

MEMO TO THE MAFIA: SMUGGLE CIGARETTES

by Edward L. Hudgins

THE U.S. SENATE RECENTLY KILLED A PROPOSED BILL that would have forced the tobacco industry to pay some \$516 billion to cover the supposed higher medical bills that governments claim they must pay to treat illnesses caused by smoking. That legislation was part of a concerted attack that has been waged against that industry by state attorneys general, the White House, and Congress.

The attacks are likely to continue. In addition to renewed efforts at the federal level, state governments probably will be tempted to seek new taxes on cigarettes or try to force tobacco companies into costly settlements that could add significantly to the price per pack of cigarettes. (Proposed per pack taxes have averaged around \$1.50.) Those actions are likely in part because the revenue raised with the taxes would allow government officials to fund new programs. President Clinton had planned to use \$105 billion in tobacco taxes as part of the funding for his original health care plan. That plan failed to gain Congressional approval in 1994. But since then, the administration has begun to implement the plan piecemeal, most notably through the KidCare program, encouraging state governments to offer health care through schools. States looking for funds to supplement federal money for that program have an obvious source in tobacco taxes.

But higher costs for tobacco will offer excellent opportunities for organized crime to reap huge profits by smuggling cigarettes from sources of production, military bases, Indian reservations, or other sources that do not pay taxes on cigarettes. Even taking account of the fact that all smokers will not have access to smuggled cigarettes, black marketers conservatively can be expected to pocket between \$4.31 billion and \$8.62 billion annually from sales of bootlegged cigarettes. The lesson of Prohibition in the 1920s and the war on drugs today is that crime can and will pay for those entrepreneurs who can provide smokers with low-cost cigarettes.

PROHIBITION PRECEDENT

When governments restrict voluntary exchanges between their own citizens, the result is smuggling and illegal sales. Sometimes the restrictions are to prevent individuals from securing goods and services of which those in power—often for moral reasons—do not approve. An obvious example of

such efforts was the prohibition of alcoholic beverages in the United States. Between the time it took effect on 16 January 1920 as a result of the 18th Amendment to the U.S. Constitution and the time it was repealed by the 21st Amendment on 5 December 1933. Prohibition helped create American organized crime as it is known today.

Smuggling was a major source of illegal alcohol during Prohibition. Canada was a principal supplier. From 1918 to 1922 Canadian imports of British liquor increased by 600 percent. Canadian liquor tax receipts increased by 400 percent. Of course, that was not because more Canadians suddenly became alcoholics. In fact, consumption of spirits by Canadians actually dropped during that period. Much of that liquor was smuggled into the United States. In Detroit, on the border with Canada, it is estimated that the value of graft, smuggling, and payoffs was about \$2 million per week. Similarly, Mexican imports of liquor rose by 800 percent during the first few years of Prohibition. Law enforcement officials estimate that they caught about one-twentieth of the smuggling.

A second source of liquor during Prohibition was illegal manufacturing. According to John Kobler in his book *Capone*, Johnnie Torrio and his associates, including the soon-to-be leader of the operation, Al Capone, had physical plants and equipment worth \$5 million and working capital of \$25 million at the beginning of Prohibition. While part of it consisted of trucks for smuggling and distributing liquor, much of it was for actual production. A third source of liquor, especially in rural areas, was moonshiners—small home-based distilling operations. Such operations are still extensive today because they allow producers to avoid taxes on alcohol. The current ban on drugs is following the same pattern of Prohibition. For examples, in spite of the decades long war on drugs about 10 million Americans smoke marijuana or hashish.

PROTECTIONIST MODEL

More often than not, rather than outright bans, restrictions on sales or special taxes on goods and services are imposed, usually to assist a special interest group at the expense of consumers. Trade restrictions are a principal example of that practice. Countries that limit trade in easily transportable items experience smuggling. Less developed countries especially

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find that their poorly-patrolled borders are emporiums for merchants and customers. The future president of Uruguay Luis Alberto Lacalle complained in 1988 that too many of his countrymen would drive across the border into Brazil, purchase inexpensive tires and drive back on their smuggled goods to avoid the Uruguayan tariffs.

The accelerating war on tobacco is an attempt to restrict the availability of a good through regulations and taxes. But the result certainly will be that smokers evade those restrictions with the help of entrepreneurial smugglers. That is in fact what has been happening in the United States and the rest of the world as governments, either for public health reasons or to gain revenue, have increased taxes on cigarettes.

WORLDWIDE SMUGGLING

Cigarette smuggling already is big business globally. Market Tracking International Ltd. in London estimates that of the total one trillion cigarettes exported annually from all producing countries, currently about 280 billion, or over a quarter of the total, are sold by smugglers. That is up from 100 billion packs in 1989. Overall, cigarette smuggling is estimated to cost governments as much as \$16 billion in lost revenues.

While cigarette taxes in most European countries are high by American standards, there is a wide variation in tax rates among the European countries themselves. The average price per pack in the United States is \$1.90, of which sixty-six cents is federal and local taxes. By contrast, in the Netherlands a pack costs \$2.66, with \$1.94 of that price as taxes; in Germany, a pack

costs \$3.18, with \$2.28 as taxes; in France a pack is \$3.47, with \$2.61 as tax; and in Britain a pack costs \$5.27 with \$4.30 as tax. That means that smuggling between European countries as well as from outside of Europe makes economic sense.

Smuggling cigarettes into Britain from nearly any other country can yield a profit. Some estimates found that in 1995 as many as half of British smokers purchased contraband cigarettes, with a revenue loss to the government of \$600 million.

Almost one in four cigarettes consumed in Spain are illegal. It is estimated that \$1 billion in annual cigarette sales in that country are black market. In Italy at least 20 percent of cigarettes are black market. In the 1980s Bulgaria was a major supplier of contraband. In Naples, Italy, it is estimated that eight thousand families live off of the \$600 million in illegal sales controlled by the Camorra, the local mafia organization. Low-priced Polish cigarettes find their way into Germany, with an annual loss of revenue to the German government of about \$600 million. It is estimated that only 15 percent of tobacco purchased in Luxembourg is consumed in that small country. The rest finds its way, usually illegally, to higher tax countries. One of Europe's larger legal cigarette traders, Michael Haenggi, actually runs a three person operation in Switzerland, selling about \$100 million in cigarettes annually to buyers who almost certainly smuggle their purchases to Spain.

In 1991 Hong Kong raised its excise tax on cigarettes by 100 percent. One estimate pegged the smuggled cigarettes at one-third of the total or \$1.5 billion in 1996. According to Don Watson, Hong Kong Commissioner of Customs at the time, some 40 percent of the cigarette sales were contraband.

CANADA'S FAILED PROHIBITION-BY-TAXATION

The most recent and illustrative example of the results of high taxation on cigarettes is found in Canada. In 1991 that country's national government increased its taxes on cigarettes by 146 percent. (In Canada the national and provincial governments each have taxing authority, thus leading to different taxes on the same commodities.) As a result, the price per carton of cigarettes jumped to as high as CDN\$50, compared to around CDN\$15 in the United States. Smuggling exploded. According to a 15 August 1994 study by the accounting firm of Lindquest Avey MacDonald Baskerville Inc., before the tax hike, one cigarette in fifty was purchased on the black market. After the tax hike, over one in four was bought illegally. (That number agrees with the proportion of illegal sales worldwide. The "Cigarette Smuggling Quantification Feasibility Study" by the same firm, dated December 1996 placed the figure between 30 percent and 50 percent.) The study pegged the total value of cigarette smuggling in Canada at about \$1 billion annually. But that figure might be low. One operation alone, tied to the Akwesane Indian Reservation, is alleged to have smuggled \$700 million.

A 1 February 1994 study by Lindquest Avey focusing on the Canadian province of Ontario, found similar results. In 1986 only about five hundred thousand cartons of cigarettes sold in

that province were smuggled. By 1991, on the eve of the substantial Canadian cigarette tax hike, that number had reached eleven million cartons. That year the retail price per carton in Ontario was CDN\$45. The contraband price was CDN\$35 but only about one cigarette in ten was contraband. That means that the weighted average price per carton was CDN\$44.

But in 1992, with higher taxes in effect, some 17.5 million cartons of contraband cigarettes were sold, with the price per carton dropping that year to CDN\$28. By 1994 some 27 million in contraband cartons were sold, with the price further dropping, to CDN\$22. Meanwhile, the retail price of taxed cigarettes was CDN\$46 in 1992 and CDN\$45 in 1993. Thus the weighted average price per carton dropped to CDN\$43 in 1992 and CDN\$38 in 1993. In other words, in spite of the high tax, smokers in Ontario could still purchase cigarettes well below the taxed price.

One means of supplying tax-free cigarettes to Canadians was for Canadian companies to export cigarettes, tax free, to the United States. From there smugglers would bring the cigarettes back into Canada. The number of Canadian-manufactured cigarettes sent south to America tripled between 1989 and 1992, from 11.1 million to 34.6 million cartons, even though there were no indications that Americans were smoking Canadian brands any more than before that time.

Canadian government officials also discovered that it was not as easy to undo the damage done by the huge tax hike. To ease the smuggling problem, by 1994 Canada had cut the tax per carton of cigarettes by CDN\$10. But it proved insufficient to reduce the trade in contraband. Eventually, the province of Quebec reduced the combined tax on a carton of cigarettes by a total of CDN\$21.00. Since then the taxes have been cut further by the government in Ottawa. Still, interprovincial smuggling in Canada remains strong, for example, between high-tax British Columbia and its lower tax neighbors.

THE MAGNITUDE OF SMOKING

To determine the magnitude of profits to be reaped by cigarette smugglers in the United States if taxes are increased, it is first necessary to examine the demographics of smoking. Some twenty-three billion packs of cigarettes on which state taxes are paid are sold in the United States each year. Of course, that figure does not include cigarettes that currently are sold on the black market. Those sales would raise the total. The question is, by how much? If that figure is one in ten, as was the case in Ontario before Canada's large tax increase, then 25.3 billion packs are smoked annually.

As of 1994, according to the Centers for Disease Control (CDC), some forty-eight million Americans, 26 percent of the population over eighteen years of age or 18 percent of all Americans, smoked cigarettes. Of those, about 34.5 percent or 15.5 million, smoke less than fifteen cigarettes per day. Some 42.6 percent or 20.4 million smoke between fifteen and twenty-four per day. And 22.9 percent or eleven million smoke

over twenty-five cigarettes per day.

The National Household Survey on Drug Abuse (NHSDA), conducted by the Substance Abuse and Mental Health Services Administration of the Department of Health and Human Services, found the number of smokers to be much higher. Based on a sample that included Americans aged twelve or older, the survey concluded that sixty-two million, or 29 percent of the population, smoke. The difference in the CDC and NHSDA numbers results from their different survey methods. The former defines a smoker as anyone who has

smoked over one hundred cigarettes in their lifetime and answered to the survey that they currently smoke, even if not every day. The latter defines a smoker as anyone who has used cigarettes in the past month.

THERE ALREADY EXIST ESTABLISHED DISTRIBUTION SYSTEMS FOR CONTRABAND CIGARETTES.

PROBABLE POOL OF LOOT

One means to determine the potential profit from smuggling in the United States is to make an analogy with Canada. Illegal sales in that country were conservatively estimated at \$1 billion annually. Since America's population is around ten times that of Canada's, 260 million compared to 25 million, it might be assumed that the illegal sales in the United States will be ten times Canada's, about \$10 billion.

Another way to determine the potential profits for smugglers is to break down the calculation into several parts. A straightforward calculation gives a preliminary indication of the pool of funds that would be potential loot for organized crime. If one starts with the CDC's more conservative estimate that some forty-eight million Americans smoke about twenty-three billion packs per year, then a \$1.50 price hike means a \$34.5 billion overall annual increase in cigarette prices. For cigarette smugglers that represents the upper bound of the premium that can be reaped from illegal sales.

But the price of black market cigarettes will certainly be less than the government taxed price. It is reasonable to assume that the price will be half of the differential between current prices and the price with the new tax added. Half of the proposed average price hike of \$1.50 would be 75 cents. That brings the likely total annual profits from smuggling to \$17.25 billion (\$34.5 billion divided by two).

But not every smoker is likely to have access at all times to smuggled cigarettes. It is estimated that in Canada, when that country's cigarette tax was increased significantly, one in four cigarettes was smuggled. The percentage in the United States would likely be higher. That preliminary assumption is based on the fact that there already exist established distribution systems for contraband cigarettes, from military bases and Indian reservations, and by organized crime between low-tax and high-tax states. (A closer examination of current smuggling in the United States will be made below.) That system would likely expand with a massive tax hike.

Thus if one-quarter to one-half of smokers acquire cigarettes through illegal sources, the profits for smugglers can be conser-

vatively estimated at between \$4.31 billion and \$8.62 billion (\$17.25 billion divide by four and \$17.25 billion divided by two). Since smugglers already profit from illegal sales of cigarettes, the additional profit will be on top of current revenues.

The formula for determining the level of cigarette smuggling might be applied to various metropolitan areas. Those areas where organized crime has a strong presence likely would have especially high levels of smuggling. For example, the New York metropolitan area, with a population of fourteen million, has five major mafia families in the city and one in New Jersey.

Arrests in the past decade has weakened these gangs and they are looking for new sources of profits. Further, other ethnic gangs operate in the New York metropolitan area, with the Russian mob growing and apparently already involved in cigarette smuggling. If the number of smokers in that region equals the national average of 17 percent, that is 2.38 million smokers. With each smoking a pack per day, that's 868.7 million packs smoked each year. A \$1.50 per pack tax thus puts an upper limit of \$1.303 billion in potential profits for smugglers. If smugglers charge consumers a premium of only half as much as the tax increase, that is, 75 cents, the potential profit will be around \$651 million. If half of the region's smokers can acquire bootleg cigarettes, actual profits in the pockets of organized criminals will be \$326 million on top of any profits they already gain from smuggling to high-taxing New York and New Jersey.

ELASTICITY OF DEMAND

A number of other factors will determine how extensive smuggling actually becomes. One is the elasticity of demand, that is, how many smokers cut down or give up cigarettes because of higher prices.

Smoking critics make contrary claims concerning the expected effects of a higher tax on cigarette use. On the one hand they claim that most smokers are addicted and simply cannot break their bad habit. On the other hand, some claim that one of the benefits of higher taxes is that they will discourage smoking. Vice President Al Gore made such a claim on 24 March 1998 to the National Parent-Teacher Association. But there is little indication that smoking fell in Canada after that country's tax increase. Thus, at least in the short and medium term, at best only a small drop in smoking can be expected.

FUTURE SMOKERS

To predict the size of the black market in cigarettes also requires projecting the number of future smokers beyond any immediate reductions that might result from a tax hike. Antismoking groups often claim that smoking is on the rise, especially among teenagers. In fact, while there has been some fluctuations in youth smoking in the past five years, there is no trend of increased smoking.

The actual number and percentage of smokers has fallen

dramatically over the past four decades. (See Table 1.)

According to the CDC, since 1965 when 42.4 percent of the adult population smoked, the percentage of smokers has been cut almost in half, to around 25.5 percent in 1994. Of course, the total population of the country has grown, from 194 million in 1965 to about 265 million today. Thus the absolute number of smokers has fallen very little, from around fifty million to about forty-eight million.

Calculations concerning black market sales of cigarettes must take into account the probability that the proportion of smokers will continue to fall. The question, then, is: by how much? Without a new tobacco tax, and assuming that the current downward trend continues, the actual number of smokers can be expected to decline only slowly, because the population of the country continues to increase, thereby offsetting the decline in the portion of the population that does smoke.

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IN CANADA AFTER THAT COUNTRY'S TAX INCREASE.**

TAX VS. SETTLEMENT

The volume and organization of cigarette smuggling depend not only on the level of a tobacco tax but on what kind of settlements tobacco companies might be forced to make with the federal or state governments. Such agreements might compel companies to turn over revenues directly to the government or to spend money on government-mandated programs, for example, education programs to reduce teen smoking. While some of the costs of settlements would result in lower profits for the tobacco companies, much of the cost would be passed along to smokers in the form of higher prices for cigarettes. That would add to the cost per pack of cigarettes on top of any added costs from a tobacco tax.

Costs passed on to consumers in that manner will be more difficult to avoid than a tobacco tax levied at the point of retail purchase. That is because tobacco companies would add the additional costs into their prices to wholesalers. But the likely result is that smugglers will have an incentive to get involved in cigarette production at the most basic level. Farmers in Latin American countries often sell cocoa plants—from which cocaine and other drugs are made—directly to smugglers. Tobacco farmers likely would come under greater pressure to sell to illegal tobacco dealers. Organized criminals would have an incentive to purchase interests in tobacco farms.

Illegal suppliers might set up cigarette manufacturing operations the way illegal distillers set up operations in American cities and illegal stills dominated rural areas during prohibition.

LIMITS OF DISTRIBUTION

It is now necessary to return to the question of just what level of black market activity in cigarettes can be expected. Certainly cigarettes will be easier to distribute illegally than are illegal drugs. To begin with, possession of cigarettes is not a crime. So unless the police can prove the origin of a pack of cigarettes, then they can take no action against the possessor.

Cigarettes might be sold to customers through two possible channels. First, smugglers might sell the cigarettes directly to customers, for example, out of the backs of cars or vans. That approach allows the smuggler to charge the maximum price consistent with attracting the most customers thus allowing the smugglers to make the maximum profit. Of course, that exposes the smuggler to arrest from revenue agents. Second, legitimate outlets for cigarette sales might purchase their supplies from smugglers, allowing such retailers to charge lower prices, thus attracting more customers. That approach shields the smuggler from some dangers of arrest. It also might allow them to sell more cigarettes overall, since it is easier for customers to purchase cigarettes from an established commercial outlet. But that approach also cuts profits for the smuggler. Further, government agents might institute means to check whether an outlet has paid the required taxes on cigarettes. Currently, for example, states require a special seal on bottles of liquor as proof that the required taxes have been paid.

HISTORICAL TRENDS CONTINUE

Some indication of the smuggling and crime problems that can be expected from a large cigarette tax hike is found in a report entitled *Cigarette Bootlegging: A State AND Federal Responsibility*, published over twenty years ago by the Advisory Commission on Intergovernmental Relation. That commission, which included members of Congress, federal executive branch officials, governors, and mayors, issued its study in May 1977. It reviewed the growth in smuggling that had occurred since 1965, the year when some states began increasing their cigarette taxes thus increasing the incentive to secure smokes from states that had kept taxes low.

At the time of the study the differences between the cigarette taxes in the various states were no where near as great as they are today. Still, the study found that net revenue loss to tax revenues in high tax states was \$337 million.

Citing a series of reports in *Newsday*, the Long Island newspaper, the study noted that four of the New York crime families, employing five hundred enforcers, peddlers, and distributors sold some 480 million packs. In a nine-state area in the Northeast, mob families sold around one billion packs for a profit of more than \$105 million. That magnitude of profit is confirmed by estimates by the Council Against Cigarette Bootlegging, which estimated that profits from illegal sales in eight Eastern states were \$97.9 million for fiscal 1975-1976.

A *Philadelphia Inquirer* story of 15 December 1975 reported annual state revenue losses due to smuggling at \$30 million. The differential between Pennsylvania's eighteen cents per pack tax and North Carolina's two cent tax meant that a tractor trailer load of ten thousand cartons of smuggled cigarettes would yield a \$16,000 profit.

BOOTLEGGING TODAY

All indications are that over past decades cigarette smuggling in the United States has increased. Unlike the case of Canada, where most of the population lives close to the border with the

United States and thus close to access to cheaper cigarettes, Americans are spread out over a wider area. Still, the population centers of America's northeast and south are a one day drive for smugglers from North Carolina, Virginia, and Maryland. The midwest is in reach of those states as well as Kentucky.

In the 1980s American companies exported fewer than five million packs of cigarettes to Mexico. But according to a 15 August 1994 Linquist Avey study, that number jumped to some 150 million packs by 1994. No doubt some of that increase was due to the Mexican market opening through the North American Free Trade Area. But U.S. Department of Agriculture export figures do not correspond with Mexican import figures. The fact that California increased its cigarette tax in 1989 from ten cents per pack to thirty-five cents suggests that million of packs are being exported to Mexico tax-free and then smuggled back into California as well as the rest of America's southwest.

Further, cigarettes sold on military bases—which are scattered around the country—and from Indian reservations are tax-exempt. Those cigarettes are smuggled into the civilian economy.

Michigan provides an instructive case of the effects of a cigarette tax increase. In 1994 that state hiked its tax from twenty-five cents per pack to seventy-five cents per pack. As a result, according to a report issued by the Michigan Coalition Against Crime and Smuggling, 20 percent of cigarettes purchased by Michigan smokers were contraband. According to Rod Stamler, who took worked on the report, about one-third of the smuggling was conducted by tightly organized criminal operations. And the report found that the state lost \$144 million in revenues annually.

ELIMINATING PRICE DIFFERENTIALS

Some might argue that a federal tax hike would reduce the relative price differentials between high tax and low tax states, thus reducing the incentive to smuggle. For example, currently if a pack of cigarettes costs \$1.50 in North Carolina and \$2.50 in New Jersey, a \$1.50 hike in the federal tax would bring those prices to \$3.00 and \$4.00 respectively.

But that price change would not eliminate the potential profit if demand stays the same. In each case a smuggler could vie for part of the one dollar difference in the price. Further, more smokers in New York would have an incentive to seek black market cigarettes. The smuggler could expect a jump in the volume of sales in New York.

STATE TAX TEMPTATIONS

If the federal government fails to place a high tax on cigarettes, it is an open question whether states will hike their taxes further. One would expect that the significant smuggling that already goes on between low tax states and high tax states, and the losses of revenue for the latter, would discourage further tax hikes. No doubt officials in some states take those facts into account in their policy decisions.

But the contraband and revenue effects have been known for a long time and have not discouraged those who really

wanted to raise taxes. The gap between tobacco taxes in the various states has actually widened. In 1975, for example, the average tax was 12.21 cents per pack. The standard deviation of the states from this average was 3.25 cents. By 1997 the average tax was 37.47 cent per pack. But the standard deviation had grown to 18.71 cents. In other words, the deviation from the average increased by 575 percent (18.71 cents divided by 3.25 cents).

Further, part of the impetus for state tax hikes will be the expansion of state medical entitlements, especially KidCare. Those federal programs will require state funding. And like all entitlements, it can be expected to expand as elected officials in essence buy votes by handing out benefits to more citizens. Thus it could be expected that officials who are blind to the problems of socialized medicine and expanding welfare programs will take little account of the economics of tax hikes.

States might attempt to protect their tax base by increasing law enforcement efforts to stop smugglers. But currently the federal government alone spends about \$12 billion annually on the war on drugs, with no appreciable results. The costs of a war on cigarette smuggling would seriously reduce and might even offset any revenue gains from tobacco taxes.

To maximize revenues from tobacco taxes, all states would need to have a similar level of taxation so that there would be no incentive to smuggle from low tax to high tax states. Governors that wanted to raise taxes might try to convince governors in neighboring states to raise taxes as well. But policy coordination between states is difficult in general. Each state has its own interest groups and politics. Citizens in low tax states generally do not want their taxes increased. Thus coordination of tax policy between states is not likely.

States that raise cigarette taxes to pay for new medical or other social programs face a strange set of adverse incentives. If taxes actually deter smoking, the states will see their revenues decline.

Consider a hypothetical example that illustrates that point. Attorneys general in many states have led the charge against cigarette companies, claiming that medical costs resulting from smoking place a heavy burden on state treasuries that foot a good part of the medical bills. But what would happen if cigarette companies simply decided not to "burden" those

states anymore, that is, refused to sell cigarettes in those states?

In Iowa, for example, a state leading the antitobacco crusade, in 1997 the state government collected \$94.6 million in taxes on cigarette products and another \$5.7 million on smokeless tobacco, for a sum of \$100.3 million. A boycott of that state by the tobacco companies would mean the loss of that revenue. Further, many convenience stores and gas stations that rely on tobacco sales as a principal source of income would find themselves out of business. But Iowa smokers would continue to get cigarettes, through smuggling. So even without higher taxes on tobacco, states deprived of revenue from tobacco sales would find themselves in fiscal trouble.

CONCLUSION

The lessons of Prohibition, the drug war, and current attempts to stamp out smoking are that smuggling and crime will follow. But the decline over the past three decades in the portion of the population that smokes teaches another lesson as well. Social or lifestyle changes are best handled through private education and moral suasion, not through government programs. Rather than using the law to limit the free choice of individuals and resorting to methods that will simply funnel funds into the pockets of mobsters, tobacco opponents would do better to use their freedom to convince their fellow citizens to change their ways.

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