

Introduction

1.1 Extralegal Governance and Lawlessness

How do private individuals mitigate risk and secure social cooperation? Thomas Hobbes, a seventeenth-century English philosopher, believed that life under anarchy was “solitary, poor, nasty, brutish and short” and people should contract with a leader and protector (i.e., the government) who would be able to remove people’s basic fears, such as violent death, wounding, and oppression, and protect them from inevitable anarchy (Hobbes 1651). Hobbes’s ideas exerted a powerful influence for the next several hundred years (Powell and Stringham 2009). Law and economics scholars, in their early contributions, examined the ways in which anarchy undermines social cooperation and investigated the role of the government, especially “the institution and machinery of the state’s law,” in providing governance for economic activities and social cooperation (Dixit 2004: 2). For example, in the 1970s, public choice scholars such as Gordon Tullock, James Buchanan, Winston C. Bush, and Warren J. Samuels began their economic analysis of anarchy and published two edited volumes, *Explorations in the Theory of Anarchy* (1972) and *Further Explorations in the Theory of Anarchy* (1974). The early public choice analysis of anarchy shows that in a state of anarchy individuals would face the prisoner’s dilemma, cooperation would be limited, and government enforcement would be needed to safeguard long-term contracts and complex transactions.

In the early 1970s, the public choice economists’ overall perspective on anarchism “could be described as sympathetic, but ultimately pessimistic” (Powell and Stringham 2009: 508). Anarchy is perceived as an unstable outcome (Nozick 1974) and a solution to the prisoner’s dilemma is to create government law enforcement (Buchanan 1974, 1975). The state capacity literature examines two essential components of state capacity – fiscal and

legal – and identifies the ability of a state to raise revenue, enforce laws and regulations, and provide “fundamental public goods, including defense, a legal framework, and some degree of productive investment” (Piano 2019: 291; see also Acemoglu et al. 2016; Murphy and O’Reilly 2020). The concept of “State Capacity Libertarianism,” which has recently been introduced by Tyler Cowen (2020: online), emphasizes the need for a strong and capable state to “maintain and extend capitalism and markets” and “protect individual rights.” However, as Murphy and O’Reilly (2020: 737) argue, state capacity libertarianism contradicts certain strands of political economy literature. As they point out, state enforcement of property rights is either redundant in situations where private institutions and norms can cost-effectively safeguard private property rights (see Stringham 2015; Williamson 2011) or counterproductive when state institutions lack efficiency and their intervention hinders the smooth functioning of private institutions and norms (see Leeson 2014; Leeson and Harris 2018).

A younger generation of researchers “has noticeably less faith in government than their predecessors,” and they have investigated how the problems in Hobbesian anarchy can be solved by private or extralegal means of enforcement (Stringham 2005). These researchers find the conventional study of law and economics problematic, because it “takes the existence of a well-functioning institution of state law for granted” (Dixit 2004: 3) and treats the enforcers of the law “as robots who will automatically do what the law asks them to do” (Basu 2018: 35). Despite many modern governments making great efforts to provide effective governance, none is able to guarantee that all social and economic activities are cost-effectively regulated (Skarbek 2011). Extralegal governance institutions therefore “play an important role in protecting property and adjudicating disputes” in circumstances in which state-sponsored governance institutions are ineffective or absent (Skarbek 2014: 6; see also Stringham 2015). Moreover, many governments, especially nondemocratic ones (e.g., Nazi Germany, Soviet Russia, Maoist China, and North Korea), are predatory and incompetent to provide governance (Murtazashvili and Murtazashvili 2020); worse, they severely undermine social cooperation within their societies (Leeson 2014). Law and economics scholars should therefore not only examine the effect of legal rules on economic activities and outcomes but also devote equal attention to “lawlessness and economics” (Dixit 2004) and investigate how private individuals enhance cooperation, enforce property rights, and settle disputes without state law.

In the absence of effective government-provided legal institutions and organizations, individuals who want to obtain benefit from social

cooperation are “considerably more creative in finding solutions to their problems than the academics who study them” (Leeson 2014: 3). Private individuals, organizations, and communities devise alternative mechanisms to improve cooperation and eliminate opportunistic behavior. Recent decades have witnessed a growing body of literature, from the disciplines of institutional economics, criminology, political science, sociology, and economic anthropology, examining the formation, prevalence, evolution, and function of extralegal governance institutions and suggesting that various extralegal governance institutions work better than conventional wisdom supposes. For example, Ostrom (1990) unmasks the ways in which local communities govern their common pool resources and overcome collective action problems. Bernstein (1992: 155) investigates “an elaborate, internal set of rules, complete with distinctive institutions and sanctions” developed by the diamond industry to resolve disputes among industry members, with the courts and legal rules playing no role. Leeson (2009) adopts rational choice theory to examine how the world of late seventeenth- and early eighteenth-century pirates was regulated by a “pirate code” and constitutional democracy: Pirate customs served to compensate workers, regulate drinking and smoking, and increase racial tolerance and equality (see also Leeson 2007; Leeson and Skarbek 2010). Stringham (2015) weaves together history and economics to show how private parties devise nonviolent mechanisms to solve the pervasive problem of fraud, facilitate exchange, and protect private property. Skarbek (2014) draws on institutional economics to examine why and how prison gangs form to produce alternative governance institutions facilitating illegal activities in the American penal system. These studies suggest that “private rules and regulations are more common, effective, and promising than most of us believe” (Stringham 2015: 4).

1.2 The Puzzle

Past research has thoroughly examined how and why extralegal governance institutions function more effectively than many believe in both democratic and dysfunctional states (Chamlee-Wright 2010; Grossman 2021; Ostrom 1990; Richman 2017; Shortland and Varese 2016; Skarbek 2014, 2020a). For example, Grossman (2020, 2021) examines the social order of informal markets in Lagos, Nigeria, and finds that market association leaders utilize informal institutions to promote trade, address group disputes, and gain the support of group members in order to avoid and respond to active government interference. Researchers have also studied how informal or extralegal governance institutions operate in authoritarian states.

For example, Murtazashvili (2016) and Murtazashvili and Murtazashvili (2021) have comprehensively investigated the capacity of customary organizations at the village level in the governance of rural Afghanistan, which is widely viewed as a fragile state where people have endured a long history of conflict and political instability.

Moreover, recent decades have witnessed a growing body of literature on informal institutions in authoritarian China, where state capacity is strong. This literature includes the research of Yang (1994), Yan (1996), and Barbalet (2021) on the changing function of *guanxi* in Chinese society, Qiao's (2017) study of strategic interactions among market participants in China's small property right housing market, and the research of Nee and Oppen (2012) and Tsai (2002) on the informal financing mechanisms developed by small business owners. However, the ways in which the Chinese state constrains or facilitates the formation and development of illegal markets, as well as how informal or extralegal governance institutions operate within these markets, remain underexplored.

To fill this gap, this book focuses on China's illegal markets and explores different categories of governance institutions that facilitate cooperation within these markets. It explores several theoretically and empirically important questions: How does the state constrain or enable the growth of illegal markets? What are the major market-based uncertainties and political-legal risks faced by illegal market participants? How do governance institutions mitigate risk and secure social cooperation in illegal markets? More specifically, why do participants in a transaction face different types of risk, and why do they view the same risk differently? Why does one form of institutional mechanism work well for governing illegal transactions in one social setting while playing a marginal role in another setting? Why and how do market participants use different forms of governance institution to deal with the same category of risks? Illegal transactions are pervasive, and illegal markets continue to grow both online and offline. How does internet technology affect the social order of illegal markets? To answer these questions, researchers need to collect firsthand empirical evidence and develop innovative frameworks for analyzing illegal markets.

1.3 In Search of an Answer: How the Chinese State Facilitates the Growth of Illegal Markets

China is the perfect example of how in many circumstances authoritarian/centralized states are predatory, rather than protective, as stated by Hobbes in *Leviathan*. Often, the predatory state enables, rather than constrains, the

emergence and development of illegal markets in many situations. The role of the authoritarian Chinese state in creating and promoting illegal markets is threefold.

First, China's regionally decentralized authoritarian system, consisting of centralized fiscal and personnel control and decentralized economic governance (Xu 2011), makes local government both developmental and predatory. Under decentralization, the central government has established "a growth-oriented performance evaluation system" (Wang et al. 2019: 3). This motivates local governments facing serious budget shortfalls to rely on the urban-biased land development policy to generate funds to "fulfil the mandates specified in the evaluation system," such as attaining high growth rates and supplying massive infrastructure and public services (Cai et al. 2021: 2333). China can be considered a predatory state due to its lack of political constraints (i.e., "separation of powers at the national level") and its partial protection of property rights; as a result, the Chinese government possesses strong abilities to arbitrarily expropriate property, such as land (Cai et al. 2020: 154). In contemporary China, ownership of urban and rural land is defined as follows: "Urban land is controlled and owned by the state ... whereas rural land is collectively owned" (Sa 2020: 2). The separation of land-use rights and ownership empowers local governments to raise substantial extra revenue from land conveyancing: "The ratio of local governments' financial expenditures to fiscal revenue from land soared from 5.7% in 1999 to 23.4% in 2015" (Zhu et al. 2019: 742). Local governments convey urban land and collectively owned rural land to real estate developers for enormous profits, while residents who possess land-use rights are largely excluded from the decision-making process by local governments and village leaders and are usually undercompensated for what they lose (Cai 2003). Given that land property rights are ambiguously defined and that there is a lack of transparency and grassroots input, villagers need to develop strategies to safeguard their interests. Due to domestic migrants' high demand for affordable housing, informal housing markets and their associated exchange institutions have emerged from the bottom of the hierarchy (Qiao 2017; Wu et al. 2013). The small property right housing market is a typical example and will be examined in this book.

Under such an urban-biased political regime, local governments not only need to promote local economies but also have to control rural–urban migration (Shifa and Xiao 2022). Urban-biased development policies, which systematically discriminate "against agriculture and the rural economy in the allocation of developmental resources" (Bezemer and Headey 2008: 1342), have given rise to a significant urban–rural gap. The enormous disparity in

income and living standards between rural and urban residents encourages rural residents to seek job opportunities and better livelihoods in urban areas. To maintain urban fiscal sustainability (Shifa and Xiao 2022), the Chinese government uses its household registration system (*hukou*) to deprive rural-to-urban migrants of equal access to employment, education, health care, and social and political advancement in urban areas. China's uneven development and the discriminatory *hukou* system have led to many migrants from rural areas working as unlicensed street vendors in urban centers (Huang et al. 2018). As the government does not recognize and protect these workers' property rights, such as user rights to public space, street vendors have developed extralegal governance institutions in order to survive.

Second, the authoritarian state has wide powers, but it lacks checks and balances to guard against abuses of power by those who wield it. The lack of political constraint and bottom-up monitoring has led to the rise of a gigantic market for power–money exchanges. Since the 1990s, corruption in China has become rampant and systematic. As Wedeman (2012: 2) points out, “in the case of China, we see rising corruption, high growth rates, and high-speed economic development.” The intensification of corruption is linked to the “commodification” of state-owned resources and the transfer of “assets from the command sector to the market” (p. 9). As a result, the primary form of corruption became transactive corruption between public officials and private actors, rather than predatory plunder such as embezzlement of state funds and property. The study of transactive corruption should focus not only on illegal exchanges between officials and citizens, however. Recent studies have started to pay attention to transactive corruption within the public sector. For example, Wang and Yan (2020: 612) observe that corruption in the form of gift-giving and extravagant position-related consumption increases “the efficiency of bureaucrats trying to develop local economies in China, where the political structure is fragmented and the formal incentive system is incomplete.” Zhu (2008) and Wang (2016) investigate the buying and selling of public appointments, which is a popular form of transactive corruption in the public sector (see also Hillman 2010; Wang and Wang 2018). These scholars argue that the weaknesses of the formal, rule-based personnel system, such as overconcentration of power in the hands of senior officials and the failure of the state to monitor these officials' misuse of office, allow many public officials to use social ties and bribery to gain promotion. The prevalence of transactive corruption in China offers an ideal opportunity for researchers to make a closer examination of how extralegal governance institutions facilitate corrupt transactions.

Third, the authoritarian state achieves legitimacy by launching campaigns and solving easily identified and easily handled societal problems (Alon et al. 2020; Wang 2020b; Yang and Zhao 2015; Zhu 2011), while illegal markets that are hidden and nonviolent are largely tolerated by the local government. The central government of China is strong in respect of the fiscal resources it controls, but local governments responsible for implementing policies – including anticrime policies – are often weak due to lack of funds (Ong 2018; Wang and Wang 2024). Faced with the rise of illegal markets, such as gambling and prostitution, local law enforcement agencies punish only those who commit violent offenses, preferring to generate extra-budgetary revenue by collecting fines from illegal market participants such as sex workers and gamblers. In other words, because local law enforcement agencies lack the motivation and capability to eradicate or regulate illegal markets, they turn a blind eye to illegal markets that are relatively nonviolent. As communication and information technology developed, illegal entrepreneurs started to use innovative internet-based strategies to market services, such as private loans and gambling, and enforce agreements. As physical violence is not a characteristic of online illegal markets, and online interactions between exchange partners are anonymous, participants in these markets are able to escape police attention and avoid punishment.

These key features of the Chinese authoritarian state – an urban bias, broadly defined powers without checks and balances, and legitimacy maintained by solving easily identified problems – are highly relevant to the growth of illegal markets. The emergence, development, and social order of illegal markets in authoritarian China are different from these in democratic countries. For example, China has witnessed the formation of large-scale markets in informal housing, the buying and selling of government appointments, and unlicensed street vending, whereas these markets are small, or simply do not exist, in democratic countries. The research into China's illegal markets contained in this book therefore enriches the literature on illegal markets and non-state institutions by offering a clear picture of extralegal governance and illegal markets in an authoritarian state. It generates new knowledge concerning the role of the state in enabling or constraining illegal markets, the range of risks, and the complexity of extralegal governance institutions in illegal markets.

1.4 Objectives and Contributions of This Book

This book aims to provide a socio-economic approach for studying the social order of illegal markets as well as risks and institutions within these markets.

It seeks to advance understanding of extralegal governance in authoritarian China, where the economy is experiencing transition (Coase and Wang 2016), private property rights are ambiguously defined (Bai et al. 2006; Zhu 2008), the judicial system is not strong (Gong 2004; Li 2012; Wang 2013b), public-sector corruption is an ongoing concern (Lu 2000; Wang 2016; Wedeman 2012), and illegal markets are thriving (Shen et al. 2010; Wang and Antonopoulos 2016; Wong 2016). Specifically, we examine, both theoretically and empirically, the characteristics of illegal markets, especially their social legitimacy, and the nature of exchange relationships, particularly regarding whether participants are embedded in power-imbalanced relations and face different risks of punishment. We also explore the existence of various types of risks and the ways in which private individuals, companies, and organizations utilize them to mitigate risk and facilitate social cooperation and economic exchange in illegal economies. We adopt a multiple case study design comprising four cases: unlicensed street vending, small property right housing, corrupt exchanges, and online loan sharks. The cases are specifically selected to sample China's illegal markets, which range from offline to online, from public sector to private sector, and from socially acceptable to socially unacceptable (Small 2009).

The first two cases are illegal but socially legitimate, whereas the latter two are neither legal nor socially legitimate. The boom of street vending and the small property right housing market are defining features of China's rapid urbanization and uneven development (Huang et al. 2018; Qiao 2017). Rampant corruption in the public sector and the rise of online illegal markets also characterize contemporary China (Gong 2002; Huang 2018; Wedeman 2012). Due to the fact that different markets include different economic activities, and participants in these markets face different market and political risks and challenges, illegal economy participants need to develop a range of extralegal governance institutions in order to secure cooperation, prevent opportunistic behavior, and counter the threat of government repression. A certain type of extralegal governance institution might work cost-effectively in regulating one category of market transaction, but its role in safeguarding another type of transaction may be marginal. Moreover, participants in street vending and the small property right housing market are willing to coordinate collective resistance to government interference, while corrupt transaction partners and online loan sharks must develop effective institutions to hide their illegal activities and avoid government crackdowns.

The empirical investigation of these four cases enables us to offer insights on a number of essential but understudied issues, including the

impact of key features of the authoritarian regime on the development of illegal markets, major market and political–legal risks in illegal markets, and the key forms of extralegal governance institutions developed by market participants in different social settings. The examination of extralegal governance and illegal markets under authoritarianism contributes to the broader study of institutions and illegal markets: It offers a foundation for comparative studies of the governance of illegal markets in democratic and nondemocratic countries. In addition, it offers valuable evidence to government agencies, offering insights into non-state governance institutions and improving agencies' ability to provide the governance needed.

This book contributes to the existing literature in three ways. Firstly, and more generally, it is one of the first English-language books focusing on private rules and regulations in illegal markets and presenting a comprehensive picture of illegal markets and extralegal governance institutions in China. Past research has focused on self-governance or extralegal governance in democratic and dysfunctional states (Chamlee-Wright 2010; Leeson 2014; Murtazashvili 2016; Ostrom 1990; Richman 2017; Shortland and Varese 2016; Skarbek 2014, 2020a), whereas studies of extralegal governance institutions in China are rare, except for Qiao's (2017) research on China's small property right housing, Ho's (2017) research on the function and credibility of institutions in the real estate land, housing, and natural resources sector, and the research of Nee and Oppen (2012) as well as Tsai (2002) on the informal financing mechanisms developed by small business owners. We argue that extralegal governance institutions may play a larger role in China than in democratic regimes. This is because the Chinese government is more predatory than democratic governments, and it frequently takes advantage of ambiguously defined property rights to rob its citizens; for example, private land ownership does not exist in China, and local governments, rather than local residents, are always the primary beneficiaries of conveying land-use rights to real estate developers (Hsing 2010; Lin 2009). As a result, informal community-based institutions for protecting private property are common in China.

The prevalence of informal institutions is also due to the importance and resilience of *guanxi* (i.e., social ties) in both the public and the private domains (Barbalet 2018; Bian 2019; Chan and Yao 2018; Li 2011; Qi 2013; Ruan 2019; Wang 2017; Yan 1996; Yang 1994; Zhan 2012). To be specific, social cooperation among Chinese people is to a large extent determined by economic calculation and social mechanisms, with formal institutions playing a comparatively small role. The discussions above suggest that informal institutions in China, specifically extralegal governance institutions,

constitute an essential research topic deserving more scholarly attention. This book's examination of the ways in which extralegal governance institutions work in China's illegal markets therefore adds value to the general literature on institutions.

Secondly, and theoretically, this book draws insights from sociology and institutional economics to establish a socio-economic approach to explain risks and extralegal governance institutions in illegal markets. The socio-economic approach considers two dimensions: macro and micro. Macro dimensions, including social legitimacy (distinguishing between legitimate and illegitimate illegal markets) and levels of state repression, are used to examine the nature of illegal markets, the different risks experienced by participants in *different* markets, and the varied forms of institutions employed by market participants. Macro dimensions also take into account the social order of illegal markets when operating online. On the other hand, micro dimensions, including power-dependence relationships and levels of criminal punishment, are helpful for investigating the characteristics of exchange relationships and identifying the different kinds of risk experienced by exchange partners (buyers and sellers) in the *same* market. The construction of this analytical approach is largely based on existing studies that use economics – especially new institutional economics – and sociology to analyze risks, private institutions, and institutional change (Beckert and Dewey 2017; Greif 2006; Leeson 2009, 2014; Liu and Weingast 2017; Skarbek 2014; Stringham 2015). This book therefore not only contributes to the study of illegal markets in China but also facilitates the exploration of illegal markets in general.

Thirdly, and empirically, this book contributes to the understanding of extralegal governance by utilizing rich and valuable empirical data collected by the two authors and their research collaborators. Non-state institutions and illegal markets in authoritarian China have been largely ignored in the existing literature for two main reasons. First, language barriers not only discourage Western scholars from conducting fieldwork and obtaining local understanding of how extralegal governance institutions work in China, but also prevent Chinese scholars from obtaining insights from Western literature and publishing their research findings in international journals. Second, the Chinese government has broadened the scope of academic censorship, meaning researchers have had to restrict their attention to politically correct and otherwise acceptable topics, leaving many essential areas, including self-governance in semilegal and illegal markets, unexplored or understudied.