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Conceptual divergence, functionalism and the economics of convergence

Contribution for Binding Unity / Diverging Concepts

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It is common knowledge amongst legal academics and practitioners that legal systems sometimes diverge. Over the years, law and economics scholarship has paid attention to that phenomenon, under the heading of "law and economics of comparative law" or "regulatory competition". That scholarship often assumes that convergence or divergence between legal systems is easily perceptible, i.e. that it can be seen in the face of the formal sources of law. For example, the applicable legislation of legal system A states that "title to the goods sold passes to the buyer upon the conclusion of a valid contract", whereas the applicable legislation in system B states that "title to the goods sold passes to the buyer upon delivery of the goods to the buyer". Divergence is explicit and open. Economic actors can be expected to behave accordingly. As a consequence, the literature considers that, through their conduct, economic actors will also influence the evolution of legal systems in order to reach an efficient outcome as regards the appropriate level of convergence or divergence. If needed, legislative action (ranging from mild coordination to outright unification) can also address explicit divergence.

This paper aims to take a broader perspective on issues of convergence and divergence between legal systems.

First of all, it takes a more complex view of convergence by relaxing the assumption that language is unequivocal: the same words can mean different things to different people, what we will call "conceptual divergence". In the case of explicit divergence mentioned in the previous paragraph, divergence literally springs to the eye, and actually in a number of cases it reflects a deliberate choice to diverge.[1] In contrast, "conceptual divergence" often lurks below the surface and is neither immediately perceptible nor entirely deliberate.

For the purposes of this contribution, the working definition of conceptual divergence put forward by Bert van Roermund[2] will be used:

> A legal term T is conceptually divergent between agents A and B, if T is common parlance between A and B, and if the sense and/or the reference of T yields meaning M_1 for A and M_2 for B, such that A and B can use M_1 and M_2 to argue differing courses of action as lawful (or unlawful) under the legal order they are both committed to.

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[1] Between different legal orders or within a single order which allows this practice under certain circumstances, like a federation.

[2] See B. Roermund {BU/DC paper}

In a case of explicit divergence, there is no doubt in the minds of the agents that there is divergence, whereas in the case of conceptual divergence, it can be that the agents believe that they are indeed using the same concept, since they label it with the same term, while they are in fact using diverging concepts. We will come back to this point during this paper: sometimes the standard analysis must be adapted to deal with conceptual divergence, but very often it makes no difference whether the divergence is explicit or conceptual.

Secondly, this paper also takes into account a broader range of dynamic tools to address convergence and divergence. As mentioned in the outset, the literature so far (perhaps reflecting a private law bent) tends to rely primarily on the choice of economic actors as regards the law governing, or applicable to, their legal relationship as a tool to reach an efficient outcome. Whilst this tool is undeniably available and effective, it is also limited: economic actors cannot influence the law at will and moreover legal issues are often peripheral in the choices made by economic actors. In this paper, we want to suggest that there is also – or ought to be – a "marketplace of legal ideas", i.e. a market-like process where legal ideas are central and where members of the legal community are the main actors. Under certain conditions, this marketplace of ideas can provide more wide-ranging and effective tools to deal with convergence and divergence.

Against this background, this paper deals with a number of basic issues, explained hereunder. At the same time, it also illustrates a number of basic propositions arising from the economic analysis of the law.

First of all, this paper examines why different legal systems would diverge (I). That part illustrates the basic proposition that the existing state of affairs is not fortuitous and will usually turn out to be in equilibrium. In other words, it is the outcome of various forces. The "spontaneous"[3] ordering of law (and of society) must at least be carefully studied on its merits, and if it is indeed in equilibrium, then it might be adequate. Note that in the context of this paper, the existing state of affairs is the legal systems as they exist at a given moment, with whatever amount of divergence or convergence might be present. We are therefore not dealing with an issue of "unbridled" market forces versus "discipline" from the law, but rather with the higher-level issue of variety amongst legal systems (each of which had to solve the first-level issue of whether and if so which law is appropriate to deal with various economic and social problems) and legal intervention to constrain that variety.

Secondly, this paper touches upon methodology, i.e. what is divergence and how it can be detected (II). This part is not so much concerned with the economic analysis of the law, but rather with comparative law methodology. It illustrates a more general proposition arising from any multi-disciplinary ("Law +") approach to the law, namely that it is crucial that the law be seen in a broader context, i.e. including both the policy choices underlying it and its practical outcome.

[3] Of course, there is no such point of reference as a "spontaneous" market economy at the scale and level of our large industrialized societies, as economists would sometimes claim. Economics tend to take for granted a set of basic law which enables the market economy to work in the first place (usually the basic legal disciplines as they would be reflected in codes or the common law). "Spontaneous" should perhaps be better read as "bottom-up" in the context of this project.

Thirdly, this paper explains under which conditions divergence should be seen as a problem (III). Finally, it explores possible solutions to the problem (IV). The last two parts rest on another fundamental proposition from economics: almost every change involves a trade-off. In the words of Friedman, “there is no such thing as a free lunch”. Jurists are notoriously weak here. We tend to focus on the downsides (disadvantages, costs) of the current situation and the upsides (advantages, benefits) of the envisaged change when deciding whether to change (grey in table below), often ignoring the upsides of the current situation and the downsides of the envisaged change.

Complete decision matrix	Costs	Benefits
Current	$\mathbf{C_{now}}$	$\mathbf{B_{now}}$
Change	$\mathbf{C_{after}}$	$\mathbf{B_{after}}$

Obviously, change should only be done if it improves welfare, i.e. if the benefits of change minus the costs thereof exceed the benefits of the current situation minus the costs thereof. In formal terms, change would be justified if and only if

$$B_{after} - C_{after} > B_{now} - C_{now}$$

and not merely because

$$B_{after} > C_{now}$$

I. Why would divergence occur?

When browsing through the legal literature, one cannot escape the impression that jurists are slightly (at least) biased against divergence. Convergence, harmonization and even stronger phenomena like unification are often perceived as positive developments in and of themselves. Even those who write in praise of divergence present it in such a fashion – calling upon irreducible cultural differences beyond apprehension[4] – that it seems to border on the irrational, a line of argument which ultimately feeds into the bias against divergence.

Still, why would divergence occur at all? With the use of economic theory, divergence can be rationally explained with at least three lines of reasoning.

A. *Divergence as a rational but not deliberate phenomenon*

Under this line of reasoning, divergence can be explained rationally, but it does not necessarily result from a deliberate choice on the part of those concerned. Two different strands of economic theory can be brought to bear here.

1. Informational imperfections

Firstly, divergence can be explained by *informational imperfections* (or asymmetries) as between various jurisdictions. The law progresses in great part as a result of outside

[4] Legrand, P. 2003 “A diabolical idea” in Towards a European Civil Code, Kluwer 2004, 245; Legrand, P., 1996 “European Legal Systems Are Not Converging." *International and Comparative Law Quarterly*, 45, 52-81; Teubner, G. “Legal irritants: good faith in British Law or How Unifying Law Ends up in new Divergences”, (1998) 61 *Modern Law Review* 11.

pressure, which takes the form of new information about the world outside the law (e.g. a new case never seen before, technological developments, social evolution, etc.) that the law must then process. Legal systems evolve within different informational environments. The comparative scholar will often observe that certain areas of the law are more developed in certain jurisdictions as a result of specific historical occurrences.[5] Similarly, larger jurisdictions tend to run ahead of cutting-edge legal developments because statistically novel cases will tend to arise there first. Furthermore, there will rarely be an obvious "perfect solution" to a given legal problem that can immediately be singled out. Therefore, much like in economic activity, when it comes to the development of the law, decisions taken under asymmetric (and imperfect) information may lead different actors onto different paths.

2. Network effects

Secondly, network economics can also help to explain divergence. The starting point is the notion of *network effects*[6] (also presented as demand-side scale effects): for certain products, the value of the product to the individual user increases as the number of users increases. The classical example is telecommunications: in the absence of interconnection, the value of a subscription to a network with 1000 subscribers is much less than that of a subscription to an otherwise identical service provided over a network with 1 million subscribers. In telecommunications, network effects are strong, but the theory can also be applied more loosely to other phenomena, including fashion and language. It can be ventured that the "market" for legal ideas is also subject to network effects:[7] the more members of the legal epistemic community subscribe to a given opinion, the more attractive it becomes, sometimes irrespective of its inherent validity.[8] The effect is not as strong as in telecommunications, of course, since some jurists – fortunately so in many circumstances – can still decide not to be swayed by the mere fact that the majority holds a certain view, and try to reverse network effects by convincing their peers to espouse another view.

More specifically, two specific properties associated with network effects can explain divergence. The first one is called *tipping*:[9] a small movement in demand can trigger a snowball effect.[10] In the case of legal ideas, a single leading decision or a leading

[5] For instance the doctrine of *Wegfall der Geschäftsgrundlage* in Germany as a result of the Great Depression.

[6] Shy, Oz, 2001. The Economics of Network Industries, Cambridge University Press; Lemley, Mark A. – McGowan, David "Legal Implications of Network Economic Effects", in *California Law Review*, May, 1998, p.479; Liebowitz & Margolis in "Network Externality: an uncommon Tragedy", in *Journal of Economic Perspectives*. 1994, p. 133; Michael Katz and Carl Shapiro "Network externalities, competition and compatibility", in *American Economic Rev.* 1985, p.425.

[7] Anthony Ogus argued, for instance that "the acknowledged characteristics of 'legal culture', a combination of language, conceptual structure and procedures, constitute a network which, because of the commonality of usage, reduces the costs of interactive behaviour". See Ogus, Anthony (2002), 'The Economic Basis of Legal Culture: Networks and Monopolization,' *Oxford Journal of Legal Studies* 2002, vol. 22, at p. 420.

[8] Hence the practice of pointing to the majority and minority views when there is a controversy.

[9] See Michael L. Katz & Carl Shapiro, Systems Competition and Network Effects, *J. Econ. Persp.* 1994, p. 93.

[10] This lies at the heart of the commercial strategy of most firms active in sectors affected by network effects.

article at a given point in time can quickly lead to the emergence of a majority view. The second one is called *path dependency*: once network effects have worked to the advantage of one firm, it becomes very difficult to "change the course of history".[11] In the case of legal ideas,[12] here as well once certain choices have been made and are deeply imbedded in the shared knowledge of the legal community, they are difficult to reverse. Path dependency can show itself also in a slightly different manner: when faced with a new kind of problem that needs an immediate remedy, legal systems tend to choose solutions that are "familiar" to them; hence, different systems easily end up choosing different solutions.[13]

Accordingly, legal systems can evidence divergence as a result of discrete choices made differently in the past. Indeed on many issues (for instance, the relationship between contract and tort law), if one goes sufficiently far back in time, the same or very similar debates can be found in each system until a choice was made. Network effects (including tipping and path dependency) amplify the consequences of these choices. Sometimes it sufficed that a single leading author or court chose option A in one system and B in the other for these two systems to evidence "irreconcilable divergences" later on, after network effects have done their work. The choices made at that time might have been the best possible at that particular time in that particular legal system. Later on, however, this implies neither that such choices are still the best ones, nor that it pays to reverse them, without assessing the costs brought about by such change.

B. *Divergence as a rational, deliberate and benign phenomenon*

The explanations above assume that divergence does not result from deliberate action. The more classical and traditional explanation for divergence, however, involves deliberate choices made by the members of a community as regards their legal system, in other words *local preferences*. Because it is intuitive and well-researched, this explanation is only briefly summarized here, but this should not take away any of its power.

In essence, the legal system reflects the consensus of the community (or at least of the ruling class) on the balance to be reached between competing policy interests. Some trade-offs are involved, and they are not always resolved in the same manner from one community to the other. For instance, in a given community, more emphasis will

[11] The classical example (P.A. David "Clio and the Economics of QWERTY", in *Am. Econ Rev*. 1985, 332) is the QWERTY keyboard that once established itself as a standard, could not be replaced by a more efficient alternative: the users had been trained in the QWERTY system and could not easily switch all together to the other system. See Brian, Arthur, W. (1989), 'Competing Technologies, Increasing Returns, and Lock-In by Historical Events', 97 *Economic Journal*, 642; Liebowitz, Stan J. and Margolis, Stephen E. "Path Dependence" in Bouckaert and De Geest (Eds) Encyclopaedia of Law and Economics, 1999.

[12] For earlier applications of these economic concepts to developments in legal rules, see Hataway, O. "Path Dependency in the Law: the course and pattern of Legal Change in a Common Law System", 2001 *Iowa Law Review* vol. 86, p. 601. Gillette C.P. "Lock-in effects in Law and Norms", *Boston University Law Review,* 1998 vol. 78, p. 813, Mark J. Roe "Chaos and Evolution in Law and Economics", in *Harvard Law Rev.* 1995, vol. 109, p. 641. For a study of the effects of path dependency in corporate law, see Heine K. and Kerber, W. "European Corporate Laws, Regulatory Competition and Path Dependence", in *Eur. Journal of Law and Economics*, vol. 13, 2002, p. 47.

[13] See Ugo Mattei "Legal Systems in Distress: HIV-contaminated Blood, Path Dependency and Legal Change" in Global Jurist Advances, Volume 1, Issue 2 2001 Article 4.

be put on ensuring that injured persons receive compensation, while in another one, the need not to overburden economic actors with liability claims will prevail. The laws of these respective communities will then most likely diverge.

C. *Divergence as a rational, deliberate but less benign phenomenon*

A third line of argument builds on the previous one, but adds a twist. Whereas the previous account assumes deliberate decisions taken in good faith and with a view to the public interest, *public choice* theory[14] would consider the production of law as a market responding to general economic principles, for instance demand and supply models, pricing theory, etc. Accordingly, the production of law will favour the interests who are best able to articulate their demand and offer a valuable counterpart to the producer of law. Public choice theory can be used to explain lawmaking in complex settings involving interest groups, lobbying and other features of modern-day democracies.

Public choice theory can account for divergence as a rational and deliberate phenomenon. However, the outcome in each jurisdiction might be affected by market imperfections, including the presence of market power on the part of certain interest groups vying for the production of law, or information asymmetries (the interest groups know more than the lawmakers and choose to disclose only that information which serves their interest). The outcome is thus not necessarily in line with the general public interest in that jurisdiction. It could be ventured that the presence in certain jurisdictions of very developed systems of admissibility control in public law claims, for instance, reflects success by the administration in influencing the production of law (here administrative procedure) rather than the greater general good.

One of the most powerful interest groups is the legal profession: it can be argued that it represents, in fact, the main driving force for maintaining divergences, especially under the pretence of “legal culture”. The conceptual device of “legal culture” allows the legal profession to keep the tensions and debates alluded to above within its ranks, and hide behind a monolithic façade, which moreover is made opaque to outsiders by being presented as a “culture”. The legal profession can then protect and perpetuate its “monopoly” on its legal “culture”.[15]

D. *Concluding note*

Three different lines of argument were explored, all of which would explain why the law could be different from one place to the other, and would do so in a more

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[14] Stigler, George J. “The theory of Economic Regulation”, in *Bell Journal Econ. & Management Science* 1971, vol. 2, p. 3; Becker, Gary “A Theory of Pressure Groups for Political Influence”, *Q.J. Econ.* 1983, vol. 98 p. 371; Mueller, Dennis C., Public Choice II, Cambridge University Press, 1989; Farber, Daniel A. and Frickey, Philip P., *Law and Public Choice: A Critical Introduction*, University of Chicago Press, 1991.

[15] This also helps explaining the lawyers’ asymmetric attitude towards “importing” foreign legal rules, as compared to “exporting” own legal solutions. See Ogus, A. (1999), ‘Competition Between National Legal Systems: A Contribution of Economic Analysis to Comparative Law,’ *International and Comparative Law Quarterly* 48: 405-418; Ogus, A. (2002), ‘The Economic Basis of Legal Culture: Networks and Monopolization,’ cit. at footnote 7; Hadfield, G.K., “The Price of Law: How the Market for Lawyers Distorts the Justice System.” *Michigan Law Review*, 2000, vol. 98, p. 953

convincing fashion than endless invocations of irreducible differences between legal cultures: it is inaccurate to consider that the state of a legal system at a given moment is the single and unavoidable outcome of a monolithic legal culture pertaining to that system. Rather, each legal system is rife with tensions and debates (at least at an academic level). Legal systems are open to many potential directions, and their state at a given moment is simply the outcome of certain policy choices – deliberate or not – that are neither pre-determined nor irreversible over time.

It will be noted that these lines of argument do not require a specific level of comparison. They can explain differences between legal systems, of course, but they could also explain differences within a single legal system. Their point of reference is not a geographical territory or a hierarchical entity (legal system), but rather a legal epistemic community.

More importantly, these three lines of argument can explain conceptual divergence equally well as explicit divergence. It makes no difference whether a common term is used or not.

II. When is there divergence?

In the light of the foregoing, there appears to be ample reason for divergence (explicit or conceptual) to appear. A foray into methodology is then necessary, to ensure that divergence will only be found where it really exists.[16] First of all, a specific remark is made concerning conceptual divergence specifically and the "keyword trap" (A), before going more generally into the methodology used to assess divergence (B).

A. *The keyword trap*

In the case of conceptual divergence, there could be a methodological trap at work, having to do with the focus on keywords (including short key phrases of a few words). Jurists like to work with keywords, since it simplifies their task considerably by enabling them to put a shorthand label on subsets of the law in a given legal system. A whole piece of legal architecture is subsumed in one keyword: for instance, the set of rules and concepts concerning cases where a decision-maker has some degree of freedom in reaching an outcome becomes "discretion". The meaning of "discretion" as a keyword can only be found by retrieving the subset of the law which it is meant to represent. Accordingly, that meaning will be linked with the rest of the legal system in question (and the broader context within which this system operates).

Unfortunately, keywords have the unfortunate tendency to take a life of their own. They then cease to be treated as shorthand labels whose meaning is to be found by looking at the underlying subset of law which the keyword is meant to represent. Instead, jurists will then believe that the keyword has an inherent meaning in and of itself, i.e. that the meaning of the keyword resides in the keyword itself.[17]

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[16] This part of the paper is based more on research experience in comparative law and inter-disciplinary work with economists than on standard law and economics literature.

[17] See on this point Hart, H. "Definition and theory in jurisprudence" (1954) 70 *LQR* 37; Ross, A. "Tu-tu" (1957) 70 *Harvard Law Review* 812.

Under those circumstances, there is a fair chance that misunderstandings can occur. Two persons from different legal systems use the same keyword – or better even, what appears to be the same keyword in different linguistic version – and expect it to mean one and the same thing, since it is assumed that the meaning is in the keyword. Yet they fail to realize that, on a proper view where the meaning is rather found by referring to the subset which the keyword represents, the same keyword can have different meanings. Conceptual divergence lurks.

It is therefore crucial that jurists beware of the keyword trap. The mere fact that the same keyword, the same shorthand label, is found in two different systems (or appears to be found once translated), does not imply convergence. On a proper view, one must consider keywords as shorthand labels and look beyond them to the subset of the legal system which they are meant to represent. Only then can a conclusion be reached as to whether there is convergence or not. Presumably, the same keyword used in two different legal systems will often actually represent a different subset respectively in each system. Does that then necessarily imply conceptual divergence?

B. *A functional methodology to ascertain divergence*

At this juncture, it is interesting to digress briefly into a comparison with economics. Jurists work only with language, which suffers from an inherent degree of indeterminacy. Economists, on the other hand, rely on much more formal tools – namely mathematical models, empirical measurements, etc. – in addition to language. Nevertheless, language remains the prime means of communication between economists, and like jurists they use keywords to simplify communications. When two economists differ in opinion when discussing with each other (using language), they go back to the underlying theories and models (and formal mathematical language). They check their conclusions against these theories and models, verifying that assumptions are satisfied and that the theories and models being used are really applicable to the situation at hand. In the end, perceived divergences at the so-called "intuitive" level, using language and keywords, can be tested against theories and models whose formalism enables a conclusion to be reached. Either the divergence is removed, or it is attributed to gaps or open issues in economics. These can then be addressed as such.

Coming back to law, there is no set of formal tools which could be used to reach a conclusion on a perceived divergence across legal systems. Nevertheless, jurists have developed methods to test for divergence (and, in the case of conceptual divergence, to avoid the keyword trap).

For instance, classical comparative law tends to take a point from within the law (typically a keyword) as a basis for comparison. Each legal system will be entered into from that point. Typically, that point will be put in context with its immediate surroundings and even with the whole legal system.[18] The inquiry is quite descriptive. Very often, a finding of divergence will be returned. The conclusion will tend to be that (even if there is an apparent similarity in keywords), the underlying legal concepts, the legal reasoning and ultimately even the "legal cultures" differ. Very

[18] In the case of conceptual divergence, this amounts to looking beyond the keyword and retrieving the subset which this keyword represents

often, the civil law/common law divide will bear the blame for this (when the sample of legal systems under study allows for it).

Yet ascertaining differences in legal concepts, reasoning and "culture" should not be enough to warrant a finding of divergence. After all, the inquiry is descriptive and offers no objective test to support its conclusion. A more solid methodology is needed, namely a functionalist methodology.[19] This involves looking beyond the "middle layer" of legal concepts and reasoning to incorporate also the "upper layer" of policy considerations and the "bottom layer" of practical outcomes. Instead of beginning the inquiry via an endogenous point in the law, the starting point is rather found outside the law, by way of a practical problem.[20] That practical problem is common to all legal systems under study (e.g. "two cars collide at an intersection"). The aim of the inquiry is then to ascertain whether legal systems, seen broadly with their respective three layers, produce the same or a similar outcome on the basis of roughly the same policy considerations. Whether the legal concepts and reasoning used in doing so are similar should not be of prime relevance. Only when the outcomes differ (usually because the policy issues have been settled differently) is there a sufficient basis for a finding of divergence.

For instance, the laws of France, Germany and England do diverge on the treatment of pure economic loss under the law of liability. However, within that sample, the laws of Germany and England tend to converge both at the policy and at the outcome level,[21] even if they evidence differences in legal concepts and reasoning. French law differs fundamentally from both, however, in policy and outcomes. The divergence is thus mainly between German and English law, on the one hand, and French law, on the other. In all of this, the civil law / common law divide is of secondary significance as an explanatory factor.

Such a functionalist approach improves on the classical comparative law approach by enabling an objective test. Indeed the starting point is not an unreliable endogenous point within the law, but rather a constant exogenous point (a practical problem arising in every legal system). Furthermore, the conclusion is reached on the basis of outcomes, which are usually easier to quantify and compare (it is either one or the other outcome) than rules and concepts. In the end, if a difference in outcome is measured for the same starting point, then one cannot escape the conclusion that the legal systems do diverge. If they originally appeared to converge because of common or similar keywords, then we have a proven case of conceptual divergence: despite common keywords, the legal systems produce different outcomes when examined from a single common starting point.

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[19] For more on this and on the functional approach in general, see the work of the Ius Commune Casebook Project, in particular the *Casebook on Tort Law*.

[20] The functionalist method usually relies on a set of facts as a starting point. Within the EC context, however, it is also possible to use as a starting point a piece of EC legislation, most often a directive. This piece of EC law applies in all legal systems and places all systems under the same constraint (implementation), and it is then interesting to examine how each legal system receives and implements that piece of EC law.

[21] Save for the fact that Germany tends to make greater use of contract law devices to soften the impact of the disallowance of recovery for pure economic loss.

If the methodology just described is used, we venture that the number of cases of divergence – explicit or conceptual – is likely to be lower than might appear at first sight.

III. What is wrong with divergence?

In the previous two parts, we have seen that divergence can be explained rationally, and that, on a proper methodological approach, it is probably less frequent than suspected.

Once there is a finding of divergence, the discussion is naturally drawn to the more normative question of whether it is undesirable.

In the first part of this paper, three lines of argument were set out to explain why divergence can occur. It can be noted that of the three, only the "local preference" argument – the second one – provides a stable (and strong) explanation for divergence. Still, local preferences can evolve. The first line of argument (rational but not deliberate) implies that divergence can disappear over time, if information imperfections are removed. Network effects can work in favour of one or another outcome and would not prevent divergence from disappearing.[22] The third line of argument (rational, deliberate but not benign) implies that divergence results in part from different power configurations which are not necessarily stable.

Even then, the mere fact that divergence is not stable over time does not mean that it is undesirable. Beyond purely legal arguments against divergence (A), which are not conclusive, there are some economic reasons why divergence should be addressed (B).

A. *Convergence as a value in and of itself*

Here, we jurists sometimes fall into the classical trap of thinking that convergence (and ultimately unity) in the law is a value in and of itself.

First of all, convergence has enormous intellectual appeal, but that of course is not a sufficient justification.

Secondly, jurists sometimes put forward rights-based arguments for convergence: it would be everyone's right to have similar situations be treated in the same way across legal systems or communities. Given the arguments made above to explain why there might be divergence, we do not think that a mere assertion of rights is sufficient to trump the cards.[23]

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[22] In fact, in network markets, network effects can be overcome and a new solution can replace the one previously in place, not necessarily by means of a top-down intervention, but also through bottom-up provision of incentives to transition.

[23] In Bhagwati J. "The demand to reduce domestic diversity among trading nations", in Fair Trade and Harmonization, eds. J. Bhagwati and R. Hudec, Cambridge MA: MIT Press 1996, at page 9 *et seq*., a survey of the arguments against diversity is presented, by highlighting (1) the philosophical arguments (basic human rights beyond national borders, distributive justice and fairness), (2) the structural arguments (globalisation), (3) the economic arguments (domestic decisions impairing international trade; distributive concerns and predation) and (4) the political arguments (protectionism and the need for a common set of standards within an integrated union).

A third but related argument is very present in EC law, namely the need to ensure the effectiveness of the law (here, EC law). This argument pertains more to conceptual divergence within a larger system such as EC law: it would be essential to ensure that EC law is interpreted, applied and enforced the same way throughout the EU, lest it lose its effectiveness. After all, the ECJ has construed the EC Treaty in a very purposive fashion, which naturally leads to emphasizing effectiveness.

At the same time, throughout its case-law, the ECJ is also willing to accept a degree of divergence in the laws of the Member States. For instance, it might appear that the case-law on the internal market is naturally favourable to convergence, given the ease with which the ECJ will conclude, often without empirical evidence, that a specific provision in a given Member State constitutes a barrier to the free movement of goods, workers, services, capital or the freedom of establishment of firms and self-employed persons. At the same time, the "rule of reason" developed to save restrictions on the free movement of goods in *Cassis de Dijon*[24] and subsequently extended to other freedoms enables vast areas of law to remain divergent across Member States. Similarly, in the line of case-law including *Keck*[25] and *Gourmet International*[26], the ECJ retreats on its earlier statements and leaves potentially divergent Member State laws outside of the realm of Article 28 EC.

More recently, the judgment in the *Tobacco Advertising* case[27] provides a useful reminder that convergence is not a value in and of itself. Writing about the availability of Article 95 EC as a legal basis, the Court stated that:[28]

> [i]f a mere finding of disparities between national rules and of the abstract risk of obstacles to the exercise of fundamental freedoms or of distortions of competition liable to result therefrom were sufficient to justify the choice of Article [95] as a legal basis, judicial review of compliance with the proper legal basis might be rendered nugatory.

In *Tobacco Advertising*, the ECJ laid down the bases for a more economic approach to the use of Article 95 EC as a legal basis. Indeed from an economic perspective, the mere fact of divergence is not undesirable.
In order to come to a normative conclusion, the assessment must look more broadly at the costs and benefits of divergence (and in a later step, discussed below under part IV, at the costs and benefits of removing divergence).[29]

B. *The costs associated with divergence*

1. Starting point: benefits, but no costs

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[24] ECJ, 20 February 1979, Case 120/78, Rewe-Zentral v Bundesmonopolverwaltung für Branntwein [1979] ECR 649

[25] ECJ, 24 November 1993, Keck and Mithouard, joined cases C-267/91 and C-268/91, [1993] ECR I-06097

[26] ECJ, 8 March 2001, Case C-405/98, Konsumentombudsmannen (KO) v Gourmet International Products AB (GIP) [2001] ECR I-01795

[27] ECJ, 5 October 2000, Case C-376/98, *Germany* v. *Parliament* [2000] ECR I-8419.

[28] At Rec. 84.

[29] An obvious point for economists. See, for example, in the context of discussions concerning harmonisation: Sun, Jeanne-Mey and Pelkmans, Jacques Regulatory Competition in the Single Market in *Journal of Common Market Studies*, 1995, vol. 33, p. 67.

The benefits of divergence flow from the lines of argumentation put forward earlier. They are strongest when divergence is explained by local preferences. Each legal system is then better attuned to its respective reality: when they reflect differences in preferences of different communities, divergences are in principle preferable to a unified solution since the latter will not, by definition, match every community's needs equally well.[30] Since variety increases utility, social welfare is enhanced.

Moreover, since the most suitable solution is hardly, if ever, known in advance, the existence of different solutions can enable a learning process towards the discovery of the most appropriate one.[31]

In principle, divergence as such does not create costs. To be sure, in presence of a divergence between legal systems, acknowledging it and being aware of alternative solutions can help highlighting the possible costs associated with a certain legal choice within a given legal system. However, in such cases, costs are not due to divergence but are caused by unsatisfactory choices made in the past. This is especially true when divergence is explained not by local preferences but rather by non-deliberate factors (information asymmetries, network effects) or via public choice theory (pressure of interest groups).[32] In such cases, the existence of divergence does not constitute ground for harmonisation, but may prompt domestic revision of own inefficient legal choices and eventually lead to a change.

2. The more realistic case: benefits but also costs

Positive costs are usually generated, however, when diverging systems are actually communicating with each other. Communication can take place through various means, be it trade in goods, movement of persons, etc. Certainly this kind of communication can be considered as an increasingly recurrent feature when markets are integrating.

More specifically, when diverging systems communicate, the following costs might arise:

1. *Externalities*: Normally, the state of the law should reflect the choices made in a given jurisdiction, in the light of the various tradeoffs involved. It is possible, however, that the choices made in a jurisdiction impose costs which are borne by another jurisdiction, in which case the choice of the first jurisdiction is not based on a complete picture of costs and benefits (tradeoffs) involved. A typical example is environmental legislation in the presence of cross-border effects (water and air flows across boundaries). In the presence of externalities, there is no reason to respect divergence arising from local preferences (e.g. minimal pollution controls upstream), since they can result in sub-optimal results overall (e.g. unwanted pollution downstream). A similar problem may arise if a state has a lax competition policy that allows the

[30] Save for what is discussed in the subsequent section.
[31] Hayek, F. "Competition as a Discovery Procedure" in Hayek (ed) New Studies in Philosophy, Politics, Economics and the History of Ideas, 1978 Chicago p. 179-190
[32] See above at pages 2 *et seq*.

formation of cartels which then negatively affect consumers in other jurisdictions to the benefit of domestic firms.

2. *Transaction costs*: When there is trade between jurisdictions, divergence creates transaction costs. Indeed participants in trade – sellers as well as buyers – must acquire knowledge about the legal situation in other jurisdictions in order to engage into trade efficiently (otherwise, they incur risks). They must incur the costs necessary to draft contracts according to each legal system in which they are doing business and they must incur the costs of possible litigation under multiple legal regimes. The risks associated with unexpected changes in each of the legal systems concerned by the transaction also represent costs for cross-border economic actors and so on.[33] On the seller side, for examples, this means that products, terms and conditions, etc., must be adapted to meet the legal requirements of a number of jurisdictions, thereby increasing the cost of production and consequently the price. On the buyer side, not only is the price higher due to the just mentioned extra costs, but also the cost of buying can be increased; more likely, however (especially with consumers), buyers would refrain from buying outside of their jurisdiction. The same applies to business transactions other than sale and even to personal endeavours (employment, family matters). Besides these "static" effects, also dynamic ones can be identified on a macro-economic level, namely the reduction in the international trade volume, in the level of investment, consumption and income and ultimately in the economic growth.[34]

   Transaction costs offer a very powerful argument against divergence. With respect to consumers and persons in general, transaction cost analysis can reinforce rights-based arguments: the right of a person to be treated the same way irrespective of the legal system in question can be justified because it is deemed unacceptable that persons should bear the transaction costs associated with divergent legal systems.

Externalities and transaction costs are the standard arguments used to support the conclusion that a given instance of divergence is undesirable. These arguments apply equally to conceptual or explicit divergence. Presumably, transaction costs are higher in the case of conceptual divergence, since the precise scope of the divergence is harder to ascertain.

In addition, a third type of cost could be associated with conceptual divergence only, namely costs arising from *information imperfections*. Indeed conceptual divergence differs from explicit divergence in that, on the surface, the same term is used, but with diverging concepts. Ideally, if acquiring information were costless, individuals and firms would spend enough resources to ascertain the legal situation that they would come across conceptual divergences as well. Since, unfortunately, obtaining information is costly, parties will invest resources in such activity only until its

[33] On the costs of diversity, see Ribstein, Larry E., and Kobayashi, Bruce H. (1996), "An Economic Analysis of Uniform State Laws" 25 *Journal of Legal Studies* p. 131, at p. 138 *et seq.*.

[34] More extensively on this, see H. Wagner "Economic Analysis of Cross-Border Legal Uncertainty – The example of the European Union", in *Jan Smits (ed) The need of a European Contract Law. Empirical and Legal Perspectives*, Europa Law Publishing 2005.

marginal cost equals the marginal benefit.[35] There is therefore a risk that they will not look beyond the surface and will then take decisions based on the assumption that the same term is conceptualized in the same way in every jurisdiction, only later to find out that their assumption was wrong (at their cost, but perhaps also to their benefit). They could thus be misled into taking decisions which they would not have taken with complete information on the status of the law. This can lead to inefficiencies, in the form of unsuspected losses or extra costs to undo mistakes. In the end, the uncertainty and the risk of hidden conceptual divergences arising only after the transaction has been entered into, if too extensive, could result in economic actors refraining from cross-border trade.

In sum, divergence is not undesirable as such. Yet in many cases it engenders significant costs, such as externalities, transaction costs and (in the case of conceptual divergence) costs arising from information imperfections. These costs can exceed the benefits from divergence and thus justify the conclusion that divergence should be addressed. However, the inquiry does not end here. It must still be ascertained whether change would lead to an improvement.

IV. What can be done about divergence?

A number of options are available to deal with a situation in which divergence would be undesirable.

A. *Do nothing and leave the market to deal with it*

At the outset, it must be remembered that markets typically provide "private" solutions to deal with certain costs associated with diverging legal systems. Such solutions do not in fact eliminate divergences but constitute a way to factor them into the choices of economic actors.

First of all, if parties can influence the law through contract, they will likely do so. In commercial contracts, for one, parties can either opt for one or the other legal system (or a third one) or define the law *inter partes* themselves.

Secondly, the legal profession can assist market players in reducing the costs of divergence by providing accurate advice, thereby minimizing transaction costs and the costs of information imperfections linked with conceptual divergence. In fact, through their work, legal professionals contribute to identifying cases of conceptual divergence. Over time, once these cases become common knowledge, the information imperfections are eliminated and conceptual divergence becomes equivalent to explicit divergence in economic terms.

Thirdly, in commercial but also in consumer relationships, the insurance market can offer a possibility to translate divergence into quantitative terms, i.e. an insurance premium. In the case of liability laws, in particular, insurers have superior knowledge of the state of the law in each market and can provide a lower-cost alternative to

[35] This is referred to as rational ignorance: I will spend on information only to the point when the last bit of information I have acquired allows me to reap net additional benefits.

endless inquiries, product modifications, etc. If a firm wants to keep relatively uniform prices, it can then equalize the cost of insurance over all of its customers.

Thirdly, large and multinational companies are generally familiar with dealing with multiple legal systems and have developed the necessary structures for cost-minimising information gathering, thanks also to economies of scale. In fact, they might find worthwhile to develop international standards for contracts and products; those standards could bring about some sort of "harmonisation".[36] In such cases, the interest of Member States (or of the European Commission) would rather lie in making sure that such standard-setting activities do not conceal competition law infringements.

These solutions can only work in certain cases: for instance, divergences in administrative procedure cannot be compensated via contract or insurance. Moreover, for SMEs[37] and consumers, such solutions might be less affordable or practicable. In situations where they are available, however, these market-based solutions can be attractive, especially if there are no externalities involved and the costs associated with divergence (transaction costs, information imperfections as the case may be) are limited in comparison with the value of the overall activity.

Market-based solutions apply equally to explicit and conceptual divergence. It can be added, however, that when parties themselves draft in the contract the law applicable to their transaction, they must be aware of the existence of a conceptual divergence and explicitly address the problem, otherwise the contract will become itself the source of the hidden divergence, instead of removing it.

B. *Top-down harmonization*

Jurists tend to be less sanguine than economists about divergence between legal systems, and they readily see it as a problem. What is more, they often propose to remedy that problem with a fairly drastic solution, namely harmonization or even unification of the law. In such a process, the respective laws of each legal system, on the area when divergence is deemed problematic, are replaced by a single law common to all systems.

Looking back at the costs associated with divergence, as they were identified above, the case for harmonization is most compelling when divergence leads to externalities. In such cases, given that market players and national legislators are unable to decide on the basis of a complete picture of costs and benefits, it is unlikely that an efficient outcome will be reached. Indeed, externalities are a typical form of market failure which requires intervention by public authorities.

The benefits of (successful) harmonization, including uniform implementation, are that the costs of divergence are removed:

- externalities are addressed and removed;

[36] In this sense, H. Wagner, cit. supra at footnote 34, and the references contained therein.

[37] It has been noted, however, that in the debate launched by the Commission on the harmonisation of contract law at the European level, some associations of SMEs have expressed their opposition to full harmonisation.

- transaction costs are eliminated, since cross-border activities will be subject to the same set of rules in all the relevant legal systems;
- information imperfections disappear, since parties can rely on the common legal framework thus established.

As a consequence, cross-border activity would be boosted and so would also investment, consumption and growth.

Furthermore, there might be occasions where economies of scale are possible, thus justifying the need of a uniform solution. This might be the case of problems of complex technical nature that are more cheaply dealt with in a one-stop-shop setting.

As mentioned at the outset, however, jurists tend to ignore the benefits of the current situation and the costs associated with change. Even if divergence leads to costs, it is conceivable that harmonization would generate even higher costs.[38]

1. A superficial cost-benefit analysis of harmonization

At a superficial level, harmonization removes the benefits associated with divergence, first and foremost that the law is better attuned to local preferences. Presumably, if divergence were found to be a problem, it is because the costs flowing from divergence exceed those benefits, and therefore if harmonization can remove these costs, it would still produce an overall benefit even if the benefits of divergence were removed by the same token.

On that count, harmonization will always be beneficial and indeed jurists would be right to focus solely on the costs of the current situation and the benefits of change.

2. A more complete cost-benefit analysis

The above analysis is incomplete on two accounts: harmonization itself generates costs (as opposed to the mere removal of the benefits of the current situation), and the benefits of harmonization must be discounted to reflect uncertainty as to realization.

Harmonization generates costs of its own, which must also be taken into account. First of all, the production of the harmonized legislation is costly, involving as it does extensive background studies and discussions. Costs also arise because of the need of "developing new bureaucracies or demolishing old structures".[39] Costs are also incurred in order to adapt to the new rules, in terms of information spreading and re-training.

Secondly and more fundamentally, it is a rare occurrence where the area to be harmonized is relatively autonomous within the law as a whole. More frequently, this area interacts with the rest of the law. For instance, product liability or State liability for breaches of EC law are part of the law of liability and more generally of private and/or public law. Ahead of harmonization, each legal system is in an equilibrium of sorts: the various areas of the law are supposedly seamlessly integrated into the legal system. Top-down harmonization, coming from the outside, implies a break within

[38] There is a shared presumption in the literature that full harmonisation generally brings about higher costs than those caused by maintaining diversity.
[39] H. Wagner cit. *supra* at footnote 34.

the legal system, i.e. the creation of a specific "harmonized area" which co-exists with other remaining areas. In the ideal situation, implementing (incorporating) the harmonized law should be done seamlessly, without distorting the legal system. For instance, under EC law, the very mechanism of the directive is meant to allow Member States for some room to adapt the harmonized law to their legal system and thereby minimize distortions. The ideal being an ideal, more often than not harmonization will generate distortions within the legal system or miss its goal because harmonization is undone at the implementation stage (as mentioned above), or even both.

When faced with such distortions as a result of harmonization, legal systems can react in two ways. Firstly, via a kind of ripple effect, the changes introduced in the harmonized area can induce further changes outside of the harmonized area in order to restore the system to a seamless equilibrium. There are numerous examples of Member States using the implementation of a directive as an opportunity to change a broader area of their law (often in a spirit of "cleaning up"). Such a ripple effect generates costs, but they are limited in time. Secondly, the legal system can treat the harmonized area as a form of foreign body (*Fremdkörper*) and seek to isolate it. For an example, see the reaction of German courts and writers to the introduction of State liability for breaches of EC law via the *Francovich* and *Brasserie du Pêcheur* judgments. The ensuing tension within the legal system generates costs on a lasting basis.

Moreover, the need to legislate in many languages – leading to often lamented inaccuracies, even within the same language[40] – may facilitate the reproduction of the divergence in the implementation phase.

The above analysis applies to explicit as well as conceptual divergences. However, given the complexity of the law, harmonization exercises sometimes end up replacing explicit divergence with conceptual divergence or merely pushing conceptual divergence deeper, so that it does not deliver all the expected benefits. There is an illusion of convergence in terminology and presumably a fair amount of conceptual overlap, but somewhere at the conceptual level undesirable divergence was found. If this happens as the result of an harmonisation effort aiming at removing externalities and costs of an existing divergence, then it will instead merely replace such costs with new ones, perhaps adding those peculiar to conceptual divergences.

In addition to the above costs of harmonization, by implication the benefits of harmonization must be discounted with a higher degree of uncertainty as to the results. By the same token, it is more likely that harmonization will induce significant distortions and thus costs.

Accordingly, top-down harmonization efforts must be analysed as a trade-off between the benefits of harmonization and the costs associated with inducing distortions within legal systems.

[40] See, for example, Barbara Pozzo, "Harmonisation of European Contract Law and the need of Creating a Common terminology", in *European Priv. Law Rev.* 2003, p. 754.

C. *Bottom-up alternatives: regulatory competition and the marketplace of legal ideas*

Between doing nothing and introducing top-down harmonization, there is a third option, namely relying on bottom-up processes to bring about convergence when needed. This is essentially a more sophisticated version of the doing nothing alternative, or to use an oxymoron, doing nothing with a plan.

If legal systems diverge but they do communicate with each other through trade and other forms of exchange, they will also communicate at the intellectual level, in the proverbial marketplace of ideas. If the various legal epistemic communities are introduced to each other's ideas, one could expect that they will compare them. Over time, they might adopt the policies, concepts, reasoning or outcomes of another community if they are convinced that it is preferable. A certain amount of convergence will then result.

Of course, if divergence echoes local preferences, one could object that local law will remain in place even after the comparison. However, in many cases, the need to reduce transaction costs and improve trade will act as a counterweight and will provide an incentive to move away from a law based strictly on local preferences.[41]

This is the theory of *regulatory competition*:[42] it considers legal rules as a "product" and depicts law-makers in the different legal systems[43] as the suppliers of such product. On a given topic,[44] different law-makers compete with each other for the provision of the legal rules that are more attractive to their "customers", intended as individuals as well as firms. Those "customers", in turn, respond by relocating in the jurisdiction whose set of rules best suits their preferences.[45] This way, law-makers are pushed to experiment and try to find out the best legal rule (so-called "race to the top"). Legal systems will eventually converge towards such "best" legal solution.

This theory has been used extensively to explain developments in American company law,[46] as one of the topical legal fields where legislators compete to attract businesses to incorporate within the boundaries of their jurisdiction. The ECJ judgments in

[41] It has been remarked, however, that some areas of law might be deeply connected with local preferences and therefore less subject to regulatory competition and that this might in particular be the case of "interventionist" law, as opposed to "facilitative" law. See A. Ogus "The economic basis of legal culture" cit. *supra* at footnote 7

[42] R. van den Bergh (2000), "Towards an Institutional Legal Framework for Regulatory Competition in Europe", *Kyklos* p. 435; D. Esty, and D. Geradin (2001), "Regulatory Competition and Co-opetition": in Esty & Geradin (Eds) *Regulatory Competition and Economic Integration: Comparative Perspectives*, Oxford University Press; Anthony Ogus, (1999), "Competition Between National Legal Systems", cit supra at footnote 15.

[43] Or at different levels in a single legal system with a federal structure.

[44] This is generally the case for legislators that, each within their geographical borders, have the power to regulate the same kind of situations.

[45] The so-called "vote by feet" as developed by Tiebout, in relation to the provision of public goods, in his influential article "A Pure Theory of Local Expenditures", in *Journal of Political Economy* 1956, p. 416.

[46] Romano, R. "Law as a product: some pieces of the incorporation puzzle", *Journal of Law, Economics and Organisation*, vol. 1, 1985 p. 225.

Centros[47] and *Überseering,*[48] by affirming the incorporation principle,[49] may allow the same kind of competition also in the European setting.[50]

To be sure, critics of the theory have argued that such competition may easily lead to the degradation of legal standards in order to attract more business (by, for instance, relaxing the protection of shareholders to the managers' advantage – the so-called race to the bottom or "Delaware effect").[51] Such critique, however, has been questioned on theoretical as well as empirical grounds.[52] It has been also remarked that the very concepts of "top" and "bottom" are not very clear, being based on value judgements, and therefore, the race concept is not able to provide univocal policy guidance.[53] It is not for granted either that there will in fact be a "race".[54]

What is important for regulatory competition to work effectively are, in fact, its assumptions and in particular:

- a sufficiently large number of divergent legal systems among which to choose;
- mobility or, more in general, reactivity on the part of individuals and firms to differences in the rules;
- reactivity on the part of the law-makers to the choices made by their "customers";
- full knowledge of the legal rules adopted in the different systems;
- no externality problems.

The possible need of an action that will assure that such assumptions do occur, explains why the "doing nothing" was coupled with the addition "with a plan".

The first assumption contains a clear policy indication against top-down harmonisation pressures: uniform legal systems do not provide alternatives and nullify the "discovery" procedure.

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[47] ECJ, 9 March 1999, Case C-212/97 Centros Ltd v Erhvervs- og Selskabsstyrelsen, [1999] ECR I-1459.

[48] ECJ, 5 November 2002, Case C-208/00 Überseering BV v Nordic Construction Company Baumanagement GmbH (NCC), [2002] ECR I-9919.

[49] According to this principle, the legal existence and capacity of a company depends on the law of the State in which it is incorporated. What the Court has ruled is that any company, once incorporated in one Member State, is free to establish itself and do business in another Member State – even if this implies transferring its "real seat" – without having to comply to the host country legislation.

[50] Discussion of this issue can be found, *inter alia*, in: Heine, K. "Regulatory competition between Company Laws in the European Union; the Überseering case", in *Intereconomics* 2003, p. 102; E.M. Kieninger "The legal framework of Regulatory Competition based on company mobility: EU and US compared", in *German Law Journal* 2004, vol. 6, p. 742.

[51] L. Bebchuck "Federalism and the corporation: the desirable limits on state competition in corporate law", in 105 *Harvard Law Rev.* 1992 p. 1443

[52] See D. Vogel and R. A. Kagan "National Regulations in a Global Economy. An Introduction", UCIAS Edited Vol. 1 Dynamics of Regulatory Change: How Globalization Affect National Regulatory Policies, 2002; Radaelli, Claudio M. "The Puzzle of Regulatory Competition", in *Journal of Public Policy*, Volume 24, Issue 01, May 2004, p. 1

[53] See Radaelli, cit. supra at footnote 52

[54] Heine, K. "Regulatory competition between Company Laws" cit. *supra* at footnote 50; Kahan, M. and Kamar, E. (2002), "The Myth of State Competition in Corporate Law" in 55 *Stanford Law Review* 679-749.

The mobility issue, at first glance, might seem problematic, as it might imply very high relocation costs. However, for many legal areas individuals do not really need to move in order to express their preferences: for instance, in presence of mutual recognition, free movement of goods replaces the necessity of relocating; a choice of foreign law made by parties to a contract also shows individuals' preferences without actual relocation.

As it has been effectively emphasised, in many cases it is a question of private international law, i.e. whether legal systems will recognize and enforce the choice of law rule elected by the parties to a transaction.[55]

Some doubts have been cast as to the reactivity of law-makers to the preferences of individuals and firms.[56] However, so far, there seems to be no conclusive evidence in one sense or the other.[57]

The problem of knowledge of alternative legal rules and of their effects seems to be a more severe one. Circulation of ideas between legal communities is obviously a condition *sine qua non*. At this juncture, in Europe, such exchanges are still in their infancy. While EC law fosters the free movement of ideas (among others), there are still vast areas of law (and of the legal community) which remain generally shielded from any confrontation with ideas from other legal communities. National legislation and judgments of national courts are not disseminated beyond national borders, and only a small group of academics actually looks across these borders. The recent creation of networks of regulatory authorities such as the ECN/ERG/ERGEG and ICN may be seen as examples of institutional devices for boosting circulation of information among legal systems.

Lastly, the presence of market failures and in particular of externalities can effectively prevent the development of a healthy regulatory competition or generate a race to the bottom. Economics teaches us that in such situations, non-coordinated actions of individuals (in the present case, of individual Member States) do not lead to the best outcome, the one that maximises social (overall) welfare. This can justify some degree of coordination or some sort of top-down intervention.

In fact, it seems clear that we are never really faced with a binary choice – full harmonisation or bare regulatory competition – but there is a whole range of possibilities with variable degrees of competition and cooperation.[58] The necessity of a certain regulatory harmonisation at the procedural level or at an *"institutional meta-*

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[55] See F. J. Garcimartín Alférez "Regulatory Competition: a Private International Law Approach", in *Eur. Journal of Law and Econ.* 1999, p. 251.

[56] Radaelli, cit *supra* at footnote 52, page 7 and A. Harcourt "Institution-driven competition: the Regulation of Cross-Border Broadcasting in the EU", EUI Working Papers, RSCAS no. 2004/44, although one might doubt whether the broadcasting sector is the most representative example.

[57] See, for instance, on reactivity of legislators in the "competition" for incorporations, E.M. Kieninger, cit supra at footnote 50, at page 766 *et seq.*.

[58] In this sense, A. O. Sykes, "Regulatory Competition or Regulatory Harmonization? A silly question?" in *Journal of International Economic Law* 2000, p. 257; Geradin & Esty, cit. *supra* at footnote 42; C.M. Radaelli, cit. *supra* at footnote 52.

level" is generally advocated in order to allow regulatory competition to take place and avoid the risk of a race towards the bottom.[59]

Actually, the form of "regulatory competition" referred to in this paper is broader than just market actors "voting with their feet". It extends also to a "marketplaces of legal ideas" where law is central and members of the legal community are looking for the best solution to the issues they are confronted with.

There are at least three dimensions of this "marketplace of ideas" that can work in favour of elimination of divergences among legal systems, in the sense advocated by this paper.

1. Free movement of persons and goods, choice of law rules
2. Circulation of legal ideas through academics or through new forms/institutions of cooperation
3. Role of the European Court of Justice and principle of proportionality

The first point refers to the classical view of regulatory competition, but takes into account the alternatives to actual relocation of economic agents, as referred to above.

The second dimension pushes regulatory competition one level up, by touching directly the problem of circulation of legal ideas not among the economic actors but among the legal actors and the regulators. Institutions could maybe be devised for such a purpose on the model of what is currently happening in the ECN, ICN or ERG settings.

The third point emphasises the role of the European Court of Justice in the circulation of legal ideas and legal solutions. The Court can be seen in this context as a "coordinator of information":[60] parties to the proceedings may refer to practices in other Member States and the Court itself may evaluate the proportionality of certain legal rules (such as mandatory requirements) in the light of what is done in other Member States.

V. **Conclusion**

By taking the consequences of what has been said in the previous sections, we can attempt to draw some conclusions.

Bearing in mind that the mere existence of a divergence is not a problem in itself, it is worthwhile noting that none of the alternatives described above seems to be the panacea for all forms of "problematic" divergences.

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[59] See, among others, Barnard C. & Deakin S., "Market Access and Regulatory Competition", Chapter 8, *The Law of the Single European Market, Unpacking the Premises*, ed. by Barnard C. & Scott J., Hart Pub. 2002; K. Heine, cit. *supra* at footnote 54; F. Garcimartín, cit. *supra* at footnote 55. It is sometimes also argued that harmonisation is indispensable when diverging terminology exists across legal systems (in this sense, R. Van den Bergh cit. supra at footnote 42). However, if we adopt the functionalist approach suggested above in Section II, the purely terminological problem looses much of its relevance.

[60] Barnard and Deakin, cit. supra at footnote 59 at p. 223.

If the divergence problem is, in fact one of externalities, then, as it has been highlighted, non-coordinated actions might result in failures. In such cases, therefore, both explicit and conceptual divergence are probably best cured by an harmonisation intervention. Such intervention might affect directly the substance of the problem, by providing a uniform rule for all the involved jurisdiction, but it could also take the form of a procedural framework,[61] such as establishing an appropriate (uniform) private international law rule.[62]

If the problem is caused by the presence of transaction costs, the recipe will probably not be the same for every case. In some cases, the "do nothing" approach might work well, in particular, when the legal area allows it and when multinational firms are concerned. Full harmonisation is generally prone to bring about very high costs, without being sure of the overall result. Moreover, in the case of conceptual divergences, it might push the problem deeper, thus reinforcing the costs specific to such form of divergence.

A broader version of regulatory competition – extending to the "marketplace of legal ideas" – offers a valid alternative to the abovementioned solutions.

Moving back to conceptual divergence in particular, in general, the use of economic analysis tends to reduce the sense of urgency which might be felt when conceptual divergences are detected. Indeed, by and large, the various economic analysis tools used to examine explicit divergences are applicable to conceptual divergences as well. As is the case with explicit divergence, they show that divergence can rationally be explained, that it does not really occur that often, that it may not always undesirable and that removing it can sometimes make the situation worse.

[61] Barnard and Deakin in this direction, cit. *supra* at footnote 59 at p. 220.
[62] In favour of this alternative, F. Garcimartín, cit. supra at footnote 55.