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The Rhetoric of Negative Externalities

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INTRODUCTION

Negative externalities are costs imposed on third parties. The paradigmatic example is pollution. A firm manufactures a product that generates toxic waste, and dumps the waste; society pays for the associated cost, including, for instance, the community’s health problems caused by the waste. Profit is supposed to measure the firm’s revenues in excess of the associated costs; because this cost is not included, the firm’s profits are higher than they should be, and there is more pollution than there should be. What is privately optimal diverges from what is socially optimal.1

The concept of negative externalities is intuitively appealing. It is firmly entrenched in economic analysis even though it is almost impossible to apply with any rigor in many important real-world contexts. What is the baseline from which “pollution” is measured? How clean must the air and water surrounding the firm be? And whose costs must the firm take into account in order to internalize the externalities? Clearly, the

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The answer to these questions cannot be determined mechanically. There is no neutral way to set the baseline below which deviations count as costs (and above which positive deviations count as benefits), nor is there a neutral way of determining whose costs count. Indeed, the baseline that separates negative and positive externalities and, more broadly, taking only one’s own versus others’ interests into account, is not only indeterminate, it is also dynamic, affected by actions and reactions. The rhetoric of negative externalities has the pernicious effect of reinforcing a view to the contrary: that a firm should, and should be required by law to, avoid imposing what can uncontroversially be characterized as negative externalities, but that it need not otherwise take others’ interests into account. An uncritical acceptance of the concept of negative externalities has led people on seemingly opposing sides of a hot debate in corporate law to miss large areas of existing convergence and fail to capitalize on possibilities for more convergence. The convergence concerns what society wants firms to do. Society does not, of course, speak with one voice. However, some areas may be commanding increasing consensus.

This consensus is of course not always easy to discern. Moreover, in the short term, the convergence may lead to pursuit of “causes du jour” rather than more principled assessments of what society might, and arguably should, want. Finally, there will always be areas where societal interests and profit-seeking conflict. But the difference between pure profit-maximizing firms and socially responsible firms may be far more evident in theory than in practice. This last point goes beyond externalities, addressing firms’ conduct with those with whom they directly deal, including their employees and their customers. Consider the recent example of Martin Shkreli, who

was vilified on social media and became the symbol for price gouging after his company, Turing Pharmaceuticals, raised the price of a 62-year-old drug it had acquired to $750 a pill from $13.50.

While not the first huge overnight price increase for a drug, this one touched a public nerve and intensified . . . .

After fiercely defending the price increase in various interviews and on Twitter for two days, Mr. Shkreli backed down a bit late Tuesday. He told television news networks that the price of the drug, Daraprim, would be lowered, though he did not specify what the new price would be.

“I think that it makes sense to lower the price in response to the anger that was felt by people,”
said Mr. Shkreli.  

In late November, Turing announced that it would not lower the price after all, “[b]ut . . . said it would offer discounts of up to 50 percent to hospitals and would take other measures to help patients afford the medicine.”  

It is hard to appraise how meaningful this relief will be, or how much the negative reaction to the price increase will affect what drug companies using this business model do going forward. Even after the extremely negative publicity Shkreli got from the dramatic price increase, another company he and other investors acquired, KaloBios Pharmaceuticals, announced that it would dramatically raise the price of a drug for another serious disease.  

But there are two Congressional probes of the business practice at issue.  

Certainly, there will continue to be market, regulatory, and popular pressure for a solution. One company, Imprimis, using what is arguably a loophole, has announced that it will produce and sell for $1 a drug identical to the drug on which Turing was raising the price, and has pledged to manufacture and sell other “sole source legacy” drugs cheaply. Shkreli had contributed to Bernie Sanders’ presidential campaign; Sanders gave Shkreli’s money to an AIDS charity (because the medication on which Turing raised the price was especially important for AIDS patients).  

Hillary Clinton has spoken out against Shkreli as well, as has

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Donald Trump. Clinton has vowed to address the problem legislatively should she become President. Finally, Shkreli himself has been arrested for securities fraud, for using funds of a company he controlled to pay off investors who lost money in another company he controlled. Certainly, the publicity accompanying the arrest, if not also perhaps the push to investigate and charge Mr. Shkreli, reflect the disgust his practices have elicited. A Google search for “Shkreli most hated man in America” done on December 17, 2015, yields 1,250,000 hits. Some articles reporting the story of Mr Shkreli’s arrest were titled: Shkreli, CEO Reviled for Drug Price Gouging, Arrested on Securities Fraud Charges. Shkreli has now resigned as CEO of Turing, and been terminated as CEO of KaloBios, also resigning from the KaloBios board.

Is Turing’s business model—of pricing drugs so as to get the most money possible from customers who desperately need them and seem to have no ready alternative supplier—profit-maximizing? Maybe not. Maybe those otherwise inclined to pursue such a strategy will be dissuaded by the saga of (and responses to) Mr. Shkreli. Indeed, at this juncture, it is hard to know whether the business model will be viable. Different firms will have different views on what they should do. These views will be strongly influenced by firms’ beliefs about what law, reputation, and their relationships with regulators require. But the reaction to Shkreli may augur in an era where societal pressure, and regulators who are responsive to this pressure, erode the model’s viability, perhaps ultimately eliminating it.

11. See, e.g., id.
Morgenson describes the history of the relationship between drug companies and investors:

Until recently, investors were positively star-struck by drug companies that could raise prices indiscriminately, letting their patients struggle to pay the freight. Lauded for a laserlike focus on shareholder returns, companies like Valeant Pharmaceuticals International . . . received high marks and even higher valuations from besotted shareholders.
This picture suggests a complex role for law. A starting point might be that law should get firms to internalize externalities— even commentators who are quite skeptical of law consider this function of law to be legitimate. But if internalizing externalities cannot feasibly be operationalized in many important contexts, what role can and should law play? Law’s instrumental force is important, but so is its expressive force. Conversations about what law should forbid and encourage are part of a broader societal dialogue that can lead to consensus and convergence.16

I. THE INCORENCE AND UNINTELLIGIBILITY OF NEGATIVE EXTERNALITIES

The 2008 financial crisis, from which we are still recovering, caused considerable pain to many people and to society at large. The history of the crisis is still being written and its causes are still being debated. But the securitization of an enormous volume of subprime mortgages is clearly a significant cause. Mortgages, many based on fraudulent documentation, were made to borrowers who could not repay, to buy houses with inflated valuations; these mortgages were sold and packaged into securities that were sold to investors, including many institutional investors investing for others, as safe, high-quality investments.17 Critically

Now, however, investors are beginning to see the peril in such a business model. Sure, price jumps may generate earnings and stock gains, but when the enrichment of a few comes at the cost of many, unwanted scrutiny often follows.

The article continues with the story of the Shkreli controversy:

Valeant, which generated $8.25 billion in revenue last year, up 43 percent from 2013. Among its well-known drugs is Ativan, a treatment for anxiety. Valeant caught the eye of Congress this year after it increased the price of two heart medications it had just bought the rights to sell: Nitropress and Isuprel. Valeant raised the price of Nitropress 212 percent and Isuprel 525 percent. Democratic members of the House Committee on Oversight and Government Reform, led by Elijah Cummings, the Maryland Democrat who is its ranking member, have been investigating rocketing drug prices. This year they asked Valeant to provide documents about the increases; it declined.

So last Monday, 18 Democratic members of the committee asked its chairman to subpoena Valeant for those documents.

It is unclear whether the subpoena will be issued. But Valeant’s stock slid 16.5 percent on the news. It recovered somewhat later in the week, but it has lost more than 30 percent since its August high closing price of $262.52.

15. See Parisi, supra note 1; see also AVERY WIENER KATZ, FOUNDATIONS OF THE ECONOMIC APPROACH TO LAW 42 (LexisNexis Matthew Bender 2006) (1998). Imposing negative externalities is a market failure; an accepted use of law is to remedy market failures.

16. This is, of course, not to say that law should not forbid or encourage behavior for other reasons; this Article takes no broad position on what law should, or should not, do.

for purposes of this Article, many of the people hurt were not parties to either the mortgage transactions or the securitization transactions.

Standard economic theory argues that firms should be made to internalize the costs—negative externalities—they impose on others. The “should” is normative: firms will be able to profit at society’s expense if they can foist costs of their business on others. Whatever else law should do, it should force firms to internalize negative externalities.

Let us return to the well-worn and supposedly simple example of pollution. A firm that pollutes is imposing costs on others; law should determine the appropriate fine and probability of detection that aligns the firm’s interests with those of society. But how would we go about trying to get the appropriate firms to internalize the negative externalities at issue in the financial crisis? Trying to articulate a principled basis for characterizing some of the costs as negative externalities suggests how difficult—I would say impossible—the task ultimately is.

Consider this article written in 2013 by Sheila Bair, former chairperson of the FDIC, including during the years that the financial crisis was most acute:

I told myself I wasn’t going to do a “Lehman” column given the media frenzy over this month’s five-year anniversary of that institution’s bankruptcy. But in researching a new book I am writing for young adults about the 2008 financial crisis, I have been uncomfortably reminded of the hardship so many families encountered because of the crisis, particularly their kids.

Their plight has been largely forgotten in the power politics that have overcome financial reform. It’s all about winners and losers, with regulators and reform advocates pitted against a powerful industry lobbying machine, oiled by political money and the grease of revolving door jobs. The objective of protecting the public from another recession brought on by an unstable financial sector seems lost in the Washington shuffle.

So let me recount the heartbreaking memories of the families I have interviewed. They bear tragic similarities. Their problems usually started with a steeply resetting mortgage payment, or job loss or cutback, frequently combined with an unexpected health problem not covered by insurance. Whatever the catalyst, it is almost always followed by high levels of stress for the family, sleepless nights for parents and kids, deteriorating grades at school, lost hope as savings are depleted, and finally the loss of a home. The kids give up their

18. See PARISI, supra note 1; KATZ, supra note 15.
rooms, their pets, their schools, their neighborhoods, and will always live with the traumatic memories of their forced dislocation.19

Whose costs should be included within an assessment of the negative externalities of the financial crisis? This Article makes a case for the children of parents whose homes were foreclosed upon. Many others have been identified and discussed in the press and in scholarship on the crisis: neighbors in neighborhoods with many foreclosed homes and people providing services in those neighborhoods; municipalities that counted on tax revenues and instead got lower revenues and perhaps increased crime; any investor in the stock market who suffered from the wild volatility and, especially, those who may have needed money before the market recovered, and so on.20

Bair continues:

To be sure, many of the parents I have interviewed bear some responsibility for their troubles. As home prices escalated, they repeatedly refinanced their houses to pull out cash. When the housing market turned, they were left with unaffordable mortgage debt, which far exceeded the value of their homes. But these cash-out refis were not always done to pay for fancy vacations or flat screen TVs as apologists for Wall Street would have you believe. Rather, more typically, the money was used to pay for college tuition, medical bills, or simply to help make ends meet.21

Note that the externalities are characterized as being imposed by the lenders even though the borrowers voluntarily took out the loans. Why is this? In the period leading up to the crisis, banks were known to make borrowers believe they could always refinance their houses and repay in that manner; sometimes, banks lied about borrowers’ assets and income to make them qualify for loans.22 Thus, even where “parental responsibility” is part of the overall story, bank behavior can be seen as imposing negative externalities given the banks’ responsibility for the loans. But imagine such “responsibility” where banks were lending money at the borrower’s behest, with full disclosure and no deception, perhaps even actively attempting to discourage the loans from being taken out. The costs to the children would be just as great. But characterizing the costs to the children as a result of negative externalities imposed by the banks would no longer seem apt (except for those with highly paternalistic

20. See generally HILL & PAINTER, supra note 17.
22. See HILL & PAINTER, supra note 17.
views as to companies’ roles in protecting people against themselves.) Pressure—even law—might be brought to bear on the banks in those cases, to add even more disclosure or tests that the disclosure had been understood, or even to not make the loans at all, although banks would in this case be helping to remedy a societal problem, not “internalizing an externality.”

Complicating the analysis, the assumed baseline for these borrowers is that they would not have gotten a loan but for these lenders. But determined borrowers can very often get loans, and the other loans available to these borrowers might very well have had far worse terms than the loans they actually took out. Had the parents taken out those other loans instead of the loans they did take out, their children might have been worse off. In sum, we want banks to do certain things and not do other things; getting banks to “internalize negative externalities” is at best a first step, and, I would argue, more of a rhetorical step than a real guide to policy.

Even the paradigmatic and seemingly easy case of pollution is far harder than it seems. Where there is a discrete event, such as an oil spill, we can envision a baseline from which to measure negative deviations: the pre-spill state. And we can often say, at least in retrospect and probably even in prospect, that companies did not spend enough, certainly in retrospect and arguably even in prospect, on even a conservative assessment, to prevent or minimize the harm they caused—that they should be incentivized to better “internalize the externality.” But we are hard pressed to quantify the harm within a very broad range. And again, which parties’ injuries count?25 The range of estimates for the 2010 BP


25. Consider this account of effects of the 2010 BP Deepwater Horizon oil spill.

For one young family living in Long Beach, Miss., the Macondo well blowout and BP oil spill that began April 20, 2010 is more than a footnote in our nation’s tragic environmental history.

For Christina Tillman and husband Derek, now raising three boys just a few miles from where they lived in coastal Pass Christian, everyday life means continual trips to the doctor and worries about their children’s and their own long-term health.

While no one in the family worked on the Vessels of Opportunity, like many residents there, the toxic effects following the Macondo well blowout were horrific.

At the time, the couple’s only son, Gaven, was 2. Prior to the BP oil spill, his mom says he was a very healthy little boy. But afterwards, she says, “We went to the beach every now and then, [and later] chemicals found in his body showed a lot of the symptoms and signs [of the toxicity of the spill].”
oil spill were within an extremely broad range; what was eventually paid was at the high end of the range, in billions, even putting aside the cost to BP's reputation.\textsuperscript{26} Indeed, the actual cost a company ends up paying is far from a perfect measure of what it should have taken into account ex ante. Many factors not related to the damage it imposes can affect the computation of costs considerably, such as political pressure, negative publicity, and the recruitment efforts of plaintiffs' lawyers. Furthermore, under pressure from regulators or voluntarily, a company might return the area to a better condition than it was in before the pollution.

For pollution that does not occur in a discrete event, the range of possible damage may be lower, but the issue of assessing whose costs count remains. People whose health is better on account of diminished pollution are clearly in the category; what about less salient actors, such as farmers who save money because their animals can be given the water from the local stream rather than purified water they had to be given when the stream was polluted, and even the animals themselves? And there might be costs to some and benefits to others. The purified water plant required because of pollution could produce many positive externalities itself—employment, water that is more pure than the nonpolluted stream’s water would otherwise have been, and so on.

Where does this leave us? Internalizing negative externalities is an appealing concept, but it is not clear how to operationalize it: what, concretely, should corporations do to internalize negative externalities and what should law do to require them to do so? Indeed, law has a more complicated role in influencing corporate behavior, as I will argue below. It is part of a broader set of pressures and influences, some legal and some reputational.

\footnotesize
\begin{center}
\begin{quote}
Indeed. [sic] She shared the boy’s bloodwork results with this examiner, which show that on Dec. 15, 2010, Ethylbenzene in the amount of 0.1” to 0.3” ppb was detected, placing him in the 95th percentile for volatile solvents.

It cost the couple about $450 for this test, one of a flurry of bills they’d incur over the years as they struggled to handle not only the physical but the financial and emotional tolls of post-spill life.

Christina says they left Pass Christian because it was evident that it was toxic to live there.

And the dangers didn’t just issue from the petroleum products, but from the copious amounts of Corexit [dispersant used as part of the clean-up effort] being air dropped along the Gulf.

Laurie Wiegler, \textit{BP Oil Spill 5 Years Later: A Young Family Struggles with Oil, Corexit Effects}, \texttt{EXAMINER.COM} (Apr. 19, 2015, 6:33 PM), \url{http://www.examiner.com/article/bp-oil-spill-5-years-later-a-young-family-struggles-with-oil-corexit-effects}. The article continues with a listing of the many symptoms reported by each member of the family. Notably, besides the huge monetary damage, BP was vilified in the press.

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Commentators have distinguished between firms that are pure profit-maximizers, pursuing their own interests (profits) without taking into account others’ interests, and firms that are “socially responsible” and take others’ interests into account. My argument suggests that given the complex role and interaction of law and other pressures, profit maximization is a far less different endeavor from being “socially responsible” than might be supposed.

II. PROFIT MAXIMIZATION VERSUS CORPORATE SOCIAL RESPONSIBILITY

In popular parlance, and in much academic literature, profit-maximizing firms are contrasted with socially responsible firms. To caricature, the former care (only) about “themselves” (profits), while the latter also care about “others” (interests beyond shareholder value). These two stylized types of corporations can be viewed as extreme points along a continuum, where one end is “concern for self” and the other is “concern for others.” Of course, by contrast with profit maximization, what concern for others means, and how it would be evidenced, is not a matter of general consensus. That profit maximization is relatively straightforward has well-known felicitous features, including that its pursuit would be expected to be favored by all shareholders, whereas different shareholders might have different views as to other corporate aims. Profit maximization is also associated with more rigor: with an agreed-upon goal, energy can and will be focused on achieving that goal in the most cost-effective way possible.

A debate exists as to whether corporations “should” operate exclusively or primarily for the purpose of maximizing profit, or whether they “should” also be “socially responsible” as that term has come to be understood. Part of the debate is a matter of first principles, not amenable to resolution: do firms have obligations to the greater society (beyond those law or their self-interest require)? One can argue that society grants to firms privileges such as limited liability for their owners, which incentivizes externalization of risks; therefore, firms should as a matter of morality and also as a matter of countering the perverse externalization in-

27. Many commentators have weighed in on this debate. For views from various different perspectives, see the posted articles and the links at the blog of a leading corporate law professor, Stephen Bainbridge at Corporate Social Responsibility, PROFESSORBAINBRIDGE.COM, http://www.professorbainbridge.com/professorbainbridgecom/corporate-social-responsibility/ (last updated Dec. 16, 2015).
28. Id.
centive take others’ interests more readily into account. Thus, besides arguments from first principles, there are also arguments as to what makes more sense all things considered.

The pure profit-maximizing firms will take into account others’ interests consistent with their profit-maximizing mission. They will respond appropriately to legal incentives, which ideally should make them act as though the baseline incorporated in the law were their own baseline. But they have other incentives to take the interests of other stakeholders into account. One such incentive is their concern for their reputation. Perhaps taking such interests into account helps with their reputation, or perhaps not doing so hurts their reputation if their competitors are taking such interests into account. What helps or hurts reputation is, in significant part, both contingent and dynamic, as the contrast between bank and banker bravado precrisis with bank and banker circumspection postcrisis evidences. Moreover, firms will have an incentive to preempt potentially problematic regulation, and also dispose regulators favorably to them; taking others’ interests into account may help in those regards as well. All these reasons for taking others’ interests into account are instrumental for a corporation’s own benefit—that is, profit; they are not motivated by a view that others’ interests should be taken into account. Socially responsible firms, too, may be being instrumental—they may want to brand themselves as socially responsible to get business. Indeed, interestingly, when firms make efforts to take others’ interests into account, they increasingly are publicizing their rigor in doing so—the selection principles they used, and the results they achieved.

III. Beyond Externalities: The Societal Convergence

I have argued that notwithstanding its important use in standard economic theory, and its common sense appeal, the concept of externalities promises more than it can deliver. This matters because in the context of an important debate, between those who think firms should exclu-

30. The types of “others” whose interests socially responsible firms generally consider are, however, not generally the people they injure because their owners have limited liability.

sively or principally profit maximize and those who think firms should (also) behave “responsibly” to other constituencies, the concept of externalities has obscured the extent of convergence between the two sides. Both types of firms are guided not only by law but also by reputation. A profit-maximizing firm might conclude that it would do better by living up to some societal consensus as to what a firm should and should not do. Perhaps it would do better than its competitors if it did so, or it would do worse if it did not do so, and perhaps regulators might be more favorably inclined toward it or unfavorable regulation might be preempted. The motive for these socially responsible actions would not be to help others for its own sake, but rather, to help itself. But so what? Attributing a motive to a firm is difficult given how many people are involved in the firm’s decisions. Society should presumably be almost as pleased by self-serving socially responsible conduct as by socially responsible conduct motivated by a concern for others. What counts as socially responsible conduct? Even firms motivated by a concern for others (to the extent this construction is intelligible) want the conduct to get them reputational benefits, and firms who are principally profit-maximizers are in it for the benefit. That reputational benefits are available suggests that the behavior at issue is subject to a societal consensus as to its desirability. The societal consensus seems to be what is really at issue.

Recall the example of the Turing Pharmaceutical Company discussed earlier in this essay. Perhaps Turing acted illegally; it is being investigated for, among other things, antitrust violations, with the New York attorney general arguing that it may have tried to restrict competition in the drug in order to be able to raise the prices so dramatically. Perhaps laws will be changed to make raising drug prices under certain circumstances illegal. Or perhaps the expensive and time-consuming FDA approval process for generic drugs, which caused other companies not to be interested in manufacturing or marketing the drug, will be changed. As discussed above, a pharmaceutical “compounding” company that is allowed to manufacture small “custom” quantities of drugs without needing FDA approval, Imprimis, has announced plans to sell at a very low cost a drug very similar to the drug whose price was raised so

32. Google searches such as “corporate social responsibility reputation” and “corporate social responsibility” elicit many articles discussing reputational benefits of corporate social responsibility. Academic literature elicited with the search term “motivations for corporate social responsibility” also generally addresses the benefits to a corporate brand from having a reputation as being socially responsible.

33. See Pollack & Creswell, supra note 2.

dramatically by Turing;\(^{35}\) insofar as very few people had the condition for which the drug was needed, the specific problem of Turing’s price increase should now be solved. Pressure of various sorts is being brought to bear on corporations whose conduct is deemed to be undesirable, whether by reason of “costs” being imposed on third parties, or on other bad effects, based on whatever baseline is being used. Insofar as one company’s outrage-inspiring behavior is another’s profit and reputation-enhancing business opportunity, markets can be an important part of the solution. But society may lose interest in the broader problem—and nothing will change, at least until the next visceral example.

What is the right answer here? Consensus is arguably the best guide for what society should encourage firms to do, but it is, of course, notoriously imperfect. There are certainly “causes du jour” that detract from far worthier causes, for instance. And there are genuinely hard issues that reflect deep fissures in societal values. Indeed, profit maximization’s appeal in significant part reflects that what it means to be profitable is much better understood and agreed upon than what it means to be socially responsible. But society will necessarily impede pure profit maximization, whether through its norms, law, or more likely, a combination of the two. We should try to reign in the pathologies that social responsibility allows and arguably even encourages, while also reining in the well-known pathologies of profit maximization, as so well displayed in the financial crisis. In a recent case in which he assessed considerable damages against Bank of America, which bought Countrywide, for Countrywide’s origination of bad loans that it sold to Fannie Mae and Freddie Mac, U.S. District Court Judge Jed Rakoff said:

In short, while the HSSL process [the loan origination process, aptly nicknamed Hustle] lasted only nine months, it was from start to finish the vehicle for a brazen fraud by the defendants, driven by a hunger for profits and oblivious to the harms thereby visited, not just on the immediate victims but also on the financial system as a whole.\(^{36}\)

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