

The Risk of Freedom Briefing

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Cost-benefit and the Clandestine Economy

A long tradition of political thinking has emphasized that law is not a threat to liberty but its precondition. Law reconciles my liberty with yours, and so makes both of them possible. Moreover, as societies become larger, more anonymous and more complex, law must expand to regulate new forms of association, and counter new possibilities of crime. Inevitably, therefore, a free economy will also be a regulated economy, and a free society will be a society governed by law.

Hence we must always ask, of any regulation, whether it promotes or undermines the rule of law. It seems that there is a natural limit to the legislative burden that a law-abiding society can bear. Beyond a certain point the habit of obedience is eroded, and the law disregarded. That this is a threat to our freedom is evident; but it is also a threat to the very cohesion of modern societies, by making criminal activity central to their economy, and so normalising it.

A paradigm case of this is the black economy — now running out of control in many sectors, and providing a haven for criminals, for laundered money, and for illegal migrants. The distinctive feature of the modern black economy is not that it involves criminals — for who would be a criminal if there were no economic motive? — but that it is maintained in being by otherwise law-abiding citizens. If some favourite item on the family budget is suddenly taxed beyond the easily affordable level; if the sale and purchase of some desirable product is governed by intolerable and intrusive regulations; if goods taxed out of the market in one country are cheaply available in another, then ordinary citizens have a motive to go beneath the counter. And to an increasing extent they do.

In this issue we carry articles which attempt to assess the extent of the black market, its varieties and its consequences. Work carried out by Professor Schneider in Austria has shown a direct link between the growth of the black economy and high rates of labour taxes. In the case of domestic labour in Western economies, both employer and employee prefer a relationship in the informal, rather than official economy, since tax burdens act as a disincentive to both parties. From this no great social disorder ensues, and no great opportunity is provided for organised crime. Likewise, as Dennis O'Keeffe shows, extra tuition outside the official

school system benefits pupils, teachers and governments alike.

Things are far more serious, however, when it comes to the black market in commodities. When respectable people are involved in smuggling alcohol or cigarettes, then it is easy for criminals to appear respectable. The product in which they are dealing is a legal product, with an established social use and a law-abiding clientele. Unlike hard drugs or prostitution, cigarettes and beer can be sold to decent people; moreover decent people travel freely in countries where the burden of taxation is less and have revised their expectations and their budgets accordingly. The perception of smuggling as a criminal act is

lessened, in proportion as the burden of taxation is raised. However, as Timur Moon points out, comparatively 'innocent' bargaining by consumers links them more directly than they might think to the criminal underworld. For instance, the Real IRA raises approx. £200,000 per lorry-load of smuggled cigarettes to fund its bombing campaigns.

The black economy in commodities is also a serious threat to legitimate business. It is estimated up to 30% of cigarettes now sold in Britain are sold on the black market, usually in car-boot sales. This is one of the major factors behind the closure of village shops and pubs, whose businesses had previously been kept afloat by their tobacco licenses. Our rural crisis is therefore exacerbated by the trade in contraband.

One solution that is often suggested — for example by the WHO in its proposals to control the contraband market in tobacco products — is that of tax harmonisation, to eliminate the incentive to smuggle from one market to another. This proposal would be rational, however, only if purchasing power were uniform, so that cigarettes could be sold at the same price everywhere.

Another solution is simply to lower taxation to the point where the differential in price between legal goods and contraband is not sufficient to tempt the law-abiding citizen. This solution has much to recommend it, not least to the tax authorities themselves, since it is an established fact that, as soon as law-abiding citizens turn to contraband, tax revenues fall. But as Tony Curzon Price points out, as fast as we think of solutions, the criminal bosses will re-balance their portfolios!

... there is a natural limit to the legislative burden that a law-abiding society can bear ...

Our theme

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Boom Time on Black Market

A sudden surge in smuggled and dodgy goods is costing Britain a packet, reports Timur Moon in the *Daily Express*

From fake designer gear and cheap smuggled cigarettes and booze to pirate videos and stolen goods — the Del Boys of Britain are thriving as never before. Enforcement agencies seized £70 million of counterfeit goods last year, but as they estimate this represented only about 10 per cent of the trade, the total annual market could be at least £700 million. The Department of Trade & Industry believes counterfeiting has led to the loss of 4,100 UK jobs. Latest studies show the black market for imported cigarettes and alcohol, much of it brought in by cross-Channel traders in battered vans, outstrips the 'oldest profession' — prostitution — which is said to gross an annual £770 million.

'Shopping is the nation's favourite pastime,' says Gary Cochrane, of the Anti-Counterfeit Group, lobbyists on behalf of 200 major brands. No wonder, if consumers can save up to three-quarters of the retail price on items such as compact discs and cigarettes. 'You can pick up the latest pirate video games for as little as a fiver at a car-boot sale,' he explains. 'In the shops they sell for £40 to £60.' Most dramatic is the surge in tobacco trafficking over the past five years. The British smoke 81 billion cigarettes a year, of which one in five is smuggled. It is hardly surprising when a £4.33 pack of 20, of which £3.44 goes to the Government in duty and VAT, can be bought on the street for as little as £2. Customs and Excise seized 2.1 billion cigarettes in the nine months to February, outstripping the previous year's 1.7 billion, itself three times the 560 million grabbed in 1999. Last year £3.8 billion in VAT and excise duty was lost on tobacco alone, while the number of new smokers rose for the first time in 25 years. Customs and Excise spokesman Mark Thomson says untaxed cigarettes are so cheap people can ship them in from virtually anywhere and still make a vast profit. Some newsagents in London's East End now routinely ask customers if they want 'the £2 pack or the £4.30'. A recent survey found 40 per cent of discarded cigarette packets retrieved at British soccer grounds were imported.

Thomson reckons alcohol trafficking lost the Government about £325 million in revenue last year. 'That's only a tenth of the tobacco figure because beer bottles in the back of a van are more cumbersome and offer smaller profit margins,' he says. All the same, beer trafficking was up 28 per cent, with imported Kronenbourg and Carlsberg Special Brew changing hands at about half-price. And there was a 44 per cent increase in illicit wine dealing. 'The scale of each market fluctuates depending on the flavour of the month,' says Ed Chicken head of counterfeiting at the Institute of Trading Standards. 'A few years ago audio cassettes were big business. But that pales into insignificance compared with today's trade in CD-Roms, DVDs and video games.'

The Internet offers a potentially limitless market. With its facility to source the lowest cost products from anywhere in the world, legitimate or otherwise, it even threatens to render excise taxes obsolete. A US court ruled last month that online music

Some Distinctions:

Counterfeiting, like smuggling, brings illegal goods on to the market. But counterfeiting, unlike smuggling, is theft. The person who sells counterfeit Gucci shirts is endeavouring to obtain a pecuniary advantage by deception, as defined in the Theft Act. The person who sells smuggled whisky is deceiving no-one; but he is violating the customs regulations and is guilty of tax avoidance. Counterfeiting is a crime against the individual producer; smuggling is a crime against the state. And when smuggling is normalised not only is the authority of the state called in question; civil society is corrupted, since ordinary citizens are enticed into crime.

service Napster was in breach of copyright and would no longer be allowed to provide music free. But dozens of other sites have sprung up with the same service.

The Cosmetics and Perfumery Retailer's Association has spotted some 160 websites offering Chanel products cheaply. Cigarettes are available at £2.50 for a pack of 20 on sites such as halfpricecigarette.com and cigiworld.com. Though the operators assure customers the trade is legal, Customs and Excise insists duty must be paid in the UK and it destroys all such products it finds. But the law is sometimes sketchy. Arsenal Football Club recently lost a case to stop Essex trader Matthew Reed selling unauthorised merchandise at his stall near the Highbury ground. In the Gunners' shop, adult replica Arsenal shirts cost £39.99 with children's tops £8 cheaper and all scarves priced at £6.95, but Reed undercuts the club with his own gear.

Two weeks ago Tesco claimed an initial victory in its European Court battle to sell cut-price Levi denims. As a result shops could now have the right to stock designer goods without the manufacturer's consent and sell at vastly reduced prices. The court will pass its final ruling later this year. Meanwhile Tesco has vowed to keep selling bargain Levi 50ls at £25 instead of the usual £55. When High Street stores were short-stocked with Sony's much hyped PlayStation 2 games console at Christmas, a thriving black market sprang up. But there were few bargains. Games consoles retailing at £380 changed hands for as much as £3,000. A roaring trade also arose in 'chipping' the console, which allows it to run the latest games and DVD movie discs months before they are available in Britain. But Sony cancels the warranty on chipped consoles, voiding a customer's right to service.

More worryingly, gangs have lately been caught dealing in potentially lethal goods. Batches of fake vodka, whisky and alcopops have been found to contain anti-freeze and industrial meths that cause blindness. Perfumes triggering skin reactions — some bottles even contained urine — have been seized plus washing powder with caustic ingredients causing burns. Flammable Star Wars and Teletubbies merchandise has been intercepted; along with 'Tetley' tea bags made from metal filings floor sweepings and rat droppings.

The DTI predictably advises consumers to buy only from reputable retailers and it recommends checking labels and packaging for misspellings or poor quality 'I want people to understand that counterfeiting damages everyone, not just big business,' says Kim Howells, Minister for Consumer and Corporate Affairs. 'Fake goods are at best poor quality, at worst very dangerous, and they help fund organised crime. Shoppers might think twice about buying fake products if they knew their money could go to drug dealers targeting their children outside the school gates.'

This article first appeared in the *Daily Express*, 18 April 2001

Cash Holdings and Government Control

Tim Congdon

One of the most elementary enquiries in monetary economics is to ask how much we, as individuals, keep on ourselves at any one time in terms of notes and coin. Typically on Fridays I go to a cash machine and get some cash out. Sometimes there are piles of litter around cash machines and, being very nosy, I look at the statements. The withdrawals are usually of amounts such as £15, £20 or £50. I might conclude that — for most people for most of the time — their cash holding isn't more than £50.

How does that compare with the official statistics? The resident population of the UK in the middle of 1999, according to the latest *Annual Abstract of Statistics*, was 59,501,000 people. A little over 15 million were under the age of 19. So that means there are approx. 45 million people, of money-carrying age. What ought to be the total amount of money in circulation? Surely, it must be close to £50 multiplied by 45 million, which is about £2 billion. But according to *Financial Statistics*, the total of notes and coins in circulation outside the Bank of England at June 1999 came to £28,681 million. We need a bit more detail as some of this sum was held by banks in their vaults and by shops, companies and so on. The non-bank private sector's notes and coins at June 1999 totalled £23.3 billion. This was held predominantly by a category called 'households and non-profit institutions' — you and me. In fact, the official estimate is that household and NPI cash holdings were

£21.5b. in mid-1999. In other words, the holdings of notes and coin per head were not £50 — which is the figure I suggested from my scientific market research survey at cash machines — but nearer £500. Per household it's obviously nearer to £1,500. It follows that the gap between the £50 and the £500, between the logical average individual cash holding and the actual average cash holding implied by the official data, gives a tentative estimate of the stock of 'black money' in the British economy.

You might think I'm about to say that the black economy is enormous. Actually it isn't in comparison with the money held by people, companies and financial institutions in bank accounts. The value of all the bank and building society deposits held by UK residents is about £900b, more than 30 times as large as the total note and coin issue, and an even higher multiple of notes and coin held in the black economy. An implication is that the black economy in Britain is quite small compared with the white economy.

Broadly speaking, a nation with a well-developed banking system and small holdings of notes and coin is also a nation with a high ratio of formal, up-front, pukka economic activity to informal, clandestine and improper economic activity. Switzerland and Singapore have a large banking system and — relative to its bank deposits — a small issue of Swiss franc and Singapore dollar notes; Russia has an exiguous banking so-called 'system' and a heavy dependence on notes and coin in transactions.

Further, the scope for 'emigration' in their money holdings is also very important for the people of oppressed, badly-governed countries. The 'emigration' takes at least two forms. First, there is a tendency to choose

foreign currency notes in preference to domestic currency notes. This tendency is commonly known as 'dollarisation', but in the last decade has also involved deutsche-marks, pounds, Swiss francs and other convertible currencies. Secondly, there is a tendency to transfer domestic currency deposits both into other currencies (which causes the exchange rate to fall) and into banks located in other countries.

Governments may retaliate against this monetary 'emigration' by imposing exchange controls. Classic examples of this are third-world countries and also Eastern Europe and Russia in the communist period. Where notes and coin are the only way to evade identification by the authorities, there is obviously a natural demand to hold legal tender. To some extent this gives a temptation to bad governments to exploit this natural demand by over-issuance. So what one found in East European countries in the good old Brezhnev days was black markets, and not just in goods and services, but also in the currency itself.

The gap between the black market exchange rate for a currency and the official price was a measure of the extent to which people distrusted their governments and, in a sense, of the degree of bad government. Again, the abuse of the money-issuing power and the introduction of exchange controls are examples of government over-extension. They stimulate black markets, they encourage monetary emigration and — in the contempt held for the national currency — they lead to a kind of civil disobedience.

Tim Congdon CBE is chairman of Lombard Street Research. These thoughts were presented to a discussion forum hosted by the Institute of United States Studies on 1/5/01

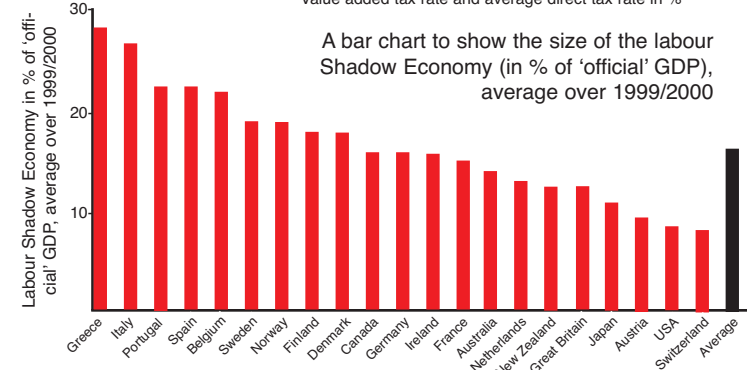
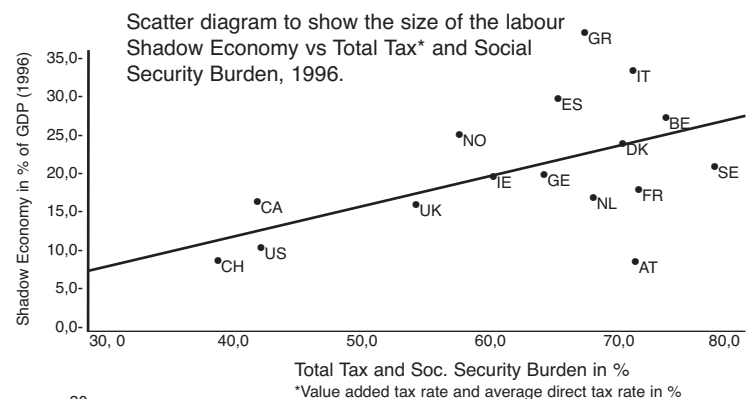
A paler shade of grey . . . a problem of parallel markets by Joe Clark

In Western Europe and North America, the easiest way to meet consumer demand for a cheaper product is through so-called grey-market, or parallel, trading. Grey-market goods are sold outside established distribution agreements, and their purveyors take advantage of the fact that companies charge different prices for their products in different markets. A widget produced in Britain or Germany, for example, may be cheaper in Greece, and cheaper still in a Third-World nation. This is due to a variety of reasons. Prices may be trimmed in certain markets due to lower local consumer purchasing power, or for competitive reasons to maintain or develop market share. Prices may also be higher in markets like those in Western Europe or North America because of the cost of more extensive after-service and marketing requirements and infrastructures.

Grey-market products can be traded among EU members as long as all applicable taxes are paid. Thus, British or German-made widgets sold at a lower price to Greece can be re-imported and sold in Liverpool or Leipzig. But grey-market goods purchased outside the EU cannot be imported into the Union. Widgets made in the United States, for example, cannot be imported as grey-market goods into the Union. Grey-market products are generally permitted in the United States, though there are efforts to curb this practice. In a number of jurisdictions, strong links have been noted between the grey-market and smuggling. In the pharmaceutical sector in Europe, grey-market channels have been used to camouflage counterfeit products so as to minimise the risk of detection of their illicit goods.

Joe Clark is Executive Director of The Alliance Against Contraband

The Shadow Economy and GDP Friedrich Schneider's findings:



Friedrich Schneider is Professor of Economics at the University of Linz, Austria.

Criminal bosses have portfolios too . . .

Tony Curzon Price

People are tempted to see crime as a symptom that the state has over-extended itself. Drugs-related crime, bootlegging, tax fraud ... to be 'tough on the causes of crime' would, in these cases, imply a liberal approach of legalising drugs, lowering excise tax and making public policy friendlier to wealth creation. And what would be a tough remedy for that most common of modern crimes, theft? Proudhon and Kropotkin would have welcomed the liberal reflex: abolish property, of course. Even if property is not itself theft, it is surely the cause of theft.

But we are not tempted to fix the theft figures by abolishing property, because human nature would not support social life without property. The number of crimes that one would want to abolish by repealing their prohibition is determined by one's degree of optimism about human nature.

Every law creates an incentive for a crime or a criminal service. When we make our laws, we choose our crimes. Prohibition is a good example: a criminal

underworld grew out of alcohol distribution. But the marketing savvy of organised crime — with diversification into the various illicit drugs and vices, the licit but highly taxed ones, and more recently into smuggling humans (in parts or living wholes) — should remind us that the end of prohibition was just a change in the risks and returns of particular criminal niches.

The public policy lesson is this: before we conclude that a crime comes from an over-extended state and accept a radical call to legalisation, we need to think how the criminal boss will rebalance his portfolio, re-focus his organisation and deliver the performance his stakeholders expect. Do we prefer a good measure of black GDP from bootlegging, and just a bit from humans and their organs, or would we have the Chancellor of the Exchequer reverse the proportions by reducing excise duties?

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“... This black economy in education provision . . . partially repairs the whole curriculum, from basic literacy and numeracy to degree level, the formal system having failed millions of people. It also modifies another sad feature of state controlled education: the grossly inadequate remuneration of teachers . . .” writes Dennis O’Keeffe:

It is now quite apparent that the combination of a free society and a publicly financed school system will never work well under any circumstances. Modern free societies are characterised by intellectual factionalism. Capitalist societies like Japan or Singapore are neither free nor intellectually mature as Westerners understand these things, and are therefore not good role models. They are good at schooling but most unaccomplished intellectually.

In all free societies in the last half century, ideological factions have seized educational control. Short of privatisation they cannot be dislodged. The attempt at their removal by bureaucratic Leninism in the British instance, as in the National Curriculum or the increasing centralisation of university and teacher education, merely played into the hands of the political elite. This elite, in Britain, France, America and all Western rich societies, does not want high intellectual standards, which in fact it condemns, paradoxically, as elitist. It wants relativisation of life-styles, culture and intellectual activity. But parent who want their children to realise their full potential fight back legally and illegally. Some put their children in private schools while millions of others pay for additional tutoring outside the normal school day.

This black economy in education provision is functional in two ways. It partially repairs the whole curriculum, from basic literacy and numeracy to degree level, the formal system having failed millions of people. It also modifies another sad feature of state-controlled education: the grossly inadequate remuneration of teachers. Many British teachers at all levels stand little chance of ever earning more than about £30,000 a year in their professional careers. In many cases £30,000 is unjust because it is too much. In many others it is grossly inadequate. The black economy modifies this, and also helps educationally competent people who are not officially qualified teachers to earn some extra income.

No British government will ever move against the black educational economy. It would be suicide in terms of standards as well as electorally. Under a rational system of economics and politics, the difference between legal and illegal educational production would simply melt away under the impact of low taxation and private finance. Schools would be efficient and any extra spending on education would simply be legal, low-taxed production, like the tuition provided by schools and universities.

Professor Dennis O’Keeffe recently retired from the University of North London

Publications

The United Kingdom National Accounts 2001 (The Blue Book), National Statistics, September 2001. For the first time this official compilation of the UK national accounts will take into account the economic value of underground activity.

The Green Paper on combating counterfeiting and piracy in the single market, European Commission, Brussels, 1997 and the *Follow Up* paper 8/11/00. ‘The scale on which the phenomenon takes place in the Single Market is considerable and generally increasing,’ ‘Traffickers have sunk a lot of money into churning out more and better goods, as any industry would.’ Among the goods cited are toothbrushes, washing powder, toothpaste and energy drinks.

The Underground Economy: global evidences of its size and impact, edited by Owen Lippert and Michael Walker, Vancouver, B.C., The Fraser Institute, 1997.

‘Shadow Economies: Size, Causes, and Consequences’ by Friedrich Schneider and Dominik Enste in *The Journal of Economic Literature*, 2000, 38/1. p. 77-114.

The Value Added of Underground Activities by Friedrich Schneider, Centre for the New Europe, Brussels, 2000.

‘Brand name goods should cost less,’ *The Guardian* 17/11/00; ‘Hardly the full Monti,’ *The Economist* 25/2/99.

The following texts focus on the unique perspective of the economics of taxation and crime:

Crime and Punishment: An Economic Approach by G. S. Becker, *Journal of Political Economy*, 1968, No 76.

‘Rational Addiction, Lagged Demands and the Efficiency of Excise Taxes: Revisions of Standard Theory’ by R.B. McKenzie, 1991, *Public Choice* No 71.

‘Estimating The Economic Model of Crime’ by A. D. Witte, *Quarterly Journal of Economics*, 1983, No. 98.

‘Parallel Trade – Consumer Benefit or Consumer Loss’, European Brands Association, Brussels, 1999.

www.

www.hmce.gov.uk details the areas of responsibility for HM Customs and Excise

www.targetingfraud.gov.uk provides details of the extent of benefit fraud. Confirmed fraud is costing over £2 billion. More than 22,000 people were sanctioned or prosecuted in 1999/2000.

www.bsa.org the Business Software Alliance website where estimates of the scale of software fraud and its cost to the industry are detailed.