

# Irredeemable Acts, Rent Seeking, and the Limits of the Legal System: A Response to Professor Raskolnikov

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In a thoughtful article in a recent issue of *The Georgetown Law Journal*, Professor Alex Raskolnikov made a distinction between two types of socially undesirable behavior: irredeemably inefficient acts (or “irredeemable acts”) and contingently inefficient acts.<sup>1</sup> Irredeemable acts are acts that are always socially undesirable; contingently inefficient acts are acts that are sometimes undesirable but sometimes desirable. Irredeemable acts always reduce welfare, in any form and at any level, because they are “inefficient at their core.”<sup>2</sup> Theft of money, for instance, never creates a surplus because it is essentially a zero-sum exchange that becomes negative-sum as soon as there are transaction costs. Contingently inefficient acts, on the other hand, may or may not be socially undesirable depending on the magnitude of costs that need to be balanced. Pollution, for instance, is socially harmful when its costs exceed the benefits of the polluting activity, but socially desirable when the pollution costs are relatively small compared to the benefits. Therefore, we cannot say categorically that pollution is always bad; there is such a thing as “good pollution” too. Similarly, speeding can be bad for society when the accident costs outweigh the timesaving benefits, but good in the opposite situation.

To be sure, novel insights are never completely novel anno 2014. The best-known precursor—mentioned in Raskolnikov’s article—is Professor Robert Cooter’s distinction between “prices” and “sanctions,” dating back to 1985.<sup>3</sup> Prices, in Cooter’s framework, are remedies that make the wrongdoer internalize the harm; they make sense for activities for which the optimal amount is higher than zero. Sanctions, on the other hand, are meant to make the wrongdoer stop; they make sense for activities for which the optimal amount is always zero, such as violent acts. But Cooter did not come up with a theory on why the optimal levels are zero or nonzero and did not look at other legal implications besides the magnitude of the remedy. And for some inexplicable reason, no other scholar has developed the point since then. Moreover, lawmakers often fail to make the distinction between irredeemable and contingently inefficient acts. Speeding tickets, for instance, typically increase for repeat offenders—which is inconsistent with the notion that their goal is to make the speeder internalize the safety risks associated with speeding.

Raskolnikov’s contribution is important because it offers the first in-depth analysis of the nature and implications of these two types of behavior. His conceptual framework may be superior to Cooter’s in that the names refer to the essence of the phenomena (their intrinsic efficiency) and not to one of their consequences (the optimal sanctions to treat them). He also shows that the distinction has many other legal implications besides just the choice of remedies, for instance arguing that irredeemable acts are nonconsensual and require intent. Finally, he

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<sup>1</sup> Alex Raskolnikov, *Irredeemably Inefficient Acts: A Threat to Markets, Firms, and the Fisc*, 102 GEO. L.J. 1133, 1135 (2014).

<sup>2</sup> *Id.* at 1133.

<sup>3</sup> Robert Cooter, *Prices and Sanctions*, 84 COLUM. L. REV. 1523, 1524–25 (1984).

illustrates the usefulness of the conceptual framework by pointing at the deeper unifying logic behind seemingly unrelated legal rules—law and economics at its best. Raskolnikov opened a scholarly goldmine; my guess is that many contributions will follow.

In this short reaction paper, I hope to enrich Raskolnikov's framework in three ways. First, I suggest making a further distinction between three types of contingently inefficient acts—those that can be cured by telling the actor what to do (for instance, through due care rules), those that can be cured by letting the actor internalize the harm (for instance, through corrective taxes for pollution), and those that are too hard to cure and therefore given up on by the legal system (for instance, by simply permitting advertising even though it may be wasteful in some cases). Second, I want to go deeper into a topic briefly raised by Raskolnikov—the relationship between irredeemable acts and rent-seeking behavior. And third, I want to connect the first two points by showing that rent seekers will avoid plain rent-seeking acts that are easily recognized by the legal system as irredeemable acts, and choose more disguised forms of rent seeking that may also have social benefits—in essence moving from Category I (irredeemable acts) to Category IIc (contingently inefficient acts that cannot be simply cured through harm internalization and are therefore permitted by the legal system). This way, I hope to show how “rent camouflage theory” could be integrated into Raskolnikov's framework.

### I. THREE TYPES OF CONTINGENTLY INEFFICIENT ACTS

Raskolnikov's conceptual system is binary: there are irredeemable acts (let's call this Category I) and contingently inefficient acts (let's call this Category II). I suggest dividing the latter category into three subcategories (Categories IIa, IIb, and IIc). We may want to subdivide contingently inefficient acts because the job of the legal system is intrinsically more challenging for those acts than for irredeemable acts. Irredeemable acts are always inefficient; therefore the legal system can simply forbid them. But contingently inefficient acts are sometimes inefficient and sometimes efficient. Simply forbidding them could mean throwing the baby away with the bathwater.

If the legal system could always identify when contingently inefficient acts are inefficient versus when they are actually efficient, its job would be as simple as for irredeemable acts: it could just forbid the inefficient acts. But this requires information that may not always be available. Therefore, a distinction may need to be made that takes information constraints into account.

The first subcategory of contingently inefficient acts I propose comprises those acts for which the legal system can identify the inefficient cases (let's call this Category IIa). Suppose that judges know when injurers were negligent and when they weren't. In this case they could establish a negligence regime in torts and hold only those injurers liable who violated the due care norm (as they effectively do in the American legal system). In such a regime, the legal system knows what is good behavior (due care) and what is bad behavior (violation of due care). All potential injurers will opt for good behavior because bad behavior is made financially unappealing.

The second subcategory of contingently inefficient acts comprises those for which the legal system cannot identify the inefficient cases but for which the legal system can make the injurer internalize the harm (Category IIb). An example may be strict liability for pollution: the legal system may not know in which individual cases pollution is good or bad (because the legal system cannot observe the benefit of the polluting activity) but can make the actor choose only

good pollution by letting the actor internalize the environmental harm. This way, the potential injurer (who has more information on what is good and bad behavior) will only do the good acts.

The third subcategory comprises contingently inefficient acts for which the legal system cannot identify the inefficient cases and for which harm internalization is not feasible (Category IIc). Consider advertising. We know that advertising can be good for society when its information benefits outweigh its direct and indirect costs in terms of distorting preferences; advertising can be bad when these costs outweigh the benefits.<sup>4</sup> The problem is that it is hard to measure some of these costs, so it is hard to tell in individual cases whether advertising is good. Moreover, because some of the costs are hard to measure (for instance, how does one measure the costs of distorted preferences?) the legal system cannot solve the problem by letting the actor internalize the harm. Therefore, the legal system has but two choices: simply forbid all advertising (treating advertising as an irredeemable act) or simply permit it. Whatever the choice, the outcome is imperfect.

Note that there is a difference in terms of a happy ending. In Categories I, IIa, and IIb there are happy endings: socially undesirable behavior will not take place. In Category IIc, by contrast, there is a sad ending: socially undesirable behavior will take place. Here, the legal system has essentially given up preventing the socially undesirable cases.

Why is this further distinction important? Because it explains the behavior of individuals under the constraints of an imperfect legal system. Individuals who want to benefit from bad acts will try to choose acts that do not fall in Category I (irredeemable acts) but in Category IIc (contingently inefficient acts that are given up by the legal system). I will develop this point in Part III.

## II. IRREDEEMABLE ACTS AND RENT SEEKING

Raskolnikov makes an interesting observation—that irredeemable acts are a subset of rent-seeking acts.<sup>5</sup>

To see why irredeemable acts can be seen as rent-seeking acts, consider theft of money—Raskolnikov’s poster child of an irredeemable act—and assume for a moment that theft is legal. In that case, a thief would collect a rent whenever he steals something. Indeed, a rent is a profit that would not have been earned in a perfect market.<sup>6</sup> If an item costs \$100 in a perfect market (because it costs \$100 to produce it) but is acquired for \$0 because it is stolen, the thief receives a rent of \$100—a super-profit of \$100 that would not have been made in a perfect market.

The same holds for other irredeemable acts, such as pure cartels, pure fraud, pure self-dealing, or purely opportunistic renegotiations. They all generate a profit for the wrongdoer that could not have been earned in a perfect market. For instance, when a low-quality good, costing \$20, is fraudulently sold for \$100 as a high-quality good, the seller obtains an \$80 rent. When a cartel raises the market price from \$20 to \$100, the participants receive an \$80 rent per

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<sup>4</sup> The analysis of the costs and benefits caused by an individual advertisement is also complex because the costs and benefits are a function of the response of competitors. For instance, in some cases the preference distortions may cancel out each other; in other cases an advertisement may trigger a wasteful arms race between competitors.

<sup>5</sup> See Raskolnikov, *supra* note 1, at 1137 (“Scholars studying rent seeking will recognize irredeemable acts as a subset of rent seeking and directly unproductive profit-seeking activities.”)

<sup>6</sup> Raskolnikov is right to note that the term “rent” has varying definitions in the literature. See *id.* at 1155 (“[R]ent seeking has no clear definition.”). Still, from a purely economic viewpoint, a rent can easily be defined as a profit that would not have been made in a perfect market. Because prices in a perfect market reflect only the true costs, a rent is the part of the price that exceeds the true costs.

transaction. All undesirable economic activity can be seen as an attempt to acquire an undeserved profit.

But irredeemable acts are only a subset of rent-seeking acts because not all rent-seeking acts are inefficient. One of Raskolnikov's examples is a monopoly. Monopoly positions generate rents and are usually inefficient, but there can be exceptional cases in which they are better than any alternative, for instance when they lead to economies of scale or increased innovation.<sup>7</sup> Therefore, monopolies do not fall in Raskolnikov's category of irredeemable acts but in his broad category of contingently inefficient acts. It should be no surprise that U.S. antitrust law makes only the abuse of a monopoly position illegal, not the monopoly position itself.<sup>8</sup>

### III. IRREDEEMABLE ACTS AND RENT CAMOUFLAGE

Simplistic forms of rent seeking are a piece of cake for the legal system. Since such acts are irredeemably inefficient, the legal system can simply deter them by imposing severe punishments whenever they are observed. As a result, simplistic rent-seeking activities such as theft, explicit cartels, plain fraud, or plain economic duress are not attractive options for smart rent seekers.

Fortunately for those rent seekers, there are rent-seeking forms that are socially harmful but nonetheless perfectly legal. Indeed, when rent seeking takes the form of activities with ambiguous social effects, which are in addition hard to measure such that a harm-internalizing solution cannot be implemented, rent seeking may simply be permitted by the legal system.<sup>9</sup>

To illustrate, suppose that a CEO simply steals \$10 million from his corporation. If discovered, this would lead to jail time. Simple theft is too easily recognized as a socially harmful activity. But now suppose that the theft is disguised as a bonus based on a complex formula that only weakly correlates with CEO performance. Here, the transfer is no longer irredeemably inefficient. Maybe the bonus makes the CEO work harder, resulting in a profit increase of more than \$10 million. For the legal system it now becomes hard to determine whether the transfer was good or bad. Full internalization of the output is not feasible—this would require that 100% of the firm's profits (plus 100% of the externalized innovation benefits) would go to the CEO. At the end of the day, the legal system has only a binary choice: forbidding such bonuses (i.e., treating them like irredeemable acts) or always permitting them.<sup>10</sup> The legal system may give the benefit of the doubt to CEOs, and simply permit such bonuses. In this case, a rent-seeking CEO may legally keep the proceeds of what is essentially a theft.

Here is another example. Suppose you walk into a grocery store and the owner of the store suddenly steals \$50 out of your wallet. If you notice it and complain, you get your money back. If you don't notice it, the store owner keeps the money and receives a rent (indeed, the \$50 is a super-profit that could never have been made in a perfect market). This form of rent seeking would definitely be labeled "theft," and the store owner would quickly end up in jail. But now suppose the store owner uses a slightly different strategy: for an item that elsewhere costs \$100,

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<sup>7</sup> *Id.* at 1144.

<sup>8</sup> *See id.* at 1144–45.

<sup>9</sup> The literature on rent camouflage includes Lucian Bebchuk & Jesse Fried, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* 62–64, 122–27 (2004) (arguing that CEO bonus schemes mask their underlying rent-seeking goals).

<sup>10</sup> This is not to say that the legal system cannot forbid certain extremes or permit certain clearly efficient cases. But within the large gray zone, the choice is binary.

he charges \$150. If you notice that the price is less expensive elsewhere, he gives you back the \$50, lowering the price for you to \$100 using the “best price guarantee.” If you pay \$150, not knowing that the normal price is \$100, the store owner receives a so-called “information rent” of \$50; it is a rent because it is a super-profit that could never have been made in a perfectly transparent market, and it is an “information rent” because the store owner acquires it by exploiting his superior knowledge of market prices over naïve customers. Nonetheless, this time the store owner will not end up in jail. Why? Because his strategy could be framed as “price discrimination”—an act that is not irredeemably inefficient. Sure, price discrimination can lead to price distortion and wasteful avoidance costs by customers (who want to avoid paying more than others), but it can also reduce fixed cost inefficiency and stimulate innovation by helping innovators capture a larger share of the surplus they create. Because these costs and benefits are notoriously hard to measure, the legal system cannot identify the cases in which price discrimination is inefficient, nor can it solve the problem by letting the store owner internalize all social costs. Therefore, the legal system has only a binary choice: simply forbid price discrimination or simply permit it. In the former case, price discrimination is treated as an irredeemable act; in the latter it is treated as a contingently inefficient act on which the legal system has given up.<sup>11</sup> Once again, the rent seeker’s strategy has consisted of transforming an irredeemable act (Category I) into a contingently inefficient act on which the legal system has given up (Category IIc).

Here is another way of looking at it: as Raskolnikov points out, overdeterrence of irredeemably inefficient acts is possible in the form of “mislabeling cost[s].”<sup>12</sup> Detering socially valuable activities by treating them like inefficient activities—look-alike good acts mistaken for bad—is undesirable. A rent seeker will therefore avoid activities with low mislabeling costs (such as plain theft or plain fraud) but choose activities with high mislabeling costs (such as complex bonus formulas).<sup>13</sup>

Consider a third example. Suppose a corporation pays \$10 million to the personal account of an influential politician, who in turn makes sure that the corporation gets a \$1 billion gift from the government. This would be considered corruption—an irredeemable act that leads to jail time. But now suppose instead that the \$10 million is not paid directly to the personal account of the politician but to his election campaign, and that the \$1 billion is not given in the form of a gift but in the form of a regulation that boosts the corporation’s profits by \$1 billion. Here, the transaction is no longer irredeemably inefficient. Maybe the \$10 million campaign promotes valuable ideas that eventually improve the country. Maybe the regulation corrects significant market failures. So here we have entered into the territory of contingently inefficient acts, which are not easily identifiable and whose effects cannot be simply internalized. Once again, the legal system has a binary choice: simply forbid such campaign contributions (or such regulation) or simply permit it. In the first case, some good acts will be prevented and in the second case some bad acts will be permitted.

The binary choice is based on the balancing of all social benefits and costs. But those are

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<sup>11</sup> Moreover, this pricing strategy does not fall under the usual definition of common law fraud.

<sup>12</sup> See Raskolnikov, *supra* note 1, at 1146–47.

<sup>13</sup> Another way to translate this into Raskolnikov’s framework is as follows: some of the “transfer costs” associated with irredeemable acts are costs made by the actor to prevent being caught. Camouflage costs, that is, the costs of moving from Category I to IIc, could be seen as “transfer costs.” Indeed, there are two fundamental ways to prevent being punished: reducing the chance of the act being caught or reducing the chance of the act being labeled an irredeemable act.

hard to measure, and therefore the choice will largely be a function of the strength of prior beliefs. So let me make a few bold predictions—which are largely untested hypotheses at this point but which nevertheless follow from the previous observations.

First, in societies with a stronger belief in the benefits of free speech, there will be more free speech but also more rent seeking camouflaged as free speech.<sup>14</sup> Second, in societies with a stronger belief in the importance of entrepreneurship and individual incentives, there will be more entrepreneurship and stronger individual incentives but also more rent seeking camouflaged as entrepreneurship or incentive contracts.<sup>15</sup> Third, in societies with a stronger belief in the importance of free choice, there will be more free choice but also more behavioral manipulation of consumers camouflaged as offering free choice.<sup>16</sup>

This brings me to a final observation. Raskolnikov sees irredeemable acts as intrinsically inefficient. You could be an analytical philosopher, think with your eyes closed, and find which acts are irredeemable without making a single empirical observation. Irredeemability seems to be a matter of nature; the nature of an act makes it irredeemable or redeemable. But in the real world there are few phenomena with a one-dimensional nature. So the set of irredeemable acts is never pure; there are always some babies in the bathwater. And therefore, the decision of a legal system to consider an act irredeemable depends on the balancing of costs and benefits; since these costs and benefits are often hard to quantify, the outcome depends partly on beliefs. As a result, irredeemability may vary across countries and across times. Law is not about certainties; it is about allocating the benefits of doubt.

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<sup>14</sup> The fact that corporations are allowed to make campaign contributions in the United States but not in some other countries can be considered anecdotal evidence in support of this hypothesis.

<sup>15</sup> The recent strand of literature that examines the effect of cultural norms on economic performance may offer some empirical evidence. For instance, Gill found in a cross-country study that the magnitude of bonuses is correlated with a positive cultural attitude toward risk taking and individualism. Ralph Gill, *Law, Culture, and Corporate Governance: Insights from Executive Compensation* 23 (Sept. 29, 2012) (unpublished paper), *available at* <http://ssrn.com/abstract=2164532>.

<sup>16</sup> Although this is no hard evidence, it is nonetheless remarkable that marketers who use the insights from behavioral economics to manipulate consumer choice often justify their strategies as offering consumers more choice. *See, e.g.,* Rafi Mohammed, *THE ART OF PRICING* 95–97 (2005).