

Black markets and smuggling

An unintended consequence of government intervention

by

Roger Bate

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PO Box 785121, Sandton 2146, South Africa

Telephone: (011) 884 0270

Fax: (011) 884 5672

Email: fmf@mweb.co.za

Website: www.freemarketfoundation.com

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Contents

Foreword

The author

Acknowledgement

Chapter 1

The cause of smuggling – government intervention

Chapter 2

Prohibition – the ultimate government intervention

Chapter 3

Taxation-induced smuggling

Harmonisation of tax – is it the answer?

Chapter 4

Economic costs of smuggling – a negative sum game

Chapter 5

The societal harm from smuggling

Corrupting individuals

Beating the system

Chapter 6

Conclusions

Policy recommendations

References

Foreword

FMF *Occasional Papers* are designed to make available to a wider audience essays on particular matters of moment or currency. Recent press headlines that South Africa is taking stronger action against various instances of corruption are probably to be welcomed. The Public Protector, Selby Baqwa, predicts a decline in corruption over the next five years. Yet it may be both inappropriate and premature to celebrate.

In this *Paper*, Roger Bate examines, in particular, the reasons why smuggling – a form of black marketeering – exists, what its benefits and costs are, and what can and should be done about it.

It is possible to argue that smuggling has beneficial effects. Smugglers provide both suppliers and customers with opportunities to engage in entrepreneurship. Absent the activity certain scarce goods and services would find no market.

Nobel prize-winning economist Robert Barro noted (2000, p.36) that “in some circumstances, corruption may be preferable to honest enforcement of bad rules. For example, outcomes may be worse if a regulation that prohibits some useful economic activity is thoroughly enforced rather than circumvented through bribes.” Chaufen and Guzman (2000, p.53), on the other hand, point out that “corruption is the cost of obtaining privileges that only the State can ‘legally’ grant, such as favouritism in ...tariffs... government contracting, and regulation.”

In other words an argument can be made in favour of smuggling. Smugglers usually do no “moral” wrong. Frequently they benefit society by providing outlets for providers of goods and sources of supply for clients. And if their activities were effectively prohibited all would lose.

The kernel of truth in this argument overlooks the fact that smuggling and black markets are themselves the direct consequence of government interventions in the market place. Smuggling occurs only if the government has taxed heavily, regulated tightly or outlawed outright some activity in the past. Thus the “criminalisation” of recreational drugs, the imposition of “sin” taxes on alcohol, the creation of high trade barriers to protect local industries, or the weakening of intellectual property rights all encourage smuggling, piracy or theft of the products concerned.

Rather than stamping out corruption and smuggling, public policy would be better directed at removing its proximate cause: over-regulation. To do otherwise encourages crime and damages economic growth.

Adam Smith (1776, p.898) wrote that the smuggler, from “being at first ...rather imprudent than criminal...too often becomes one of the hardest and most determined violators of the laws... (by his ruin) his capital, which had before been employed in maintaining productive labour, is absorbed in... the revenue of the state... and is employed (in prevention) to the diminution... of the useful industry which it might otherwise have maintained.” Smuggling then is bad for economic growth.

It also aggravates poverty, since it is the wealthy or politically influential who are able to deal with the smugglers – who in their turn require higher than normal market prices, and/or receipt of the special favours the politically powerful can grant.

Tackling smuggling, black markets and corruption successfully requires strong leadership. The message the leader must send out is *not* that malpractice will not be tolerated. Rather it is that the regulatory framework which encourages it and permits it to flourish in the first place will be dismantled in a general freeing-up of the economy. Only strong leaders are willing voluntarily to release the reins of patronage.

This *Paper* by Roger Bate will prompt thinking along these lines. Not all will agree with the thesis. And while the Free Market Foundation, its Directors, members and staff have no corporate view, the *Paper* is offered as a contribution to the wider debate on corruption in South African society.

W. Duncan Reekie
Bradlow Professor
University of the Witwatersrand
Publications Editor, FMF

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The author

Roger Bate founded the Environment Unit at the Institute of Economic Affairs in 1993 and co-founded the European Science and Environment Forum in 1994. He is currently completing a research project on water allocation in South Africa, for the South African Water Research Commission, and Cambridge University.

Mr Bate is the editor of *What risk?* (Butterworth Heinemann, 1997), a collection of papers that critically assess the way risk is regulated in society. He has also written several scholarly papers and numerous shorter scientific articles for newspapers and magazines, including the *Wall Street Journal*, the *Financial Times* and *Accountancy*. His most recent book is *Life's adventure: Virtual risk in a real world* (Butterworth Heinemann, 2000).

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I would like to thank the Alliance Against Contraband for many of the examples used in this *Paper*.

Roger Bate

Chapter 1

The cause of smuggling

The high duties which have been imposed upon the importation of many different sorts of foreign goods, in order to discourage their consumption, have only served to encourage smuggling.

Adam Smith, *The wealth of nations*

Smuggling is an important catalyst in stimulating the underground economy. It encourages existing criminal gangs and helps new ones to become established. Chapter 2 explains some of the causes of smuggling, drawing on examples from the attempts to control drugs, tobacco, alcohol and other goods. It discusses the possibility of reducing smuggling, which generally means reversing the causes. The main focus is on products, especially tobacco, that are legal in most countries, yet are smuggled because of high levels of taxation.

It is useful first to define terms. *Smuggling* – the process of illegally importing or exporting goods (usually to avoid government duty). The product may be illegal (cocaine) or legal (cigarettes) in either the importing or exporting country, but products once smuggled are illegal (contraband). Counterfeit – something produced to be passed off as a copy (fraudulent imitation – bootlegged) of a legitimate product. The legality of the genuine product will often determine whether a copy is illegal but, regardless, the copy becomes illegal once it is passed off as an original.

Smuggling occurs because the incentives to avoid some form of government intervention are large enough to overcome the expected costs of undertaking an illegal activity. Therefore, smuggling can be understood from analysis of government intervention like regulation or taxation, the most extreme manifestation of which is prohibition (see Thornton, 1991). Most interventions on legitimate products such as alcohol and tobacco are intended to be supply-reduction policies. The result of the policy is that the cost of supplying the legitimate product increases, which at the margin decreases supply. The quantity demanded will fall at the higher price, and demand may shift to substitutes. Those substitutes may include inferior copies – counterfeit or, where there is significant tax disparity between countries, smuggled products¹. For products such as alcohol and tobacco which are presently legal but heavily taxed, both counterfeit and smuggled substitutes offer higher profits and lower penalties to smugglers than trafficking prohibited products such as illegal narcotics.

Many products and most markets are subject to some form of government intervention, but few products become widely smuggled. The main reason that products are smuggled is because *transaction costs* for illegal activity (the cost of finding willing suppliers and distributors, the risk of being caught and punished, etc.) are low relative to the gains from undertaking such illegal activity. With more extensive and intensive government intervention, more products will offer benefits of smuggling that outweigh the costs.

As Cave and Reuter (1988) found, smugglers learn from experience, which manifests itself in many ways. For example, once a route and couriers are established to transport and distribute one product, switching to a new product is often easy. A group of smugglers dealing in narcotics can easily smuggle tobacco or even rhino horn, if and when the illegal rent they can obtain (the differential between the price they pay for the product and the price the legal product costs in the market) is sufficient.

In some contraband markets in legal products, consumer demand may instead be stimulated by a perceived quality difference. For example, smoking smuggled but genuine American cigarettes in India is fashionable because these are perceived to be of a higher quality than supposedly identical locally-produced versions. In this instance, high taxes on legal imports appear to act as a stimulus not by offering consumers a saving, but by providing a widened choice, thereby generating a significant profit margin for contraband vendors. Such policies ensure that contraband market vendors can retain a much larger profit margin than if they were lawful sellers of legal products, because there is no need to attract customers with lower prices. These fat profit margins also provide

contraband sector participants with a great deal of room to manoeuvre should price competition develop.

¹ Some smuggled products, such as major brand cigarettes penetrating third world markets, will actually be of higher quality than the legal product.

Chapter 2

Prohibition – the ultimate government intervention

In 1921, Albert Einstein (1989) commented on the recently enacted Volstead Act of 1919:

...nothing is more destructive of respect for the government and the law of the land than passing laws which cannot be enforced. It is an open secret that the dangerous increase of crime in this country is closely connected to this.

The Volstead Act, which between 1920 and 1933 prohibited the manufacture, sale or transportation of alcoholic beverages, directly caused the increases in crime observed by Einstein. The Act led to the establishment in North America of a criminal underworld that remained powerful for decades afterwards.

Although violent crime was the most obvious manifestation of the Volstead Act, a more insidious effect was the increased power that attempting to control crime gave to government. The taxpayer's contribution to law enforcement increased by 120% during the time of Prohibition (Einstein, 1989; Miron & Zweibel, 1990), with no appreciable results. By the time Prohibition was repealed, criminal organisations were so profitable that they simply diversified.

Smuggling operations had become so entrenched by the Second World War that they readily turned to other commodities and services. The War provided new opportunities to put to good use the experience and systems developed during the alcohol-smuggling years by controlling black markets on rationed goods.

Chapter 3

Taxation-induced smuggling

Sin taxes raise nearly 20 billion pounds a year in the UK.

The Economist, 8 May 1999

Because of the obvious and total failure of the Volstead Act, both in its intended effect – alcohol consumption was back to its pre-Prohibition level by 1934 – and in its more serious side-effects, few governments have since attempted such a policy. Alcohol and tobacco, products that are used by significant minorities in most countries of the world, have not been banned since, despite official qualms about their detrimental effects. But, other products (like ivory or cannabis), which appeal to smaller percentages of the world's population are widely, though not universally, banned – yet both have thriving illegal and semi-legal markets (Stevenson 1994; Sugg and Kreuter 1994). Furthermore, governments the world over have taxed alcohol and tobacco in an attempt to raise revenue and to show disapproval of these products. In some instances, such as in several Scandinavian countries, the price of a pack of cigarettes or bottle of whiskey comprises over 80% tax (Persson, 1999). This provides enormous revenues for many countries. A full quarter of the Chinese Government's budget comes from tobacco tax revenue, and it makes up a sizeable 4% of the EU's budget (*Tobacco Journal International*, 1999).

The result of this type of massive taxation on legal 'sin' products is smuggling in numerous other products. As John Magaw, former Director of the Alcohol Tobacco and Firearms (ATF) Unit of the US Government, has noted:

In addition to illegal trafficking by traditional organised-crime groups and Native Americans, ATF has also uncovered involvement in cigarette smuggling by Russian, Middle Eastern, and Asian organised crime groups. Investigation has revealed that these groups are also involved in firearms- and narcotics-trafficking, alien-smuggling, and other illegal activities.

(US House Commerce Committee, 1997)

According to the Alliance Against Contraband (2000), the European experience has been no better. In the 1950s, cigarette-smuggling established a strong association between the Mafia in Sicily, the Camorra in Naples, and the Corsican crime groups in the French port of Marseilles. Smugglers subsequently branched out from contraband cigarettes into narcotics:

...[their] fleet [also] carried morphine-base from Lebanon to Marseilles, and refined heroin from Marseilles to Sicily for forwarding to Cosa Nostra in America. This was where the international heroin network got its start. (Sterling, 1990)

Since then, cigarette and alcohol smuggling has offered organised crime in Italy a low-risk source of cash flow to finance other criminal activities like narcotics trafficking (Sterling, 1994).

Italy has become a gateway for smuggled products from the Balkans into Europe. As an Agence-France Presse (1999) dispatch stated:

Smuggling cigarettes from the Balkans across the Adriatic Sea and on to northern and western Europe has become a thriving industry in southern Italy...

...smugglers store cigarettes in the Adriatic port of Bar in Montenegro before loading them onto speedboats that can carry between 300 and 400 boxes of cigarettes each. With each box containing 500 packets of cigarettes, that means up to 225 000 packets of cigarettes in a speedboat. The boats, driven mainly by young Italians, head for Bari on Italy's Adriatic coast, a three-hour trip if the sea is calm. Cigarettes destined for the in-

ternational market, mainly Britain and Spain, are shipped by truck under loads of fresh fruit and vegetables.

In Spain, key cigarette smugglers in the Arosa Estuary region of Galicia have used their success in the contraband tobacco market as a platform for entering the drugs trade (*La Voz de Galicia*, 1998). Furthermore, Andorra has become a centre for alcohol and tobacco traffic (*Sunday Times*, 1999).

Harmonisation of tax – is it the answer?

The problem of smuggling is often used by those in favour of harmonising European tax levels as another argument in favour of such harmonisation. They argue that, since much of the EU's internal smuggling is due to differential tax rates within the EU, those tax rates should be harmonised. It is almost certainly true that if tax rates on tobacco and alcohol were the same in Italy, Britain and Sweden this would cut down the amount of smuggling.

But the cost of tax harmonisation may be greater. It would reduce one of the only forms of governmental competition amongst the EU states. According to economist Arthur Laffer (1998), this would further the sclerosis of the EU economy. Nobel Laureate, Milton Friedman argues that "a governmental tax and spending cartel is as objectionable as a private cartel" (1998). The reason for these famous American economists' hostility to tax harmonisation is explained by Roland Vaubel, Professor of Economics at Mannheim University, who says that for Europe "harmonised taxes are higher taxes". Most European politicians argue against tax competition because if the Government of a "single country thinks about raising taxes it must be afraid of losing taxable resources to other countries. If all European governments agree to raise taxes, taxpayers cannot escape" (Vaubel, 1998).

Tax harmonisation would also, perversely, wed the EU governments more closely to products they disapprove of, as initially tax revenues would rise. Furthermore, sin-tax harmonisation in EU would have bad long-run effects. It would encourage smuggling from non-EU states, potentially leading to a real customs-led 'Fortress Europe' to fend off the smugglers, and it would harden the resolve and power of the international gangs, who tend to be the most violent (Thornton, 1991).

The other significant effect of higher harmonised tax is that it encourages counterfeiting. Intra-EU smuggling of high quality products becomes harder with tax-harmonisation, but the incentive for passing off inferior products as genuine increases because of the massive differentials between the cost of producing copies and the retail price (which may be 85% tax) of the genuine article. For illegal drugs, counterfeit products can be fatal. Illegal but freely-available ecstasy tablets may be mixed with bicarbonate of soda to stretch profit margins for the supplier, or they may be cut with something more harmful. The consumer has no guarantee of quality from the supplier, who would disappear at the first sign of any trouble. For legal products like alcohol, inferior substitutions can be fatal. For tobacco, counterfeiting usually means poorer processed quality with higher tar and nicotine levels. A quarter of the cigarettes packets swept up after a football match in Liverpool were smuggled. Further analysis showed that many of the packs were counterfeit 'Marlboro' produced at a factory in the former Soviet State of Georgia (*Mirror*, 1999).

Chapter 4

Economic costs of smuggling – a negative sum game

Government tax losses are the most well-known consequence of smuggling. Tobacco smuggling currently costs the UK Exchequer over £1,7 billion a year in lost tobacco taxes (*The Times*, 1999). The situation in many other European countries is similar, as with other products like alcohol. It is estimated by the British brewing industry that over one million pints of beer cross the English Channel every day. Some of this is illegal, and even where it is legal the UK Exchequer is losing hundreds of millions of pounds to the French and Belgian authorities.

In strictly economic terms there are significant losses because of the way the smuggling business conducts itself. Smugglers require concealment and so accept higher levels of spoilage, numerous packaging and repackaging in all sorts of ingenious ways (inside animal carcasses, spare car parts, toilet tissue boxes – the list is almost endless). Furthermore, smugglers are inevitably short-termist: to remain undetected they cannot benefit from long run contracts, which keeps their costs of transaction high.

But because their margins are still large enough, smugglers displace business from more efficient competitors who do obey the law. In short, smuggling takes place within the framework of a negative sum game, causing losses that run into the tens of billions of pounds across the EU yet defy accurate measurement.

Chapter 5

The societal harm from smuggling

While tax and business losses reflect an overt part of the destructive impact of smuggling, a less obvious but insidious effect is the societal harm caused by the resulting increase in organised crime.

Perssen (1999) shows that in Sweden, in addition to the legitimate manufacturers and illegitimate suppliers of cigarettes, there are 12 black-market wholesalers, 300 retailers, and 10 000 major consumers.

Many people seem to be drawn into the illegal markets in order to compete with organised crime, becoming criminals themselves. This is a constant feature of all mature black markets. Legitimate businesses see their prices undercut by cheaper contraband products. Sales plummet and some simply cannot compete and are forced out of business. Faced with huge losses or even bankruptcy, some honest business people feel forced into the black market, and are often coerced into handling contraband. They don't want to, but feel they must protect their businesses. But once they act illegally there is no turning back (Alliance Against Contraband, 2000).

It should be remembered that the cause of these negative effects is the desire of government officials to raise massive revenue from tariffs for their activities. It can be observed that smugglers are often liked, even revered, by consumers who see them as reducing prices. Nevertheless, the activities of smugglers are criminal, even if admirable in a Robin Hood way.

According to the Alliance Against Contraband (2000), "the battle for lucrative contraband markets can lead to violence and heightened street crime". Consider:

- In Berlin, key members of a Vietnamese gang were charged with committing nine murders in 1998 as part of the bloody fight for control of city's lucrative contraband trade (*Agence France-Presse*, 1998).
- In the United Kingdom, retailers were warned to be on their guard in 1999 after a series of roadside hijackings (*Off Licence News*, 1999; *The Grocer*, 1999).
- In Italy, an Italian police union called for a government crackdown "after a series of fatal accidents caused by smugglers fleeing police" in 1999. In some cases, smugglers use armoured, four-wheel-drive vehicles to transport their cargoes (*Bloomberg*, 1999).
- In Ireland, eight armed and masked men hijacked a train in 1999 and used a crane to remove £800 000 worth of cigarettes (*The Birmingham Post*, 1999).
- In Naples, the battle for control of the Italian city's lucrative cigarette-smuggling trade claimed at least 50 lives in 1998 (*Los Angeles Times*, 1998).

The crime-increasing aspects of smuggling are readily seen in Sweden. In early June 1998 Finland's *Vastra Nyland* ran a story saying Stockholm was well on the way to turning into the "Chicago of the North".

The warnings that smugglers and criminal gangs would flourish because of the high price of cigarettes and alcohol have come true... Together with the massive and incredibly profitable cigarette and alcohol smuggling, increasing quantities of narcotics are coming into Sweden, usually via the Baltic route (Vastra Nyland, 1998).

The International Association for the Study of Organised Crime (IASOC 1998), said that these crimes were:

believed to be part of an ongoing battle between organised crime factions operating in Stockholm for control of the large trade of smuggled cigarettes.

Even in France, which has not reported a substantial smuggling problem, the effects of contraband smuggling are seen. On average there is one assault on a tobacconist every day, generally when a

shop is opening or closing or when money is being transferred. The Confederation of Tobacconists reports that in four years 12 tobacconists have been killed.

Corrupting individuals

Individuals become corrupted by the incentives to avoid high taxation. Criminals win when society's leaders succumb to corruption, which results in harm for the respect for the rule of law.

For example, the average smoker or drinker is often persuaded to break the law by smugglers offering him cheap goods (often in the pub). Individuals offered bargain deals in such circumstances know the game and don't ask questions as to sources, especially given that they feel that "they pay too much tax anyway" (*The Sunday Times* 1999).

In Autumn 1998, two members of the Civil Guard in Spain were arrested, along with nine others, as part of a network that handled more than \$100 million in contraband tobacco (EFE, 1998). In early 1997, eight high-ranking officers of the Spanish navy were charged with smuggling duty-free tobacco (*El Pais*, 1997).

There are hundreds of such cases in Europe and around the world. Organised criminals look for weakness in police and politicians – family problems, hidden affairs, financial difficulties – and use threats or bribery to bring people to do their bidding.

The financial costs of trying to prevent this, and of prosecuting cases of corruption, are enormous. The wider societal costs are incalculable. In the end smuggling becomes inevitable and the respectable way of life is replaced by something more sinister.

Beating the system

A related but distinct part of the market for illicit or dangerous products is the lure for young people of beating the system and tasting forbidden fruit. According to the work of Engs (1999), Furedi (1997) and Mitchell and Simonds (1994), politicians seeking vote-winning opportunities will observe changes in public sentiment and promote legislation in response.

For example, concern from health professionals about substance abuse has led to greater public awareness of these problems and an aggregate reduction in such abuse. Legislation and product tax increases have often been passed after the reduction in use has occurred. Indeed, once policy is promulgated to encourage abstinence, youths often rebel against it (see Engs 1999).

One reason for this is because young people find government action hypocritical. Government officials benefit from the tax revenue generated from these products, but simultaneously lecture the young against use. One of the activists' slogans at the recent Seattle World Trade Organisation meeting was 'People Before Profits'. Governments may enjoy the double dividend they reap from taxing tobacco and alcohol, since it raises revenue and reduces demand, yet to others it appears as though they are benefiting from peoples' addiction. It is hard to criticise those who expose the moral ambivalence of Government policy.

Whatever the exact cause of youth rebellion, the result is the worst nightmare for parents. Your son or daughter goes out and buys drugs, drink or cigarettes which may harm or kill them, at exorbitant prices from people you would never let into your house, and they do so because it's naughty or dangerous.

Conclusions

Smuggling costs governments around the world billions in lost revenues and prevention efforts every year. These losses fuel an illegal economic sector and amount to a major redistribution of tax burdens without public consent. Revenue losses resulting from organised crime-dominated smuggling force governments to cut programmes and services, increase taxation or even run deficits.

Not only do organised criminals siphon off money from society, but they create billions in expenses for society to bear. These include the costs of prevention, detection and apprehension, justice and correctional systems and private security. There also are social costs that can be associated with fear of crime: refusal to go outside at night, moving to a safer neighbourhood, pain and suffering and loss of quality of life.

Cigarette smuggling can also result in job losses in legitimate production facilities and government, lower productivity, and general stress on legitimate businesses trying to compete honestly against black market operations.

While the economic impact of some social costs is difficult to quantify, they are nonetheless significant. Smuggling and black markets breed disrespect for the law and put otherwise honest citizens in contact with criminal sub-cultures. They also foster violence in our communities, and corruption of police and public officials.

A broader, related effect is that the increase in smoking, drugs and drinking among young western people is directly related to the lure of forbidden fruit (Engs 1999), and a desire to openly oppose the moral ambivalence of government policy.

Policy recommendations

The obvious recommendation is for governments with high tax rates on 'sin' products to reduce taxation rates on legal products, and decriminalise illegal products where demand is robust, since this would alleviate the significant problems (explained above) of smuggling. Of course, this recommendation is unlikely to be followed in the short run, because tax rates have been increased so that government officials can appear tough on these nasty products that lead to illness, while raising revenue for their expenditure plans – the so-called 'double dividend'. In the long run, politicians will notice the growing public hostility to their ineffectual and ethically dubious policies. New constituencies may develop to which courageous politicians can appeal and overturn policy. In the medium term, economic considerations may make politicians act to reduce taxation – the only sure way to reduce smuggling and counterfeit products.

For example, the Canadian and Swedish Governments were bold enough to bite the bullet and reduce tax. After cutting its tobacco tax by 27% in 1998, Sweden is benefiting today from lower smuggling, and probably lower teenage smoking (especially of previously unrecorded bootlegged products), even if official figures of teenage consumption are increasing.

Harmonisation of taxes at a high level may alleviate some forms of smuggling, but the incentive for counterfeiting is increased the higher the aggregate level of tax. Furthermore, even if harmonisation of tax levels across the EU were achievable, harmonisation for the countries and regions from which the main counterfeit and smuggled products come (such as China, India, Eastern Europe, former Soviet States and Africa) will be impossible.

Addressing smuggling by increasing penalties on smugglers (such as taking private property from alleged criminals) has proven a failure. It deters the 'jack the lad' smuggler, but the void he leaves is filled by the toughest criminals, with drug traders prepared to fight whenever cornered rather than risk arrest. Spending more money on customs and excise will reduce smuggling, but not significantly over time. Each new method will be overcome by the smugglers. More officials, x-ray machines, and other technologies look good but have little impact on incentives. New discoveries of smuggled products may be lauded as successes, but they demonstrate failure by being only the tip of an enlarging iceberg. Unless we wish to move toward *de facto* prohibition, tax rates on alcohol and tobacco products should be reduced to lower, more economically optimal levels.

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