



**ORGANIZED CRIME:
STRATEGIES AND COUNTERMEASURES**

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AN ECONOMIC ANALYSIS

INTRODUCTION

While there have been vast numbers of studies on criminal money-laundering, the great majority of them appear to be devoted exclusively to evaluating the amounts of money involved. These essentially quantitative analyses are inadequate because they give us only an abstract view of the money-laundering problem and provide no precise information about its impact on the legal economy or about the true threat that the existence of such illegal activities presents to society. Concentrating as they do on the extent of money-laundering, studies of this kind tend to focus attention on the methods used by criminal organizations to remove their income from police surveillance, at the expense of an analysis of the strategies these organizations use to obtain income to the detriment of society.

Public policy in the fight against money-laundering has focused too much on the use of the most sophisticated techniques put at our disposal by the international financial system, whereas most criminals who launder their income continue to use the most elementary methods, and among those methods the most primitive of all—namely consumption. Hardly more sophisticated are the shifting of cash from one place to another and the opening of several bank accounts, which often constitute the only precautions taken. Complex scenarios such as those uncovered in the Jurado affair are put in hand by only a minority of criminals, among whom the large criminal organizations occupy the first rank.

Many of our methods of combating money-laundering have been designed to prevent, or render extremely difficult, the sophisticated use of banking and financial mechanisms, which has led the law enforcement authorities to take little interest in the most common money-laundering practices. Because of its growing complexity, the campaign against money-laundering—confined to its most sophisticated aspects—has acquired a kind of autonomous status which is too often unrelated to the real struggle against criminal organizations; and this limits the efficiency of the campaign.

The law enforcement authorities have had to admit their inability to oversee the whole network of international transactions themselves. As a consequence they have had to delegate this function to the banking and financial system. Since they are not in a position to impose a mandate directly on that system, they have had to offer special incentives to secure its cooperation. Banks and financial institutions are required, under pain of sanctions, to oversee their clients. Criminals must therefore either give up money-laundering or else resort to more complex and costly arrangements, which is in itself an indirect way of checking laundering.

We shall show in this report that government policy in the fight against money-laundering, as commonly implemented, reflects these concerns that are too exclusively focused on the use of

methods designed to increase the cost of laundering, to slow down its implementation and to limit the sums of money whose criminal origins can effectively be disguised. The public authorities base their actions on assumptions regarding the behaviour of the actors involved (criminals and banks) which accord great confidence to the effectiveness of incentive arrangements whose foundations are at best uncertain.

Limiting public policy to this one line of attack is all the more regrettable as the 1998 Convention clearly intended that the campaign against money-laundering should be used as a Trojan horse in the struggle against the economic power of criminal organizations. In practice, the efforts made since then have been limited to the campaign against laundering in the strict sense: their main purpose was to prevent criminal funds from infiltrating legal channels, without any real effort to find out in what proportion these illegal revenues were being recycled by the financial and banking system, what their origins were and for what purpose they were intended to be used. To use a military analogy, the response of the international community has consisted in building a line of defence around the banking system without taking any real interest in the enemy's attack strategy, his military capacities, the extent of his forces in the field and the type of weapons used.

We have to confess that the results of these tactics, measured by the yardstick of an actually observed reduction in flows of laundered money, are not at all encouraging. It seems to be a highly unequal struggle. On the one hand, we have large sums of money protected by the fluidity of modern financial transactions and a dense network of complicity; on the other, a handful of individuals working in highly constrained circumstances owing to the legislative and regulatory yoke which continues effectively to protect bank secrecy. The international institutions cannot ignore this situation.¹

The aim of the present analysis is to provide a better understanding, resting on scientifically established foundations, of the extent of the economic power of the most important criminal organizations, of their laundering strategies and of the real threat that this economic power represents for States. Particular attention will be given to organizations involved in drug trafficking. As far as the fight against drug trafficking is concerned, the focus on laundering has certainly favoured a salutary shift of attention from trafficking as such to the interface between the criminals and the banking, financial and legal services which they use. Furthermore,

¹For some people, it seems logical that the fight against money-laundering should be ineffective because the real aim of the international institutions, in their opinion, is not to combat money-laundering but rather to embed society in ever more constraining regulations. If that is so, the fight against money-laundering is nothing but one more manifestation of the regular tendency of the State to reduce the freedom of the market place by constraining the liberty of individuals. In the opinion of others, on the contrary, the international institutions are motivated exclusively by the disinterested aim of protecting the well-being of our societies. This is why, quite independently of the results achieved, they feel duty-bound to undertake a campaign against criminal money-laundering. We do not share either of these opinions. Without claiming to respond to all aspects of the questions raised here, the answers to which would require a more general understanding of the motives underlying State intervention, we shall limit ourselves to showing how present assumptions regarding the economic functioning of criminal organizations constitute a substantial source of error in the establishment of public policy.

it seems certain that the interest accorded in Europe to this struggle against the laundering of money derived from drug trafficking has given fresh impetus to the attention focused, if only indirectly, on the fight against organized crime as a whole. However, it remains true that the fight against money-laundering should not be seen as an operational point of departure in drawing up battle lines for the campaign against organized crime, especially as the methods used are based on flimsy hypotheses and focus on only a fraction of what constitutes, every day, the money-laundering activities of most criminals.

1. DEFINITION OF ORGANIZED CRIME

Let us begin with one obvious fact: the development of effective strategies to combat what we have agreed to call *organized crime*² presupposes some knowledge of the manner in which crime is organized. The term *organized crime*³ has in fact been used in very different ways in different countries and by different writers. In 1967 the Task Force on Organized Crime offered the following definition: *The core of organized crime activity is the supplying of illegal goods and services (gambling, loan-sharking, narcotics and other forms of vice) to countless numbers of citizen customers.* This definition established a clear link between the core activities of *organized crime* and illegal markets. Thus, whereas crime consists generally in acquiring goods produced by someone else, *organized crime* responds to a demand that exists independently of itself. In the light of this definition, the structure of *organized crime* seemed to resemble closely that of a firm. T. Schelling (1971)⁴ soon contested this approach, stressing that it did not attribute a sufficiently important role to the activities of *organized crime* involving the use of threats and violence in the conduct of legal and illegal affairs.

According to Schelling, the difference between traditional criminal activities and *organized crime* lies in the fact that the latter aims at controlling the whole range of activities of the underground economy. For Schelling, in the first place, organized crime always endeavours to secure a monopoly position in order to extort income from all illegal activities without incurring the risk of managing them directly itself. Secondly, since it is establishing itself as a *rules setter*, organized crime is bound to have recourse to violence. This being so, the core activities of *organized crime* are to be found, according to Schelling, in illegal activities (not because organized crime particularly wishes to control specifically those types of activities but because

²Let us make it clear at this point that we will be concentrating on *trafficking crime*, which requires minimal coordination between the actors involved going beyond the sporadic relationship that brings together, for example, a thief and a fence. Our research will focus on types of crime which offer a service or a product on a comparatively large scale (drugs, weapons, prostitution, etc.). Racketeering on a large scale fits in this category to the extent that it is a *protection service* offered to counter a threat which emanates from the racketeer himself.

³See G. Fiorentini, S. Peltzman, *The Economics of Organized Crime*, CEPR.

⁴T. Schelling (1971), *Economics and Criminal Enterprise*, *The Public Interest*, 7, pp. 61-78, reprinted in *Economics of Crime*, Cambridge MA: Schenkman and T. Schelling, (eds.) (1984), pp. 158-178.

the people in charge of them are in a poor position to protect themselves against threats since they cannot turn to the legal authorities for protection. Thus Schelling's thesis is that organized crime should be described more as a Government of illegal activities⁵ than as a Firm⁶.

More recently, P. Reuter⁵ proposed another definition of organized crime⁷ which leads implicitly to rejection of the two foregoing definitions. According to Reuter, organized crime consists of organizations that have durability, hierarchy, and involvement in a multiplicity of criminal activities.⁸ This definition is fairly general and makes no reference to the legal or illegal character of the activities carried out. The definition is, however, precise enough to exclude from its purview enterprises which are engaged in only one area of criminal activity or which have no precise internal hierarchical structure. Reuter's definition stands in contradiction to that of the Task Force, which included in organized crime only activities carried out on illegal markets.

An approach of this kind is obviously very restrictive. It stands in contrast, moreover, to Schelling's analysis, because the main burden of Reuter's work consisted in showing that there was no monopoly controlling illegal markets and the use of violence in any centralized way. There exist, therefore, numerous illegal markets to which there are essentially no barriers (loans, prostitution, smuggling, counterfeiting and so on) and which are plainly not controlled by a criminal monopoly. As a consequence, these markets are competitive and any tendency for monopolistic revenues to arise is blocked by the forces of competition and conflicts between rival organizations.

On the one hand, there are a number of elements which operate in favour of Reuter's thesis and help to give organized crime a no more than poorly centralized character: (a) the fact that the risks inherent in illegal activities decrease less than proportionally with the scope of the activity, (b) the fact that property rights in illegal merchandise are ill defined and that such merchandise may be seized by law enforcement authorities, (c) the fact that the risk of the organization being infiltrated by the police increases with the number of its members, and (d) the fact that it is not easy to ensure the efficiency of financial markets when they are not very competitive.

What speaks in favour of Schelling's thesis, on the other hand, is that there exist markets (both legal and illegal) in which criminal organizations are involved in a vertical integration process (drug trafficking, money-laundering etc.). To be sure, there remains some room for competition in these markets, but the more powerful organizations try to eliminate it and to coordinate activities among themselves. Such coordination generally takes a cartel form⁹ on a territorial basis¹⁰ and relies on the reinforcement of vertical relationships between organizations specializing in the provision of different inputs (violence, corruption, financial expertise) needed for the production of illegal goods and services.

⁵P. Reuter (1983), *Disorganized Crime. The Economics of the Visible Hand*, MIT Press, Cambridge MA.

A number of factors support the thesis that organized crime plays a central role in the conduct of criminal affairs. This centralization makes it possible (a) to achieve economies of scale in the production of certain services needed for the conduct of illegal activities, (b) to benefit from monopolistic prices in certain markets not exposed to the risk of external competition, (c) to internalize negative external factors due to excessive recourse to violence, (d) to indulge in corruption and lobbying, which constitute appreciable sources of revenue, (e) to optimize the distribution of activities according to the degree of risk involved, and (f) to facilitate the use of international financial markets.

Table. Organized crime: the Acompany@ thesis versus the Agovernment of crime@ thesis

	Schelling	Reuter
<i>Theses of the two writers</i>		
Markets where CO* are active tend to be monopolistic in nature	Yes	No
Existence of room for competition in these markets	Yes (slight)	Yes (lots of room)
CO tend to coordinate their activities (cartels, integration processes)	Yes	No
<i>Factors supporting the theses of the two writers</i>		
Coordination of CO activities and monopolization of markets:		
- Enable CO to eliminate competition	X	
- Make possible economies of scale	X	
- Make it possible to fix monopolistic prices	X	
- Make it possible to internalize negative external factors (violence between CO)	X	
- Enhance opportunities for corruption and lobbying	X	
- Make it possible to optimize the distribution of	X	

activities in accordance with the degree of risk

- Allow the effective use of international financial markets X

Coordination of CO activities and monopolization of markets are impossible because:

- Increase in the size of CO does not lead to any proportional decrease in the risks associated with criminal activities X
- The risks inherent in illegal activities decrease less than proportionally with size X
- The risk of police infiltration of CO increases with the number of members X
- Property rights in illegal merchandise are ill defined, and the merchandise may be seized by law enforcement agencies X

*CO ' criminal organizations.

It is no easy matter to decide between the vision of Schelling, for whom organized crime is a centralized agent, a sort of Aillegal world government@, and that of Reuter, in which the underground economy consists of numerous Afirms@ active in the various markets, essentially illegal ones, but also legal ones on occasion.

However, it is not a useless occupation to reflect on the degree of centralization of organized crime. Reasonable decisions regarding law enforcement policy are closely dependent on the way this question is resolved. After all, one would not devise the same combat strategy for a centralized criminal organization and a random assortment of small criminals. At the same time, however, it would be dangerous and illusory to define a programme for combating delinquency on the basis of a Ageneral model@ reflecting the centralized nature of organized crime. The ways in which criminal activities are organized vary too much from one country to another, and even within a single country, to allow an approach of this kind. We are therefore bound to rely on detailed observation of national or local realities.

But whatever the fine structure may be, neither of the two extreme positions described above is tenable. On the one hand, to ascribe to organized crime only the traits it borrows from centralized government is to overlook the great suppleness of the organizational structures of

crime and leads us, in particular, to overestimate the positive consequences that will result from supposedly destroying these structures. On the other hand, to generalize from the relationships that criminals engaged in a trafficking activity maintain among themselves makes very little sense.

The example provided by the Colombian cocaine cartels is particularly instructive. At the beginning of the 1970s, some of the main figures in cocaine trafficking had no criminal past at all, while others came from the world of smuggling or small crime; but all of them operated fairly independently of one another. Then came a time when arrangements became more organized, but they never attained the degree of centralization sometimes attributed to the large organizations of Cali and Medellin. Following the strikes against Pablo Escobar's organization, it seemed at first that the role of the Cali drug traffickers had been underestimated, because their organizational arrangements were rather different from those of Medellin and because, after all, there existed behind the Cali and Medellin cartels a multitude of flexible arrangements between regional bands of drug traffickers. The case of Colombia shows us clearly, therefore, that many different forms of organized crime can coexist in a single country and that they can be highly adaptable to their environment.

2. ECONOMIC ANALYSIS OF ORGANIZED CRIME

Realization that the world of organized crime is heterogeneous should not discourage us from trying to understand how the internal organizational arrangements of criminal organizations affect their results. Clearly, the action of criminals operating on their own⁶ cannot be envisaged without taking into account the many interactions which link them to their milieu. Indeed, any organization, whether criminal or otherwise, has to resolve one key problem: it must ensure that a large number of individuals, each retaining a certain independence and pursuing its own interests, cooperate and abide by rules that are necessary for the functioning of the group. According to the sociological meaning of the term, organizations are human groups structured in a formal and hierarchical manner for the purpose of achieving the cooperation and coordination of their members in the attainment of given aims.⁷ It now remains to be seen how criminals reconcile their desire to engage in lucrative activities on an individual basis and the obligations that belonging to a certain milieu imposes on them.

The answer put forward here is based on an analysis of the functioning of organized crime in terms of networks.⁸ This approach makes it possible to appreciate a feature of the criminal

⁶The phrase 'criminals on their own' is rendered in French as *criminels individuels* (DELETE THIS FOOTNOTE FROM THE TRANSLATION).

⁷E. Friedberg (1992), 'Organization' in R. Boudon (ed.), *Traité de sociologie*, PUF, Paris.

⁸P. Kopp (1992), 'La structuration de l'offre de drogue en réseaux', *Tiers-Monde*, No. 131, vol. XXXIII, July-September. See also J. Cartier-Bresson (1997), *Corruption Networks*, Transaction Security and Illegal Social

world, namely the absence of any apparent contradiction between a certain degree of hierarchical coordination and the allowance of considerable freedom of action at the individual level. Indeed, in a network, the creation of wealth does not follow a simple vertical course as in standard industrial production lines, where firms' hierarchy corresponds to a functional segment of the manufacturing activity. On the contrary, the many elements making up a network ascend or descend within its structure, bypassing the intermediaries in order to set up operations on their own account. The organization of the criminal world follows this pattern. Far from being characterized by vertical integration that assigns fully specified tasks to subcontractors, it can be seen as a meshwork where each operator deals with its regular partners at the same time and simultaneously conducts activities on its own behalf.

Vertical decentralization of responsibilities thus allows the fulfilment of a vast number of individual contracts that form part of a series of functional allegiances backed by regional or family-based complicity or simply by bonds of trust. A vast number of relatively independent operators enter into agreements of varying duration set in motion by the top echelons of the organization, who finance some operations and then use the same logistics to conduct their own personal activities. The criminal network does not therefore resemble a centralized pyramid organization or a system of competing subcontractors or a system of franchised dealers. This emphasis on the concept of an organization as a network of operators in the criminal economy highlights the flexibility of this form of organization and its adaptability for those who adopt it, which is essential for dealing with the enforcement measures directed against them.

There are two major families of networks, whether criminal or otherwise, namely Anarrow networks that are driven by a high level of social capital⁹ and Abroad networks with a low level of social capital⁹. The term Asocial capital¹⁰ denotes the economic benefits that accrue from social interactions of trust between the actors. This trust reduces transaction costs and enhances the capacity for collective action. Criminal networks would appear to fall rather into the former category. There is good reason to believe that law enforcement action encourages criminals to restrict their contacts to a small number of relatives or trustworthy friends. Within such a network, the level of trust is high and transaction costs are low but the narrowness of the network will ultimately be a barrier to the flow of information and to social mobility. Narrow networks in fact isolate individuals from the outside world. While they may facilitate their local

Exchange⁹ in P. Heywood (ed.), APolitical Corruption⁹, *Political Studies*, vol. 45, No. 3, Special issues, pp. 463-476; published in book form, Blackwell Publishers, 1997, pp. 47-60.

⁹In an area far removed from the economics of crime, P. Granovetter (1982), AThe Strength of Weak Ties: A Network Theory Revisited⁹ in *Social Structure and Network Analysis*, P. V. Marsden, N. Lins (eds.), Sage, Beverly Hills, shows that job hunting is easier when an individual has the benefit of an Aextended network⁹ composed of simple acquaintances and driven by a weak social tie than when he or she relies exclusively on a Anarrow network⁹ consisting of friends and relatives but driven by a strong social tie.

¹⁰P. Collier; J. W. Gunning (1999), Explaining African Performance, *Journal of Economic Literature*, vol. XXXVII, March, pp. 64-111.

establishment, they nevertheless hinder social mobility and the dissemination of ideas. In short, when the requirements for reasonably effective law enforcement action are met, crime cannot succeed in Aorganizing@ itself in the general sense of the term. In such cases, Aorganized crime@ will amount to nothing more than a cluster of highly compartmentalized networks.¹¹

The particular organization of the criminal milieu does not therefore conform to a principle of coordination that is sufficiently powerful to dictate the behaviour of the different participants. How then can the many producers, transporters, importers, sellers and buyersCnot to mention the vast number of intermediaries who are not subject to centralized, hierarchical control and are often unaware of each otherCachieve a level of coordination so that they successfully conduct their activities and at the same time evade enforcement action? Part of the answer lies in the very existence of the market: the decision making of a vast number of buyers and sellers is guided by information provided by prices. Admittedly, the functioning of the criminal market cannot in any way enable criminal entrepreneurs to make optimum decisions regarding the different possible uses of their resources. Nevertheless, controlled competition, inadequate information and fiercely guarded market access are characteristics which hamper the optimum allocation of resources by the criminal market. That does not necessarily mean that criminal activities do not generate profit. Indeed, despite the existence of these obstacles to optimum resource allocation in such a market, the anticipated gains constitute a powerful factor in encouraging the expansion of criminal activities.

However, because of its specific characteristics, the criminal market is diametrically opposed to the reassuring image of the traditional markets, where apparent disorder leads to a stable equilibrium. By contrast, the operating modalities of the criminal economy are constantly changing but do not reach a stable condition. The alternating movement and inertia of the criminal economy are the outcome of strategies which, although seen as rational by those who implement them, are still fraught with uncertainties due to unreliable information exchange and to sometimes irrational and often opportunistic behaviour. Despite those imperfections, the criminal market nevertheless performs its role somehow or other, which to guide and reconcile the decision-making of those operating within this black economy.

It has to be acknowledged that coordination among criminals essentially relies on the legitimate market (not organization), a fact which obliges us to resort to economic analysis in order to understand the functioning of the crime industry.¹² One then has to think of the characteristics of criminal markets as emerging from the strategic choices made by the actors themselves, account being taken of the constraints placed on them by the existing institutions (and notably the specific forms taken by public policy).

¹¹P. Tremblay; M. Cusson (1996), AMarchés criminels transnationaux et analyse stratégique@ in *La criminalité organisée*, M. Leclerc (ed.), La Documentation française; P. Kopp (1992), ALa structuration de l'offre de drogue en réseaux@, *Tiers-Monde*, No. 131, vol. XXXIII, July-September.

¹²While the functioning of a religious sect is better explained by the sociology of organizations than by economic analysis, that of the rituals of a criminal group owe more to ethnology.

The ambition of economists is to bring about informed public decision-making so that the most efficient action programmes are put in hand. A public action is *Aeffective@* when the cost of its implementation is less than the profit it generates for the public at large. Among all the solutions described as *Aeffective@*, the *Aefficient@* solution is that which makes it possible to move the public at large from one state to another state which can no longer be improved on. In the case of the struggle against organized crime, the profits one hopes to gain from the application of a particular measure lie in reducing the negative effects of criminal behaviour, or, in other words, the cost this behaviour inflicts on society. A given measure is therefore justified when the reduction of social cost that it brings about is greater than its own cost (cost-benefit criterion). In choosing between two measures, therefore, it will be wise to choose the one that yields the greatest reduction of social cost per unit of money spent (cost-efficiency criterion).

This approach, however, which involves monetarizing all the effects anticipated from a measure so as to be able to compare benefits and costs, is not without its difficulties. Evaluation by means of a single standard or criterion (in our case, the monetary standard) of consequences of crime as various as the death of victims, losses of productivity, the effects on prices of closing certain markets to competition, etc., often leaves those who are not economists sceptical. Here we defend the point of view that it is not so much the actual figure that emerges from this sort of calculation which is of interest as the methodology employed. By enabling us to compare the scope of the different effects anticipated, it provides a remarkable foundation course enabling us to discuss matters of public policy in a way which is not ideologically coloured.

However, the approach taken in economic analysis of policies for combating crime raises problems. If we want to discuss the effectiveness, economic or otherwise, of a policy we must assume at the very least that such a policy exists. Yet in present circumstances we may legitimately wonder whether a true policy for combating organized crime does exist. In most countries there is no agency that effectively coordinates public action in this sphere. In actual fact, the fight against organized crime is, more often than not, the outcome of a multitude of uncoordinated actions, the general sense of which is neither sufficiently clear nor sufficiently well digested by those who are conducting the policy to yield even the bare bones of some kind of strategy.¹³

The irreversible nature of some of the factors involved is another reef on which economic analysis can founder. If we consider that the danger represented by organized crime is serious enough to threaten the very foundations of our societies, the principle of economic calculation *Cas in wartime* closes its validity. The problem is no longer to attain an objective by the most economic means but to preserve at all costs the very existence of the community.

¹³Italy is an exception here.

These two difficulties should not, however, prompt us to abandon economic analysis of organized crime altogether. Obviously, we cannot get around the two problems mentioned above except by assuming that the fight against organized crime is, or should be, an objective of public action clearly identified as such. At the same time, one must accept that the economic calculation principle should guide our discussion of public policy choices, even while remaining aware of its limitations. These may seem to be bold assumptions. However we shall endeavour to show that subscribing to them is justified because of the fresh light which economic analysis can shed on our understanding of organized crime.

SECTION ONE

CRIMINAL ORGANIZATIONS: MYTH AND FACT

Criminal organizations should be one of the main targets of law enforcement policy. However, that policy can be effective only if the operations of the targeted criminal groups are correctly understood. Here, we must confess, there is still a vast amount of research to be done. In fact, the intrinsic difficulty of learning about secret organizations would appear to be the most obvious explanation for the situation that confronts us.

This explanation does not, however, go far enough. The subject of organized crime has actually been obscured by the law enforcement agencies and the media in order to mobilize opinion and obtain resources for the implementation of their policies. It has to be recognized that the law enforcement agencies presented in the media often tend to quote fantastic figures which are designed not so much to inform the public as to strike the public imagination. One must fear that this sort of practice will in the end have the perverse effect of making the whole theme of organized crime less credible and wearying public opinion.

We propose to show in this part of our paper that Aorganized crime@ constitutes only one part of the criminal economy, which itself is no more than one subsection of the illegal economy. After all, criminal organizations are not responsible for all criminal activities. It is therefore important to determine what fraction of the total proceeds of crime is accounted for by organized crime as such.

Despite the inaccuracies and the heterogeneity of the different studies consulted, it emerges that the aggregate sums of money accounted for by illegal activities do not exceed a few percentage points of GDP in the developed countries. In fact it would seem that one per cent of GDP is a reasonable order of magnitude, at least in the developed countries, to ascribe to the criminal portion of these illegal activities.¹⁴ Last but not least, the very few sources available to us suggest that the part of the one GDP percentage point for all criminal activities (in the case of Italy) attributable to organized crime is itself less than one per cent. In other words, a tiny fraction of that one percentage point.

One would therefore be tempted to think that Aorganized crime@ is not a real threat to society. This would be a profoundly erroneous conclusion. We will show that the overall weighting in GDP is not the most relevant indicator of the menace that organized crime represents but rather the mass of distortions which it introduces into the official economy. While this approach may not enable us to impress the reader with exorbitant figures, it does nevertheless have the merit of greater accuracy.

¹⁴Obviously, the result is bound to be very different in countries that produce natural drugs, particularly the three Andean countries Bolivia, Colombia and Peru, where the share of GDP attributable to drugs is, respectively: [no figures in original]

In order to show the impact of the criminal economy more precisely, we intend, in this part of our study, to look successively at the problems confronting us in our efforts to measure the size of the Ablack@ economy, that of the criminal economy as a whole and finally the fraction that can be attributed to criminal organizations in the strict sense of the term. After that we shall try to indicate the negative effects which these criminal organizations have on the proper functioning of the official economy.

1. WHY MEASURE ILLEGAL ACTIVITY?

The economic activities of Aorganized crime@, as we have seen, are only a fraction of those of the criminal economy as a whole, which itself is a subsector of the illegal (or Ablack@) economy. The last-mentioned category includes activities as various as stone-masonry or child-minding, when these go undeclared, and cigarette smuggling. We accordingly need to be specific about the importance of each of these categories.

By not taking into account expenditure on the acquisition of illegal goods, national accounts underestimate the total expenditure of consumers and overestimate their total savings. Also, by not considering income from illegal activities, they underestimate the disposable income of consumers. Thus, the failure to take account of illegal activities in the national accounts gives rise to distortions in international comparisons, and these distortions are all the larger when the comparisons involve countries having widespread illegal activities.

Another point is that the failure to take account of certain illegal activities in the national accounts leads political decision makers to take decisions on the basis of false information. Thus, the level of employment is often underestimated and macroeconomic policies, particularly at the regional level, may be misjudged.¹⁵ It has been realized for a long time that certain illegal (though not criminal) activities, such as moonlighting or Ahidden activity@, should be reflected in the national accounts. Hidden activity is defined as legal production that is deliberately concealed from the authorities. Illegal activities, on the other hand, relate to illegal productionCthat is, production subject to the appropriate penalties of the law. However, this distinction is not always clear. Many transactions become illegal simply because the requisite authorization, permit or licence has not been obtained, as in the case of construction without a building permit. Finally, certain transactions which are illegal but not hidden are in fact reflected in the accounts, for example the sale of alcohol to minors or of seats in the cinema for films which are prohibited to persons under 18 years of age.

¹⁵E. L. Fiege (1981), The UK=s Unobserved Economy: A Preliminary Assessment, *Economic Affairs*, 1, 4, pp. 205-212.

Furthermore, the legal status of a product is not immutable; it may alter with time, as was the case with alcohol in the United States during the prohibition era. As a consequence, if international comparisons and comparisons between one period and another regarding levels of economic activity are to have any meaning, the legal status of products cannot be used as an accounting criterion.

The United Nations System of National Accounts (SNA 1993) provides quite clearly, moreover, that the legality of a transaction is not a relevant criterion for defining the manner in which the transaction is to be reflected in the system of accounts. What matters is whether the transaction is voluntary or subject to constraint. Accordingly, all transactions based on mutual consent must be included in the accounts. Among other things, this means that drug deals, unlike theft, should be reflected in the accounts. The European System of Accounts (ESA 1995) adopts the SNA recommendations.

Unfortunately, these recommendations have not been effectively implemented so far and one has to refer to highly heterogeneous studies in order to discover the economic significance of illegal and, a fortiori, criminal activities.

2. THE SIGNIFICANCE OF ILLEGAL AND CRIMINAL ACTIVITIES

Criminal activities are a mere fraction of illegal activities.

Illegal activities. Illegal or black activities are the first group whose scope we must try to gauge. Many studies have been devoted to this question. It would seem,¹⁶ according to MaCaffee,¹⁷ that by comparing the expenditure of economic actors with declared income it should be possible to evaluate the scope of undeclared income. Dilnot and Morris (1984) are rather critical of MaCaffee's method and propose a calculation based on the *Family Expenditure Survey*. It emerges that the hidden economy represents about two to three per cent of the United States GDP, a figure which appears to attract a certain consensus.

We must now single out the share of illegal activities attributable to criminal activities.

Criminal activities. Knowing as we do that the illegal economy represents, beyond any doubt, a few percentage points of GDP, it will be instructive to look at the available studies on the

¹⁶See the following surveys: M. O'Higgins (1981), *Measuring the Hidden Economy*, Outer Circle Policy Unit, July, reprinted in the *British Tax Review* Nos. 5 and 6, pp. 286-302 and 367-378; A. Dilnot and C. N. Morris (1981), *What Do We Know About the Black Economy?*, *Fiscal Studies*, No. 2, 1, pp. 58-73; M. Carter (1984), *Issues in the Hidden Economy: A Survey*, *Economic Record*, No. 60, 170, pp. 209-221.

¹⁷K. MaCaffee (1980), *A Glimpse of the Hidden Economy in the National Accounts*, *Economic Trends*, No. 316, pp. 81-87.

portion of GDP due to the criminal economy and to see whether the figures are consistent with the above.

In order to do this, we shall distinguish four types of criminal activity:

- Activities which are unequivocally criminal in the light of their characteristics (theft, murder, extortion, blackmail etc.);
- Activities whose criminal character consists in circumventing a law which could in theory be abolished (VAT fraud, trafficking in cigarettes, smuggling, illegal betting, illegal loan-sharking, prostitution, drug, alcohol and arms trafficking);
- Activities whose criminal nature consists in the forced monopolization of a market (forced sales, as in the case of compulsory provision of drinks to bars and restaurants, Aclosed shops@ in the labour market, dividing up of public deals among Afriendly@ undertakings);
- Activities whose criminal nature consists in impeding application of the law (offers of protection through corruption of the police, judges, prison administrations and elected representatives).

Typology of criminal activities

The foregoing typology was designed essentially to distinguish illegal from criminal activities and to clarify the origins of the criminal character of an activity. Generally speaking, the following activities are regarded as criminal (this is not an exhaustive list):¹⁸

- Fraud
- Prostitution
- Clandestine gambling
- Sale of illegal copies of software, music, videos etc.
- Sale of stolen goods
- Sale of/trafficking in/production of drugs

¹⁸Let us recall that under the definition which appears in the United Nations System of National Accounts (1993) an activity such as racketeering should not appear in national accounts because there is no mutual consent involved in the transaction.

- Money-laundering
- Dealing in weapons
- Others.

For purposes of estimating the share which these criminal activities have in the economy of a country,¹⁹ the few studies available to us²⁰ propose treating criminal property as legal property. For these purposes the various authors single out six main variables:

1. The value of imports, which affects the trade balance;
2. The value of exports, which has the same effect;
3. Domestic production;
4. Intermediate consumption;
5. Gross profit margin;
6. The value of final consumption by residents.

Variables 3, 4 and 5 enable us to calculate value added (VA), which reflects approximately the wealth created in the national economy by the activities considered (VA = domestic production minus intermediate consumption plus gross profit margin). Variable 6 (final consumption) makes it possible to calculate the gross profit margin and to estimate the distribution of income between consumption and savings. Finally, variables 1 and 2 complete our macroeconomic table.

However, to estimate these variables we need to know certain data such as the amounts consumed from each of the various goods and services, the selling price, quantities imported and exported, import and export prices and so on. Even so, accounting problems can arise, particularly in connection with intermediate consumption. In fact, intermediate consumption can already be

¹⁹For the studies referred to below, estimating the error margin is facilitated by the fact that they show quite clearly the considerations on which the results are based. The same cannot be said, unfortunately, for the majority of studies concerning the volumes of money laundered each year.

²⁰Our information is taken from the following sources: G. Rey (1997), *Economic Analysis and Empirical Evidence of Illegal Activity in Italy*, translated and reprinted from *Analisi economica e evidenza empirica dell'attività illegale in Italia*, *Quaderni di Ricerca*, ISTAT, 1992; R. Van de Werf, P. Van de Ven (1996), *The Illegal Economy in the Netherlands*, International Association for Research in Income and Wealth, Twenty-fourth General Conference; T. Davies and C. Groom (1998), *Developing a Methodology for Measuring Illegal Activity for the UK National Accounts*, *Economic Trends*, No. 536.

entered in the accounts as final consumption. For example, the leasing of an apartment for professional use in prostitution would certainly be entered in connection with final consumption of households. On the other hand, illegal activities can sometimes be declared as legal activities (for example prostitution can be declared as massage) and thus included in the national accounts. As a result, in interpreting the figures obtained we must allow for a fairly large margin of error.

The table below presents estimates from the above-mentioned studies relating to four types of criminal activity (drugs, prostitution, sales of stolen property and clandestine gambling) for three countries of the European Union: Italy, the Netherlands and the United Kingdom. It should be stressed that these studies use different methods and confront rather different problems. The figures below are therefore merely indicative, but we give them because they are for the moment the only available estimates. The studies agree on one thing, however: criminal activities represent between one half and one whole percentage point of GDP in the countries considered.

EXAMPLE OF ESTIMATES OF CERTAIN CRIMINAL ACTIVITIES

(in millions of ECU*)

	Italy	Netherlands	United Kingdom
Drugs			
Turnover	7 577.80	600.05	7 301.40
Exports	na	1 430.88	0.00
Imports	na	969.31	849.00
Domestic production	na	1 061.62	339.60
Intermediate consumption	3 890.69	46.16	169.80
Value added	3 633.95	1 015.46	6 622.20
VA as % of GDP	0.39	0.33	0.53
Prostitution			
Turnover	na	461.57	2 037.60
Exports	na	0.00	na
Imports	na	0.00	na
Domestic production	na	461.57	na
Intermediate consumption	na	0.00	na
Value added	na	461.57	2 037.60
VA as % of GDP	na	0.15	0.16
Sale of stolen goods			
Turnover	1 237.03	na	1 188.60
Exports	na	na	na
Imports	na	na	na

	Italy	Netherlands	United Kingdom
Domestic production	na	na	na
Intermediate consumption	na	na	na
Value added	1 237.03	na	1 188.60
VA as % of GDP	0.13	na	0.09
Clandestine gambling			
Turnover	1 296.68	276.94	1 358.40
Exports	na	0.00	na
Imports	na	0.00	na
Domestic production	na	276.94	na
Intermediate consumption	na	0.00	na
Value added	778.01	276.94	1 358.40
VA as % of GDP	0.08	0.09	0.11
Total Acriminal activities@			
Turnover	10 111.51	1 338.56	11 886.00
Exports	na	1 430.88	0.00
Imports	na	969.31	849.00
Domestic production	na	1 800.14	339.60
Intermediate consumption	3 890.69	46.16	169.80
Value added	5 648.99	1 753.98	11 206.80
VA as % of GDP	0.61	0.57	0.89

- * Italy: GDP for 1991; rate of exchange in 1991, 1 ECU ' 1,542.4 lire
 UK: GDP for 1996; rate of exchange in 1996, 1 ECU ' 0.5889 , sterling
 Netherlands: GDP for 1996; rate of exchange in 1996, 1 ECU ' 2.1665 Guilder

Thus, if the GDP of the United Kingdom were calculated in such a way as to include the four criminal activities considered here, it would be 0.89 per cent higher than its present official level. Allowance for drugs alone would increase it by 0.53 per cent and prostitution by 0.16 per cent . For Italy, inclusion of just three of these criminal activities (an estimate of VA associated with prostitution is not available) increases the GDP by 0.61 per cent , most of which is due to drugs (0.39 per cent). The GDP of the Netherlands would be increased by 0.57 per cent if drugs, prostitution and clandestine gambling were included in the national accounts.

If we accept the idea that the illegal economy of a developed country probably represents a few per cent of GDP, it is reasonably logical to assume that the criminal fraction of this economy would not be more than 1 per cent.

The balance of trade is also affected by allowing for criminal activities, notably the drug trade. The effects of this in the Netherlands and in the United Kingdom go in opposite directions: there is a positive impact in the first instance (+461.57 million ECU) and a negative impact in the second case (-849 million ECU).

It will be useful to verify, using different sources, what we know about the share of criminal organizations in criminal economic activity, and also to verify whether the orders of magnitude are consistent with each other.

3. THE SIGNIFICANCE OF AORGANIZED CRIME@ IN THE CRIMINAL ECONOMY

The fact that the criminal economy represents between 0.5 and 1 per cent of GDP is bound to give us pause. If a criminal organization could, by itself, claim a turnover of this size, it would rank among the largest companies in the world.²¹ In fact, however, the criminal organizations share this turnover among themselves and also with the broad mass of petty criminals. Let us recall for example, just to get a graphic picture of the situation, that while Italian criminal organizations comprise 20,000 or so members, they represent only a very small fraction of the total number of criminals. We do not know what the situation is in other countries, but it would be very interesting to calculate, for each country, the share of the criminal economy belonging to Aorganized crime@. Unfortunately, as matters stand at present, such an evaluation is possible only for Italy.

The estimates below should be interpreted with the greatest caution because they come from very different sources²² which may in some cases not be altogether reliable. However, they show fairly clearly that, in contrast to what one might be tempted to think, the economic significance of Aorganized crime@, expressed as a percentage of GDP, is probably rather small.

²¹The turnover of the AGruppo Telecom Italia@, for example, amounts to 22.1 billion ECU.

²²See P. Bernasconi et al. (1998), AI soldi della mafiaCRapporto 98@ , Editori Laterza.

TURNOVER OF ITALIAN CRIMINAL ORGANIZATIONS

(in millions of ECU*)

	Criminal organizations				Total
	Camorra	>Ndranghe ta	Cosa Nostra	Nuova Sacra Corona Unita	
Drugs (approx. figures)	7.21	9.79	7.99	0.88	25.87
Enterprises	2.58	2.06	2.58		7.21
Prostitution	0.26	1.03	0.18	0.77	2.24
Extortion and usury	2.06	1.80	1.55	0.52	5.93
Weapons	0.36	1.03	0.35	0.35	2.09
Miscellaneous	6.18	1.55	3.61	1.03	12.37
Total	18.65	17.26	16.24	3.55	55.70
Total (%)	33.49	30.99	29.16	6.36	100
Number of members	7 400	6 000	5 500	1 700	20 600
Turnover/member (ECU)	2 520	2 876	2 953	2 085	2 703

* Rate of exchange in 1997.

We may note that the Italian criminal organizations do not have a very large number of members (about 5,000 per organization). Moreover, the turnover of each of the three large organizations (Camorra, >Ndrangheta, Cosa Nostra) is in the neighbourhood of 17.5 million ECU, which represents a rather low average per head of the order of 2,700 ECU. This is of course only an average figure and says nothing about the distribution of turnover among the members; it is

also a low estimate owing to the fact that certain members of the organization also have legal income.

It is instructive, however, if we stressCwith all the usual qualificationsCthat the Italian criminal organizations are probably not responsible for more than 0.55 per cent of the aggregate criminal economy of the country. This fraction seems relatively small in the light of estimates commonly circulated which attribute 50 per cent of the turnover of the whole criminal economy to organized crime,²³ but without any attempt to offer proof.

Nevertheless, we believe that the orders of magnitude indicated here are not particularly shocking. It is logical that the weight of organized crime in the criminal economy as a whole should be rather slight because it relates to turnover figures at the final stage of transactions, not at the wholesale stage. Let us take the example of drug trafficking. Most of the turnover is realized at the final sale stage, but the profit is dispersed among numerous sellers and resellers who have no links with organized crime. Turnover figures at the wholesale stage are more modest because the prices are much lower, but here the profit is concentrated in the hands of a few people, notably the criminal organizations. It is thus logical that the share of criminal organizations in total drug-related turnover should be relatively slight. Similarly, with regard to prostitution, while criminal organizations take a percentage from the brothels, they generally have nothing to do with street prostitution, and this explains their meagre participation in the turnover of this branch of activity.

²³According to T. Crétin (*Finances criminelles*, PUF, 1998), official American estimates for 1990 put the turnover of Italian crime at 21-24 billion ECU (i.e. double the figures accepted in this report) and attribute half of this to organized crime.

4. DAMAGE CAUSED TO THE LEGAL ECONOMY BY AORGANIZED CRIME@

How does the existence of criminal organizations disrupt the operation of the economy? Contrary to the traditional view shared by the majority of people who comment on this question,²⁴ the problems created by Aorganized crime@ for the conduct of ordinary economic activities are not associated with its significance in GDP@ which is generally slight in the developed countries@ but are rather related to its penetration of the legal economy and to the distortions it creates there.

4.1 Penetration of the legal economy by criminal organizations

It is a fact that criminal organizations are not content to thrive on criminal markets but also endeavour to penetrate the legal economy. We will find it useful, therefore, to gain a better understanding of the reasons why criminal organizations allocate their resources among different activities@ legal and illegal.

The few studies that have been done on this subject show that Aorganized crime@ takes an interest above all in branches of the legal economy having at least one of the following characteristics: obsolete technology, absence of any requirement to make large irrecoverable investments, a large fraction of demand emanating from the public sector, or location in regions where property rights are not well defined and established.

Conversely, criminal organizations cannot easily increase their share of legal markets where the competitive process aims at an accumulation of human capital and new technology, or where frequent variations of demand structure are to be observed. On the other hand, they have a real comparative advantage in branches of the economy characterized by low opportunity cost of invested capital where they can establish a monopolistic control over the requisite key inputs.

These characteristics of the legal activities in which criminal organizations engage have yet further specific implications if one takes into account the mobility of capital on financial markets. Companies controlled by organized crime can easily be resold without loss of capital@ owing to the virtual absence of irrecoverable capital@ so that measures taken in one

²⁴ Many writers have tried to show that organized crime has reached such proportions in certain countries that it virtually matches the legal economy. Some claim that organized crime is worth 1000 billion dollars, other say 750 billion (for the IMF the amount lies between 700 and 1000 billion). These figures are generally accompanied by a comment such as, Aa thousand billion dollars@ that= s more than three times the French national budget@ i.e. comments essentially designed to impress the public. For such estimates, see T. Cr tin, *Finances criminelles*, PUF, 1998.

particular country are very likely to bring about movements of capital towards new countries where law enforcement is weaker.

4.2 Distortion of legal economic activities by criminal organizations

According to economic theory, efficient allocation of resources is characterized by a situation in which market forces are free to play their role and in which risk-adjusted returns on investment are equalized at the margin for all forms of economic activity. We know that, in practice, such a situation is never actually achieved. External factors and market imperfections disrupt the allocation of resources and prevent the theoretical correspondence between private efficiency and social efficiency break down. The destructive effects of the criminal economy are added to the market imperfections and inflict further distortions on the legal economy.²⁵

A study of the impact of the distortions inflicted on the legal economy by criminal organizations gives far more useful information on their harmfulness than the inevitably questionable evaluations made of their weight in GDP.

§ Distortions of competition in production

Since organized crime is in a position to obtain sizeable profit margins in illegal activities, it drives prices downward in legal activities and induces competitors to make adjustments. Prices then become abnormally low by comparison with production costs and competing firms cannot long hold out against this unfair form of competitive pressure. Globally speaking, this technique amounts to a sort of dumping thanks to crossover subsidies moving from illegal activities towards legal activities. In the end, once the competition has been eliminated, Aorganized crime@ enjoys a monopoly position in the legal activity on which its sights have been set (for example, clothing manufacturing, catering and so on).

§ Distortions of competition in the execution of contracts

Companies are supposed to respect the law. The extent to which they can break the law is essentially the same for all, except for those that enjoy the support of criminal organizations. By resorting to illegally recruited and underpaid manpower (in the building sector for example), firms that operate in league with organized crime drive honest enterprises in the direction of bankruptcy. Similarly, the payment of a supplier's bills is one thing if he is honest and quite a different matter if he is connected with organized crime. More generally, the availability of recourse in the event of unsatisfactory execution of contracts can vary enormously depending on the legal constitution of the enterprise.

²⁵P. J. Quirk, (1996), *Macroeconomic Implications of Money Laundering@*, IMF, draft paper.

§ Distortions of competition in access to credit

By putting pressure on a credit institution or by controlling one or more of these, organized crime has at its disposal a preferential source of credit with which it can provide for several Afront@ companies that are fated to disappear or go into bankruptcy. In such cases the insurance companies or the general public have to stand in to settle unpaid bills or the banks renounce their claims.

§ Distortions of competition in access to profit opportunities

It is always possible for organized crime to get a corner on new opportunities for profit and either to exploit them directly or to resell access to them. For example, when a new commercial zone is being set up, the granting of leases may be a free and even-handed process or it may not be. Free movement of capital towards the most important sectors is thus blocked by organized crime.

§ Distortions of the rules of confidence

Organized crime concentrates its investments in certain sectors, notably real estate. It corrupts the systems controlling the allocation of loans and thus enables larger amounts of credit to be concentrated in one area than should be the case (for example in tourist properties). By introducing dishonest practices within legal companies, and by corrupting the accountants, organized crime favours the growth of speculative bubbles. It is difficult to determine exactly what share of responsibility organized crime bears in this area. Even so, it is certain that by falsifying the information available from accounting systems and the pricing system, it plays a significant role in the emergence of crises of confidence.

§ Distortions in the allocation of capital

Although we have no formal proof, there is a strong presumption that organized crime exerts a kind of blackmail in relation to exchange rates and the shares of joint stock companies. By bribing a politician with influence in the financial world, one can induce him to make a statement to the effect, for example, that the national currency is substantially overvalued, or to refer in public to the possibility of a forthcoming devaluation. The currency plummets and, before the markets succeed in correcting this information, the speculator can realize easy profits. The same is true of shares. The most flagrant cases of manipulation are those carried out by armed political organizations. By intensifying their actions in some particular economic sector (for example, pipelines in Colombia), such organizations can precipitate a sharp drop in the shares of the nationalized companies associated with this sector (engineering). Buying the shares, then, just before a (temporary) cessation of hostilities is announced is a most profitable operation if coupled with reselling them before launching the same kind of manoeuvre again. This sort of manipulation, sometimes linked with a straightforward racket involving the firms concerned, gives rise to irrational movements of capital in and towards the economy of a country.

\$ Distortions in the award of public subsidies

As soon as a criminal organization has a minimum number of legal intermediaries to rely on (firms, unions, corrupt elected officials and so on), it will try to lay its hands on public subsidies, in particular community subsidies in the case of the European Union countries. The further the sources of payment (and hence of expertise) are from the terrain of the criminal organization, the easier it will be to trick them. There have been numerous cases of agricultural subsidies being diverted for illicit purposes. To these we must add natural catastrophes, which constitute a real windfall for organized crime. When international assistance is to be sent to a particular country, the urgency of the situation often makes it impossible to carry out a careful and serious evaluation of the purposes to which the aid is put, and a sometimes very large part of the assistance is then diverted from its proper purposes.

The distortions introduced by organized crime are so various that it is extremely difficult to summarize their final effect on the economy of a country by means of any conventional accounting system.

On the one hand, the relative weight of the four principal segments of criminal activity (criminal activity as such, activities whose criminal nature consists in circumventing a law, activities involving forced monopolization of a market, and activities whose criminal nature consists in impeding application of the law) in the total turnover gives an indication of the core activity of the organization concerned. Once we know the principal activity of the criminal organization of interest, we can begin speculating about its effects on the legal economy. For example, an organization specializing in drugs affects the rest of the economy indirectly through its reinvestment strategy, whereas another organization specializing in extortion has a more direct effect.

By the same token, we should consider the possibility that the distortions introduced by criminal organizations may actually be *Apro-efficient@C* they may enhance efficiency. In the case of administrative corruption in a country where the government is particularly bureaucratic and inefficient, it could plausibly be concluded that corruption might actually reduce the costs of transactions and boost trade. Its consequences on the efficiency of markets would then be positive, or indeterminate if we offset this positive effect against the negative one that always results from infractions of the legal rules, even if they are inappropriate. The case of drug trafficking suggests that this line of reasoning might be justified. At the price of perverse effects which are often quite extreme, drug trafficking can sometimes act as a force for social modernization by sweeping clean the foundations of a society in which the market had been unable to exert its benefits.

Let us consider a second paradox. When an economy has been totally corrupted by criminal activities, it is no longer possible to speak of distortions. In fact, every economy experiences some kind of *Acriminal@* regulation which makes honest economic activity the exception and

crime the rule. In these paroxysmal situations, which generally do not last long, the very idea of a negative influence of criminal organizations on economic activity becomes meaningless.

From our study of these paradoxes, it will be seen that criminal activity always distorts the structure of legal activities, more often than not by working counter to the rules of the market place and exploiting opportunistic profits which it protects through violence and corruption. Sometimes these distortions accelerate the introduction of modern commercial rules, but always at the cost of perverse effects that cannot be overcome.

Moreover, the precise mode of operation, the internal functioning, of organized crime has an influence on the extent of the damage inflicted on the legal economy. We know that criminal organizations gather individuals together in a more or less loose structure. Thus, the more centralized the organization is, the larger will be the financial means that can be used to distort the normal structure of the economy to the profit of organized crime. Conversely, the less centralized the organization is, the less serious but at the same time the more numerous the attempts at distortion will be.

In addition, criminal organizations may resort more or less to violence in settling their conflicts. Violence gives rise to a kind of negative externality which affects first of all the lives of individuals (through insecurity), but also the proper functioning of the economy (paralysis of a transport system, endemic violence in one part of town or another and other such factors cause companies to leave the scene and in a sense reallocate the revenues of households between rural and urban neighbourhoods). At the same time, the more violent the criminal organizations are, the more inadequate will be the efforts of the community to provide security and the more palpably the presence of these organizations will be felt as a threat.

Finally, the size of the distortions produced by organized crime must be related to the degree of competition prevailing in the economy. Thus, the less transparent markets are, the more they will be monopolized; and the more weakly entrenched property rights are, the better the terrain is for organized crime.

Similarly, for a given scale of organized crime, an economy in which lack of competition is the rule rather than the exception will tend to weaken the real distorting effects of the criminal organization. Thus, paradoxically, the less competitive an economy is, the more easily it can adapt itself to organized crime.

From these few reflections it will be seen that the seriousness of the threat which organized crime represents for societies is not measured principally by the percentage of GDP attributable to the criminal world. In fact, the influence of organized crime is more subtle than that and brings its influence to bear through a series of distortions which have a negative effect on the allocation of resources.

CONCLUSION

This first section finishes with a conclusion that will recur throughout the report. The information available and conceptualization of the strategy of the fight against organized crime waver between figures which are striking but often erroneous and the production of accurate information which is, however, more complex and for some has a damping effect on public opinion.

Now that we have brought into perspective the relatively small amount of reliable quantitative information at our disposal concerning the weight of the criminal economy, we must consider in closer detail the conditions in which organized crime arises and try to gain a better understanding of its strategy.

SECTION TWO

STRATEGIES OF CRIMINAL ORGANIZATIONS

The view that criminal organizations²⁶ are fragile structures runs throughout our report. They have to meet sizeable transaction costs; these are the costs associated with carrying out commercial transactions or, in other words, all expenditure with the exception of production costs. Production costs reflect the amount spent on producing goods or services (e.g. purchasing merchandise, transportation and storage and so on), whereas transaction costs²⁷ encompass any expenditure required to keep the market active and operating smoothly.²⁸ In concrete terms, supply of and demand for a product are by no means a guarantee that the market will function properly. The existence of an appropriate institutional environment is also important in which trading partners are able to exchange contracts, enforce them and make a claim against the delinquent party in the event of non-performance. This environment is not cost-free; to a limited extent the burden is borne by the public purse through State expenditure, particularly in the case of the costs involved in running the judicial system.²⁹ The remainder, however, is covered directly by market participants.

To minimize the costs of conducting business in the market, crime syndicates constantly have to implement simplifying organizational measures, whose simplicity then becomes a handicap. They are forced to make constant trade-offs to prevent the lack of certainty and formal rules which are characteristic of the crime milieu from turning into a source of inefficiency. The

²⁶The definition of Organized crime adopted here is similar to that of P. Reuter (see the Introduction): Organized crime consists of organizations that have durability, hierarchy, and involvement in a multiplicity of criminal activities. Thus, a criminal organization can be any of the following: a group of criminals, whose apparent aim is having the capacity to undertake wider-scale operations than an isolated small-time criminal could attempt; or an agency providing fictitious protection against the very real threat that it is itself posing; or a producer of intermediate, criminal goods, such as an individual supplying low-level criminals, external to the organization, with the input required for their final, criminal output (such as supplying guns to bank robbers or cameras to paedophiles); or a food distribution company which supplies bars and restaurants at excessive prices; or a drug distribution cartel; a street gang and so on.

²⁷A Transaction cost denotes the integral costs of running the trading system and, more specifically, in the context of a market economy it means the cost of making use of the market to allocate resources and transfer property rights.

²⁸More often than not, production costs are actually disbursed, whereas transaction costs, which are incurred as a supplementary charge, are generally not disbursed. For example, the violence employed amongst drug dealers to ensure territorial control constitutes a market organization cost which is necessary to ensure market accessibility. This is not an absolute rule however, since the fees that traffickers pay to their lawyers, for example, fall into the transaction costs category and constitute a disbursement.

²⁹Most often at their own expense but sometimes on their own initiative, criminals have recourse to the judicial system which forms part of the institutional environment that coexists with criminal markets. The cost of this system is borne by the public purse; legal costs alone are met directly by the parties involved.

success of their strategy is by no means guaranteed. Moreover, if confronted with a well-targeted and even slightly aggressive law enforcement policy, criminal organizations have to expend boundless ingenuity to survive. In fact, technically they are far from being out of the reach of the law enforcement agencies. The real difficulty facing government policy today is that of adopting overall strategies that are adapted to the true nature of criminal organizations rather than their general image.

Extreme vigilance is required in the fight against crime in order to prevent crime syndicates taking root and to implement pre-emptive measures before they have reinforced their hold. We will therefore attach great importance to determining the types of configuration favourable to criminal organizations and describing in detail their preferred areas of activity. Our comments will be expanded upon with particular emphasis being accorded to criminal organizations' main strategies.

From an analytical standpoint, our analysis contains an element of originality. Indeed, it seems that attention has wrongly been concentrated on the macrosocial factors which further the development of crime syndicates. They certainly merit consideration and we shall be presenting our observations on the issue in due course. However, before examining these Afacilitating@ factors, which merely contribute to the process of independent criminals organizing themselves in groups, an understanding of what prompts individuals to group together in this way is required. This latter point is too often downplayed, hence the value of an economic perspective, which will automatically accord particular importance to people's individual behaviour and to the extent that existing institutional parameters incite them to act as they do.

1. RELATIONS BETWEEN CRIMINALS AND CRIME ORGANIZATIONS

It is crucial to be able to determine the conditions which are favourable to the emergence and strengthening of crime syndicates. Beyond what is, incidentally, an exciting tale of how criminal organizations originated in each country, we will endeavour to highlight general traits in their financial operation; on this basis a relatively general analytical matrix can be drawn up. Such an approach is highly reductionist since it glosses over historical specificities, yet it is also fairly original since it focuses on how the behaviour of criminals adapts to signals from the criminal market. Gaining a greater knowledge and understanding of the interaction between the functioning of the criminal market and the behaviour of participating organizations is shedding new light on law enforcement policy instruments, resulting in the formulation of a number of rather innovative recommendations.

1.1 The temptation of establishing a monopoly in the criminal world

Why is the criminal world not limited to the existence of independent criminals alone? The immediate temptation is to attribute the constitution of criminal enterprises, i.e. criminal organizations, to economies of scale. This is related to the issue of monopolies. It seems perfectly Anatural@ that an enterprise, irrespective of the market in which it operates, should

use all available opportunities to establish a monopoly over a sizeable market segment. What company would refuse such an opportunity? It may be the case, however, that for legal reasons such a position is simply unattainable or that it is too costly to achieve and/or to defend relative to its potential advantages. Violence is one instrument not employed by Alicit@ firms but available to criminal groups. We may ask ourselves, therefore, whether the use of violence can guarantee a lasting monopoly and whether it can result in stability (with the monopolizer successfully establishing himself in an unassailable position).

This issue has been examined by a number of economists, notably T. Schelling³⁰ and J. Buchanan.³¹ The main idea is that organized crime emerges in the lines of business that lend themselves to monopoly@ (T. Schelling), or in other words in certain areas where size is such a significant comparative advantage that the largest player is able to force the other competitors out of the market and prevent them from re-entering.

Clearly, a position of monopoly offers a number of advantages. A monopoly enables a criminal group to achieve a large size whilst benefiting from the ensuing economies of scale. Moreover, the criminal firm in a position of monopoly is able to fix a monopoly price yielding an additional profit. Falls in price can also be capitalised on to prevent potential competitors entering the market.

Criminals who have jointly established a monopoly increase their chances of influencing the rule-making process. A single organization, for example, is likely to be more successful than a group of individuals in bringing about favourable amendments to the law on the running of casinos. Criminals become rule makers when organizing themselves as a monopoly. They offer a certain Amode of governance@ to the criminal world.

Although the assertion that criminals seek the power associated with monopolies has been largely accepted, it remains a highly debatable point. Empirically, the number of cases in which a lasting monopoly has been established by a criminal organization is extremely rare, if indeed such

³⁰T. Schelling (1971), AWhat is the business of organized crime@, *Journal of Public Law*, No. 20, reprinted in T. Schelling (ed.) (1984); and T. Schelling (1976), AEconomics and the Criminal Enterprise@, *The Public Interest*, No. 7, pp. 61-78, reprinted in R. Andreano; J. Sigfried (eds.) (1980), AThe Economics of Crime@, Cambridge Schenkman M.A., and in T. Schelling (ed.) (1984).

³¹J. Buchanan (1973), AA Defense of Organized Crime@ in S. Rottemberg (ed.) AThe Economics of Crime and Punishment@, Washington, American Enterprise Institute for Public Policy Research, Cambridge Schenkman M.A.

cases exist at all. An oligopoly, it seems, is the most common form of market organization with several large-scale organizations dividing up the shifting market. Fighting amongst Chinese triads and also amongst New York mafia families is a clear illustration of this. Consequently, no crime syndicate is able to establish a lasting monopoly in any market segment, so the oligopolistic set-up seems to be the next best alternative to a monopoly.

This form of oligopoly, however, is not entirely pure. Many criminals, such as bank robbers, drug dealers, particular drug wholesalers and numerous arms traffickers, do not belong to any criminal organization. They may well maintain links with the criminal world: they obtain forged papers from experts and use the services of other receivers; occasionally they buy protection from criminal syndicates or Aborrow@ their smuggling networks. Yet they remain outside the organization. Even if they are in a position to join, it may prove more beneficial to continue paying for the crime syndicate's services than to become a member. From the organization's point of view, it may be more advantageous to limit numbers. Indeed, beyond a certain size it is likely that the admittance of new members will be counter-productive. The costs involved in running an organization, and particularly the risks of defection, infiltration and betrayal, increase with size. Thus, above a certain threshold the additional cost incurred by taking on a new member outweighs any potential gain. In other words, diseconomies of scale mean that large criminal organizations choose to offer their services to other criminals, without seeking to integrate them into the group. In this way, the expectations of both sides conspire to limit the expansion of crime syndicates.

Moreover, whilst it may seem that criminal organizations are not necessarily looking to swell their ranks by integrating Aoutsiders@ but are striving, rather, to eradicate other criminals in order to establish a monopoly and thus wipe out the competition, there will always be a certain number of potential entrants who successfully penetrate the criminal market. In this way, any real total monopolization of the market becomes impossible.

Thus, the reality of the criminal world does not tally with the model put forward in the original argument which applies economic analysis to the study of criminal organizations. This explains why the reasons prompting criminals sometimes to remain independent and sometimes to join an organization still need to be determined; we will undertake to provide an answer.

1.2 Becoming a member of a criminal organization: the exception, not the rule

Let us imagine an initial situation in which a large number of independent criminals are active in a particular sector of the economy and consider the reasons why they may be tempted to join a criminal organization.

What makes an individual decide to become a member of an organization rather than set up on his own (or vice versa)? On the whole, the traditional notion that individuals are often forced to join is wrong. As a matter of fact, this analysis mixes up the concepts of becoming a member and membership itself. In other words, a criminal, once integrated into an organization, probably

has little choice other than to remain. In the case of joining a syndicate, however, it is clear that few of those wishing to join will ever be fully accepted. Indeed, it would be completely understandable should a criminal wish to join an organization, provided that the ensuing benefits outweighed the downside. However, given the considerable costs involved in joining and leaving a syndicate, along with problems of gathering enough information to give an independent criminal a reasonable idea of what possible membership might mean in practice, the conditions in which a decision over membership is taken are far from ideal. Moreover, the organization itself is not necessarily eager to take on new members, knowing full well that its stability is being undermined through expansion. On their own account, on that of the criminal organization or again through a lack of good contacts, many criminals will continue to remain on the fringe of organized crime.

Therefore, oligopoly in the criminal world is *sui generis*, characterized by a fringe of independents and an absence of cartels. This arrangement reflects a situation in which, flanked by individual criminals, a number of crime syndicates coexist without finding any real areas of mutual consensus. The two worlds are far from hermetically sealed off from one another, however, with independent criminals sometimes becoming involved in organized crime or forming new organizations and some syndicate members regaining their independence.

Consequently, criminal organizations and individuals may be prompted to forge relations. Providing assistance, in return for payment, to help independent criminals successfully conduct their affairs will form an important part of the work of Aorganized crime@. Thus, in circumstances to be determined in due course the organizations will provide individuals with Acriminal production factors@ (and vice versa).

1.3 Relations between criminal organizations and independent criminals

Whilst many criminals remain independent, and will continue to do so, they nevertheless maintain close links with criminal organizations. By way of example, let us imagine a situation in which a number of criminals are working independently but in the same market. Let us consider the Aprotection@ market as an illustration of the circumstances in which they will ask a syndicate for help. Individual criminals want protection and to get this they hope to buy the required complicity of the police and judicial authorities. The following set of alternatives is open to them: either they try to procure the complicity they need themselves or they go to a criminal syndicate to obtain it. For such a criminal organization to exist it must be able to provide the protection sought by small-time criminals at a lower price than if they were to produce it themselves.³²

The comparative advantage of crime syndicates, over independent criminals, in providing the necessary production input is smaller when the input is Aspecific@.³³ It is therefore in criminal

³²The general character of this line of argument should not be forgotten. The same reasoning applies whether it is a matter of complicity or of smuggling rings.

³³An input is Aspecific@ when it can only be used by one firm. Thus, for example, moulding a car component is

lines of business that provide less specific inputs which are nevertheless vital to criminal activities that criminal organizations will emerge. If the input required by the independent criminal is very specific, i.e. only of use to the person wishing to obtain it, then the organization will not profit from any returns of scale by producing it.

For example, a crime syndicate may invest heavily in corrupting the police. The syndicate can then pass onto the individual the benefits that a corrupt police force can bring, but at a lower cost. Conversely, without the advantage of such economies of scale, the independent criminal lacks the resources to corrupt the police. He will, therefore, gain more from making use of the services offered by the large-scale organization than by producing his own Acorruption@ input.

Let us take another example: imagine that police units are no longer responsible for patrolling a large territory but each police officer is assigned a modestly sized zone instead. A criminal operating in such a zone has to attempt to corrupt the police officer on his beat. A large organization can be of no use whatsoever to the individual since the input he requires is so specific that the syndicate cannot produce it and simultaneously benefit from economies of scale. Consequently, there would be no economic logic behind the criminal organization's involvement since it can offer no advantage in terms of cost.

Such a strategy is effective as long as the corruption input remains relatively impersonal. If it becomes highly specific, however, recourse to a criminal organization ceases to be of value and self-production becomes the more profitable option.

In the case of a corruption attempt in the customs services, the more pronounced its hierarchical structure, which means a customs officer is unable to refer a matter to an independent authority or to the upper echelons without first passing through his immediate superior, the more likely it is that a criminal organization will try to corrupt those relatively high up in the hierarchy, banking on the fact that the honest elements will not be able to go straight to the top, bypassing those directly above them. An independent criminal is unable to make such an investment profitable and therefore this step is not an option. Consequently, he will want to corrupt the customs officer standing right in front of him and hardly requires the services of the criminal organization for that. If this proves impossible, however, the independent criminal will turn to the organization and benefit from its corruptive influence at a higher level.

Our analysis thus makes it possible to establish a rather general basic rule: criminals will be more willing to use the services provided by a criminal organization the less specific they are. Indeed, this is prerequisite for the organization to achieve economies of scale. In other words, the more general the criminal production factor requested by the independent criminal to assist

of value to the car manufacturer alone. Consequently, in contrast to computers, the assets are highly specific.

his work, such as drawing up forged papers, the more likely it is that he or she will turn to the criminal organization for help.

1.4 Loyalty or betrayal

When criminals who are looking for a fairly unspecific criminal production factor use the services of a criminal organization, the deal is often hindered by the incentive to betray one another. When an independent criminal pays a criminal organization protection money for his or her activities, the organization's opportunism may result in the provision of an inferior level of protection to that on which the two parties originally agreed, for example, or in demands for unforeseen additional payments.

Games theory can be used to demonstrate, on the basis of a simple example, the impact of opportunistic behaviour of criminals on the relations they maintain with large organizations.³⁴ The independent criminal and the crime syndicate can act in two different ways: loyally or opportunistically. An independent criminal registers a net gain of 5 when he or she pays a criminal organization protection money. The net gain derived by the organization is also 5. If one partner fails to honour the contract (i.e. the organization does not provide the guaranteed degree of protection or the individual underestimates his income so as to minimize his contribution to the syndicate), the cheat makes a net gain of 7 whilst his or her partner makes only 2. The net gain of each side, if they both behave opportunistically, is 4. Thus, the matrix of net gains is as follows:

		Criminal organization	
		Loyalty	Opportunism
Independent criminal	Loyalty	(5.5)	(2.7)
	Opportunism	(7.2)	(4.4)

³⁴The reference here is to the analysis proposed by A. Dick (1995), *When Does Organized Crime Pay? A Transaction Cost Analysis*, *International Review of Law and Economics*, No. 15.

The outcome of this Prisoner's dilemma³⁵ is well known: both the individual and the organization will choose to violate their commitments as long as neither side has the resources to guarantee that there is mutual fulfilment.³⁵ The independent criminal will cease to purchase the protection he needs and attempt to produce it himself. In this way the criminal organization loses its *raison d'être*.

However, two factors undermine this conclusion. The strategic choice that an agent makes is partly influenced by the potential reprisals that his actions could expose him to. Clearly, the two parties in question are not in an equal position to take reprisals and the independent criminal will undoubtedly think twice before double-crossing an organization whose reputation is based on the notion that no traitor should be given a second chance. Moreover, the incentives to betray are considerably reduced when there is a chance of further deals between the two parties.³⁶ As far as the individual criminal is concerned at least, where there is likely to be further business, the less specific the input, the less the chance of betrayal, since the cost savings to be made by using the organization will be all the greater.

1.5 The importance of reputation

The fact that neither partner can observe the behaviour of the other must be taken into account when considering the relations between independent criminals and organizations. How can the criminal possibly know whether he evaded the police because of the protection provided by the crime syndicate or out of pure luck? And how can the organization know exactly how much income the independent criminal makes? The lack of certainty over the exact sums of money involved and the outcome of both sides' actions considerably undermine the mutual trust required if the contracts are to be successfully executed.

In a bid to alleviate this problem the criminal organization will be tempted to invest in its reputation by, for instance, giving regular reminders of its power through well-publicized executions.

³⁵To use the terminology of games theory, opportunism is the dominant strategy. Let us take the case of an independent criminal. If the organization behaves in a loyal way, the independent criminal makes a gain of 5 if he himself is loyal and a gain of 7 if he is not. Consequently, it is in his interests to act opportunistically. Should the organization decide to behave in an opportunistic way, the independent criminal will make a gain of 2 if he remains loyal and 4 if he does not. In this case too, therefore, it is in his interests to behave opportunistically. If the matrix of gains is symmetrical, the same reasoning applies as far as the organization is concerned. Thus, irrespective of the other's behaviour, both sides have an incentive to opt for opportunism above loyalty; the strategy of opportunism prevails over that of loyalty.

³⁶Here, again, we have a classic outcome of games theory. When the Prisoner's dilemma game is repeated indefinitely, mutual opportunism is no longer the only way of maintaining a balance. Both sides may rationally choose the loyalty option.

The risk of betrayal is particularly high for Aone shot@ deals. Thus, it is particularly tempting for the independent criminal to disappear with his entire haul. Consequently, the criminal organization must invest in its reputation so as to reduce this temptation amongst its occasional customers. Syndicates prefer, therefore, to maintain relations with individuals whose continuing presence on the spot is ensured by the nature of their criminal pursuits (drug dealing, pornography, prostitution, betting and so on) than with amateurs intent on the Ahold-up of the century@.

To reduce the risk of betrayal, robbery or clients disappearing off the scene without paying for services rendered, crime syndicates are now establishing companies which enable them to monitor exactly how much business their partners are transacting, whilst collecting a percentage of the turnover. Thus, it is more practical for a criminal organization to force a bar or a restaurant to stock up with more expensive alcoholic beverages and foodstuffs than to demand a proportional cut of total income. One of the advantages of this method is that it diminishes the risk of turnover being understated. Similarly, distributors of pornographic videos will purchase cassettes from the criminal organization, the producers will hire filming equipment from registered dealers and so on. The criminal finds it preferable to pay the organization for a service which has a measurable effect, such as arms sales for example, than for a service such as protection which is more like a tax that brings no obvious benefits to his or her criminal activities. By developing laundry businesses (there is a direct correlation between the number of meals served and the number of serviettes to be washed) and food and alcohol distribution firms, criminal organizations can keep track of actual sales levels and they overcharge for their services in order to receive their percentage cut. In this way they not only benefit from an effective monitoring system but they can also launder the proceeds from their racket.

2. RELATIONS BETWEEN CRIMINAL ORGANIZATIONS AND THEIR ENVIRONMENT

Thus, the criminal world tends to be structured in the form of an oligopoly with a fringe where, on the one hand, the crime syndicates attempt to stabilize their position of dominance while, on the other, individual criminals pursue their activities, frequently in cahoots with Aorganized crime@.

Once there is a clear explanation of the reasons why individuals join or, conversely, keep out of the criminal organizations, the question still remains as to the ways in which the institutional environment facilitates or inhibits the development of crime syndicates. The organized side of crime will develop all the more effectively if helped by a number of factors characteristic of the institutional environment.

2.1 Institutional factors which foster the development of criminal organizations

The existence of restrictive laws prohibiting the consumption of certain products (e.g. drugs) or certain practices (e.g. gambling) is just one factor that fosters revenue-creating niches

for criminals likely to further the development of criminal organizations. This line of argument is admittedly something of a truism insofar as, without laws, crimes and hence criminal organizations would simply not exist!

On closer analysis, the scope of the issue is shown to be broader. Let us look at the stock market, for example. Despite being, in a sense, the biggest Agambling@ industry that exists in a country, the stock market has never been greatly affected by Aorganized crime@. This is because it functions too successfully to be taken over by organized crime. AOrganized crime@ has, however, been able to penetrate the world of casino gambling because there are restrictive laws against this type of activity. If these laws did not exist, anybody would be able to open a gaming room. All you would need would be some gamblers and some chips.³⁷ Clearly, the full legalization of gambling is one factor that would enable this activity to be taken out of the hands of Aorganized crime@. In actual fact, restrictive laws provide criminals with a protection similar to that of a tariff or trade barrier. They reduce the level of competition by separating off those individuals who are incapable of violating the law and provide a sphere of activity for those who have a particular talent for sidestepping it. Such laws increase the incentive to corrupt the police. They place in a position of illegality law-abiding citizens who succumb to buying illicit goods. When the price of the goods goes up, the market forces dependent consumers to turn to crime. The existence of sizeable black markets facilitates the creation of large criminal organizations whose competitive advantage stems from their very size.³⁸

³⁷This comment does not prejudge perverse effects from an increase in gambling supply.

³⁸These restrictive laws are not hard and fast. Products such as tobacco and firearms which are authorized in today=s society may be prohibited tomorrow or might have previously been illegal (contraception and abortion, for example); activities that are currently illicit, such as prostitution and drugs, may be legalized tomorrow. It is the combined effect of the moral standards of the policy makers, the need for consumer protection and the evaluation made of the scope of the notion of individual freedom that is pushing different commodities onto the black market or, conversely, forcing their withdrawal. These preferences are subject to change. There is, therefore, a certain trade-off between an activity=s intrinsic disadvantages (drugs or gambling) and the repercussions that one accepts by making them illegal. The question is whether the desire to reduce consumption of a substance or pursuit of an activity

should remain inelastic in relation to the cost imposed on society by the application of laws that generate criminal markets. Unfortunately, such comments have limited operational scope. It is especially difficult to judge in economic terms (cost-benefit analysis) the comparative advantages of two diametrically opposite situations (presence or absence of prohibition). Consequently, the economic analysis prefers to renounce some of its normative objectives and to take a more modest, Asecond best[©] approach. Lacking the authority to deem laws to be just or unjust, the economic analysis merely considers the cheapest ways in which policy objectives can be reached.

Organized crime is now particularly geared to providing certain goods and services sought after by individuals. In contrast to independent criminals, who are experts in acquisitive crime such as theft, organized crime is especially adept at catering to markets through which there is a need expressed, such as the drugs, prostitution and protection markets.³⁹

As a matter of priority, criminal organizations are committed to building up their lines of business around Avictimless@ activities, such as clandestine moneylending, bookmaking and prostitution, or wholesale drug distribution networks. Their aim is to avoid being targeted by increased law enforcement stringency, triggered by public exasperation at the successful intrigues of burglars, and gangs responsible for hold-ups in shops, depots and banks. Therefore, criminal organizations avoid, insofar as possible, investing in lines of business where the risk of public opinion campaigns being launched against a criminal activity is considerable. Clearly, with the intense competition that exists between criminal organizations, should one of them brave the risk of diversifying into a new market sector, such as street drug distribution for example, the others will be highly tempted to follow suit so as not to fall behind.

A crime syndicate will resort to violence to ensure that binding commitments are respected. If an independent criminal is involved in an activity for which enforcement is weak, he or she can always turn to the police for protection from the criminal organization. That explains why the organization would rather issue false identity papers to hardened criminals than to illegal immigrants. If illegal immigrants are deemed to constitute a market, the syndicate will only deal with an intermediary whose own criminal involvement is sufficiently clear to ensure that he or she will not seek the protection of the law in the event of a dispute with the criminal organization.

Organized crime attempts to penetrate the legal economy for a number of reasons: to gain respectability, to form a consensus of opinion binding its members, to establish control over the territory in which it operates and to reduce the risk of arrest. Consequently, it is helped if the markets are not altogether transparent. In this sense, regulations designed to increase the transparency of transactions are a good thing. Regulations restricting entry to the banking profession are worthwhile, for example, and should be extended to other professions. At the same time, however, such laws can depress competition and breed inefficiency, thus assisting criminal penetration. In the fight against crime, efficiency requires us to strike a balance between regulation and deregulation. Regulation is essential when transparency is vital for identifying the persons operating in the market, but deregulation is called for when we need to reduce criminals' opportunities to benefit from monopolistic practices. Such policies are useful and Acost-effective@. They serve, accordingly, as a natural complement to traditional crime control policies.

³⁹A shopkeeper who pays protection money to the very person threatening him is still an Aend user@ of the service in the same way as a client who pays for the services of a prostitute or a person buying drugs.

Let us now consider the current situation in a number of former socialist countries. During the transition from socialism to capitalism there was a growth of protection racketeering, of criminal organizations which offer private protection services against threats which they themselves have formulated. While this is indisputably extortion, it takes the form of a voluntary contribution to the criminal organization. Several general lessons can be learned from such a situation (D. Gambetta, 1991, and F. Varese, 1994).⁴⁰ The socialist countries were characterized in particular by a sort of State monopoly in property. There was little if any private demand for protection, except where real estate, personal estate and personal security were involved. The change in regime and the end of the State monopoly in property have resulted in an increase in the number of property-owners. Consequently, the level of social demand directed towards the institution responsible for ensuring respect for property rights⁴¹ has grown. By failing to satisfy this demand in full the State has left considerable room for the development of private-sector protection, which in effect replaces the trust placed in the State, the institution that acts officially as guarantor of property rights. The emergence of crime syndicates, in Russia for example, would thus reflect a rational demand for private protection,⁴² in spite of the number of collective negative external factors that this entails. The lesson to be learned is that the transition to a market economy, if not accompanied by clearly specified property rights, can result in an alarming criminalization of the economy.

3. FACTORS UNDERMINING THE FUNCTIONING OF A CRIMINAL ORGANIZATION

Once the factors which foster the emergence of crime syndicates have been determined, it remains for us to determine what can inhibit their development. In this respect, however, some caution should be exercised. The ways in which criminal groups are organized depend to a great extent on the history of the country in which they arise.

The economic analysis to which our study is intentionally confined is an attempt to identify certain general evolutionary tendencies in the criminal world. It should be borne in mind, however, that the forecasting capacities of such an analysis are slight because it cannot predict the momentum of change, but it is helpful in that it provides a retrospective explanation of

⁴⁰F. Varese (1994), *Is Sicily the Future of Russia? Private Protection and the Rise of the Russian Mafia*, European Sociological Archives XXXV; D. Gambetta (1991), *The Origins of the Mafias*, Cambridge, mimeo.

⁴¹Y. Barzel (1989), *An Economic Analysis of Property Rights*, Cambridge University Press, Cambridge.

⁴²Such an analysis, in particular that by F. Varese, fails to explain why it should be criminal organizations that fill the niche created by the need for security that the State is unable to satisfy. Trustworthy private security agencies could handle security just as successfully. Explanations in terms of the special compatibility that exists between the tradition of violence amongst criminals and the qualities that are required for this type of work are not totally satisfactory. Stimulation of the demand for security through the threat of extortion would seem to be an essential additional explanation.

observed trends in the criminal world. It should also be noted that in considering the conditions in which crime syndicates emerge and develop we have been able to formulate an implicit hypothesis: that organizations are subject to a medium-term selection process which only the most efficiently operating syndicates survive. Hypothesizing in this way, however, means that the obstacles in such a selection process are too easily overlooked.

Criminal organizations are too often regarded as just versatile and efficient bodies that do not hesitate to use force against the outside world and to resolve their internal differences in summary fashion. Functioning in this way is seen as putting them out of the reach of law enforcement action. As stated at the beginning of this section, we hold a very different view. In opposing these generally accepted ideas, we will demonstrate the considerable difficulties which criminal organizations face.

Indeed, crime syndicates are not free from the general rules applicable to human organizations. Their dealings entail transaction costs which, as we have seen, correspond to the costs involved in organizing business and the market. Thus, the rules which organizations in the criminal world set themselves are designed to minimize transaction costs and make the deal more profitable. We will see how the constraints that arise from this significantly affect their chances of coming out as winners in a selection process which sets them against the law enforcement agencies.

The clandestine and underground nature of the activities of all the members of the production line makes it difficult to assess the contribution made by each to the final product. Consequently, determining the property rights of the different operators is no easy task and enforcing those rights is also difficult since there can be no recourse to the legal authorities. Thus, the costs of criminal transactions are inevitably high owing to the number of disputes over distribution of the proceeds of crime. Quarrels, conflicts and blood-lettings are a considerable source of expense to criminal organizations and impede the successful functioning of the market.

In an attempt to reduce expenditures, crime syndicates may be tempted to introduce vertical integration. In other words, conflicts can be limited if as many stages of the criminal network as possible are brought together within the organization. A tightly integrated vertical structure is only efficient while the head of the organization has the power to set the rules for individual retribution. Should the head of the organization lose that authority, notably because enforcement action is disrupting the syndicate's communication channels, this type of organizational structure is no longer appropriate. The organization will implode if the evaluation system for goods and services and the contribution of each member cannot be administered hierarchically. Vertical integration ceases to be efficient and the organization breaks up into a large number of autonomous cells, such as the cocaine cartels. There is a real trade-off between vertical integration as a means of reducing transaction costs and an increase in those very costs due to a longer line of command.

More generally, criminal organizations often feel that limiting their recruitment to a small group of people from the same family or village is a wise move. Whilst this allows them to reduce

the risk of betrayal, it simultaneously limits their chances of market expansion. When crime syndicates are seeking to increase their zone of influence they have no choice but to expand the network of people with whom they work. This means that they have to conclude sophisticated contracts with several partners, contracts which are all the more difficult to enforce since the State cannot intervene. Criminal organizations can adopt different strategies in order to counter this problem. They must regulate the degree of violence generated within the organization, according to the situation and above all the type of law enforcement policy confronting them. In cases when the public authorities remain relatively indifferent to murders within the criminal world, organizations will employ greater violence in their ranks as a means of ensuring that commitments are honoured. If this strategy provokes considerable police action, internal violence, or at least the extent to which blood-lettings are visible in the public eye, will be reduced.

The fact that the State can in no circumstances be used to arbitrate disputes between criminals increases the costs of criminal transactions. This explains why crime syndicates may be tempted to establish alternative systems such as the *Acouncil of elders*. More often than not these systems rapidly fall apart. Thus, the organizations are forced either to revert to violence as a means of regulating disagreements or to take steps to simplify the contracts concluded amongst themselves or with independent criminals. Indeed, the simpler the contract, the easier it is to monitor whether it is being honoured.

The common expression *Adivision of territory* is a good illustration of this situation. Division of territory is a particularly primitive type of contract that exists between two organizations. Its effectiveness stems from the sole fact that any more complex form of cooperation, where several participating groups are paid on a pro rata basis, will be a source of conflict which, without an impartial arbitrator, will inevitably result in the use of violence. Here, again, we have a trade-off between the goal of reducing transaction costs, through the establishment of sophisticated forms of cooperation between criminal groups, and the risk of obtaining the opposite effect by thus provoking disagreements.

Fortunately, the idea that one has to respect the rules is a feeling shared by the broad mass of society, which thus censures any potential propensity to behave as free-riders. Criminals, on the other hand, have chosen to live outside the law. There is no reason, a priori, to think that they are any more likely to respect the rules of an organization than they are society's rules. Lacking the strong cement that binds society as a whole together, criminal organizations are left particularly vulnerable to the opportunism of their members. To protect themselves they can reinforce membership rites. In spite of their occasionally spectacular character, as in the case of the Sicilian mafia, these rites constitute a somewhat fragile masquerade, as shown by the confessions of members who have gone straight. The threat of violent sanctions against traitors may well act as a deterrent to those contemplating betrayal; yet at the same time the use of terror to pressurize members in the organization can lead to some individuals' seeing no way out but to seek police protection. Thus, on the one hand criminal organizations want to make their work more effective by implementing a system of joint values which keeps the market

functioning smoothly, yet, on the other, the brutality of this system of values incites defection and has the opposite effect to the one intended. Once again, the organization needs to be able to find a compromise between the advantages of instituting a criminal ritual, which places a real cost on defection, and the risk of an increased number of defections due to the very existence of this bloody ritual.

These comments are by no means exhaustive but represent an attempt to systematize available information on the factors that facilitate or inhibit the development of criminal organizations. The following table summarizes these points but is not intended to prompt over-hasty recommendations regarding public policy. It is not because tough enforcement with regard to independent criminals incites them to seek the protection of criminal organizations and thus stimulates the latter's activities that it needs to be toned down. We shall see later on that an effective system for combating organized crime requires all measures to be coordinated; otherwise, even the best initiatives may prove to be ineffective or even counter-productive.

Factors which facilitate and inhibit the development of criminal organizations

	Inhibitors	Facilitators
Institutional factors	Limiting insofar as possible cases in which the principle of consumer sovereignty is violated	Existence of restrictive laws
	Stigmatization of crime	The seemingly Avictimless@ nature of some criminal acts
	Rigorous law enforcement in relation to organized crime	Tough enforcement measures in respect of individual criminals
	Law on transparency of conditions of market entry, setting out the legal framework for trade	Lack of transparency in economic affairs
	Enforcement of property rights	Insufficient property rights
Internal factors within the criminal world	Problems of evaluating how much criminal goods and services are worth	Unspecific nature of the input supplied by organizations to individual criminals

The large size of the market	The organization is able to determine precisely how much business has been done by the criminals under its protection
Low level of voluntary membership of a system of common values	Belonging to a firmly structured family, religious or ethnic group
Lack of an impartial authority to settle disputes	Criminal activity requires frequent contact between the criminals and the organization

CONCLUSION

These few comments on the way criminal organizations function highlight the difficulties facing them today. Crime syndicates, with all of their shortcomings, are far removed from the myth of an efficient organization free from the constraints of labour law and respect for individual rights. Powerless to assess the efforts and income of its members, composed of individuals who are loosely joined together around a set of common values, deprived of an arbitrator to settle disputes and limited to tight markets, the majority of criminal organizations, with the exception of a few large and particularly resistant mafia families, are fragile structures, shaken by internal problems and highly vulnerable to enforcement actions.

These factors become meaningful when juxtaposed with the previous section's conclusions. Not only, as has been demonstrated, do criminal organizations lack the size and economic significance with which they are credited by some, but their operating principles are also something of a handicap. Once again, far be it from us to minimize the threat to society posed by organized crime. On the contrary, by highlighting the precise ways in which this threat manifests itself, we are hoping to engage in an initiative whose avowed aim is to improve public policy in the area of combating organized crime. Thus, the following section of this report will restate these same points whilst focusing on one aspect of criminal organizations' activity: money-laundering. We shall once again diagnose the same problems, namely overestimates, inaccuracies and poor knowledge of how criminal organizations really function, which cause the public authorities to implement inappropriate law enforcement measures.

SECTION THREE

MONEY-LAUNDERING STRATEGIES

After attempting to define the conditions in which criminal organizations appear and develop and identifying the factors which contribute to their strength or, conversely, to their fragility, it is time now to take a closer look at this special activity known as money-laundering.

Before going any further, one ambiguity needs to be cleared up. The bulk of the literature on the subject is devoted to the more complex laundering techniques, namely those making use of the most sophisticated tools offered by the international banking and financial system.

Little or no attention has been paid to the more rudimentary methods of laundering. The simple fact of using the proceeds from a criminal activity constitutes the most elementary and most common form of laundering. Likewise, a large proportion of criminal revenue is simply stashed away in safes, deposited in one or several accounts, or used for purchasing real estate.

Furthermore, many official reports have a rather laconic way of describing the situation. On the one hand, there is circulating among the various international agencies an extremely high figure for the volume of criminally derived drugs money available for laundering while, on the other hand, attention is focused on the most sophisticated means of laundering. The illusion is thus created that it is in fact this same sum that the international banking and financial system has assisted in laundering. Last but not least, a dramatic finishing touch has been added to the picture: organized crime is allegedly at work behind this vast sum of money.

Insidiously, there are figures that are thrown in as reasonable estimates of criminal activity. In particular, the idea is given that the international turnover of the drugs business is between 300 and 500 billion dollars and that a total of 85 billion dollars are channelled for laundering each year in Europe and the United States. This is just one small step from asserting that criminal organizations inject this amount annually into the legal economy.

While they are arguable, figures such as these have had the salutary effect of helping to raise awareness of the dangers posed by criminal organizations to society at large. However, there is a great risk of having these efforts ruined by the emphasis placed on unrealistic data which undermine the credibility of the policies they are intended to support.

Even more seriously, the biased information available to State policy makers causes them to adopt policies that are poorly gauged. Understanding and assessing the true extent of the problems posed by organized crime not only furthers the advance of knowledge but should involve a reappraisal and redeployment of law enforcement policies.

The purpose of our study is not to propose a new evaluation of the volume of money laundered but to identify the recurrent distortions in the calculation methods that repeatedly

lead to the same errors. It is not just a matter of calculation. If gross overestimates of laundering have been circulating for a long time without causing any particular surprise, this is because they tally with an approach to laundering issues that is now open to challenge.

The problems stem from the fact that the cost of laundering for criminals has been underestimated. This cost cannot be reduced to the cut taken by shady intermediaries generally working within the banking system. If one takes account of all the costs associated with laundering and, in particular, all the transaction costs (implementation of the strategy, risk, etc.), the reasons why criminals seldom employ the more sophisticated laundering techniques become more clear. Only criminal organizations of a certain size take advantage of the resources offered by the modern world of finance; others make do with spending their income or laundering it by simpler means.

The overestimation of volumes laundered by sophisticated means and the underestimation of the factors inhibiting the use of such techniques are closely linked. Our purpose is not in any way to downplay the problems of laundering but to classify them in various categories by attaching credible figures to each of them. Rethinking our qualitative and analytical ideas of laundering is a *sine qua non* condition for improving public policies.

This part of our study will therefore result in a rather original view of the parameters which determine criminal activity with respect to the laundering of their income. This re-examination of the problem will prepare the way for the next chapter, which will explore the solidity of the foundations supporting the general strategies for the suppression of laundering.

1. EXTENT OF LAUNDERING

The quantitative evaluation of laundering demand is based on an estimation of the proceeds from criminal activities, proceeds which are in turn evaluated on the basis of an estimation of the turnover of criminal ventures.

Mechanisms specially designed to counter laundering often rely on collaboration among banks and are detrimental to bank secrecy, and in such cases have been instituted in the first instance exclusively for the purpose of countering the laundering of drugs money. This framework may well have been gradually expanded, but the production of data still bears its trace. Essentially, the only type of criminal income taken into account in calculations of world levels of laundered assets is that linked to drugs.

This focus on drugs money is not without a certain justification, since drug trafficking continues to be the activity second to none that brings in vast earnings and requires international movements of funds. Because burglars, pimps and other small-time criminals use straightforward methods to launder their proceeds, the law enforcement machinery in place seemed to be sufficiently comprehensive in the past. It is the sudden appearance on the scene of drugs money that has pointed to a Agap@ into which criminal organizations have been diving headlong.

It is simply a matter of consistency therefore. Since we will be discussing the most sophisticated forms of laundering, those which use the most modern means available in the banking and financial system and which are the prerogative of major criminal organizations, care must be taken to produce figures that correspond to that situation and not to any other.

Traditional studies of the extent of laundering essentially adopt one of two different approaches. They estimate volumes laundered either on the basis of an evaluation of criminal proceeds or on the basis of the volume of cash transactions.

We propose to show the most common technical distortions that are present in these methods and lead to an overestimation of the volumes of money channelled into laundering operations. It is immediately clear, moreover, what are the possible sources of the distortions leading to such an overestimation: the overestimation of criminal proceeds in the first place and the exaggeration of the importance of cash transactions in the second.

1.1 Demand side studies: a systematic overestimation

There are two types of exaggeration that can result from this type of evaluation: exaggeration of the turnover of the criminal economy on the one hand, and exaggeration of criminal proceeds on the other.

The Financial Action Task Force on Money Laundering (FATF)⁴³ estimated in 1990 the turnover of retail sales of drugs during the 1980s at US\$ 108 billion in the United States and US\$ 16.3 billion in Europe, making a total of US\$ 124.3 billion.

FATF estimate of the drugs retail sales turnover (Europe and United States)

Drug	Turnover (billions of dollars)
Cannabis	74.7 (United States: 67.2) (Europe: 7.5)
Heroin	12

⁴³FATF Working Group on Statistical Methods, Narcotics Money Laundering Assessment of the Scale of the Problem, 1989, Financial Action Task Force on Money Laundering, report (7 February 1990).

Cocaine	28.8
Total	124.3 (United States: 106) (Europe: 16.3)

Source: FATF Working Group on Statistical Methods, Narcotics Money Laundering Assessment of the Scale of the problem, 1989, Financial Action Task Force on Money Laundering, report (7 February 1990)

This evaluation of annual drugs turnover is somewhat dubious and probably a little exaggerated for the 1980s. There are a number of uncertainties regarding details of the calculations.⁴⁴

The evaluation of the annual world drug trafficking turnover put forward by UNDCP⁴⁵ (1997 report) is even higher and fits into the pattern of the figures which are now widely circulated, i.e. between 300 and 500 billion dollars.

As far as Peter Reuter⁴⁶ is concerned, this estimate is at least double what would be a reasonable figure and is around twenty times the figure for the world international drug trade. Reuter believes this figure to be based on the estimate of total consumption from the point of view of quantities and on an approximate level of United States prices, which represents the main source of the error.

⁴⁴With regard to the calculations for heroin, P. Van Duyne has correctly stated that it is impossible to understand what figure has been used for the street sale price in order to arrive at the figure of 12 billion dollars. For cocaine, the result of \$28.8 billion has been reached by using the highest amounts in the range (price \$80-\$192, and quantity 100-150 tons); P. Van Duyne (1992), *Estimates in the Fog*, The Hague.

⁴⁵United Nations International Drug Control Programme, *World Drug Report*, Oxford University Press, 1997.

⁴⁶P. Reuter (1998), UNDCP World Drug Report Reviewed by Peter Reuter, *Policy Analysis and Management*, vol. 18, No. 4, pp. 730-733.

For example, in the United States the retail price of heroin, according to the report, is in the range of \$70-900, hence a turnover of \$50 billion to \$641 billion. The authors decided to take a result from the mid-point of the range, i.e. \$346 billion. The average price of a gram of heroin used in the calculations for Western Europe, Oceania and Australia is \$150, which gives a turnover of \$107 billion.

However, the report also contains data which conflict with these results. If we refer to the per capita costs of drug users, as surveyed by UNDCP, we note that the addicts who give rise to the bulk of the turnover consume approximately \$20,000 per year in drugs (principally heroin and cocaine). The total cost in the United States and Western Europe is therefore close to \$100 billion (equally distributed), which means that a further \$400 billion in drug costs have to be sought in countries such as Afghanistan, Burma, Thailand, India and so forth in order to arrive at the total figure, which represents, assuming that their annual drug expenditure is \$1,000, several hundreds millions of addicts! An expenditure of \$50 billion for the developing countries would seem to be a high estimate in itself. Reuter's conclusion is that the drugs turnover is closer to \$150 billion than \$500 billion.

Annual drugs expenditure

Country	Thousands of dependent users		Income per capita (1994)	Expenditure, in \$ billions, on drug purchases (in \$ per user)	
Italy	170-420	(515)	\$18 160	7-13	(33 898)
Sweden	17	(194)	\$17 900	0.4	(23 529)
United States	2 700	(1 037)	\$24 680	48.7	(18 037)
Australia	100-300	(1 121)	\$18 530	2.0-4.4	(16 000)
Thailand	1 300	(2 203)	\$6 350	1.1-1.9	(1 154)
Pakistan	3 000	(234)	\$2 160	1.5	(500)

The calculation error is even greater if one considers that the figure of \$400 billion is meant to correspond to international drug trade. However, even if the turnover was \$400 billion, international trade would not exceed \$60 billion. And if, as is more plausible, the turnover is close to \$150 billion, then international drug trade is no greater than \$20-25 billion.

From the drugs retail turnover, let us now go on to the share of the proceeds allocated for laundering. On the basis of an overestimated drugs turnover, FATF evaluates the amount of drug money potentially laundered each year at between 61 and 85 billion dollars. However, the calculation of volumes of assets for laundering on the basis of turnover is a method that is somewhat open to criticism.

For example, in the case of cocaine in the United States, we have seen that the retail turnover was estimated at \$28.8 billion. In order to calculate the profit from this amount, the costs of the purchases, i.e. \$5.1 billion, is subtracted, giving \$23.7 billion. The net profit made in retail sales is obtained by subtracting the famous 10 per cent that is supposed to correspond to seizures by customs. The result is then \$21.33 billion. The net wholesale profit is estimated at \$4.88 billion. The total net profit from cocaine trafficking (retail plus wholesale) is thus \$26.21 billion.

The report then casts some doubt on the meaning of this figure. A strong element of ambiguity is maintained, allowing this result to be interpreted as the amount of money derived from cocaine trafficking that is available for laundering. This interpretation is clearly incorrect since it amounts to asserting that small retailers and wholesalers launder all of their profits. FATF, for example considers that a proportion of 50 to 70 per cent of the turnover of drugs sales is available for laundering. With a turnover of around \$122 billion for the United States and Europe, the potential amount available for laundering would thus come to between 61 and 85 billion dollars.

It is illogical to treat the profits of small retailers and of wholesalers in the same way. By definition, all the profits are used and, hence laundered with varying degrees of efficiency if controls are applied. Thus, \$122 billion are Alaudered@ as long as the holders of these assets are not disturbed in the process. However, only a fraction of the profits of wholesalers, and of them alone, is subjected to fairly sophisticated banking or financial handling operations designed to seriously confuse the trails. In very approximate terms, a share of 20-25 billion dollars of the wholesale international traffic could be estimated as the share possibly laundered by sophisticated means. The volume of money constituting a more or less centralized resource which could potentially subvert the world economy is therefore no more than \$20 billion. But this figure should be properly understood. We are not suggesting that the amount of money available for laundering should be reassessed as \$20 billion, but that a distinction should be made between the amounts that may be in the hands of criminal organizations and the amounts that pass

between the hands of small retailers and become dispersed in the formal economy, in particular through bank deposits.

This notion of the dispersion of revenue can be expressed more specifically by means of a rule-of-thumb calculation. The five million American regular users of cocaine require approximately 500,000 dealers⁴⁷ (1 dealer per 10 users), implying a turnover of \$40,000 per retailer. After deducting the purchase cost, an approximate amount of \$20,000 is left. One only has to deduct from this the drug use itself and everyday drug consumption to realize that, at this stage of drug distribution, sophisticated laundering is simply not happening. It is all a matter of a few thousand cocaine wholesalers who, according to FATF, share a profit of \$5 billion, part of which they will launder by means of banking procedures of differing degrees of complexity.

It should be noted, however, that criminal use of the banking system is not confined to its use as a stage in a laundering process. Its intermediate role in criminal transactions should also be taken into account.

A criminal organization which is solidly anchored in the world of international organized crime will inevitably develop trade relations with its counterparts. Many analysts stress the contacts between the Sicilian and Colombian mafias. Russia appears to be a territory where useful relations are established between Afghan traffickers and the Yakusa. Commercial relations of this kind require substantial transfers of money, for which the international banking system is used. We would once again emphasize that the reason for such use is not so much to launder money but to conclude a commercial transaction.

To be sure, a criminal organization can be fairly marginal in the world of major organized crime and have only occasional relations with a large trafficking organization. For example, this might be true of a group of European criminals which has contact with a Colombian group that sells its drugs locally. It is the responsibility of a French group to transport the drugs to their final destination. This type of network generally involves units from different countries to take care of the different stages of the transport. If the network extends to the distribution site, it is obliged to use fairly sophisticated banking channels in order to allow part of the money to be paid to the Colombian party. After an initial exchange, the latter will frequently agree to deliver the goods on the basis of a part loan. It is then practical to be able to pay the latter from an offshore account.

It is therefore not so much the need to launder, i.e. to separate the criminal proceeds from their origin, that explains the recourse made to the mysteries of the banking system, but rather

⁴⁷P. Reuter and M. Kleiman (1986), *Risks and Prices: An Economic Analysis of Drug Enforcement*, Morris Norval and Michael Tonry (eds.), *Crime and Justice: A Review of Research*, vol. 7, University of Chicago Press.

the complexity of illicit international transactions. This point is very important as it explains why criminals often employ the Apayment method@ facility of the banking system rather than its Afunctional@ facility allowing them to use their own funds.

1.2 Cash flow studies: improbable results

Cash flow studies are based on the assumption that an abnormal volume of cash transactions is the trace left behind by the criminal economy. In order to lessen their chances of detection, criminals do indeed have every interest in conducting their transactions by using the most impersonal means of settlement possible, i.e. those that leave the least trace. On this premise, numerous studies have undertaken to assess the scope of the criminal economy by investigating the circulation of bank notes in the economy. According to a Netherlands study,⁴⁸ the criminal economy of the Netherlands, evaluated on this basis, accounted for between 6.3 and 17.5 per cent of the gross national product (GNP) during the period 1978-1980. This evaluation is surprising, to say the least, and calls for a closer look at the calculation on which it is based. There would appear to be good reason to scale down the extent of the cash needs of the criminal economy and to reevaluate the needs of the formal economy.

1.2.1 Cash needs of the criminal economy

The nature of the transaction made, whether cash or transfer, essentially depends on the type of offence or crime at its origin. In the case of organized fraud, for example, transactions always have to begin with conventional transfers in order not to arouse suspicion. Accounts which are used for this purpose are naturally very short-lived before the money is transferred to a more discreet account. In the same way, an investment fraud⁴⁹ cannot be set up without recourse to the sophisticated tools of the banking system. Finally, VAT and fuel tax scams often consist in buying by cheque and selling in cash, the cash then being transferred to a Swiss or Luxembourg account.

A large proportion of criminal income is therefore held not in cash but in bank accounts. The criminal entrepreneur often leaves the proceeds of his activities in a conventional account. A case in point is fraud involving transfers of football players, in which large commissions are paid to the intermediaries in the form of payment for fictitious consultants' services. These amounts enter bank accounts and remain there without any exotic bank locations being involved. Moreover, a not insignificant proportion of frauds are never discovered at all and the money is therefore Alaudered@ to all intents and purposes because there has been no detected crime. Lastly, part of the income of criminals is used within the criminal economy without ever leaving it. Criminals

⁴⁸W. C. Boeschoten and M. G. Fase (1984), *Betalingsverkeer en officieuze economie in Nederland 1965-1982*, De Nederlandsche Bank NV, Deventer, Kluwer.

⁴⁹D. Francis (1988), *Contrepreneurs*, Toronto, Macmillan of Canada.

spend large amounts of money on their own protection, keeping their families and buying goods and services on black markets (electronics, weapons, clothes, drugs, and so forth).

All in all, it seems reasonable to conclude with the United States Inland Revenue Service that 25 to 30 per cent of criminal transactions are settled by cheque or transfer. This figure is corroborated by a Norwegian study quoted by W. C. Boeschoten and M. G. Fase and also by a Netherlands study by Van Duyne.⁵⁰

1.2.2 Cash needs of the legal economy

The cash needs of non-criminal economic operators are currently underestimated. The following table prepared by the Dutch Central Bank in 1991 shows how 1,000 guilder notes were distributed in 1986 among the different sectors of the economy.

⁵⁰P. C. Van Duyne, R. Kouwenberg and G. Romeyn (1990), *Misdaadondernemingen. Ondernemende misdadigers in Nederland, Arnhem, Gouda-Quint*.

Distribution of 1,000 guilder notes in the Netherlands in 1986

Sector	% banknotes	Total in millions
Agriculture	4.6	557
Industry	1.7	2.06
Construction	2.0	242
Car trade	6.7	811
Retail trade	2.8	339
Wholesale trade	1.2	145
Hotel and catering	0.2	24
Real estate	1.8	218
Other services	1.4	169
Private households	9.3	1 215
Banks and government	6.4	774
Foreigners	2.7	327
Caravan dwellers	2.9	353
Sector	% banknotes	Total in millions
Illicit drug trade	10.1	1 211
Gambling	3.7	448
Subtotal	57.5	6 949

Financial institutions	1.0	121
Transport	1.4	169
Other institutions	0.2	24
Abroad	1.0	85
Total known retention	61.1	7 348
Unknown	38.9	4 752
<hr/>		
Total	100	12 100
<hr/>		

Source: Dutch Central Bank in 1991.

Note: 1 guilder ' 1 f.

The investigation conducted by the Dutch Central Bank makes exciting reading. It shows that almost 40 per cent of holders of 1,000-guilder notes remain unknown. The two sectors with the largest holdings are illegal drugs (10.1 per cent or a little over 1.2 billion guilders) and households (9.3 per cent, or a little over 1.1 billion guilders). According to the theory whereby cash holdings are a sign of criminal transactions, these data could then be interpreted to mean that households have a laundering need almost on a par with that of the illegal drugs sector!

In the interests of greater refinement, the analysis needs to be cross-checked against movements in the balance of payments.⁵¹ Of the capital exports amounting to 2 billion guilders, only 1 billion can be seriously considered to be potentially launderable, this being approximately the amount of cash held by the illegal drugs sector. This amount represents the sum that is potentially available for laundering and not the sum that is actually being laundered. In fact, there are very few criminal entrepreneurs who have the necessary expertise or who have any intention of setting up a laundering operation.

⁵¹When an individual wishes to keep his cash hidden he can put it in an attaché case and take it to Luxembourg or Switzerland. If he deposits it in a locker, this will not affect the export route. If he opens an account, the foreign

In conclusion, a meticulously conducted study of cash transactions would find that only a fairly small proportion of around 10 per cent of the total amount of cash held in the form of thousand guilder notes could be identified as laundered.⁵² According to such an analysis, the extent of laundering is considerably less than the normal estimate, although what we are talking about here is only the need for laundering arising from drug trafficking. Little credence should be given, therefore, to the view that the calculation of the Netherlands gross domestic product (GDP) should be increased from 6.3 per cent to 17.5 per cent to take account of the criminal economy.

1.3 A credible alternative

In 1995, in the report prepared for the Australian Transaction Reports and Analysis Centre (AUSTRAC), J. Walker⁵³ developed a method for estimating the amount of money laundered each year in Australia. This analysis represents a radical departure from traditional analyses in its rigour and its concern to avoid the pitfalls of systematic overestimation of the amounts involved. The method used is actually based on inquiries conducted among police officers and experts regarding their views of the crime phenomenon. On the basis of the different data that they gathered and cross-checked, Walker considers that the amount of money laundered each year in Australia is between 1 and 2 billion dollars. He therefore views it as extremely unlikely that it could be as much as the 4 billion suggested by previous studies based on one or other of the methodologies described above.

As regards laundering of drugs money, we find, if we refer not only to the results given in the tables annexed to the end of the chapter but also to Walker's questionnaire, that Federal Police officers calculate that over 75 per cent of the revenue of drug traffickers is laundered as compared with the estimate of 15 to 25 per cent given by officers of the State and Territory Police. This discrepancy is easily explained by the fact that federal police officers have greater contact with major traffickers. It therefore stands to reason that they should give a higher estimate. The opinions offered by experts, on the other hand, are fairly consistent despite appearances, most of them being in general agreement. Thus, the average estimate given by

bank will have Dutch bank notes at its disposal and will use a small proportion of them to settle its commercial transactions with the Netherlands. The remainder will be sent back as quickly as possible to the Netherlands. The entry of the notes into the country will be registered by the central bank. The departures of guilders in notes are also registered. The central bank makes a distinction between exports of sums, purchases by foreign banks, salary payments and inter-bank settlements. Exports of cash amounts are fairly insignificant: some 200 billion guilders. Exports of funds are in the region of 2 billion guilders. Inter-bank settlements, amounting to around 3.7 billion guilders, are due to the imbalance in exchanged amounts between travellers from the Netherlands abroad and tourists in the Netherlands.

⁵²Notes in smaller denominations should also be taken into account.

⁵³J. Walker (1995), *Estimates of the Extent of Money Laundering in and through Australia*, AUSTRAC.

experts is that 66 per cent of income is laundered in the case of drug imports, 62 per cent in the case of cultivation and transport and 45 per cent in the case of proceeds from wholesale trafficking.

By combining the evaluations made by the different groups of persons consulted, the following proportions of laundered income are obtained: between 65 per cent and 75 per cent for drug imports, around 60 per cent for cultivation and traffic, and between 25 and 45 per cent for wholesale trafficking.

We have therefore come a long way from the 50-70 per cent of criminal income available for laundering put forward by FATF, especially the 70 per cent actually used in their calculations. The discrepancy in percentages is particularly pronounced at the end of the line, where most of the drug revenue is created, and laundering ratios of 25 to 45 per cent are infinitely more realistic.

Lastly, the AUSTRAC report does not refer to laundering at the final resale stage, although it is precisely the price at this stage in the process that served as a basis for the FATF calculation. The percentages of proceeds available for laundering drawn from the AUSTRAC report are consistent with the empirical findings that point to the large amount of the cash sums discovered when the biggest international traffickers have been arrested, ample proof of the fact that laundering does not necessarily have the significance that some would attach to it.

As regards fraud, the evaluations of the laundering percentage given by the persons consulted are extremely polarized. One of the Northern Territory regional police departments believes that all fraud, by definition, gives rise to laundering, whereas the two other territorial zones take the view that between 7 and 13 per cent of income is laundered; the five experts consulted gave the following percentages: 15, 38, 8.5, 45 and 12. In any case, since it is known that the various forms of fraud generate criminal revenue well above that produced by drug trafficking, they most probably give rise to a volume of money for laundering greater than that linked to drugs since, concomitantly, the laundering rates assigned to such proceeds are fairly high (32, 57 and 29 per cent; cf. tables).

This finding, according to which the different forms of fraud generate a volume of money to be laundered which is most probably greater than that linked to drugs, may seem surprising in view of the clear tendency in the literature on the laundering of criminal money to link the phenomenon to drugs. In carrying out an insurance fraud or illicitly obtaining a public subsidy, the criminal is *ipso facto* laundering his revenue (provided that he is not discovered). While this type of laundering injects a large amount of money into the legal economy, it does not give rise to procedures as complex as those in the case of drugs money-laundering, which is accompanied by a rather clandestine lifestyle and calls for more sophisticated techniques.

This last comment reminds us of a point which has received insufficient attention. It is not the volume of illegal revenue that determines whether or not it is necessary to employ a specific

laundering procedure so much as the combination of a sizeable income with a clandestine lifestyle. A driver may operate in criminal circles but has no need to launder his profits since they are insufficient for him to make a saving. A person who embezzles public subsidies has laundered his profits the moment he takes receipt of the subsidy, provided of course that the fraud is not discovered. An importer of drugs conducts his operations surrounded by a wall of secrecy and launders all income that he cannot justify and is liable to be confiscated if he is arrested.

In addition to merely stressing the general trend to exaggerate the share of criminal revenue that is laundered, it is also important to understand why this is the case. Analysis of laundering strategies provides part of the explanation.

2. CHOICE OF LAUNDERING TECHNIQUE

We have dwelt on the fact that the amount of money available for laundering has been overestimated in traditional studies. It remains to be clarified why criminals, and in particular Aorganized crime@, do not attempt to make wider use of international financial circuits in laundering their profits. We will show that this is perfectly sensible and understandable behaviour if one bears in mind the true cost of laundering.

Taking the hypothesis that the cost of laundering is limited to the 10 or 15 per cent cut paid to financial intermediaries, it is difficult to understand why criminals should forego the services of financial institutions. However, taking a more realistic view of what laundering actually costs criminals, including transaction costs, it then becomes clear that use of the financial system is far from cost-effective in every case.

2.1 Different laundering techniques

According to the traditionally accepted view, a laundering operation consists of three distinct successive stages. Money is introduced into the financial system by means of Aplacement@. The subsequent Alayering@ stage consists of piling on layers of complex transactions in order to reduce the traceability of funds and thus to permit their ultimate Aintegration@ in the form of investments in various sectors of the legitimate economy.

We propose now to take a look at the different techniques used⁵⁴ in these three stages, taking them in order of increasing complexity. The main idea here is to examine the techniques used in layering transactions which make it possible to separate the criminal proceeds from their origin and those designed to account for the source of enrichment. These different procedures are classified in order of increasing cost, in particular transaction cost, i.e. all the costs incurred in applying the strategy.

⁵⁴J. Blum et al. (1998), *Financial Havens, Banking Secrecy and Money-Laundering*, UNDCP.

The simplest techniques are based on **gambling laws**. Casinos make it possible to launder small amounts by disguising them as profits and winning racing coupons or lottery tickets are repurchased with a bonus to the original winner.

The **stock exchange** can also be used by simultaneously buying a call and a put. Only the winning transaction is recorded and the broker paid off. The money to be laundered appears as a capital gain.

Property purchases and sales are a further possibility. Property is bought at a below-market price and a share is paid under the table. The property is then resold at the market price, the capital gain lending legitimacy to the origin of the money.

Use of the informal banking system. The principle applied here is that of multiple transfers.⁵⁵ The banking systems of two countries are used, together with one intermediary, a real banker in the informal sector, who ensures that the transactions are carried out on both sides simultaneously and are duly completed. This technique works better where there are large diasporas of an ethnic group in several countries. Trafficking in smuggled goods or the use of illegal migrant workers' wages/pay also makes it possible to conceal transfers of criminal assets.

Use of the banking system. The use of numbered accounts allows the launderer to benefit from bank secrecy. Commercial secrecy can be added to bank secrecy through the use of an offshore company plus a numbered account. The inclusion of lawyers on the board of a company offers a third layer of protection, that of judicial secrecy. Further complexities can be introduced ad infinitum by playing around with imaginary domiciles and dummy identities. In short, the more complicated the system, the more costly it is to monitor and the greater the risks of betrayal.

Assets can be repatriated by debiting a credit card issued abroad. Invoices can be directly settled through a foreign bank.

⁵⁵The basic procedure is as follows: let us suppose that individual A, located in country 1, owes the amount \$X to individual B located in country 2 and that B owes \$X to C located in country 1. A sends \$X to B and B sends \$X to C. This comes to two international transfers and four withdrawal and deposit transactions. In order to settle the various debts, the whole arrangement operates as though A from country 1 is settling the debt of B to C in country 1. There are only two bank transactions between A and B and no international transfers.

Use of commercial transactions. Debts in the source country are paid by an offshore company. Fees can be paid by an offshore company to fictitious consultants in the source country. The criminal sells real estate to an offshore company at an inflated price and deposits the money in the account of the estate agency. Transactions of this kind can also apply to raw materials and securities. The capital can also be repatriated in the form of loans granted by the offshore company, a procedure which is becoming extremely widespread.

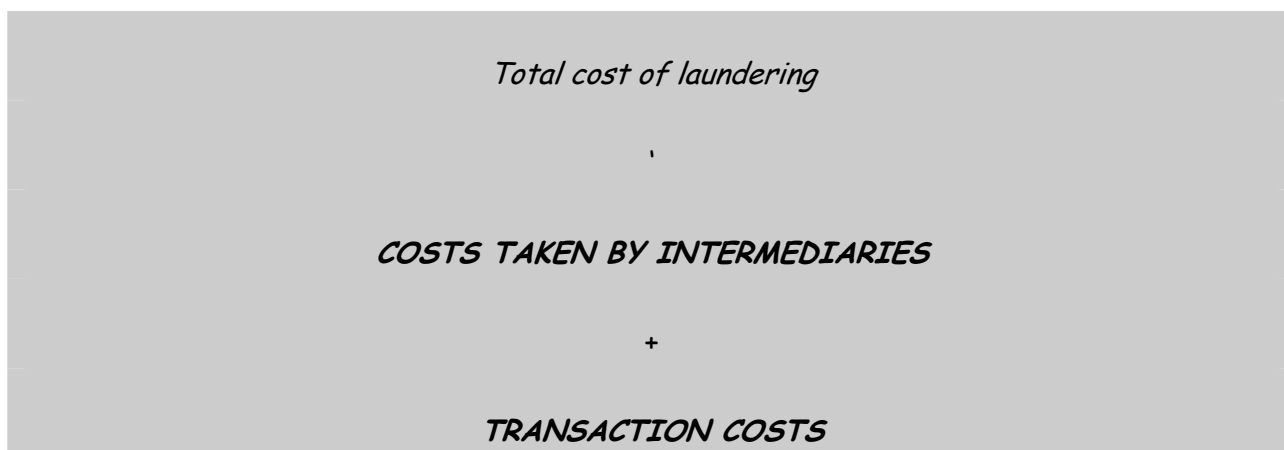
The different techniques listed above call for differing degrees of competence and use different networks. They also apply to widely differing sums of money and involve differing costs.

2.2 The real factors inhibiting laundering

The question of the cost of laundering is crucial to an understanding of which procedure the trafficker is likely to opt for. Whatever the technique used, the total cost of the laundering procedure⁵⁶ for the criminal comprises two elements: the cut paid to intermediaries, which is often in the order of 10 to 15 per cent, and the set of costs which need to be met for the laundering operation to take place, i.e. the transaction costs.

2.2.1 *The real cost of laundering*

Specifically, a trafficker not only has to pay a cut to intermediaries but also has to cover various costs such as lawyers' fees, travel costs, various legal costs, fixed costs, the costs of admission to the criminal milieu, and so forth. Using complex financial channels carries a certain risk, which also represents a cost (probability) for the criminal. We have classified the transaction costs entailed by a laundering operation according to two categories: the strategy implementation cost and the risk cost.



⁵⁶The total cost of laundering corresponds to the cut paid to intermediaries plus transaction costs (i.e. the cost of implementing the strategy and the cost of the risk involved).

strategy implementation cost

+

cost entailed by the risk

(law enforcement + internal defections)

Cuts taken by intermediaries. It can be legitimately argued that the competition for laundering cuts is sufficiently stiff for the cuts taken to be approximately the same from one intermediary to the next. We do not, unfortunately, have any data on the amount of a typical cut, which is therefore, in the absence of reliable information, taken to be generally in the region of 10 to 15 per cent of the amount laundered, although the indications are that intermediaries are increasing their demands in response to tougher anti-laundering procedures. It would seem reasonable to assume, however, that the search for the smallest cut on the market is not a very influential factor in the choice of laundering technique.

Transaction costs (1): Strategy implementation cost. This consists of the operating costs entailed by the laundering strategy chosen. Laundering money by repurchasing winning lottery tickets on the one hand or by setting up an offshore company on the other are techniques that entail differing expenses for information gathering, travel, legal advice and other fixed operating costs. The volume and frequency of the amounts to be laundered must justify the use of sophisticated combinations. The criminal organization will only set up a complex laundering procedure if it is able to predict its income flows and if it considers that the channels to be used are stable. An independent criminal will not have any sufficiently established strategy to be able to maintain a costly laundering procedure.

Transaction costs (2): The cost entailed by the risk. There are two types of risk: the risk posed by law enforcement to the criminal who is planning to undertake a laundering operation, and the risk of internal defections. The law enforcement risk derives from the fact that laundering is subject to surveillance and that a criminal may be under surveillance for other reasons and thus lead the police to his laundering channel. The risk of betrayal stems from the fact that the criminal accomplices necessary for setting up the laundering channel will be tempted to betray the organization. By enlarging its surface, the criminal organization increases its costs of coordination in the illicit sphere and also increases the risk of opportunism.

The logical economic behaviour of criminals, or of a criminal organization, is to try to use the least costly laundering technique. It therefore needs to take account of the three aforementioned cost components. An optimal laundering strategy therefore requires that the expected benefit from laundering will at least cover its cost, comprising the cuts taken by intermediaries plus the cost of access to the market and the risk cost.

In the graph below* we have summarized the link between laundering techniques and the amount of the total cost of laundering.

The left part of the graph sets out the various techniques used to conceal the criminal origin of a sum of money. The various layers of protection available are displayed horizontally and the total cost entailed by the operation is set out vertically.

The right part gives the various possibilities for using the money, once again classified according to transaction cost. This part of the graph describes the *Aintegration@* techniques, i.e. the application of measures designed to account for the origin of the laundered assets. The x abscissa gives the various categories of secrecy that can be used, while the y ordinate gives the transaction cost of the operation.

The graph highlights the total cost entailed by the chosen combination of a layering technique and an integration method. It is shown very clearly that the total cost of implementing a complete laundering procedure can become exorbitant. Thus, cost considerations may argue against the use of sophisticated laundering techniques.

To the extent that consistency calls for the origin of the assets to be concealed (left part) and laundered money to be used (right part) by means of methods located at approximately the same height on the graph, i.e. entailing a similar level of transaction costs, the total cost of laundering can increase fairly rapidly.

2.2.2. The weight of transaction costs

The use of fairly simple techniques can be attributed to the cost of implementing a complex laundering system and the risks presented to the person responsible for doing so.

Laundering a sum of money presupposes that ownership of that money is clearly established. As long as a sum is held in liquid form, the issue of its sharing can remain pending. The rules of mutual trust governing the holding in common of a liquid sum among a group of associated criminals are not very complex. Alarm bells will soon begin to ring if one of the associates tries to make off with all the money. As soon as the money is laundered on a foreign account, and even if several associates have a share, the risk of betrayal will be all the greater if the bank serves the specific aim of never contacting its foreign customers.

The laundering of money therefore requires that the rules for sharing it out are clearly established among the associates and the laundering operation thus greatly increases the risks

* *Translator's note:* No graph has been included in the French original.

of betrayal by removing the holder of the money from the money itself. The lack of a mandate to operate accounts means that the holder risks not having access to them in the event of his imprisonment. Joint accounts also give rise to a risk of betrayal. The act of initiating a laundering procedure leads to a certain irreversibility in the allocation of funds, which often discourages use of such a procedure.

Implementing complex laundering procedures, therefore, requires that there should be stable relationships based on mutual trust among the associates and clear rules governing the process of sharing. As long as there are no properly established rights of ownership and relationships free of the taint of opportunism among the criminals, there will continue to be a strong reluctance to undertake laundering.

The purpose of laundering is to invest a saving and therefore presupposes that the criminal entrepreneur or organization is making plans for the future. The financial decisions of criminals, however, are often not carried through. By placing such a low value on the future, criminals have little desire to incur costs today in order to reap a very uncertain benefit tomorrow from the wealth thus accrued. This psychological law has the ring of truth and probably goes hand in hand with a second type of behaviour specific to the criminal: a low degree of intergenerational altruism. If it is true that criminals are less disposed than the rest of the population to invest part of their income in the form of a saving available for their descendants, then they have one motivation less to launder their money. Admittedly, there have been no specific studies of criminals' attitudes to their wealth, but it is nevertheless indicated by numerous anecdotes, especially those relating to the Medellin trafficking cartel, that most criminals do not give any great thought to the fate of their descendants. Only a very small proportion of the major criminals have attempted to provide protection for their family in the wide sense of the word. These strategies have generally also been aimed at giving a symbolic show of power. By rescuing his enlarged family from poverty, the criminal demonstrates his power and assists his efforts to find a place in *Agood@* society by severing his links with origins that are often poverty-stricken. Consequently, the criminal's strategy with regard to his wealth usually consists in purchasing real estate on behalf of his relatives and using the latter as dummies. This strategy is limited in terms of both the numbers of criminals using it and the amounts of money required. Such laundering strategies make use of fairly primitive laundering techniques such as investment in real estate. Generally, the only major risk incurred is tax-related, namely the problem for traffickers' family members of how to justify their enrichment. However, the tax authorities are often more readily corruptible than the judicial authorities and can be persuaded to simply look the other way.

These few brief comments underline the importance of the factors which inhibit the use of the more sophisticated laundering techniques. Criminal organizations are keen only to go for those techniques which suit their organizational structure. Their spontaneous aversion to overly complicated techniques beyond the wit of their members is due directly to the presence of transaction costs which can prove exorbitant. Only certain specific organizations will use the

more complex techniques, while the bulk of laundering will continue to be done through more simple channels.

2.2.3 Empirical confirmations

The hypothesis that criminals do not make heavy use of sophisticated laundering techniques seems to be well-founded both empirically and theoretically. From the empirical point of view, several, albeit rare, studies appear to suggest as much. From the theoretical point of view, certain characteristics of the operation of criminal organizations explain why their specific management style may prove to be a source of sufficiently substantial transaction costs to deter them from laundering their assets.

All the qualitative studies (Reuter, 1983,⁵⁷ D. Zaitch, 1998⁵⁸) show that complex laundering strategies are used in only a small number of cases of drug traffickers with a significant market share. It is interesting to look at the factors inhibiting such strategies. Zaitch notes the systematic exaggeration of the figures relating to drug production. In this case, the exaggeration is not merely quantitative but also applies to the methods ascribed to traffickers. It may well be that certain operations are extremely complex and properly planned, but in the view of Zaitch, who conducted an ethno-sociological study of Colombian traffickers in Amsterdam, the number of such cases is considerably exaggerated by the media and some official reports. Most Colombian traffickers whom he has observed are satisfied with sending their profits back to Colombia through a bank or *bureau de change*. Zaitch confesses that he is still looking for a real laundering professional in Amsterdam. When questioning his contacts on the rudimentary nature of their laundering technique, he always hears the same reply: *These methods are fine as long as no one makes a stupid mistake*.

Thus, it seems clear to this author that the suitcases of cash and bank transfers remain far and away the preferred methods used by the vast majority of traffickers. The image of ultra-sophisticated laundering techniques springs from the myth of extremely centralized cartels organized along the lines of multinationals. Zaitch notes that the individuals questioned describe with humour how this milieu tends to transform the one-off purchase of a quantity of drugs from an organization X into full membership of that organization. In the same way, mere smugglers of money present themselves as *money managers* without having any special expertise. Even Bettien Martens, who has often been presented as the intermediary between the *Colombian cartels* and the *Italian mafia* and whose role has been highlighted by Operation Green Ice, a criminal, in fact, who has played virtually every role in cocaine trafficking, has not gone beyond the stage, in his laundering ventures, of merely carrying suitcases of cash headed for Gibraltar. Zaitch considers that the case of F. Jurado shows that, even in this case-file where the

⁵⁷P. Reuter (1983), *Disorganized Crime: The Economics of the Visible Hand*, M. I. T. Press, 232 pages.

⁵⁸D. Zaitch (1998), *The Dutch Cocaine Market in European Perspective*, Amsterdam, Universiteit van Amsterdam (unpublished).

laundering techniques used were very sophisticated and corresponded to the archetypal case of laundering set up directly by a large-scale criminal organization (the Cali cartel), some of the Colombians arrested held over 100 bank accounts in more than 15 countries, which demonstrates that sophisticated methods are still being coupled with more primitive techniques.

3. LAUNDERING AND CRIMINAL ORGANIZATIONS

Having insisted at some length that laundering should not be reduced to its most complex expression, we nevertheless feel that the latter merits comment. It is precisely the more complex form of laundering that has fallen through a legal lacuna in a large number of countries and seems to be the almost exclusive preserve of large criminal organizations. It is therefore important to understand how such mechanisms work in order to firmly establish specially designed enforcement tools, a subject to which the next chapter will be devoted.

3.1 Type of criminal organization and laundering

The use of sophisticated laundering techniques through the international banking system has to be confined to fairly sizeable criminal organizations, in terms of either the number of countries which they cover or their membership of a well-established mafia family.

Where a criminal organization belongs to a solid core of organized crime (the Chinese triads, Colombian cartels, Camorra, etc.), it will use the international banking system to launder its revenue. This practice requires that the hierarchical positions in the organization are sufficiently stable for access to the laundered sums not to create a source of subsequent dispute. Such stability in criminal relations is seldom achieved. Consequently, the purpose of laundering is not to conceal from the scrutiny of the judicial system large sums of money belonging to the organization as such. The concept of money belonging to the organization is too elastic to be useful. Generally, criminal organizations will opt to use the international banking system in order to separate the money from its origin and to reinvest it in the legal economy. Dummies will be used to carry property titles and part of the business revenue thus created will be legally paid out to the members of the organization. Such a system is fairly flexible. For example, if a member of the organization dies, sometimes in accordance with expectations, it is enough to change the beneficiary of the salary. Dummies are unable to sell their share because they cannot do so without alerting the other shareholders. They therefore prefer to take a bonus rather than expose themselves to a risk. Such a laundering technique fits in with the basic rules whereby criminal organizations preserve their wealth. The form in which the wealth is held is thus intended to discourage potential betrayals and to be sufficiently flexible to change as the power relations in the organizations change.

It is also important to distinguish between the laundering practices employed by members of the organization on an individual basis and the strategies implemented collectively for the organization and its ruling elite. In laundering their proceeds, the members of a criminal organization, even an extremely large one, will tend to use fairly primitive strategies common to all criminals (purchase of real estate, use of dummies, deposits in cash and foreign accounts).

The use of a complex laundering stratagem has no financial sense except in a very limited range of cases. When a criminal organization is sufficiently long-standing and the evolution of its members' positions in the internal hierarchy is fairly well regulated, the organization may have a sufficiently long-termist vision to contemplate a laundering strategy of benefit to the entire group. This is the case when the combined pressure of the police and tax authorities on the known leaders of criminal organizations is such that they cannot derive any practical benefit from their profits without immediately being charged with tax fraud. A case in point was that of the Italian American mafia leaders on the east coast of the United States at the end of the 1970s, who found it necessary at that time to implement fairly sophisticated laundering mechanisms.

Criminal organizations also have a kind of life cycle, which can prompt them to attempt to implement strategies aimed at their reinsertion in the legal economy. In practice, it is not a question of shifting and redirecting the whole organization in the direction of licit activities, but allowing its senior echelons, accompanied by a small number of essential family members, to buy shares in legal activities. This particular form of Agentrification@ is also aimed at facilitating transfers of fortunes within the families of the organization's members. As soon as the desire to organize the future emerges, i.e. when concern goes beyond the individual criminal and encompasses a family group whose future has become problematic, the setting up of complex laundering systems is essential. This explains why a criminal organization in which the family plays a powerful symbolic role (the Italian American family of the East coast) will employ more complex methods designed to perpetuate wealth than a gang of bikers might.

Use of the arcane intricacies of the international banking and financial system for the purposes of laundering money is not perceived in precisely the same way by all criminal organizations. There is a tendency today to confuse the notions of fund transfers and laundering strategies. Colombian traffickers in the 1980s essentially either sent their income back to Colombia or reinvested it without taking any particular precautions. The assets were mostly repatriated in cash, through transfers or through *bureaux de change* and served to meet the need for dollars created by exchange controls. The need for sophisticated techniques does not emerge until the country in which the assets are to be used starts to conduct an active policy to combat drug trafficking or until the tax authorities gain greater powers. For instance, Pakistani heroin traffickers do not have any complicated laundering strategies. From the point of view of the situation in their country, their problem is merely a matter of the logistics necessary to escort the money and dispatch it. Laundering has not yet emerged as a problem in itself and use of the banking and financial system is therefore limited, being confined essentially to transfer transactions.

<i>Type of criminal involved</i>	<i>Type of banking or financial strategy</i>
Individual criminal entrepreneurs (burglars, swindlers, pickpockets, small-time pimps, prostitutes on his books, etc.)	<p><i>In the course of criminal activity:</i> Limited use of banking and financial procedures. Use of sophisticated techniques to carry out sophisticated fraud and swindling operations.</p> <p><i>For the purpose of using and preserving criminal proceeds:</i> Heavy use of goods and services provided by the underground economy. Use of illegal goods and services (drugs, gambling, etc.). Some real-estate purchases.</p> <p>The banking and financial procedure essentially serves the</p>

	<p>purpose of conserving the assets and permitting discreet withdrawals.</p> <p>Cash payments.</p> <p>Safes.</p> <p>Use of credit cards backed up by accounts under dummy names.</p> <p>In some countries, anonymous accounts.</p> <p>Movements of cash and transfers to accounts abroad are sufficient.</p> <p>A complex laundering strategy would present a poor cost/benefit ratio.</p>
<p>Criminal entrepreneurs belonging to a criminal network (racketeers, bookmakers, wholesale drug dealers dealing in retail quantities, smugglers, importers of illicit labour, traffickers in arms and illegal medicine, pilots, escorts of illicit consignments, crooked lawyers, small groups of drug traffickers operating in the consumer countries and supplied by a major criminal group, members of hierarchical organizations who manage their revenue on their own account etc.)</p>	<p><i>In the course of criminal activity:</i></p> <p>Limited use of banking and financial procedures.</p> <p>Use of sophisticated techniques in order to carry out sophisticated fraud and swindling operations.</p> <p>Use of sophisticated techniques where the criminal activity covers several countries in order to reduce the costs of travel and cash movements.</p> <p><i>For the purpose of using and preserving criminal proceeds:</i></p> <p>Heavy use of goods and services provided by the underground economy.</p> <p>Use of illegal goods and services (drugs, gambling etc.).</p> <p>Cash payments.</p> <p>Safes.</p> <p>Substantial use of cash transfers to other countries.</p> <p>Use of credit cards backed up by accounts under dummy names and accounts located abroad.</p> <p>Sizeable real-estate purchases.</p> <p>Use of credit cards backed up by numerous accounts opened under dummy names or accounts located abroad.</p>
<p>Hierarchical criminal organizations (gangs of bikers, street gangs, Italian American mafias, triads, Colombian cartels, etc.)</p>	<p><i>In the course of criminal activity:</i></p> <p>Substantial use of a sophisticated banking and financial strategy in conjunction with more primitive techniques.</p> <p>Use of sophisticated techniques to carry out transactions between similar criminal organizations (Camorra/cartel transaction).</p> <p>Use of sophisticated techniques where the criminal activity</p>

	<p>covers several countries in order to reduce the costs of travel and cash movements.</p> <p><i>For the purpose of using and preserving criminal proceeds (of the group of leaders of the organization, no longer on an individual basis):</i></p> <p>Very sophisticated techniques in conjunction with primitive techniques.</p> <p>Stabilization of hierarchical relationships, consideration given to the future, a high premium set on family values, intergenerational altruism, pressure from the police and internal revenue authorities, and the desire to redirect the organization towards legal activities all argue in favour of sophisticated laundering techniques.</p> <p>The absence of clear rules for sharing proceeds delays the laundering decision.</p> <p>The trade-off between the cost of laundering (not insignificant transaction cost, risk of internal betrayal, enlargement of the surface of the organization, use of new networks) and the expected benefit (access to legitimized revenues) determines the degree of use of sophisticated techniques.</p>
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CONCLUSION

This chapter represents the real pivot of the entire report. We have demonstrated the incompatibility between, on the one hand, a definition of laundering which reduces it to its smallest share that makes use of the sophisticated techniques offered by the banking and financial system and, on the other, an overestimation of the volume of the sums available for laundering.

From the analytical point of view, the mere fact of enquiring into the total cost of laundering rather than simply the cut taken by intermediaries leads to a radical reevaluation of the cost of laundering, which explains why the vast majority of criminals try to avoid using it. As a general rule, only criminal organizations know how to take advantage of laundering or have any interest in using the resources of the financial system to mask the criminal origin of their income.

Even when they do so, they are faced with substantial costs which have not been correctly identified by the literature. The more sophisticated a laundering operation, the more time and expertise it will require. The greater the number of individuals associated with it, the greater the risk of betrayal. The more frequently an identical operation is repeated, the greater the risk of discovery. Because criminal organizations are aware of these dangers, they make a careful

calculation as to whether there is sufficient benefit to be derived from undertaking a complex laundering operation.

The tendency to overestimate the degree of coordination characteristic of criminal organizations provides one explanation for the obstacles to establishing a realistic view of the phenomenon of sophisticated laundering. With very few exceptions, criminal organizations show a low level of centralization, unstable hierarchical structure and fluctuating internal power relations. Consequently, laundering requires separating the money from the members of the group who would wish to use it and believe themselves to possess it jointly without the rules of sharing necessarily being clearly established. However, it is precisely because the thinking of individuals prevails over that of the organization that the former are generally averse to seeing their profits being withdrawn from them and being introduced into a financial circuit over which they have little control.

Criminals and criminal organizations will therefore generally attempt to reject the use of sophisticated laundering mechanisms because they are aware of their cost and of the risks of destabilization inherent in the use of complex procedures within a fairly rough and ready management context.

This report will now continue by showing how the analysis which we have performed regarding the operation of criminal organizations and their strategies, notably in the area of laundering, can help to provide positive guidance in designing the models used in public policy and in putting in place more effective strategies for combating organized crime than those which currently exist.

Annex

PERCEPTION OF LAUNDERING IN AUSTRALIA EVALUATED BY AUSTRAC

Perception of the extent of laundering by the State/Territory Police

<i>Category of crime/social cost of crime*</i>	<i>Criminal revenue (% of total cost)</i>	<i>Criminal revenue (in millions \$)</i>	<i>Proportion set aside for laundering (% of criminal revenue)</i>	<i>Amount of criminal revenue laundered (in millions \$)</i>
Homicide, maximum \$275 million	10-20	Max. 2.75	0.1-20	0.003-0.55
Other against person, minimum \$331	1	Min. 3.31	0.1-5	0.003-0.166
Robbery and extortion, \$93	80	74.4	0-25	0-18.6
Breaking and entering, \$893	80	714.4	5-10	35.72-71.44
Insurance fraud, \$2,040 million	75	1.530	0-100	0-1530
Business fraud, \$500-\$1,000	90-75	375-900	5-90	18.75-900
Public sector fraud, \$1,000	75	750	5-100	37.5-750
Thefts/illegal use motor vehicles, \$667	80	533.6	2-8	10.67-53.36
Stealing from person, stock theft, shoplifting, \$577-\$2,045		462-		
Other thefts	80	1636**	0-4	0-81.8
Arson/property damage, \$525-\$1,645	1	5.25-16.45	0-10	0-1.645
Pollution/environment				

Total non-drug \$6,901-\$9,989 Average \$8,445	63	4.451-6261	32	102.6-3408
		Average 5356		Average 1755.3
Import/export drugs Drug manufacturing/cultivation, \$1,875 Deal/trafficking	80	1500	15-25	225-375
Total crime cost \$8,776-\$11,864 Average \$10,320	66	\$5951- \$7761	30	327.6-3783
		Average 6856		Average 2055.3

*The cost of crime includes hospital costs, costs deriving from loss of employability, the cost of lost working hours and the cost of suffering caused to relatives. Only a small proportion of these crimes produce an income (insurance fraud, inheritance fraud, etc.). Only a very small proportion of these sums of money correspond to Acontracts@ and give rise to laundering.

**Estimates of the total cost of crime reviewed by J. Walker.

***These figures are not taken from the survey of the Australian Federal Police but from J. Walker 1992.

Perception of the extent of laundering by the Australian Federal Police

<i>Category of crime/social cost of crime*</i>	<i>Criminal revenue (% of total cost)</i>	<i>Criminal revenue (in millions \$)</i>	<i>Proportion set aside for laundering (% of criminal revenue)</i>	<i>Amount of criminal revenue laundered (in millions \$)</i>
Insurance fraud, \$1,700 million	90	1530	90	1377
Business fraud, \$500-\$1,000	90-75	375-900	90-75	281-810
Other fraud, \$1,000	75	750	75	562
Homicide,*** \$275	1	2.75	10	0.275
Assaults including sexual assaults,*** \$331	1	3.31	1	0.331
Robbery and extortion,*** \$93	80	74.4	10	7.4
Breaking and entering,*** \$893	80	714.4	10	71.44
Theft/illegal use motor vehicles,*** \$667	80	533.6	10	53.36
Shoplifting,*** \$20-\$1,500	80	16-120	10	1.6-120
Other thefts,*** \$545	80	436	10	43.6

Property damage/environment,*** \$525-\$1,645	1	5.25-16.45	10	0.525-1645
Total non-drug \$6,549-\$9,649 Average \$8,099	59	4440.71- 5080.91 Average 4760.8	57	2398.5- 3047.51 Average 2722.7
Drug trafficking, \$1,500	75	1125	75	844
Drug manufacturing, \$500	75	375	75-90	280-338
Total drug \$2,000	75	1500	77	1124-1182
Total \$8,549-\$11,649 Average \$10,099	62	5940.7- 6580.9 Average 6260.8	62	3522.5-4229 Average 3875.75

*The cost of crime includes hospital costs, costs deriving from loss of employability, the cost of lost working hours and the cost of suffering caused to relatives. Only a small proportion of these crimes produce an income (insurance fraud, inheritance fraud, etc.). Only a very small proportion of these sums of money correspond to Acontracts@ and give rise to laundering.

**Estimates of the total cost of crime reviewed by J. Walker.

***These figures are not taken from the survey of the Australian Federal Police but from J. Walker 1992.

Perception of the extent of laundering by Australian experts

<i>Category of crime/social cost of crime*</i>	<i>Criminal revenue (in millions \$)</i>	<i>Proportion set aside for laundering (% of criminal revenue)</i>	<i>Amount of criminal revenue laundered (in millions \$)</i>
Homicide, maximum \$275 million	Max. 2.75	3.5	0.003-0.14
Other against person, minimum \$331	Min. 3.31	5.5	0.003-0.33
Robbery and extortion, \$93	74.4	30.3	0.74-44.64
Breaking and entering, \$893	714.4	27.3	14.29-500.1
Insurance fraud, \$2,040 million	1530	9.1	38.25-306
Business fraud, \$500-\$1,000	375-900	46	56.25-900
Fraud on public sector, \$1,000	750	31.6	37.50-600
Thefts/illegal use motor vehicles, \$667	533.6	34	26.65-480.2
Stealing from person, stock theft, shoplifting, \$577-\$2,045 Other thefts	462-1636**	8.8	8.18-346.5
Arson/property damage, \$525-\$1,645	5.25-16.45	23	0.105-8.225

Pollution/environment

Total non-drug	4451-6261	29	102-3006
\$6,901-\$9,989	Average		Average 1554
Average \$118,95	5356		
Import/export drugs			
Drug manufacturing/cultivation, \$1,875	1500	20-90	300-1350
Deal trafficking			
Total crime cost	\$5951-	35	402-4536
\$8,776-\$11,864	7761		Average 2379
Average \$10,320	Average		
	6856		

*The cost of crime includes hospital costs, costs deriving from loss of employability, the cost of lost working hours and the cost of suffering caused to relatives. Only a small proportion of these crimes produce an income (insurance fraud, inheritance fraud, etc.). Only a very small proportion of these sums of money correspond to Acontracts@ and give rise to laundering.

**Estimates of the total cost of crime reviewed by J. Walker.

***These figures are not taken from the survey of the Australian Federal Police but from J. Walker 1992.

SECTION FOUR

THE FLAWED RATIONALE OF ANTI-LAUNDERING POLICIES

Laundering encompasses the entire range of means employed by criminals to exploit the income from their activities. Where standard methods of laundering are involved (consumption, placing of sums in abeyance in bank accounts, use of safe-deposit boxes, real-estate purchases, etc.), there do not appear to be any legal gaps in the enforcement apparatus. Also, specific action against laundering of this kind would not offer any particular opportunities for striking at criminals. The situation is quite different in the case of laundering that employs highly sophisticated techniques. We have shown that using the facilities of the world of modern finance gives rise to substantial transaction costs and proves expensive for those employing such methods. Laundering of this kind therefore essentially involves only those criminal organizations that are sufficiently large to enable the cost of laundering to be covered by the expected profits. Within this area of laundering, a previously existing gap in the law has gradually been filled over the past decade. Much was at stake since by making the enforcement apparatus more watertight in that respect a genuine opportunity was afforded for creating a new angle of attack in the fight against organized crime.

We aim to show in the present section that some of the chances have been wasted. It is pointless to dwell on the record of achievement. The fight against laundering has not delivered any severe blows to Aorganized crime@, not so much through a lack of resources but rather as a result of an overall strategy that was badly flawed and based on too many unsubstantiated theories. It is thus hardly surprising that any government policy founded on such a strategy would prove ineffective.

The novel aspect of our argument thus lies in the fact that we will not, as is too often the case, place the blame on a shortage of resources or difficulties of coordination between each country's law enforcement agencies. We will focus our discussion rather on the shortcomings in the analytical basis of law enforcement policy. Significant improvements could be achieved in enforcement policy simply by a rejection of the fundamental principle on which anti-laundering action is based.

It is necessary to stop believing that enforcement action against laundering is sufficient to dissuade banking and financial institutions from collaborating in such activities or will, at the very least, cause them to increase their commission, and that, for want of intermediaries or because of the resulting prohibitive cost of laundering, criminals will thus be discouraged from laundering their proceeds.

This incentive-based approach to combating laundering does not take accountCwhich is a mistakeCof the overall cost of laundering but only of the percentage taken by the intermediaries. As soon as the overall cost is taken into account, it becomes apparent that, even if the intermediaries doubled their cut, the total cost of the laundering operation would be increased

by a few percentage points only. For that reason, the strategy of dissuasion through increased costs of laundering does not have a sound rationale.

We will begin by setting out the analytical basis of strategies to combat laundering. We will then describe the existing anti-laundering machinery, pointing out the gaps. Finally, we will explain the nature of the resistance that any attempts at a reorientation of government policy will inevitably provoke. The reader should not be under any misapprehension. The theoretical detour which he is being invited to make is not simple rhetoric of a purely academic nature; it is warranted by the total conviction that anti-laundering policy can only be reoriented at the cost of abandoning the flawed analytical principles on which it is based.

1. THE CURRENT ANALYTICAL APPROACH

It is generally accepted that the mechanism of laundering can be regarded as being quite similar to the mechanism employed to avoid the payment of tax on income that is not derived from crime but is unlawfully obtained. This similarity makes it possible to construct the Arational choice⁵⁹ interpretative model, of which a well-known illustration is that of the economic analysis of crime.

1.1 The economics of crime

The starting postulate of the economics of crime,⁵⁹ taken from the axiomatics of rational choices, is that any criminal act is the outcome of a rational calculation. According to this approach, an individual will decide to engage in criminal activity if the benefits that he can obtain from it exceed the costs that he is likely to incur. Such costs depend, *inter alia*, on the likelihood of his being arrested and on the harshness of the penalty imposed. By exploiting these two parameters, the judicial and law enforcement machinery can alter the conditions of an individual's rational choice and discourage potential criminals.

The efficacy of crime control thus depends on the extent of the resources assigned to combating crime, which determines the likelihood of arrest, and on the system of penalties devised by the Government. If the level of crime is deemed to be too high, the authorities will most frequently elect to attempt to reduce it by increasing the penalties. An increase in penalties is in fact cheaper for society than an increase in the level of probability of tracing criminal activities.

The economics of crime can therefore be seen as a theoretical construct that is appropriate for guiding decision makers in their quest for the right level of public spending to be allocated to combating crime. In order to achieve the optimum level, society should therefore increase its

⁵⁹Put forward by G. Stigler and G. Becker, University of Chicago, in the early 1970s.

crime control budget only to the point where any additional expenditure (taking account of the dry loss connected with the financing of such expenditure through taxation) would reduce the social cost of crime (i.e. the cost which criminal activities represent to the public) by an equivalent amount. In other words, the Aoptimum@ crime control budget allocation is where the marginal cost of government policy does not exceed its marginal benefit.

1.2 The economics of laundering

The fight against laundering has been conceived in terms of an intellectual matrix that is strongly influenced by the economics of crime and that also takes a number of elements from the economic theorizing of informational asymmetries.⁶⁰

Anti-laundering laws are based on a dual incentive mechanism. They are aimed, on the one hand, at encouraging banks to cooperate with the State and, on the other, at making the cost of laundering operations sufficiently discouraging to cause criminals to discontinue such activities.

The State is unable to see, and therefore to punish, all illegal activities which lead criminals to make use of the banking and financial systems. The State therefore has to delegate to the banks the task of monitoring the use made of the banking system (bank Aagents@ are commissioned by the State Aprincipal@ to detect laundering operations). However, while banks may possess sufficient information to carry out that task, they do not have any motive to make them report their customers and deprive themselves of profitable transactions. The State must therefore introduce incentive-based mechanisms by amending the law. Basically, banks have to decide between the benefit which they derive from the operations of their dishonest customers, the risk of losing customers to their competitors and the likelihood of damaging their reputation if they infringe the law. The optimum legislative mechanism is therefore one which induces banks to make up for the State's lack of information by assuming a role that the State is unable to perform. Such a mechanism must impose a sufficiently tight constraint on banks to stop them shirking; in other words, the likelihood of their being punished for laundering offences and the

⁶⁰Economists are of the opinion that the possession of important information by one of the two parties (supply or demand side) in a transaction gives strategic power which affects the transaction and distances the market from the optimum. The Aprincipal-agent@ models describe a situation where two individuals wish to cooperate with each other, with one of them (the agent) carrying out, in return for payment, one or more tasks for the other (the principal). The purpose of these models is to develop incentive schemes, e.g. contract clauses, that will make the agent act in the way the principal wants.

amount of the fine to which they would be liable have to be sufficient to dissuade them from taking part in such operations.

The State also suffers from insufficient information regarding the level of income from crime and the extent of the need for laundering. It must nevertheless, i.e. in spite of this lack of information, endeavour to dissuade criminals from using the banking system by making the cost of such use prohibitive. For that purpose, it can increase the likelihood of detection of laundering operations and/or the severity of punishment. Increasing the likelihood of detection means allocating additional resources to the supervision of banking transactions. It can readily be appreciated that such a strategy ceases to be cost-efficient after a certain point, beyond which the money would be better used in other areas of crime control.

The approach to combating laundering: the role of incentives

2. THE RATIONALE UNDERLYING ANTI-LAUNDERING ACTION

We intend to examine the main characteristics of current anti-laundering mechanisms and to discuss their effectiveness. We will distinguish between the aspect involving the State-bank relationship and that dealing with the bank-customer relationship.

2.1 Forcing banks to cooperate

Specific laws on laundering require banks to report movements which appear to them to be connected with laundering operations. Banks which disregard that obligation are liable to penalties.

The first aspect of anti-laundering mechanisms thus consists in threatening banks with penalties if they do not cooperate with the public authorities. From a theoretical viewpoint, this is fully in line with the model which underpins anti-laundering action: the amount of the penalty should be such that it discourages banks from not cooperating. In practice, these financial penalties prove to be ineffective, as is apparent from the fact that not only is it impossible to compile a list of cases where they have actually been implemented but also the range of the sanctions is kept secret.

Indeed, the only threat from the authorities to which a bank might respond is that of providing the media with information to help ruin its reputation. While such a threat may be convincing, to carry it out would not be without drawbacks for the economy as a whole. Moreover, it employs discretionary channels that lie outside the general theoretical framework.

2.1.1 The ineffectiveness of the financial penalty incentive

Financial penalties imposed on banks failing to report suspicious customers to the authorities are a weak form of incentive. The economic cost of fines is not in fact a disincentive when compared with the potential benefits obtainable through participation in laundering operations on a large scale. One might think that it would suffice in such cases to increase the penalties in order to make them serve as a deterrent. However, while failure to report a laundering operation may be the result of collusion between the bank and a criminal, it may also be due to unintentional negligence or inability to identify the operation. Overly heavy sanctions against banks that are merely negligent could thus turn the cooperation sought by the State into a legal war of uncertain outcome.

The effectiveness of a penalty-based incentive mechanism could also be enhanced by increased supervision of banking institutions. However, such a policy is bound to prove very costly to the State. To save on the public purse, it is preferable to encourage banks to cooperate in combating laundering by the promotion of self-regulation within the banking system. The internal imposition of high standards of conduct will cause banks to abide by the law at a cost for oversight or penalization which is virtually nil for the State. It is thus fully in the interests of

the public authorities to exploit the threat of a damaged reputation in order to implement anti-laundering mechanisms at low cost.

2.1.2 A convincing threat: damaged reputation

The authorities have at their disposal many ways of making public a bank's knowing participation in the laundering of proceeds of crime. The resulting damage to its reputation, the risk of having hedge funds withdrawn from its capital and the danger of triggering a collapse of capital stock represent a far more powerful threat than that of financial penalties to induce banks to cooperate.

Where reputation is concerned, it is all a matter of image and communication. To encourage self-regulation of banks, the public authorities should not hesitate to highlight those cases where a lack of vigilance and failure to observe the law explicitly serve the interests of unscrupulous banking institutions. However, it would be pointless to focus the public's attention on the larger number of cases which are the result of involuntary negligence or technical failure.

The public authorities' use of the Jurado, BCCI and Ambrosiano Bank cases as symptomatic examples has thus reinforced the idea that banks' infringement of the law or failure to apply it strictly promotes interests which have nothing to do with those of their habitual customers, even where delicate situations with the revenue authorities are involved. The fact that BCCI's customers suffered personal losses, for example, is a trump card to be exploited through the media in order to give credibility to the threat of ruining the reputation of banks that do not abide by official directives by turning against them the opinion of a public appalled by criminal embezzlement. The more corruption at a high level is revealed by publicizing laundering cases, the more banks will have to fear for their public image.

The idea that there cannot be double standards in law enforcement still needs to be firmly established in the mind of the public. The State has to display extreme vigilance in this respect. Condoning breaches of the law as a natural response to excessive State intervention in the life of private individuals can only serve to seriously weaken banking ethics and deprive the State of an inexpensive enforcement tool.

The use of such a tool can, however, prove harmful, for two main reasons. Firstly, it is subject to the discretion of the public authorities and may thus be employed for purposes other than those for which it was devised. It can consequently be used for political ends and cause major imbalances in competition between banking institutions. Secondly, banks will not remain indifferent to the implementation of legal mechanisms aimed at restricting their involvement in laundering. The response capability of banking institutions should not be underestimated. In particular, banks could develop a communication strategy designed to impair the public authorities' ability to undermine their reputation. They will seek to convince the public that non-observance of anti-laundering laws does not in fact constitute reprehensible conduct if it was intended to protect the customer's privacy. They will endeavour to give credence to the idea

that, if their reluctance to assist actively in combating laundering unfortunately serves the interests of a few criminals, that is the price to be paid for ensuring the confidentiality of the private transactions of the vast majority of their customers from the State's natural tendency to interfere everywhere. They will portray the services that they offer the public as being of the same type as those provided by lawyers or notaries, i.e. occupations where no one would think of questioning the existence of professional secrecy.

The effectiveness of action to combat laundering also lies in its prophylactic nature, that is, its ability to persuade banks to part with their most dubious customers. The recommendations set out in international conventions to combat laundering will not be implemented with the same degree of zeal in all financial markets. Banks in some countries will continue to provide an irregular service, namely connivance. The banking institutions in countries with the most advanced anti-laundering systems will react by setting up agencies in those countries in order to continue to capture part of the market for money to be laundered.

In this connection, professional banking associations represent a central element in the self-regulation machinery of the banking system. By fixing the rules of the game, they can help to discourage the behaviour of Astowaways@. Some banks might be tempted to plead the absence of coordination between their different establishments in order to shirk anti-laundering regulations. Individual rationality will prompt establishments to not to restrict their opportunities for gain while they have the assurance that their counterparts are doing the same. The public authorities must therefore be highly attentive to the professional associations, not so much because of their actual influence, about which no one is under any illusion, but, on a more practical level, because of their value as rule setters. In a situation where the different banking institutions have difficulty finding out precisely what the practices of their competitors are, a professional association can perform a role in standardizing practices. Its usefulness stems not from its weight within the profession but from the level at which it assimilates public concerns. Its ability to echo those concerns is due not to its lobbying power but to the visibility that it gives to the rules proposed by the authorities. The often noted fragility of the professional associations and their lack of genuine influence within their own sphere do not necessarily represent a handicap as regards their use by the authorities. A weak association without major resources is more responsive to public recommendations than a powerful and independent organization. The degree of assimilation of public concerns can therefore be greater in a weak organization than in a strong one. A weak professional association then has to succeed in persuading its members to comply with official strategy.

2.2 Forcing banks to oversee their customers

The second aspect of anti-laundering machinery concerns the bank-customer relationship and focuses on Abad@ customers, in this case criminals. It is based on a system of penalties aimed at discouraging criminals from using banks to launder their income.

2.2.1 Failure of increased costs as a disincentive

We are dealing with the central element of anti-laundering machinery, whose effectiveness greatly depends on its ability to keep bad customers, i.e. criminal organizations, away from banks.

Hughes Hallet (1994)⁶¹ has formalized in a way that is technically very satisfactory the model underlying this aspect of anti-laundering policy. His theoretical model is particularly instructive since its limitations clearly show the difficulties encountered in practical action to combat laundering.

The Hallet model describes a criminal's choice whether to launder his income.⁶²

The factors affecting his decision are as follows:

- The portion of the income that the authorities would deduct if the income was declared;
- The probability that the authorities would discover the existence of the illegal income if the criminal chooses not to launder it through the banking system;
- The amount of the fine imposed for possession of illegal income;
- The cost of the operation to enable laundering to take place;
- The likelihood of being punished for the laundering offence; and
- The amount of the fine incurred for laundering.

⁶¹H. Hallet, *An Economic Analysis of Money Laundering and Measuring Illegal Activity*, paper presented to the International Conference on Preventing and Controlling Money Laundering and the Use of the Proceeds of Crime: A Global Approach, 18-20 June 1994.

⁶²The decision to launder money is similar to the decision to evade tax income that is not of a criminal nature but illegally acquired. See the reference model in M. Allingham; A. Sandmo (1972), *Income Tax Evasion: A Theoretical Analysis*, *Journal of Public Economics*, vol. 1, pp. 323-338.

Individuals are assumed to conform to standard principles of behaviour in an uncertain world. The well-being of the operator, i.e. his A profitability, is a function of his income. It increases with income but at a decreasing rate since the criminal is risk-averse.⁶³ Also, the income derived from unlawful activities is assumed to be known to the criminal alone. In the case of proceeds from crime, it can reasonably be presumed to be the operator's entire income that is to be laundered, since the operator would declare nothing to the authorities.

A criminal will attempt to determine amount X of income to be laundered that will maximize his expectation of profitability. He will decide not to launder his income if what the laundering operation could cost him (i.e. commission paid to the intermediary plus the likely cost of the penalty for laundering) exceeds the likely amount that he would have to pay if the authorities discovered the existence of his unlawful income (i.e. the amount of the fine multiplied by the probability of discovery of his unlawful income). Otherwise, he will decide to launder his money.⁶⁴

If the authorities step up the pressure on criminals and impose heavy penalties on those in possession of unlawful income that they have not laundered, criminals will thus be encouraged to attempt to launder their proceeds. Anti-laundering policy thus has to take specific account of enforcement action against the possession of unlawful income.

In order to reduce the amount of money being laundered, the authorities should accordingly take steps so that the overall cost of laundering to the criminal increases.

For that purpose, their action can focus on both components of this cost:⁶⁵ the intermediaries' percentage commission and transaction costs.

To date, emphasis has been placed only on the commission element. It is generally accepted that this represents approximately 10 to 15 per cent of the amount of the laundered money and it is wrongly concluded that an increase of a few percentage points would be sufficient to

⁶³The marginal profitability derived from income is positive but decreasing, i.e. the first derivative, in relation to income, of the function of profitability is positive and the second derivative is negative.

⁶⁴With A as the amount of the fine for possession of unlawful income and pA as the likelihood of that unlawful income being discovered, the probable fine equals pA .

With B as the amount of the fine for laundering and pB as the likelihood of the laundering being discovered, the probable cost of the penalty for laundering equals pB .

With C as the amount of the commission paid to the intermediary, the total cost of laundering equals $C + pB$.

If $C + pB > pA$ (i.e. if the total cost of laundering exceeds the probable amount of the fine for possession of unlawful income), the criminal will not launder his income.

If $C + pB < pA$ (i.e. if the total cost of laundering is less than the probable amount of the fine for possession of unlawful income), the criminal will decide to launder his income.

⁶⁵Note the formula expounded in the previous section: total cost of laundering = commission received by intermediaries + transaction costs (cost of implementing the strategy + risk-related cost (enforcement + internal defections)).

discourage potential launderers. Again the error stems from failure to take the other transaction costs into account. Those costs are not disbursed, i.e. they do not correspond to sums that are actually paid. However, just like journey time which is added to the price of petrol when the cost of travel is calculated, they too have to be taken into account.

There are no studies⁶⁶ to give a general idea of the cost that the threat of enforcement action and the risks of betrayal represent for traffickers. To enlighten the reader, we will take a simple numerical example.

Let us assume that the amount to be laundered is 100 and the commission 10 per cent, i.e. 10. Let us imagine that the threat of being arrested or betrayed exerts a pressure on the trafficker three times greater than that of the intermediary's cut. The transaction cost will then be 30. The total cost of laundering will be 40 per cent. This clearly illustrates that sophisticated laundering is an expensive operation. The total cost of laundering will thus be 40 per cent of the amount to be laundered!

Let us now suppose that enforcement policy causes intermediaries to increase their commission by 50 per cent to cover the increasing risk incurred by them as a result of implementation of the anti-laundering policy. The percentage will accordingly rise from 10 to 15, while the total cost of laundering will be 45 per cent but will have increased by 5 per cent only.

Forcing intermediaries to increase their commission by 50 per cent would make the total cost of laundering only 5 per cent higher! The ineffectiveness of such a measure can thus be appreciated.

Admittedly, this outcome is obtained from the figures we have applied, but the notion that the threat of enforcement action and internal betrayal exerts on traffickers a pressure three times greater than that of the percentage paid by them to intermediaries does not appear to be an exaggeration.

Criminal organizations will arrange to pay the intermediaries' percentage while attempting to displace the risk by compartmentalizing those who bear the laundering-related risk. In the

⁶⁶In the case of street sales of cocaine, Peter Reuter and Jonathan Caulkins have calculated that 23.6 per cent of the price of one gram of cocaine sold on the street in the United States of America represents compensation for the risk of traffickers= incarceration and 33 per cent the risk of their being injured or killed in the course of their operations. The transaction costs thus represent approximately 50 per cent of the price. J. Caulkins; P. Reuter (1998), *What Price Data Tell us About Drug Markets*, mimeo.

Jurado case, the fall of Franklin Jurado did not cause any real damage to the cartel that employed him. Since transaction costs do not have to be disbursed on each operation but are incurred only in the event of arrest or internal blood-letting, there will always be individuals to perform that role.

By concentrating on the mistaken effect of intermediaries' increased commission on laundering activities, law enforcement authorities have overlooked the possibility of directly influencing the likelihood⁶⁷ of conviction and have not looked into ways of increasing the occurrence of internal betrayals.

2.2.2 The limitations of incentive-based mechanisms

Even after shifting the focus of their attention to increasing the overall cost of laundering and not simply the share paid to intermediaries, law enforcement agencies cannot confine their operational responsibility solely to incentive-based mechanisms. Such a model entails four main limitations which restrict the effectiveness of enforcement action.

Firstly, the idea that a criminal compares the overall cost of laundering (direct cost + transaction costs) with the likely amount of the fine for possessing unlawful income presupposes that one unit of laundered income and one unit of non-laundered income have the same value in the eyes of the criminal. This equivalence does not in fact exist if the criminal cannot use the unlawful income unless it is laundered. In that eventuality, the cost that he is willing to incur to launder his proceeds is obviously far higher. This is admittedly an extreme case but it illustrates the fact that laundering can remain a rational option for a criminal beyond the boundaries set by the model if the pressure on the criminal is particularly strong.

Secondly and conversely, enterprises, criminal or otherwise, in some countries regularly juggle between two sets of accounts: official and actual. Their possession of funds that have not been laundered does not present any specific problems. Such possession is even necessary in order for them to take part in a certain number of transactions. The desire to launder criminal proceeds is thus considerably diminished. This is even more the case if, as we have pointed out, the cost of sophisticated laundering is high.

⁶⁷In order not to overelaborate, we are not proposing here a formalization of the argument. By way of explanation, using the structure of the Hallet model, our criticism basically amounts to a suggestion that the focus should be on pB and not on C . It is necessary to introduce the A risk of internal defection@ variable.

Thirdly, the effectiveness of an anti-laundering strategy aimed at increasing the cost of laundering to the criminal presupposes that the criminal cannot pass on the extra cost of laundering to his clients. In the case of drug trafficking, the commission demanded by laundering intermediaries does not exceed two per cent of the street price of cocaine, according to the estimate made by Jonathan Caulkins and Peter Reuter (1998).⁶⁸ Even if intermediaries double their demands, the street price of cocaine would increase by two per cent only.⁶⁹ Since cocaine users would be virtually unaware of such a minor increase in price, drug traffickers can pass on to users the increase in price charged by laundering intermediaries without fear of a fall in consumption. The increase in intermediaries' percentage share brought about by enforcement action does not therefore harm the traffickers' profit. No significant effect on the scope of laundering can thus be expected from such a strategy.

Fourthly, it is necessary to take account of criminals' response capability in the face of anti-laundering initiatives. The entire official strategy rests on the theory that banks can identify undesirable customers and oust them. It is highly likely that criminals know how to quickly conceal their business name from their partners in the banking system. Reporting of suspicions will soon be regarded as an antiquated mechanism in the range of anti-laundering measures. Criminals' adaptability will rapidly make such a device ineffectual. There is no reason to believe that action to combat laundering can escape a trend frequently observed in other sectors, namely that a mechanism which is solely incentive-based tends to be quickly overcome by the response strategy of operators who take steps to circumvent it. The public authorities are then forced to adopt regulations and implement ad hoc mechanisms. A proliferation of direct regulations (reporting of transfers, prohibition on cash payments in excess of a certain amount, etc.) will be the prelude to a trend that is probably unavoidable. Reliance on a mechanism based on incentives and on the idea that criminal operators make cost-benefit calculations would appear to be a misguided strategy for effectively combating laundering.

3. RESISTANCE TO CHANGE

Enforcement practitioners often point out ironically that they do not need theoretical models to perform their task. Nevertheless, the existence of a common reference model, i.e. a common representation of the situation and of the very general purpose of their task, is essential for the proper functioning of law enforcement agencies. It enables enforcement practitioners to organize and process the information which they gather. It also makes it possible to win over decision makers who have sufficiently similar rule-making conceptions. In addition, it provides enforcement agents with a ready means of signalling their support for a situational view through a stereotyped reference to the model.

⁶⁸J. Caulkins; P. Reuter (1998), *A What Price Data Tell Us About Drug Markets*®, mimeo.

⁶⁹A similar calculation should be made for other criminal activities.

Unfortunately, the model underpinning the fight against organized crime and money-laundering is a mishmash of beliefs, myths, pseudo-theories and dogma. It is distressing to note how much time is spent theorizing about enforcement policy. The models around which enforcement options continue to be discussed need to be supplemented, reviewed and in some cases abandoned. Before proposing alternative avenues, we will attempt to see how models which clearly are theoretically flawed and inefficient in practice can continue to serve, admittedly implicitly rather than explicitly, as a reference for official policy-making.

3.1 Inhibitors

It is generally understood that the judicial system constitutes a means of coercion whose actual effectiveness can be inhibited by difficulties or resistance encountered in the implementation of the law. Operators who take steps to circumvent a law are acting in defence of their immediate interests but against collective efficiency.

The legal machinery for combating organized crime is no exception to this general rule. Enforcement action is impeded by intellectual conservatism, simplified representations of the world and outmoded theories on how to strike at criminal organizations. The effectiveness of such action can be improved by overturning the implicit rationale underlying the strategies for combating organized crime and money-laundering. The entire problem lies in successfully bringing about the necessary changes.

The symbiotic relationship between society's expectations with regard to organized crime control and law enforcement practice shapes the direction taken by changes in strategic action. Changes in the rationale underlying the activity on which a law enforcement agency's efforts are based on the outcome of the actions of thousands of decentralized agents who are inadequately coordinated by the organizations representing them. It is through a whole series of minor changes that a strategic approach will become gradually transformed, this being an incremental process which favours actions that are clearly consistent with public expectations. Since choices that would clash with such expectations are obviously not advantageous, the profitable short-term reorientation opportunities ultimately determine the course of long-term change.

Long-term change is often the unintentional outcome of the actions of the actors. Decision makers are in fact only aware of the direct consequences of their choices and, to a lesser extent, of external repercussions. However, the direction of the choices that they make influences the extent to which the store of collective knowledge increases. Similarly, their choices will encourage or discourage operators' movements. For all these reasons, the outcome of efforts expended will differ from the actors' expressed intentions. It is, however, difficult to reverse the general direction which institutional change takes. Change is the product of a great many incremental choices which constantly alter institutional constraints. The inevitability of certain courses of development that it is difficult for change to avoid is an indication of the force of history.

This strong tendency of organizations to produce inefficient strategies will continue as long as there is no feedback effect to help create new strategies that will lead to more efficient action. When organizations prefer to exploit a position advantage rather than strive for efficiency, they bolster outmoded action strategies. Their efforts will be channelled in that harmful direction. A change of policy for combating money-laundering and organized crime will ultimately depend on the relationship of power established between the proponents of change and the proponents of routine practice.

3.2 Policy reorientation and resource reallocation

Speculating on the direction which efforts to control money-laundering and organized crime will take in the coming years is no simple matter. Such a forecasting exercise is necessarily more hazardous than the exercise undertaken in the second section of this report, that of putting forward recommendations.

We should begin by noting that the issue of organized crime arose as a more or less separate subject only on the fringes of the discussions concerning drug-trafficking control strategies. In Europe at least, organized crime is generally referred to in connection with the concerns over the fragility of the financial systems in the Eastern European countries or emerging markets. Even at the height of the war between the drug enforcement agencies and the Medellin cartel, the terms Anarco-traffic@ and Anarco-terrorism@Cnot Aorganized crime@Cdominated. Such a semantic distinction highlights the extent to which the term Aorganized crime@ appeared to apply only to the developed countries and the way the role of such criminal organizations in the rich countries was glossed over.

Of all the stages of drug distribution, wholesale dealing, including small-quantity selling, is the stage in which national criminal organizations are most involved. However, it is the stage about which the least is known in Europe. The recent trend of channelling research resources into this deficient area will help to remedy the situation. The issue of organized crime is therefore likely to occupy an increasingly large place in the debate on drug control strategies in the coming years. Such a development has long been hampered by the reluctance of the police services to acknowledge the existence in Europe of structured criminal organizations that survived the dismantling of the notorious crime networks such as the French connection. The strategic nature of matters of internal security prior to the collapse of the Eastern bloc in 1989 also explains the reluctance to make the issue of organized crime public. Recent historical developments are particularly favourable to a change of direction. Transformations taking place in Eastern Europe and the emergence of new criminal groups which represent a potential threat both to Europe and to America are prompting decision makers to include organized crime on their agendas. Lastly, growing dissatisfaction in the face of the poor results of efforts to combat drug trafficking at a high level is arousing understandable interest in the idea that the formulation of an effective enforcement strategy requires that criminal organizations be singled out as a specific target.

One is forced to remain pessimistic, however, knowing the time lag between the realization of the urgency with which a problem has to be tackled and the actual reallocation of resources to that new area. The reorientations that have taken place in drug-control policy serve as a good illustration. The 1960s and 1970s were marked by an enforcement focus on the drug consumer. In the early 1980s, seizures were pointed to as an indication of the effectiveness of efforts to combat drug trafficking. From the second half of the 1980s, the issue of anti-laundering action became part of the discussions on strategy. The present trend is to increasingly link drug-trafficking control with action against terrorism and the traffic in arms. It is, however, impossible to state whether any of those enforcement methods was followed by a reallocation of resources. The few studies devoted to assessing public spending on drug control⁷⁰ reveal a lack of budget flexibility. Given that enforcement action is carried out by several general administrations (police, *gendarmerie*, customs) and a few agencies specializing in drug control, it is virtually impossible to reassign the budget for one strategic sector to another since that would mean reducing the budget of one administration for the benefit of another. The development of any new angle of approach thus leads to an increase in the overall drug-control budget and not to a reallocation of existing resources among the different areas. In view of the severity of the budgetary constraints currently existing in the countries that have joined the European Monetary Union, it is unlikely that the new areas of drug control action can be provided with the necessary resources.

Although it is certain that organized crime will represent a major challenge for enforcement choices as the new century begins, caution should continue to be exercised as to the speed with which a likely strategic change can be translated into resources. The essential role to be assigned to combating Aorganized crime@ is dependent not only on revolutionizing the models of enforcement strategy but also on States' ability to release sufficient resources for a policy reorientation to become a reality.

CONCLUSION

The last section made it possible to locate precisely the root causes of the malfunctioning of Aorganized crime@ control policy through anti-laundering action. Even so, it was logical that attempts should be made to undermine the activities of Aorganized crime@ by focusing on the most sophisticated forms of laundering which virtually only organized criminal groups can engage in. Although other criminals also launder their income, it was not necessary to make the law enforcement apparatus more watertight in order to strike at them. Indeed, they can more easily be brought to justice through proceedings instituted in respect of their main activity than through specific action directed against the laundering side of their business.

⁷⁰See European Monitoring Centre for Drugs and Drug Addiction (1997), *Annual Report on the State of the Drugs Problem in the European Union*, Lisbon.

Overconfidence in incentive-based mechanisms focusing exclusively on increasing the cost of laundering by means of a strategy of questionable efficacy can largely explain the difficulties encountered in anti-laundering endeavours. Many avenues still remain to be explored. It is undoubtedly possible to improve the efficiency of law enforcement policy provided that the simplistic views of the economic basis of criminal organizations' behaviour are abandoned.

The purpose of the present report was not to examine the avenues that would contribute to a reshaping of anti-laundering and Aorganized crime@ control policies. It sought rather to link the distorted quantitative evaluations of laundering to the conceptual weaknesses of the strategies underlying action to combat laundering. That exercise once again confirms the rule that, when statistical data are unconvincing but continue to be bandied about despite criticism of them, it is because such data cannot be dispelled without overturning a number of theoretical convictions.

1. DEFINITION OF ORGANIZED CRIME

A. The Task Force on Organized Crime adopted the following definition:

The core of organized crime activity is the supplying of illegal goods and services (gambling, loan-sharking, narcotics and other forms of vice) to countless numbers of citizen customers.

A clear link between the core of organized crime activities and illegal markets.

Whereas crime generally involves the acquisition of goods produced by others, organized crime is **the response to a demand** that exists independently of it.

The structure of organized crime resembles that of a **firm**.

B. T. Schelling (1971) disputed that approach.

According to Schelling, the **difference** between traditional criminal activities and organized crime lies in the fact that only the latter claims to **control** all the activities of the underground economy.

In Schelling's view:

- Organized crime always seeks to achieve a **monopoly position** in order to obtain income from all unlawful activities without running the risk of conducting those activities directly;
- Since it sets itself up as a **rule setter**, organized crime has to resort to the use of violence.

Organized crime is viewed as a **government of unlawful activities** rather than as a **firm**.

C. P. Reuter proposes a different definition of organized crime which implies a rejection of the two preceding definitions. In his opinion, organized crime consists of organizations that have durability, hierarchy and involvement in a multiplicity of criminal activities.

This is a fairly general definition which makes no reference to the lawful or unlawful nature of the activities of organized crime.

It contradicts Schelling's analysis.

The main thrust of Reuter's work was to demonstrate that there was no monopoly that exercised centralized control over illegal markets and the use of violence. Hence, there are many illegal markets in existence for which there are no barriers to entry.

Clearly, the action of criminals operating on their own⁷¹ cannot be envisaged without taking into account the many interactions which link them to their milieu. Indeed, any organization, whether criminal or otherwise, has to resolve one key problem: it must ensure that a large number of individuals, each retaining a certain independence and pursuing its own interests, cooperate and abide by rules that are necessary for the functioning of the group. According to the sociological meaning of the term, organizations are human groups structured in a formal and hierarchical manner for the purpose of achieving the cooperation and coordination of their members in the attainment of given aims⁷². It now remains to be seen how criminals reconcile their desire to engage in lucrative activities on an individual basis and the obligations that belonging to a certain milieu imposes on them.

The answer put forward here is based on an analysis of the functioning of organized crime in terms of networks⁷³. This approach makes it possible to appreciate a feature of the criminal world, namely the absence of any apparent contradiction between a certain degree of hierarchical coordination and the allowance of considerable freedom of action at the individual level. Indeed, in a network, the creation of wealth does not follow a simple vertical course as in standard industrial production lines, where firms' hierarchy corresponds to a functional segment of the manufacturing activity. On the contrary, the many elements making up a network ascend or descend within its structure, bypassing the intermediaries in order to set up operations on their own account. The organization of the criminal world follows this pattern. Far from being characterized by vertical integration that assigns fully specified tasks to subcontractors, it can be seen as a meshwork where each operator deals with its regular partners at the same time and simultaneously conducts activities on its own behalf.

Vertical decentralization of responsibilities thus allows the fulfilment of a vast number of individual contracts that form part of a series of functional allegiances backed by regional or family-based complicity or simply by bonds of trust. A vast number of relatively independent operators enter into agreements of varying duration set in motion by the top echelons of the organization, who finance some operations and then use the same logistics to conduct their own personal activities. The criminal network does not therefore resemble a centralized pyramid

⁷¹The phrase 'Criminals on their own' is rendered in French as *A criminels individuels* (DELETE THIS FOOTNOTE FROM THE TRANSLATION).

⁷²E. Friedberg (1992), 'A Organization' in R. Boudon (ed.), *Traité de sociologie*, PUF, Paris.

⁷³P. Kopp (1992), 'La structuration de l'offre de drogue en réseaux', *Tiers-Monde*, No. 131, vol. XXXIII, July-September. See also J. Cartier-Bresson (1997), 'A Corruption Networks, Transaction Security and Illegal Social Exchange' in P. Heywood (ed.), *A Political Corruption*, *Political Studies*, vol. 45, No. 3, Special issues, pp. 463-476; published in book form, Blackwell Publishers, 1997, pp. 47-60.

organization or a system of competing subcontractors or a system of franchised dealers. This emphasis on the concept of an organization as a network of operators in the criminal economy highlights the flexibility of this form of organization and its adaptability for those who adopt it, which is essential for dealing with the enforcement measures directed against them.

There are two major families of networks, whether criminal or otherwise, namely Anarrow networks that are driven by a high level of social capital⁷⁴ and Abroad networks with a low level of social capital⁷⁵. The term Asocial capital⁷⁵ denotes the economic benefits that accrue from social interactions of trust between the actors. This trust reduces transaction costs and enhances the capacity for collective action. Criminal networks would appear to fall rather into the former category. There is good reason to believe that law enforcement action encourages criminals to restrict their contacts to a small number of relatives or trustworthy friends. Within such a network, the level of trust is high and transaction costs are low but the narrowness of the network will ultimately be a barrier to the flow of information and to social mobility. Narrow networks in fact isolate individuals from the outside world. While they may facilitate their local establishment, they nevertheless hinder social mobility and the dissemination of ideas. In short, when the requirements for reasonably effective law enforcement action are met, crime cannot succeed in organizing itself in the general sense of the term. In such cases, organized crime will amount to nothing more than a cluster of highly compartmentalized networks.⁷⁶

The particular organization of the criminal milieu does not therefore conform to a principle of coordination that is sufficiently powerful to dictate the behaviour of the different participants. How then can the many producers, transporters, importers, sellers and buyersCnot to mention the vast number of intermediaries who are not subject to centralized, hierarchical control and are often unaware of each otherCachieve a level of coordination so that they successfully conduct their activities and at the same time evade enforcement action? Part of the answer lies in the very existence of the market: the decision making of a vast number of buyers and sellers is guided by information provided by prices. Admittedly, the functioning of the criminal market cannot in any way enable criminal entrepreneurs to make optimum decisions regarding the different possible uses of their resources. Nevertheless, controlled competition, inadequate information and fiercely guarded market access are characteristics which hamper the

⁷⁴In an area far removed from the economics of crime, Granovetter P. (1982), AThe Strength of Weak Ties: A Network Theory Revisited@ in *Social Structure and Network Analysis*, P. V. Marsden, N. Lins (eds.), Sage, Beverly Hills, shows that job hunting is easier when an individual has the benefit of an Aextended network@ composed of simple acquaintances and driven by a weak social tie than when he or she relies exclusively on a Anarrow network@ consisting of friends and relatives but driven by a strong social tie.

⁷⁵P. Collier; J. W. Gunning (1999), Explaining African Performance., *Journal of Economic Literature*, vol. XXXVII, March, pp. 64-111.

⁷⁶P. Tremblay; M. Cusson (1996), AMarchés criminels transnationaux et analyse stratégique@ in *La criminalité organisée*, M. Leclerc (ed.), La Documentation française; P. Kopp (1992), ALa structuration de l'offre de drogue en réseaux@, *Tiers-Monde*, No. 131, vol. XXXIII, July-September.

optimum allocation of resources by the criminal market. That does not necessarily mean that criminal activities do not generate profit. Indeed, despite the existence of these obstacles to optimum resource allocation in such a market, the anticipated gains constitute a powerful factor in encouraging the expansion of criminal activities.

However, because of its specific characteristics, the criminal market is diametrically opposed to the reassuring image of the traditional markets, where apparent disorder leads to a stable equilibrium. By contrast, the operating modalities of the criminal economy are constantly changing but do not reach a stable condition. The alternating movement and inertia of the criminal economy are the outcome of strategies which, although seen as rational by those who implement them, are still fraught with uncertainties due to unreliable information exchange and to sometimes irrational and often opportunistic behaviour. Despite those imperfections, the criminal market nevertheless performs its role somehow or other, which to guide and reconcile the decision-making of those operating within this black economy.