

# What you don't see can't hurt you: an economic analysis of morality laws

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*Abstract.* This paper provides an efficiency explanation for regulation of sex, drugs, and gambling. We propose that these 'morality laws' can be explained by considering some activities to impose a negative externality *when the activity is observed*. Efficiency requires discretion by the individual who engages in such activities. When discretion is difficult to regulate directly, the activities can instead be proscribed, thereby giving individuals incentive to hide their actions from others. We find conditions for the first-best levels of consumption and hiding to be implementable. Since some level of activity is efficient, the optimal sanctions are not maximal. JEL classification: K42, H32

*Ce que vous ne voyez pas ne peut pas vous faire de tort: une analyse économique des lois de moralité.* Ce mémoire propose une explication en termes d'efficacité des régulations sur les industries du sexe, de la drogue et du jeu organisé. On suggère que ces 'lois de moralité' peuvent être expliquées quand on considère que certaines activités imposent une externalité négative quand l'activité est observée. L'efficacité réclame donc une certaine discrétion de la part de l'individu qui s'engage dans de telles activités. Quand cette discrétion est difficile à régler directement, les activités peuvent être prohibées, et de ce fait on donne aux individus une incitation à cacher leurs activités aux autres. On établit que des conditions de premier ordre sur les niveaux de consommation et de camouflage peuvent être mises en application. Puisque qu'un certain niveau d'activité est efficace, les peines optimales ne sont pas maximales.

This paper has benefited from comments by Doug Allen, David Andolfatto, Steve Easton, Eric Rasmusen, Paul Rubin, Lior Strahilevitz, and two anonymous referees, as well as from participants at the ALEA and CLEA meetings and at seminars at the University of Western Ontario, Queen's University, and the University of Calgary. We thank Scott Skjei for excellent research assistance. Email: pcurry@sfu.ca; mongrain@sfu.ca

## 1. Introduction

Can there be such a thing as a victimless crime? For the majority of crimes, the activity is proscribed because of the negative externality imposed on others. However, when an individual sells drugs or sexual favors to another, where is the victim? Where are the externalities? Some arguments have been made that, while such acts may not create externalities in and of themselves, they lead to other acts that do. For example, drug use may increase one's proclivity towards crime. This type of argument however, has been challenged.<sup>1</sup> Our paper proposes a different explanation. While such acts may not affect others physically, an observer of the act may suffer a loss of utility because it conflicts with her moral views. We use the term 'psychic externality' to refer to a situation in which the harm caused by an activity is due to the observer's distaste for the act. It is worth mentioning that laws governing drug and alcohol use, sexual activity, and gambling are often referred to as 'morality laws.' This paper proposes that these laws are in place to safeguard the morals of agents who do *not* choose to take part in the proscribed acts.

We are not the first to pay attention to psychic externalities. Rasmusen (1997) argues that the law need not differentiate between real and psychic externalities. For example, if person A is willing to pay person B to stop using drugs and willing to pay more than B needs to be compensated to stop, then efficiency requires that B stop using drugs. In the presence of transaction costs, regulation might be required to achieve efficient outcomes. This is true whether A's willingness to pay stems from real or psychic externalities. This paper extends the analysis of Rasmusen in the following manner. Suppose A is willing to pay \$100 for B to stop using drugs altogether and \$40 for B to stop using drugs in A's presence. If B needs at least \$120 to be compensated for not using drugs and \$30 to use drugs away from A, then efficiency requires that B use drugs, but only out of A's sight. However, enforcement of discretion may be difficult.<sup>2</sup> This paper demonstrates that the first best (i.e., efficient consumption and hiding) can be implemented even when it is impossible to legislate on discretion directly. Specifically, legislators can provide incentive for B to consume drugs discreetly by making drug use illegal but with a low penalty. If we use the above example, as long as detection by the authorities is correlated with observation by others, B will be deterred from using

1 Posner (1992) and Miron and Zweibel (1995) argue that, while drug use is associated with increased violence and crime, it is actually *prohibition* that is the cause, not consumption. A similar case can be made for the argument that prostitution increases the spread of STDs. However, other explanations for prohibition do exist. Becker, Grossman, and Murphy (2003) consider a social planner that does not value drug consumption purely according to the utility of the agents in society.

2 A law stipulating that drug consumption can take place only in private homes would be easy to enforce. However, it may not necessarily be the appropriate discretion level. It may be that B should be allowed to consume in some public places, as is often the case with alcohol. Similarly, it may be that legalized consumption at home does not offer enough discretion. It may be the case that family members are precisely the ones who are affected by the externality, and such legislation would force them to be in harm's way. We thank Ig Horstmann for this last insight.

drugs in public, where the probability of getting caught is relatively high, but not from doing them in private, which is efficient.

When externalities are real, hiding by criminals is a socially wasteful allocation of resources. Malik (1990) shows that when criminals can invest effort in hiding their crimes, maximal sanctions may be suboptimal. Higher sanctions increase the incentive to hide, which is welfare reducing. In our case, some amount of hiding can be welfare enhancing. When hiding cannot be legislated directly, an injurer chooses to hide her consumption only if it is illegal. As a result, the government bans the good, even though the efficient level of consumption is positive, but chooses sanctions and enforcement such that the injurer still consumes a positive amount and engages in socially beneficial hiding. Our model predicts that optimal fines are not maximal, as in Andreoni (1991), Malik (1990), and Polinsky and Shavell (1984). Moreover, it is efficient for crime to be committed even though it may be costless to deter it.

If hiding is efficient, however, then there should exist a body of legislation that makes only the public aspect of an activity illegal. Indeed, there exist many such laws. Alcohol is legal in all western countries, but is subject to many restrictions. While these restrictions vary somewhat from country to country, they all entail keeping consumption of alcohol to specific areas and preventing public drunkenness. In addition, in Canada and much of western Europe, prostitution is legal, but solicitation is not.<sup>3</sup> In other words, it is legal to exchange money for sexual favours, it is just not legal to discuss it in public.<sup>4</sup> Finally, brothels, or ‘bawdy houses,’ are illegal in Canada, Italy, Luxembourg, the UK, and parts of Spain. Where they are not illegal, brothels are often relegated to ‘red-light districts,’ as in the Netherlands, Germany, and Belgium. As such, anyone wishing to engage in prostitution must do so discreetly.

An important prediction of our model is some degree of non-compliance, which is often the case with morality laws. The Alcohol and Other Drugs Survey of 1994 found that 23% of Canadians had tried marijuana. Easton (2004) estimates that there may be as many as 17,500 ‘grow-ops’ currently in British Columbia.<sup>5</sup> Also, when the harm is greater (i.e., there are either more victims, or the victims

3 In Europe, only Ireland and Sweden prohibit prostitution. European countries that allow prostitution but not solicitation (sometimes written as legal as long as it ‘does not disturb public order’) include the UK, Germany, Belgium, Finland, France, and Italy. A summary of the various prostitution laws in Europe can be found in Galiana (2000).

4 The Canadian Criminal Code states that ‘every person who in a public place or in any place open to public view (a) stops or attempts to stop any motor vehicle, (b) impedes the free flow of pedestrian or vehicular traffic or ingress to or egress from premises adjacent to that place, or (c) stops or attempts to stop any person or in any manner communicates or attempts to communicate with any person for the purpose of engaging in prostitution or of obtaining the sexual services of a prostitute is guilty of an offense punishable on summary conviction.’ This particular part of the Canadian Criminal Code can be found at <http://laws.justice.gc.ca/en/C-46/267334.html#rid-267359>.

5 Easton also notes that penalties for running a grow-op are very low. In Vancouver, 55% of grow-op ‘busts’ led to no jail time and only 13% received jail time greater than 90 days. Further, only 35% of cases led to a fine, and the average fine meted out was a paltry C\$1,200.

are harmed to a greater degree), efficiency would require less consumption and more hiding. In countries where the puritan ethic is stronger, we should expect to see more prohibition, as well as stronger penalties. Canada and western Europe have less regulation on sexual activity than the US, which would be consistent with this hypothesis. With regard to drugs, the United States has the strongest penalties; Pastore and Maguire (2005) note that in 2002 the median sentence for drug possession in the US was 12 months, while Corkery (2000) finds that in the United Kingdom in 1998, the average sentence for drug possession was 3.4 months, and in Canada over the years 1999 and 2000, the average sentence was only 50 days, according to Statistics Canada (2001).

## 2. The model

### 2.1. The environment

We consider a simple economy with two agents and a government. The first agent, whom we call the injurer,  $I$ , derives utility from the consumption of a single good or activity. Denote the injurer's consumption by  $\theta$ , and let  $B(\theta)$  be the benefit derived from consumption, where  $B(\cdot)$  is continuous, differentiable, strictly concave, and  $B'(0) > 0$ . We normalize  $B(0)$  to be 0 for notational simplicity later on. The injurer can also choose to hide her consumption. Let  $h$  denote the level of hiding, which has a per unit cost of 1, so that the injurer's utility from consumption  $\theta$  and hiding  $h$  is given by  $U^I(\theta, h) = B(\theta) - h$ . The second agent we call the victim,  $V$ . The victim suffers some disutility from the injurer's consumption. This disutility is reduced by the injurer's hiding. Denote the harm incurred by the continuous and differentiable function  $C(\theta, h)$ , where  $C_\theta(\theta, h) > 0$  and  $C_h(\theta, h) \leq 0$ , with the last condition satisfied with inequality when  $\theta > 0$ . We further assume that  $B'(0) > C_\theta(0, h)$  and that  $-C_h(\theta, 0) > 1$ . Note that the victim does not make any decisions in this simple model. It is assumed that transaction costs are such that bargaining cannot take place.

### 2.2. Efficiency

In the absence of transaction costs, the injurer and victim would be able to bargain to maximize the sum of the injurer's and the victim's utilities. That is, the efficient levels of consumption and hiding, denoted by  $\theta^o$  and  $h^o$ , respectively, solve the following problem:

$$\max_{\theta, h} B(\theta) - C(\theta, h) - h.$$

Suppose that a solution exists, that is, that the first-best levels of consumption and hiding are finite. Denote these efficient levels by  $\theta^o$  and  $h^o$ , respectively. This social optimum is characterized by the system of equations

$$B'(\theta^o) = C_\theta(\theta^o, h^o) \tag{1}$$

$$-C_h(\theta^o, h^o) = 1. \quad (2)$$

The following section considers how a central planner could promote efficiency when the instruments of the courts are available to it.

### 2.3. *The government's problem*

The government is assumed to maximize the sum of agents' utilities derived from the injurer's consumption less enforcement costs. The set of instruments available to the government could vary depending on the particular good or activity being regulated. In particular, the government may or may not be able to regulate hiding behaviour directly. If the government is able to regulate hiding, then the optimal policy would be to set a quota equal to  $\theta^o$  and to require that the injurer choose  $h^o$ . This would be accompanied by minimal enforcement and penalties for deviating from  $\theta^o$  and  $h^o$  sufficiently high to ensure that the injurer complies. As noted above, examples of such regulation on hiding behaviour can be readily found.

However, regulation on hiding behaviour may not always be possible. Furthermore, quotas on consumption may also be difficult to enforce. In this case, the government is limited to choosing enforcement, the penalty and amount of monitoring, for consumption only. If the injurer decides to consume the good, she will be fined with some probability. The probability that illegal consumption is detected is given by  $p(e, h)$ , where  $e$  is the enforcement effort chosen by the government. The larger the effort by the government, the larger is the probability of being detected,  $p_e(\cdot) > 0$ . The cost of enforcement effort is given by  $\kappa(e)$ , where  $\kappa'(e) > 0$  and  $\kappa''(e) \geq 0$ . It is also assumed that  $\kappa'(0) = 0$ . The injurer's hiding behaviour decreases the probability of being caught,  $p_h(\cdot) < 0$ . Finally, we assume that there exists a small chance that the injurer is caught even if the government does not expend any enforcement effort. That is, we assume  $p(0, h) > 0, \forall h$ .<sup>6</sup>

An injurer who is caught consuming the banned good receives a sanction  $S(\theta)$ . It is assumed that these fines can be collected without cost. As such, any sanction levied acts as a transfer between individuals and does not appear in the government's objective function. The government's maximization problem is given by

$$\max_{e, S(\theta)} B(\theta) - C(\theta, h) - h - \kappa(e).$$

In order to examine the government's optimal policy, it is necessary to examine how the injurer's decisions of  $\theta$  and  $h$  depend on  $(e, S(\theta))$ . Note that the sanction may depend on the amount of consumption by the injurer. Such a schedule may be

<sup>6</sup> This assumption has no bearing on the results. Without this assumption, attention would be restricted to suprema of the government's objective function as opposed to maxima.

continuous and differentiable, but it is not necessary for it to be so. The following section examines the behaviour of the injurer.

#### 2.4. The injurer's behaviour

Given a governmental policy,  $(e, S(\theta))$ , the injurer can decide to commit a crime (choose  $\theta > 0$ ), or comply with the law. If the injurer does not consume the good, her utility is given by

$$U^I = B(0) - h = -h.$$

If the injurer chooses to consume the good, then her (expected) utility is given by

$$U^I = B(\theta) - p(e, h)S(\theta) - h.$$

First, note that when the injurer complies with the law, her utility is strictly decreasing in  $h$ . Thus one possible solution to the injurer's maximization problem is given by  $\theta = 0$  and  $h = 0$ . We shall refer to this solution as *compliance*. Another possible solution is for the injurer to choose  $\theta > 0$ . An injurer who decides to consume a positive amount of the good  $\theta$ , also chooses an optimal hiding effort  $h^*(\theta)$ . This optimal hiding effort is characterized by the following first-order condition:<sup>7</sup>

$$-p_h(e, h^*)S(\theta^*) = 1. \quad (3)$$

The injurer chooses the level of hiding to equalize the marginal reduction in the expected sanction with its marginal cost of one. The higher the sanction is, the more hiding is chosen. This implies that if the sanction is an increasing function of consumption  $\theta$ , higher consumption is coupled with higher hiding. In other words, consumption and hiding decision are complements. The injurer also chooses how much to consume. If we consider the sanction to be a continuous and differentiable function of  $\theta$ , the optimal consumption  $\theta^*$ , is characterized by<sup>8</sup>

$$B'(\theta^*) = p(e, h^*)S'(\theta^*). \quad (4)$$

<sup>7</sup> For the second-order condition to be satisfied, it requires that the marginal benefit of hiding be decreasing ( $-p_{hh}(\cdot) < 0$ ), which we assume. Note that this implies a unique solution for  $h^*(\theta)$ .

<sup>8</sup> The second-order condition requires that  $B''(\theta) - P(\cdot)S''(\theta) - P_h(e, h^*(\theta))(\partial h^*(\theta)/\partial \theta) < 0$ . In general, as long as the marginal benefit of consumption decreases fast enough this condition will be satisfied. However, if hiding is very productive ( $-P_h(\cdot)$  is very large), infinite consumption could be coupled with very high hiding. Note that sanctions that increase at an increasing rate,  $S''(\theta) > 0$ , help ensure that the second-order conditions will be satisfied. This is consistent with penalties for possession of large amounts of drugs being significantly higher than for small amounts. Again, we assume that the second-order condition is satisfied and so a unique solution for  $\theta^*$  is guaranteed.

Equation 4 states that when the injurer chooses her level of consumption, she equalizes the marginal benefit of consumption with its marginal cost, which is given by the probability of being detected times the marginal sanction. Let  $\theta^*$  and  $h^*$  denote this solution. Note that if the sanction schedule is not everywhere differentiable, the solution may not be characterized by such an equation.

We now consider the government's optimal policy, given the injurer's behaviour as described above.

## 2.5. Optimal policy

### 2.5.1. Discontinuous sanction schedules

At this point, we consider discontinuous sanction schedules that implement the first-best outcome  $\theta^o$  and  $h^o$ . Consider the following penalty scheme:  $e = 0$ , and

$$S(\theta) = \begin{cases} \frac{1}{-p_h(0, h^o)} & \theta \leq \theta^o \\ \infty & \theta > \theta^o \end{cases}.$$

Such a sanction schedule would lead the injurer to choose  $\theta^o$  and  $h^o$ , as long as she did not comply (choose  $\theta = 0$  and  $h = 0$ ). Note that the arbitrarily high penalty above  $\theta^o$  (which acts as a threshold), leads the injurer to choose the efficient level of consumption, while the level of the sanction at the threshold (call it  $S^*$ ) is what leads the injurer to choose the efficient level of hiding. With such a sanction schedule, the government employs two costless instruments: the threshold and the level of the sanction at (and also below) the threshold. In such a manner, the government is in effect choosing the injurer's consumption and the penalty paid (which sets the hiding). As such, the first best is in fact implementable without cost. The government chooses monitoring to be equal to zero, so that no costs are incurred, and the level of the non-infinite sanction is chosen so that the marginal benefit to hiding is equal to its marginal cost of one.

Interestingly, this enforcement strategy does not involve the traditional maximal sanctioning. Since the solution involves the injurer's choosing to commit crime, the sanction  $S(\theta^o)$  has to be set to a finite value even though it is costless. In the traditional analysis, as in Polinsky and Shavell (2000), if the social cost of an act is  $c$ , the socially optimal fine is given by  $f = c/p$ , where  $p$  is the probability of detection (at zero monitoring cost). As  $p$  gets arbitrarily small, the optimal fine gets arbitrarily large. Here, it is the effect that hiding has on  $p(p_h)$  that determines the optimal fine. This is because the fine is set, not to internalize the harm from the activity itself, but to internalize the harm caused from being conspicuous.

It is worth commenting on the assumption that victims do not make any decisions. If there exist parts of a city in which activities such as prostitution or drug use are permitted, then efficiency may require effort from the victim to avoid such areas. This would explain why, for example, pay-per-view channels that show explicit adult films are not part of regular cable packages and why they have been

allowed to persist. The logic here is that people who don't like the programming of these channels shouldn't order them. Victim precaution can create a problem for tort law, since victims have incentive to take less than the efficient level of precaution because they receive damages. For criminal charges, however, victims do not receive any compensation. As such, it is privately optimal for victims to take the efficient level of precaution when the injurer hides efficiently.<sup>9</sup> Thus, we do not need to modify our model in order to incorporate the idea of victim precaution.

It is possible that the implementation of the first best may be thwarted by the injurer's choosing to comply. This occurs when  $B(\theta^o) - p(0, h^o)S^* < 0$ . In this case, the government must drop the sanction so that the injurer chooses to consume the illegal good. However, if  $S^*$  decreases, the injurer would reduce her hiding as its marginal benefit becomes too low.

Recall, however, that hiding and consumption are complements for the injurer. Thus, if the government were to increase the threshold above  $\theta^o$ , then the injurer would increase both consumption and hiding. The government could thus trade off social costs arising from too much consumption with costs from too little hiding. In addition, if monitoring on behalf of the government increases the marginal benefit to hiding, that is,  $p_{eh}(\cdot) < 0$ , then the government could also trade off the costs of insufficient hiding with enforcement costs. The following result formalizes the above intuitions.

**RESULT 1.** *When  $B(\theta^o) < p(0, h^o)/-p_h(0, h^o)$ , the second-best policy involves excessive consumption ( $\theta^* > \theta^o$ ) and too little hiding ( $h^* < h^o$ ). In addition, the government monitors with  $e > 0$  if and only if  $p_{he}(\cdot) < 0$ .*

*Proof.* Recall the government's maximization problem. Using a sanction schedule that sets an arbitrarily high penalty above a threshold level, the government in effect chooses  $\theta$ ,  $S^*$  (the penalty associated with consuming  $\theta$ , which affects  $h$ ), and  $e$  (which also affects  $h$ ) to maximize the sum of utilities. In order to get the injurer to commit crime, however, there exists a constraint that  $B(\theta) \geq p(e, h)S^* - h$ . If we write the injurer's choice of hiding as  $h^*$ , to denote that it is a function of  $S^*$  and  $e$ , the maximization problem is given by

$$\max_{\theta, S^*, e} B(\theta) - C(\theta, h^*) - h^* - \kappa(e) + \lambda[B(\theta) - p(e, h^*)S^* - h^*].$$

The necessary first-order conditions for the government's problem are therefore

$$[B'(\theta) - C_\theta(\theta, h^*)] + \lambda B(\theta) = 0 \quad (5)$$

$$[-C_h(\theta, h^*) - 1] \frac{\partial h^*}{\partial S^*} - \lambda p(e, h^*) = 0 \quad (6)$$

<sup>9</sup> This is because the social benefit to victim precaution is entirely composed of the victim's private benefit in the reduction in harm.

$$[-C_h(\theta, h^*) - 1] \frac{\partial h^*}{\partial e} - \kappa'(e) - \lambda p_e(e, h^*) S^* \leq 0, \quad (7)$$

where the inequality in (7) holds with equality if the optimal monitoring effort is positive.

When the government uses such a sanction schedule, the injurer's first-order condition for hiding is

$$-p_h(e, h^*) S^* - 1 = 0.$$

Using the Implicit Function theorem, we find that

$$\frac{\partial h^*}{\partial S^*} = -\frac{p_h(e, h^*)}{p_{hh}(e, h^*) S^*} > 0$$

$$\frac{\partial h^*}{\partial e} = \frac{p_{eh}(e, h^*) S^*}{p_{hh}(e, h^*) S^*},$$

where  $\partial h^* / \partial e > 0$  if and only if  $p_{eh} < 0$ , which states that government monitoring increases the marginal return to hiding.

Returning to the first-order conditions, we see from (5) that when the constraint does not bind, then  $\lambda = 0$  and it is optimal to choose the efficient level of hiding. However, when the constraint does bind,  $\lambda > 0$ , and so the optimal policy must entail  $[B'(\theta) - C_\theta(\theta, h^*)] < 0$ , which occurs when consumption is greater than the efficient level. Examining (6), we see that when the constraint does not bind, the efficient level of hiding is implementable, but when  $\lambda > 0$ , the optimum has  $[-C_h(\theta, h^*) - 1] (\partial h^* / \partial S^*) > 0$ . Since  $\partial h^* / \partial S^* > 0$ , it must be that  $[-C_h(\theta, h^*) - 1] > 0$ , which occurs with hiding less than the efficient level. Finally, when the constraint binds, the government will use monitoring only when  $\partial h^* / \partial e > 0$ , which occurs when  $p_{eh}(\cdot) < 0$ . ■

### 2.5.2. Continuous and differentiable sanctions

Optimal sanctions need not be discontinuous and prohibitively high above a certain threshold; continuous sanctions can also be used. As mentioned above, discontinuous sanctions give the government two costless instruments to use. This is also the case with continuous sanctions, since both the level,  $S(\theta)$ , and the rate of increase,  $S'(\theta)$ , affect the injurer's behaviour. Figure 1 depicts the implementation of the first best. The government uses  $S(\theta)$  and  $S'(\theta)$  to emulate the marginal social costs at the efficient levels of consumption and hiding. This leads the injurer to internalize the costs imposed on the victim. Specifically,  $S'(\theta)$  is set such that the marginal expected penalty to illegal consumption is equal to the marginal cost to the victim at the efficient level. At the same time,  $S(\theta)$  is set so that the marginal benefit of hiding to the injurer is equal to the marginal benefit of hiding to the victim, again at the efficient level.

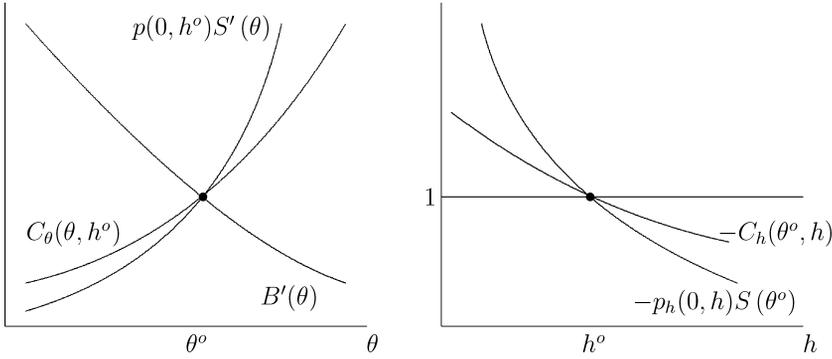


FIGURE 1 Implementation of the first best

**RESULT 2.** *The first best is implementable if and only if  $B(\theta^o) \geq p(0, h^o)S(\theta^o)$ .*

*Proof.* If the government chooses the policy  $e = 0$ ,  $S(\theta^o) = 1/-p_h(0, h^o)$  and  $S'(\theta^o) = B'(\theta^o)/p(0, h^o)$  and the injurer chooses to commit crime, her optimal choice is  $\theta = \theta^o$  and  $h = h^o$ . This can be seen as follows. Recall that the injurer chooses  $\theta$  and  $h$  to solve equations (4) and (3). The injurer will choose  $\theta = \theta^o$  and  $h = h^o$  when  $e = 0$  if  $\bar{\theta}$  and  $s$  are such that

$$\begin{aligned} B'(\theta^o) &= p(0, h^o)S'(\theta^o) \\ -p_h(0, h^o)S(\theta^o) &= 1. \end{aligned}$$

The first equation yields  $S'(\theta^o) = B'(\theta^o)/p(0, h^o)$ . The second equation yields  $S(\theta^o) = 1/-p_h(0, h^o)$ . Note that in order for the injurer to choose to commit crime, it must be that  $B(\theta^o) - p(0, h^o)S(\theta^o) \geq 0$ .

Since the injurer is choosing the efficient levels of consumption and hiding and the government is not incurring any costs, this must be the optimal policy. ■

The above model does not consider differential enforcement of the law. That is, the model assumes no discretion by authorities when it comes to making arrests or where to monitor. If police have such discretion, then this model suggests that police should enforce the law in such a way as to keep the activity less conspicuous in parts in which there are relatively more people that are offended by the activity. In particular, the police might allow these activities to take place as long as there were no complaints. This also suggests that, when it is possible to regulate hiding behaviour directly, this legislation would often take things like location into consideration. For example, the activity could be legal with a licence, but licences be restricted to certain parts of town.

### 3. Conclusion

This paper demonstrates that the existing body of laws surrounding sex, drugs, and gambling can be efficiency promoting. As noted by Rasmusen (1997), if these activities impose a negative externality on others, then there exists the potential for welfare improvements through regulation. This paper demonstrates that if this externality is diminished through costly hiding by the injurer, then the socially optimal legislation closely resembles what we observe. In particular, we observe a large body of legislation directed at the public aspect of these activities. However, this paper does not presume to have considered all the factors behind such laws. In particular, it does not consider the problems caused by prohibition, as suggested by Miron and Zwiebel (1995). However, it is worth mentioning that when governments do legislate on the visibility of an activity rather than the activity itself, many of these problems are lessened. For example, individuals would have legal recourse if a transaction did not go as advertised. Many of these problems may also be solved if quotas are implemented. Whether this is the case is, to a large extent, an empirical issue, and further research in this area would be helpful.

If externalities stemming from prohibition are not an issue, and regulating the public aspect is difficult, then granting discretion to law enforcers can also be beneficial. For example, we observe that the enforcement of such activities often depends on the conspicuousness of the activity and the number of people in the area who might be bothered by it. For example, police often do not make any attempt to shut down brothels or grow-ops until they receive a sufficient number of complaints from people in the area. If the police could enforce the law in such a way as to keep the activity less conspicuous in parts in which there are relatively more people who are offended, or ‘injured,’ by the activity, then this would be equivalent to an increase in hiding.

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