PRECONDITIONS TO REGULATORY COMPETITION

*Régis Lanneau**

ABSTRACT

Regulatory competition is often believed to be a hard fact of the post globalization era. Legal systems must be economically "attractive" – and thus law makers must work to achieve this purpose. However, this view – as simple and seductive as it is – is not sound. Indeed, a quick analysis of the preconditions to regulatory competition will show that far from being a brutal reality, it is quite reduced, even in the context of the European Union.

This article has two purposes. The first one is theoretical: what are the conditions required to enter regulatory competition in the real life? This question will lead to a new "understanding" of regulatory competition's problematics. For example, it will be made clear that the doing business approach is largely flawed. Indirectly this question will also lead to an inquiry into the interconnections that exist between legal system and the necessity to think about a new model (like coopetition). The second one is more practical. To what extent should law makers be focused on the attractiveness of their own legal system? Clearly, they will have to pay attention to this dimension, but their freedom in choosing a rule is wider than it seems under the regulatory competition's approach. Frequently paying attention only to the internal efficiency of their system is sufficient.

Keywords: regulatory competition, legal system, efficiency

* *Associate Professor, University of Paris Nanterre*

INTRODUCTION

Globalization – as a process that leads to an increase of links, integration and exchange between economies, culture, etc. – has changed the way we think about the law and moreover the way we think about the interconnections between legal systems. It would nowadays be foolish for law making powers to disregard the international legal environment when accomplishing their tasks or to adopt a "closed" view of regulation (restricted to the nation state). More than paying attention to what happens outside the realm of the nation state, it is often believed that globalization puts pressure on national legal systems; they now have to be economically "attractive" … and since the attractiveness is purely relative, a regulatory competition is thought to be at stake.

In the EU, Centros[1] and Uberseering[2] decisions paved the way to a regulatory competition of business forms and company law; often fiscal competition is denounced (regarding corporate tax, especially in Ireland). At a global level, the attractiveness of business law is supposed to be synthesized in doing business' rankings. It seems then that law making powers have no choice or limited choices when they regulate because of an "intense" regulatory competition. However, we should not forget that the possibility of a regulatory competition is, in part, framed by the law (freedom of movement in the EU for example, infra).

Regulatory competition – as a competition process between decentralized law-making entities to attract and retain scarce resources through the design of an attractive legal system– is not a new idea. Indeed, Charles Tiebout's article "A Pure Theory of Local Expenditure"[3] addressed – at least indirectly (if law is seen as a local public good) – this question in the mid 50's. In Tiebout's model – which is a static model –, local government competed to attract residents with a package of public services and taxes that tries to "match" residents' preferences; at the end of the process an efficient equilibrium is found in which diversity is still present (since preferences of residents are). This model, thus, does not directly address regulatory competition (especially in the real world since it is a "pure" theory) but it opened the possibility and the relevance to inquire into such question with economic tools. Indeed, if law

[1] Centros Ltd. v. Erhvervs-og Selskabsstyrelsen, CC-212/97 (Denmark).
[2] Überseering BV v. Nordic Construction Company Baumanagement GmbH (NCC), C-208/00 (Germany).
[3] Charles Tiebout, *A Pure Theory of Legal Expenditures*, 64 J. POL. ECON., 416 (1956) (hereinafter Tiebout).

is seen as a public good supplied by law making powers – and surely it is –, it is possible to extend this model to regulatory competition and to say that suppliers will try to "please" residents in order to retain or attract some valuable "assets". If residents or market players have the same preferences, it is reasonable to assume that legal systems will converge.

A vast literature explores the probable consequences of regulatory competition. For some it will produce a race to the bottom, the famous Delaware effect[4]. Being attractive would then mean to free from constraints. For others this regulatory competition will lead to more efficiency, hence a race to the top[5]. If Delaware is so attractive, it is because its regulation is efficient. It is also possible to argue that regulatory competition will lead to a race to the bottom or a race to the top depending on the issue[6] or even that this is a meaningless debate[7].

My purpose in this paper is not to solve the debate over the consequences – I doubt that it is even possible – it is more modest. I would like to inquire into the preconditions to regulatory competition. That is, to what extent are these models relevant for the real world? To what extent is regulatory competition a force that drives law making powers? Indeed, too often this regulatory competition is assumed to be intense and is used to justify some legal reforms mostly in corporate and fiscal law. This problem could be easily explained: from economic models, it is easier to take the results without paying attention to the conditions that define its possible relevance in the real world (and sometimes, this leads to tragedies. Ricardo comparative advantages is surely archetypical of the transposition of a model to the real world without paying attention to its limitations). I would then like to highlight the limits of regulatory competition. This does not mean that there is "no" regulatory competition but that it is far more complex than it seems when we are leaving the world of models to the real world. My purpose is then both theoretical and practical. Theoretical since I will try to

[4]William Cary, 1974, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J., 663 (1974).

[5]Frank Easterbrook, *Manager's discretion and Investors' welfare: theory and evidence*, 9 DEL. J. CORP. L., 540 (1984); Daniel Fischel, *The "Race to the bottom" revisited: reflections on recent developments in delaware's corporation law*, 76 NORTHWESTERN UNIVERSITY LAW REVIEW, 913 (1982); Ralph Winter, *State law, shareholder protection, and the theory of the corporation*, 6 J. LEGAL STUD., 251 (1977) (hereinafter Winter).

[6]Lucien Bebchuk, *Federalism and the corporation: the desirable limits to state incorporation in corporate law*, 105 HARV. L. REV., 1435 (1992).

[7]Claudio Radaelli, *The Puzzle of regulatory competition*, 24 JOURNAL OF PUBLIC POLICY, 1 (2004) (hereinafter Radaelli).

identify these preconditions that are required for regulatory competition; Practical since from this identification it will be possible for law making powers to assess the possible consequences of their regulation. I will proceed as follow. First, I will try to identify the preconditions relatives to "law makers" (section 2), that is the supply side. I will show that too often the political dimension of law making is forgotten in regulatory competition models although it is definitional in the real world. I will also demonstrate that the domain of regulatory competition as conventionally understood, is quite restricted. Second, I will focus on the preconditions relatives to "law takers" (section 3), that is the demand side. I will show that more than far from perfect freedom of movement, regulatory competition approach overestimates the role of legal parameters in the choice of allocating scarce economic resources. In the conclusion, I will plead for a broader conception of regulatory competition or more precisely for integrating more complexity in the analysis, although it will also blur any predictions.

1. PRECONDITIONS RELATIVES TO "LAW MAKERS"

Regulatory competition assumes a lot regarding law makers. Not only should they have an interest in entering into regulatory competition (2.1), but they also need sufficient freedom in the design of law (2.2). These two preconditions are certainly unrealistic in the real world – for both economic and legal reasons – so that regulatory competition is not as simple and intense as it seems.

Of course, and this precondition does not need lots of comment, for regulatory competition to exist, it is necessary to have a diversity of law makers and thus a diversity of legal system. If we observe a perfect unity in legal systems, no regulatory competition could possibly emerge. Harmonization within the EU is thus a tool to reduce the scope of a possible regulatory competition between European nation states.

1.1. Law makers must have interests in entering regulatory competition

For regulatory competition to be fuel it is necessary that law makers adapt their law. This means that they must have an interest in doing this (it is not a mere "reaction"; in Tiebout's model, it was nevertheless the case.). This precondition might seem obvious. However, it leads to two remarks. First, if attracting and retaining scarce resources is certainly interesting,

the model does not explain what a scarce economic resource is (2.1.1). Thus, regulatory competition can be intense in some legal fields and quite reduced in others. Indeed, when regulatory competition is mentioned, it refers, in general, to commercial / corporate law and to fiscal law and it has not been observed outside of these fields.[8]

Even if law makers might have an interest in attracting and retaining scarce economic resources, they will not necessarily enter regulatory competition. Indeed, the cost of doing so must be lower than expected benefits (2.1.2).

2.1.1 Attracting yes but attracting what? The domain of regulatory competition

Regulatory competition could only appear if resources are sufficiently scarce. If it is not the case, it is obvious that there is no interest in trying to "attract" or retain them. Scarce is then relative to one specific country: a country that already has "enough" does not necessarily need to attract more and then enter a harsh regulatory competition. The more a country needs some of these scarce economic resources (the intensity of the need), the more it is expected that it will try to use its legal system to give good incentives.

What are these needs? In the literature, it generally refers to business and capital. The first is fundamental to reduce unemployment, to stimulate economic growth or to obtain more fiscal resources – that could be used to build new public services or to cut taxes. The second refers mainly to FDI (foreign direct investment) and their links to economic growth. FDI are for example of tremendous importance for developing countries. In both domains, it is believed that legal parameters are crucial (the validity of this belief will be examined in section 3.2), thus regulatory competition concerns especially the field of business law, investment law and fiscal law. Indirectly it concerns most of legal fields from contract law and property law (since contract and property are the cornerstones of business law) to procedure and labor law(doing business reports assess the ease of doing business along 9 criteria from construction permits to contract enforcement, getting credits and paying taxes.).

[8] DANIEL ESTY & DAMIEN GERADIN, (eds), REGULATORY COMPETITION AND ECONOMIC INTEGRATION: COMPARATIVE PERSPECTIVES, (Oxford University Press, Oxford 2001) (hereinafter ESTY & GERADIN).

Most of legal fields and not all of them! Thus, regulatory competition is supposedly not at stake when designing law in some domains, for example family law. The choice to implement gay marriage, a market for babies or to legalize surrogate motherhood is considered as a political choice without real impacts regarding scarce economic resources; It is then outside the realm of regulatory competition. It would be possible to advocate that these choices have a tremendous symbolic impact (prestige or disgust) that indirectly will benefit (or not) the country, but it is difficult to assess to what extent. Nevertheless, if a country believes that there is an interest for its legal system to appear "modern" some regulatory competition might occur – this competition is however quite different from "classic" regulatory competition since the sole purpose is to be the first whatever the efficiency of the reform. It would also be possible advocate that gay people are "scarce economic resources" or that opening a market for surrogate motherhood will raise GDP… but would it be in a meaningful sense? Conventional wisdom seems to exclude this kind of reasoning when addressing the question of regulatory competition.

For some fields, it is harder to decide whether a regulatory competition is at stake. There is certainly a market for guns, drugs or prostitution and these activities generate a lot of money and jobs (but also some negative externalities). However, no countries seem to have entered regulatory competition for these fields. Regarding less controversial domains regulatory competition might appear in bioethics and biotechnologies in order, for example, to attract researchers and to promote patenting. Nonetheless, this kind of regulatory competition has not yet been observed or not yet been qualified as a form of regulatory competition.

To sum up, if regulatory competition is a fact, it seems that it does not concern all legal fields but, according to the literature, a relatively short sub-set: corporate and tax law. Theoretically it could be extended to other legal fields depending on what is perceived as a "scarce economic resource". What is perceived as such depends on the preferences of law makers.

2.1.2. The cost of "attracting" scarce economic resources must not be too high

Attracting scarce economic resources might be a goal for law makers. However, it is impossible not to consider the price of doing so. That is, law makers, as rational economic players, will engage themselves into costs and benefits analyses. These costs are not only financial costs, but they are also political costs (for these costs, see section 2.2.3).

Take the example of incorporation. It is often advance that regulatory competition for incorporation is at stake because corporation pays taxes (or at least some of them like franchise taxes or incorporation fees) to their state of incorporation. Indeed, Delaware earns several hundred millions of dollars in annual franchise taxes. It came thus at no surprise that Winter[9] argues that: "the purpose of corporate code revisions has been the attraction of charters to their state to produce significant tax revenues" or that Subramanian[10] claims that: "*States compete to have companies incorporated within their boundaries in order to maximize their corporate charter revenues*". Nevertheless, nowhere the idea that such revisions are costly is observed or that the competition strategy will be efficient. However, if revisions were costless, we should notice a clear tendency towards the elimination of inefficient rules. For example, the Section 630 of New York's Business Corporation Law[14] which states that the ten largest shareholders of a company are personally liable for wages and salaries payable to the company's employees is considered as inefficient but has not yet been repealed. (For a possible explanation see section 2.2.2.)

Kahan and Kamar (Kahan and Kamar, 2002)[11] find out that regulatory competition in corporate law is not significant among states in the USA. One key explanation is the presence of economic entry barriers. They first highlight the fact that Delaware has a specialized corporate court. To compete then implies to create an equivalent court which is costly… without certainty that in the long run it will be a beneficial strategy. They also note that Delaware enjoys a well-developed corporate case law (which leads to less uncertainty in transactions). The more incorporation in Delaware, the more corporate case law could be developed, précised, and expected. To compete with Delaware means to also achieve such developed corporate case law: this imply first to "copy" Delaware law – assuming this is possible (The problems of legal transplants are well known [12]) – and then to build on its law

[9]Winter, *supra* note 5, at 255.

[10] Guhan Subramanian, *The disappearing Delaware effect*, HARVARD LAW AND ECONOMICS DISCUSSION PAPER, 391 109 (2002).

[14] § 630, New York Business Corporation Laws, 1961.

[11]Marcel Kahan, & Ehud Kamar, *The Myth of State Competition in Corporate law*, 55 STAN. L. REV., 679 (2002) (hereinafter Kahan & Kamar).

[17]ALAN WATSON, LEGAL TRANSPLANTS: AN APPROACH TO COMPARATIVE LAW, (University of Georgia Press, London 1993).

to achieve more efficiency. This strategy might lead to some benefits[13](Gelter emphasizes that "*Franchise tax revenues from small companies may be too insignificant for any state to develop incentives to seriously compete for charters, allowing courts more latitude to implement their own ideas in corporate law cases*". Which means that there are costs implied by this regulatory competition.) (if it succeeds in attracting incorporation) even if it imposes costs on residents who have invest in learning the corporate law of this specific state, but could also be a failure[14] (Kahan and Kamar (2002: p 726) nevertheless believed that: "*Even if only modestly successful, such a strategy could generate a positive return on the investment*". Gelter (Gelter 2008: p 10) notes that: "*Most of all, legal systems that have to deal with a larger number of cases are better positioned to reach a higher level of development more quickly*" pointing then to the influence of network externalities.). Indeed, it might merely emulate Delaware's corporate law without eating its market power. Note also that the fact that a specific law is well known might lead to lock-in situation due to network externalities where even if inefficient no one as any interest to switch to another legal system since it will imply costs of learning this new legal system. For example, the fact that US contract law is widely used does not mean that it is efficient, but merely that since it is widely used, it is not possible not to use it. If this phenomenon works for Delaware, competing with Delaware will likely be a failure.

For developing countries, the problem is even harder since they often lack sufficient resources to implement the law that is believed to be attractive. For example, ensuring sufficient physical security or protecting goods is costly so that they will have to make some trade-offs because of their constraints in terms of resources. When law is completely absent and ineffective, entering regulatory competition is not a priority. It is necessary to remark that regulatory competition does not concern law in books but law in action.

If we extend the idea of regulatory competition, non-legal systems and legal systems could compete. For example, the inefficiency of some legal rules could be reduced thanks to corruption (if corruption helps to accelerate one procedure and leads to sufficient "certainty" in its results): if it takes 1 year to obtain a construction permits without corruption and 1

[13]Martin Gelter, *The Structure of regulatory competition in European corporate law*, HARVARD DISCUSSION PAPER 20, 29 (2008).

[14] Kahan & Kamar, *supra* note 16, at 726

month with corruption (which correspond to a reasonable amount of money); the legal system plus corruption might appear, for some, efficient. In that case, there would be no incentives to adapt the official legal system… and maybe only an incentive to adapt the "non-legal" part of the broad legal system.

Entering regulatory competition is not costless so that if expected benefits are less than expected costs, law makers will not even try to compete. Among these costs are costs of learning new law and costs related to legal certainty (that is not achieved during the process of reforming the legal system).

1.2. Law makers must have enough freedom to legislate as they please

If law makers have an interest in entering regulatory competition, for them to be efficient sufficient freedom is required (in the words of Easterbrook[15]"*jurisdictions can select any set of laws they desire*".); indeed, in the regulatory competition approach law makers are like "entrepreneurs" that try to offer the best product to their customers (Romano, 1985). This implies first that law makers have a real power in designing the law (2.2.1); a power without legal (2.2.2) or political (2.2.3) constraints. Of course, these preconditions are rarely met. Taking them into account will then lead to more complexity when addressing regulatory competition. It will also be clear that regulatory competition cannot be a "description" of some interaction between legal systems.

1.2.1. Law is a product of law makers

This precondition might appear as a tautology: if law is designed by law makers, it is a product of law makers. Nevertheless, it is necessary to push the inquiry a little further since regulatory competition rests on a certain idea of the law.

First, it assumes that law can be built. In modern legal systems it is certainly the case at the level of legal proposition because of constitutional rules that set the condition under which a

[15] Frank Easterbrook, *Manager's discretion and Investors' welfare: theory and evidenc*e, 9 DEL. J. CORP. L., 540 (1984) (hereinafter Easterbrook).

text becomes a law. Moreover, it will be easy to identify legal makers and to visualize their incentives. But for legal systems that rest on tradition regulatory competition does not make sense… since law is not something that is consciously built but something that is "here" and that evolve with society and not according to the will power of some identified agents.

Second, even if law could be consciously built, regulatory competition implies that law is seen as merely instrumental. Tamanaha[16] notes that: *"[a]n instrumental view of law is so taken for granted today that it rarely evokes comment, but in the 1960s and 1970s its novelty in legal education was recognized and prompted expressions of concern*". Instrumentalism means, crudely, that law is trying to promote something outside itself, in general social purposes; a stronger definition of instrumentalism adds the idea that these social purposes are "deliberately" targeted. It is of course implicit in the idea of regulatory competition since law is used to "attract" or retain scarce economic resources. Without this instrumental view of law, law makers cannot enter into regulatory competition. Indeed, if the content of law is believed to be immanent or objectively determined, there are no choices in designing the law… so no possibility to compete since law is not a "product".

Third, for regulatory competition to have a meaning, it is necessary that the legal norms that are enacted are effective. Indeed, what matters for businessmen and investor is what happens, not what happens in legal books. Two implications could be derived from this idea. First, legal rules must be "stronger" than social norms that operate in the same domain. If not, regulatory competition is merely virtual without any consequences in the realm of facts. Second, legal rules must be applied as enacted by judges. This means that their power of interpretation is reduced to a minimum; thus, a legal norm could simply be transplanted from one legal system to another with the same consequences (of course, this is far from being true). If judges could really interpret the law, it is the combination of judges and legislators that should be considered when we try to assess the attractiveness of a legal system… then analyses are of course far more complex than the existing literature that focuses on announced law.

It could be added that regulatory competition seems to restrict itself to some specific domains of law, without really considering the fact that law is a system of norms and not a simple set

[16] TAMANAHA, LAW AS A MEANS TO AN END, (Cambridge University Press, Cambridge 2006).

of norms. Thus, it is the entire system that matters and not one specific norm within the system.

For regulatory competition to take place, it is necessary that law makers have the possibility to frame the law. It is then their product which is perceived as instrumental and sufficiently powerful to lead to changes.

1.2.2. There are no legal constraints on designing rules

Assuming that law makers are "free to choose" means that they didn't have any constraints in accomplishing their task. Among these constraints are legal constraints that are far more powerful than assumed in regulatory competition's models. In framing the law, law makers are facing constraints from the inside (constitutional law for example) and from the outside (European Union law or international law) … because law is a hierarchical system of norms – an idea that generally does not appear in the literature relative to regulatory competition.

Constitutional constraints are numerous in reality. For example, sex equality is recognized in the French constitution and it may lead to inefficiencies (when for example sex is a good proxy to assess the risk in some activities, like driving). Striking or human dignity are also recognized as constitutional rights. Law makers should then abide by these constitutional norms – at least if the constitution could be used in front of court(s). They might also try to change constitutional rules in order then to adapt some laws but costs of so doing are often heavy. Nevertheless, lots of constitutional rules try to ensure sufficient freedom for economic agents, and thus limit the possibility of inefficient regulation.

International, federal, and European laws are also constraints in framing legal rules… because law makers are not entirely free to select any set of laws. The European convention of human rights, for example, clearly puts limits in framing laws. Value added tax harmonization in the European Union (2010/112/EC directive) also restrict regulatory competition: standard VAT should be at least 15% and reduced rates at least 5%; standard rules also apply regarding who and how a person is charged or how to deal with imports and exports. Rules against state aids, entry barriers and so forth also put limits of the set of law

that could be selected by law makers. WTO laws are doing the same. International convention relative to the environment, labor or human rights constitutes also relative limits to the set of rules that could be selected by law makers.

These legal constraints should not then be disregarded – or constraints believed to be inefficient – when we are addressing the question of the domain of regulatory competition. Indeed, they are shaping its domain. It is for example obvious that harmonization is a tool to stop or reduce regulatory competition on one specific question.

1.2.3. There are no political constraints on designing rules

What is most problematic with regulatory competition approaches is that they did not sufficiently consider the fact that law is built within a political context. If this context is taken seriously pressure on law makers can come from the inside and not only the outside of the legal system (as regulatory competition assumes).

The idea is simple and derives from public choice literature. Law makers are under the pressure of voters and lobbies since they want to be reelected. If these parameters are considered, incentives to attract capital and corporations are necessarily reduced. Take for example fiscal competition. It is well known that this competition will lead to reduce taxes on mobile fiscal substance that could be compensated with high taxes on less mobile fiscal substance (labor and consumption). However, the increase in labor and consumption taxes will impact voters far more than the decrease in corporate and investment taxes. Thus, law makers could hesitate to implement this strategy since it will be harder for them earn a new mandate. This does not mean that they should completely disregard the attractiveness of their tax law for mobile fiscal substance since it will have an impact on the level of employment in the country… which is something that is valued by voters [17].

This line could also explain the enactment of the "seven sisters act" in New Jersey which provoke a massive outflow of incorporation for this state. From an economic point of view, this act was a disaster… but for political reasons it has been enacted and is now difficult to revoke. The same could be said about section 630 of New York's business corporation code.

[17] Régis Lanneau, *La Concurrence Fiscale, Revue de gestion et finances publiques*, 918 (2011).

Because of the opposition of organized labor, this strong deterrent to incorporation in New York is still in force. This explanation could also be used to explain specific high-income taxes (like the former ISF in France).

As Kahan and Kamar[18] summarize "*Regulators will be influenced by political factors which may induce them not to compete in the first place or affect the way they compete*" and these political factors are of disproportionate importance compared to economic incentives (Swank, 2002: p 274)[19]. Thus, the responsiveness of law makers to regulatory competition will depends on voters' preferences. Of course, if the system is nondemocratic, law makers are far freer to choose their own rules.

In this section, we inquired into preconditions to regulatory competition relative to law makers. It clearly appears that what is assumed in economic models is far from what is realized in the real life. For example, law makers are in a network of constraints that limits their choice in the set of rules they can enact; they are not merely reacting to the preferences of corporation and investors. Moreover, the costs of adapting a legal system are often disregarded in regulatory competition's model. This, of course, limits their validity. There certainly is a form of regulatory competition in the real world but this form is certainly more complex than what is assumed in economic models. What is true for the supply side is also true for the demand side.

2. PRECONDITIONS RELATIVES TO "LAW TAKERS"

Law takers' threat of exit is what put pressure on law makers to adapt their legal systems. This implies that law takers have the possibility to react to legal incentives to maximize their own utility (This was indeed the second assumption set in Tiebout's model (Tiebout, 1956: p 419): "*Consumer-voters are assumed to have full knowledge of differences among revenue and expenditure patterns and to react to these differences*".)[20] (3.1) which is not always the

[18] Kahan & Kamar, *supra* note 16, at 748.

[19] DUANE SWANK, GLOBAL CAPITAL, POLITICAL INSTITUTIONS, AND POLICY CHANGE IN DEVELOPED WELFARE STATES, (Cambridge University Press, Cambridge 2002).

[20] Tiebout, *supra* note 3, at 419.

case, and which requires the recognition of freedom of movement at a state level. Moreover, regulatory competition's approaches assume that the normative environment is of a particular value for law takers (3.2). However, it will be shown that the choice to invest or to reside in one country does not only depend on legal parameters. Thus, the crude conception of regulatory competition could only be relevant when two countries are relatively identical except for the legal system.

2.1. *Law takers must have the possibility to react to legal incentives*

For regulatory competition to work, law takers should have the possibility to exit which means that sufficient freedom of movement is not only recognized but also a reality (3.1.2). It also implies that law takers are behaving like rational informed economic agents (3.1.1) which, in the real life, is far from being true because of the costs of doing so (In Tiebout's model[21] it is assumed that "*Consumer-voters are fully mobile and will move to that community where their preference patterns, which are set, are best satisfied*" which means that there is not costs linked with reallocation of resources; the assumption that all person are living of dividend income strengthen the "no cost of moving" idea. This condition also appears in Easterbrook[26] who used the idea of "perfect mobility". Once again costs are not taken into account.). Indeed, when unsatisfied by a legal system, they will not necessarily choose the exit option but also voice and loyalty options (Hirschman, 1970)[22]. Moreover, inherent costs implied by moving resources across jurisdiction lead to a threshold approach: in that case the exit option

2.1.1. Law takers must be rational and informed

The first assumption which is classic in economic models is that law takers are rational and try to maximize their utility. Since the legal environment might impact their utility (which is clear concerning tax law for example), they will "react" to opportunities. Other things being equal, they will choose to invest or to develop their activity in the friendliest legal system (It should nevertheless be remembered that sometimes the geographical location has no impact:

[21] Tiebout, *supra* note 3, at 419.
[26] Easterbrook, *supra* note 19, at 34.
[22] HIRSCHMAN, EXIT, VOICE AND LOYALTY, (Harvard University Press, Cambridge (MA) 1970).

for example, in product safety standards (if you want to sell in the US or in the EU, you have to abide by these standards)). By saying this, we are assuming a lot.

First, we are assuming that people have sufficient information so that their choices will reflect their preferences. Without this information, it is impossible for them to compare between two legal systems or to assess costs and benefits that might derive from a change in location of their activities or investment – especially since what matters is not what is announced but what is working (infra, section 3.2.1). Obviously, in the real life, it is not the case: corporations do not have a perfect knowledge of all legal systems across the world and their strategy will not only be focus of legal parameters (infra, section 3.2.2).

Second, it seems that most models assume that rational players only have two options: to leave or to stay. As Friedman put it: "*you may decide to live in one community rather than another partly on the basis of the kind of services its government offers. If it engages in activities you object to or are unwilling to pay for, and these more than balance the activities you favor and are willing to pay for, you can vote with your feet by moving elsewhere*"[23]. However, as Hirschman put it, people may try to change the system if it did not match their preferences: they will complaint or protest… often before choosing the exit option; the pressure to adapt the legal system comes from the inside of the legal system and is not necessarily linked to regulatory competition (Note also that, for Hirschman, the greater the availability to exit, the less the voice option is chosen). This political option (voice) – since it is more political than economical – is often forgot in "pure theory" models that only concentrate on very simple reaction of economic agents. A loyalty phenomenon could also appear in which a preference for not leaving the country is so important that some clear opportunities are not taken. For example, "nationalists" will choose to invest in their country whatever the legal system. It is of course rational regarding their preferences.

Third, it is necessary to deconstruct the "other things being equal". It is obvious that other things being equal, a corporation will choose a location where it will be less taxed. However, these taxes have a purpose: to build public services, skilled labor force and infrastructures that are of some benefits for corporations. Thus, it is a combination of costs (taxes) and

[23] MILTON FRIEDMAN, FREE TO CHOOSE, (Harcourt, New York 1980)

benefits (public services) that is taken into account and since preferences are subjective and not homogenous, it is difficult to assess the consequences of a modification in the legal environment (Often homogeneous preferences are assumed in economic models… because it is easier to deal with such preferences). Moreover, the other things being equal mean that there are no costs in moving from one jurisdiction to another. In Tiebout's model, it is for example assumed that people are living on dividend income so that job opportunities will not be a relevant parameter. If costs are taken into account, some threshold could appear: until it is reached, people will stay in their location even if there are some opportunities to move (but these opportunities are not sufficient to lead to the exit choice). Further will be said on this in the next section. As will be developed in section 3.2, choices to invest in one country or to develop a business do not only depend on the legal system but on other parameters that are disregarded in regulatory competition approaches. When fully considered, how regulatory competition is working appears far more complex than what has been developed until now. Finally, all things being equal, assumptions might blur the fact that what count is the entire legal system and not one specific rule in it. To quote Radaelli[24]: "*it is the whole policy system (rules, enforcement, institutional performance, and nexuses of comparative advantage) that matters*".

The apparent classicism of "rationality" assumption should not dupe law makers and scholars. It assumes a lot in the realm of models and thus for the real world. The ceteris paribus clause that is implicit in the model should also be deconstruct to earn a better understanding of how regulatory competition is working.

2.1.2. Law takers must have sufficient freedom of movement

Even if an opportunity is identified, it does not mean that law takers will seize it. Indeed, reality departs a lot from pure theory approaches. Empirical evidence shows that capital is relatively immobile (Gordon and Bovenberg, 1996)[25].

For the exit option to be effective, it is necessary first that a legal right of freedom of

[24] Radaelli, *supra* note 7, at 15.

[25] Roger Gordon & Lans Bovenberg, *Why is Capital So Immobile Internationally?: Possible Explanations and Implications for Capital Income Taxation*, 86 AM. ECON. REV., 1057 (1996).

movement (entry and exit) is recognized for both persons and resources. In the European Union or in the United States such rights are recognized for their citizens. However, for foreigners, it is not possible to emigrate in the US or in some European countries to take job opportunities or to create a corporation (you need a "green card" if you want to work freely in the US). Ideally this freedom of movement should be complemented with a nondiscrimination rule. Indeed, if it is possible to discriminate regarding your citizenship, the exit option will be less attractive. This nondiscrimination rule exists in the European Union. Regarding freedom of movement for workers, article 45 of TFEU states that: "Freedom of movement for workers shall be secured within the Community. Such freedom of movement shall entail the abolition of any discrimination based on nationality between workers of the Member States as regards employment, remuneration and other conditions of work and employment". It is however possible to discriminate between EU citizens and non-EU citizens (so EU is not as attractive as it could be for foreigners). It is remarkable that regulatory competition could then only occur thanks to legal rules!

These rules can also constraint freedom of movement. For example, under US corporate law, reincorporation in other states necessitate a proposal by the board of directors and a shareholder vote. The necessity of this proposal requires that there are some advantages for the board of directors[26]. Thus, the institutional structure of the firm should be considered to qualify strategy of reincorporation. More generally, developing a business in one country implies some administrative fees.

Freedom of movement also implies that people have sufficient resources to move. If not, it will be impossible for them to choose a new set of law – in which case their only option is to protest against some legal rules. Undeniably moving is costly and the exit option is only opened to rich people or to big corporation. This entails that people are not seizing all available opportunities because of their costs. These costs are not only monetary costs but also non-monetary costs. For example, you could believe that leaving your country would be of some interest for you; however, leaving your country is leaving your culture, your language (so you will have to learn a new one), your job, your friends and family and also

[26] Lucien Bebchuk, *Federalism and the corporation: the desirable limits to state incorporation in corporate law*, 105 HARV. L. REV. 1435,1460 (1992).

your habits. These costs are rarely considered in regulatory competition which is often restricted to corporation (for which such costs could be neglected).

Assuming that law takers could choose the set of law that they prefer by moving from one jurisdiction to another is a strong assumption. It is certainly the case that if all things are equal economic agents will favor the legal system and the jurisdiction that they prefer. However, saying this is not saying much without trying to figure out what lies behind the "all things being equal".

2.2. *The normative environment must be of a special importance for law takers*

Regulatory competition implies that the normative environment is of a specific value for law takers. However, the legal environment cannot really be understood without considering the normative environment at large (3.2.1). Indeed, if legal norms evolve in a dialogue with social norms, focusing only to legal norms would be too restrictive. Moreover, it seems far fetch to believe that the allocation of scarce economic resources will depend only on legal parameters (3.2.2). Far too much is disregarded. For example, the attraction power of China cannot be explained by the attractiveness of its legal system! Thus, regulatory competition might be a relevant paradigm to inquire into allocation of resources' decisions, but it is only and only one parameter.

2.2.1. Regulatory competition focuses only on state law and not on the working of the regulatory system

Regulatory competition model's only focus on the announced law. This approach is obviously restricted. Indeed, the dynamic of the law is not sufficiently considered; the institutional environment is often neglected; and social norms are generally disregarded. However, to figure out how a legal system is actually working these parameters have to be considered.

What matters in regulatory competition's models are the content of law and not the dynamic of its evolution and its influence on the attractiveness of the legal system. Besides, it has been pointed that legal certainty and predictability are parameters of tremendous importance for FDI. These parameters were not seen in economic models since perfect mobility was

assumed: the possibility to reallocate from one jurisdiction to another was supposed to be costless. If there is a cost in reallocating, then economic agents should benefit from sufficient predictability to avoid "hold up" problems. Indeed, investing or doing business in one country implies costs that will be compensate by benefits through time. If the period of compensation is not very short, the strategy necessitates sufficient predictability in the evolution of the legal system.

Regulatory competition's models also assume that the legal system that is announced is the actual regulatory system. Certainly, what matters for economic agents is the regulatory system that is working not the regulatory system that exists in books. This picture cannot be drawn without an analysis of the institutional environment. In general, economic models assume effective legal institutions: judges are applying the law in a sufficient predictable way; the legal system is sufficiently powerful; legislators are assumed to look for efficient regulation, etc… If this might be true for developed countries, it is certainly less evident for developing countries. Since what matters for economic agents is the actual working of the regulatory system, announced law should not focus all attention. Indeed, when the law is not effective, social norms and parallel legal systems could develop. In that case the knowledge of these alternative regulatory systems will be fundamental since they will define the regulatory environment. If legal certainty is not achieved through the official legal system but could be achieve through a parallel regulatory system (social norms or corruption), these alternatives systems have to enter into analyses.

Moreover, the actual working of a legal system is enlightened by social norms. Comparing product responsibility in France and in the US is certainly of some interest but comparing them without considering the fact that litigation is far less exercised in France than in the US is missing something. The same is true for contract law and labor contract. It could be the case that contract enforcement might appear as defective. However, if contract default is rare because of a social norm, the fact that contract enforcement by legal authorities is deficient is not a real problem. Regarding labor contract, everything must be précised in a US labor contract but in a French labor contract a lot is presumed so that labor contracts are very short. More generally, social norms will impact how judges are applying the law; neglecting to look at this kind of phenomena will reduce our understanding of legal opportunities. Note that this

is one of the reasons why legal transplants cannot be perfectly achieved.

What matter for economic agent is the real working of a regulatory system and not the mere knowledge of the theoretical legal system. If this is true, it is necessary to broaden our approach of regulatory competition to legal and non-legal regulations.

2.2.2. Regulatory competition exaggerates the role of legal parameters for law takers

Because of the "all things being equal" implicit assumption, regulatory competition's models presume that firms decide essentially on legal consideration. Non legal aspects are simply disregarded.

Even if law is a relevant parameter for decision making, it is only one parameter and many more is contemplated by corporations; geographical location, risk diversification, quality of the workforce, expected growth of a country, quality of infrastructures, political stability, possibility to bribe (since it impacts the announced legal system), inputs access, markets access, signal logic etc… constitute obvious relevant parameters. For example, if you are in the fashion industry, you must have shops (and thus invest) in Paris, Milan, New York, Tokyo or Beijing whatever the legal system; moreover, regulatory competition between these cities will not be efficient since you have to be in all of them and not one in particular. You might also consider that a specific "made in" will be a signal that is valued by consumers. If you are a watchmaker, Swiss made is of some value; if you are a designer "made in Italy" or "made in France" is also valued. If you are working in the oil extraction industry, you must be present in oil producing countries and ideally, you want to be present in every oil producing countries. If you are dealing diamonds, you must be present in some African countries. If you want to have access to the Chinese market, it will be easier to have a corporation in China. If you are in the defense industry, since the US market is the largest and since there is a tendency to favor US corporations, you must be implanted in the US.

Thus, the decision to reallocate scarce economic resources from one jurisdiction to another is not a signal that the legal system from which exit takes place is inefficient. It would be then wrong to draw conclusion relative to a legal system only based on "exits". Exits are signs that something is "wrong" but not that the legal system is inefficient (except if decisions are only based on its attractiveness). Indeed, trade-offs are possible between attractiveness of the legal

system and other relevant parameters. For example, in fiscal competition, low tax rate could have been implemented to "compensate" an unfavorable geographical location (ex: Ireland) or might simply indicate that there are poor public services and infrastructures (thus there is more in fiscal competition than comparing fiscal law). Access to inputs might also be a reason to invest in a country which legal system is believed to be inefficient.

Sometimes, law is simply disregarded. For example, Levinson[27] concludes his article (Levinson, 1996) is arguing that: "environmental regulations do not deter investment to any statistically or economically significant degree […] The literature as a whole presents fairly compelling evidence across a broad range of industries, time periods, and econometric specifications, that regulations do not matter to site choice".

Decision making relative to the allocation of resources to one jurisdiction, or another are far more complex than what is assumed in regulatory competition models because the legal system is not the only this that enter into decision making by economic agents. If this complexity is taken seriously, the impact of legal reforms on its attractiveness cannot be assess theoretically but requires empirical data.

3. CONCLUSION

It clearly appears in this paper that regulatory competition as a fact is not as brutish as it is too often said and believed. Indeed, preconditions to its occurrence are, to say the least, very restrictive. It does not mean that the international environment could be completely disregarded by law makers but that the actual paradigm of regulatory competition is not adequate to figure out the links and interactions between legal systems.

More complexity and empirical data are required to really grasp the interaction between legal systems that is supposed to be driven by some sort of competition (and this line of

[27] Arik Levinson, *Environmental regulation and industry location: international and domestic evidence* (1996), in J. BHAGWATI AND R. HUDEC (eds), FAIR TRADE AND HARMONIZATION: PRE- REQUISITES FOR FREE TRADE?, (MIT Press, Cambridge (MA)).

explanation is not the only one; coopetition (Esty and Geradin, 2001: 30)[28] and emulation (Larouche, 2012)[29] might also be used). Of course, this complexity will be more difficult to handle but I think that Hayek[30] (Hayek, 1974: 26 and 29) was right when he said that: "the social sciences… have to deal with structures of essential complexity, i.e. with structures whose characteristic properties can be exhibited only by models made up of relatively large numbers of variables". "I confess that I prefer true but imperfect knowledge, even if it leaves much undetermined and unpredictable, to a pretense of exact knowledge that is likely to be false… Seemingly simple but false theories may… have grave consequences".

4. REFERENCES

Bebchuk, Lucien, 1992, Federalism and the corporation: the desirable limits to state incorporation in corporate law, *Harvard Law Review*, vol 105: 1435

Cary, William, 1974, Federalism and Corporate Law: Reflections upon Delaware, *Yale Law Journal*, vol 83: 663

Easterbrook, Frank, 1983, Antitrust and the economics of federalism, *Journal of Law and Economics*, vol 26: 23

Easterbrook, Frank, 1984, Manager's discretion and Investors' welfare: theory and evidence, *Delaware Journal of Corporate Law*, vol 9: 540

Esty, Daniel and Geradin, Damien (eds), 2001, *Regulatory competition and economic integration: comparative perspectives*, Oxford University Press, Oxford

Fischel, Daniel, 1982, The "Race to the bottom" revisited: reflections on recent developments in delaware's corporation law, *Northwestern University Law Review*, vol 76: 913

Friedman, Milton, 1980, *Free to Choose*, Harcourt, New York

Gelter, Martin, 2008, The Structure of regulatory competition in European corporate law, *Harvard discussion paper n°20*

Gordon, Roger and Bovenberg, Lans, 1996, Why is Capital So Immobile Internationally? Possible Explanations and Implications for Capital Income Taxation, *American Economic*

[28] ESTY & GERADIN, *supra* note 10, at 30

[29] Pierre Larouche, *Legal emulation between regulatory competition and comparative law*, TILEC DISCUSSION PAPER, DP 2012-017 (2012).

[30] HAYEK, LAW, LEGISLATION AND LIBERTY, (Chicago University Press, Chicago 1974).

Review, vol 86: 1057

Hayek, 1974, *Law, Legislation and Liberty*, Chicago University Press, Chicago Hirschman, 1970, *Exit, Voice and Loyalty*, Harvard University Press, Cambridge (MA)

Kahan, Marcel and Kamar, Ehud, 2002, The Myth of State Competition in Corporate law, *Stanford Law Review*, vol 55: 679

Lanneau, Régis, 2011, La Concurrence Fiscale, *Revue de gestion et finances publiques*, n°12 : 918

Larouche, Pierre, 2012, Legal emulation between regulatory competition and comparative law, *Tilec Discussion paper*, DP 2012-017

Levinson, Arik, 1996, Environmental regulation and industry location: international and domestic evidence, in J. Bhagwati and R. Hudec (eds), *Fair trade and harmonization: pre-requisites for free trade?* MIT Press, Cambridge (MA)

Radaelli, Claudio, 2004, The Puzzle of regulatory competition, *Journal of Public Policy*, vol 24: 1

Romano, Roberta, 1985, Law as a Product: some pieces of the incorporation puzzle, *Journal of Law, Economics and Organizations*, vol 1: 225

Subramanian, Guhan, 2002, The disappearing Delaware effect, *Harvard Law and Economics discussion paper* n°391

Swank, Duane, 2002, *Global Capital, Political Institutions, and Policy Change in Developed Welfare States*, Cambridge University Press, Cambridge

Tamanaha, 2006, *Law as a means to an end*, Cambridge University Press, Cambridge Tiebout, Charles, 1956, A Pure Theory of Legal Expenditures, *Journal of Political Economy*, vol 64: 416

Watson, Alan, 1993, *Legal Transplants: An Approach to Comparative Law*, University of Georgia Press, London

Winter, Ralph, 1977, State law, shareholder protection, and the theory of the corporation, *Journal of legal studies*, vol 6: 251