The macroeconomic impact of organised crime: A post-Keynesian analysis

Caterina Astarita, Carlo Capuano*, Francesco Purificato

University of Naples "Federico II", Italy

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ABSTRACT

The paper proposes an extended post-Keynesian model, where effective demand drives income levels and growth rates, to explain how organised crime affects the economy. In our set-up, some criminal activities, such as extortion, the criminal trade and corruption, reduce demand by draining resources from the legal sector; whereas others, such as money laundering, increase demand. The model determines under which conditions each effect prevails. Finally, we perform a simulation exercise that considers Italy, showing that the size of the criminal trade is so excessively large that organised crime impacts negatively on the Italian economy. In this context, we also provide several policy recommendations.

1. Introduction

Organised crime (OC) has a significant economic size: for 2006, Schneider (2010) provides a preliminary estimate of USD 790.0 billion for worldwide revenues attributed to criminal activity. In the context of supply side analysis, the empirical results seem to support the view that both crime and OC have an adverse impact on the level of economic activity and the growth process (Powell et al., 2010; Daniele, 2009).[1] According to Goulas and Zervoyianni (2015) and Daniele (2009), crime and OC can produce these negative effects through three main channels. The first channel is related to the lower capital productivity, due to decreased domestic savings and foreign investments; indeed, less secure property rights lead to a poor business climate, discouraging innovation and entrepreneurship. The second addresses a reallocation of public resources from growth-enhancing policies, related to education and infrastructure, to policies ensuring protection against crime. The third channel is connected to a lower labour supply in legal activities, given that individuals can choose to provide their services in illegal markets.

Despite its important contribution to understanding how OC distorts the allocation of factors, supply side analysis neglects the role of effective demand. Nevertheless, considering such a role carries a significant advantage, given that it is possible to disentangle the influence of OC on economic activity. The aim of the paper is to provide a theoretical framework that shows the mechanisms through which OC alters the economy within a post-Keynesian approach. According to Lavoie (2014), an essential presupposition of the post-Keynesian economics is the principle of effective demand, which states that the economy is demand-led both in the short run and in the long run; as a corollary, this implies that investment determines saving. It is worth noting that the choice of a post-Keynesian model is based on the fact that we aim to focus on the impact of OC on the demand side of an economy, rather than on the supply. Thus, we propose a theoretical model to explain the channels through which OC can affect the level of effective demand and, in turn, the level of economic activity and the growth process of an economy. The model contributes to the existing post-Keynesian literature by simultaneously studying the economic effects of extortion, the trade in criminal goods,[2] corruption and money laundering, in other words, the typical crimes that characterise the workings of criminal organisations, as identified by the literature (Fiorentini and Peltzman, 1995).

Concerning theoretical analysis, the post-Keynesian literature shows that OC can alter the equilibrium level of income, affecting effective demand and the Keynesian multiplier (Pressman, 2008). Reuter (1984) assumes an exogenous demand for illegal goods that reduces the demand for legal goods: as a result, it negatively affects the equilibrium level of income. Based on the contribution of Reuter (1984), a model by Centorrino and Signorino (Daniele, 2009) assumes

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[1] These findings appear to be sufficiently robust, even allowing for the following problems about the quality of data available: under-reporting, namely the tendency of victims not to report crimes to the competent authorities, and the non-uniform legal definitions of offences in different countries (Powell et al., 2010).

[2] The Organisation for Economic Cooperation and Development (OECD, 2002) suggests the following definitions of an illegal economy and an underground economy. The former comprises productive activities that generate goods and services completely prohibited by law or those performed by unauthorised producers; the latter concerns productive activities that, per se, are legal but are deliberately performed in violation of the legal framework to evade the charges related to the payment of taxes or that are necessary to comply with the provisions of the law. In our model, the expression 'criminal good' identifies a good traded by criminal organisations, which can fall into one of the two categories of the OECD definition.

the demand for illegal goods as a linear function of legal income to focus on three elements: first, the propensity to consume illegal goods out of legal disposable income; second, the capacity of OC to appropriate legal income through crimes such as extortion; and, third, its propensity to consume illegal goods out of illegal income. Despite the vague specification of the demand for illegal goods, the analysis shows that OC causes, in addition to a fall in the equilibrium level of income, a reduction in the Keynesian income multiplier. Moreover, this literature suggests that the lower the share of criminal revenues recycled in the legal sector is, the greater the negative influence of OC on the equilibrium level of income. Indeed, in the OC literature, Unger (2007) argues that money laundering can produce both a positive and a negative impact on the level of economic activity: the former concerns inflows of illegal funds into the legal sector, whereas the latter concerns all crimes generating illegal funds. Although the empirical evidence appears to detect an overall adverse effect, a theoretical framework for explaining all forms of influence that OC exerts on an economy through its typical crimes is still lacking.

The main contribution of this paper is to fill the gap within a post-Keynesian model. In this context, we implement the principle of effective demand through a standard neo-Kaleckian investment function, where investment decisions of firms depend on the level of economic activity.[3] Our theoretical framework gathers the effect of the four crimes attributed to OC: extortion, corruption of public officials, the trade in criminal goods and money laundering. The model explains how the workings of OC have, ex-ante, an undetermined effect on the level of economic activity and the growth process. Indeed, whereas it decreases demand by draining resources through extortion, corruption of public officials and the promotion of the consumption of criminal goods, it increases demand through money laundering when the recycled income is allocated to the consumption of legal goods and real investments in legal activities. The model identifies the analytical conditions for a negative or positive impact on the level of economic activity and the growth process. Finally, to provide an ex-post evaluation of these conditions, we consider Italy as a case study to which a simulation exercise is applied, concluding that the impact of criminal organisations on Italian economic performance is negative and mainly depends on the key role played by the trade in criminal goods and money laundering.

The remainder of this paper is organised as follows. Section 2 is devoted to explaining the concept of OC and the four types of crimes referred to in the model. Section 3 describes the analytical model and the relationship between legal income and criminal income, in addition to examining how the presence of OC affects the level of economic activity and the growth process. Section 4 presents a simulation exercise applied to Italy. Finally, Section 5 summarises the key findings and provides some policy recommendations.

2. The characteristics of organised crime

Many countries are plagued by criminal organisations, such as the Yakuza in Japan (Hill, 2003), 'La Cosa Nostra' in Sicily (Gambetta, 1993), the Russian Mafia since the collapse of the Soviet Union (Varese, 2001), and the drug cartels in Colombia (Levitt and Rubio, 2005). Although criminal organisations differ from each other with respect to their origins and social and economic characteristics, they share some common traits. Hence, based on the literature (Paoli, 2002), we define OC as a set of criminal organisations with the following specific traits:

✓ They tend to act in geographical areas characterised by an institutional vacuum with the aim of filling the gaps left by the legitimate authority in regulating relationships among individuals.
✓ They are involved in various activities, both economic and non-economic, both legal and illegal.
✓ They develop various structures to coordinate their affiliates.
✓ They use violence or the threat of violence to achieve their objectives.

The first two traits identify the activities performed by OC. The first defines the local dimension of OC: only where there is an institutional vacuum, OC finds fertile ground to develop, given that there is room for it to regulate individual relationships, including those related to property rights. When it is difficult to ensure the protection of property rights and contract enforcement, criminal organisations can provide protection services, acting as guarantor and mediator in highly uncertain transactions.[4] An institutional vacuum can be due to the state's being geographically, ethnically or socially distant from its population; to the occurrence of recent wars, uprisings and other political changes; or to the presence of widespread illegal activities (Kumar and Skaperdas, 2009). In this context, the same legal institutions sometimes use criminal organisations to retain indirect control over some regions.[5] The second trait defines the global and economic dimension of OC; according to Schelling (1971), territorial control is required for a criminal organisation to run its business. Criminal organisations perform many economic activities, some of which are illegal, such as the production and distribution of drugs and human trafficking. Overall, these activities sketch a picture of the international projection of OC (Fiorentini, 2000). The link between legal and illegal economic activities is represented by money laundering, through which OC employs the proceeds of crime in the legal economy, infiltrating mainly traditional manufacturing sectors dominated by small or medium-sized enterprises, low levels of technology and human capital, limited market competition and the strong presence of the public sector (Lavezzi, 2008).

The third and the fourth traits define the structure of and instruments used by OC to achieve its objectives, respectively. In terms of the structure concerned, OC employs hierarchical forms of coordination among its members, particularly when it performs activities aimed at regulating the relationships between individuals and establishing territorial control, whereas more flexible forms of organisation prevail for those activities considered more strictly profit-driven (Paoli, 2002; Morselli, 2014).[6] Among the tools used by OC to impose its authority, violence or the threat of violence is peculiar to such organisations. Schelling (1971) shows that violence is frequently associated with the adoption of hierarchical forms of coordination and the establishment of monopolistic or oligopolistic markets. Note that the first and the fourth traits underline the 'anti-state' nature of the OC: the state should be the only legitimate subject to regulate individual relationships, making use of violence, but criminal organisations aim to take its place in regions where they have strong local roots.

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[3] Within the post-Keynesian economics, we can distinguish five strands, which share the principle of effective demand but focus their analysis on specific themes: the fundamentalist Keynesians, the Kaldorians, the Kaleckians, the Sraffians and the Institutionalists (Lavoie, 2014). By assuming a neo-Kaleckian investment function, we can describe in a simple analytical way the role played by effective demand. However, we prefer to refer to our model as post-Keynesian instead of neo-Kaleckian: in fact, it does not consider others crucial elements of the neo-Kaleckian approach, such as, for instance, the assumption that prices are of the cost-plus type and depend on conventional forces instead of market forces (Lavoie, 2014).

[4] Varese (2001) explains the development of the Russian Mafia as a result of the climate of uncertainty and political weakness following the collapse of the Soviet Union, when many businessmen demanded criminal groups to provide protection. See also Dixit (2003).

[5] As reported by Hill (2003), in the early twentieth century in Japan, political leaders and businessmen demanded that criminal groups, belonging to the Yakuza, fight the threat of political radicalism.

[6] The United Nations Office on Drugs and Crime (UNODC, 2002) classifies 40 selected criminal organisations according to the forms of coordination: a rigid hierarchical structure prevails in Chinese and Eastern European organisations, whereas a network structure is detected for Mexican and Colombian cocaine cartels.