

MARKET-BASED EXTORTION

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Charles Tilly (1985:171) makes the following distinction: 'Someone who produces both the danger and, at a price, the shield against it is a racketeer. Someone who provides a needed shield but has little control over the danger's appearance qualifies as a legitimate protector, ...'. In this note we discuss a third case where all violent entrepreneurs are drawn from the same pool. There is a division of labor between those who use violence and those who protect against violence and each entrepreneur chooses the activity that is most profitable. All entrepreneurs interact in a market-based extortion where the violent entrepreneurs as a group produce both the danger and the protection. This market is particularly important when the state fails to supply basic security and protection.

One example is Russia. After the collapse of communism, Russia has experienced an economic downturn and a downsizing of the military forces. This implied that many young men, some with violence as part of their trade, did not have proper jobs to go to. Privatization and restructuring provided a large number of new targets to exploit as the state apparatus was in ramshackle, unable to provide basic protection of property. As a consequence crime rates in Russia increased by 70 percent from 1989 to 1993 (UNDP 1999).

Parallel to the growth in crime there was an explosion in the number of private security companies. The number of such companies went from zero in 1989 to five thousand in 1993 and reached ten thousand in 1996 (Volkov 2000). While the protection business continued to grow, the crime rates stabilized from 1993 and then declined somewhat from 1996. Who were the entrepreneurs of these security firms?

In some cases they were officers of the police, the Interior Ministry, and the KGB. In other cases, the criminal groups themselves established their own security enterprises. As Vadim Volkov (2000: 494) observed in St Petersburg: "one of the oldest and most prominent protection companies 'Scorpion' was set up and headed by A. Efimov (...), one of the leaders of *tambovskaya* criminal group [...] . The private protection company Adris, providing protection to more than a dozen companies, [...] is known to belong to the *malyshevskaya* criminal group". These are examples of a general phenomenon in Russia where criminal groups themselves are engaged in the provision of protection against similar groups.

Surely, we are not witnessing a transition towards secure property rights, efficiently guarded by private security firms. On the contrary we are experiencing the emergence of a *protection screw* where violent entrepreneurs exploit producers in an extortionist manner. In the protection screw a higher violent capacity increases both the supply and the demand for protection increasing both the price of protection and the incomes to all the violent entrepreneurs.

The main sources of income for violent entrepreneurs are: *plundering* of unprotected areas or property, *trafficking* in drugs, weapons, precious stones etc., and *protection* of areas and property from plundering. Plundering and trafficking require mobility and represent apparent law violations. The enterprises that are engaged in these activities are like roving bandits, to use Mancur Olson's term. When engaged in the protection business violent enterprises protect targets against plunder by the roving bandits. With a limited capacity each violent enterprise has to specialize. An enterprise in the protection business has a varnish of respectability; after all it fights criminals. The enterprise can therefore do less of plundering and trafficking. Using

again one of Mancur Olson's metaphors, a protector is a stationary bandit (Olson 2000).

The targets can be anything from households, shops and industries to communities, cities and regions; all vulnerable to plundering and with a need for protection. With protection a target is safe from plundering, but has to pay protection money. To sharpen our discussion of the entrepreneurial choice between plunder and protection we simply assume that the protection business consists of opportunistic enterprises that are willing to enter banditry if the price is right. Furthermore, an enterprise that moves into roving banditry must exit from the protection business to get incomes from plundering and trafficking. Vice versa, a violent enterprise must exit plundering and trafficking before entering the protection business.

Protection is therefore supplied at a price that is determined by the protectors' outside option as roving bandits. The return to roving banditry goes down as the number of bandits rises, since a higher number of bandits reduces the trafficking rents for each of them. The willingness to pay for protection is equal to the expected loss of an unprotected target and is proportional to the probability of being approached by a roving bandit. This probability is equal to the number of roving bandits relative to the number of unprotected targets. A higher number of violent entrepreneurs unambiguously increases this probability. Obviously the probability goes up if all the new entrepreneurs enter as roving bandits. If the new entrepreneurs all enter as protectors, the number of roving bandits is unaffected, but as the number of unprotected targets declines, the probability that an unprotected target is approached, goes up also in this case.

Equilibrium in the market for protection requires that the supply price equals the demand price. This implies that the return to each roving bandit equals the return to each protector. Let us now consider how an increase in the violent capacity for instance due to demobilization of military forces, affects the equilibrium outcome of this market-based extortion. A higher number of violent entrepreneurs increases both the supply and the demand for protection. Hence, the extent of protection goes up. In the protection screw the price of protection goes up as well, and all violent entrepreneurs gain from an increase in their number. A complete discussion of this logic is provided in Mehlum, Moene, and Torvik (2001)

Africa provides many examples of a protection screw following from an increase in the supply of violent capacity. The supply of violence reached new levels after the end of the cold war. As military budgets began shrinking in the mid 1980s, many countries undertook considerable demobilizations. For instance, in the early 1990's Ethiopia reduced the army by 500 000 soldiers and Eritrea by 50 000. Also in the 1990s, Uganda reduced the army by 36 000 soldiers, Mozambique by 90 000, Namibia by 50 000, and Liberia by 20 000 (Kingma 2000). Demobilized personnel and low paid officers found new sources of income as violent entrepreneurs. Unfortunately, a substantial part of their entrepreneurial talent was used in extra-legal activities. As the large number of military personnel were demobilized without appropriate civilian jobs to go to, many countries got a rising supply of qualified people for violent crime, local warfare, and private protection. As Lock describes (1998:1400) "(N)o matter whether large scale demobilization after conflict or the pervasive slow-motion demobilization are characterizing the scene, the emerging private security industry and the criminal sector of the economy alike....draw from a labor market oversupplied with a wide range of military experience and know-how to chose from". In Liberia people talked about "sobels", soldiers who turned rebels at night and "pobbers", police who turned robbers at night.

The nature of military security, fighting and peacekeeping has also changed in a way that has generated a protection screw. Some observers talk about a new warrior class in a world of low-intensity conflicts. William Reno (1998) describes warlord capitalism in Africa, with special reference to the privatization of violence. Private groups and military corporations have stepped in to fill the vacuum after the redrawing of super power support. According to Kevin O'Brien (1999: 54), private organizations "are increasingly taking over the role of either (sometimes both) exploiter or peacemaker." One of the most prominent examples of the private security companies is Executive Outcomes, also called the world's first corporate army. This South African based company, could on its height field a powerful force including a medium artillery and air support. It employed former members of the South African Defence Force and fought both against UNITA in Angola, and against rebels in Sierra Leone.

The working of market-based extortion is different from both ordinary markets and extortions by organized crime. In ordinary markets the entry of new enterprises hurt the profitability of the established ones. This is not the case in market-based extortion where the entry of new violent entrepreneurs enhances the profitability of all. Of course, violent entrepreneurs provide beneficial services of protection that the state may fail to deliver. But the problems that such an entrepreneur solves are created by his competitors. Thus a rise in violent capacity creates a higher demand and a higher price for protection. In this way a flow of new businessmen of crime into the pool of violent entrepreneurs, boosts their profitability, but increases the costs to producers. What is a virtuous cycle for violent entrepreneurs, is a vicious cycle for producers, a process that eventually may lead the economy into a violence induced poverty trap.

As strongly emphasized by Thomas Schelling in his seminal paper from 1967, organized crime is conventionally perceived as monopoly or exclusivity. While the bosses of organized crime have an interest in order and peace within the area under exclusive control, each violent enterprise in market-based extortion has an interest in disorder and violence. Disorder and violence increase the willingness to pay for protection and increase the rents to be collected by each warlord and roving bandit. Thus market-based extortion needs not to be dominated by a single enterprise stronger than the others. It is a competitive market driven by Says law: the supply of violence creates its own demand. This is why market-based extortions are so harmful for development.

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