

Economic Analysis of Law
Villanova -- Spring 2018
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 28, 2018. 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, 2018. 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:

The issue of marijuana legalization/decriminalization is currently under fierce debate at the state and federal level in the US. Using the tools of microeconomics, sketch out a framework for considering how marijuana sales/use should be regulated (through various legal tools, including criminal and noncriminal regulatory means) including the possibility that there should be no regulation at all. In your analysis, also consider the pros and cons of federal preemption of state laws regulating marijuana sales/use.

Law and economics generally starts from the presumption that regulation is used to internalize externalities. Individuals already are inclined to make personally "efficient" decisions where personal marginal benefit equals personal marginal cost and so drug transactions will only take place where the seller receives at least as much in return as it cost to produce/acquire the drugs and the buyer will only purchase when the benefit from using the drugs at least equals the cost the seller is charging. Prices in this market will tend toward an allocatively efficient outcome, just as they do in any other market, unless there are some kind of externalities.

These externalities could be of the form of violence/harm/risk to third parties, such as accidents that occur when marijuana users drive while under the influence. Efficient regulation would start with attempting to set any regulatory penalty equal to the expected harm caused by the externality. This could take the form of a tort-like liability system where the marijuana user pays the realized harm when it actually occurs, or it could take the form of a fine where the user pays the average harm whenever s/he is caught using the drug (perhaps inflated by some factor accounting for the fact that users will not be caught 100% of the time), or perhaps the "fine" could instead be charged as a sales tax. The choice among these systems will depend mostly on two factors – transactions costs and concerns about judgementproof users. With respect to transactions costs, litigation, policing, and tax collection all have different costs associated with them (including information costs – namely, can the relevant authorities accurately predict the expected external costs of marijuana use – this is lower in the litigation model since the costs will be observed and won't need to be predicted; however, the litigation model might not benefit from the fixed cost aspects of the other system since cost data will need to be investigated anew in each case; there might also be differential costs among the systems with respect to the potential for corruption; etc). As regards the issue of judgementproof users, litigation is the most problematic since the external cost applied will be highest there (and will only be applied after harm occurs), so users with no assets will be undeterred by such a system; fines also are somewhat limited by judgementproof users (unless failure to pay the fine is backed up by jail time or some other non-monetary punishment). Taxes are the least affected by this concern if access to

marijuana is conditioned on the payment of the tax, though one still might be concerned about black market sales where the taxes are avoided.

Although the standard economic model only views externalities as costs/benefits that accrue to third parties, behavioral models might also include so-called internalities (i.e., effects that accrue to “future selves” that the current self does not adequately account for in current decision making).

Conceptually, these internalities are just costs that create wedges between MB and MC such that market transactions no longer generate allocatively efficient outcomes in much the same way regular externalities do. In practice though, we might need to adjust some of the policy responses. Taxes and fines might still work out the same way (though accurately measuring the harm to future self may be more difficult), but litigation becomes a little trickier. A future self would have a hard time suing a past self for decisions that led to subsequent harm, though suits against producers/sellers might work.

Concerns about judgementproof users might push in favor of using some kind of non-monetary sanctions such as prison time, though such sanctions tend to be inefficient in that they represent resource losses to society (the costs of building and running prisons are pure losses and, to the extent that the prisoners would otherwise be productively employed, losses accrue there as well). It is for these reasons that Becker disfavored non-monetary sanctions such as prison, but there may be little alternative if users are generally judgementproof and externalities require the threat of a sanction. Luckily, if the threat is effective, it will not generally need to be carried out (and so the resource loss is avoided).

In addition to transaction costs and concerns about judgementproof users, there may be some other considerations in choosing among taxes, fines, litigation, and non-monetary sanctions/incentives (e.g., prison). Although the standard deterrence model suggests that changing the probability of sanction and the severity of the sanction should have comparable effects, there is some belief (perhaps even evidence) that individuals are relatively more responsive to changes in the probability of the sanction than the severity. This implies that, all other things equal, regulation can get proportionately more “bang for the buck” by making the sanction more certain than by making it larger. This may lead one to disfavor litigation, fines, and criminal approaches in favor of the automatic taxation approach.

As for the preemption issue, since there may be location to location heterogeneity in the expected costs of any externalities, the transactions costs associated with various regulations, and the degree of judgementproofness of users, it may be efficient to allow for jurisdictional flexibility in regulatory approach. That said, if there are fixed costs to determining the appropriate level of sanctions or in the implementation of those sanctions, a national approach to regulation could minimize the costs of formulating and implementing the regulations. To the extent that there is uncertainty about costs, federalization of regulation limits the ability to learn through experimentation with different approaches.