

Economic Analysis of Law
Villanova -- Spring 2020
The Armageddon
Klick

Please submit your answer to the following question to jklick@law.upenn.edu with the subject line "Klick LE Exam" by 6 pm on Wednesday February 26, 2020. You may consult any outside materials in formulating your answer, but please do not confer with any other individual (including, but not limited to, your classmates) in the process of completing the exam. Also, even if you submit your exam before the deadline noted above, please do not discuss the exam with anyone prior to March 1, 2020. If you want to include graphs or other illustrations in your answer, feel free to scan/photograph hand-drawn graphs and submit them in separate files if it is easier for you than embedding them in the main test file (of course, feel free to insert them in the main file if you prefer to do that). Good luck.

Question

Mexico has recently proposed a "citizen trust registry" whereby individuals and firms can affirm that they are currently and plan to continue to be in compliance with various regulations. Inclusion in the registry is entirely voluntary and if someone joins the registry, he can remove himself at any time later. In exchange for being in the registry, the government agrees to audit/investigate/monitor the person/firm at a lower than baseline rate (i.e., if the government generally audits people with a 10 percent probability, individuals in the registry will face an audit probability of less than 10 percent). However, if someone in the registry is found to be in violation of one of the regulations covered (either through normal audits or because evidence arises through other channels), they will be penalized at a higher rate (increased fine or jail sentence) than would individuals who are not included in the registry. Analyze this proposal from a law and economics perspective.

This registry has two primary effects. First, it functions like a Beckerian damages multiplier. If we generally think it is more costly to investigate (i.e., affect the probability of the punishment) than it is to punish (which is true if we are relying on fines which are a social redistribution rather than a real resource cost; if we are relying on imprisonment, maybe the investigation costs are not higher than the punishment costs), lowering the probability of an audit and replacing it with a proportionate increase in the punishment leads to a social welfare gain.

Second, and perhaps more subtly, this registry has the potential to induce people to reveal private information about their "type" with respect to engaging in law breaking behavior. Assuming a system that doesn't make mistakes (i.e., if you are audited, you are found guilty only if you have actually broken the law; also, every time a law breaker is audited, it is discovered he has broken the law), people who know they do not (and will not) break the law will find it advantageous to join the registry. All audits of non law breakers are wasteful, so reducing the likelihood of audit for these people is a social welfare gain. Likewise, a law breaker will generally not find it advantageous to enter the registry (as long as the registry audit probability reduction and punishment increase are set correctly), so the country's non registry audits will generally be more successful. If law breaking is probabilistic (people are neither guaranteed to be one way or the other, but some people have higher probabilities than others), a similar logic holds. If the system makes mistakes, however, this rationale need not hold (in the extreme, in a system that always gets things wrong, a registry will not generate this "sorting" benefit, while a system that mostly gets it right will generate this benefit).

The registry then has the potential to allow Mexico to either generate its current level of deterrence at a lower cost, or generate more deterrence for the same cost, or some combination of those two.