Regulating Rackets

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ECONOMIC REGULATION has been given many justifications; Stephen Breyer in his *Regulation and Its Reform* lists five major and five minor rationales. Here I discuss an industry subjected to extensive regulation for a reason scarcely mentioned in the literature—namely, to eliminate racketeer influence and violent restraints on competition. This regulatory effort seems to have failed. The most plausible explanation for its failure is every bit as distinctive as its original rationale.

The industry in question is the garbage collection business in New York City, usually referred to as the "carting" industry. Although the city picks up residential trash, commercial establishments must contract with private carters to collect their refuse. The carters have been alleged, at least since the 1950s, to be controlled by racketeers, members of the Mafia. In 1956, responding to this concern and to the general belief that there was a collusive arrangement in the industry, the city gave its Department of Consumer Affairs (DCA) the responsibility of licensing carters and setting maximum rates.

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That regulation has been in place ever since. Yet repeated investigations have found that racketeers continue to play a role, that the city's carting market is not competitive, and that customers are regularly defrauded. In summary, the regulation has been utterly ineffective, a contention that is privately accepted by the regulators themselves. Indeed, it can be argued that the regulation has helped rather than hindered efforts to restrict competition among carters.

In what follows, I will show that the best explanation of the available evidence is that a customer allocation scheme, initiated and policed by racketeers, has existed from the beginning and appears to have grown in strength over the years. In 1980, the most recent year for which I have data, the scheme extracted supracompetitive profits (rents) from the commercial sector of about $36 million, or 30 percent of the industry's total billings of $120 million.

The key question is why new carters have not entered a market that offers such large rents and that contains no significant economic barriers to entry. I conjecture that this is explained by the industry's reputation for being

a "racket," a reputation that naturally deters new entrants. This produces a policy conundrum. The more the government tries to clean up the industry through its major tool, investigation and prosecution, the more it reinforces the major barrier to entry.

The Sale of Customers

There are approximately 300 firms in New York City's cartage market, operating a total of about 800 trucks. The largest firm has fewer than 20 trucks, and a fifth of the firms have only one truck. Most firms are sole proprietorships or partnerships, and all are privately owned, mainly by the sons or grandsons of the founders. As in other large cities, the owners are almost all of one ethnic group (Italian in New York City, Dutch in Chicago, Lebanese and Jewish in Los Angeles). This homogeneity and the close family links among many small firms arise historically from the need of undercapitalized owners to obtain back-up equipment when their own equipment breaks down; reliability of service is particularly critical for garbage collection firms. Such collaboration facilitates collusion.

Conspicuous by their absence are the three national waste collection firms—Browning-Ferris Industries, SCA Services, and Waste Management. These three companies, all much larger than any other in the industry, have grown by acquiring small local companies throughout the nation. None has entered the New York City market, for reasons we will get to later.

The number of firms in the market has declined substantially since 1956, when regulation was introduced. The decline has resulted not from business failures but from the disappearance, through merger, of small companies. All observers agree that there has been no significant new entry during this period.

The main evidence that carters have a customer allocation arrangement is that they frequently sell customers to each other at very high prices. The DCA requires that all transfers of assets between carters be approved, including sales of customers, which are conducted under the guise of the sale of goodwill. That is, the seller asserts that, because he has provided good service in the past, his customers will purchase future services from the carter that he recommends, just as a doctor is able to persuade his patients to use the doctor to whom he sells his practice. But the circumstances of the customer sales, as well as the prices paid, make the claim that they are sales of goodwill an unreasonable one. More plausibly, the sales merely confirm that the carters have agreed not to compete for each other's customers.

Two recent transfers suggest the true nature of the transactions. One is Triboro Carting's purchase in June 1979 of 149 customers, located in northern Manhattan, from another carter named Cancro. During the next six months, many of these customers complained about the service they were getting, and the local newspaper reported that uncollected refuse was piling up outside businesses. Triboro's president, testifying at a DCA hearing, admitted some service difficulties, noting that the company had had "nothing but aggravation" from the time it took over the new customers. The problems came from two sources. First, there were a number of incidents in which Triboro's equipment was damaged—tire slashings, for example—and this led to service interruptions. Second, Triboro took the attitude that customers should adjust to its routine, rather than the reverse.

In December 1979, on the eve of a DCA hearing concerning the propriety of Triboro's financing of its purchase of Cancro's customers, three Triboro trucks were burned. The record explicitly attributes this to arson, but contains no discussion of either the motive or identity of the arsonist. At this stage, Triboro asked another firm, Inwood Carting, to assist by lending equipment for service of the 149 customers. The equipment was manned by Triboro employees. Shortly afterwards, Triboro sold the customers to Inwood Carting. The price was $10,000 plus the assumption of Triboro's debt to Cancro—making a total of about $214,000, equal to twenty-five times the monthly billings yielded by the customers.

The counsel for the Department of Consumer Affairs contested the sale on the ground that there was no goodwill to be transferred. After all, he argued, the customers in question appeared generally dissatisfied. Furthermore, Triboro had served them for only a short time and had not even bothered to inform them that Inwood was a fine company and would provide good service. Indeed, Inwood billed the cus-

tomers directly—and all the customers paid—before any formal transfer took place.

At the hearing, the presidents of both Triboro and Inwood were quite explicit about the nature of the transaction. Inwood asserted that its purchase of the customers gave it the "exclusive right to serve" them; both companies agreed that this was industry practice.

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Another transfer of customers that indicates the existence of a customer allocation scheme occurred when a major carting company was dissolved under court order. In 1979 New York Carting, a firm with approximately twenty trucks, was convicted of attempted commercial bribery and attempted grand larceny. The firm and its chief operating officer pled guilty to the charges, which involved payments to purchasing agents of customers for overlooking grossly excessive charges by New York Carting. Soon after the conviction the Department of Consumer Affairs revoked the company's license, intending that revocation to take effect immediately. New York Carting went to court and successfully applied for a stay, gaining six months to dispose of its assets. The physical assets, consisting of trucks, containers, and some plant, were valued at less than $1 million. Yet the firm was able to sell out for over $10 million.

The difference between the two figures represents the value that other carters placed on the firm's customers, or "stops." The customers were sold in six individual transactions. In some of them the sale included physical assets as well as customers, in others it did not. In one transaction the dominant element was a single customer, the United Nations, whose contract was (and is) awarded following public bidding procedures. The purchaser of the contract was willing to pay more than the total income to be generated over the remaining years of the contract—despite the cost of serving the customer—even though, on renewal, the contract would be awarded to the lowest bidder. For other customers, the sale prices were roughly forty times the gross monthly billings provided by the customer.

These transactions provide even stronger evidence of a broad customer allocation scheme within the industry than does the routine sale of customers by an ongoing carting firm. In the latter case, it could be argued that the new firm was paying the existing supplier to agree not to compete—that is, not to continue to provide the service. But in this instance, a carter who wanted to obtain the custom of a particular stop had no need to hold New York Carting to such a restrictive covenant. It could simply wait. After all, that firm had lost its license and would not be able to provide service after 1979. Yet New York Carting sold its stops at prices at least as high as those reflected in earlier transactions.

In this case, too, it is highly implausible that the sale of customers was a sale of goodwill. As already noted, the court record shows that New York Carting had been overcharging many of its corporate customers and bribing their purchasing agents to look the other way. If New York Carting had any goodwill to trans-

Author's Note

This article draws on a two-year research study that I carried out, with National Institute of Justice funding, on racketeering in legitimate industries. It is based on data from New York City's Department of Consumer Affairs, court records, ongoing investigations by state and local law enforcement agencies, and some informants who have helped obtain convictions against carters in New York City and environs. For further details on industry practices and on my sources of information, readers may wish to consult two of my earlier works, *The Value of a Bad Reputation* (Rand Corporation, P-6835, December 1982) and *Racketeering in Legitimate Industries: Two Case Studies* with Jonathan Rubinstein and Simon Wynn (U.S. Department of Justice, National Institute of Justice, January 1983). Other useful works on the subject include *Vicious Circles* by Jonathan Kwitny (New York: Norton, 1979) and *The Imperfect Union* by John Hutchinson (New York: Dutton, 1972).

It is important, and only fair, to point out that the pattern of mob influence described here does not imply that all individual carters in the five boroughs of New York City are culpable. An individual carter may turn out to be a net loser from the customer allocation scheme analyzed in the article, particularly if he tries to run a "clean" operation; alternatively, he might benefit passively from the scheme without taking any actions of his own to further it.

fer, it was with the corrupted purchasing agents. The Department of Consumer Affairs could scarcely approve a transfer of goodwill based on the payment of bribes.

The sale of carting customers is a fairly routine activity in New York, according to a review of DCA records for two successive twelve-month periods starting on November 20, 1978. In the first, there were twenty-four route sales (in which a carter sold all its customers) and twelve stop sales (in which a carter sold only some of its customers). In the second twelve-month period, the figures were twenty and twenty-four.

The prices that carters pay for customers, expressed as a multiple of monthly revenues, have risen steadily over the past quarter century, according to long-term DCA employees. The most recent recorded transactions appear to be at multiples as high as fifty, whereas in the late 1950s the figure may have been as low as ten. It was not possible to review transactions over the entire period, but it appears that the increase has been steady during that time.

The explanation for this may be that, over time, the carters have become increasingly confident that their customer allocation scheme will endure and prove enforceable. After all, there have been only a few criminal convictions and only two lengthy sentences in the carting industry in the past quarter century. Thus, it would be surprising if any carters seriously doubted either their ability to continue to treat each customer as a monopolist would or the likelihood of other carters' abiding by the rules of the scheme. In addition, the efforts of customers to resist the carters' monopoly prices would probably have declined, given the clear lack of alternative suppliers. Finally, the lack of new entrants always makes coordination easier.

These transfer prices enable us to calculate a rough lower bound for the costs arising from the customer allocation arrangement. The cost is the difference between the price that would be paid for a customer transferred in a competitive market, where the price would reflect goodwill only, and the price paid under the customer allocation arrangement. To be on the safe side, let us assume that the multiple in a truly competitive market would be ten times monthly revenue, much higher than is likely. In New York City the price paid is at least forty times monthly revenue. The excess of thirty months' revenue is then a lower bound for the capitalized value of the customer scheme.

Exact measures of the total revenues of the carting industry in New York City are impossible to obtain. I suggest that a figure of $120 million, or $10 million a month, is reasonable for 1980, the year for which I collected data. The excess valuation then amounts to $300 million. Since carters can sell and buy customers freely, as DCA records show, we can infer that they are earning a competitive rate of return on this capital value. Assuming a relatively modest pretax return of 12 percent, the estimated excess billings work out to $36 million a year, or about 30 percent of the industry's annual revenue. (Note that these figures set only a lower bound for another reason: they ignore consumer costs resulting from productive inefficiencies caused by the allocation arrangement.)

The $36 million figure is necessarily a rough estimate. But if it errs, it is probably too low, not too high. The allocation scheme imposes a significant cost on the commercial sector of New York City.

The Role of Regulation

Why has price regulation failed to prevent this monopolistic pricing? After all, the Department of Consumer Affairs sets ceiling prices, using a process that follows the standard lines of transportation industry price-setting. The industry initiates the process by requesting an increase in the ceiling rate. Then, the DCA's auditors collect evidence on the industry's revenues and expenses, disallowing some expenses, and produce an estimate of average operating costs per cubic yard hauled. The commissioner allows 10.9 percent as a "fair and reasonable profit" on top of that and the ceiling is set. In making this calculation, the DCA refuses to let carters include the costs of buying customers from other carters.

If the carters are earning only the fixed 10.9 percent profit, it is hard to see why they pay $4,000 for a customer yielding gross billings of $100 a month and an annual pretax profit of only $132. The fact is that their actual profit rates must be significantly higher than the DCA's ceiling. In other words, regulation has failed. Law enforcement officials offer two ex-

planations for this situation. First, they say, it is common practice for carters to overstate the amount of trash they pick up from individual customers. It is easy for a hauler to charge the official per-cubic-yard price but simply overstate the number of yards it has collected. The result is that any change in the DCA ceiling price merely affects the degree to which carters overstate the amount of trash they pick up. Second, they say, it is also common for carters to conceal a significant portion of their revenues from the authorities. This not only reduces their tax obligations, but turns the whole rate-setting process into a meaningless ritual.

To deal with the second problem first, there is not much direct evidence to judge the extent of income underreporting—just two recent prosecutions and the statements of a few informants. But the opportunity is certainly there, since many small businesses pay their carters in cash. In any case, not only do observers and participants generally agree that underreporting is ubiquitous, but only the underreporting explanation makes sense of the prices carters are willing to pay to obtain customers.

We have a clearer picture of the problem of overstating service. Many customers have only a vague idea of how much waste their carter collects. The carter usually provides the container in which the waste is placed as well as the label, which may or may not state the container's volume. If it states the volume, the carter may have put on the label itself and, given the odd shape of most containers, the customer will have some difficulty in verifying the volume claim. One prosecutor who investigated the industry in another state measured a sample of containers and found that the volume was, on average, 30 percent less than claimed. Carters may also pick up containers that are not completely full, or alternatively, they may not entirely empty the containers they do pick up.

The investigation of New York Carting provides a straightforward illustration of the measurement problem. The company claimed to be picking up 213 cubic yards a month from the Roger Smith Hotel, but the hotel's owner, a former civil engineer who was used to estimating volumes, contended that the hotel generated only 48 cubic yards. The ensuing investigation proved that overcharges of roughly 300 percent had gone on for some years, with only one challenge. In the earlier indictment of members of the Kings County (Brooklyn) Trade Waste Association, in 1974, the district attorney showed that overcharging of 500 percent occurred routinely.

Where the Racketeers Come In

Perhaps this particular cartel-like scheme could be maintained by the members themselves, though one would expect (as I argue in the next section) that entry by new firms would have defeated it. However, there is good evidence that it is maintained, and was in fact initiated, by members of the Mafia.

In 1957, in the course of its long investigation into labor racketeering, the McClellan committee (the Permanent Subcommittee on Investigations of the Senate Government Operations Committee) found that members of New York's Mafia had acquired control of Teamsters Local 813 and were using it to discipline carters who would not go along with the customer allocation scheme. Specifically, the chairman's concluding statement focuses on one Vincent J. Squillante, whose "only previous qualifications were in the New York policy rackets and as a pusher of narcotics. . . . [and who] traded on his associations with the underworld and the union to . . . create a monopoly with respect to the collection of garbage and refuse in the Greater New York area." The racketeers also set up "whip" companies to discipline nonconforming carters by bidding away their customers with artificially low prices.

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Then in 1974 the Brooklyn district attorney's office announced the results of its lengthy investigation of the carting industry in that borough. It showed that a Mafia member had regularly attended weekly meetings of the Brooklyn Trade Waste Association's leadership and had sat on their so-called grievance committee—which had the function of settling dis-

putes over rights to serve customers. In 1980, an informant gave a similar description of a Mafia presence on a grievance committee in another New York City borough.

According to these accounts, the grievance committee decided which of two carters should serve a particular customer mostly by finding out which of them had begun to serve that site first. Each carter would present ledger sheets showing its dates of service there, and the committee ruled accordingly. However, if the racketeer had an interest in the dispute—if, for example, it involved a carter with whom he was closely linked—he would probably favor his client and the other committee members would go along, regardless of the merits of the case. Reportedly, he did not have an interest in most cases, and the rulings seem to have been fairly objective. Informants also report that if, for some reason, the customer could not be transferred back to the carter that the committee ruled should have him, the second carter had to provide either a customer generating approximately the same revenues or a cash payment. The payment was some fixed multiple of the monthly revenues from the disputed customer.

The grievance committee's rule appears simple enough, allowing of little discretion by the committee or funny business by its clients: whoever had the earlier entry "owned" the customer. In fact, however, cheating was possible, because the method for establishing the date of first service required only the presentation of ledger entries. Two participants started to cheat systematically, creating false ledger pages and scuffing them up to make them appear old. Eventually, they were caught. The "rules of evidence" were changed so that carters had to present some external documentation, such as a billing, that could be less easily faked.

The critical observation is that the grievance committee seems to be amazingly effective. It is difficult to believe that every member of the New York Trade Waste Association accepts that its individual interests are best served by this process. Certainly other cartels have foundered on the impatience of a few members with the existing market allocation. Yet there are no accounts of prolonged disputes between New York City's carters, and one informant asserted that he had not, in two decades of participation, ever heard of an instance of noncompliance. It seems plausible that the presence of the racketeer on the grievance committee is central to the smooth working of the process. The implied threat of force provides the ultimate incentive to accept the committee's rulings.

The Impotence of Law Enforcement

Perhaps the most surprising finding of my research is the frequency with which law enforcement agencies in New York City and its suburbs have investigated racketeering in the solid waste industry. Ignoring purely administrative procedures conducted by agencies such as the Department of Consumer Affairs and the City Investigations Commission, I counted fourteen different investigations of criminal behavior in the solid waste industry since 1956. There may have been more.

In light of the difficulty of getting adequately detailed complaints, undercover operations are the most plausible investigative tool. In 1972 the Brooklyn district attorney began such an investigation, which found compelling evidence of a broad customer allocation agreement. The result was an indictment of fifty-five carting firms, along with nine racketeers, Brooklyn Trade Waste Association officials, and other persons, for "restraint of trade." Most of the defendants pled guilty and received light fines; those who did not were later able to have the indictment quashed on a technicality. The judge ordered the dissolution of the association.

The Department of Consumer Affairs, for its part, issued temporary license renewals to the indicted carters but then, following the guilty pleas, gave them permanent renewals and a fine of only $500 a truck. DCA's action was clearly inadequate, whether viewed as punishment or deterrent. The fines of $500 a truck represented less than 1 percent of the overbillings that the district attorney plausibly alleged were being generated annually.

The city's commissioner of consumer affairs took a rosy view of the effects of these punishments. "We have no evidence now that the industry is ridden with crime," she said. "Commercial firms and customers of the carting industry now seem to be able to change companies fairly easily" (*New York Times*, December 11, 1975). Yet her agency did not do a

study to verify that claim, nor did it monitor its complaint files to find out whether the situation in Brooklyn had changed.

This failure, together with the license renewals, surely signaled to the carters that they faced little risk in continuing their customer allocation scheme. The Brooklyn Trade Waste Association was soon reconstituted as the Kings County Trade Waste Association. More recent investigations in 1977 and 1982 have uncovered overcharging comparable to that which went on before. There is no reason to believe that anything has changed in the past decade, apart from names and numbers.

Reputation and Barriers to Entry

Neither regulation nor prosecution has been able to defeat the cartel-like scheme. It remains to be discussed why new competitors have not entered the market—an especially remarkable fact in an industry full of firms that thrive by holding less than 1 percent of the city-wide market.

Consider, first, efforts to get into the business by acquiring an existing carter. The prospective buyer is likely to place a lower value on an existing list of customers than does the owner. This is obviously true where the buyer is unaware of the allocation scheme. In that case, the owner values the customers as though they are permanent, while the buyer values them only to the extent that he believes that prior service to those customers has generated a stock of goodwill. Of course, many buyers are well aware of the customer scheme, particularly national firms that are experienced in the ways of the industry. But even these buyers will place a lower value on the customer lists, for they will have to take into account the probability that they will not be permitted to participate in the scheme. This is especially true if the buyer is a national firm whose entry might be regarded by the others as a threat to the agreement.

Even if the new buyer is allowed into the scheme, it will be limited to the list of customers it has bought, unless it wants to challenge the scheme, or is able to get a disproportionate share of the market for new customers. Thus it can reap the returns to efficient operation only by cutting its costs in servicing existing customers. When a national firm enters a "clean" market, its increases in efficiency pay off in larger market shares as well as lower costs. For such national firms, conspiracy-ridden markets will be among the least attractive entry opportunities.

To the extent that current participants conceal income from tax authorities, there is a second disincentive for entry by a corporate buyer. Even aside from ethics, most corporate buyers would be unable to conceal corporate revenues from the Internal Revenue Service. Thus, even if they accept the present owner's figures on how large the unreported income is, they value that income only at its aftertax value. Worst of all is the possibility that drivers or supervisors might succeed in concealing revenues from the parent corporation. These factors may help explain why so many firms are passed along within the family.

It is the third barrier to entry that is of greatest interest here, for it also strikes at the alternative entry strategy, namely, creating a new firm. That barrier is reputation, in two senses. The reputation of an industry for being racketeer-controlled has one obvious deterrent effect. Prospective entrants have to be concerned that they would be the objects of retaliation by racketeers. Their trucks and plant might be destroyed. Their customers might find themselves threatened or actually subjected to physical violence. This is certainly what happened when the Brooklyn district attorney's office, in an undercover operation, started its own carting firm in 1972.

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But there is a second aspect of reputation that may be equally important. Any firm that succeeds in the New York City carting industry is likely to come under suspicion for profiting, at least passively, from the racket. A national firm that wants to overcome the vaguely unsavory reputation that the waste-collection industry has nationwide is likely to pause at the prospect of acquiring the additional taint of as-

sociation with New York racketeers. Successful entry might be quite as costly as unsuccessful entry.

This suggests an extremely awkward dilemma for prosecutors and regulators. For the more aggressively they attack the industry, the more notorious it becomes. Every investigation, with its accompanying headlines in the newspapers (even the staid *New York Times* gives considerable prominence to allegations of racketeering in this industry), adds to the bad name of the industry and further deters honest entrepreneurs from becoming part of it. The barrier to entry that protects the conspiracy may be strengthened by each investigation and prosecution.

What if an investigation should actually bring an end to the customer allocation scheme? Surely in that event prosecution would induce entry. But the experience of the New York prosecutors suggests it will not happen. The Brooklyn district attorney was able to outline the conspiracy in quite precise terms—routine overcharges of 500 percent, for example. Yet neither the courts nor the regulators came close to taking effective action. Only where prosecutors were able to show the use of violence did the courts impose substantial sentences.

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A mature racket of the kind we seem to have in New York's carting industry does not need to make much use of violence, precisely because of its reputational asset. Customers appear to accept the predations of their carters as an inevitable consequence of residence in the fabled Gotham. No doubt there is a level of extortionate pricing that would lead them to test the strength of the agreement aggressively, but quite high levels of monopoly pricing may stir little protest from fear of the consequences, even when no threat is uttered. Every prosecution that once again publicizes the ties between the carting industry and criminals that command great resources of violence presumably adds to customers' reluctance to challenge the carters. The numerous fictional accounts of rackets in New York do their part to reinforce these fears.

With both customers and potential competitors disinclined to challenge the setup, the carters need only worry about internal dissension. Their industry has many firms, and history suggests that attempted cartels in such industries have a short life—unless they are controlled by racketeers. The defining asset of the racketeer is his reputation. His promise to enforce the agreement is credible, precisely because he is believed to be able and willing to coerce others. Cartel organizing may indeed be his optimal strategy for capitalizing on his reputation.

The New York City garbage collection industry represents, in my view, a case of a mature, racketeer-initiated cartel that is peculiarly hard to suppress because the prime instrument for weakening it, prosecution, has the unintended consequence of adding to the industry's adverse reputation and thus further deterring entry. If this were true only of New York and the cartage industry, it might do nothing more than confirm the widely held belief of Americans that life in New York City is unpleasant and costly. In fact, the phenomenon is not restricted to carting in New York City. It has been found in carting in other places, including Philadelphia, New Jersey, and West Florida. It once was present in certain parts of the garment industry and nowadays is seen in the garment trucking industry. Similar allegations have been made, though not convincingly proven, of vending machine distribution and of fresh produce wholesaling.

In general, these industries are characterized by low technology, minor economies of scale, low entrepreneurial status, a homogeneous product, and local markets. A common ethnic background for both racketeers and entrepreneurs probably also facilitates racketeer involvement. Other factors might be listed. But the list is long enough to suggest that this phenomenon, while not limited to carting in New York City, is likely to be something less than ubiquitous and to be found in activities of declining importance in the national economy. Given the difficulty of breaking up such rackets once they have become mature, this is just as well. ■