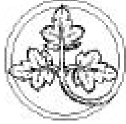
Gemeinschaftsgüter: Recht, Politik und Ökonomie

Preprints
aus der Max-Planck-Projektgruppe
Recht der Gemeinschaftsgüter
Bonn
2000/13

Breaking the Spell of Regulatory Competition: Reframing the Problem of Regulatory Exit

von
Henri I. T. Tjiong



Preprints aus der
Max-Planck-Projektgruppe
Recht der Gemeinschaftsgüter

Bonn 2000/13

Breaking the Spell of Regulatory Competition:

Reframing the Problem of Regulatory Exit

Henri I. T. Tjiong

August 2000

Max-Planck-Projektgruppe Recht der Gemeinschaftsgüter, Poppelsdorfer Alle 45,
53115 Bonn
www.mpp-rdg.mpg.de

Henri I. T. Tjiong

Breaking the Spell of Regulatory Competition:
Reframing the Problem of Regulatory Exit

Table of Contents

I.	**Introduction**	**2**
II.	**Analyzing the Assumptions of the Tiebout Model**	**5**
III.	**The Puzzle of Regulatory Competition: Identifying The Actual Mechanisms of Economic Arbitrage**	**8**
	A. Regulatory Competition Depends on Product Competition in an Integrated Market	*10*
	B. Regulatory Competition Depends on Corporate Choice about Locating Economic Transactions	*16*
	C. Empirical Evidence of Regulatory Arbitrage	*19*
IV.	**A “Cognitive” Critique of Regulatory Competition**	**20**
	A. Incentives and Regulatory Behavior	*21*
	B. Efficiency and Optimality in Regulatory Competition	*22*
V.	**Reformulating the Problem of Regulatory Exit**	**25**
VI.	**Recapitulation and Further Research Orientation**	**26**

I. Introduction

Regulatory competition is increasingly becoming the dominant argument on regulatory structure in both the debate on federalism in the United States and that on subsidiarity in the European Union.[1] The argument, briefly put, is that regulatory competition might produce efficiency benefits that justify yielding federal or harmonized regulation in favor of decentralizing governance. The present direction in this debate is to identify in which contexts and under what circumstances these efficiency benefits are likely. This paper intends to contribute to this debate by analyzing the proposition that regulatory competition can be understood as an argument of regulatory structure modeled on the principles of market order. The purpose of this paper is to clarify but ultimately to challenge the wisdom of this intriguing argument.

Regulatory competition is an intriguing and sophisticated argument which, as it deals with interpreting the complex dynamic between political and economic integration, deserves to be spelled out in full and with considerable care. The persuasive force of regulatory competition as an academic proposition however lies in the double efficiency argument hidden in it. Regulatory competition can be and is most often understood as a macro-argument for federal governance structures in that these allow for extrinsic efficiency benefits in the form of experimentation and innovation at a broad scale (economies of scope).[2] But regulatory competition can also be framed as a force for improving the intrinsic efficiency of regulations by allowing actors to structure their need for economic coordination to their own liking, thus incorporating the preferences of consumers into the structure of regulation (a micro argument).[3] The debate in the US after several critiques which expressed frustration at the broadness and inexactness of

---

1 The literature has meanwhile grown far too wide to even try to capture in a footnote, but representative contributions include in general regulatory competition theory: Joel P. Trachtman, *International Regulatory Competition, Externalization, and Jurisdiction* 34 HARV. INT'L. L. J. 47 (1993), REGULATORY COMPETITION AND COORDINATION: STRATEGIES AND DEBATES OF ECONOMIC REGULATION IN EUROPE AND THE USA (William Bratton et al. eds., 1997) which contains an excellent introduction and overview of the regulatory competition literature. In corporate governance, Roberta Romano, *The State Competition Debate in Corporate Law* 8 CARDOZO L. REV. 709 (1987) Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law* 105 HARV. L. REV. 1435 (1992). In antitrust, Frank H. Easterbrook, *Antitrust and the Economics of Federalism*, 26 J. LAW & ECON. 23 (1983) In environmental law, Richard B. Stewart, *Environmental Regulation and International Competitiveness*, 102 YALE L. J. 2039 (1993). In internet regulation: Dan L. Burk, *Federalism in Cyberspace*, SSRN paper (1996), available on http://ssrn.com.

2 This line of argument began with Justice Brandeis' famous observation that federalism fosters innovation by inducing states to compete and experiment. These themes are resounded in the caselaw of the Supreme Court of the early nineties, such as Gregory v. Ashcroft, 111 S. Ct. 2395 (1991), New York v. United States 112 S. Ct. 2408 (1992) analyzed e.g. by Edward L. Rubin & Malcolm Feeley, *Federalism: Some Notes on a National Neurosis*, 41 UCLA L. Rev. 903 (1994); Ann Althouse, *Variations on a Theory of Normative Federalism: A Supreme Court Dialogue*, Duke L. J. 979 (1993).

3 Paul B. Stephan, *Regulatory Cooperation and Competition: The Search for Virtue*, University of Virginia School of Law Legal Studies Working Papers Series, Working Paper No. 99-12, June 1999, downloadable at http://papers.ssrn.com/paper.taf?abstract_id=169213.

the initial macro arguments[4] has steadily moved on to focus on the micro argument which attempts to detail the instances and conditions under which regulatory competition might indeed work to improve the intrinsic efficiency of regulation. Regulatory competition, to the extent that actors internalize the costs of their decision, has come to be viewed as a largely untapped mechanism for improving the efficiency of rules in a potentially wide range of legal domains.[5]

The European debate appreciates regulatory competition in light of the common market and the effort to reduce regulatory trade barriers. Regulatory competition is treated here under the nomers of standortwettbewerb,[6] competition among rules,[7] institutional competition[8] or competition over organizational arrangements. Regulatory competition is argued essentially in its macro form: Negative integration leads to economic flows of mobility unleashing arbitrage over regulatory policies.[9] The room left for this type of arbitrage by existing harmonization measures is the topic of continuing discussion among commission officials, political scientists and economists.

Generally, the European Commission perceives regulatory differences to be undesirable as it will interfere with the common market or result in—what is seen as—unfair competition. Hence, the Commission has embarked upon harmonization commonly without reference to the scale of economic arbitrage to be expected. We may observe this from Commission efforts in fields as disparate as taxation (where economic arbitrage is very much prevalent) and social or environmental regulation (where economic arbitrage is much less strong). It seems that regulatory competition plays a role only in so far as it allows the Commission to construct it as

---

4 See in particular, Edward L. Rubin and Malcolm Feeley, *Federalism: Some Notes on A National Neurosis,* 41 UCLA L. REV. 903 (1994).

5 In tax: Jane G. Gravelle, *International Tax Competition: Does It Make a Difference for Tax Policy?,* 39 NAT. TAX J. 375 (1986); Peggy B. Musgrave and Richard A. Musgrave, *Fiscal Coordination and Competition in an International Setting* in INFLUENCE OF TAX DIFFERENTIALS ON INTERNATIONAL COMPETITIVENESS 59 (Mc Lure, et al. Eds., 1990) In environmental regulation: Richard Revesz, *Rehabilitating Interstate Competition: Rethinking the "Race to the Bottom" Rationale for Federal Environmental Regulation*, 67 N.Y.U. L. REV. 1210 (1992); Richard B. Stewart, *Environmental Regulation and International Competitiveness*, 102 YALE L. J. 2039 (1993). In securities regulation: James D. Cox, *Rethinking US Securities Laws in the Shadow of International Regulatory Competition*, 55 L. & CONTEMP. PROBL. 157 (1992). In corporate law: Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225 (1985); Lucian Bebchuk, *Federalism and the Corporation; The Desirable Limits on State Competition in Corporate Law* 105 HARV. L. REV. 1435 (1992). And even in product quality law: David A. Rice, *Product Quality Laws and the Economics of Federalism*, 65 B.U. L. REV. 1 (1985).

6 For generally representative contributions, see the essays contained in Thomas Apolte, Rolf Caspers, and Paul J.J. Welfens (eds), STANDORTWETTBEWERB, WIRTSCHAFTSPOLITISCHE RATIONALITÄT UND INTERNATIONALE ORDNUNGSPOLITIK (1999).

7 Stephen Woolcock, *Competition among rules in the single European market* (1994) discussion paper of the Royal Institute of International Affairs, 71 p

8 See COMPETITION AMONG INSTITUTIONS (Lüder Gerken, ed. 1995).

9 See for a legal perspective on this process, Norbert Reich, *Competition Between Legal Orders: A New Paradigm of EC Law?* 28 COMMON MKT. L. REV.861 (1992).

a credible threat to the ability of individual member state governments to pursue national policies unilaterally.[10] The political use of the regulatory competition argument in this way seems to favor cooperation rather than competition.

Political scientists explain regulatory competition as a game in which national regulators are interested in bringing forward national policy approaches at the EU level which minimize the degree of institutional adaptation to European legislation and possibly confers a competitive advantage to domestic producers.[11]

Economists construct regulatory competition as an allocative efficiency argument made possible by the existence of different centers of rule-production in Europe. To the extent that rules or regulations have economic implications inducing arbitrage or the threat of arbitrage, competition among rules is seen to correlate with the—perceived—number of exit options offered by the internal market. Normative welfare economics and the Tiebout model suggests that legal heterogeneity may create regulatory arbitrage as a result of the normal arbitrage occurring in the markets, thus hitching regulatory competition on the process of market competition and producing additional avenues for improving regulatory efficiency.[12] To be sure, regulatory arbitrage is limited by progressively increasing opportunity costs that would limit the scope of such arbitrage (consumers would move until the erosion of the tax base would threaten the possibility of providing the desired public goods).[13] In addition, externalities limit the case for allocative efficiency of regulatory heterogeneity further and justify efforts for positive integration at a higher political level that can internalize the costs of negative externalities.[14]

This essay aims to analyze the positive and normative claims put forward by regulatory competition theorists on both sides of the Atlantic. It is structured as follows. Part II starts with an account of the Tiebout model–generally considered to be the analytical backbone of regulatory competition arguments. It preludes the discussion on regulatory competition by developing a caveat on the Tiebout hypothesis of voting with feet focusing on the inadequate conception of politics within the model. Part III discusses regulatory competition in its macro form and uses the European debate on regulatory competition to elucidate factual mechanisms

---

10 See the introduction of Stephen Woolcock's paper, loc.cit. Similarly, Fritz W. Scharpf, *Introduction: the problem-solving capacity of multi-level governance*, in 4 J. EUR. PUB. POL (1997) p. 520-38.

11 Adrienne Héritier, Christophe Knill and Susanne Mingers, Ringing the Changes in Europe—Regulatory Competition and the Transformation of the State: Great-Britain, France, Germany. de Gruyter, Berlin/New York 1996.

12 Jacques Pelkmans, *Regulation and the Single Market: An Economic Perspective* in THE COMPLETION OF THE INTERNAL MARKET (H. Siebert ed., 1990).

13 Stephen Woolcock, loc.cit. p. For the theoretical point that competition stops at the point where opportunity costs outweigh the costs of exchange, see e.g. Wallace E. Oates, and Richard M. Schwab, *Economic Competition among Jurisdictions: Efficiency Enhancing or Distortion Inducing?* 35 J. PUB. ECON. 333 (1988).

14 See e.g. Horst Siebert, & Michael J. Koop, *Institutional Competition versus Centralisation: Quo Vadis Europe?* 9 OXF. REV. ECON. POL. 15 (1993).

of arbitrage which are supposed to underpin the competitive process. Regulatory competition in this context is seen as embedded within institutional efforts toward economic integration and mutual recognition. This portion of the essay examines the internal logic of the argument and argues that even if regulatory competition were to operate as conceived, the factual mechanisms of economic arbitrage in a regulatory market do not justify the application of normative welfare economics to demonstrate an invisible hand in the market for regulations. Part IV develops an external critique focussing on the behavorial assumptions (derived from economic theory) that structure regulatory competition theory. It argues for relaxing these assumptions and working toward a more credible and richer set of hypotheses about regulatory behavior. It discusses regulatory competition in its micro form and examines the conditions structuring the problematic proposition that regulatory competition ipso facto is a force that can attribute to intrinsic regulatory efficiency. Part V attempts to formulate the case of regulatory competition from the perspective of post-international politics. Part VI finally recapitulates the theoretical argument made so far and develops some of its positive and normative implications. The article concludes by outlining a new investigative orientation to the problem of regulatory exit and by demonstrating some ramifications of the argument for policy purposes.

II. Analyzing the Assumptions of the Tiebout Model

Commentators on federalism and regulatory competition frequently refer to the notion of consumer mobility or use the term voting with feet in order to denote a process of jurisdictional arbitrage. In this, regulatory competition builds on the early contribution of Charles Tiebout whose attempt was to formulate a general theory on public goods competition. The following will discuss the Tiebout model in order to indicate the intellectual pedigree of current regulatory competition arguments. The comments attempt to illuminate some of the problems when using this particular frame to analyze empirical phenomena of regulatory competition.

Tiebout presents an intriguing argument to respond to the characteristic public goods problem defined by Samuelson, namely how to establish appropriate incentives for consumers truthfully to state their preferences for public goods.[15] This investigative context is worth emphasizing since Tiebout cannot be accused of desiring to substantiate, from an economic viewpoint, an efficiency rationale for federalist governance structures.[16] Tiebout did not try to explain, much less promote, the existence of a federal structure of governance – although it is true he was concerned about the consolidation of governance in metropolitan areas in the '50s which

---

15 Charles M. Tiebout, *A Pure Theory of Local Expenditures* in 64 J. POL. ECON. 416 (1956).

16 This is different from contemporary writers. Cf. Barry Weingast, who constructs a political efficiency argument and visualizes the functional competition between groups, *already existing in federalist systems of governance*, to result in limited government. See his "*The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Growth*" in 11 J. L. ECON. & ORG. (1995) p. 1-31.

threatened to obliterate existing local boards, hence, his concern to preserve local governance and make it more effective by competition. Nonetheless, his work was extrapolated to become the analytic sub-field of economic federalism,[17]a notion first restricted to the fiscal realm by economists, but subsequently applied by legal scholars to a wide range of legal areas and even to re-ignite the normative debate around the appropriate scope of constitutional federalism.[18]

Let us investigate the workings of the Tiebout model. The actors in the model are local governments and constituents. The task of the local governments is to determine first the optimal level of output of public goods – presumably by gleaning from the homogenous preferences of the community – and then calculate on the basis of that output the tax revenues to be collected. Apart from the assumption of preference homogeneity,[19] the optimal level of output is also constrained by the notion of an objectively given optimum size of a community and a limited number of consumer-voters. The optimum is described in terms of the number of residents for which the bundle of public services can be produced at the lowest average costs. The restraint allowing the optimum to be objectively given is conceived as a fixed factor in the cost function of public goods, causing it to be U-shaped (and thus there will always be a point of lowest average costs). This output and revenue-setting by the community is considered to be a once and for all process. Once governments have adopted the appropriate output and revenue, it is visualized as fixed (governments are not supposed to "adapt" to consumer-voter preferences p.420) after which consumer-voters set the general equilibrium mechanism in motion by exercising spatial mobility. What follows is relatively clear. Provided the following conditions apply

> consumer-voters are 1) fully mobile; 2) fully knowledgeable about the differences among revenue and expenditure patterns and to react to these differences; 3) there are a large number of communities in which the consumer-voters may choose to live; 4) there are no restrictions due to

---

17 WALLACE E. OATES, FISCAL FEDERALISM (1972), Wallace E. Oates, and Richard M. Schwab, *Economic Competition among Jurisdictions: Efficiency Enhancing or Distortion Inducing?* 35 J. PUB. ECON. 333 (1988), COMPETITION AMONG STATES AND LOCAL GOVERNMENTS (Daphne E. Kenyon and John Kincaid eds., 1991) See for a useful survey and discussion of the voluminous "Tiebout" literature, James M. Buchanan, and Charles Goetz, *Efficiency Limits of Fiscal Mobility: An Assessment of the Tiebout Model,* 1 J. PUB. ECON. 25 (1972). Also, Joseph E. Stiglitz, *The Theory of Local Public Goods Twenty-Five Years After Tiebout: A Perspective,* in LOCAL PROVISION OF PUBLIC SERVICES: THE TIEBOUT MODEL AFTER TWENTY-FIVE YEARS (G. Zodrow ed., 1983).

18 See the literature cited in footnote 1.

19 One could also call this the assumption of community integrity, which works to allow a theorist to treat a local community for the provision of public goods as long as other inhabitants can be excluded from its provision. In a later article, Tiebout and Ostrom defined the notion of packageability to denote the ability of communities to exclude others located outside the boundaries from the use of public goods. See Vincent Ostrom, Charles Tiebout and Robert Warren, *The Organization of Government in Metropolitan Areas: A Theoretical Inquiry*,

55 Am. Pol. Sc. Rev. 831-42 (1961).

employment opportunities; 5) there are no externalities between communities; 6) optimal community size is defined (see above) and 7) communities below the optimum size seek to expand to lower average costs – communities above the optimum size seek to contract (hence, local governments are assumed to be profit-maximizing).

then an allocation of consumer-voters over communities will in theory result with allocative attributes comparable to those in a general equilibrium analysis of private goods, i.e. a Pareto-optimal outcome is theoretically feasible.

The model resorts to using assumptions for precisely those aspects of public goods provision that phenomenologically are at the center of it, i.e. *what is* the optimum output and revenue pattern to be decided by—in this case—local government? The Tiebout model sees the optimal level of output determined by: (1) homogeneous community preferences; and (2) the existence of a given optimum community size. These two conditions, when combined, yield an objective optimal output-expenditure pattern. Once decisions on output and expenditure are fixed, consumer-voter mobility is conceived to match the composition of the population over the local jurisdictions resulting in efficient allocation of consumer-voters over public goods services. However, it is not clear how governments are supposed to attract consumer-voters or get rid of voters, since they are not allowed to change policies. Remember that they are not allowed to "adapt" to preferences and neither can they learn from new information and change their public goods provision. The model rather than framing local governance as positively contributing to more direct democratic governance through closer voter participation and experimentation, tacitly but definitely conceives of local governments as utterly passive. How does this observation qualify the model?

It might be that the empirical restrictions of the Tiebout model relating to, in practice limited anticipated consumer mobility and knowledge about regulatory differences, in the end matter less in evaluating the model's policy relevance. Rather, it might be that from a theoretical perspective, the most important observation to make in applying the Tiebout model for illuminating policy conditions under economic interdependence, is that this model assumes governments not to do what they are (under any currently conceivable social construct of governance) envisaged to do, i.e. to govern the public and to learn about new public demands. It must be noted that this criticism is not at the level of immanent critique: institutional rigidities cannot be brought forward to remedy this defect.[20] Rather, the problem indicated concerns the precise focus of the analytical effort and the specific purpose for which the theory is being called upon (i.e. to discern the demand conditions for *public* goods).

A closer look at the Tiebout model may clarify this, at first sight, rather bewildering statement. Tiebout conceives of local governments as having goals (i.e. expenditure-revenue patterns)

20 Tiebout, loc.cit. n.1 p. 424.

which can as a matter of starting point be gleaned from their homogeneous communities. Hence, Tiebout seems to suggest that the key asset to be associated with local governance, especially when compared to federal governance, is that the former can in principle strive for homogeneity in preferences. Tiebout however does not allow adaptations inbetween to be made to initial output-revenue decisions, indeed the model requires public goods expenditures to be fixed. The exit option is postulated to be the only means to ameliorate whatever "mistakes" communities may have made with regard to their initial settings. Technically speaking, however, the model does not allow for acting upon discovered mistakes and so the model does not conceive of local governments actively attracting consumer-voters by *re*adjusting public goods provision – this behavior is limited to the constitutive phase. However, even in this phase, governments are not endowed with the ability to make mistakes because homogeneous preferences arguably include those of the government – we have in the constitutive phase the seductive "solution" of a one man government. If the puzzle Tiebout sought to solve was that of finding mechanisms which could overcome the difficulties surrounding "rational" consumer preference revelation for public goods. Then his approach – and in its wake, every attempt that depoliticizes regulatory competition – suppresses from view the very features of the normative problem it sets up and tries to address in the claim that regulatory competition leads to (socially/economically?) desirable or undesirable rules. These features, it will be shown, relate to the debatable attributes a political process of constituents' preference revelation for public goods is to fulfil if it is to produce normatively attractive regulatory outcomes. Without efforts of governments or governance structures that seek to know the preferences of consumer-voters, however, one is tempted to conclude that there *is* no problem.[21]

III. The Puzzle of Regulatory Competition: Identifying The Actual Mechanisms of Economic Arbitrage

The foregoing observations only prelude, but do not by themselves suggest a better understanding of regulatory competition. For that, we need to reframe the conceptual picture of regulatory competition reconstructing it more closely to the multiple phenomena of regulatory arbitrage at hand.

To investigate the empirical world of regulatory competition analytically we need to reconstruct the mechanism that transposes the political effects of economic mobility into regulatory policies. This mechanism can be broken down into two processes. One is the process of regulatory arbitrage triggered by consumer, corporate, or factor mobility (with different analytic characteristics pertaining to each). The second is a process of translation–we need a

21 This interpretation of the Tiebout model is by no means original. Cf. Dennis Epple & Alan Zelenitz, *The Implications of Competition among Jurisdictions: Does Tiebout Need Politics?* 89 J. POL. ECON. (1981) 1197.

mechanism that describes *how* regulators interpret signs of mobility (or construct regulatory competitiveness) out of the mass of concrete market events and *how* this interpretation is eventually reflected in the content of regulatory policies. Only when these two processes are visualized is it possible to conceive of regulatory competition as an actual change-inducing force.

We need to allow however for two further qualifications. First, in some conditions the mechanism of arbitrage need not rely on actual mobility–a mere threat of economic exit may be sufficient to trigger a concomitant regulatory response. If such is the case however we need additional variables that can specify the response of regulators to the threat in order to know its consequences for regulatory policy. No outcome can be specified on general theoretical grounds.

The second qualification relates to the transposition of economically mobile power into the shape and content of regulatory policies. This feedback mechanism can at least analytically be employed with two differing roles of the regulator in mind: an active and a passive role. Where regulators presume the knowledge to interpret market events in terms of competitiveness, rules may change directly as a result of this interpretation. It is at least conceivable that regulators would be engaged in active search of market information and seek regulatory adaptation accordingly. By contrast, a libertarian view of regulatory competition would see the market, regardless of any interpretation of the capabilities of regulators, as superior in selecting a rule or a regulatory regime on the basis of its purely incentive-oriented considerations. In this view, the market would hardly leave any choice for regulators other than to conform to its discipline and we see a passive adoption of whatever rule the market has selected.[22]

These two views of regulatory competition are analytically distinguished to focus more clearly on the normative claims associated with regulatory competition. Normativity in the realm of regulatory competition I associate with the possibility of achieving '*intrinsically' optimal*[23] rules as opposed to 'extrinsic' allocative efficiency. In the case of adaptation, where regulators are conceived to use the signal of product market decisions as a direct aid in regulatory decisions, optimality relates to the institutional possibility of extracting valuable consumer regulatory preferences from ordinary product market decisions to optimize the provision of public goods. By contrast, in the case of the indirect route where rules or regulations are conceived to be merely selected ex post by the market, the assertion of optimality relates to the stronger claim that **market selection** de facto and adequately, substitutes for traditionalist, or worse, paternalist, criteria of regulatory desirability. For both analytical possibilities, however,

---

22 The contrast between adaptation by rational actors and adoption by market selection originates from Armen Alchian, *Uncertainty, Evolution and Economic Theory*, 58 J. POL ECON. 211-22 (1950).

23 By intrinsically optimal I mean simply that rules are evaluated according to the policy objectives they were set up to achieve. I contrast this with social optimality. Socially optimal rules I associate with those rules that in addition to achieving the intrinsic objectives of a policy which after all might be arrived at in a purely technocratic way, are also characterized by social acceptance (one form of democratic legitimacy). Social optimality thus relates to the democratic content of policies whereas intrinsic optimality refers only to the problem-solving aspect of policies. See infra the discussion on efficiency in section IV.

it is imperative that the theorist elucidate a feedback mechanism to demonstrate the essential corrective capacity of arbitrage on regulatory policy-making associated with the economic account.

Different propositions on regulatory competition in Europe are used to illustrate different empirical mechanisms of regulatory arbitrage supposedly underpinning the competitive process. Within the European debate two conceptions of regulatory competition result from two mechanisms of arbitrage that are supposed to fill out the above theoretical requirements for a process of competing rules. The first is the mechanism associated with *negative integration* in which disciplines of market access and mutual recognition ensure that a European scale of competition will force national rules to be exposed to hitherto unknown market forces unleashed essentially by mass consumer choice. The second mechanism of arbitrage relates to the repeat player ability of organizations (mainly multinational corporations) to exercise *contractual choice* between regulatory regimes where such contractual choice over a transaction is embedded in existing European regulation. This transaction may involve the choice of incorporation, the decision to invest in a foreign jurisdiction, but also decisions on corporate structure which to the extent that they may involve foreign rules can be seen to produce regulatory arbitrage. [24] The following discussion aims to understand the differences between these two conceptions of regulatory competition and their normative implications.

A. Regulatory Competition Depends on Product Competition in an Integrated Market

It is argued that present European institutional strategies of negative integration and mutual recognition only increase the scope of regulatory competition. This is because a common European market will expose still remaining regulatory differences to common market forces.[25] The crucial question relates to the scope for regulatory competition left by current institutional strategies. What variables determine the scope for regulatory competition and how? The argument starts with explaining the following two counterpositions.

Regulatory Competition leads to Deregulation

The continuing economic and legal integration of the EU has resulted in the loss of national governments' capacity to police the economic boundaries of their jurisdiction. Whereas before the project of negative integration, governments could impose regulatory costs onto national

24 This definition thus incorporates the notion of legal mobility made possible by choice of law, and choice of forum contract clauses, or other formal connection categories offered by private international law.

25 Norbert Reich, *Competition Between Legal Orders: A New Paradigm of EC Law?* 28 COMMON MKT. L. REV.861 (1992) Stephen Woolcock, *Competition among rules in the single European market* (1994) discussion paper of the Royal Institute of International Affairs, 71 p. Also, Jacques Pelkmans and Jeanne-Mary Sun, loc. cit.

firms who could in turn pass the bulk of these costs on to domestic consumers simply by charging higher prices, this regulatory behavior now comes at a cost in the form of putting domestic manufacturers immediately at a competitive disadvantage vis-a-vis international competitors. Crucial in this argument is the loss, caused by negative integration, of state capacity to police the economic boundaries of its jurisdiction. Whereas in national economies, states could mitigate the pressures of global competition and adjust for lack of domestic competitiveness by initiating countervailing measures through direct state aids, exchange rate adjustments or outright trade restrictions (import quotas and tariffs), the prohibition of these policies now brings the competitive effects of regulation on corporate performance in full view. Hence, the full force of this argument would suggest a sharp reduction of domestic economic regulation being the result of mere negative integration.[26] Regulatory competition thus produces questionable constraints on the capacity of regulators as fear of short-term capital outflows or long-term loss of economic attractiveness will prevent them for pursuing otherwise pursued collective goals.[27] Let me refer to this as the deregulation by competition thesis. A thesis which is a priori at least plausible as long as one supposes that regulations do impose significant compliance costs (if regulations provide competitive advantages, then the argument can easily be turned around). A more extreme version of the deregulation by competition thesis is the race to the bottom thesis which argues that in case of negative externalities, states are locked into a PD game which creates incentives for states to iteratively lower regulatory standards to a suboptimal equilibrium.[28]

Regulatory Competition leads to Regulatory Efficiency and Learning

The very same pressures however are construed quite differently by (economic) optimists who view the increasing exposure of regulatory costs as a step towards improving regulatory efficiency. Their formal models can be read as invoking the market mechanism to create incentives for regulators to engage in a search for discovery that has the potential to improve regulatory efficiency. As a result, market pressures related to the distribution of competitive advantages and disadvantages created by different rule-configurations are (implicitly) associated with pressures to initiate processes of regulatory self-discovery and re-assessment. Combined with principles of mutual recognition which expand the domain of regulatory options by allowing multiple rules to operate within a single product market, these pressures will create in principle an appropriate setting for learning about the economic effects of different regulatory approaches. To be sure, the premise of regulatory learning is never spelled out in economic models, rather discovery (i.e. learning) is ever implied. My research hypothesis is that the

---

26 See Fritz W. Scharpf, *Negative and Positive Integration in the Political Economy of European Welfare States*, in GOVERNANCE IN THE EUROPEAN UNION, Gary Marks, Fritz W. Scharpf, Philippe C. Schmitter, Wolfgang Streeck (eds., 1996) p.16-17.

27 Fritz W. Scharpf, id.

28 See e.g. Richard L. Revesz, Rehabilitating Interstate Competition: Rethinking the "Race to the Bottom" Rationale for Federal Environmental Regulation, 67 NYU L Rev. 1210 (1992).

potential for regulatory learning should vary with particular mechanisms of regulatory arbitrage. The following will thus discuss consumer choice as a mechanism for regulatory arbitrage and examine its relevant attributes for improving regulatory learning.

As many commentators have pointed out, mutual recognition–if effective(!)–is likely to increase consumer choice among the regulatory options offered in a common market. This suggests product market decisions to be an additional channel for regulators to interpret the regulatory preferences of consumers.[29] The reason that commentators single out product market decisions as a good instance for regulatory choice revelation is that product standards are likely to present regulatory differences in the form of different product characteristics. For example, a standard on product safety has direct consequences on the design of the product which when marketed can establish regulatory preferences for safety by consumers–at least theoretically. By contrast, this theoretical option is not available for production standards. These carry implications for the competitive position of corporations but they do not implicate the design of the product, hence restricting the scope of the product market to reveal regulatory preferences. [30]

It should be clear by now that where this analysis diverges from ordinary economic accounts is with the too easy acceptance–of the latter–of a regulatory market coming into being as a result of product market integration. The concept of a regulatory market leads economists to associate regulatory competition with well-defined ideals of allocative efficiency–a proposition which in this underspecified context I regard as largely meaningless. In addition, associated concepts such as a race to the top–meaning that regulatory competition operates to produce a set of rules generally efficient to social welfare[31]– or the evolutionary notion that competition will weed out those rules sub-optimal to the workings of the market (ex post harmonization around a set of efficient rules)[32] suffer from similar deficits of underspecification and theoretical over-speculation to be considered meaningful. Finally, it should be clear that at this stage of the

---

29 This is the Exit option identified by Hirschman as providing the main corrective device for improving organizational performance in the market. See ALBERT O. HIRSCHMAN, EXIT, VOICE AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS AND STATE (1970).

30 The notion of "piggybacking" requires clarification. Regulatory choice "piggybacks" on consumer's product decisions if the effect of the regulation shows up "in" the product in ways that may affect consumer decisions at the margin. This type of regulatory arbitrage over the product market is in principle not limited to product regulation, but may occur wherever regulation has effects on the price and quality of the product. Thus regulations governing production conditions may, to the extent that they affect the price and quality of the manufactured product, be implicated by this type of regulatory competition. For a different interpretation, see Fritz W. Scharpf, *Introduction: the problem-solving capacity of multi-level governance*, in 4 J. EUR. PUB. POL (1997) p. 520-38 who perceives the possibility of regulatory arbitrage to be limited only to those regulations that govern product conditions.

31 Horst Siebert, *The Harmonization Issue in Europe: Prior Agreement or a Competitive Process* in THE COMPLETION OF THE INTERNAL MARKET (H. Siebert ed., 1990) [cite more here].

32 See Horst Siebert, & Michael J. Koop, *Institutional Competition versus Centralisation: Quo Vadis Europe?* 9 OXF. REV. ECON. POL. 15 (1993).

debate these arguments are insufficient to justify a vision of competing jurisdictions as an agenda for institutional reform in Europe.[33]

In the following I will analyze these varying propositions about regulatory competition along the dimensions of mobility and consumer or corporate feedback about regulatory preferences. The analysis starts with reconstructing the real world conditions that govern the possibility of a feedback mechanism in the product market that would conceivably be able to transpose the effects of mobility or market competition into regulatory outcomes. Only if we know *how* mobility and market competition influence regulatory policies, can we evaluate likely outcomes of regulatory arbitrage.

Regulatory competition that operates over the product market anticipates that consumers can in some sense "choose" the regulatory regime attached to the product. We are therefore concerned here with the conditions that relate to the possibility that regulators may correctly use consumers' product market decisions as an additional interpretive road to discover regulatory preferences of their constituency. Looked at generally, it is not difficult to see why this must be a problematic proposition. If it is generally problematic to infer preferences from revealed choices,[34] then it is doubly problematic when the preferences to be imputed relate to a good (regulation) which is different from that directly chosen (the product). However, these problems of inference and interpretation are never absolute. We thus have to investigate the conditions under which product choice can be used as a reasonable proxy for regulatory preferences. In order to do so, let us consider the following thought experiment.

Suppose a product obtains mutual recognition and as a result is able to enter the domestic market where it would compete with products manufactured under different regulatory circumstances. A reasonable assumption prima facie, and one that is frequently used to produce the race to the top story, is that a product manufactured under "state-of-the-art" regulatory protection would acquire comparative advantage that when translated into improved product quality would hence attract consumers and capture market share. Other competitors would now follow suit and request similar "state-of-the-art" regulation and regulators would have incentives to copy the success of the innovator. In this case, a race to the top would ensue.[35] However, it is extremely questionable to what extent this generalization applies. It is easy to think of conditions that would disturb this scenario. In particular, the projected scenario might

---

33 Contrariwise, Bruno S. Frey & Reiner Eichenberger, *FOCJ: CompetitiveGovernments for Europe,* 16 INT'L. REV. L. & ECON. 315 (1996), who advocate establishing a constitutional right to government competition as a step towards implementing their notion of Functionally Overlapping and Competing Jurisdictions. The remaining sections of this essay will hopefully allow the reader to perceive the difficulties surrounding this concept.

34 CASS SUNSTEIN, FREE MARKETS AND SOCIAL JUSTICE (1997).

35 In fact, the California effect described by Vogel, constitutes a mechanism not very unlike the race to the top story, albeit with a twist. Vogel studied automobile emission standards and observed that where a sufficiently large market such as California, would set high standards, other jurisdictions would have incentives to follow suit, mainly because car manufacturers already serving the California market would face little additional cost to install similar emission technology for other markets. See generally, DAVID VOGEL, TRADING UP: CONSUMER AND ENVIRONMENTAL REGULATION IN A GLOBAL ECONOMY (1995) .

clearly not work if the "state-of-the-art" regulation would cause the product to be outpriced by competitors, which would lead to product decline and the product eventually be taken off the market.[36] The point is that consumer choices are driven by price-quality ratios which may or may not reflect regulatory conditions. But even if supposing they do, following this rationale, the ultimate direction of regulatory change will be guided by the relative price and quality elasticities of demand assigned to particular products rather than the regulatory conditions to which they are attached. These ratios under particular circumstances, may or may not be, good indicators of regulatory quality. However, they should not generally be considered to converge with political or social desiderata nor do they correspond to conventional democratic criteria of regulatory performance.

However, if the direct path of inferring regulatory demand conditions from consumer market decisions is not available or at least problematic, then perhaps the indirect path of manufacturer response to product market decisions might supply the more important feedback mechanism. In this perspective, regulatory competition is conceived to work as a result of the political intermediation of manufacturers, the directly implicated parties of consumer's product decisions. For instance, the race to the bottom argument assumes that if a firm were to lose its competitive advantage as a result of being subjected to high regulatory compliance costs, regulators concerned with the economic fate of domestic firms and located within a strategic context of co-competing regulators, face strong economic incentives to deregulate. At one stage or another, however, the force of this argument depends on the regulatory pressure exerted by the political intermediation of manufacturers in different jurisdictions. After all, it is the political clout of economic exit that is conceived to lead the regulator to deregulate. The same applies when we examine the race to the top story. This story assumes that if regulation were significantly to confer comparative advantage to economic actors allowing them to capture market share, this would create incentives for other manufacturers to press their regulators for similar competitive regulation. In both scenarios, one may or may not observe political intermediation of manufacturers. However the point is – and this may perhaps not be immediately obvious – that regulatory competition theory needs to problematize the analytic step of subsequent political intermediation in due recognition of the multiple economic and political options open to disgruntled manufacturers to respond to a lack of international competitiveness. To mention a number of economic strategies manufacturers might plausibly adopt. If burdened by high compliance costs producers could try to cut costs elsewhere; restructure the organization better to deal with these costs; or ally with a foreign partner to avoid such costs, at least for foreign markets. Alternatively, producers might resort to political solutions such as try to seek state subsidies, negotiate protection, or find more favorable terms of competition (deregulation or re-regulation). The particular cut-off point between economic and political solutions, although subjectively determined, depends on objective conditions such

36 The opposite story would be that an under-regulated product would win out on the product market triggering a race to the bottom. Or conversely, an under-regulated product would lose out on the product market and trigger a race to the top.

as the cost structure of the affected undertaking, the position of the undertaking within the strategic context of the market, the existing structure of interest intermediation, success estimates considering the exercise of political voice, etcetera. The point is that regulatory competition when conceived to operate along the indirect path critically depends on manufacturer response. The analytical reconstruction of this response however is a next step and involves additional cause-effect segments which would need to be fleshed out with help of empirical research rather than be left to theoretical assumption. Hence, a feedback mechanism equilibrating the political response towards economically optimal rules cannot, on theoretical grounds alone, be assumed.

Assymetric information

Another qualification to the proposition that regulatory choice can be inferred from the structure of product market decisions relates to the possibility of asymmetric information about the desirability of public goods. To the extent that regulation was justified by lack of information on the part of consumers (as for instance where consumers have little knowledge about the risks involved in using particular chemical compounds in foodstuffs) allowing regulatory choice to follow product decisions might be thought problematic. Consumers would be allowed to choose un- or under-regulated products without being able to evaluate properly the risks involved in that choice. Vice versa, however, it can be argued that actual tolerance of consumers of regulatory differences in a product market, once allowed, would suggest the relative obsolescence of regulatory protection in the first place.[37] Yet, if we deem the regulation at choice to be robust in the sense of addressing true market failure, we are faced with the troubling situation that allowing regulatory choice under those conditions does undermine the protection formerly offered and deemed socially desirable at least at an earlier stage.

An example may work to clarify this set of propositions. Let us take a product regulation that addresses a subjectively considerable, but from a scientific viewpoint not substantively discernible health risk to consumers, say foodstuffs regulation as in the BSE hormone beef cases. We may assume from its existence that the regulation was predicated on a social choice involving some judgement considering the likelihood that consumers would not be able to recognize or evaluate the risks involved in eating BSE treated meat (otherwise the doctrine of caveat emptor would not have been trumped by regulation). Now introduce the option of exit through regulatory choice. Obviously, it does not help to say that we should evaluate regulatory choice as socially desirable if those making that choice have the ability to evaluate all the consequences of their decision – in economic language, they are able to internalize the relevant costs of their decision. Should we judge them – the all-important legal-institutional

37 This argument ultimately depends on the cognitive autonomy one accords to consumers. It is rather far removed from that of regulatory optimality. We will come back to the message signals of exit can transmit in section III.B.

question concerns *how* one is to make this judgement – indeed capable of evaluating all the consequences resulting from this decision on regulatory choice, this is tantamount to saying that they could have evaluated and hence, *avoided* the risks involved in consuming BSE treated meat in the first place which on mentioned prior assumptions would cancel out the need for regulation altogether.[38]

B. Regulatory Competition Depends on Corporate Choice about Locating Economic Transactions

Regulatory competition is often associated with the need to attract capital and/or corporate activity within a certain jurisdiction (standortwettbewerb). In this view, capital or corporate mobility imply a form of arbitrage among jurisdictions that provides an impersonal means of checking on regulatory activity by constraining regulators by the threat of economic exit. From the time of Hayek on, this mechanism has been constructed as providing an essential check on government largesse in regulation.[39] The question however is whether this check constitutes a feedback mechanism similar to that of consumer exit in the market which creates incentives for producers (in this case, regulators) to interpret demand correctly. Only if such is the case can we establish a reasonable presumption that the commonly quoted economic benefits associated with regulatory competition apply, e.g. production efficiency, innovation and experimentation, and even allocative efficiency in the form of an invisible hand providing a socially beneficial coordination of private values. The question regulatory competition poses, therefore, is not as much whether regulatory arbitrage occurs, but whether this behavior can be interpreted as completing a market mechanism such that an invisible hand argument applies also in the context of regulatory competition.

The latter question can and must be investigated along the two principal analytical dimensions outlined above, i.e. whether arbitrage occurs and whether the arbitrage can be interpreted to result in a direct or indirect feedback mechanism with informational properties similar to that of a market. We start with the former. It is not difficult to fill out the conditions for arbitrage that would make exchange theoretically efficient. They are as follows: (1) corporate actors must be knowledgeable about regulatory differences;[40] (2) choice between regulations must be

38 Joel Trachtman makes the same observation: "if one assumes that the protected parties are sophisticated enough to police regulatory arbitrage, it would seem a small next step to expect them to protect themselves without any regulation." See his, *International Regulatory Competition, Externalization, and Jurisdiction* 34 HARV. INT'L. L. J. 47 (1993) at p.67.

39 F. A. Hayek, The Use of Knowledge in Society, in: Individualism and Economic Order, 1948.

40 There is an interesting, but ominous unit of analysis problem here. If corporations, as is likely, will determine their choice not singularly by one rule or one regulation, but by a set of rules or regulations, then the relevant unit of analysis in regulatory competition research may not be the regulation, but the regulatory regime (or those sets of regulations) of relevance in the eyes of the corporate decision-maker. Of course, there may additionally be complex substantive linkages made by corporate actors between individual or different sets of regulations that can considerably complicate the analysis of whether such competition will work to be "optimal" even in broadly defined contexts. Similarly, Stephen Woolcock, *Competition among*

economically justified; and (3) transaction costs associated with the exercise of mobility are sufficiently low.

With firms, the knowledge and transparency problems surrounding an informed regulatory choice are less pronounced as they are with consumers as they generally are repeat players with time and resources at their command to solve issues of regulatory interpretation. However the costs associated with obtaining legal counsel and obtaining correct regulatory knowledge are not neglible and may sometimes be prohibitive. This suggests that regulations need to be transparent to an extent that would afford companies an adequate picture of the economic consequences of regulation for valuable regulatory arbitrage to become possible. Nonetheless, even if firms can be assumed to be knowledgeable about regulatory differences, interpreting relocation decisions as a matter of regulatory choice is problematic for essentially the same reasons as mentioned earlier with consumer product choice. Obviously, companies may move and do move for regulatory considerations. However, they usually relocate for a variety of different reasons usually not related to regulation–skilled labor, proximity to endmarkets, sophisticated consumers, these are all considerations that usually play a role in relocation decisions. And yet, the possibility of this interpretation is crucial to the issue of whether regulatory arbitrage can supply a feedback mechanism with equally powerful coordination potential as the price mechanism in the market.

To problematize the issue of feedback, we need to attend to the combined asymmetric information and delegation problem that corporate choice over regulatory jurisdictions poses. As we have seen, the asymmetric information problem qualifies regulatory choice to the extent that firms need to have accurate knowledge about the regulatory good before the "purchase" – i.e. the choice among regulations – becomes economically valuable.[41] In a transaction costless world, this condition would suggest to allow regulatory choice only when it can be secured that firms have accurate knowledge about regulatory differences. In this situation both the firm as well as the regulator are presumed to have increased their utility by allowing the transaction to proceed. The added value consists of the benefits new investment brings to the regulator and the lower cost of regulatory compliance secured by the firm by choosing a new regime. However, this clear-cut picture of economically desirable exchange is too simplified as it sidesteps the delegation problem build into regulation. Let us see why that is the case.

Build into regulation is the problem of delegation. Regulators receive their mandate from Congress (in the US) or function in the wake of the democratic legitimacy of a chosen executive. Constituencies are represented and the problem with regulatory competition from a delegation perspective is that there is no guarantee that even if firms have accurate knowledge about regulatory differences and thus will make informed decisions, the outcome of regulatory choice will be that outcome that would have been chosen by the people–the ultimate delegators

---

rules in the single European market in REGULATORY COMPETITION AND COORDINATION: STRATEGIES AND DEBATES OF ECONOMIC REGULATION IN EUROPE AND THE USA (William Bratton et al. eds., 1997).

41 George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism* in 84 Q. J. ECON. (1970) 488-500.

of regulatory activity.[42] At bottom, this is because there is no reason to assume that the considerations upon which corporate actors will draw in deciding upon regulatory choice will respond to the same collective expectations that compel the regulator to draw strategies for the provision of the public good. In other words, the content of the signal regulatory choice may transmit to regulators is problematic and cannot, unlike in standard exchange situations, be associated with an unproblematic – because voluntary – market transaction. Hence, we cannot generalize about the efficiency of regulatory choice.

Not surprisingly, when we analyze the efficiency of regulatory choice we see similar analytic patterns appear as encountered in the context of consumer arbitrage in the product market. The extent to which regulatory choice can be evaluated as adding value – whether through expanded consumer, or corporate choice –, depends critically on the evaluation of the starting position of the regulation. Generally speaking, if the regulation is deemed to be socially desirable (addressing market failure, or otherwise contributing to social welfare), exit may undermine the regulatory protection formerly offered and is then considered to be social welfare diminishing. However, if the regulation is deemed to be inefficient in the first place (over-inclusive, externalizing costs, or lacking flexibility), regulatory exit or contracting around rules, is considered to be allowing for additional voluntary exchange and thus becomes efficiency enhancing. We are brought back to the pervasive point that regulatory exit at best offers a mechanism for deterrence; it lacks a feedback mechanism that would allow it to become a mechanism for optimization.[43]

There remains one important point needing to be addressed. It must be remarked that the potential domain of regulatory competition is considerably extended by taking account not only of the economically rational criteria associated with regulatory choice, but also of the fact that regulators may respond to the threat of regulatory arbitrage. Although this objection definitely needs to be taken seriously on empirical grounds, I would limit my response to the observation that for the threat to be credible, considerations that parallel those mentioned above in principle apply, i.e. the costs associated with economic mobility must be sufficiently low for the threat to be credible vis-a-vis regulators and, importantly, the political cost of issueing such a threat must be manageable so as not to jeopardize future relations among actors who are, where multinational corporations are concerned, after all repeat players.

To summarize, the above analytical remarks have shown that normative welfare economics cannot freely be applied to a situation of competing rules or must at least be qualified in the following two respects. First, with respect to the positive domain to which economic mobility

42 Nor is value-added in fact guaranteed to the regulator (the agent), because the dimensions of the exchange are by no means equal, i.e. the power of exit is rather one-sided and requires no consent by the regulator.

43 Cf. ALBERT O. HIRSCHMAN, THE PASSIONS AND THE INTERESTS at p.88 Hirschman discusses this very same point in the context of Montesquieu and Steuart's ideas about the tendency of a mobile and complex economy to deter "excessive" or "brutal" political extraction by the state. The discussion particularly relates to the bill of exchange and its political relevance resulting from the obviated need to hold physical possession of goods and money for the conduct of commerce.

and regulatory arbitrage applies. Do the appropriate incentives and informational conditions exist in order for actors to engage in regulatory arbitrage? Second, with respect to the normative claim that regulatory competition is to contain a feedback mechanism that favors a laissez-faire argument in regards of regulatory competition. The lack of an equilibrating mechanism that systematically produces incentives for regulators to push regulatory protection back to an internally optimal level shows that a general invisible hand argument demonstrating regulatory competition to be an efficient allocation process is not available. The preliminary conclusion thus must be that regulatory competition theory alone offers us little in analytical tools to investigate the *actual* process of arbitrage or to evaluate hypothetical or actual regulatory competition outcomes.

This raises the question of what political or economic theory might allow us better to speculate on both the positive and normative impact jurisdictional mobility has on state actors responsible for regulation. Before this inquiry can be started however, it might be thought that we need some indication of the extent of economic arbitrage in order to assist the theoretical reconstruction of regulatory competition. The following is to give a general sense of the difficulties surrounding the determination of economic arbitrage.

C. Empirical Evidence of Regulatory Arbitrage

Regulatory competition requires that corporate actors orient themselves in their location decisions towards regulatory conditions. A cursory examination makes it clear that this hypothesis will be hard to evaluate empirically. Yet, if we cannot measure to what extent regulatory exit occurs, how can we observe regulatory competition to occur or gauge its actual significance? To be sure, there is plenty anecdotal evidence of the significance policy-makers and business actors attribute to the threat of regulatory exit.[44] There is a relative paucity of empirical research however that systematically investigates the costs of regulatory compliance and implications for economic competitiveness.[45]

44 See for documented anecdotes, Arik Levenson, *Environmental Regulations and Industry Location: International and Domestic Evidence* in FAIR TRADE AND HARMONIZATION (Bhagwati and Hudec, eds. 1996) 429-57.

45 What information there exists, seems limited to investigating mobility in environmental regulations. See, A.B. Jaffe, S.R. Peterson, P.R. Portney and R.N. Stavins, *Environmental Regulation and the Competitiveness of U.S. Manufacturing: What Does the Evidence Tell Us?,* J. ECON. LIT. 132-163 (1995) and Arik Levenson, *Environmental Regulations and Industry Location: International and Domestic Evidence* in FAIR TRADE AND HARMONIZATION (Bhagwati and Hudec, eds. 1996) 429-57. Both studies survey the literature for evidence of corporate location as a result of variation in environmental regulations. They do this on the basis of trade data and FDI patterns Both studies conclude that environmental regulations have not affected interjurisdictional trade or the location decisions of manufacturers. Jaffe et al.estimate that regulatory compliance costs in the environmental field range generally from two to four percent of total production costs which would not seem to justify corporate location under normal circumstances at p. . Levinson concludes that "environmental regulatory stringency does not have significant effect, either statistically or economically, on manufacturer location." at p.447.

As a general theoretical observation however, it follows from the multiplicity of possible individual motives and the likelihood of these being interlocked that rational location decisions are complex enough to be decided by the firm in question. These difficulties compound for the observer who is faced with the unattractive task of reconstructing that decision in order to gauge the existence and significance of regulatory arbitrage. As empirical social science has shown, it is hard to test this type of multiple "causality" empirically and systematically. There simply seems to be no straightforward way to isolate these considerations such as to measure the vagaries of regulatory arbitrage with any sense of confidence or closure.[46] Note that even if regulatory considerations played a role only at the margin of such a decision, this fact would only support the presumption that regulatory arbitrage was indeed occurring. It would not suggest anything in regard of the result of this arbitrage, i.e. in which direction the law would evolve. Although a conclusive answer to this question would, as was said, require close empirical investigation, we can nonetheless on purely theoretical grounds make the following observation. Let us suppose that (even if) legal rules played a role only at the margin tipping the decision to locate for one rather than the other place. Then still the fact that other considerations figured in a decision for which legal considerations cannot be isolated, will distort the partial equilibrium outcome for efficient rules. The direction of these distortions will not, as a matter of theory, be definable. Without developing a full model, it seems reasonable to infer from this circumstance that the possibility of reaching an allocatively efficient equilibrium in a neo-classic economic model becomes rather hypothetical.

IV. A "Cognitive" Critique of Regulatory Competition

Up until now, the discussion of regulatory competition took place within the existing market paradigm. In the interest of a theoretical reconstruction, the remainder of the discussion will develop critical arguments that let go from economic assumptions about rational regulatory behavior altogether. Rather than relying exclusively on the internal logic of economic incentives to predict the outcome of regulatory policies, I argue that theoretical work on regulatory competition cannot do without a fundamental reconstruction of the interests that shape the response regulators adopt to signs of regulatory exit. This reconstruction must take account of the institutional context in which regulators operate. Political culture, regulatory traditions and

46 Cf. Levinson, who discusses the problems in accessing establishment-level microeconomic data and the subsequent difficulties in interpreting data p.443 Direct survey data has its disadvantages as well as industrialists are quick to blame plant closures on tough regulations, but are understandably not very forthcoming in saying that a new factory will be polluting more heavily than would be allowed elsehwere, loc.cit. p.434. Applicable to the area of corporate governance, the work of Dodd and Leftwich may also be mentioned. They conducted econometric event studies attempting to isolate and measure the effect of incorporation decisions on several indicators of company performance. They conclude that there is an extremely weak correlation between the timing of incorporation decisions and usual indicators of company performance. For the full argument, see Peter Dodd & Richard Leftwich, *The Market for Corporate Charters: "Unhealthy Competition" Versus Federal Regulation,* 53 J. BUS. 259 (1980) [deal with this in more elaborate fashion].

institutional routines are all likely to play a role in the framing of issues and the selection of responses to economic pressures. These issues in an incentive-based theory are accommodated only in so far as they are covered by assumptions, but receive no explicit attention otherwise.[47]

A. Incentives and Regulatory Behavior

The starting point for the "cognitive" critique is the assumption central to regulatory competition theory that regulators will react to actual or threatened exit with corresponding legal measures. Yet, it can be pointed out that in the context of political actors such as regulators, the notions of mobility producing "constraints" or as incentivizing regulators to take "corrective" action involve taking a number of theoretical shortcuts.

The view that sees exit as producing *constraints* too quickly assumes an interpretation scheme in the minds of regulators that signals a threat to its own survival and deters the regulator from pursuing expansionary policies. This is plainly not the case. Even with considerable regulatory exit, countries have maintained the same rules and regulations without even worrying about the long-term effects. It is clear that deterrence is not automatic and, if available, must depend on additional mechanisms such as voter response to rising costs and unemployment induced by capital outflows. As such, mechanisms of deterrence will in each instance have to be elucidated. However, the more general theoretical point to be made here is that it is not an advisable strategy to replace the rationality of social actors with that of the observers. We will come back to this point in the discussion.

Likewise, the view that sees regulatory exit as straightforwardly producing *incentives to corrective action* makes the same mistake; again rationality assumptions are being transposed by the theorist to anticipate regulatory behavior. Exit is seen as automatically incentivizing regulators into action as regulators presumably carry an interpretation scheme in their mind that allows them to see this as failure, calling for immediate error correction and equilibrating action. This explanation is simply wrong; regulators do not correct errors and they do not converge automatically toward a social optimum. This view too easily presupposes that there exists an optimal outcome in principle "out there"; one that regulators do not necessarily have

47 This discussion of the proper behavioral assumptions that should guide regulatory competition research is informed by a general theoretical perspective that is not developed here, but tacitly relies on the work of a wide range of writers including Max Weber, Michael Polanyi, Ernst Haas and Charles Sabel who, each in their own terms ("Verstehen", tacit knowledge, consensual knowledge and epistemic communities, or the need to obviate the tacit distinction between context and economic actor which theories of rational economic behavior ask us to make) have developed theoretical interpretations that emphasize the importance of understanding the actor in his context. See generally, MAX WEBER, ON ECONOMY AND SOCIETY, MICHAEL POLANYI, TACIT KNOWLEDGE (1961), ERNST B. HAAS, WHEN KNOWLEDGE IS POWER (1990). See in particular, CHARLES SABEL AND JONATHAN ZEITLIN, WORLD OF POSSIBILITIES, who develop this theme in a much more elaborate way in the introduction of their book "Stories, strategies, structures: rethinking historical alternatives to mass production" 1-33. Also, JAMES M. MARCH AND JOHAN P. OLSEN, DISCOVERING INSTITUTIONS (1989).

to understand provided they interpret the signals correctly. So long as regulators "get" the signal, they will take corrective measures (but one is tempted to ask, corrective to what?). This surely underestimates the professional advertence and ingenuity of regulators and, more importantly, the complexity of the analytic problem which regulatory competition behavior presents for the theorist. The regulator is likely to be aware of the phenomenon of jurisdictional exit and may in principle be equally puzzled by its implications. She may for instance ask herself whether and to what extent jurisdictional exit occurs and what consequences such exit will have on the law's effectiveness and "integrity". Moreover, she is likely to be interested in its effects on the organization's own prestige and survival as well. The economic theorist of regulatory competition, however, in trying to make sense of the phenomenon ironically does not see the similarity between the regulator's predicament and that of his own. Instead, he cuts off a significant portion of the theoretical problem by attributing a simplified rationality to the regulator which presumes that regulatory exit automatically incentivizes regulators to take corrective action.

The immediate views on regulatory response allow straightforward theorizing about regulatory competition but at the cost of ignoring the actual response of regulators to economic pressures on regulatory regimes. As a result, the purely economic story of regulatory competition is too thin. A more accurate description of regulatory competition will need to reconstruct both the signal of economic mobility as well as the regulatory response to it. The reformulation of the research problem implied by this proposition however cannot be started without first clearing the conceptual hurdle posed by the notion of efficiency, or regulatory "optimality", implicit in an account of regulatory competition. I would now like to examine the intricate efficiency and optimality problems that any presentation of regulatory competition cannot avoid, yet can also not solve entirely.

B. Efficiency and Optimality in Regulatory Competition

Standard treatments of regulatory competition use efficiency criteria commonly to denote the allocative efficiency of regulatory competition without questioning what substantive meaning that phrase might contain in a particular context. Allocative efficiency in standard economic analyses is used to describe a general equilibrium with Pareto characteristics; meaning that the allocation of resources over the utility preferences of economic actors cannot be improved without someone experiencing a loss in economic utility. It is however problematic to visualize what this abstract economic concept might mean when applied to a process of regulatory competition. Although most legal commentators maintain an audible silence on this issue, its meaning comes closest to something like this: that the expanded possibilities for exit created by the market increase the possibility that an economic actor might find a regulatory regime to its liking. Yet, this external efficiency argument is not what is at stake in many of the discussions of regulatory competition. What is at stake in most regulatory competition debates is the internal efficiency argument – call it the internal optimality of rules in terms of the purely

instrumental contribution to policy goals achieved, i.e. the protection they buy for regulatory constituencies, or more ambitiously, the rule's social optimality, i.e. its contribution to social welfare democratically achieved. Locating this inconsistency however does little to improve the evaluative terms in which the regulatory competition debate is conducted. Rather the problem is similar to that discussed in respect of the Tiebout model: we simply cannot understand optimality when it relates to public rules and regulations without reference to the particular goals the regulatory policy was meant to achieve (internal optimality) or the political process by which it was achieved (social or democratic optimality).

As mentioned before, the more evolved accounts of regulatory competition in American legal scholarship have moved away from general equilibrium conceptions about the allocative efficiency of a competition process. We may therefore expect an improvement of the evaluative terms in which the regulatory competition debate is conducted. Indeed, claims for regulatory competition to result in efficient allocation of legal subjects over regulatory regimes are increasingly being substituted by claims concerning the economic desirability of regulatory choice. The more limited micro-economic efficiency claim of regulatory competition suggests that the desirability of regulatory choice depends on the incentives of the actor(s) privileged to make that choice.[48] For instance, in the corporate governance discussion, the question is whether managers of incorporated firms have incentives to exercise choice in such a way as to maximize shareholder value or whether they have incentives to shirk and to seek managerial rents. Using standard economic efficiency paradigms to gauge the desirability of regulatory choice, this particular frame asks whether the actors making this choice have the ability to internalize the costs of their decision.[49] If so, regulatory choice is considered to be economically desirable. But if those who decide upon the regulatory regime can externalize the costs of this decision on outside parties, regulatory choice is considered to be economically undesirable.[50] There are a number of possible disadvantages to holding strictly to this method to evaluate regulatory choice and exit: the one remaining within the economic efficiency paradigm being that it may not provide a solution and can instead lead to an interminable regress on the "reasonable" behavioral assumptions to be guiding legal decision-making.

To know when regulatory choice is economically virtuous we need to know both the domain and likelihood of internalization available to actors. This may in the last analysis be impossible to know as the assumptions under which internalization is supposed to occur may be recursive and refinable ad infinitum. This can be demonstrated by the build-up of normative arguments in

---

48 Lucian A. Bebchuk differentiates corporate law issues on the basis of the leeway regulatory choice affords to managers to pursue managerial rents. On the basis of this criterion, he proceeds to establish a categorization of corporate law issues requiring, in his view, federal regulation. See his *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law* 105 HARV. L. REV. 1435 (1992).

49 See Paul B. Stephan who explores the potential of this idea to conceptualize the transformation of regulatory competition into virtuous regulatory cooperation, *Regulatory Cooperation and Competition: The Search for Virtue*, University of Virginia School of Law Legal Studies Working Papers Series, Working Paper No. 99-12, June 1999, downloadable at http://papers.ssrn.com/paper.taf?abstract_id=169213.

50 Id. at IV B.

the long-standing state incorporation debate.[51] The question in this debate is whether allowing managers to choose amongst state incorporation rules leads to corporate rules that enhance the efficiency of economic organization or to rules that bias economic outcomes consistently to favor managerial interests. The basic idea is that regulatory competition is driven by managers who are privileged to choose an incorporation regime amongst several state regimes on offer. These managers may use this possibility to select those regimes that enhance efficiency, or they may use this type of discretion to pursue incorporation rules that are biased to favor their interest. The asymmetric information argument detrimental to regulatory choice in this specific context consists of the possibility that shareholders and perhaps other affected parties may be unable sufficiently to monitor the incorporation decisions of managers. The resulting problem for allowing regulatory competition and jurisdictional differentiation is thus that managers may exercise regulatory choice to pursue managerial rents because of the lack of external monitoring. Note that in this specific context the working requirements for mobility and economic arbitrage are largely fulfilled, i.e. (1) economic actors have incentives to be knowledgeable about regulatory differences; (2) actors have sufficient economic interest in exercising regulatory choice; and (3) transaction costs associated with exercising mobility are sufficiently low as formal incorporation does not require actual relocation.

The threat exercised by the asymmetric information argument on state competition and managerial choice is however countered by those who point toward certain external corrective devices able to check managers from exploiting regulatory choice to seek incorporation rules that allow managerial rents. These devices consist of the stock market and the market for corporate control which can in theory reflect the effect of any incorporation decision management might make on the performance of the firm.[52] Thus in the event that management chooses an incorporation regime that is biased toward their interests, shareholders and institutional investors in the stock market will not fail to detect this causing the corporation's stock value to drop. Similarly, managerial abuse over incorporation prerogatives cannot but in the long run affect the general performance of the company and thus open up the potential for a take-over in the market for corporate control. These external market mechanisms may curb managerial discretion over incorporation decisions sufficiently so as to prevent long-term

---

51 The back-and-forth movement in this debate can be traced to William Cary's 1974 article on the 'Delaware effect' which was answered by Ralph Winter in 1977. See William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L. J. 663 (1974); Ralph Winter, *State Law, Shareholder Protection, and the Theory of the Corporation,* 6 J. LEGAL STUDIES 251 (1977) Winter was to my knowledge the first to present economic arguments to counter the intuitive claim that regulatory competition would lead to a race to the bottom. For purposes of my argument it is not necessary to fully track the intricacies of developments in the corporate law discussion (which has gone on to discuss the case of statutory take-over protection as either an exemplary case or a limiting case of the potential for bad outcomes in the law). For representative contributions in the debate, see the cited literature in note 4. The latest contributions include: Bratton, W.W. & McCahery, J.A., *Regulatory Competition, Regulatory Capture, and Corporate Self-Regulation*" 73 N. CAR. L. REV. 1861 (1995) Bratton (1997), Bebchuk (1999).

52 See, Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle,* 1 J.L. ECON. & ORG. 225 (1985).

externalization.[53] Not surprisingly, the debate has focused on critiqueing and qualifying the conditions under which it is reasonable to suppose that these market punishments occur. However, even if the complex issues surrounding market reactions could be decided, it would still be necessary to determine the likelihood that, and the domain in which, economic actors would internalize the impulses of the market and factually produce the desired behavior.[54] One may therefore characterize these arguments as ones which delve increasingly deeper into the particular conditions governing internalization without however coming to a definite stop-holder argument to which to attach regulatory choice.[55]

However, it seems that the underlying problem of discerning when regulatory competition can be deemed internally, or functionally optimal continues in this way to be shirked. To discern the desirability of regulatory diversity and competition by pursuing the quest of internalization of regulatory choice unduly narrows the question of optimality in its scope. After all, what we are, presumably, after are the effects of regulatory competition on the fate and content of legal rules and regulatory decision-making as measured against the actual policy goals to be achieved. What hence seems to be missing in theoretical accounts of regulatory competition is an analysis of the political processes required (and the social discourse presumed) that must undergird the legitimacy of regulatory outcomes.

One can make the same point in economic terms. While it is generally true that cost internalization over a private transaction leads to social efficiency at the macro level, it may be inappropriate to compare regulatory exit with a private transaction if what is exited from is not a private good, but a legal instrument used to achieve a collective good.[56] This method for evaluating the good of allowing regulatory competition casts the dimensions over which regulatory exit is supposed to play, too narrow. It focuses on the micro dimensions of regulatory choice at the peril of ignoring the macro dimensions of regulatory competition (especially on the political concerns of what the regulation was supposed to achieve and for whom). Questions of political aggregation and different stabs at tackling the problem of political integration are at stake here which the above cost internalization approach tends to ignore, if not to obscure.

---

53 One of the problems associated with this view is that possible abuse of incorporation choice typically is not limited to the long-term, but may involve short term considerations, especially where managerial choice on incorporation occurs in the context of an endgame (as where managers anticipate a takeover).

54 In this respect, Eisenberg observes that the state incorporation debate is limited to an analysis of economic incentives but contains no discussion of whether the anticipated behavior will actually occur. See Eisenberg, loc.cit. n.

55 Cf. Stephan, loc.cit.

56 This point, although substantively the same as that discussed in I. A., merits repetition.

V. Reformulating the Problem of Regulatory Exit

To avoid these theoretical shortcuts one should reformulate the research problem of regulatory competition and perceive regulatory competition from the larger canvas of the transformation of domestic and international politics. An astute observer of world politics has recently commented on the advent of *postinternational* politics.[57] Changes in the social structures embedding individual actors and a concomitant increase in the analytical skills and capabilities of individuals are seen to have led to a world politics that is bifurcated in a multi-centric and a state-centric realm of international political action.[58] From this viewpoint, we may perhaps interpret regulatory competition (or rather, regulatory exit) as the legal expression of the inroads the multi-centric system is making upon the state-centric system. Following this line of reasoning we can more readily appreciate the shifts in political power that this development may be the bearer of. It may be that these underlying power shifts are re-orienting domestic legal systems in more subtle ways than can be perceived through the lenses of standard regulatory competition theory. In fact, regulatory competition may be the varnish that needs to be scratched in order to unveil a political reality whose main legal momentum shows itself negatively through the inability of nation-states to deal with interdependence using traditional legal strategies. Rather than one response, this broad viewpoint allows us to speculate upon a range of credible responses regulators might take. For example, rather than urging them to adopt competing regulatory solutions or to pursue unified harmonized policies, regulatory exit may trigger nation-states to find new ways to cooperate and to reform their domestic administrative approaches in order better to manage economic interdependence in their own domestic economies.

VI. Recapitulation and Further Research Orientation

This essay has systematically examined regulatory competition arguments with a view towards their potential to trace out and interpret the possible linkages between economic and political/legal integration. It started with a caveat on the Tiebout hypothesis which, when taken on its own terms, was structured to answer a different set of concerns than for which it is currently being applied. This is shown to have consequences for the debate on regulatory competition which avails itself of the Tiebout hypothesis to generate scenarios about the political effects of economic integration – i.e. whether regulatory competition is likely to trigger an iterative process leading to increased efficiency of regulatory control (better standards and a race to the top) or diminished effectiveness of regulatory authority (competition for laxity, or race to the bottom). These consequences relate to the lack of analytical tools regulatory competition theory offers us to investigate the actual process of arbitrage or to evaluate the outcome of a regulatory competition process. In addition to this external criticism, an internal

---

57 JAMES ROSENAU, TURBULENCE IN WORLD POLITICS: A THEORY OF CHANGE AND CONTINUITY, (1990).

58 Ibid. p. 11.

conceptual critique was developed demonstrating that regulatory competition, even when taken on its own terms, does not provide a feedback mechanism that would allow one to construct an invisible hand argument for regulatory competition. The examination shows regulatory competition to be a poor conceptual strategy to address the *political* concerns that economic mobility raises regarding the appropriate level of policy intervention and hence, the scope of autonomy left to governments in an economically interdependent environment. In particular, the internal and external critique seem to disqualify regulatory competition as a general purpose strategy for investigating the (contingent) institutional consequences of existent regulatory heteronomy or a federal governance structure on the shape and content of regulatory policies. This obviously raises the question of how and with what analytical tools we should address these – different – concerns better. The search for a conceptual picture that can adequately capture the complex and dynamic reality of economic and legal integration remains in that respect wide open.

In the meantime however the analysis performed in this paper may have shed some light on both the normative and positive problems which, independent from regulatory competition strictly conceived, continue to animate academic interest in regulatory heteronomy/diversity in combination with economic choice. Normatively, the analysis performed in this paper shows that the abiding normative conundrum related to the desirability of economic exit over regulatory authority can only be solved by defining the starting position of regulation. Within the context of current efforts at harmonization and international approximation of regulatory practices, an analysis of regulatory competition might thus serve – in this admittedly highly circumlocutious way – to expose the serious limitations of existing mechanisms for discerning regulatory demand conditions of regulatory constituencies and suggests that, in order to discern the desirability of a world of regulatory choice, one should improve the means of discerning regulatory quality in the first place. However, rather than a meta-concern with regulatory competition, this exercise seems to me better to be justified under primary considerations of – and indeed, prior commitment to – democratic governance. However, it is at least conceivable that the practical significance of regulatory competition in the real world lies in the fact that the political pressures resulting from economic mobility might contribute to an awareness with regulators, academic observers and the larger regulated public alike, of the normative ambivalence associated with centralized regulation.[59] In that regard, regulatory competition might contain yet another signal for the need to improve the underlying democratic robustness of regulation.

From a positive concern with examining the real world consequences of regulatory exit one is presented with the need more accurately to trace out the possible and plausible connections between (economic) regulatory exit and political response. In a way, the documented lack of

---

59 Although this statement must largely go unchecked here, it seems that present political discontent with the European integration project as well as the growing political opposition to the WTO generally and to its dispute settlement mechanism particularly, can be interpreted to speak for this possibility. See Opposition to Seattle International Herald Tribune, 11/03/1999.

sustained regulatory arbitrage and the critical analysis on the theoretical possibility of regulatory competition simply raise the question onto another level. This question would have to be framed at the level of phenomenological context, and would be: Why do business and political actors engage in the rhetoric of regulatory competition and competitiveness and with what consequences? This phenomenological perspective would, rather than attempt to establish a straight relation between regulatory competition and the "quality" of national legal rules, call for positive research uncovering the relations of increased options for regulatory exit with particular behavioral patterns of corporate and regulatory actors. For example, what consequence does the anticipation of regulatory competitiveness have for the behavior of policy actors – especially in regards of their decisions at which level to pursue policy intervention, i.e. national or supranational/intergovernmental levels? Does regulatory exit suggest a reformulation of the authoritative roles administrative units perceive themselves to play – relative to the state? relative to corporate and social actors? Will these role changes contribute to new action scripts for governance and how can one describe both the role changes and the new action scripts, routines, and habits from the viewpoint of the regulator? In turn, in what ways do these new action scripts for governance combine with increased options for regulatory exit to produce expanded opportunities for political entrepreneurs (corporate or social) to express political voice?[60] These questions all point toward the somewhat paradoxical, yet ultimately instrumental and contributory role, regulatory exit plays in empowering non-state actors and creating a world of multi-level governance. In this author's perspective, regulatory competition and mobility may largely stand for the observed near absolute requirement on regulators to co-opt economically powerful mobile actors into the policy-making process. Interestingly, this happens at all levels, domestic as well as international.[61] Obviously, these positive developments raise normative concerns about international regulatory capture needing to be addressed by the democratic analysis of multi-level governance alluded to above. But it also leads to positive questions regarding the response of disadvantaged actors and other political entrepreneurs to this perceived international regulatory capture and the political pressures they are likely to exert on the future institutional shape of multi-level governance.

Both of these types of questions, normative and positive, obviously extend regulatory competition research far beyond the scope of the present essay – not to mention the present

60 Regulatory competition may thus be speculated to be one of the most important and at the same time, increasingly ubiquitous, instances in which Exit rather than undermine, actually increases the willingness to exercise Voice. A possibility which although not initially mentioned by Hirschman in his original EXIT, VOICE AND LOYALTY (1970) is discussed by him in a more recent essay titled, *Exit, Voice, and the Fate of the German Democratic Republic*, in ALBERT O. HIRSCHMAN, A PROPENSITY TO SELF-SUBVERSION (1995) p.9-44.

61 This observation, if correct, is damaging for race to the bottom arguments whose proponents stake their claim on the existence of a politically more inclusive level of governance at which the political costs of economic mobility can be internalized. My guess is that continuing globalization will make the search for such an inclusive level increasingly elusive and non-meaningful as the economic world will continue to shift and repattern itself along trajectories that do not respect the jurisdictional boundaries of any system of governance. In addition, one must point towards the democratic ambiguities involved in any project that proposes to raise political integration to yet another higher level.

abilities of its author. However, they do suggest interesting alternative approaches and directions in which regulatory competition research efforts could, as an academic matter, as well be spended.

Finally and for policy purposes, the analysis performed in this paper showing on theoretical grounds the limited scope for regulatory competition suggests foremost that we need hard empirical evidence on the existence and extent of economic arbitrage, especially where the fear of such arbitrage seemingly provides the sole ground for undertaking large-scale, i.e. Europe-wide harmonization or even speculated global concerted action in the WTO.[62] To the extent that harmonization is motivated by a general concern for a level playing field and a political unwillingness to create unfair conditions for competition, econometric event studies showing the actual extent of economic arbitrage (and thus in legal terms, the amount of actual inflicted unfairness) to be anticipated could be conducted before one is to constrict the locus of policy intervention to more centralized – and democratically problematic – levels. These remarks are obviously relevant in light of the coveted subsidiarity of EU decision-making procedures which seem notwithstanding the expanded competences contained in the TEU treaty, for politically understandable reasons, to continue to depend rather heavily on the internal market mandate and majority decision-making powers of Art. 95 (ex Art. 100a) – even where other arenas of both normative legal justification as well as positive policy-making might in principle be both theoretically visible as well as empirically available.

62 This is an admittedly not entirely satisfactory attempt to respond to the challenge of gauging the significance of exit threats as a mechanism of regulatory arbitrage. This issue however can only be addressed empirically by simply investigating to what extent such threats occur.