The Economics of Prohibition

- Prohibition Laws make trading illegal in certain markets.

- Some examples of prohibition laws are:
Motives for Prohibition

- Consumption of this good damages Buyers (who can’t be trusted to know this). Examples are:
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- Production of this good causes damage to environment or to third parties. Examples:
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- Trade in this good reduces profits of competitors. Examples:
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Figure 1: Demand and Supply of Drugs
Horizontal Supply and Zero Profits

- Notice that the equilibrium price of drugs is $10.
- In equilibrium, dealers make zero profits.
- Why are they willing to supply with zero profits?
- We count the wage they could earn at their best alternative occupation as part of their costs.
- When they are paid $10, they are making the most money they can possibly make in any activity.
Figure 2: Confiscation & Fine–No Resale

(15 Addicts, 15 Casual Users, 30 Dealers)
The Effects of Confiscation and Fine: No Resale

- Horizontal part of supply curve shifts up. Vertical part shifts left. Demand Curve does not change.
- Price rises, casual users quit, addicts continue.
- Total production is twice total consumption. (Half is destroyed.)
- Total expenditure on drugs rises from \(10 \times 30 = 300\) to \(25 \times 15 = 325\).
- Expenditure rises as you move along the demand curve if demand is inelastic.
Figure 3: Confiscation & Fine–Drugs Resold
The Effects of Confiscation and Fine: Cops Resell

- Horizontal part of supply curve shifts up. Vertical part stays put. Demand Curve does not change.
- Price rises, casual users quit, addicts continue.
- Total production is same as total consumption. (No drugs destroyed.)
- Total expenditure on drugs rises from $10 \times 30 = 300$ to $25 \times 15 = 375$.
- Police gain revenue that would be lost if drugs destroyed.
- Effect on consumption is the same as when confiscated drugs are destroyed.
The Cost and Effects of U.S. “War on Drugs”

- Federal expenditures on drug enforcement rose from $1 billion in 1981 to $10 billion in 1998.

- In 1980, 50,000 people were in jail for drug offenses. In 1995, 400,000 people. Extra cost to the govt of the additional prisoners is over $10 billion, so total cost to govt of drug war is about $20 billion per year.

- Marijuana use has declined from 13% of adult population to 5%. Cocaine use has declined from 2% to 1%. Heroin use has been roughly constant at 0.1%.

- Drug-related admissions to hospital emergency rooms have doubled and deaths from drug overdoses has quadrupled between 1981 and 1998.
War on Drugs: Economic Analysis

What effects does our experiment predict for the “war on drugs.”

- The price of drugs would rise and consumption by casual users would be reduced.

- Addicts would continue to use drugs.

- Since the cost of drugs rises, addicts are made much worse off. Many will be driven to crime or prostitution to support this habit which has been made expensive by government policy.

- Total expenditures on drugs will rise if demand is inelastic.

- These predictions are roughly consistent with what has happened. Note decline in use of drugs, but an increase in severe drug-related effects.
Alternative Policies for Drugs

Has criminalization of drug sales and use been successful? Seems dubious. What about alternative policies.

- Demand reduction policies. What policies would shift the demand curve down?
- Education, Treatment, Prevention and research on drugs and addiction.
- Punishing Demanders
- Taxation
Figure 4: Demand Reduction Policy
Figure 5: Prohibition of Drugs
Comparing Prohibition and Demand Reduction

- Figure 4 and 5 show the effects of a demand reduction policy and a prohibition policy, each of which achieve the same reduction in drug consumption.

- The prohibition policy increases the drug price, makes addiction more damaging, and increases total expenditures on drugs.

- The demand reduction policy does not increase drug price, does not harm addicts, and reduces total expenditure on drugs.
What about a Sales Tax on Drugs.

- The graph in Figure 4 shows the demand shift that would result from a sales tax of $20 per unit.

- A sales tax would have to be enforced. This is not costless, but is unlikely to be as expensive as enforcement costs of prohibition.

- With a sales tax, the price of drugs rises, but the government gets the revenue, which can be substituted for other taxes.

- Decriminalization of drugs would drastically reduce number of people in jail.

- Taxing drugs seems much kinder to addicts than treating them as criminals and forcing them to deal with underworld.