.1953 | .898 | | | |
| | Faculty | 75 | 0.4438 | .658 | | | |
| Tax System | Undergrad | 302 | -0.0284 | .859 | 6.349 | .002 | G>F,UG |
| | Graduate | 228 | 0.2422 | .903 | | | |
| | Faculty | 75 | 0.0146 | .903 | | | |
| Discrimination | Undergrad | 302 | 0.0180 | .912 | 2.495 | .083 | none |
| | Graduate | 228 | 0.1726 | .921 | | | |
| | Faculty | 75 | -0.0446 | .924 | | | |

The general descriptive statistics and the statistical test results of the mean comparisons for the factors are shown in Table 4 for the education levels. As shown in the table, the two of the three statistical tests indicated significant mean differences across countries: fairness (p=.000), tax system (p=.002), and discrimination (p=.083). For fairness, it is shown that faculty respondents are more likely to think tax evasion is unethical, while the undergraduates are the least likely to see tax evasion as unethical. Graduate students exhibit means in the center on fairness issues of tax evasion. For the tax system, it is the graduate students that think tax evasion is unethical, while the faculty and the undergraduates are less likely to see these issues as unethical. No significant differences are evident for discrimination across education levels.

## DISCUSSION & LIMITATIONS

The purpose of this study was to derive a measure and its underlying dimensionality for the investigation into the ethics of tax evasion across different demographic groups. Eighteen items are presented which cover the domain of tax evasion. Two of the original items are eliminated, resulting in sixteen variables which are useful for this and future studies. In the final factor analysis, three dimensions are evident which focus on different aspects of this important topical area. The three dimensions are (1) fairness as it relates to the use of money, (2) the tax system as it relates to the levies and possible corruption, and (3) discrimination as it relates to avoidance under certain conditions.

The analyses reveal that each of the demographic groups exhibits significant mean differences across the three dimensions of the ethics of tax evasion.

> <u>Fairness</u>: Men more than women seem to think that tax evasion is less ethical when fairness is the issue, while women more than men seem to think that tax evasion is less ethical.

In the geographic realm, Argentineans and Guatemalans are most likely to think tax evasion is unethical, while Romanians and people from the United Kingdom are least likely to reject tax evasion. Respondents from the United States and Poland were in the middle of the geographic grouping.

When considering the fairness issue, faculty respondents are more likely to think tax evasion is unethical, while undergraduates are least likely to see tax evasion as unethical.

> <u>The Tax System:</u> Respondents from the United States are most likely to reject tax evasion, while people from Poland and the United Kingdom are least likely to reject tax evasion. The Argentineans, the Romanians, and Guatemalans are in the middle regarding the ethics of tax evasion.

Women more than men seem to think tax evasion is less ethical when the tax system itself is the issue.

For the tax system, graduate students think that tax evasion is unethical, while faculty and undergraduates are less likely to see these issues as unethical.

> Discrimination: Women more than men tend to view tax evasion as less ethical when considering the discrimination dimension.

People from the United States are also most likely to think tax evasion is unethical when considering discrimination as a factor, whereas Polish people are least likely to reject tax evasion under this dimension. The Argentineans, Romanians, and people from the United Kingdom exhibit mid-level means on discrimination.

There were no significant differences in the perception of the ethics of tax evasion among faculty, graduate, or undergraduate respondents when the discrimination dimension was considered.

Several other studies have examined gender in connection with tax evasion. Some studies have found that women are more opposed to tax evasion while others have found no significant differences between male and female views. A few studies have found that men are more opposed to tax evasion. Most of the country studies mentioned above have examined views on tax evasion from the perspective of gender, as has Torgler (2003). A summary of many of these and other studies may be found in McGee and Tusan (2008). One purpose of the present study was to determine whether opinion toward tax evasion differs by gender in the six countries being examined. A detailed examination of the relationship between gender and attitudes toward tax evasion is beyond the scope of the present study.

This study is limited in that the sample consisted mostly of graduate and undergraduate students, which may or may not be representative of the general population. However, social scientists have been using student samples for decades, so there is substantial precedence for the use of student samples.

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# ETHNICITY/RACE AND GENDER EFFECTS ON ETHICAL SENSITIVITY IN FOUR SUB-CULTURES

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## ABSTRACT

*The paper expands ethics' literature by asking participants to evaluate different scenarios involving ethical dilemmas. Data from a sample of 536 students show that ethical sensitivity varies among the four dominant ethnic/race groups in the U.S.. Consistent with other studies, results of this research supports the gender socialization approach and demonstrates that there are significant differences in ethical sensitivity between males and females.*

## INTRODUCTION

Business Ethics has been defined as "the moral principles and standards that guide behavior in the world of business" (Ferrell and Fraedrich, 1991, p. 5). A number of authors investigated the topic from different perspectives and examined the effects of different variables on ethical behavior. News reports documented questionable behaviors of business executives in all areas of corporate life. Household names such as AIG, Enron, and WorldCom are now synonyms with fraud and deception. The recent financial crisis, the collapse of Wall Street icons, and the responsibility of their executives guarantee that business ethics will continue to get the attention of academic scholars, the press, and business professionals.

Previous research examined the effects of culture on ethical behavior. The topic received a considerable amount of attention with the majority of the studies focusing on cultural differences across national boundaries (O'Fallon and Butterfield, 2005). Research on ethical differences among ethnic/racial groups within the United States is lacking (Gerlich, Turner and Gopalan, 2007). The purpose of this study is to investigate the effects of ethnicity/race and gender on ethical sensitivity. The next section discusses the literature review and provides the background for the hypotheses. The methodology, research design, and data analysis follow. The paper concludes with a discussion and suggestions for future research.

## LITERATURE REVIEW

The majority of studies that examined the effects of culture on ethical values accepted the position that different cultures have different ethical values (Tsalikis and Nwachukwu, 1988). McClelland (1961) advanced the notion that the different value systems observed among different cultures have an effect on ethical beliefs. He concluded that different cultures have an effect on business practices. England (1975) proposed that people exposed in different cultures have a different system of values and ethical beliefs. Hofstede (1980) describes how cultures have an effect on value systems and ethical beliefs. Prasad and Rao (1982) argued that ethical values are part of any society. However, commitment to these values differs among its subgroups.

Tat (1981) examined the ethical values between Black and White students and found that Black and White students evaluate ethical scenarios differently. Stead et al. (1987) used scenarios to examine the relationship between race and ethical/unethical decision making. The hypothesis of racial differences in ethical behavior was not supported. Tsalikis and Nwachukwu (1988) exposed Black and White students to different ethical scenarios and found that the two groups have similar beliefs in one scenario, but differed in the second.

Lee (1981) studied the impact of culture and management level on ethics in marketing practice. The comparison between Chinese and English managers found no significant differences. Consistent with Lee, Abratt et al. (1992) found no difference between managers from South Africa and Australia. However, Hegarty and Sims (1978) identified a significant relationship between unethical behavior and non United States citizenship. These findings were replicated by Okleshen and Hoyt (1996). They found U.S. students to be less tolerant of unethical situations than New Zealand students.

In a recent review of the empirical ethical decision making literature O'Fallon and Butterfield (2005) identified 25 empirical studies that examined the effects of culture and nationality on ethical behavior (Jackson and Artola, 1997; Davis, Johnson and Ohmer, 1998; Jackson, 2001; Cherry and Chien, 2003; Christie, Kwon, Stoeberl and Baumhart, 2003). Whipple and Swords (1992) compared U.S. and United Kingdom on business ethical judgments and found significant differences between gender and country. They noted that theses differences explain only a small percentage of the variance in ethical judgments and they suggested that cultural and ethnic group effects should be given more consideration. Previous research examined cultural differences across national boundaries. However, examination of differences among ethnic/racial groups within the United States is lacking. McCuddy and Peery (1996) stated that the relationship between race and ethics is an unexplored topic and deserves more attention.

The examination of the effects of ethnicity/race on ethical behavior is a sensitive, if not controversial issue. This position might be used to provide a partial explanation of why research in the area is limited. However, Lauritsen (2004) suggested that there is a need for more research in the area of race and ethnicity. As she noted (p. 5*) "…only after a very long period of demonstrating that race and ethnicity are irrelevant to life's outcomes should we cease to collect such data*."

Gerlich, Turner, and Gopalan (2007) investigated the attitudes of Black and White students toward downloading music and file sharing. Although the study contributes to our understanding of the relationship between ethical behavior and race, its value is limited due to its focus to a specific behavior, downloading music. The authors acknowledged that future research should include Asian, Hispanic, and other ethnic groups to examine the relationship of ethical behavior among racial groups.

Hartman, Fok, and Zee (2009) examined the effects of race and gender on ethical behavior. Unlike other studies that focus on cultural differences across national boundaries, the study by Hartman and her coauthors (2009) examined the differences between two racial groups, Blacks and Whites and two gender groups in the United States. They found no significant differences in behavioral choices between Blacks and Whites. However, their findings demonstrated that the rationales used to justify behavioral choices differed between the two groups. Consistent with previous studies they found significant differences in behavioral choices between males and females.

This paper expands ethics literature by asking participants to evaluate different scenarios involving ethical dilemmas. While Hartman et al. (2009) examined racial differences between Blacks and Whites, the present study examines ethical sensitivity differences among the four dominant racial groups: Blacks-African Americans; Asians; Whites-Caucasians; and Hispanics-Latinos, and the two gender groups in the United States (Gerlich, et. al., 2007)

## HYPOTHESES

The majority of the research that examined the relationship between gender and ethical sensitivity produced consistent results. As stated by O'Fallon and Butterfield (2005, p 379)

> "*There are often no differences found between males and females, but when differences are found females are more ethical than males*." Therefore it is hypothesized that:

> *H1: Compared to male subjects, female subjects exhibit higher ethical sensitivity.*

The literature review in the previous section (England, 1975; Hofstede, 1980; Tat, 1981; Prasad and Rao, 1982) reveals that culture has an effect on individual's ethical behavior, therefore it is hypothesized that:

> *H2: There are differences in ethical sensitivity among the four dominant ethnic/racial groups in the United States.*

## METHODOLOGY

Data was collected using a self-administered questionnaire from students attending a Comprehensive College in the Northeast region of the United States. The cluster sampling technique was utilized to select classes to be included in the sample. In some classes, students were given enough time to complete the surveys during class time. In other cases students were instructed to complete the questionnaire at their convenience and return it the following class meeting. In both cases participation was optional. No credit or other incentive was given to participants for completing the survey.

Analysis showed no significant differences between those who completed the questionnaire in class and those who completed it outside the class. The overall response rate was 74.6% yielding a total sample size of 655. Seven questionnaires were excluded from the analysis because of missing data making these questionnaires not useable. The final sample size was 648. This study is a component of a larger study which examined the effects of gender, ethnicity/race, area of study, and personality traits on ethical behavior. The sample size for this study is 573. A total number of seventy-five observations were excluded from the analysis because respondents did not answer the ethnicity/race question or choose the “other” option. Table 1 presents the profile of the sample in terms of ethnicity/race, gender, family income, school attended, GPA, and employment status. The average age of the participants is 23.9 years.

### Ethical Sensitivity Scale (ESS)

Ethical Sensitivity (ESS) was measured using 30 items of ethically related decision making statements/scenarios. These statements (Table 2) covered ethical dilemmas involving: (1) the use of company resources for personal gain, (2) relationships with co-workers, (3) personal job performance, (4) company policies, and (5) gift utilization to obtain/provide preferential treatment. The items for the ethical sensitivity scale were taken from the study by Stevens, Harris and Williamson (1993). Each item scores 1 = Very Unethical to 5 = Not at all Unethical. Thus the lower the score (sum of the 30 items) on ESS scale, the higher the ethical sensitivity.

The base for the ESS scale was originally developed by Ruch and Newstrom (1975). Stevens and et al., (1993) added additional items based on judgments of business faculty. As Stevens and its co-authors noted, the construct validity of the ethical sensitivity scale is based heavily on these judgments. The internal consistency reliability index for the 30-item ESS scale is $\alpha$ =.94.

| Table 1: Sample Profile | | | | | |
|---|---|---|---|---|---|
| Variable | Frequency | % | Variable | Frequency | % |
| Ethnicity/Race | | | School Attended | | |
| African American | 166 | 29.0 | School of Liberal Arts | 156 | 27.2 |
| Asian | 91 | 15.9 | School of Business | 304 | 53.1 |
| White/Caucasian | 217 | 37.8 | School of Education | 113 | 19.7 |
| Hispanic | 99 | 17.3 | Total | 573 | 100.0 |
| Total | 573 | 100.0 | | | |
| Gender | | | Grade Point Average | | |
| Male | 266 | 46.4 | Below 2.50 | 23 | 4.2 |
| Female | 307 | 53.6 | 2.51 – 299 | 134 | 24.4 |
| Total | 573 | 100.0 | 3.00 – 3.49 | 232 | 42.2 |
| | | | 3.50 or above | 161 | 29.3 |
| Family Income | | | Total* | 550 | 100.0 |
| Less than $ 20K | 64 | 11.9 | | | |
| $ 20,001 - $ 40K | 115 | 21.5 | | | |
| $ 40,001 - $ 60K | 99 | 18.5 | Employment Status | | |
| $ 60,001 - $ 80K | 90 | 16.8 | Full time | 155 | 27.1 |
| $ 80,001 - $ 100K | 71 | 13.2 | Part time | 246 | 42.9 |
| More than $ 100K | 97 | 18.1 | No at all | 172 | 30.0 |
| Total* | 536 | 100.0 | Total | 573 | 100.0 |
| * The sample size (n) is different because of missing data. | | | | | |

| Table 2: Ethically Related Decision Making Scenarios/Vignettes | |
|---|---|
| 1. | Using Company services for personal use is. |
| 2. | Padding an expense account up to 10%. |
| 3. | Padding an expense account in excess of 10%. |
| 4. | Giving gifts/favors in exchange of preferential treatments. |
| 5. | Taking longer than necessary to do a job. |
| 6. | Taking care of personal business on company time. |
| 7. | Divulging confidential company information. |
| 8. | Concealing one's work errors. |
| 9. | Passing blame for work errors to an innocent co-worker. |
| 10. | Claiming credit for someone else's work. |
| 11. | Falsifying time/quality reports. |
| 12. | Calling in sick to take a day off. |

| Table 2: Ethically Related Decision Making Scenarios/Vignettes | |
|---|---|
| 13. | Authorizing a subordinate to violate company rules or policies. |
| 14. | Using company materials and supplies for personal use. |
| 15. | Accepting gifts/favors in exchange for preferential treatment. |
| 16. | Taking extra personal time (long lunches, late arrivals). |
| 17. | Not reporting others' violation of company rules and policies. |
| 18. | Not hiring a prospective employee because of his sexual preference. |
| 19. | Dropping medical coverage for people that have high medical bills. |
| 20. | Borrowing $50 from petty cash until pay day. |
| 21. | Betting on sports events during office hours. |
| 22. | Having job interview with competitors to obtain inside information. |
| 23. | Dating the boss (both are single). |
| 24. | Smoking in no smoking areas |
| 25. | Making copies of company software for personal use. |
| 26. | Having a receptionist tell a caller that someone is not in when they are. |
| 27. | Inflating job experience in a resume. |
| 28. | Not reporting to authorities company violations of the law. |
| 29. | Setting not real sales goals to get greater sales effort from sales people. |
| 30. | Quoting an optimistic/unrealistic shipping date to a buyer to get a sale. |

## DATA ANALYSIS AND RESULTS

An SPPS ANOVA was performed to examine the relationship between ESS and the two independent variables Gender and Ethnicity/Race. The dependent variable ESS was computed by summing the individual scores of the 30 items, describing ethical scenarios. Table 3 presents the SPSS ANOVA results. The overall model is significant ($F = 5.02$, $p = 0.00$). $F = 5.02$). There are no interactions effects (Ethnicity/race*Gender, F=0.46. p = 0.71).

Hypothesis1 (H1) states that compare to male subjects, female subjects exhibit higher ethical sensitivity. Hypothesis 1 is supported. Differences between males and females are significant ($F = 24.72$, $p=0.000$.) This finding is consistent with the majority of previous research that examined the relationship between gender and ethical behavior (O'Fallon and Butterfield (2005). Hypothesis 2 (H2) states that there are differences in ethical sensitivity among the four dominant ethnic/racial groups in the United States (Blacks-African Americans, Asians, Whites-Caucasian, and Hispanics -Latinos) in the United States ($F = 2.38$, $p = 0.07$). The fact that p-value is greater than 0.05 can be used to draw a conclusion that there are no significant differences between the four ethnicity /race groups. Instead the authors took the position that Hypothesis 2 is partially supported ($p = 0.07$).

Post Hoc multiple comparisons were performed to examine the differences between the four ethnicity /race groups. Table 4 presents the results of post hoc comparisons. The Post hoc comparison results indicated that there are significant differences between the Black-African American and the Whites-Caucasians groups (p=0.03) and partial differences between Black-African Americans and Hispanics (p=0.08), and Asians and Whites-Caucasians (p=0.07).

**Table 3: Anova Results: Between-Subjects Effects**

| Source | Type III Sum of Squares | Degrees of Freedom | Mean Square | F value | Sig. p-value |
|---|---|---|---|---|---|
| Corrected Model | 13708.75 | 7 | 1958.39 | 5.02 | 0.00 |
| Intercept | 1915102.06 | 1 | 1915102.06 | 4910.62 | 0.00 |
| Ethnicity/Race | 2790.26 | 3 | 930.09 | 2.38 | 0.07 |
| Gender | 9638.98 | 1 | 9638.98 | 24.72 | 0.00 |
| Ethnicity * Gender | 535.41 | 3 | 178.47 | 0.46 | 0.71 |
| Error | 205915.76 | 528 | 389.99 | | |
| Total | 2424691.00 | 536 | | | |
| Corrected Total | 219624.51 | 535 | | | |

**Table 4: Differences Between Subgroups (Based On Post Hoc Multiple Comparisons)**

| Groups | Mean Difference | Std. Error | Sig. |
|---|---|---|---|
| African Americans vs. Asian | 0.19 | 2.75 | 0.95 |
| African Americans vs. White- Caucasian | 4.81 | 2.17 | 0.03 |
| African Americans vs. Hispanic-Latino | 4.86 | 2.66 | 0.08 |
| Asian vs. White-Caucasian | 4.63 | 2.59 | 0.07 |
| Asian vs. Hispanic | 4.69 | 3.01 | 0.12 |
| Caucasian vs. Hispanic | 0.05 | 2.49 | 0.98 |

SPSS GLM Multivariate Analysis of Variance was performed to examine the sources of differences among the subgroups of the study. The 30 individual items that combined to compute ESS scale are now the dependent variables. The analysis shows that both gender differences (Wilks' Lambda =.881, Hotelling's Trace=.135, F=30.00, p=0) and ethnicity/race (Wilks' Lambda =.704, Hotelling's Trace=.369, F=120.00, p=0) are significant.

| Table 5: Mean Comparisons Between Male and Female Respondents | | | | | |
|---|---|---|---|---|---|
| Ethically Related Decision Making Scenarios | | Male (n=263-266)* | Female (n= 304-307)* | F | p value |
| 1. | Using Company services for personal use is. | 2.29 | 2.24 | 0.47 | 0.50 |
| 2. | Padding an expense account up to 10%. | 2.29 | 1.90 | 16.49 | 0.00 |
| 3. | Padding an expense account in excess of 10%. | 2.05 | 1.74 | 12.60 | 0.00 |
| 4. | Giving gifts/favors in exchange of preferential treatments. | 2.20 | 1.97 | 4.80 | 0.03 |
| 5. | Taking longer than necessary to do a job. | 2.65 | 2.33 | 10.38 | 0.00 |
| 6. | Taking care of personal business on company time. | 2.48 | 2.26 | 6.23 | 0.01 |
| 7. | Divulging confidential company information. | 1.65 | 1.41 | 6.02 | 0.01 |
| 8. | Concealing one's work errors. | 2.39 | 2.10 | 8.87 | 0.00 |
| 9. | Passing blame for work errors to an innocent co-worker. | 1.45 | 1.22 | 10.64 | 0.00 |
| 10. | Claiming credit for someone else's work. | 1.55 | 1.26 | 14.63 | 0.00 |
| 11. | Falsifying time/quality reports. | 1.81 | 1.51 | 9.47 | 0.00 |
| 12. | Calling in sick to take a day off. | 3.14 | 2.99 | 2.63 | 0.11 |
| 13. | Authorizing a subordinate to violate company rules or policies. | 1.89 | 1.57 | 11.01 | 0.00 |
| 14. | Using company materials and supplies for personal use. | 2.61 | 2.36 | 9.94 | 0.00 |
| 15. | Accepting gifts/favors in exchange for preferential treatment. | 2.17 | 1.82 | 9.86 | 0.00 |
| 16. | Taking extra personal time (long lunches, late arrivals). | 2.36 | 2.25 | 0.88 | 0.35 |
| 17. | Not reporting others' violation of company rules and policies. | 2.59 | 2.32 | 1.63 | 0.20 |
| 18. | Not hiring a prospective employee because of his sexual preference. | 1.68 | 1.33 | 9.95 | 0.00 |
| 19. | Dropping medical coverage for people that have high medical bills. | 1.81 | 1.49 | 9.59 | 0.00 |
| 20. | Borrowing $50 from petty cash until pay day. | 2.26 | 1.96 | 7.45 | 0.01 |
| 21. | Betting on sports events during office hours. | 2.61 | 2.26 | 11.33 | 0.00 |
| 22. | Having job interview with competitors to obtain inside information. | 2.40 | 1.96 | 14.90 | 0.00 |
| 23. | Dating the boss (both are single). | 3.09 | 2.70 | 11.27 | 0.00 |
| 24. | Smoking in no smoking areas | 2.12 | 1.85 | 4.54 | 0.03 |
| 25. | Making copies of company software for personal use. | 2.34 | 1.04 | 5.81 | 0.02 |
| 26. | Having a receptionist tell a caller that someone is not in when they are. | 2.91 | 2.80 | 2.88 | 0.09 |
| 27. | Inflating job experience in a resume. | 2.63 | 2.27 | 18.32 | 0.00 |
| 28. | Not reporting to authorities company violations of the law. | 2.18 | 1.84 | 9.06 | 0.00 |
| 29. | Setting not real sales goals to get greater sales effort from sales people. | 2.94 | 2.37 | 24.37 | 0.00 |
| 30. | Quoting an optimistic/unrealistic shipping date to a buyer to get a sale. | 2.36 | 1.88 | 23.33 | 0.00 |
| * n is different due to missing data | | | | | |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| **Table 6: Mean Comparisons among the Four Ethnicity/Race Sub-Groups** | | | | | | | |
| | Vignette | Blacks/ Afr. Am n=162 | Asians n= 89 | Cauca sians n=215 | Hispa-nics n= 98 | F | Sig. |
| 1 | Using Company services for personal use is. | 2.39 | 2.11 | 2.24 | 2.23 | 1.38 | 0.25 |
| 2 | Padding an expense account up to 10%. | 2.07 | 2.30 | 1.92 | 2.24 | 3.01 | 0.03 |
| 3 | Padding an expense account in excess of 10%. | 1.96 | 2.05 | 1.70 | 2.02 | 3.54 | 0.02 |
| 4 | Giving gifts/favors in exchange of preferential treatments. | 2.22 | 2.10 | 1.94 | 2.09 | 1.62 | 0.19 |
| 5 | Taking longer than necessary to do a job. | 2.62 | 2.70 | 2.31 | 2.41 | 3.15 | 0.03 |
| 6 | Taking care of personal business on company time. | 2.55 | 2.25 | 2.35 | 2.17 | 3.07 | 0.03 |
| 7 | Divulging confidential company information. | 1.58 | 1.76 | 1.38 | 1.52 | 2.53 | 0.06 |
| 8 | Concealing one’s work errors. | 2.28 | 2.40 | 2.12 | 2.26 | 1.65 | 0.18 |
| 9 | Passing blame for work errors to an innocent co-worker. | 1.39 | 1.44 | 1.24 | 1.29 | 1.37 | 0.25 |
| 10 | Claiming credit for someone else’s work. | 1.48 | 1.60 | 1.25 | 1.37 | 3.39 | 0.02 |
| 11 | Falsifying time/quality reports. | 1.68 | 1.97 | 1.52 | 1.60 | 3.38 | 0.02 |
| 12 | Calling in sick to take a day off. | 3.02 | 3.03 | 3.13 | 2.98 | 0.29 | 0.83 |
| 13 | Authorizing a subordinate to violate company rules or policies. | 1.77 | 1.91 | 1.59 | 1.74 | 2.00 | 0.11 |
| 14 | Using company materials and supplies for personal use. | 2.60 | 2.34 | 2.40 | 2.56 | 2.47 | 0.06 |
| 15 | Accepting gifts/favors in exchange for preferential treatment. | 2.15 | 2.08 | 1.83 | 1.96 | 2.94 | 0.03 |
| 16 | Taking extra personal time (long lunches, late arrivals). | 2.32 | 2.26 | 2.37 | 2.17 | 0.88 | 0.45 |
| 17 | Not reporting others’ violation of company rules and policies. | 2.51 | 2.42 | 2.49 | 2.26 | 1.03 | 0.38 |
| 18 | Not hiring a prospective employee because of his sexual preference. | 1.55 | 1.68 | 1.42 | 1.34 | 2.28 | 0.08 |
| 19 | Dropping medical coverage for people that have high medical bills. | 1.72 | 1.81 | 1.46 | 1.71 | 2.31 | 0.08 |
| 20 | Borrowing $50 from petty cash until pay day. | 2.24 | 2.57 | 1.94 | 1.80 | 6.10 | 0.00 |
| 21 | Betting on sports events during office hours. | 2.69 | 2.46 | 2.29 | 2.23 | 4.67 | 0.00 |
| 22 | Having job interview with competitors to obtain inside information. | 2.32 | 2.32 | 1.98 | 2.18 | 2.91 | 0.03 |
| 23. | Dating the boss (both are single). | 2.93 | 3.00 | 2.79 | 2.88 | 1.00 | 0.39 |
| 24 | Smoking in no smoking areas | 1.86 | 2.02 | 2.09 | 1.88 | 1.62 | 0.18 |
| 25 | Making copies of company software for personal use. | 2.23 | 2.34 | 2.02 | 2.28 | 1.74 | 0.16 |
| 26 | Having a receptionist tell a caller that someone is not in when they are. | 2.86 | 2.76 | 2.98 | 2.65 | 2.25 | 0.08 |
| 27 | Inflating job experience in a resume. | 2.55 | 2.54 | 2.44 | 2.15 | 2.33 | 0.07 |
| 28 | Not reporting to authorities company violations of the law. | 2.07 | 2.12 | 1.94 | 1.89 | 1.10 | 0.35 |
| 29 | Setting not real sales goals to get greater sales effort from sales people. | 2.66 | 2.74 | 2.57 | 2.66 | 0.44 | 0.73 |
| 30 | Quoting an optimistic/unrealistic shipping date to a buyer to get a sale. | 2.16 | 2.28 | 2.00 | 2.08 | 1.14 | 0.33 |

Table 5 presents the mean score of each of the 30 items for the two gender groups. Gender differences are significant in 26 of the 30 items (p-values<0.05, reported in the last column of table 5). Only four items exhibit no difference between the two gender groups: item 1, using company services for personal use; item12, calling in sick to take a day off; item 17, not reporting others' violation of company rules and policies, and item 26, having a receptionist tell a caller that someone is not in, when they are.

Table 6 presents the mean score differences of the 30 items of the ethical sensitivity scale among the four ethnicity/race groups. While gender differences were found in 26 of the 30 scenarios, ethnicity/race differences, significant at $p < 0.05$, are observed in only 10 of the 30 scenarios. An examination of Table 2 reveals that the differences among the four groups cover all the dimensions of the ESS. However data in Table 6 indicates that differences among the four groups are more evident in the area of "using company resources for personal use" and "personal job performance", and less evident in ethical behaviors related to "company policies" and "relationships with coworkers".

## DISCUSSION AND CONCLUSION

The study examines the ethical sensitivity differences among the two gender and the four dominant ethnic/race groups in the United States. Results demonstrated significant differences between male and female students. These results are consistent with previous research that found support for the gender socialization approach. The differences among the four ethnic/racial groups are only partially supported. We attempt to explain the observed differences between the ethnic/racial groups by focusing on the individual items comprising the ethical sensitivity scale.

The differences between Black-African Americans and White-Caucasians can be explained by considering Gilligan's (1982) theory of moral reasoning that distinguishes between care orientation and justice orientation. Using recourses for personal gain and job performance are personal goals and are based on justice orientation. This orientation focuses on principles of fairness and equity defined by rules and regulations. The observed difference between Black-African Americans and the White-Caucasians can be attributed to the different moral reasoning between the two groups. Jackson et al. (2009) found that African American children have a more caring orientation and are more flexible about rules when personal goals are at stake. On the other hand, they found that Caucasians approached morality from a ruled based, justice perspective.

The observed differences between Asians and White-Caucasians are consistent with the findings of White and Rhodeback (1992) that revealed significant differences in perceptions of ethicality between U.S. and Taiwanese students. Their findings and argument can be extended to explain the variability in ethical behavior of different subcultures investigated in the present study.

In conclusion, the present study focused on ethical differences among ethnic/race groups in the United States. The use of student subjects limits the validity of the results. Future research should examined ethical differences among the ethnicity/race groups other than students before making final conclusions.

Results of the study have important implications for both academic institutions and organizations developing training programs for business managers with diverse backgrounds. Robin (1980) argued, based on ethical relativism, that moral norms vary among different cultures. Rules of contact in one culture might not be appropriate in another. Academic institutions and organizations should carefully consider the ethnic/race composition of their students/employees when developing curricula and ethics programs. These programs should account for moral norms and other differences in each culture.

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# THE TAX COLLECTOR COMES KNOCKING: AN EVALUATION OF THE STATE INCOME TAXATION OF NONRESIDENT PROFESSIONAL ATHLETES AND THE ROLE OF CONGRESS

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## ABSTRACT

*This treatise evaluates the evolution of a taxation tactic used by several state and local jurisdictions known as the "jock tax." This controversial method of taxation involves professional athletes and those associated with professional sport franchises paying taxes on money earned while working in a state in which the individuals do not reside. Implemented in the late 1980s and early 1990s, this form of taxation has added yet another way for some states to generate additional revenue. Specifically, this study examines the issues associated with implementing this form of income taxation including perceived monetary gains for local and state governments, limitations of enforcement, calculation variances, double taxation, and the impact on non-athletes. In addition, an extensive review of the legislative history of the Constitutional Clauses reveals potential violations of the Commerce Clause, Due Process Clause, Privileges and Immunities Clause, and Equal Protection Clause.*

Most everyone knows about the two certainties in life: death and taxes; although, some Cubs fans would argue for a third with respect to their team's chances of never winning another World Series Championship. Of the three, however, it is the "certainty" of paying taxes that we seem to have the most control over (sorry Cubs fans). Or do we? The current tax structure in this country is convoluted at best and inequitable at worst. Who should pay taxes and how much one should pay are issues that have been debated for centuries in every forum from the kitchen table to the Halls of Congress. Some would suggest that citizens of this great land might as well agree to disagree over issues of taxes because no single answer can satisfy all "payers" involved. There are specific tax issues, however, that arise from time to time that are worthy of debate and should be examined more closely in order to establish or maintain a perception of equity. One such issue involves the state income taxation of nonresident athletes. The "jock tax", as it is more commonly known, is a plan implemented by most states which is designed to generate additional revenue by taxing visiting professional athletes and employees affiliated with professional sport franchises.

## A BRIEF HISTORY

Prior to 1990, the only states and cities that taxed visiting team athletes were Detroit, California, Cleveland and Wisconsin. Cleveland has always imposed an earnings tax, which is withheld at the source and does not require the filing of a tax return, while Detroit has always required the filing of a tax return. While all resident team states have always taxed their nonresident players on the games played in the resident state (which is usually 50%), the aggressive taxing of nonresident visiting players did not begin until mid 1989, in the midst of the battle with the state of Wisconsin. One by one, with New York leading the way, states and localities began "to join the union" in taxing nonresident athletes, especially in light of the average baseball players salaries' increasing from approximately $350,000 in the mid 1980's to $1,084,408 in 1992 (MLB Salaries, 2009). The reason there was such a dramatic increase in player salaries is that there was extensive collusion among the Major League Baseball owners to keep the salaries low (Brown, 2006). While the highest paid player in the league in 2009, was paid in excess of 30 million per year, the average salary in 2009, was $3.24 million (MLB Salaries, 2009).

Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington and Wyoming are the only states (and their localities), which do not impose a state income tax on individuals. Therefore, forty-one states are left to exercise their taxing power. Additionally, only four of the nine non-taxing states have professional major league sports teams.

## ISSUES WITH IMPLEMENTATION

There are several issues with implementation of the so called "jock tax". Among them are the apparent lack of uniformity with respect to the collection methods imposed by different states. For example, some states calculate taxation of income based on a formula for "duty days", while others determine tax amounts based on the number of games played in the respective taxing state. "Duty days" are typically defined as the amount of days worked between preseason the end of the regular season (Ekmekjian, Wilkerson, & Bing, 2004). This lack of uniformity based on the ambiguous nature of a player's tax obligation to a certain state or jurisdiction leads to issues of double taxation involving nonresident athletes. For example, if one state calculates tax obligations based on the number of games played in that state, yet another state relies on the duty days formula, there is a risk of overlap and subsequent multiple taxation of the same income.

According to Hoffman (2004), the cry for intervention from U.S. Legislators is long overdue in the area of nonresident state income taxation of professional team athletes. Numerous states and localities continue to impose arbitrary, unconstitutional and quite burdensome taxes on high net worth individuals. Opponents of nonresident income taxation may wonder why Congress forms a Congressional Committee to study the use of steroids and other performance enhancement drugs (PED) in baseball, but does not address a major issue regarding the unconstitutional enforcement practices used by taxing jurisdictions and the need for estoppels on those matters. In actuality, it will always be more attractive for a jurisdiction to export the tax burden on nonresidents. This allows cities and states to receive monetary compensation without alienating potential voters. Similar to the way that some professional sport stadiums and arenas are publically subsidized through “tourist taxes”, including hotel taxes, rental car taxes, and airport taxes, jock taxes are generally supported because the perceived targets are “privileged” wealthy individuals who earn more than substantial amounts of income.

Additionally, the nonresident jurisdictions’ interests continue to increase while the cost benefits to the jurisdictions are far outweighed by the administrative burdens to teams and individual players alike. Teams and/or players themselves are expected to comply with each state’s taxation rules and regulations with respect to payment and withholding taxes. It is not uncommon for professional athletes to be required to file more than a dozen tax returns in a given year. This is attributable in part to the visibility of professional athletes, the relative ease with which their time in the state and their employer can be identified, and player salary levels relative to the population as a whole. Presently, athletes perform services in 28 states and the District of Columbia, and they have become the focus of state and local authorities (Krasney, 1994).

This research will evaluate the federal constitutional limitations, (as well as the lack there of), on the states’ powers to tax nonresidents’ income. Additionally, New York and California are believed to be the two most aggressive states in pursuing the nonresident athletes and entertainers, and both states have current landmark cases and appeals pending. Perhaps the most famous and publicized case on nonresident athlete income taxation involved current New York Yankee, Derek Jeter. Mr. Jeter recently settled his case which was on appeal in New York regarding residency status for the filing of nonresident tax returns.

Many opponents on nonresident income taxation have advocated for Congress to adopt a consistent single rule of general application to protect every individual who performs services in more than one jurisdiction, calling for the creation of greater conformity at the state and local levels. In response to the perceived injustice, several affected parties, including professional team athletes’ agents, athletes’ business representatives, and the athletes’ union officials, specifically MLBPA, have begun to join forces to challenge the validity and constitutionality of these controversial taxation methods. These joint efforts have assisted in easing the onerous compliance and arbitrary enforcement imposed by the states on nonresident athletes. Professional athlete union officials are challenging the states by hiring legal experts to docket cases in the state and local jurisdictions and are working out settlements on behalf of the players (Ekmekjian, et al., 2004).

## IMPACT ON NON-ATHLETES

Although it may be hard to garner empathy for millionaire sports superstars who pay high taxes, the "jock tax" actually extends beyond the domain of professional athletes. In fact, anyone whose job requires interstate travel may be subject to pay nonresident taxes on portions of their income. In the world of sport, this includes coaches, assistants, trainers, front office staff, scouts, media, league officials, and umpires/referees. Outside the realm of sport, those subject to pay nonresident income taxes could include doctors, entertainers, salesmen, government employees, attorneys, construction workers, and even lowly college professors, just to name a few.

In short, the "jock tax" has far reaching implications for non-professional athletes. Although, up to this point, professional athletes have been the biggest targets due to their high incomes and readily available travel schedules, many states are within their rights to exercise this type of taxing authority on non-athletes. For example, even within the context of sport, those individual employees traveling with professional and amateur sport teams are required to pay nonresident taxes on the prorated portion of income earned during the duration of their stay in a particular state. This includes the aforementioned office staff, team assistants, and trainers, some of whom earn a small fraction of income when compared to professional athletes and coaches.

## APPROACH TOWARD UNIFORMITY AND COMPLIANCE

In 1992, The Federation of Tax Administrators (FTA) formed a Task Force to examine various nonresident income tax issues facing the professional athlete. After a two and one half year study, the FTA made recommendations based on their evaluations with a belief that there would be strength in numbers. However, without the enactment of federal legislation, the FTA's recommendations were not enforced upon the states. The necessity of a call to arms is still outstanding and there remains no uniformity in the various jurisdictions' statures and regulations. As long as Congress applies the rational basis constitutional standard to fiscal policy, the Supremacy Clause of the United States Constitution will not trump state legislation in the area of state income taxation.

The Task Force reviewed and analyzed four options for resolving the uniformity and compliance issues involved in the taxation of nonresident athletes. The alternatives itemized below are evaluated for any constitutional prohibitions and other potential complexities involved with the implementation of each respective alternative:

a) **Home State Apportionment** - which was the primary alternative advocated by the team sports industry, would allocate all income earned by an athlete for performance of personal services to the state where the team plays its home games or otherwise maintained its primary facilities. Under this scenario, the athlete would be required to file returns in no more than two states, the home state and the athletes' state of residency, if it were different than the home state. The states where away games are played would forgo taxation of any nonresident player's income, but would then be allowed to tax all income of a player whose team plays its home games in the state. Although this approach would provide the most simplistic scheme, numerous constitutional concerns were raised which arguably violated the Commerce Clause, the Privileges and Immunities Clause, the Due Process Clause and Equal Protection;

b) **Uniform Apportionment Formula** – designed to provide for a consistent approach to the division of income by all states taxing nonresident athletes. The Uniform Apportionment Formula is more commonly known as the duty day method and is the most commonly used method today. However, the arbitrary application of such duty days by the states still imposes a very onerous, tedious, and complex set of rules onto the players. Greater detail to this alternative is provided in the analysis of various state cases and their respective statutes and regulations;

c) **Base State Model** - under which the tax return filing responsibilities would be satisfied by a single filing with the state in which the team was domiciled. The state, in turn would be responsible for providing the relevant information and funds to all other states involved. This approach would be very similar to the International Fuel Tax Agreement (IFTA) for apportioning interstate motor carrier fuel use tax liability. Under IFTA, a carrier files a single tax return and any necessary payment with its "home state" or state of domicile rather than filing with each state in which it traveled. The carrier is liable for fuel tax on the basis of the proportion of miles traveled in each state. The base state then provides payments and information to any other state in which the carrier operated. This type of interstate compact was made possible by imposing federalism principles upon states and removing the constraints that the states were imposing on the carriers. This also shifted the compliance burden upon the states, instead of allowing them to proceed with their "witch-hunts" for nonresident taxpayers. This is the same type of legislation that the team sports industry would like to see enacted by our U.S. Congress;

d) **Partnership Model** - wherein the tax return filing responsibilities would be satisfied through a composite or consolidated return filed on behalf of all eligible players. Many states permit large multi-state partnerships to file a composite return on behalf of nonresident partners. Conditions imposed on such partnership filings generally include: agreement to the filing, the income included is the only income received from the state, the highest marginal rate is applied, and no deductions, exemptions, or credits unrelated to the partnership can be claimed. This alternative would shift the compliance burden onto the teams, as well as the responsibility of withholding and remitting the correct state income tax. The Leagues' officials would not endorse this method, therefore rendering this a nonviable option.

In short, the Task Force concluded their two-year investigation by making two general recommendations, but left the adoption of their proposals up to each individual state. Thus, the wars are still being fought through exhausting administrative proceedings and courtroom battles. The two recommendations made by the Task Force were as follows:

- States should adopt a uniform formula for apportioning the income of professional athletes. To encourage the uniformity of this endeavor, the task force developed a specific recommended formula and set forth a model regulation to implement the formula.
- States should take affirmative steps to reduce the return filing and compliance burden facing professional athletes and sports teams. The Task Force further reiterated that the adoption of simplified filing approaches would help promote voluntary compliance among professional athletes and teams (Ekmekjian, et al., 2004).
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Throughout the 1990s, many states amended their regulations and adopted the uniform formula apportionment of income recommended by the FTA Task Force (Krasney, 1994). However, the continued uphill and decade long battles with states like Illinois, further illustrate the need for enforceable federal legislation. These types of experiences lend a lot of credence to the notion that "one bad apple can spoil the whole bunch," especially with the knowledge that other state and local jurisdictions will continue to follow suit of assessing state income taxes upon the nonresident athlete.

## FEDERAL CONSTITUTIONAL ISSUES

The following Constitutional Articles and Amendments demonstrate how the "Home State Apportionment" may be prohibited by the U. S. Constitution. Additionally, the constitutional violations by the State of Illinois pursuant to its current taxing scheme of nonresident athletes, employed by Illinois based employers, is also discussed wherever applicable.

a. U.S. CONST. art. I, § 8, cl. 3- Power of Congress to regulate commerce. **The Commerce Clause-**

- The allocation of 100% of the home state of where the athlete's team is domiciled would violate the Commerce Clause which mandates that state taxation of interstate commerce be fairly apportioned and that the tax imposed be related to services provided by the state. While the tax is applied to an activity with a substantial nexus with the taxing state, the home team state has rendered no benefits to the athlete on the away games played in other states against other teams. However, the Illinois Department of Revenue was clearly in violation of the Commerce Clause by taxing nonresident athletes' income that is not earned in their state because the athlete's business activity lacks sufficient contacts with the taxing state for games played in other states. The tax also leads to an unfair cumulative burden because it is not fairly apportioned as between the company's in-state and out-of-state activities, or it is unrelated to services rendered by the taxing state.

b. U.S. CONST. amend. XIV, § 1. **The Due Process Clause of the Fourteenth Amendment.** …nor shall any state deprive any person of life, liberty, or property, without due process of law.

- The Due Process Clause prohibits states from taxing income earned outside their borders under the industry proposal of "Home State Apportionment." The Due Process Clause imposes essentially three restraints on the states' power to tax income from interstate activities. The industry proposal raises no question of sufficient nexus between the taxpayer and the taxing state, since athletes will have more than sufficient contacts with their home states to justify the exercise of state taxing authority. Also, there must be a minimum connection between the taxpayer's income-producing activity and the taxing state, since the athlete will be performing the same "unitary" professional sports services both within and outside the state. The problem, if there is one, relates to the "fair apportionment" of the income generated by the athlete's activities. With regard to athletes who are residents of their home states, the industry proposal raises no due process issue since it is well established that states possess the constitutional power to tax residents on all their personal income from whatever source derived. The critical due process question thus becomes whether the home state may tax all of the compensation that a nonresident athlete earns from his professional sports services, including income tax earned from services performed in other states. Specifically, the question becomes whether the benefits derived by an employee from his employer's base of operations are, as a matter of due process, sufficient to justify a tax on all of his compensation, including compensation for services performed elsewhere. The State of Illinois maintains that the nonresident athlete receives "substantial" benefits from the home state as a result of the business or employment relationship between the athlete and the home state. However, under the Due Process Clause, a state is prohibited from the taxing, on an unapportioned basis, property that was taxable in other states on an apportioned basis, otherwise taxation by two or more states of the same property would be unconstitutional. Illinois began unconstitutionally taxing nonresident athletes in this manner in 1992, and continued the unconstitutional practice throughout a 12 year plus litigation process.

c. U.S. CONST. art. IV, § 2, cl. 1. **Privileges and Immunities of Citizens.** The citizens of each state shall be entitled to all privileges and immunities of citizens in the several states.

- Since there is no discrimination against nonresidents in favor of residents under the industry proposal, no privileges and immunities challenge could successfully be made to the proposal.
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d. U.S. CONST. amend. XIV, § 1. **The Equal Protection Clause of the Fourteenth Amendment**. …nor deny to any person within its jurisdiction the equal protection of the laws.

- The Equal Protection Clause prohibits the states from making unreasonable classifications. The states enjoy broad leeway, however, in making classifications for tax purposes. The same standard used in evaluating other forms of state economic and commercial regulation will generally determine the validity of a state tax statute. Under modern equal protection doctrine, a state tax classification will pass constitutional muster so long as it is rationally related to a legitimate state purpose. Home state apportionment unquestionably would survive constitutional scrutiny under these standards since the separate classification of athletes is rationally related to the state's legitimate purpose in simplifying the personal income taxation of professional athletes.

## CONCLUSION

The need for congressional intervention in the area of state taxation of professional team sports can be analogous to numerous other federal enacted statues. In numerous instances, such as the Federal Motor Carrier Act (1980), Congress exercised its plenary power and preempted state regulations when the state regulation was in direct conflict with federal law, or as in this case, the tax scheme impermissibly discriminated against interstate commerce. Violations of constitutionality in the case of nonresident professional athletes are evident by examining past violations of constitutional provisions. The rationalization of federal statues spawned by the resulting congressional action when the states unduly exercised their taxing powers compared to the unconstitutional actions of the states in taxing the nonresident professional athlete suggest a need for congressional intervention. In fact, a federal statute may be the only hope of bringing an end to the ongoing constitutional violations apparent among states that exercise this form of taxing authority. Ultimately, the major impasses, continued burdens, and complexities are all issues that require Congress to speak in a legislative uniform manner to be used by all jurisdictions.

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