The Mind-Expanding Economics of Pot

Marijuana legalization may not undercut the illicit drug trade as hoped

“The black market is going to come back extremely strong”

This is a blazing moment for American stoners. Colorado has just legalized the commercial production, sale, and recreational use of marijuana, while Washington State will begin its own pot liberalization initiative at the end of February. On Jan. 8, New York Governor Andrew Cuomo said his state would join 20 others and the District of Columbia in allowing the drug for medical purposes.

Libertarians and progressives are thrilled. Addiction specialists are anxious. And economists, well, they’re a little like undergrads lost in a bong-induced thought experiment: One moment the economics of pot seem beautifully elegant, then the real-world implications suddenly become bewilderingly complex.

The champions of marijuana’s legalization have long argued that regulated sale of the drug would drive down production costs and the retail price. The availability of cheaper, legal cannabis would generate precious tax revenue and refocus drug enforcement efforts on more socially harmful narcotics such as cocaine, heroin, and crystal meth.

“On the black market, a lot of folks are compensating drug dealers and everyone else in the supply chain for the risk of arrest and incarceration,” says Beau Kilmer, co-director of the RAND Drug Policy Research Center. “If marijuana were fully legalized and you could grow it outdoors like any other commodity, the production costs would plummet over 90 percent.”

Standing in the way, Kilmer and economists say, are variables including state tax policies, the shifting behavior of buyers and sellers, and contradictory drug laws nationwide. In Colorado, where authorities have levied a 15 percent wholesale and 10 percent retail tax on marijuana transactions, the price of legal commercial-grade pot has doubled to $400 an ounce since the start of the year, says Aaron Smith, executive director of the National Cannabis Industry Association. That’s twice the price for medical marijuana at state dispensaries that require a doctor’s prescription. On the black market, high-grade offerings are fetching $150 to $250 an ounce, according to data compiled by Narcotic News.

That prevailing $400-per-ounce price is no doubt inflated by limited inventory and pent-up consumer demand that may fade over time. To optimize profits, though, enterprising pot retailers will still have an incentive to go high-end, specializing in more potent grades, promoting add-ons such as vaporizer refillable cartridges that can be used for pot consumption, and conjuring up new products (cannabis-infused chocolate lava cake, anyone?). “I don’t think we should expect the legal price to be that different from current [black market] prices,” says Harvard University economist Jeffrey Miron. “People will want to pay more for a quality product.”

For policymakers, the challenge is getting the taxes right, says Kilmer at RAND. In Washington State, authorities will impose a 25 percent excise tax on every phase of the newly liberalized market: production, processing, and final sale. That’s on top of standard state sales tax of 8.75 percent. A consulting firm hired by the state projects these taxes will add 37 percent to the price. In Colorado’s Western Slope region, Gregory Viditz-Ward, owner...
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- of a pot retailer called the Telluride Green Room, says he thinks "the black market is going to come back extremely strong," due to what he considers the high state cannabis tax.

Back in 2010, California considered pegging taxes to marijuana weight before a failed ballot initiative to legalize pot. (The Golden State is still home to a big legal medical marijuana market.) Critics said the approach would encourage producers to sell more potent products to lower the tax hit. Kilmer suggests states consider taxing pot based on its level of tetrahydrocannabinol (THC), the psychoactive ingredient in the drug. "Just as some states differentiate among the alcohol levels of beer, wine, and spirits, you could set a tax based on the amount of THC," he says.

There may be a positive net fiscal impact for states from legal marijuana. A 2010 study by the libertarian Cato Institute, co-authored by Harvard's Miron, forecast that states could save $17.4 billion annually from reduced drug enforcement costs and increased tax revenue, assuming marijuana production and sales were legal nationwide.

Those gains could be eroded, however, if an expanded market started to displace alcohol sales, which are also taxed. A more worrisome scenario: What if more people consumed marijuana and alcohol together—and in greater amounts? The trend might contribute to more traffic accidents and other health costs, says Kilmer.

Perhaps the biggest unknown is law enforcement. How seriously Colorado authorities police unlicensed sellers will shape market supply and pricing trends—or determine whether legal Colorado cannabis is illegally sold in other states that still ban the drug. (On Jan. 5, local Colorado police raided a pot-growing operation of 1,200 plants.)

The production, sale, and use of marijuana has been illegal at the federal level since 1937. The U.S. Department of Justice recently announced that it would not challenge state legalization laws. Who knows if the next administration will be so accommodating, or if a majority of public opinion, as a late-2013 Gallup poll showed, will still support marijuana legalization? "We don't know what's going to happen in two years, five years," says Miron. "Pendulums swing in both directions." - Brian Bremner and Vincent Del Giudice

The bottom line Pot prices have doubled to $400 an ounce in Colorado, which has just legalized marijuana use among adults.

Emerging Markets

The Edifice Complex Driving Turkey's Scandal

- Prime Minister Erdogan's obsession with building triggers a probe
- "Turkey's development model is not only skewed but also corrupt"

An hour's drive north of Istanbul, two giant concrete towers flank the Bosphorus, one in Asia, the other in Europe. By 2015 a $2.5 billion suspension bridge will hang between the towers, which will reach 322 meters (1,056 feet). Nearby, a Manhattan-size swath of forest is being readied for a $14 billion airport, one of the world's largest.

The projects continue a decade-long $200 billion public works plan under-taken by Prime Minister Recep Tayyip Erdogan that strengthens Turkey's ambitions as a regional power. After arrests that targeted Turkish politicians and businessmen close to Erdogan, the building sites now risk becoming emblems of the corruption and largesse that prosecutors say has permeated Erdogan's designs for a new Turkey.

Executives from companies building the bridge and airport are among the 100 people arrested, questioned, or sought by prosecutors since news of a 15-month secret investigation broke in December. Also ensnared were the sons of three cabinet ministers, the chief executive of a state-run bank, and a construction magnate who's become one of Turkey's richest men. The three ministers have resigned.

Although there have been no formal indictments, at least a dozen suspects remain in custody on charges ranging from taking bribes to rigging bids on government contracts. Many of the allegations involve the public works that helped Erdogan prop up the economy and bolster an Islamic business class loyal to his Justice and Development Party (AKP). "The growth miracle of Turkey was largely due to construction," says Atilla Yesilada, an Istanbul-based analyst at Global Source Partners, a New York economic adviser. "If these allegations have a single grain of truth to them, then it turns out that Turkey's development model is not only skewed but also corrupt. It's really disturbing."

Erdogan vows that anyone guilty of corruption will be punished. He calls the probe an attempt to derail Turkey's transformation. The prime minister has overseen growth of more than 5 percent a year since 2002. In the same period, inflation fell from more than 70 percent to 7.4 percent. Behind the probe, according to Erdogan and the AKP, is Fethullah Gulen, a 75-year-old diabetic cleric based in Pennsylvania's Poconos. He runs a network of Islamic schools that has influence with Turkey's police and judiciary. Gulen once worked with Erdogan but now criticizes the regime. He doesn't have the "slightest involvement in or knowledge about" the inquiry, says Orhan Eredemli, Gulen's lawyer.

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