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# **Conceptualizing Organized Crime: A transaction cost approach to make-or-buy decision and corruption.**



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## **Executive Summary**

This chapter aims at theoretically addressing the role played by criminal organizations in fostering and/or governing corrupt exchanges. Apart from some noteworthy exceptions, organized crime remains a neglected concept in the study of political corruption. In order to fill this gap, the paper illustrates some empirical and methodological issues in the existing definitions of organized crime and political corruption. Empirically, there is in fact a difference between groups aiming at simply producing illegality through criminal transactions (such as corrupt exchanges), from groups seeking to govern the same transactions and the whole market through the provision of protection to both criminal and legal actors. Therefore, the paper presents an alternative conceptualization of the problem, departing from the “make-or-buy” decision that all corruption actors have to make in relation with protection. Drawn on transaction costs theory, the paper analyses the conditions under which some rudimentary hierarchical structure can govern corrupt transactions, addressing also the effect of temporality and path dependence upon stationary or predatory types of organized crime. On the theoretical side, the paper adds to the existing literature on political corruption, by introducing and studying the organization and governance of corrupt exchanges. On the empirical side, the conceptualization proposed in this paper have informed other empirical parts of the project, in particular, the research activities of WP9 (Organized crime and impact on vulnerable groups). The theoretical results of this paper are in fact used to disentangle empirically the mechanisms that link together organized crime with political corruption.

## Introduction

Literature on political corruption usually underestimates the role played by criminal organizations as makers and/or buyers of corruption and protection. Apart from some noteworthy exceptions (Gambetta, 1993; Della Porta & Vannucci, 1999; 2012; Hill, 2003; Varese, 2001; Gournev and Bezlov 2012), organized crime remains a neglected concept in the study of political corruption. Moreover, the increasing availability of data about this phenomenon around the world also makes the lack of theoretical frameworks even more remarkable. Most of the approaches have poorly developed a theoretical framework able to grasp the complexity of this relationship. Beyond major studies on Italy (Gambetta, 1993; Della Porta and Vannucci 1999, 2012; Paoli 2003), Bulgaria (Gournev and Bezlov 2012) and Mexico (Pimentel, 2000) few empirically based academic studies examine how traditional and non-traditional organized criminals interact with politicians and civil servants. This paper aims at theoretically addressing the role played by organized crime in fostering and/or governing illegal markets, effectively filling the theoretical gap in the literature. Transaction costs theory could be useful in understanding the specific contribution of criminal organizations, and especially how their presence can provide an infrastructure of governance to contracts. Empirically, there is in fact a difference between groups aiming at simply producing illegality in criminal markets (such as corrupt exchanges), from groups seeking to govern the same market through the provision of protection to both criminal and legal actors. Therefore, this paper aims at offering an alternative conceptualization of mafia-type criminal organizations. By doing this, it analyzes the conditions under which some rudimentary hierarchical structure more likely might govern also illegal transactions. In contrast with most dominant approaches, this theoretical frame decisively de-emphasizes the role of violence as a resource of disputes' settlement, by explaining, on the contrary, other enforcement mechanisms that can lead to *ex-post* regulation of transactions.

The paper is organized as follows. In the first section, we illustrate some methodological issues in the existing conceptualizations of organized crime and mafias. Then, we present an overview of new institutional approach to organization and crime. A new conceptualization of the varieties of criminal organizations is proposed in the following section, departing from the “make-or-buy” decision that these organizations have to make in relation with protection. In another section, we address the effect of path dependence upon stationary or predatory types of organized crime, followed by an analysis on the governance of corrupt exchanges. At the end, there is an overall evaluation of the benefits of a similar approach, and a brief assessment of policy implications.

## 1. Concept Stretching and Organized Crime: “The night in which all cows are black”

Organized crime, as many authors indicated, is an ambiguous and confused concept (Paoli, 2002). It has become commonplace to observe that there is no uniform understanding of it, not to speak of a generally accepted definition (Levi, 1998; Finckenaue, 2005; Varese, 2011). As a result of it, their utterances in everyday language have tended to be imprecise and detrimental to social and political researches, and thus we are left with an ambiguous, conflated concept, produced by a stratification of different meanings<sup>1</sup>. The literature has produced an endless list of definitions as a result of disciplinary, geographical, regional, cultural and legal differences<sup>2</sup>. This has progressively reinforced the idea that it is not possible to achieve a common conceptualization of the phenomenon (Allum and Siebert, 2003: 6). In most of the cases, in fact, the concept has developed inductively, through prototypical case studies, or the adoption of definitions taken from legal frameworks at national and international levels. Because of it, *uniqueness* is still a dominant conclusion in the studies on organized crime, not only in terms of theory – see the proliferation of approaches – but also in terms of empirical analysis due the supposed lack of comparability across cases. Without doubt, the phenomenon has multifunctional examples and a multifaceted nature: criminal, economic, ethno-cultural, and political ones. In organized crime, we can see at the same time the hunger for money and profits, the rhetoric of cultural and natural codes, the will to power. However, this is also true for most of the phenomena in social sciences. If we handle the problem by considering the methodological issues encountered in other fields of research – such as security studies, democratic theory or political mobilization – we would notice that there are no concepts in social sciences whose definitions have not been contested or considered ambiguous. Nonetheless, no one would question the comparability of democracy, for instance, as a concept able to travel across countries, even though many different measurement strategies have been proposed.

Therefore, on a methodological point of view, the most summary examination of the definitions suggested in the literature cannot but discover at least two main issues. First, there is a problem of the levels of abstraction. What are missing in the literature are middle-level categories to define the phenomenon (Sartori, 1971). By contrast, especially in the past, organized crime has been defined very narrowly. The net result has been that the gains in connotative precision have tent to be matched by losses in comparability. For instance, there was the idea in many approaches that

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<sup>1</sup> Paoli properly noted that the expression ‘organized crime’ has been used as an ‘ambiguous catchphrase’ (Paoli 2002: 51-52)

<sup>2</sup> As von Lampe pointed out “the multidisciplinary dimension has not necessarily ensured a high level of theoretical penetration of the objects of study” (von Lampe, 2006:77).

organized crime was dominated by a single and monolithic criminal organization made up of criminals sharing the same ethnicity – like in the case of the Italian mafias in the US. Even today, the category of monopoly is still considered a necessary condition in order to define an association of criminals as “organized”. However, by arguing that, we might confuse an outcome of the market/system – and thus the result of interactions between actors and structural conditions – with an intrinsic characteristic of single/collective actors. This has been a quite predictable outcome since simultaneously policy-makers were trying to design legal frameworks suitable to capture a hidden phenomenon for the first time in the history of crime. Consequentially, in many cases, scholars have been more interested in developing a legal taxonomy of organized crime, instead of explaining it in terms of behavior. By contrast, in more recent contributions we experience what is called a “concept stretching” (Sartori, 1970, 1984) problem. In the attempt to let the concept travel beyond the environments in which it has been originally formulated (primarily in the US and in Italy), the concept finally has accommodated broadly dissimilar cases, losing any analytical leverage. We see the routine inclusion of inappropriate cases into the same conceptual categories – such as the lack of distinction between provider of illegal goods and providers of contracts’ enforcement. Or, the extreme watering-down of the concept itself such that it no longer retains any real defining characteristics and ceased to reveal useful information about organized crime and its counterparts – like in the case of some all-encompassing concepts such as “global crime” or “state crime” (von Lampe, 2006)<sup>3</sup>.

Second, poorly developed concepts can also be the result of a selection problem concerning the unit of analysis. When we look at the actors, the literature often confuses single families with organizational orders between more groups. The result is that an independent group becomes a nation-wide conspiracy with wide and strong connections. In the same way, the hierarchical order within a group is taken, as there are also hierarchies between groups. This makes no sense when measuring the impact of groups in the respective limited areas/sectors in which they effectively operate. In addition, this state of equilibria are taken for granted, and presented as time-invariant orders, or, in some cases, as product of formal constitutions enforced by criminals. A similar problem occurs when we refer to the protection-extortion business. In this case, the literature has systematically conflated the market of the (illicit or licit) good being protected, with the market of protection itself (Gambetta 1993:19). On the contrary, any successful analysis must preserve a clear distinction between protected commodities and protection as a commodity (Gambetta 1993: 18-20).

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<sup>3</sup> In recent approaches, the term “encompasses such diverse phenomena as the whole illegal market, quasi-governmental criminal structures, corporate crime and state crime (von Lampe 2006: 77).

It is due to these ambiguities that the term still shows limited ability to explain or predict both variation in the organization of illegal markets and in the interplay with legitimate institutions and actors. Part of the problem has been the lack of cross-national analyses of criminal organizations, though some of the dilemmas that could emerge in cross-national comparisons would arise even in comparing organizations within the same country. What is needed is testing and refining the concept through comparison with other cases, but this is made more difficult by varied usage, including either too much vague or restrictive definition of the phenomenon. Therefore, the accumulation and comparison of cases represent a solution to expanding explanatory power of the concept we are in use.

## **2. Illegal Markets and the Informal Infrastructure of Governance**

Contracts and transactions are complex and unavoidably incomplete in the upper world. This condition is especially true also in instable environments – such as in illegal markets. As a result, the hypothesis that institutional environment closely determines the measure in which the agents are going to cooperate or, on the contrary, compete, is not valid only in the case of formal and legitimate forms of regulation but also in informal and illegal ones. With no doubt, producing illegality affects the way we make or sell both goods and services in the environments (Schelling, 1971; Reuter, 1983).

As proposed by the new institutionalism theory, any forms of economic, social or political interactions, in fact, need an institutional infrastructure of governance (Dixit, 2004:1-2). Any kind of agents may find it beneficial to engage in behavior that is “privately profitable but socially dysfunctional”, or that are simply “dysfunctional” for the system. Like in the upper world, extensive arrangements fundamentally shape the incentives and resources of criminal actors, and the implementation of certain type of “informal” institutions can help actors overcome various dilemmas arising from collective choice situations – especially the need to coordinate their behavior by disciplining expectations about the behavior of others. Some conducts need to be deterred too, because, otherwise, they would negatively affect the incentives to produce and exchange valuable goods and services. In criminal contexts, informal rules are both weakly enforceable and poorly institutionalized (Reuter, 1983). By contrast, in the legitimate world, the law provided by the State should usually do the job. When rules are enforced, thieves are prosecuted and contracts are guaranteed, etc. The State provides the legal framework in which all activities take place, though it faces high costs to enforce this framework. However, as suggested by new institutionalism, it is not

only the State facing the cost of transactions. More generally, any organization, both internal and external, imposes costs because in reality contracts are complex and thus incomplete. This applies to written contracts, but also to relational and to implicit contracts (Klein, 2008). Consequently, in every institutional environment agents are exposed to risks because circumstances may change unexpectedly the negotiated conditions, and partners can fail in adapting to such changes. These are what Williamson (1991) calls as “maladaptation costs”. According to the economist, contractual difficulties can arise from several sources: “(1) bilateral dependence; (2) weak property rights; (3) measurement difficulties and/or oversearching; (4) intertemporal issues that can take the form of disequilibrium contracting, real time responsiveness, long latency and strategic abuse; and (5) weaknesses in the institutional environment” (Williamson, 1996 : 14). All actors aim at reducing these costs, by adopting an appropriate governance structure with the particular characteristics of the transaction. Therefore, markets as form of institution exist beyond the operating independent agents, because an underpinning infrastructure of governance operates also in illegal contexts (Varese, 2010). In fact, even when “standard” features of the state are absent, alternative institutions for governance emerge. The explanation can reside in the different costs: building up from scratch, or modifying state institutions may be costly, other alternatives may cost less. The issue is whether these alternative institutional arrangements are widely effective, in which conditions, and in which span of time. More than in legal transactions, opportunism is a crucial problem in illegal contracts, and several conditions weaken cooperation favoring opportunistic behaviors. First, in illegal agreements there is a low degree of *ex-ante* definition of property rights. Second, agents have no possibility of *ex-post* regulations of disputes, and to recourse to the law to ask for their settlement. There are no possibilities for using “legal” authority to enhance asymmetries of power, that at the end are the result of the changeable balancing of power among the actors. Spontaneous and conventional enforcement mechanisms can emerge – such as change of partners, reiteration moved by loyalty or embeddedness, diversification of exchanges over time – but these mechanisms would not tackle the uncertainty caused by the lack of ultimate forms of punishment. Third, under incomplete information, conventional mechanisms of disputes’ settlement have less chances of success. Agents have not the possibility to collect freely and openly missing information, filling the gap of asymmetric and incomplete information, thus, they have fewer opportunities to minimize *ex-ante* transactions costs by themselves. Especially in illegal markets, information is limited and the same agents deliberately block and manipulate its circulation in order to reduce competition or to escape from law-enforcement and seizure. Therefore, when workable arrangements and good order about *ex-ante* property rights cannot be easily achieved, a demand of *ex-post* mechanisms of enforcement would gain ground on the market. However, it is not merely a problem of disputes’

settlement, but as Williamson suggests “the object is not mainly to resolve conflict in progress but also to recognize potential conflicts in advance and devise governance structures that forestall or alternate it” (Williamson, 1985:23). Forth, foreseeing conflicts is especially required in illegal markets, where the precariousness of order and structures is often a consequence of exogenous shocks from external players (such as law-enforcement actors).

This approach to analyze persistence and change in both formal and informal institutions, gives a crucial insight into the world of illegal transactions, and moves towards a more concrete explanation of the contribution that each agents can give to the establishing and institutionalization of governance structure also in illegal markets. What clearly emerges is that there are actors not able to enforce and protect their transactions by themselves, and are forced to ask for this service on the market. On the hand, there might be some actors carrying out these activities of protection, that can enforce some forms of governance designed to drop the costs of internal organization, and, sometimes also, those external costs fueled by the market. These differences within the same environment can lead to the formation of hierarchies among actors, which finally order and rule illegal transactions, but also those that are informal or legitimate. Based on this assumption, we can thus propose some categories that help us in differentiate criminal organizations from mafia-type ones, anarchic forms of governance from stationary and enduring ones.

### **3. Conceptualizing Mafias: “make-or-buy” decision and governance**

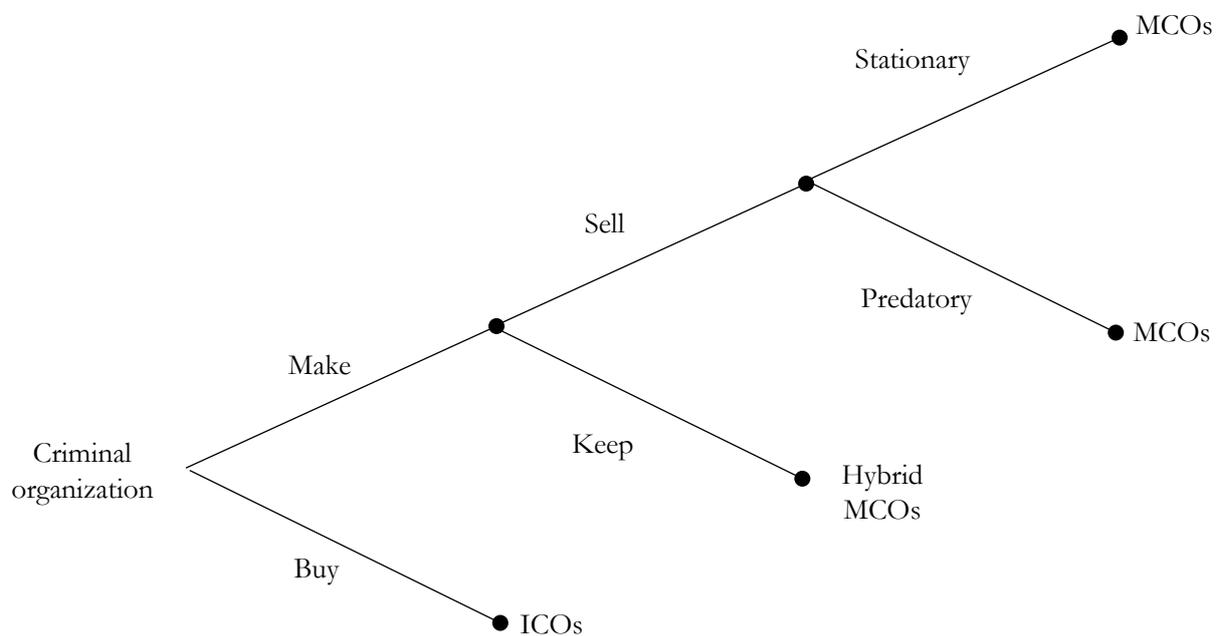
Some type of crimes are intrinsically linked to the idea of organization. If a crime is committed by an individual or by a criminal network depends in part upon the nature of the crime. Certain crimes literally cannot be committed by persons acting alone because of their complexity, interactive and multi-faceted nature. Whether a group or an individual can produce certain illegal goods or services is also dependent upon the nature of the situation and the availability of partners. Therefore, the characteristics of certain sectors in informal or illegal environments lead to more or less organized production modalities that means that agents involved into that network go beyond a single or limited criminal opportunity and actually organize themselves to continue to produce certain illegal commodities in a durable way. Organizations can have more or fewer of these characteristics, but criminal networks that are totally or even substantially lacking in them, should not be considered true independent criminal organizations (ICOs)<sup>4</sup>. In this section, we try to capture

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<sup>4</sup> In simple, crimes “that are organized” cannot be considered as being the same thing as organized crime. As a matter of fact, in many cases, corrupt exchanges are certainly organized and see the involvement of a networks of actors, but in many cases these are not committed by a single and enduring criminal organization. When this happens, an organization with some specific characteristics would emerge.

the varieties of these organizations, by singling out some abstract categories able to grasp the complexity of this phenomenon. By doing this, we answer to a research question traditionally developed in institutional economics. In particular, we question why independent criminal groups should make its own inputs concerning the protection of transactions, they should buy them on the spot market, or they should maintain an ongoing relationship with a particular supplier. As argued by some authors, we believe that “firm boundaries depend not only on technology, but also on organizational considerations; that is, on the costs and benefits of various contracting alternatives” (Klein, 2008:436).

Figure 1. Conceptualization of Organized Crime



*Independent Criminal Organizations: better to buy than to make...*

The initial divide is between independent organized criminals and mafia-type criminal organizations. The obvious transaction with which to begin is the “make-or-buy” decision upon protection. Not all organized nor independent agents have the capacity to protect themselves and their transactions on the market, or, in other words, to succeed in eliminating competition from

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Following Finckenauer (2005, pp. 67-70), criminal organizations, in fact, can be envisioned as being arrayed across a spectrum based upon having a greater or lesser degree of the following features: (a) Criminal sophistication, and in particular the degree of planning is used in carrying out crimes. The persistence across time of these illegal activities and skill and knowledge required in carrying out these crimes; (b) Structure, in regard to the existence of a division of labor with clearly defined lines of authority and leadership roles, and if this structure maintains itself over time and over crimes; (c) Self-identification, thus the participants in criminal activities see themselves as being members of a defined organization, relying on some specific type of bonding, such as the use of initiation rites, tattoos, blood ties.

others, or to enforce the deals contracted by doing business. As presented above, opportunistic behaviors are favored in this environment and cheating might not encounter in any forms of sanction. Although violence is not the only resource could be used to enforce transactions, however, not all agents are willing and have the capacity to use it in a way to punish opportunism.

Therefore, for some agents it is more advantageous to buy protection services rather than to make them by themselves. An ICO “attempts to regulate and control the production and distribution of a given commodity or service unlawfully”, as stated by Schelling (1971 : 179). For instance, a political corrupt network may seek to extract and allocate political rents, but do not have the capacity to govern it over time. Such an aspiration requires investments in a special set of resources, which are not necessarily available to illegal entrepreneurs. Nonetheless, they remain independent from those organizations providing protection, and do not belong to them though they benefit from it. However, in real-world, this demand of protection or informal governance does not always meets a supply. Establishing a reputation of protection provider is not an easy task for any agents. Although collectivity in a market gains an advantage from the presence of alternative forms of governance that drop transactions cost – as explained in Buchanan’s paradox – however, independent criminals would see increased their costs in producing illegality due the presence of an informal taxing authority (Schelling, 1971). In the absence of alternative sources of protection, agents normally face the risks of contracts breach or of state’s seizure, with no other exits. Then, what is interesting to know is why some criminal groups choose a vertically integrated structure, while others specialize in one stage of production of illegal goods or services and outsource protection and contracts enforcement. They can outsource to another group, a mafia-type one, or, when, as most of the cases, a single supplier does not exist, limit the risks outsourcing services to many third-part enforcers.

#### *Hybrid Mafioso Criminal Organizations: self-protection but not provision*

Conversely, they are organizations that pursue a “make decision” upon protection, internalizing the costs to achieve it. As we know, in fact, the autonomous search for protection – i.e. the goal to drop transactions costs without relying on the market – requires the control of critical resources whose combination permits the self-enforcement of transactions. Reputation, information, intelligence and violence are the main resources singled out by Gambetta when he explains the modalities of producing protection. All these resources constitute a sort of production costs for those organizations facing a problem of protection of their own transactions. The access to these resources has different modalities. Certainly, producers of illegal goods and services at large-scale

have more opportunities to afford the costs of producing protection, to the point to decide the internalization of such costs, especially when they realize that their transaction cost level would go down, gaining an absolute cost advantage in comparison with ordinary criminals and competitors. In effect, protection means also control of competition, hence the capacity to limit the entrance of new agents by placing various barriers. For example, by minimizing transaction costs they have more chances in dropping the prices to prevent the entry of potential competitors to the market, or, if they also decide to sell this protection to other agents, to benefit from the economies of scale that accompany this business. However, as suggested by organizational theory, there are also some organization costs that cannot be ignored before taking a “make decision”<sup>5</sup>. Internalization brings other kinds of costs, namely problems of information flow, incentives, monitoring, and performance evaluation. The capacity to afford these costs without outsourcing protection sets a crucial distinction among the agents operating in the same environment. At this stage, protection can also be measured in terms of self-governance, thus the power to enforce and regulate contracts within the same organization<sup>6</sup>. Setting *ex-ante* regulations for the members, monitoring their conducts, disputes’ settlement and rents distribution are primary examples of self-ruling governance of transactions. In illegal environments, this means that before providing this commodity to others, the organization should be able to protect its own members from law-enforcement and competitors, by internalizing the resources and activities needed for it. Literature often underestimates internal transaction costs, by emphasizing only external ones. Especially in illegal markets, the costs of transacting business, i.e. discovering the relevant partners, negotiating and enforcing contracts, should also include the costs of internal organization and coordination (Dick 1995)<sup>7</sup>.

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<sup>5</sup> More recently Dick (1995) has developed a framework to analyze the issue of the vertical integration in different institutional settings. In particular, Dick focuses on the illegal firms’ choice between buying protection from a specialized organization and producing it internally. To investigate such issue, Dick suggests an decomposing the total transaction costs between production and organizational costs. Production costs are typically lower in a specialized organization due to economies of scale and scope and would call for market supply by a non-integrated producer. On the contrary, the organizational costs to coordinate inputs in specific uses and to adjust to unforeseen contingencies are lower in an integrated structure because of the high specificity of the assets involved

<sup>6</sup> “An agent who serves only one buyer depends totally on that buyer. In an extreme case the agent may be just an employee. [...] Protection in this case is internalized within the buyer’s firm and kept under his control (in the extreme case it is “internalized” in the buyer himself, who provides his own protection directly without paying for anyone else’s services.)” (Gambetta, 1993: 85)

<sup>7</sup> In the same way, as any other organizations in society, criminal groups are based on a set of agency relationships. Any organization faces problems of asymmetric information, imperfect monitoring and opportunistic behavior, although such problems are pervasive in the underworld. The relevance of these agency problems also explain why large criminal organizations are not such a natural outcome also in illegal markets. Only a limited criminal family can shorten the agency chain, dropping the costs and risks of organizing activities. If agency problems, in fact, already negatively affect the underworld, where legitimate and more less effective enforcement mechanisms have been set up, in the underworld these problems are

*Mafioso Criminal Organizations: to sell is better than only to make...*

To sum up, in Figure 1 we can distinguish at least three different modalities of organizing transactions. First, independent agents (ICOs) that rely on the market to regulate transactions and look for alternative form of governance (a group in the gambling sector demanding protection from other criminals, for instance). Second, there are agents that find more convenient to protect themselves without asking for the help of the market. A large drugs cartel has the resources, on one hand, to capture policy-makers or law-enforcement agents to gain immunity for its activities, and, on the other one, to enforce deals with business partners against potential desertion or breaches of contracts. This agent can be considered a hybrid mafia type organization, because it is not imposing itself yet as a provider of protection services for those who demand it on the market. By contrast, this occurs in the case of a mafia-type organization. In his compelling study, Gambetta clearly points out the peculiar characteristics of mafiosi. He says that: “Mafiosi may sometimes be dealers in a variety of commodities both legal and illegal [...] but this is not the *differentia specifica* separating mafiosi from ordinary entrepreneurs. Mafiosi are first and foremost entrepreneurs in one particular commodity – protection – and this is what distinguishes them from simple criminals, simple entrepreneurs, or criminal entrepreneurs (Gambetta 1993: 19). The choice to sell the same protection to other independent agents is not consequential, but it depends primarily on the ability to fulfil the “make decision” goal. Internal organization also affects this process, because goods and services traded in market are previously produced within a firm (Williamson 2008:50). The provision on the market, in fact, requires the power to protect independent agents from other providers, taking Schelling’s words “against the one who offers it, [...] against rival taxing authorities” (Schelling 1971: 185)<sup>8</sup>. The presence of a market – that agents can also contribute to create – opens new opportunities for agents to move from “make” to “sell” decision<sup>9</sup>. Since there is

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even more critical. Because of it, criminal organizations are localized, relatively small, unable to control members perfectly, and forced to rely on different resources in order to govern interactions (Varese 2011:3).

<sup>8</sup> “Criminal monopoly means the use of criminal means to destroy competition. Whether competitor is actually destroyed or merely threatened with violence to make him go out of business, the object is to get protection from competition when the law will not provide it and when it cannot be legally achieved” (Kopp, 2003:63).

<sup>9</sup> Protection means several activities. For instance, scholars have established that mafia-type criminal organizations are able to supply genuine services like protection against extortion; protection against theft and police harassment; protection in relation to credit obtained informally and the retrieval of loans; and the settlement of a variety of social disputes. The Mafia offers protection services to entrepreneurs of illegal commodities, such as protection for thieves, prostitutes, loan sharks and drug dealers. Mafiosi also protect their clients against law enforcement, or enforce illegal agreements and deals among corrupt actors (see Varese 2011 for a more detailed review).

a voluntary demand for these services, the coercive elements in the relations between organized crime and illegal firms are in its need to use violence occasionally to preserve its reputation as an authority to solve disputes or to enforce contracts<sup>10</sup>. This change is clearly described by Gambetta (1993) in his attempt to analytically distinguish mafiosi from independent criminals.

If the agent is to become independent, the number of clients must be greater than one, and ultimately numerous enough so that no individual buyer is essential for business to succeed. It is better still if there is a variety of customers so the agent can avoid depending on any one type of buyer; his protection then becomes abstract currency, a credible commodity in more than one area” (Gambetta, 1993 : 85).

As soon as an organization establishes itself as a protection provider, it starts aspiring “to govern transactions in the underworld by providing services of dispute settlement, cartel enforcement and more generally governance of illegal transactions” (Varese 2011:12). Along this line, Gambetta (1993) builds on Schelling’s intuition and argues that organized crime operates as a governance structure mostly addressed to the underworld so that its activities cannot be reduced to the supply of illegal goods. A mafia group can be directly involved in some stages of production and distribution of illegal goods and services, as any other illegal firms (Varese 2011). However, the distinguishing feature of mafia-type organizations is to perform some activities typical of a governmental authority: maintaining peace, setting rules, arbitrating disputes, enforcing discipline, providing protection (Schelling (1971)). In a ladder of abstraction, a mafia group would be a sub-type of independent criminal organization that attempts to control both internal and external costs in the supply of protection. By giving this definition, we base the primary category of mafia-type organization on the role/activities effectively carried out by a group, and not on the existence of any specific internal and vertical integration of functions. Nonetheless, we assume that the organizational methods of supplying an infrastructure of governance determine the conditions under which protection is guaranteed, the degree of intimidation and violence on the underworld, and the influence of criminal organizations. Each of the supplier groups adopt different strategies of internalization, pursuing different goals in terms of vertical integration. However, some organizational modalities of transactions are needed in order to internalize both internal and external protection costs, and then to play a regulatory role in the market. With no doubt, the organization would benefit from economies of scale. In a way, it can drop some costs in the provision of some activities that are crucial both for its internal and external governance. Violence is a costly resource for criminal organizations, though criminals are not always considered risk-

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<sup>10</sup> The main reference is Gambetta (1993). When agents engage in: “unstable transactions in which trust is scarce and fragile” (Gambetta 1993, p. 17), they are not protected. A *mafioso* can sell protection to one party, or to both in exchange of a fee, making the transaction possible. The idea is that he offers a guarantee. The difference with respect to simple intermediaries, is that the latter do not use violence. Selling protection, as remarked, implies the possession of violence (force) among the resources of the protector.

adverse actors. On the contrary, by constraining violence, a mafia drops one of their most important “external costs”, especially when this group is able to internalize rivals or competitors within the same organizational boundaries, and to institutionalize and restraining violence through internal procedures and hierarchies. Lobbying and corruption also benefit from economy of scale. Independent criminals can probably afford the costs of corrupting a single law-enforcement agent, but they cannot cultivate at the same time relations with more hierarchical structure – such the senior management or policy-makers. By contrast, mafia-type organizations can establish corrupt exchanges with both political actors and administration based also on reciprocity: mafiosi can protect corrupt exchanges between politics and business both in electoral markets and policy-making, getting back money and lenience on enforcement and legislation. Therefore, there are more advantages for independent criminals to turn to the services of a larger organization than to produce the “corruption” input themselves (Kopp 2003:35-37). As a result of it, we can say that certain mafia-type organization may aspire to proceed to vertical integration, by bringing within their network a number of agents sufficient to dropping external costs and providing protection at larger scale. Whether or not an organization is able to pursue this strategy determines a further distinction between those organizations that become stationary from those that shift to a more predatory strategy. In the next section, we explain the difference between the two categories.

#### **4. Path Dependence, Protection and Market: stationary vs roving bandits**

Different infrastructures of governance created by mafia-type organization can exist. First, transactions can take place within a hierarchical or an anarchic market. Not all MCOs, in fact, share the same organizational arrangements to govern first their own members and then the environment in which they operate. Especially in illegal markets where interdependence is high and risky, new informal institutions are costly to create and often generate learning effects, coordination effects, and adaptive expectations without violent response.

Marcus Olson uses a ‘criminal metaphor’ to set a distinction between stationary and roving bandits. Those in power in a certain domain, in fact, can be moved by a ‘narrow interest’ (self-interest) or an ‘encompassing’ one. Individual criminals differ from a mafia family in the way they control a community. The individual thief gets very little from the gains of that society and has a limited control upon his self-interest. Whereas, the mafia family, which gets a major share from the income of society monopolizes crime in that community and develops a moderate encompassing interest or stake in the overall income of the community. Based on this difference, a ‘roving bandit’

(under anarchy) has an incentive only to steal and destroy. A predatory organization is aware that even cultivating the market can be risky because opportunistic competitors might take advantage of the market he creates. Therefore, they don't aim to pursue a long investment in cultivating a consumer interest, or, as a result of it, a relation with the political elites. By contrast, a 'stationary bandit' has an incentive to encourage a degree of economic success, since he will expect to be in power long enough to take a share of it. The stationary bandit thereby takes on the primordial function of government – protection of his citizens and property against roving bandits.

“Under anarchy, uncoordinated competitive theft by “roving bandits” destroys the incentive to invest and produce, leaving little for either the population or the bandits. Both can be better off if a bandit sets himself up as a dictator – a “stationary bandit” who monopolizes and rationalizes theft in the form of taxes” (Olson, 1993: 567).

In other words, a stationary bandit seeks to achieve a dominant position in the underworld itself, participating in its governing. In this sense, a similar organization contributes to establish a governmental structure into the underworld, helping to maintain peace, setting rules, arbitrating disputes, and enforcing discipline (Kopp 2003:67). Two important mechanisms can explain the “institutionalization” of certain infrastructure of governance ordered by mafia-type groups: path dependence and territory.

Issues of territory and temporality are at the hearth of the analysis of mafias' organizations. Conversely, many approaches in the literature still underestimate or neglect their relevance. However, if path dependence arguments are appropriate and crucial in many political phenomena, these arguments certainly shake previous explanations of behavior in criminal world. As opposed to other circumstances when they are absent, mafias set up the conditions for a regulation of transactions grounded in a dynamic of “increasing returns”. It means that in a similar context the “costs of switching from one alternative to another, increases markedly over time”, because “the relative benefits of the current activity compared with other possible options increase over time” (Pierson, 2000: 251-252). In the underworld, the assumption that “once a state has started down a track, the cost of reversal are very high. There will be other choice points, but the entrenchments of certain institutional arrangements obstruct an easy reversal of the initial choice” is even more valuable (Levi 1997, 28).

As presented in the previous sections, higher transaction costs make illegal and informal markets much more instable and mutable than institutional arenas. These factors would lead to the conclusion that increasing returns are less likely to occur in the underworld. However, different starting conditions can also lead to similar dynamics of increasing returns, especially in the presence of strong efficiency-enhancing mechanisms of competition and learning. MCOs are an example of it. Coordination among actors can change the path of crimes' organization, resembling

collective action processes and problems. In places where effective mafia-type organizations operate, observers would be struck by the considerable stability of patterns of these groups over time. Therefore, in places where these type of organizations emerged independently from a specific demand of protection, the governance of illegal markets cannot be easily avoided over time. Some key historical junctures or exogenous conditions might lead to the emergence of mafias<sup>11</sup>. Once these organizations have surmounted initial start-up costs (the presence of competitors and alternative legal commodity) and fueled processes of adaptive expectations, these are reproduced through time, “freezing” the criminal markets. The long and enduring presence of criminal organizations in many countries around the world gives support to the hypothesis that “organizations have a strong tendency to persist once they are institutionalized” despite massive social, economic, and political changes over time. Dealing with organizations, and not only with diffuse networks, we can also observe in the case of mafia-type groups self-reinforcing dynamics associated with collective action processes. Data on criminal groups in Italy, or the same in US, give strong evidence of the organizational persistence that can result from positive feedbacks also in the underworld. In other words, as organizations, mafia have a life of their own, and want to become and remain durable institutions (Selznick, 1950: 10), benefiting from path dependent forces. Because of it, the institutionalization of mafia-type organizations induces self-reinforcing processes that makes reversals of course increasingly unattractive over time (North, 1990). This is particularly true, especially in the case of MCOs, when certain actors are in a position to impose rules on others, and the employment of power may be self-reinforcing (Mahoney, 1999), Actors may use criminal authority to generate changes in the informal rules of the game designed to enhance their power. Disparities in resources among contending members remain stable over time as positive feedback sets in, though the overall impact upon the reality outside the organization is negative. Douglas North gives a general explanation about the persistence of these equilibria:

“Unproductive paths persist ... The increasing returns characteristics of an initial set of institutions that provide disincentives to productive activity will create organizations and interest groups with a stake in existing constraints. They will shape the polity in their interests. Such institutions ...provide few rewards from increases in the stock and dissemination of economically useful knowledge. The subjective mental constructs of the participants will evolve an ideology that not only rationalizes the society’s structure but accounts for its poor performance. As a result the economy will evolve policies that reinforce the existing incentives and organizations.” (North 1990, p. 99)

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<sup>11</sup> A large literature has scrutinized this puzzle, especially in the political economy literature. Scholars have addressed several hypotheses from different approaches, but only few empirical works have tried to control for them (Bandiera, 2003). Most of the studies, in fact, have preferred explanations at macro-level, without profiting from the variation existing both across space and over time. More recently, other approaches have accounted for this variation, offering more plausible model of analysis. Following Sung (2004) and Skaperdas (2000), we can group the causes within five main sources of change: 1. institutional/political changes and crises; 2. economic conditions and changes; 3. geography; 4. state regulation and policy changes; 5. ethnic and social distance.

In the case of stationary MCOs, two crucial mechanisms deserve more attention: bureaucratic distortions and mechanisms, and second, the territorial dimension. Certain organizational arrangements may encourage groups to deepen and foster relationships with individuals of the same groups and/or with other organizations, also by relying on biological and familiar ties (such as blood ties). The strategy to overlap criminal and blood family in many criminal organizations clearly shows the interest in preserving a certain criminal order, which means reinforcing coordination and adaptive expectations within and among groups. Those who design the organizations in such a way may wish to bind their criminal successors and internal competitors. More than in the upper world, criminal actors must anticipate that their criminal rivals may soon control their reins of government. To protect themselves, they may create rules that make preexisting arrangements hard to reverse. In doing that, criminals also want to bind themselves. To constrain themselves and their most favored friends, criminals create large obstacles to institutional changes. These obstacles facilitate forms of cooperation and transaction that would be too costly otherwise. To avoid anarchy, existing organizational rules increase the attractiveness of existing institutional arrangements relative to hypothetical alternatives. “As social actors make commitments based on existing institutions and policies, their cost of exit from established arrangements generally rises dramatically” (North, 1990; Pierson, 2000). For instance, above all organizational arrangements in mafias, exit is not an option available for “made” members. Defection is paid with the life. By no coincidence, the strongest sanction ever in human behavior is preferred.

Second, stationary mafia organizations are associated with groups having specific areas under control in which generally they have sole operating authority or in an oligopoly situation. In some cases, in fact, they are basically territorial groups, providing an infrastructure of governance for all those transactions occurring in the same area – as opposed to groups controlling and ordering transactions in a limited sector, such as, for instance, the construction building. Rooted in a territory, these organizations can reduce some internal and external transaction costs that can critically endanger the continuity of governance. Organizations can easily monitor their own members, controlling for any initiatives against the leadership, but also their clients/victims whose activities are necessarily located on their territories. Monitoring costs for enforcement are then drastically dropped. Second, limited small-areas also facilitate the putting into place of alternative systems of governance among mafia-type groups, by simplifying the complexity of contracts and especially the allocation of *ex-ante* property rights. Territories are then regulative tools that order mafia groups’ relationships and limit the use of violence to settle disputes. Moreover, territorial anchoring favors economy of scale, and, more importantly, vertical integrations with the political

and institutional sphere. As a matter of facts, electoral politics is territorial as well. Registration and voting process generally depend on where voters live. As a result of it, these organizations can use a variegated menu of electoral manipulation consisting of several alternatives for controlling voters, more than the mere use of intimidation and force (Schedler, 2002). They can then help favored politicians in retaining political support by voters. Thanks to territories, stationary organizations can better “rationalize thief”, but also rationalize their own internal arrangements.

### **3. Organized Crime-Corruption nexus: a transaction cost perspective**

In borrowing from Oliver Williamson (1985), some authors argue that in illegal markets just as in legal markets it is a question of relative costs whether a transaction is market-based or occurs within the framework of an organization (Andersen, 1995; Fiorentini and Speltzman, 1995). They further argue that the factors determining transaction costs in the legal sphere are also decisive in an illegal setting, these being bounded rationality, opportunism and asset specificity (Smith, 1994). When the parties of a transaction operate under conditions of uncertainty, when they are prone to self-interest seeking with guile, and when they are making investments that cannot be easily redeployed to other purposes some form of organization is inevitable (Smith, 1994: 135). In particular, if we consider corruption, transaction costs are crucial.

“Transaction costs of corrupt agreements differ from those of legal deals because there is a need to camouflage and because partners to such a deal end up with potentially damaging information about each other. For these reasons, corrupt agreements are more likely to employ middlemen or result as a by-product of legal exchange and social structures.” (Lambsdorff 2002, pp. 221-222)

Lambsdorff (2002) defines at least three different types of transaction costs in corrupt exchanges: the costs of searching for partners, the setting up of contract conditions, and the enforcement of contract terms. As in many other illegal exchanges, corruption deserves an infrastructure of governance to control for these costs. MCOs are particularly efficient in providing the necessary services to reduce uncertainty among corrupt actors. In some noteworthy studies the contribution of middle-men in corrupt exchanges has already been analyzed (Lambsdorff 1999, 2002; della Porta and Vanucci 1999, 2012; Rose-Ackerman 1999, pp. 91–110). We can thus summarize MOCs’ contribution to corruption stability in three main factors: (1) they can reduce the costs of seeking partners because they have and provide information with respect to the capability of potential partners of the corrupt network; (2) they can drop the costs of determining contract conditions, by monitoring the negotiation about corrupt agreements among actors, by increasing trust among corrupt agents, and, in case, by forcing reaching some contract dealings among the actor; (3) in

corrupt networks there is again the problem of enforcing deals and promises among criminals in the absence of third-party enforcers. In the literature scholars have proposed different solution paths for this problem. An appropriate punishment can be inflicted so as to reduce future payoffs of any defector (and transmitting information on such defectors) in bilateral continuing relationships and within the context of small groups. Punishment takes the form of refusing future interaction. A minimum of collective action is then required to ensure that information on cheats flows to others in the group. However, MOCs might be more effective in favoring the enforcement of corrupt agreements using several resources. They offer to enforce the corrupt agreement, thereby deterring actors from cheating on the deal. They do not only punish defection with violence, but are also able to monitor compliance in networks that include a large number of actors (Vannucci, 2013). The efficacy in enforcing the agreement is mainly based on other conventional resources: such as the reputation established within and outside of illegal markets; the territorial presence in the same area for a long span of time, which favor repetition of corrupt exchanges and also stronger social relationships which increase the advantages to be gained in the long run from profiting from opportunistic behavior; by vertically integrating either with politicians or with private entrepreneurs.

Nevertheless, what is important to emphasize, here, is that corrupt networks might implement forms of governance not necessarily based on the intermediation and enforcement of MOCs. As stated above, we can also find ICOs which simply organized the exchanges among corrupt actors replacing in a certain way the role played by MOCs. There has been evidence of party organizations that at local level have created structured system of corrupt exchanges, mainly based on conventional resources of enforcement of such agreements (Della Porta & Vannucci, 1999; 2012), whereby some individual actors were in charge of monitoring the system, enforce the agreements and settle the disputes. However, as argued in the previous section, MOCs' governance would differ not only in terms of the different inputs they can put into the system (violence among all), but also for the expectations they raise in other actors and for the overall longer stability of the networks. As a matter of fact, not all corrupt networks are under the governance of MOCs, even in those areas where these organizations operate. The transaction costs' theory can help in predicting the intervention of MOCs in these exchanges, and thus in explaining the variation in mafias' presence into corrupt networks. Here we analyze the vulnerabilities linked to the economic and institutional settings of policy of interest, and how they impact the potential intervention of MOCs.

#### *Vulnerability of Corrupt Networks to Mafia Intrusion*

Different policy decisions create different incentives and mechanisms of rents' extraction and allocation amongst the actors. Source of variation is not only the policy sector and its characteristics, but also who are the recipients of such policy decisions (in other words are they targetable or not?). Following the characteristics that make a firm more likely to become victim of extortion, we can think about those that make a corrupt network more likely to be protected by criminal organizations. Some of the arguments are related to legal and institutional actors, others related to illegal ones that can be relevant for legal activities as well. Following Fiorentini (2000), we can argue that the probability of mafias' enforcement is higher:

1. the higher the difficulty of obtaining protection from others organizations or institutions, as is the case of firms operating in areas in which weak party organizations operate or other type of corrupt enforcers are lacking. In this case mafia's intrusion can also occur when transactions are still legal, though carried out through informal and unfair practices. The overall actors' perception about the "rule of law" in the country – "the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, the police, and the courts, as well as the likelihood of crime and violence" ( Kaufman et al., 2006: 4) – is a good predictor of the demand alternative source of transactions' enforcement. In the case of Italy, for instance, World Bank Indicators place the country at the seventy fourth position in the world. In addition to that, if transactions are purely illegal, as already remarked, both payers and takers bribes, e. g., other "criminals", cannot obtain protection by the State or any other legal institution;

2. the higher the observability of output and profits, which makes more difficult for the actors involved in the corrupt network to hide these magnitudes and potentially escape from the payment of protection money. Thomas Schelling (1971: 187) makes the example of the bookmaker. A bookmaker must be visible to attract customers. Being visible makes it difficult for him to hide from mafia intrusion. In addition, the activity of the bookmaker is simple and easy to monitor. The same can be argued for those policy decisions that determine the allocation of a great amount of political rents. Big public contracts and tendering, or those companies operating, for instance, in "protected markets" – such as those depending on public transfer and spending – cannot easily hide their position in these markets and especially rents extracted through corruption exchanges;

3. the higher the territorial specificity of policy intervention, given the importance of control on territorial basis typically exerted by criminal organizations, and, the difficulties in carrying away the policy intervention "in an attempt to escape extortion" (Schelling 1971:187). Most of policy decisions apply to targetable places – as in the case of those economic activities in need of "a place of business" (Schelling 1971: 187) – because are designed to affect some specific locations that deserve the attention of policy-makers. This is the case of public investments in construction and

infrastructure, or the provision of other public services and utilities that cannot be displaced in other territories – such as transport, healthcare, waste-collection, and so on so forth (Gambetta & Reuter 1995 : 122);

4. the higher the capacity to transfer the payment of bribes and protection services on the final price, such as overpricing for services carried out by private providers and setting higher prices for the public payer;

5. higher are the transactions costs amongst competitors and public contracts receivers due to higher possibility of market-sharing mechanisms. The latter can be a consequence of (a) **location** when firms operating for public tenders in one territory do not compete with firms in other territories (and are therefore protected from competition from firms from different territories); b) **customers**, when “cartel members ... agree not to accept or seek business from customers who are currently served by another member of the cartel” ( Gambetta and Reuter, 1995 : 123). This kind of collusion is especially easy to maintain when public contractors are few, easily identifiable, and violations of the agreement can be easily detected and the corresponding sanction easily imposed; c) **queues**, when public contractors are few, and buy repeatedly, then a cartel of sellers may be organized in which sellers create a queue. This case perfectly fits with a public works chain. A1 adjudicates the first contract, then A2 sells the next time, etc. For example, Gambetta and Reuter (1995:124-125), describe the mechanism by which cartel members agree in advance on the firm which will adjudicate the public work, and make fictitiously high offers to let the chosen one prevail. This occurs within a broader agreement on the rotation of cartel firms in the adjudication of public contracts. The enforcement of the agreements is guaranteed by the organization, which levies a “tribute” on the participating firms. This is true for those public interventions, which give more chances for cartel members to share the same public decision-maker and payer. An example is represented by suppliers of the public administration, in which firm X supplies schools, firm Y supplies hospitals. If clients are not numerous and therefore sharing them is not viable, to create “queues” among the cartel firms, for instance to supply the same client repetitively in time. The Public Administration can be quoted as a case of a unique client which can be supplied by many firms in time, for instance because it can contract out different works, services, etc, following the procedure described above.

#### **4. Conclusions: disentangling the link between corruption and organized crime**

The infrastructure of governance in corrupt exchanges is a crucial variable to understand the development and persistence over time of corruption in a certain country. Both theoretically and empirically, the study of political corruption needs to focus also on those “less-than-good” arrangements that secure corrupt agreements over time, increasing their long-term efficiency and stability (Varese, 2010). Although principal-agent models still play a crucial role to theoretically framing and studying corrupt exchanges, scholars should not ignore or underestimate the impact that some self-reinforcing dynamics associated with collective action processes may have upon corrupt networks. The presence, for instance, of organizations that devise and enforce governance structures to forestall and economize the potential costs of illegal transactions, would dramatically affect the way corruption is produced. This is especially true, if these organizations do not only aspire in governing corruption, but also any other forms of illegality carried out in a limited territory. In this case, the ordering of corrupt exchanges that would not emerge spontaneously – through, for instance, repeated interactions among corrupt actors –, on the contrary, will be supplied by a single organization able to perform some activities typical of a governmental authority: maintaining peace, setting rules, arbitrating disputes and providing protection. Mafia-type criminal organizations offer a similar contribution to corruption network. Without doubt, they can be also involved directly in some stages of production of illegal goods, but their peculiarity is to supply forms of regulation and governance in both legal and illegal markets. This paper tries to frame theoretically the intervention of these type of organizations by using the analytical tools of transaction costs theory (Williamson, 1985). This approach helps us in distinguishing the two-fold interaction of MCOs with political corruption.

First, a more classical interaction, in which these groups naturally gravitate toward government as any other private interest group that try to capture policy decisions and alter public interests. Following this logic of interaction, these organizations seek to influence the direction and content of governmental action to reach organizational goals – immunity against law-enforcement, rent-seeking (Della Porta & Vannucci, 1999). In this sense, MOCs are, after all, organizations, which pay attention to whatever is necessary to the maintenance of the integrity and continuity of the group itself. This means that mafias have preferences over public policies and do not attempt to displace the state, even though they are at war with it. They exist side-by-side with the state, in a relationship variously referred to as complementary or symbiotic (Armao, 2003; Della Porta &

Vannucci, 2012). Although this is the archetypal interpretation of link between organized crime and political corruption, this model of analysis still contradicts those recent approaches, which state that these organizations want only to replace the State, being constantly at war against authorities. Both in theory and in reality this relationship differs from this interpretation.

Second, MCOs can be involved in corrupt exchanges as regulator of these transactions, not as producer. As shown by this paper, the governance of corruption market allows these organizations to exploit economies of scale and scope related both to their illegal and legitimate economic activities. Both legal and illegal activities carried out by these organizations often produce outputs or use inputs that are also needed in corrupt exchanges (information, money, connections, reputation, protection) so that it is profitable to integrate in these transactions (Anderson, 1979).

The characteristics of the policy arenas, some self-enforcing dynamics in the system and the different organizational arrangements of MOCs are source of variation in both the interaction modalities between these organizations and corrupt actors, and, thus, are crucial in understanding their development.

To conclude, the benefits of including also the study of criminal organizations in corrupt exchanges are not only theoretical, but this approach has crucial policy implications as well. Anticorruption policies, in fact, cannot be devised and framed only thinking about the principal-agent relationship behind corrupt exchanges, but should also consider their real impact on the infrastructure of governance, especially if this is enforced by MCOs. The failure of anticorruption policies targeting specific forms of political corruption is also the result of MOCs intrusion in the system. This paper tries to isolate this impact from other causes, which explain the persistence of political corruption over time.

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## **Project profile**

ANTICORRP is a large-scale research project funded by the European Commission's Seventh Framework Programme. The full name of the project is "Anti-corruption Policies Revisited: Global Trends and European Responses to the Challenge of Corruption". The project started in March 2012 and will last for five years. The research is conducted by 21 research groups in sixteen countries.

The fundamental purpose of ANTICORRP is to investigate and explain the factors that promote or hinder the development of effective anti-corruption policies and impartial government institutions. A central issue is how policy responses can be tailored to deal effectively with various forms of corruption. Through this approach ANTICORRP seeks to advance the knowledge on how corruption can be curbed in Europe and elsewhere. Special emphasis is laid on the agency of different state and non-state actors to contribute to building good governance.

Project acronym: ANTICORRP

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