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DEFENDING ORGANIZED CRIME?

A NOTE.

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Nr. 120

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A Note

Abstract

The objective of this note is to discuss optimal enforcement strategies vis-à-vis organized and unorganized crime.

Taking an earlier contribution by Buchanan as a starting point of the analysis, it is argued that his proposal to monopolize crime in order to reduce the general level of criminal activity is a questionable strategy to curb crime. Syndicated crime is likely to benefit from economies of scale in the provision of non-governmental enforcement of agreements and contracts. The consequent reduction in costs is likely to increase the general level of criminal activity. Nevertheless, the price-theoretic argument is seen as an interesting starting point for the design of new strategies to combat crime.

Defending Organized Crime?

A Note

Introduction

In his paper entitled "A Defense of Organized Crime?", James M. Buchanan¹ argued that the common-place that "monopoly in the supply of goods is socially undesirable" implies that "monopoly in the supply of 'bads' should be socially desirable" (p. 119). Since crime is a social 'bad', he suggested that monopoly in such illegal activities as prostitution, gambling, smuggling and drug traffic (ibidem) "is socially desirable and that this may be recognized implicitly by enforcement agencies who may encourage, or at least may not overtly discourage, the organization of such industries" (ibidem).

This paper takes Buchanan's analysis as a starting point. In what follows, I shall first consider the main points of Buchanan's argument and some qualifications he considered. Secondly, I shall proceed to criticize the argument, which I deem to be correct in principle, in order to

1. distinguish various cases in which it is certainly not applicable, and
2. draw more specific and (for that matter) rather different policy conclusions.^{2, 3}

I .

Monopolizing Crime

If an illicit trade is organized on a competitive basis, profit seeking entrepreneurs will equalize the unit price(s) of input(s) to the marginal value product, the product of output price and

¹James M. Buchanan, A Defense of Organized Crime?, in: Simon Rottenberg (ed.), Economics of Crime and Punishment; Washington, DC, (American Enterprise Institute for Public Policy Research) 1973. pp. 119-132.

²Following Thomas C. Schelling, What is the Business of Organized Crime? American Scholar, Vol. 40(4) 1971, pp. 643-652, also in: Journal of Public Law, Vol. 20(1) 1971, organized crime is (monopolistic) government of illicit trade, including such characteristics as taxation and protection. (644, 648 et passim.)

³Thus I shall exclusively deal with type 1 (victimless) crimes. For the distinction and terminology see Buchanan (1973), p. 123.

the quantity change consequent to input change. The monopolistic entrepreneur, to the contrary, will not act as a price-taker. He will, in maximizing his profit, reduce the quantity supplied and increase the price.

The illicit entrepreneur, however, faces not only his market constraints but also those imposed by state enforcement agencies. Buchanan plausibly assumes an inverse relationship between the level of criminal activity and the level of law enforcement. Thus, the reduction of criminal output will also lead to a reduction of the expected costs of this production; these costs are imposed on the illicit entrepreneur by law enforcement agencies. But due to the free-rider situation, only illicit monopolists will benefit from cost reductions consequent to the reduction of criminal activity, and therefore only monopolists will, in their own interest, withhold some of their own criminal activity to the extent indicated.

"The monopolist will take into account the relationship between aggregate industry output and the predicted enforcement response and he can control total industry output so as to increase profits above those forthcoming under competition." (Buchanan 1973, p. 126).

Buchanan did not leave the argument at this point of political irrelevance. Instead, he considered various possible objections to the policy implications of his analysis⁴ which suggests that monopolization of crime may be socially desirable. In doing so, it seems - at least to this author - that he dismissed these various objections too easily. Upon closer inspection, the analysis leads to further restrictions under which the argument can be formulated in terms of a policy proposal.

Illegitimate Profits. A distributional argument concerns the profits accruing to the illegal trade. From the social welfare point of view these illegitimate and thus undesirable profits will in the context

⁴ Buchanan himself seems to have been uneasy about the policy implications of his analysis. He did not push the policy argument very far. At one point he even stated: "In its strictest interpretation, the analysis carries no policy implications at all." (178) Nevertheless, he did not avoid dealing with policy implications following from his analysis.

of Buchanan's analysis at best partially be offset by the reduction in criminal activity. Buchanan overlooked however the possibility that monopolistic profits may be relevant with respect to self-financing of criminal enterprise.

Interdependance of Criminal Activities. Secondly he noted that monopolization has the desired effect of shifting a somewhat larger share of those inputs formerly employed in illicit activities to non-criminal pursuit (Buchanan 1973, p. 127). This, however, will not be true if criminal activities are interdependant:

If we should assume that potential criminals constitute a non-competing group of persons, distinct and apart from the rest of society, monopolization of one or a few areas of criminality may actually increase the supply of resources going into remaining and non-organized activities" (ibidem).

The beneficial effects of monopolization of crime in this model clearly depend on the validity of the assumption of a constant size of the group of criminals in society over time⁵.

Passive Acquiescence in the Syndication of Crime. Finally, Buchanan would not like to see the establishment of monopolistically organized crime to be the result of active state interventions in order to establish such a monopoly. He preferred "passive acquiescence in the syndication of crime" (p. 129) "at the expense of enforcement effort aimed at ordinary competitive criminality" (p. 126). In what follows I hope to show that on the basis of the original argument an active and discriminating political strategy should be proposed instead of passive acquiescence of state authorities.

Economies of Scale in Organizing Crime. An argument entirely neglected by Buchanan concerns the possibility of economies of scale in organizing crime. For his analysis to be held correct it has to be shown that there are no such economies accruing to the illicit entrepreneur.⁶

⁵Otherwise, this group may just expand and engage in further illicit activities, which in turn could lead to an increase in the level of criminal activity. See section III below.

⁶An argument similar to Buchanan's has recently been advanced by Michael Spence with respect to the heroin market: "A Note on the Effects of Pressure in the Heroin Market", Harvard Institute of Economic Research, discussion paper No. 588, 1977. "Over some range of regulatory effort, dealers and regulators are on the same side," according to Spence. After giving the calculus for a variety of pressure elasticities, he concludes that insofar as 'pressure' induces a reduction of sales in physical units, this may elevate the price and increase profits "where (the elasticity of demand with respect to price - J.B.) is small and the increase may outweigh the direct cost in terms of annoyance and avoidance behaviour of the increased pressure." (p. 9)

Below, I hope to show that economies of scale in the organization of crime are very likely to occur.

II

Economies of Scale in Organizing Crime.

In order to develop this argument, a closer look at the costs of organizing illicit trade is appropriate. Any trade, whether legal or illegal, depends on some guarantees provided by legal institutions: enforcement of contracts and protection of property. For legitimate business, these costs are largely external, since any single contract is normally enforced by the mere existence of enforcement institutions and property is protected already by the expectation that violations will carry negative sanctions. Since millions of transactions take place each day, the average cost of maintaining the effectiveness of legal institutions to be attributed to any particular transaction is rather small. It is, therefore, generally disregarded in microeconomic analysis, and properly so.

The situation is quite different for illicit trade. In this setting, any particular transaction is subject to three different threats (costs): first of all, enforcement agencies may interfere and the cost of such an interference is usually a multiple of the value of the particular transaction to the trader; other criminals may interfere too and take the good or money away. Since the property in question is not protected by the state, the offender is not subject to punishment - but possibly retaliation. Retaliation, of course, is not costless to the retaliator either. Finally and for the same reason, a contract may be broken and the good transacted may be lost without recompense.⁷

In effect, any given illicit transaction essentially involves the provision of two goods at a time, a service and a commodity. While in the legitimate trade, the exchanges are protected by the legal system (L) which can thus be regarded as a peculiar insurance system, illicit trade, in addition, has to produce the insurance service itself.

⁷In the long run, when many transactions of the same kind take place between a particular pair of traders it is in the interest of either party to fulfill contracts as long as the entire relationship is expected to continue.

The key difference between legitimate and illegal trade is, that an alternative institution of rules and orders (\bar{L}) has to be designed by the trader. This may be a rather rudimentary and only partially effective system, consisting of the various precautions an illicit trader may take: screening of customers, devices for the protection of property, bribes to judges and enforcement agencies as well as armed guards etc. If the criminal activity is organized at a higher level, and more transactions depend on the effectiveness of (\bar{L}), the alternative order, these devices will in general be more sophisticated, more extensive and also more effective. Very little, however, is known about the details of the internal organization of crime, and a more detailed description would necessarily tend to be speculative.

If an organization of crime is established which operates to decrease the probability of state interference, discourage other criminals and impose sanctions on those persons who break the contract, we may duly refer to this as an alternative legal institution. Similar to the legal system (L), the effectiveness of its illegitimate substitute (\bar{L}) depends mostly on its known existence. Only relatively few instances would actually provoke sanctions imposed by this organization. This being the case, the maintenance of the organization will essentially involve three kinds of costs: the fixed costs of maintaining the system as a whole; the fixed costs of insuring any particular kind of service; as well as thirdly the variable costs of providing a particular service (of a certain kind) in any particular transaction.

Assume that none of these costs are negligible. Assume further that the cost structure is stable over some relevant range. These assumptions imply that over the range indicated there will be economies of scale in illicit trade. These economies of scale will already be substantial when increasing the volume of transactions in any particular kind of illicit exchange, but they will still be more important when further kinds of illicit transactions can be included. If all exchanges of a particular kind of illicit transaction can be included into one organization, this particular illicit exchange has been monopolized and the fixed cost components of the average cost share are at their minimum. By the same argument, if all kinds of illicit exchange could be integrated into one syndicated system of illicit exchange, the fixed cost share of the entire production of illicit trade could be minimized. From this follows, that ceteris paribus⁸ monopolization

⁸These qualifications include: stability of cost structures over the relevant range and stability of the environment as shaped by enforcement agencies.

of organized crime, if this organization is designed to serve the properties described above, will tend to reduce the cost of illicit transaction to the extent of the degree of monopolization, both in a particular kind of illicit trade as well as in the entire illicit trade as such. On the assumption that the organization of a criminal syndicate is encouraged by passive acquiescence of state agencies (as proposed by Buchanan) and given profit maximizing behaviour of criminal entrepreneurs, the establishment of monopolistic organizations operating in illicit trade and enjoying the 'advantages' of employing cost minimizing technologies can be predicted.

Is the syndication of crime a precondition for the employment of such cost minimizing technologies? Various critics have suggested to me that (\bar{L}) need not necessarily be the effect of a comprehensive organization but may be provided through some decentralized process like the market. Illicit traders according to this view may e.g. build up a reputation of disposing of effective means to protect their property and have their contracts fulfilled.

The market, obviously, is a powerful institution to process information. It processes information in abundance and tends to reduce everybody's costs of access to this information. Everybody, of course, also includes enforcement agencies, which the illicit trade must make every effort to exclude from its information network. In the illicit trade, advertising does not follow but antecedes 'screening' of potential customers. Each leak is potentially dangerous. There are, again, reasons to believe that economies of scale can be realized in 'screening' which would in turn indicate an advantage of the illicit trade through integrated organization over such trade effected through decentralized market-type processes.¹⁰ The closer a trader is to the center of an illicit trade network, the more unlikely he is threatened by undercover penetration into the network undertaken by enforcement agencies, and the more information he will be able to process.

⁹See Friedrich August von Hayek, *The Use of Knowledge in Society*, *A.E.R.*, Vol. 35, 1945, pp. 517 sequ.

¹⁰It may be conceivable - although improbable - that the production of the insurance service can be separated from the trade itself; consequently, the trader would acquire the two benefits of the good exchanged and the insurance of the transaction separately and combine them to the effect of sale. In this case, the following discussion of illicit organization refers only to the production of the insurance service.

III

Interdependance of Illicit Trade and the Importance of Illegitimate Profits as a Source of Self-financed Growth

If there are economies of scale in providing non-governmental enforcement of contracts and agreements, the illicit institutional exchange system (\bar{L}) has incentives to grow. It can do so the better the more interdependant are different kinds of illicit trade. Relative interdependance in this context¹¹ has a peculiar definition:

Given an illicit exchange system (\bar{L}) which organizes (n) different kinds of exchanges $\{k_1, \dots, k_n\}$, and a 'candidate' $\{k_{n+1}\}$ which is a further kind of an illicit exchange to be integrated into the pre-existing system. Then the set of exchanges already integrated into \bar{L} and the candidate element $\{k_{n+1}\}$ are the more interdependant the smaller is the fixed cost increment consequent to the integration.¹²

The smaller are the fixed cost increments, the better illicit exchange systems can grow, ceteris paribus. Since I have deliberately made no assumption about the relative importance of the different fixed and variable costs, it is impossible to predict the precise extent of monopolistic organization and illicit trade likely to develop. At this level of abstraction, this is not necessary either. It is, however, possible to outline a few qualitative characteristics of the development. It can safely be assumed that the process of concentration would begin with those types of exchange that require relatively small initial investment in the organization (\bar{L}) itself.

The growth of an organization of syndicated crime is determined by the relative interdependance between different kinds of crime. In general, establishment of criminal enterprise with high initial investments and a relatively smaller share of variable costs will be rendered difficult by the existence of entry barriers to financial markets.

¹¹ See the author's more extensive discussion in: Jürgen Backhaus, "Homogenous Social Groups Facilitate Exchange", Zeitschrift für Wirtschafts- und Sozialwissenschaften (forthcoming), on the basis of which the following argument has been developed.

¹² This definition takes the possible effect into account, which the order of successive integration of different kinds of exchange may have on the size of the fixed cost increments.

It is unlikely that criminal enterprise can obtain major long-term loans from established potent financial institutions, which are unlikely to risk their reputation with the general public. This implies that criminal enterprise will have to rely largely on self-financing out of profits. Thus, illegitimate profits are not only morally annoying; being a precondition of the growth of criminal syndicates, their incidence is counterproductive to the entire approach of combatting crime by monopolization.

Taking the view point of a criminal entrepreneur, two cases of profit seeking can be distinguished: legitimate and illicit profit seeking. Nothing prevents a criminal organization from engaging in legal profit seeking, like operating laundries. This should not merely be regarded as a "cover up", but also as an attempt to self-financing in order to expand illicit operations. Since profits are generally higher in monopolistic than in competitive industries, monopolization of one enterprise will not only lead to a reduction of production costs as discussed in the preceding paragraph, it will also provide access to financial resources needed to expand into other criminal industries. The growth structure of criminal institutions, i.e. the decisions which illicit exchange to include next into the "program" is contingent upon the estimated demand for particular kinds of illicit transactions, on the initial investment required to adapt incrementally to the provision of such transactions, on the variable costs of providing the associated services in question as well as on prices and the availability of inputs required. Other things being equal and given the existence of entry barriers to the financial market, only those projects can be considered for which the incremental investment is equal or smaller than the legally or illicitly accumulated profit over time of the criminal enterprise. As the monopolistic enterprise grows, and given entrepreneurial success, this restriction gradually loses importance, however. Also those markets and illicit exchanges will become possible new markets, which, due to the initial investment requirements, may not have been accessible to criminal entrepreneurs initially. This being the case, profit opportunities should be higher in those markets of more difficult access, and from this follows, that other things being held equal the rate of growth of the illicit monopoly should be expected to accelerate

¹³For a formal treatment of the development and persistence of counter-state institutions, see Section III of my "Homogenous Social Groups Facilitate Exchange", referred to above in foot-note 11.

As long as the process of expanding continues, application of George Stigler's¹⁴ discussion of Adam Smith's famous theorem¹⁵ suggests that the process of concentration of illicit trade networks finds its limitation in the limits of the extent of the market. What are these limits? Since jurisdictions are delineated geographically, and since the operation of the illicit exchange system (\bar{L}) is directed mainly against enforcement agencies operated by particular jurisdictions, we might expect different markets (and consequently different illicit trade organizations) along the same lines as jurisdictional organizations. Also, certain ethnical, language and social patterns of distributional networks will have their impact on location and size of criminal organizations. Criminal syndicates are, therefore, not likely to grow indefinitely, but monopolization of illicit trade will probably lead to the inclusion also of some of those illicit exchanges which are rarely observed today and the general level of criminal activity has to be expected to increase substantially as a consequence of monopolization.

Passive Acquiescence or Active Policy: Concluding Remarks and Policy Implications

The main argument of this note has been that due to economies of scale in the organization of criminal activities, passive acquiescence in the monopolized syndication of crime will lead to a general increase of criminal activity, instead of a reduction. This is unfortunate, since passive acquiescence in the syndication of crime is a political proposal extremely easy to implement. Passive acquiescence, however, does not follow from the basic price theoretic argument that monopolization in the provision of "bads" should lead to reduction in this provision, similar to the reduction in the provision of goods consequent to the monopolization of their production. Instead, some active public policy might be effective in isolating the positive welfare implications of the monopolization of crime

¹⁴George J. Stigler, "The Division of Labor is Limited by the Extent of the Market", Journal of Political Economy, Vol. 59, June 1951, pp. 185-193.

¹⁵Adam Smith, The Wealth of Nations, Vol. I (I), Ch. III.

from their negative ones. In principle, monopolization has inter alia the following consequences:

1. a quantity reduction
2. a price increase
3. a cost increase (e.g. "organizational slack"¹⁶)
4. rent seeking¹⁷.

The first effect is unambiguously conducive to effective policy towards crime. So is the second effect provided that increased profits do not facilitate the growth of illicit monopolies. The third and fourth effect provide means to squeeze those undesired profits. The cost interdependence of criminal activities can for instance be reduced by slight changes in criminal law: in order to tax the division of labour in the criminal industry, geometrical (instead of pure arithmetical) accumulation of punishment might be suggested as various crimes of a different kind are committed by one person (or group). Rent seeking can be organized so as to tax most of the rent beforehand in order to divert the larger parts of rents from criminal monopolies into the public purse; this may be accompanied by quasi taxation (by means of e.g. harassment and blackmail). Some of these strategies towards organized crime obviously involve getting dirty hands. There is a possible trade-off between "clean" and "effective" public policy. If the overall amount of illegal trade is to be reduced by means of monopolization of this trade, "benign neglect" of syndicated crime will not suffice.

¹⁶ See such approaches as Williamson, "Managerial Discretion and Business Behaviour", American Economic Review, Vol. 53, 1963, p. 1032; or Leibenstein, "Allocated Efficiency versus X-Efficiency", American Economic Review, Vol. 56, 1966, pp. 392-415.

¹⁷ See Gordon Tullock, "The Welfare Cost of Tariffs, Monopolies, and Theft", Western Economic Journal, Vol. 5, 1967, pp. 224-232, as recently extended by Richard A. Posner, "The Social Costs of Monopoly and Regulation", Journal of Political Economy, Vol. 83, 1975, pp. 807-827, or Anne O. Krueger, "The Political Economy of the Rent Seeking Society", American Economic Review, Vol. 64, 1974, pp. 291-303. The notion of rent seeking describes the investment of resources made by economic agents in order to obtain access to the monopoly.