Organized Crime and Self-Enforcing Exchange

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ABSTRACT

This paper examines how criminal enterprise overcomes principal-agent problems by altering the internal governance institutions according to the severity and nature of the agency costs. Detrimental in commercial interactions, criminal enterprises face even more costly agency problems because they cannot rely on state-enforced contracts at all and the very fact that they are outlaws exacerbates the situation. I provide qualitative evidence on the internal governance institutions of the La Nuestra Familia prison gang and show how they alter their governance institutions to account for agency costs, resulting in the successful self-governing pursuit of criminal profits.

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1. INTRODUCTION

Due to the illicit nature of their activity, criminals cannot rely on state enforcement of contracts. As a result, criminal enterprises must engage in complicated and costly activities that legitimate business firms do not. The inability to make state-enforced contracts hampers individuals working closely in the joint pursuit of criminal profits. Situations where information and monitoring costs are substantial – such as prison – further exacerbate this problem for criminal enterprises. Moreover, dealing in criminal activities entails interacting with individuals who have less respect for property rights and higher discount rates than individuals do in legitimate commercial transactions. When monitoring is costly and contracts and property rights must be self-enforced, how do members of organized crime capture the benefits from the joint pursuit of criminal profits?

This paper examines the internal governance institutions of the La Nuestra Familia prison gang. The Nuestra Familia gang operates both within and without prison walls, yet its leadership gives orders for the entire organization while being incarcerated in the most secure housing units of Pelican Bay State Prison.

Since Becker’s seminal article (1968), economists have developed several distinct literatures on crime, addressing separately its economics effects, problems of policing it, and the determinants that foster it. Fiorentini and Peltzman (1995) provide an excellent collection of essays focused specifically on the economics of organized crime. (See also Anderson 1979; Reuter 1983; Jennings 1984; Arlacchi 1986; Reuter 1987; Jankowski 1991; Dick 1995; Konrad and Skaperdas 1998; Garoupa 2000; Skaperdas 2001; Chang, Lu, and Chen 2005; Bradley 2008, Sobel and Osoba 2008).
Despite the growing literature on these topics, few economists have researched the internal governance mechanisms developed by criminal enterprises to address principal-agent problems. Gambetta’s (1993) study of the Sicilian Mafia focuses on how the organization interacts with non-members. Reuter (1983) investigates the New York mafia but focuses primarily on interaction with non-members and the competitiveness of various illicit industries. Levitt and Venkatesh (2000) examine the internal operations and finances of a Chicago street gang\(^1\), but this study focuses primarily on the monetary incentives of intra-group organization. Leeson’s study (2007a) of 17th and 18th century pirates examines the internal governance mechanisms developed to prevent internal predation\(^2\) (but like Skarbek [2008] which focuses on prison gangs) fails to address agency problems beyond on how the agents monitor the principal.

Several authors have offered definitions of organized crime, categorizing it by the presence of monopoly control of a market (Schelling 1971), by the presence of an organizational hierarchy and engagement in multiple criminal activities (Reuter 1983), and by the particular goods and services an organization provides (Task Force on Organized Crime 1967). This paper avoids these narrow definitions of organized crime and instead adopts the more general definition of organized crime as “any long-term arrangement between multiple criminals that requires coordination and involves agreements that, owing to their illicit status, cannot be enforced by the state” (Leeson 2007a: 1052). Self-enforcement is the primary economic problem uniting these varied definitions.

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\(^1\) See Venkatesh (1997) and Venkatesh and Levitt (2000) for related sociological studies of Chicago street gangs.

\(^2\) See Leeson (2008b, 2008d) for studies on other pirate practices.
The self-governance literature has shown that private individuals can successfully cooperate without the state in a variety of residential and commercial activities (Ellickson 2005; Stringham 1998-1997; 2002; 2003; 2006; 2007), in historical cases (Benson 1990, Leeson 2007a, 2007b, 2008c, 2008d) in modern day Africa (Powell et al. 2008), and in large-scale international financial transactions (Leeson 2008a, Schaeffer 2008).

Like situations of self-governance, criminal enterprises cannot rely on the assistance of a government to protect property rights and enforce contracts. While criminal activity may not be beneficial for society as a whole, the successful cooperation of criminal enterprises would strengthen the case for self-governance. This paper argues that criminals successfully develop self-enforcing mechanisms to solve the principal-agent problem, a task that many legitimate business firms have substantial difficulty accomplishing.

Economists have long recognized the importance of principal-agent problems in the commercial firm (e.g. Fama and Jensen 1983a, Fama and Jensen 1983b, Masten, Meehan, and Snyder 1991, Miller 1992), and in political organizations (Weingast and Marshall 1988), but little is known about how criminal organizations actually overcome these problems. Identifying and understanding these mechanisms in the context of organized crime has been difficult because researchers do not have access to information about the actual internal workings of criminal enterprise. Naturally, criminals are hesitant to provide incriminating information to researchers that could subsequently become available to law enforcement officials.

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3 See Buchanan (1999) for an argument in defense of organized crime.
4 The empirical studies are abundant. See, for example, Masten (1996) for an excellent collection of case studies in contracting and organization issues ranging from 17th century whaling practices to 20th century natural gas provision.
This paper overcomes the problem of “getting inside” by drawing directly upon the gang’s internal written documentation and formal constitutional rules. The Nuestra Familia (henceforth NF) constitution is found in Reynolds (2008), described in Lewis (1980), Hunt et al. (1993), and the “La Nuestra Familia” file provided by the Federal Bureau of Investigation (Federal Bureau of Investigation 2008) under the Freedom of Information Act. In addition, a unique collection of documents, including Federal Grand Jury testimony, court documents, internal police reports, and the personal correspondence and documents of a high ranking NF leader-turned-informant provide further evidence.

By examining the gangs’ formal rule structures and operations, participant accounts, law enforcement reports, and court records and testimony, this paper shows how the internal governance structure of organized crime successfully solve the principal-agent problem even in the presence of substantial information and monitoring costs and no state-enforcement of contracts.

2. CRIMINAL AGENCY PROBLEMS

If a principal can create a contract making compensation contingent on observable outcomes, he can compensate his agent not to shirk. Given transactions and information costs, however, principals cannot write complete contracts. Alternative solutions, such as posting a bond assuring good performance or giving the agent a residual claim to profits, are also subject to monitoring problems that prevent first-best solutions\(^5\).

The complete absence of state enforcement of contracts compounds the problem of incomplete contracts that legitimate firms face, and gives rise to additional costs, as the

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\(^5\) See Miller (1992) for an excellent overview of these and related issues.
principal cannot rely even on contracts over observable variables. As a result, contracts about the minimum profit an agent must earn, for example, are not legally binding.

The property rights to the resources involved in criminal exchanges are not secure. The agent might simply appropriate and abscond with the principal’s resources, which standard principal-agent models assume will not happen. Organized criminal enterprise involves interacting with people who have demonstrated a willingness to engage in illicit activity, and this biased agent type makes the problem of outright theft of the productive resources more likely.

Organized crime faces costs due to the illegal nature of the activity. Because each accounting entry, bank deposit, or other business record is a potentially incriminating piece of evidence, criminals must devote resources to protecting the main criminal operation from detection and prosecution, consuming or idling otherwise criminally productive capital. Criminal enterprises, like legitimate businesses, would like to invest idle resources in revenue-earning investments. Large deposits in a bank will draw the attention of the Internal Revenue Service and law enforcement. Storing resources in a physically isolated or secret location can avoid this problem, but does not generate revenue. Depending on the location, idle resources may also be more susceptible to theft or damage. This leaves criminal organizations with the costly and risky task of having to launder money through legal businesses and having to reinvest it in legal venues, a task that legitimate businesses need not perform (Karchmer 1985).

Legitimate firms do not face these same constraints when acting to mitigate principal-agent problems, and these costs make four aspects of criminal governance
institutions efficient⁶. First, greater geographical distance and higher information costs make it more costly for a principal to observe an agent’s actions, which increases the agent’s likelihood of shirking. In order to prevent shirking, criminal enterprises will alter their governance structures to limit agent discretion when these costs are high.

Second, when the outcome of an agent’s actions are more uncertain, agents have a greater incentive to shirk because it is less clear to the principal whether shirking occurred and should be punished. Organized crime can operate more effectively by aligning supervision along those activities that involve the same knowledge. Third, when the cost of shirking is borne by others, agents have a greater incentive to shirk. An individual who participates in a crime has more incentive to destroy thoroughly the evidence than someone not directly connected to the crime does.

Finally, agents will shirk less when the cost of punishing a shirking agent falls. This suggests that it will be more efficient to delegate activity that is susceptible to shirking to individuals who can more easily be punished ex-post. For example, it will be efficient to delegate responsibility over criminal agents to an individual with established (and even legitimate) commercial and family ties to a community. The high costs of leaving these behind make the individual easier to punish, and thus less likely to shirk.

In sum, the principal-agent problem is worse for illicit firms than legitimate firms due to biased agent type, no legally binding contracts, the additional costs of evading law enforcement, and often, increased information costs due to incarceration. How do criminal enterprises actually implement governance institutions in the real world that reflect the theoretical and efficient response to agency problems?

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⁶ See Polo (1995) for a formal model of monitoring in the criminal context.
3. LA NUESTRA FAMILIA

La Nuestra Familia (“Our Family”) is one of California’s most violent, powerful and well-organized prison gangs. Their incarcerated members profit from dealing drugs, extortion, robbery, illegal gambling, racketeering, and smuggling contraband (California Department of Justice 2003:15). The organization has expanded beyond prison walls and has established itself as a powerful, profitable, and violent gang in Northern California neighborhoods. The street regiments of the organization engage in the distribution of narcotics, home invasion robberies, and murder for hire (California Department of Justice 2004: 9).

Nuestra Familia’s internal governance institutions are detailed in their written constitution, titled “The Supreme Power Structure of La Nuestra Familia.” It designates a four-level hierarchy: a General, Captains, Lieutenants, and Soldiers. The General is in charge of approximately ten Captains, each of whom runs regiments in different correctional facilities. The Captains are elected by the gang members within those particular facilities, however the General can demote Captains if they are performing poorly. Each Captain commands a regiment of Lieutenants and Soldiers who are directly involved in carrying out the gang’s illicit activities (Lewis 1980).

Members swear lifetime allegiance to the gang, so when members are released from prison, they are required to continue working for the gang in regiments within specific geographic regions (Federal Bureau of Investigation 2008: 13). A Federal Grand Jury Indictment describes the operation: “Outside of penal facilities, the Nuestra Familia

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7 The Constitution has changed several times over the years (see Fuentes 2006: pp. 3-11, 22-24, 28-30, 38-40, 89-92, 131-133, 137-138). This paper is based primarily on their original constitution and the "subdivision" created a short time later. Although the constitution has changed over the years, the core aspects related to this paper have remained relatively unchanged.

8 See Skarbek (2008) for a detailed discussion of the organization and operations of NF.
was divided into geographic ‘regiments’ managed by ‘regiment leaders’; these regiments served as the basic unit or crew through which the Nuestra Familia conducted much of its criminal activity (Fuentes 2006: 297). These street regiments are in charge of accumulating and investing funds, supporting the incarcerated members of the gang, and generally carrying out the organization’s business.

Communication between prisoners and to people outside of prison is costly because guards constantly monitor inmates, especially those known to be gang members. Many members of NF, and most of the top leadership, live in the Secure Housing Unit, the most restricted area in prison. They are allowed out of the cell for only one hour a day to exercise alone in a small, enclosed courtyard. Prisoners cannot directly send mail to each other, officials monitor and record phone calls, and guards constantly watch inmates during visiting hours (Grube 2008).

To communicate with other prisoners or with gang members outside of prison, inmates develop novel – and costly – ways to subvert law enforcement surveillance. NF uses the Aztec language Nahuatl, elaborate codes, ciphers, “micro writing” of letters less than a quarter of inch, and messages hidden in artwork to communicate through legitimate channels. Often, gang members rely on relaying lengthy messages via paroled members. In the presence of such costly communication, principal-agent problems are substantial.

3.1 Regiments Integrate Paroled Members

Each geographic region establishes a Regiment Familia Bank, which is managed by a lieutenant (Federal Bureau of Investigation 2008: 9-10). Despite the name, regiment
familia banks serve a number of functions not usually associated with traditional, legitimate banking. Foremost among these is the role of integrating paroled members into profitable activities. A summary of an informant interview by the FBI notes “An NF member getting out of jail is normally set up with a car, a gun, drugs, and some money. This ‘set up’ is supposed to get the NF member ‘on his feet’ and in business for himself. Those who do not take advantage of this opportunity risk severe discipline” (Fuentes 2006: 231). Once paroled, members have more opportunities, and the gang faces the risk of members leaving the organization. The organization raises the cost of desertion by providing members with productive resources and a flow of capital (i.e. narcotics).

NF supplements these incentives by establishing ex-post punishments, including monetary fines and physical assault and murder, for members who do not actively engage in gang business. An FBI summary of one of the gang’s communications shows, for example, “[a leader] wrote that [a paroled member] has been out of prison for three years and has yet to ‘produce.’ [The leader] wanted [the member] to be fined 5,000 dollars for not having produced” (Fuentes 2006: 248).

In addition to integrating paroled members into productive activities, the regiment bank pays wages and provides for medical and legal expenses to NF members in the area. In return, members deposit a portion of their profits from both legal and illegal endeavors in the regiment familia bank. A Federal Grand Jury indictment confirms that all NF

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9 After the third highest-ranking member of NF became an informant for the Federal Bureau of Investigation, he provided written correspondences that included orders from incarcerated leaders. These messages contain important insights into how the organizational structure outlined in the written constitution were actually implemented.
members and “associates” were required to pay twenty-five percent of proceeds from robberies, drug deals, etc., into the bank (Fuentes 2006: 299). Regiment leaders have the responsibility to ensure that soldiers are “acquiring at least two firearms (one of which would be donated to the regimental armory), obtaining a cellular phone, and accumulating no less than $500 on a monthly basis, which [is] put towards building the regimental bank” (Fuentes: 173-174). In short, the regimental commander integrates new labor into productive activities, supports members when necessary, and ensures that members do not violate probation, for example by not having a legitimate job.

NF mitigates principal-agent problems by 1) lowering the costs for members to earn money for the gang by supplying necessities (e.g. cars and guns); 2) raising the costs for deserting the gang by providing valuable resources (e.g. narcotics) periodically and 3) establishing punishments for members who shirk on their duties to the gang.

3.2 Regiments Monitor Soldiers

In addition to creating these incentives for the agents, the primary job of the regiment commander is to provide continuing monitoring of members. Regiment leaders communicate orders and street policies for the incarcerated leadership (Fuentes 2006: 173). Monitoring is relatively cheap for a street regiment leader compared to the costs of monitoring by incarcerated members. Regiments are constrained to particular geographic regions, where regiment leaders can access local social connections to obtain information on member activity. This information allows leaders to judge more accurately than incarcerated leaders about the competency, effort, and commitment of paroled members.
The regiment leader has not only the information, but also the incentive to monitor effectively. Correspondence between two high-ranking NF leaders indicates, “Those who are appointed to function as [a regiment leader] are also responsible for the building up of a familia bank, with no less than a $10,000 minimum” (Fuentes 2006: 90). It is the lieutenant’s job to “see that all ventures undertaken are planned efficiently [sic].” Increasing the regiment’s earnings increases the regiment leaders influence, authority and territory. The NF leadership requires captains to meet fixed percentage goals of growth for the regimental bank, creating additional incentive for regiment captains to monitor the productivity of his members (Fuentes 2006: 90). The monetary requirements that the regiment captain faces aligns his incentives with the incarcerated leadership.

The regiment captain invests funds in illegal enterprises and legal businesses (Fuentes 2006: 176). Personal correspondence reveals a situation where one incarcerated leader reminded a captain that “The money for the family must be invested when it can and put security on it. Legit biz., investments, etc., are for only you, me to know of. Don’t let family members partake in it as to keep it legit etc…” (177). Potential informants within the organization are costly. The organization must deploy resources to protect against informants, and the informants will expend resources concealing their activity and often will be less productive in their criminal activities. To prevent members from becoming informants – a particularly dangerous form of shirking – the organization limits access to sensitive information to most members. The principal agent problem is mitigated by controlling information in this way.

In short, the regiment leader is responsible to the higher-ranking, incarcerated members for his regiment’s activity, so he has an incentive to ensure compliance from the
soldiers. The leaders in charge of the regiment familia banks have an incentive to generate revenue because this leads to promotions. Regiment leaders have low costs for monitoring their soldiers because they are in the same city, working closely with members, and thus can better appraise failures in uncertain environments. In addition, they share the same local knowledge so they are much better equipped to do this than incarcerated members can. Governance institutions prevent inefficient resource use and concentrate authority with people who have low information costs.

### 3.3 Regiments Mediate Intra-Group Conflict

Regiment leaders have authority over mediating conflict within the group. A federal grand jury indictment indicates that high-ranking members “were responsible for establishing regiments and gang policy, resolving intra-gang disputes among members and associates of the Nuestra Familia, approving new memberships in the organization and authorizing significant actions by members of the Nuestra Familia and Nuestra Raza, including the commission of murder (Fuentes 2006: 297). Internal conflict is costly because members use resources to transfer wealth (or defend against wealth transfers) from other members instead of engaging in criminal profit seeking. It is important to have conflict resolution mechanisms in place to minimize these costs. The regiment captain, who has low information costs about the personalities of his members and the details of the circumstances, can effectively adjudicate intra-group conflict.

What prevents the regiment captain from abusing this power? The governance structure incentivizes the regiment captains to maximize profits because he has to meet the monetary demands of his superiors and he controls the remaining funds. As a result,
his incentive in mediating disputes will tend to be in the best interest of the organization. If he does a poor job of settling disputes, then resources will continue to be wasted. If, on the other hand, he effectively resolves conflict, members can return to earning money and will cease the wasteful expenditure of resources. The governance institutions limit the regiment captain’s potential to shirk when settling disputes because as a residual claimant he bears the costs of internal conflict.

3.4 The Main Bank

The regimental banks must contribute their money to the main bank. According to the gang’s constitution, the main bank has several functions. It acts as an emergency reserve for the regiment familia banks and supports all wars declared by the Nuestro General. It invests only in legal businesses, and the constitution mandates that two-thirds of its profits are reinvested in business and one third of profits are saved.

Given the substantial sums of money deposited in the main bank from the different regiment banks and from earnings by incarcerated members, malfeasance and wasteful rent seeking are particularly likely. The gang’s governance institutions minimize this by limiting access to the main bank. The FBI summary of an internal NF documents reads:

SOURCE explained that the money that was for the NF was to be sent to the main NF bank in Idaho. He believes his own code name for the person in charge of the bank is “JANICE.” However, he didn’t know if JANICE was male or female. SOURCE said he had documents secreted elsewhere that would refresh his memory on the bank. He believes he sent at least twenty-five or thirty thousand dollars to the main bank... Rubalcaba advised SOURCE that FABELA could show him how to use legal mail for NF business and reminded SOURCE to put aside 25% of all money earned for the ‘Organization.’ RUBALCABA wanted to know how much money SOURCE currently had for the Organization. SOURCE said at that time he had 25,000 dollars (Fuentes 2006: 242-246).
There is a risk of regiment captains shirking on their duties to conceal information from law enforcement about sensitive gang information. Isolating the main bank from regiment leaders prevents the threat of informants from revealing information about the organization’s major resources. More importantly, this governance structure reduces the rent seeking costs associated with members covertly becoming an informant, protecting against informants, and punishing informants.

Another costly form of shirking is the costs associated with people concealing how much they have earned from the leadership and the expenditures made by the leadership to identify people who are withholding funds. An interview transcript by the FBI reveals that one regiment captain, Robert Gratton, was in trouble because the leadership felt he was withholding funds earned from production of a rap CD sold in the Bay Area. As the transcript indicates: “GRATTON reported that the album did not make as much money as was rumored, and one reason he may be in trouble with the NF leadership is that the NF believes he has not contributed enough money to NF banks from album sales” (Fuentes 2006: 223). A federal court document indicates that the NF leadership imposed a financial fine on Gratton as punishment:

In the letter, Rubalcaba sharply castigates Mr. Gratton for his continuous failure to follow orders, as well as his penchant for writing and sending money only on those ‘occasions when it best suited you’ (that is, only as a means of occasionally placating the NF leadership). As a result of such conduct, Rubalcaba tells Mr. Gratton that he no longer holds any authority, but must report directly to Happy….assesses Mr. Gratton a monetary fine of $5,000, the payment of which ‘is not open to dispute or challenge!” (Fuentes 2006: 216-217).

As this example indicates, even altering governance institutions to align incentives will not eliminate rent-seeking costs entirely. The leadership imposes fines when they believe that regiment captains are not forthcoming with funds, but regiment captains still have
some incentive to invest resources to avoid payment and have trouble credibly signal
that they have made the appropriate payments. The costs of communication are greatest
between incarcerated leadership and the regiment captains, so it is not surprising that
some wasteful expenditure will persist at this level of the governance structure.

4. CONCLUSION

The incarcerated leadership of NF faces high information and monitoring costs, giving
rise to potentially debilitating principal-agent problems. One particularly costly type of
agent shirking is the expenditure of resources to transfer wealth rather than create it. NF
limits rent-seeking costs and agent shirking by shaping the governance institutions to
align incentives and establish control with individuals who have low information costs
and limiting the ability to impose costs on others through rent seeking activity.

This paper has demonstrated that self-enforcing exchange – even in the criminal
context – can achieve successful cooperation in the pursuit of shared ends. This is a
particularly surprising result given the unique costs that NF faces, including biased agent
type, no legally binding contracts, outlaw costs, and increased information costs due to
incarceration.
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