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In the shadow illegal markets and economic sociology

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MPIfG Discussion Paper 11/9

In the Shadow

Illegal Markets and Economic Sociology

Jens Beckert and Frank Wehinger



Jens Beckert and Frank Wehinger
In the Shadow: Illegal Markets and Economic Sociology

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Abstract

Illegal markets differ from legal markets in many respects. Although illegal markets have economic significance and are of theoretical importance, they have been largely ignored by economic sociology. In this article we propose a categorization for illegal markets and highlight reasons why certain markets are outlawed. We perform a comprehensive review of the literature to characterize illegal markets along the three coordination problems of value creation, competition, and cooperation. The article concludes by appealing to economic sociology to strengthen research on illegal markets and by suggesting areas for future empirical research.

Zusammenfassung

Illegale Märkte unterscheiden sich in vielerlei Hinsicht von legalen Märkten. Trotz ihres großen wirtschaftlichen Gewichts und ihrer theoretischen Bedeutung blieben sie in der Wirtschaftssoziologie bislang weitgehend unbeachtet. Dieses Papier schlägt eine Kategorisierung illegaler Märkte vor und diskutiert die Gründe für ihr Verbot. Auf der Grundlage einer umfassenden Literaturlauswertung werden die Strukturmerkmale illegaler Märkte anhand der drei Koordinierungsprobleme der Wertbildung, des Wettbewerbs und der Kooperation dargestellt. Das Papier schließt mit Empfehlungen für zukünftige empirische Forschung.

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In the Shadow: Illegal Markets and Economic Sociology

Research into markets is at the center of economic sociology (Fligstein 2001; White 1981; Zelizer 1979). Over the past three decades sociologists have investigated almost every type of market using a variety of theoretical premises. All this research, however, starts from an assumption of the legality of market exchange. Economic sociology has given no attention to illegal markets.

This is not only an important lacuna in economic sociology. Illegal markets are also a phenomenon of great economic, political, and social significance. Although estimates of the size of illegal markets are notoriously difficult to make – actors do not publish revenue and profit figures – existing estimates indicate that annual revenues on illegal markets may well surpass one trillion dollars.¹ Politically, the existence of illegal markets presents state and law enforcement agencies with significant challenges. Socially, illegal markets are important because of the challenge they pose to the moral order of societies.

A lack of attention to illegal markets also means economic sociology neglects theoretical insights which might be gained from their study. Ignoring illegal markets excludes an important source of variance from the study into markets, thereby hampering theoretical advances also into the understanding of legal markets. Illegality deprives actors of legal protection from the property rights provided by the state for legal market transactions, and limits the business strategies and organizational forms available to actors.

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1 Authors working in the field and public institutions such as the UNODC (United Nations Office on Drugs and Crime) have tried to assess the size of illegal markets. All the figures must be read with great caution, however. The wide margins of estimates alone shows their imprecision. The estimates at the upper end are often challenged by other researchers, arguing that the figures are widely exaggerated. It is generally believed that the drug market is the largest illegal market. The UNODC estimated its worldwide revenue to be \$322 billion in 2003 at the retail level (UNODC 2005: 17). Another especially large market is believed to be the trade in counterfeit and pirated products for which worldwide revenue of \$250 billion was estimated for 2007 (OECD 2009: 1). For the United States the stakes in illegal sports betting have been estimated at \$380 billion (Smith/Wynne/Hartnagel 2003: 10). Other markets are much smaller but may nevertheless comprise a substantial part of the trade in the product. It is estimated that the revenue from transactions involving stolen or counterfeit art are worth between \$2 and 6 billion (Bernick 1998: 106), which would amount to up to 20 percent of the total market. It is also estimated that about 10 percent of the worldwide market for medication consists of fake medication (Cockburn et al. 2005: 302). For an overview of the assessments of the size of various illegal markets see Wehinger (2011).

What are the consequences arising from a lack of legal protection for market actors, from the threat of legal prosecution of market participants due to their market activities, and from the absence of social legitimacy for exchange? Answering such questions by investigating illegal markets helps us to understand more fully the significance of the role of the protection of property rights in the operation of markets.

The purpose of this article is mainly exploratory and conceptual. Its aim is to provide economic sociology with a basis for empirical research by conceptually categorizing illegal markets and suggesting research questions that might be especially promising. In a first step we define illegal markets and determine the conditions for their emergence. This is followed by an attempt to systematize the different dimensions of illegality in market exchange. What does it mean to say that a market is illegal? Subsequently, we discuss justifications for the illegality of certain market activities. Why are some markets illegal? In the following part we use the existing literature on illegal markets from criminology, sociology, anthropology, and economics, to outline the most important properties of illegal market structures and operations. To ensure the link to economic sociology we will describe the operations of illegal markets on the basis of theoretical advances from the analysis of legal markets in economic sociology. Special attention is given to the role of networks and institutions, as well as the three essential coordination problems of valuation, competition, and cooperation (Beckert 2009). The conceptualization of illegal markets under the terms of legal market research, gives access to systematic differences in the functioning of markets operating illegally. In the final part of the article we highlight the research questions arising from our considerations. These provide a basis for further study into illegal markets.

1 Illegal markets

Markets are arenas of regular voluntary exchange of goods or services for money under conditions of competition (Aspers/Beckert 2008). The exchange of goods or services does not constitute a market when the exchange takes place only very irregularly and when there is no competition either on the demand side or on the supply side. Markets are illegal when either the product itself, the exchange of it, or the way in which it is produced or sold violates legal stipulations. What makes a market illegal is therefore entirely dependent on a legal definition. When a market is defined as illegal, the state declines the protection of property rights, does not define and enforce standards for product quality, and can prosecute the actors within it. Not every criminal economic activity constitutes an illegal market; the product or service demanded may be too specific for competition to emerge, or it may simply be business fraud. Since illegality is defined by law, what constitutes an illegal market differs between legal jurisdictions and over time. The comparative and historical variance of illegal markets is itself a pertinent sociological research topic within the field.

What illegal markets share with legal markets is that they come into existence only when there is supply and demand for the goods offered. However, for an illegal market to emerge, other conditions must be met. On the demand side, a legal market either does not exist or the goods illegally offered are cheaper than the ones offered legally, while at the same time the purchaser is willing to discount the moral costs and (potential) risks arising from the illegality of the purchase. On the supply side, illegal markets depend on their expected profitability for the supplier, but also on his financial and organizational capacities to produce and/or distribute the good and evade law enforcement. Like the purchaser, the supplier must be willing to overcome any scruples associated with the illegality of his activities.

Strictly speaking, the notion of illegal markets is rather loose. The phenomena covered under the notion of illegal markets are heterogeneous and also comprise markets that are, as such, legal but involve a high level of illegal activities. Indeed, most illegal activity on markets actually takes place within the confines of a market which is as such legal. In many instances the legality of the market itself is even an important condition for the unfolding and success of illegal activities. Due to the multifaceted character of phenomena of illegality in markets it is not possible to distinguish illegal markets simply in terms of the products traded on them. Instead, close reading of the existing literature on illegal markets (Wehinger 2011) makes it apparent that different forms of illegal markets must be distinguished.

To clarify the different forms of illegality on markets we present a typology which distinguishes illegality along four different dimensions: (1) illegality due to the outlawing of specific products; (2) illegality of the market exchange of an otherwise legal product; (3) illegality of exchange due to theft or product forgery; and (4) illegality due to the violation of regulatory stipulations.

1. One instance in which one can rightfully speak of illegal markets is the market exchange of products whose production or provision is as such illegal. Current examples are child pornography, child prostitution, forced labor, illegal drugs, and human trafficking. Production or provision of these products and services is forbidden and therefore any market exchange emerging for these goods constitutes an illegal market, when the necessary conditions for the existence of a market are fulfilled.
2. A second type of illegal market refers to products or services which are as such legal but whose exchange on markets is outlawed. The focus here is on the market exchange, which is seen as offensive. An example of this is markets for body parts for transplantation purposes. In the United States, as in almost all other countries, the law stipulates that it “shall be unlawful for any person to knowingly acquire, receive or transfer any human organ for valuable consideration for use in human transplantation” (U.S. National Organ Transplant Act of 1984, quoted from Roth [2007: 45]). In a similar vein the illegality of prostitution (in some countries) is not a stipulation against sexual relations but against the intrusion of monetary considerations into

such relations. To the extent a market for the exchange of these goods nevertheless develops, one can correctly call it an illegal market.

3. Thirdly, market exchange of products can be illegal because the product offered has been stolen or has been forged. The market exchange for such products differs from the first two types because the production of the good itself is legal and legal objections do not refer to the exchange of goods from this product category as such. A painting that has been stolen is not as such illegal. With regard to counterfeits, producing them for private purposes in most instances does not constitute an illegal activity. The market exchange of stolen or forged products, however, is illegal. Nevertheless, this exchange does not necessarily constitute a market in itself. Stolen or counterfeit art, for instance, is fraudulently sold through galleries or auction houses otherwise dealing with non-stolen and authentic artworks (Tijhuis 2006: 163). It is important to recognize this because the market value of stolen or counterfeit products depends on camouflaging their true properties. This can succeed only if the exchange takes place in a legal market in which at least the customer is not aware that the product is either stolen or counterfeit. However, the exchange can also take place under conditions where both parties are aware of the theft or the forgery and thereby takes place in an illegal market. Examples are informal counterfeit markets such as *La Salada* in Buenos Aires or the *Xiushui* Market in Beijing where merchants sell clothing with forged labels and the vendors and customers are fully aware of this (Chaudhry/Zimmerman 2009: 42).
4. Finally, illegality on markets can refer to the violation of legal stipulations in the production process. Examples of this are the employment of illicit labor, the illegal disposal of toxic waste, or the violation of safety standards. Such violations of the law do not necessarily constitute outright illegal markets (they may, however, form illegal segments of the market). Nevertheless they are important features of illegality because the practices are forbidden due to their consequences for the market or for society. The reduction of costs through illegal elements in the production process, often through the externalization of these costs, leads to competitive distortions. The result is a mixed market with a smaller or larger illegal share.

Obviously, there are different degrees of outlawing market exchange: from banning whole product categories to forbidding only certain forms of production or exchange. This indicates that societies find market exchanges objectionable for different reasons and that the violation of social norms through certain market exchanges is not seen as always demanding the same legal reaction. But what makes a market socially objectionable?

2 Why are some markets illegal?

At least from the perspective of standard economic theory the fact that some markets are illegal must be unexpected. If markets provide benefits to the parties involved they should exist. Hence, a question which immediately suggests itself on observing the illegality of some markets concerns why they are illegal. The “why” does not refer to the explanation of causality but rather to the justifications provided for legal stipulations prohibiting certain market exchanges. This includes legal stipulations whose violation does not constitute an illegal market in its own right but constitutes a legal defect in the production or exchange of the goods (see section 3).

Understanding the normative reasons for declaring markets or specific practices on markets illegal is increasingly being discussed in practical philosophy (Kanbur 2004; Satz 2010; Walzer 1983). This literature focuses on normative justifications for restrictions of market exchange. While the criminological, historical, and sociological literature on the legal blockage of markets also discusses reasons for illegality (Healy 2006; Steiner 2010; Zelizer 1979) it is in the normative debates of practical philosophy that these reasons are outlined systematically. This literature is concerned mainly with two of the market types distinguished above: prohibitions on the production of specific products (type 1) and the legal restrictions on exchanging certain products on markets (type 2).

The normative arguments mentioned for justifying the outlawing of certain markets refer to values other than economic efficiency. To the extent that these values empirically provide the justification for the prohibition of certain markets, it furnishes evidence of the entrance of non-economic values into the sphere of economic exchange. Already in the 1980s Michael Walzer (1983: 156ff.) developed a list of goods for which market exchange should be blocked. In this (unsystematic) list Walzer includes slavery, the purchase of political and civil rights, the purchase of salvation, love, and honors, as well as “desperate exchanges” in which one of the parties to the exchange is highly susceptible. More recently, Debra Satz (2010) suggested a taxonomy listing four conditions under which market exchange becomes normatively offensive and should perhaps be blocked. The typology distinguishes between individually or socially harmful consequences of the market, on the one hand, and certain properties of the agents in the market, on the other. An example of individually harmful consequences of markets is food markets in which the price level leads to malnutrition for some. An example of socially harmful consequences are “markets that operate to undermine the capacities that a person needs to claim her rights or to participate in society” (Satz 2010: 95). Illegal markets (like others) can have both types of consequences: illegal drugs can have negative effects on their consumers and can clash with the social values of the majority. Markets are also morally objectionable when some actors on the market have “very weak or highly asymmetric knowledge and agency” (Satz 2010: 96), as well as when the market is characterized by the extreme vulnerability of one of the contracting parties. This applies to most illegal markets.

These harmful outcomes of markets and conditions for actors do not justify automatically the prohibition of the market. Instead, the implications of possible prohibition must be normatively reflected upon as well – including the likely emergence of illegal markets – and weighed against the possibilities of achieving normatively superior outcomes through market regulation: in other words, the prohibition of certain practices and methods instead of complete prohibition of a given market. Empirical evidence to justify the prohibition of markets shows the significance of the normative considerations listed by Debra Satz. Studies on the prohibition of markets for gambling (Lutter 2010), illegal drugs (Seddon 2010), diamonds (Bieri 2010), alcohol (Mendelson 2009), prostitution (Hunt 1999), and human organs (Steiner 2010) show that these normative considerations stand front and center when markets are prohibited. When establishing legal barriers to market exchange, societies make social values economically relevant through the prohibition of markets considered noxious (Satz 2010), obnoxious (Kanbur 2004), or repugnant (Roth 2007).

However, it is not possible to comprehend the illegality of markets only on the basis of moral justifications. Next to social values, the prohibition of certain markets or specific practices on markets can also be motivated by economic considerations, with reference to the efficient functioning of markets and the protection of the interests of market participants. Such objections to certain practices are not primarily the concern of discussions within practical philosophy but rather the subject of the literature on market regulation. Economic considerations stand front and center in the outlawing of the market exchange of stolen and counterfeit products but also in the prohibition of certain practices in the production process. Allowing trade in stolen products would not only be a violation of the property rights of the owner of the product but would provide incentives for stealing, leading to an increase in transaction costs. Banning counterfeits from the market protects the intellectual property rights of the original creator or the owner of the trademark (for example, fake medication), secures the working of the monetary system (counterfeit money), and the signaling-value of certificates. The enforcement of legal regulation concerning the production process not only defends values – for instance, those of child development or environmental protection – but also prevents welfare losses from monopolies, information asymmetries, and negative external effects. On the consumer side, the prosecution of the market exchange for goods that evade product regulation – for instance, fake medication – serves to protect purchasers from potentially hazardous goods (Akunyili/Nnani 2004) and thereby allows anonymous mass markets to develop. The prohibition of illicit work protects the interest of the state in tax revenues.

This very sketchy summary shows that definitions of legality and illegality on markets are also part of a “market struggle” (Weber 1978: 72) in which actors try to secure their material and ideal interests. Normative, functional, and economic interest-based justifications for the prohibition of certain products, market exchanges, or production practices are not mutually exclusive. All three can be relevant simultaneously, as in the prohibition of slavery (Berwanger 1967) and child labor (López-Calva 2003: 256).

3 The operation of illegal markets

Given the heterogeneity of phenomena of illegality on markets it is not possible to describe the functioning of illegal markets in a general model. Nevertheless, it is possible to identify more general traits of illegal markets by analyzing existing criminological, sociological, economic, and historical research on illegal markets from a theoretically informed perspective.

To systematize the understanding of the functioning of illegal markets we make use of a typology developed in market sociology which proceeds from the identification of a set of three coordination problems that confront market actors and need to be resolved for markets to operate (Beckert 2009). This is a general approach to markets that can also guide the study of illegal markets because actors on illegal markets are also confronted with these coordination problems. However, efforts to resolve them are subject to various challenges due to the illegality of their activities and different solutions must be sought. Illegality, it will be demonstrated, leads to different and often very cumbersome structures in markets. The typology thus allows us to understand the structures and operation of illegal markets by contrasting them to legal markets.

The typology of coordination problems is anchored in the postulation that for markets to operate, uncertainty in market transactions must be reduced in several dimensions. Market actors need “stable worlds” (Fligstein 2001) or “calculability” (Weber 1978: 351) in order for role sets to be reproduced. This holds true for markets under conditions of legality and illegality. The uncertainty in markets derives from three principal coordination problems, concerning value, competition, and cooperation.

1. The problem of *value* refers, first, to the assignment of value to a certain category of goods (for instance, cars, wine, travel) and second, to the assignment of different values to heterogeneous products within the same market. Purchasers must be able to “discriminate between the worth of goods or services that confront them in the market” (Koçak 2003: 5). The basis for this is a process of classification and commensuration in which actors rank products according to their contribution to the fulfillment of a functional need or within a status order of goods (Beckert/Aspers 2011) and thus provide the basis for attaching value to products in relation to each other. To establish the value of a product, actors must be able to assess its qualities.
2. Secondly, to ensure profits, suppliers must create market structures that provide protection from (price) *competition*. In legal markets this is the outcome of market struggles between suppliers, the state, and intermediaries, leading to cartelization, monopolization, product differentiation, first mover-advantages, entry barriers, and legal regulations structuring competition. In legal markets the state plays a key role in the market struggles from which the structures of competition emerge by laying down ground rules, for instance in competition law or intellectual property law, and by granting subsidies or collecting tariffs.

3. Thirdly, market actors are confronted with problems of *cooperation* emerging from the social risks of exchange, notably that of non-fulfillment of contract – in other words, “defection.” These risks arise from the asymmetric distribution of information regarding price, product quality and the possible opportunism of exchange partners in light of incomplete or non-enforceable contracts. The resolution of this problem is indispensable for profitable market transactions. On illegal markets this problem is especially pertinent because the protection of contracts by the state, which is the crucial protector of property rights on legal markets, is absent. On illegal markets actors must operate without and against the state (Paoli 2002: 145).

Value

Problems of value on illegal markets are to be found primarily among the difficulties of assessing product qualities, as well as the consequences of the legal defects for prices. The creation of value for a certain class of goods, a vital issue of competitive struggles on legal markets (Callon/Méadel/Rabeharisoa 2002), is largely irrelevant in illegal markets. Either the value is beyond doubt for the demander (for example, organ transplants, but also such things as child pornography or drugs) or illegal markets profit parasitically (Wehinger 2011) from the value construction on legal markets. The hindrance of advertisement and other marketing measures on illegal markets makes it difficult for suppliers to contribute actively to the creation of preferences. An exception may be the offering of free drugs to new customers on illegal drug markets (Coomber 2003: 469; Hobbs/Pearson 2004: 469). The curtailing of marketing instruments on illegal markets makes these markets more demand-driven than legal markets.

Suppliers in illegal markets, however, make parasitic use of product value created by suppliers in legal markets. This holds true not only for the value given to a specific class of products but especially for the symbolic value associated with certain products (Wilcox/Kim/Sen 2009: 255). The status of luxury goods is established through the marketing activities and reputation of the manufacturer of the original product and parasitically exploited by the producer of the counterfeit, who neither incurs the marketing costs nor the same level of production costs – when quality standards for the counterfeit are, as is often the case (OECD 2008: 53), lower than for the original.

While these are examples of the parasitic use of value categories originating in legal markets, the valuation of goods on illegal markets is at the same time confronted with pertinent problems of quality assessment which must be resolved by the market actors themselves. Problems of asymmetric distribution of information (Akerlof 1970) show up on illegal markets much more forcefully than on legal markets. While legally traded products are subject to quality regulations – such as safety regulations and quality standards – their illegally traded counterparts evade such regulations. At the same time, illegal markets are strictly limited as regards the provision of institutional safeguards to

their customers if the latter come to discover quality defects after purchase. There are no legally enforceable warranties. While customers can generally assume that the quality of counterfeit products is likely to be lower than that of the original, they can never know how much lower. Only for some products offered on illegal markets of type 4 are quality problems absent. An example is the illegal market for cigarettes in which a standardized product is sold but without paying the tax (Antonopoulos 2009).

In terms of social consequences, customers' lack of knowledge regarding product quality is relatively unproblematic in the case of counterfeit products such as clothing or watches. In the case of forged spare parts for aircraft maintenance, however, the consequences can be severe. Counterfeit investment products such as forged art can incur serious financial losses. The same holds true for the purchase of stolen goods in good faith if the seller is not able to recompense the buyer in case of detection. Severe consequences must also be expected in illegal markets of the other types. Illegal drugs (type 1) may not have the quality expected by the user (Caulkins 2007: 63); in illegal kidney transplantations (type 2) medical standards may be compromised (Goodwin 2006: 189); counterfeited medicine (type 3) may be useless or harmful (Gaudio et al. 2007); toys sold by producers evading safety standards (type 4) may damage the health of children playing with them.

One can assume that the absence of the mechanisms of quality assurance and enforceability of product quality operational in legal markets is an important impediment to illegal markets by limiting market expansion and having negative effects on price. How do actors react to the information asymmetries? How do they assess the value of the products being offered? Research on illegal markets shows that suppliers attempt to provide specific devices to reduce uncertainty regarding product quality. This supports the claim that the coordination problem of valuation itself is as pertinent in illegal markets as it is in legal markets. The concrete mechanisms being used, however, differ due to the illegality of the transaction.

A device of particular importance is personalized networks. In markets for illegal drugs, for instance, networks form between dealers and customers, allowing for an iterative game in which the dealer has an increased interest in providing a predictable quality of product in order to ensure ongoing business (May/Hough 2004). Reputational networks also play an important role (Coomber 2003: 947). In a study on the illegal online market for stolen bank account data, Holt and Lampe (2010) show the mechanisms through which product quality standards are maintained by means of self-regulation. Offers of false data are made public on the online trading platform, including the naming of the person who brought the product to the market. Sellers can lose their status of "verified" through the platform administrators and thereby lose their reputational capital. Personalized networks and reputation also play an important role on legal markets, of course (Granovetter 1985; Uzzi 1997). In illegal markets, however, their role is much more prominent because actors are much more limited in the types of devices available to them to prevent market failure from information asymmetry. The branding

of products on illegal markets, although confirmed in some instances (Wendel/Curtis 2000: 230), is rather an exception and warranties would not be credible because of their non-enforceability in the juridical system. For these reasons actors are much more confined to the use of personal networks. Middlemen, who are trusted by both sides, may also reduce uncertainty by brokering and intervening in transactions (Kenney 2007b: 28; Zaitch 2002: 251). Sometimes, criminal groups are used as guarantors, stepping in if one side cheats the other (Gambetta 1993: 20).

One can also show, however, that the problem of quality assessment does not necessarily have to be resolved in illegal markets. The problem can also be shifted. Quality uncertainty is dealt with by shifting risks from the original customer to a final user who is unaware of the legal defect of the product. In the construction of a subway the contractor may use inferior building materials, with the client being unaware of this violation of safety standards. In such instances, illegal market transactions of type 3 or type 4 can be connected to corruption: that is, the trading of decisions delegated by third parties (Dewey 2011).

In addition, the uncertainty regarding product quality may be accepted by the customer either out of desperation or due to deliberate ignorance. Desperation can emerge either from a lack of an alternative legal market for the product (for example, organ transplantation) or a lack of the financial means to buy the licit product (for example, fake medication). Deliberate ignorance can be expected if the value of the product emerges primarily from its symbolic qualities which are visible to the customer. The purchaser of a faked watch – who is aware of the fact that it is a counterfeit – may be more interested in the label than in the watch's technical finesse. That status symbols are an easily recognizable characteristic for purchasers may be the main reason – besides the large difference between production costs and retail value – why those products in particular are offered illegally.

An issue connected to the valuation of products is their pricing.² Again, one can see that illegality has profound consequences for the operation of markets. Looking systematically at the factors influencing the price of products traded on illegal markets, two aspects stand out: Information and the existence of an alternative, legal market.

If the customer knows about the legal defect of the product and there is an alternative legal market for the product category – that is, if the product is counterfeit,³ stolen, or produced under evasion of legal regulations – the product will be traded with a significant discount to its legal counterpart. Stevenson (2001: 112) finds that stolen products are traded at between 14 and 38 percent of the regular selling price. The discount is even

2 For the difference between value and price see Aspers/Beckert (2011).

3 Counterfeits can also constitute a type 2 market if there is no legal counterpart for the product. This holds true for the selling of forged documents. Here the argument for the pricing of counterfeit products developed in this paragraph does not apply.

higher for more expensive goods and if large quantities are sold (Henry 1976: 795). In theoretical terms, one can also assume that the illegality discount for counterfeit products with legal alternatives depends also on the degree of moral scruple of potential buyers. The higher these scruples are, the more attractive the price must be for a transaction to take place (Marcketti/Shelley 2009).

Whether there is a price difference at all, however, depends on the distribution of information. If the buyer is unaware that he is buying a stolen product, a counterfeit or a product produced by infringing legal rules, there will be no price discount and profits are distributed among the suppliers (deceptive counterfeiting, Grossmann/Shapiro (1988: 80)). This can be observed in the art market, where unrecognized counterfeits are sold for the same price as authentic pieces by the artist.⁴ Given the importance of information for pricing (at least in type 3 and type 4 markets) suppliers do have an interest in hiding the legal defects of their products. Investigating this camouflaging is an interesting topic in the study of illegal markets. Studies of markets for stolen products show that this process often involves several transactions, with the product becoming legitimated on the market through its association with vendors of increasingly legitimate status (Aarons 2001: 29; Bogdanova 2011; Massy 2000: 141).

Prices on type 1 or type 2 markets are not influenced negatively by the existence of alternative markets and positively influenced by the illegal character of the transaction. The market for illegal drugs is one example of this. On a legal market, heroin or cocaine could be offered for a fraction of their current market price. Because the product is illegal, the producer must protect himself from the risks of confiscation of the good or the production facilities and from personal prosecution. The persons involved must insure against these risks and take preventive measures which incur costs. Hence, the illegal market has high transaction costs. The consumer pays for a high profit margin justified by the high entrepreneurial risks involved in the production and vending of the product (Reuter/Kleiman 1986: 335) whereas suppliers earn a risk premium (Viscusi 1986: 338). The prohibition of a market for a product also reduces supply and therefore leads to higher prices (Levine 1991: 472; Saffer/Chaloupka 1999).⁵

At the same time, the enforcement of prohibition rules imposes a considerable financial burden on the state, which may even outweigh the benefits of this policy (Miron/Zwiebel 1995), and may have unintended consequences because even higher possible earnings after supply has been reduced could attract more criminals (McCoy 2000: 218; Levine 1991: 488). Furthermore, persecution in one region takes the pressure off criminal activities in other regions (Thoumi 2009: 210) and contradictory policies may open loopholes for sly entrepreneurs (Mendoza 2010a: 263). That products and services re-

4 See the recent scandal involving the auctioning of a Heinrich Campendonk painting which later turned out to be a fake for 2.8 Million euros by a German auction house.

5 However, at least for organs to be used for transplantation this is contested on the basis of crowding out effects (Healy 2006; Titmuss 1970).

main outlawed despite the costs deriving from this policy must be explained by their normative offensiveness.

For some illegal markets – for example, illegal drugs – there is a political debate on whether they should be transposed into regulated legal markets due to the negative social effects of their illegal operation or because of the potential tax income for the state once the market is legalized (MacCoun 1996). There are also examples of markets – alcohol and gambling in the United States – that were once illegal and were legalized. Legalization of type 1 or type 2 markets leads to a drop in price when the legal successor market is organized as a competitive market. However, the state may keep product prices high by imposing high taxes on the product (for example, lottery tickets) which in turn may lead to the emergence of illegal shadow markets (for example, cigarettes, sports betting).

Competition

The information problems mentioned above not only influence the value and price of products traded on illegal markets but also structure competition. Lack of transparency of product quality makes the market opaque to customers and reduces the information content of prices, which distorts competition. The reduction of competitive pressures on suppliers is in part already the result of the structural conditions under which they must operate. The conditions lead to fragmented market structures in which competition is often structured through personal networks with only local expansion. The personalized structures typical of illegal markets are a far cry from economists' definition of perfect markets but also far from the much less personalized existing legal markets. If one assumes, with economic theory, that the efficiency of markets is enhanced through competition, illegal markets are structurally inefficient because of their limited ability to resolve information problems and their proneness to negative external effects.

The inability to resolve information problems prevents illegal markets from developing more competitive structures. Another impediment to the development of competitive market structures is the limitation of competition through the curtailing of vending opportunities. In the case of stolen products, sales potential is limited through the difficulties involved in finding customers. Thieves sell their merchandise primarily to fences or directly to friends and relatives (Fass/Francis 2004; Stevenson 2001: 108). Thieves may also sell to drug dealers because they have the necessary networks to resell the goods (Ferrante/Clare 2006). Competition on illegal markets suffers from the inhibition of marketing activities and the open offering of products. While these structural components lead to protection from polypolistic price competition it also hinders market development and thereby limits profit opportunities.

Although the state is absent as a regulator of competition, early suggestions that in illegal markets monopolies tend to form (Schelling 1967) have proven to be incorrect (Williams 2001: 68). Most illegal markets are shaped by a network structure instead of monopolies (e.g. Zhang 2008). Only in certain narrowly limited areas have criminal groups managed to achieve a monopoly. Examples are mafia clans in certain communities of Southern Italy (Gambetta 1988b: 164; Paoli 2004: 22) and drug gangs in certain quarters of Brazilian cities (Zaluar 2000).

The securing of competitive advantages through the exclusion of potential competitors from the market (market closure) does not have to be organized by the market supplier himself. Instead, the supplier can buy the services of organized crime groups who offer “protection” in exchange for a payoff. Protection can involve shielding from new market competitors but also access to new customers, for instance through the commissioning of public work (Gambetta 1993: 22). The need to pay protection money to organized crime groups in order to enter a market can itself be understood as an entry barrier to a market (Gambetta 1988a: 134), which reduces competition. The (potentially) violent exclusion of competitors from market access on many illegal markets secures profits. However, it is also associated with high transaction costs and a welfare loss due to lower product quality and higher prices.

Not only private groups can be employed to exclude potential competitors. Frequently, criminal actors operate not without or against the state, but actually in cooperation with corrupt state agencies or individual state employees. Corrupt state agencies desist from law enforcement against the illegal firm in return for a share in the business. Illegal entrepreneurs not willing or able to cooperate with corrupt state agencies risk prosecution. Through corruption the state enhances the stability of illegal markets, at least by stabilizing criminals’ expectations with regard to law enforcement (Dewey 2011). The state’s participation in illegal activities can go so far that the illegal market is fully controlled or even monopolized by state agencies (Paoli et al. 2007).

Illegal activities can influence competition in yet another form, which does not refer to the organization of illegal markets, but to the procurement of competitive advantages on legal markets through the mingling of legal and illegal activities. This holds true for type 4 markets where legal regulations governing production of a good are violated. The illegal disposal of toxic waste allows an otherwise completely legal firm to realize cost advantages through the illegal externalization of costs stemming from legal regulation for environmental protection (Massari/Monzini 2004: 293). Such cost reductions are competitive advantages (Westra 2004: 309). The same holds true for the use of illicit labor, the violation of safety standards or the violation of nature protection standards, for instance logging without permission (Tacconi 2007). This provides further evidence of the importance of the close interconnectedness of illegal activities and legal markets (Brodie/Doole 2001: 2), one of the most interesting topics in the study of the illegal economy.

Cooperation

A further source of uncertainty in market exchange lies in the conditions for cooperation. To what extent can one trust one's business partners? This is already an important problem on markets operating legally due to incomplete information and incomplete contracts (Beckert 2005; Gambetta 1988b; Möllering 2006). On illegal markets, the magnitude of the problem rises dramatically. Actors involved in illegal activity face the danger of being prosecuted for their activities. In the case of child pornography (Jenkins 2001), actors proceed with such care that one cannot even call the emerging exchange structures a market. Instead, they can be described as forms of barter among closed groups where commercial interests recede into the background (Quayle/Taylor 2002: 345–348). Actors on illegal markets must hide their behavior from state authorities and people who may cooperate with these authorities. At the same time, actors on illegal markets need to interact with others to conduct their business, thereby exposing themselves to the risk of being detected. Actors on illegal markets need to trust exchange partners in many more dimensions than actors conducting legal economic activities.

At the same time, the means available to them to enforce trust are much more limited; they resemble rather pre-modern trust devices than modern ones. While trust in earlier economic configurations was largely anchored in personal relations, today trust in the economy is mostly made possible through institutions (Zucker 1986; Giddens 1990). Institution-based trust allows for the unprecedented time-space distancing of modern economies and is the bedrock of the expansion of market relations. One of the most consequential differences between legal and illegal markets is that illegal markets are strictly limited in the development of institutional trust. This is because the state is absent from the enforcement of contracts and institutional self-regulation on illegal markets cannot operate in the open due to the danger of state prosecution.⁶

As a result of these structural conditions, exchange on illegal markets is to a much greater extent organized within networks. Indeed, all research on illegal markets agrees on this point. "Illicit markets may be distinguished from licit markets by their failure to adopt impersonal forms or intentional communication and distribution of goods" (Arlacchi 1998: 208). Even personal relations, however, are much more demanding to organize because the risks are much greater than in legal market transactions. Hence, to become a partner in illegal transactions presupposes credible signals of trustworthiness on the side of the trust-taker (Gambetta 2009) and intensive monitoring on the side of the trust-giver (Spremann 1988: 618). Credible signs can be time served in prison, specific tattoos, but also a reputation of reliability from former encounters (Gambetta 2009: 11). To enter the group, personal, ethnic or family relations are often necessary and indeed the organization of illegal markets on the basis of "character trust" (Zucker

6 An exception to this is when actors operating on illegal markets succeed in "protecting themselves" from state prosecution by bribing officials in law enforcement and the judicial system. See Dewey (2011) for the case of Buenos Aires.

1986) is a very common phenomenon (Kenney 2007a; Nguyen 2004; Lampe/Johansen 2004). This kind of trust can also be transmitted by intermediaries (Zaitch 2002: 251; Kenney 2007b: 28).

The high stakes involved in the personal relations and the absence of the enforcement of contracts through the legal system explain the role of violence – or at least the latent threat of violence – against defectors on illegal markets. Violence is a mechanism to enforce cooperation on illegal markets. The credible threat of violent retaliation by the trust-giver increases the costs of defection for the trust-taker. Nevertheless, studies on illegal markets show that violence is used only reluctantly (Coomber/Maher 2006: 741; Antonopoulos 2008: 281). While it exists as a background threat, actors attempt to avoid the use of violence because of the attention it generates among the public and law enforcement authorities. Violence can be observed particularly in phases of challenges to established power structures on the market, as can be seen currently, for example, in the drug war in Mexico (Snyder/Duran-Martinez 2009).

The high risks involved in illicit activities and the reduced possibilities for building up institutions based on trust lead not only to recourse to violence, at least latently, but also inhibit sophistication in the development of illegal markets. The organizational structure of “firms” operating in illicit activities provides evidence for this. Organizations are typically very small and networks are only loosely coupled. Studies on human trafficking (Zhang 2008; Subedi 2009) report that the typical “enterprise” consists of no more than three to four people. Even on illegal drug markets, organizational structures exhibit patterns of very small units or sole traders (Desroches 2005: 123). Often “employees” are hired only temporarily and as little knowledge as possible is communicated within networks concerning operations (Dorn/Oette/White 1998; Natarajan 2000: 291).

The “overembeddedness” (Uzzi 1997) of market transactions in illegal markets inhibits efficient organizational size and information flows. They are the cause of severe restrictions in the possibilities for enlargement of illegal markets and give them a specific premodern flavor. The organization of illegal markets is characterized by the segmental differentiation characteristic of pre-state societies (Paul/Schwalb 2011: 135). Market relations are established by individuals who do not occupy a formal position that can easily be taken over by any other person. Trust is in most cases bound to that person. Only under very specific conditions can de-personalized relations develop – for example, between mafia-style groups with formal membership, where the whole group is hold responsible for members’ actions. The reliance on personal relations is also strengthened by the lack of financial tools commonly used by legal business (Gottschalk 2009: 15). Banks and investors are reluctant to lend their money to criminal enterprises, which makes it necessary for entrepreneurs to finance their businesses internally or to turn to other persons whom they trust personally.

4 Investigating illegal markets: Research questions

The previous section has shown how illegal markets can be studied within a framework for investigating markets which brings coordination problems to the fore. Existing literature from criminology, economics, anthropology, and sociology provides insights into the operation of illegal markets. This research demonstrates that the challenges to be met by actors on illegal markets differ between the respective forms of markets and the products being sold. The analysis also shows some common features which are of substantial interest for the study of markets in general.

Despite the importance of the study of illegal markets for market sociology, interest in illegal markets is largely absent from economic sociology. In this section, we will identify a set of further research questions that are especially important in the study of illegal markets from a sociological perspective. These issues can be added to those discussed in the previous section relating to the valuation and pricing of products, the organization of competition, and the mechanisms through which trust is established on illegal markets.

1. Illegal markets should be studied from a process perspective, investigating their emergence, proliferation, and possible decay. Many conditions which trigger or hinder the spread of illegal markets – such as ethnic communities, social values, organizational and technological preconditions, or the effectiveness of law enforcement – have been identified in existing research. However, their exact role and interrelatedness remain unclear. Historical examples of prohibition and/or its suspensions – for example, alcohol, prostitution, mind-altering drugs – make possible the investigation of the appearance and disappearance of illegal markets and justifications for the outlawing of certain market transactions. The role of social norms, justifying the permitting or prohibition of markets and the relationship between legality and legitimacy should be taken in consideration in this endeavor (cf. Satz 2010). The investigation of newly emerging illegal markets, such as those for body parts (Foster 1997) or surrogate mothers (Krawiec 2010), allows us to study illegal markets in the making.
2. A second set of research questions concern the organizational features of illegal markets. Although network-shaped organizational styles are predominant, there are many different patterns in which production chains are organized. There are large differences within market types and, at the same time, similarities across them. The theft and sale of small products, which are a common target of petty theft, is organized very differently from, say, car theft which requires a comprehensive organizational structure. While the former involves only thieves and fences (Johns/Hayes 2003), there are many differentiated roles and sophisticated technical and commercial processes in auto theft (Sieber/Bögel 1993: 78–110). The illegal cigarette trade (type 4) and illegal drugs trade (type 1), however, may have more in common than their different classifications suggest at first sight. Under what circumstances do which organizational forms dominate? How are the emerging forms related to the

competitive structure and problems of cooperation emerging in the market? These questions are even more relevant given the variance of business styles, even in the same market: for example, illegal drugs, which range from individual traders and networks of loosely coupled individuals (Desroches 2007: 834; Massari 2005: 9) to hierarchically organized groups (Curtis 2007: 883). Not only the differences in organizational structure, but also the functioning of the different forms need further clarification. Composition, stability, internal processes, and functions of networks in illegal markets should be compared to their counterparts in the legal economy.

3. A third set of questions concerns the interfaces between legal and illegal markets. The very notion of “illegal markets” seems to suggest something strictly separated from legal market activity. However, this is often not the case. Already the discussion of stolen and counterfeit products (type 3), as well as markets in which an otherwise legal product has been produced in violation of legal regulations (type 4), shows the close interconnectedness of illegal and legal market activity. The same intermingling has been shown for actors on illegal markets who are often active simultaneously in both legal and illegal activities. The interfaces between legal and illegal markets can be systematized in a typology distinguishing between illegal markets that relate parasitically or symbiotically to legal markets (Wehinger 2011). In both cases the market for the illegal commodity cannot exist without a legal twin. An example is the trade in so-called “blood diamonds” which are cut and sold in the same production and sales facilities as all other diamonds. But how exactly the boundary crossings from the illegal to the legal are organized is unknown.
4. The state can adopt multiple positions towards illegal markets. It can fight them or become their accomplice. The extent to which the state in fact does prosecute or should in theory prosecute the actors on illegal markets is not easy to answer because of difficulties involved in cost–benefit calculations. This also has to do with the incommensurability of the economic and value related consequences of illegal markets. The factors which lead to the state’s deciding to allocate a certain proportion of its capabilities to fighting illegal markets are especially likely to include non-economic, socially founded arguments. No matter what position the state takes, it is always an actor in illegal markets to whose activities the other actors must adjust. They will try to evade the jurisdiction of the state, influence its actions, exploit it in competition with business rivals, and corrupt it. Besides “turning a blind eye” or providing a “protective umbrella” for criminal activities, it can also itself actively engage in illegal markets (Shen/Antonopoulos/Lampe 2010: 250–251) and even become the main supplier of illegal products and services (Paoli et al. 2007).
5. How much the state invests in combating illegal markets and whether it prohibits certain forms of market transactions can also be influenced by non-governmental organizations. This is the case with regard to the diamond trade. The timber market, by contrast, is still strongly affected by illegal logging; lobbying efforts for national or international regulation have not yet yielded the intended results (Banks et al.

2008: 6–7; Malets 2009). The causes and consequences of the specific interplay between illegal markets and states should be researched in diachronic and synchronic comparisons. In addition, the extent to which self-regulation is an option for illegal markets is an important question. Whether the state takes a negligent or hostile stance towards illegal markets, the participants in these markets must rely on their own ability to solve the market coordination problems described above. The finding regarding self-regulation, however, could also contribute to a better understanding of legal markets.

6. A final set of issues refers to the consequences of illegal markets. The inability of the state to eradicate illegal markets can exacerbate social afflictions (illegal drugs, prostitution) or impair general trust in state and market institutions. Potentially, the very presence of illegal markets can erode the belief that certain illegal activities are illegitimate at all and thus undermine social norms by deviating from custom. Illegal markets also have economic consequences. The mere existence of illegal markets can make consumers insecure with regard to the quality of goods offered to them as legal if illegal products capture a larger segment of the legal market. Illegal markets can distort competition if they provide competitive advantages based on the evasion of regulatory norms. Illegal markets may, however, also have positive consequences: The provision of goods which are otherwise unavailable increases individual welfare and can contribute to economic growth. In the section on the justification of the prohibition of specific market exchanges we alluded to the point that the prohibition of markets can itself have negative consequences not least due to the emergence of illegal markets over which the state cannot exercise any regulatory control. The re-legalization of markets for alcohol and gambling in the United States was also a reaction to the negative social consequences of the illegal markets that had surfaced under prohibition.

5 Conclusion

Illegal markets have economic importance and represent an interesting field for sociological research. Economic sociology, however, has not yet taken up this challenge. Research on illegal markets is virtually nonexistent within market sociology.⁷ The research conducted on illegal markets in criminology, anthropology, law, history, and economics, on the other hand, finds no connection to economic sociology. Often it is overly empirical, describing a specific illegal market (most prominently, illegal drugs) or illegal behavior in legal markets, but with no explicit theoretical anchoring. A promising way to study the operation of illegal markets systematically is to proceed from the coor-

7 Alejandro Portes's (2010) textbook on economic sociology touches on this subject in Chapter 7: "The informal economy."

dination problems in market exchange and investigate how actors on illegal markets respond to these problems and what kind of market structures develop.

One of the central premises of market sociology is that reproducible role structures in exchange relations appear only when uncertainty is reduced so that “stable worlds” (Fligstein 2001) can emerge. Reduction of uncertainty is a precondition for making decisions calculable. Market sociology shows the crucial role of formal institutions, social networks, and cognitive frames in the stabilization of markets.

In illegal markets, most formal institutions involved in securing property rights are beyond reach for the actors concerned, while social relations suffer from a lack of institutional trust. In addition, cognitive frames are constantly challenged through the turnover of actors and non-complicit competition. Furthermore, actors in illegal markets are subject to state prosecution, which makes their position even more tenuous. The fact that, nevertheless, market structures do emerge seems at first sight to contradict the proposition that the reduction of uncertainty is a necessary condition for the emergence of markets. A closer look at the operation of illegal markets, however, shows that in most instances these markets develop only deficient structures, compared to legal markets, which is why they are not able to achieve the scope and level of efficiency observable in the latter. Illegal markets rely largely on personal networks and reputation to solve coordination problems. This is a liability for these markets and makes them appear, in specific ways, un-modern; market relations do not achieve the impersonality of exchange and institutional protection of property rights characteristic of exchange on contemporary legal markets. The study of illegal markets can thus highlight also indirectly the importance of institutionally secured structures for the possibility of highly complex exchange relations with wide time-space distanciations.

Illegal markets, however, are not only confronted with the mere absence of formal institutions regulating exchange; the actors are also subject to state prosecution. This not only inhibits the development of complex organizational structures (Paul/Schwalb 2011), but also establishes an affinity between illegal market activities and weak or corrupt states. When operating undisturbed by legal prosecution, actors participating in illegal markets are at an advantage: “Criminal groups come about when the state cannot regulate certain markets due to diminished capacity, or when it chooses not to regulate markets by declaring certain commodities and services illegal” (Koivu 2007: 4).

It is strongly desirable that economic sociology turn to the investigation of illegal markets, giving up one of its most basic implicit premises, namely that the activities on markets are legal. This article is intended to be a first step towards shedding light on an aspect of markets which, so far, has been confined to the shadows of research in economic sociology.

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