

2000

Regulatory Competition or Regulatory Harmonization - A Silly Question

Alan O. Sykes

Follow this and additional works at: https://chicagounbound.uchicago.edu/journal_articles



Part of the [Law Commons](#)

Recommended Citation

Alan O. Sykes, "Regulatory Competition or Regulatory Harmonization - A Silly Question," 3 *Journal of International Economic Law* 257 (2000).

This Article is brought to you for free and open access by the Faculty Scholarship at Chicago Unbound. It has been accepted for inclusion in Journal Articles by an authorized administrator of Chicago Unbound. For more information, please contact unbound@law.uchicago.edu.

REGULATORY COMPETITION OR REGULATORY HARMONIZATION? A SILLY QUESTION?

*Alan O. Sykes**

ABSTRACT

The debate over ‘competition versus harmonization’ in regulatory policy often confuses the pertinent alternatives. This comment argues that neither pure regulatory competition nor complete regulatory harmonization is desirable or feasible where important international cross-border effects of regulation arise. Instead, a considerable degree of cooperation is almost always needed, yet non-homogeneity of regulatory policies is almost always desirable as well. This proposition holds virtually regardless of the subject matter of regulation.

Is regulatory harmonization desirable or should we instead prefer regulatory competition? This question is being asked regularly today in a wide array of regulatory contexts, at the global, regional, and national levels. In this brief comment, I wish to suggest that this question is, at best, confusing. The proper question is *to what extent should regulators cooperate with regulators in other jurisdictions?* And to that question, the proper answer is that when regulation affects actors outside of the regulating jurisdiction, some degree of regulatory cooperation is almost always valuable, at least to the extent of defining the circumstances under which regulatory deference will occur, and prohibiting regulators from engaging in certain behaviors that are the product of domestic rent-seeking. The harder question is whether cooperation on ultimate regulatory goals or targets is beneficial, and here the answer is highly context specific. It is very much the exceptional case, however, where cooperation should proceed to the point of complete harmonization or ‘homogenization’ of regulatory policies across all jurisdictions.

1. LEVELS OF COMPETITION AND COOPERATION

At the outset, it is useful to distinguish several types of regulatory competition and cooperation. They involve varying degrees of intrusion into the autonomy of regulators, and span the options from complete local autonomy under pure

* Frank & Bernice J. Greenberg Professor of Law, University of Chicago, The University of Chicago Law School, 1111 East 60th Street, Chicago, IL 60637, USA. Email: alan_sykes@law.uchicago.edu

regulatory competition to the complete elimination of autonomy through regulatory homogenization. The line between these categories can be fuzzy at times to be sure, but they nevertheless serve as useful tools for organizing the subsequent discussion.

Pure regulatory competition

The classic economic papers on local public goods and decentralized regulation, such as those of Tiebout¹ and Oates and Schwab,² envision a strictly noncooperative regulatory environment. Local governments choose the level of public services, or of regulation, taking the policies of other jurisdictions as given. Although other forms of strategic interaction between regulators have been studied,³ regulators in this literature make no legal commitments to each other and at most set their regulatory policies with an eye toward the expected strategic reaction of foreign regulators. Such conditions may be termed pure regulatory competition.

Mutual deference or recognition agreements

Regulators often wish to assert some jurisdiction over foreign practices that have an effect in their own territory. To ameliorate the conflicts that may result, regulators may agree on principles of deference to foreign regulation. In some instances, a simple choice of law rule can suffice – regulators can covenant that particular actors or transactions will be subject to the law of one jurisdiction over another under specified circumstances. Related, regulators may agree to afford mutual recognition to foreign regulation under specified conditions, so that actors complying with the regulations of one jurisdiction will be deemed in compliance with the rules in another jurisdiction.

Minimal or essential requirements agreements

At times regulators may find it valuable to agree on certain minimum standards that their regulatory policies must meet. They might agree that securities laws must include some form of anti-fraud rules, for example, or that product safety regulations must achieve a minimal degree of safety with regard to a particular class of accidents. Such agreements set a floor on the stringency of regulation, roughly speaking, leaving regulators free to regulate more stringently.

¹ Charles M. Tiebout, 'A Pure Theory of Local Expenditures', 64 *J Pol Econ* 416 (1956).

² Wallace E. Oates and Robert M. Schwab, 'Economic Competition Among Jurisdictions: Efficiency Enhancing or Distortion Inducing', 35 *J Pub Econ* 333 (1988).

³ See the paper by Ricky Revesz in this issue, and sources cited therein.

Regulatory forbearance agreements

Regulators may also agree to limit their freedom to regulate in various respects, such as to reduce the adverse impact of regulation on foreign commerce. Agreements of this sort might prohibit discrimination against foreign commerce, require that regulators employ the 'least restrictive means' to achieve their goals, and so on. Here, the emphasis is on what regulators must not do, while still preserving their ability to choose their regulatory targets.

Agreement on non-homogeneous regulatory targets

At times regulators may agree on the substantive targets of their regulations. These targets might include the permissible level of emissions of a particular pollutant in each jurisdiction, for example, or the reserve requirements for particular types of insurers in each jurisdiction. Such agreements need not set the same target everywhere, but may allow for differences in policy due to a variety of factors.

Agreement on uniform regulatory targets

In the limit, regulators might agree that rules must be the same everywhere in all of their particulars. These agreements can extend not only to substantive regulatory targets, but also to the manner by which regulators ensure compliance with their regulations (commonly called 'conformity assessment').

2. OPTIMAL COOPERATION

In the regulatory matters of interest to international economic law scholars, and to the authors of papers in this conference, cross-border issues abound. Securities regulators must decide whether to apply their laws to foreign firms and transactions; banking regulators must decide whether to apply their licensing and prudential standards to foreign banks; labor organizations propose to extend labor standards to developing countries; environmental regulators must address matters that involve cross-border pollution or harm to the global commons.

In all of these areas, a case can be made for a considerable degree of 'regulatory competition'. One or more of the standard arguments apply: (a) Conditions differ across jurisdictions (tastes, incomes, etc.), and hence there is no reason to think that an optimal regulatory policy for one jurisdiction will be optimal for another. (b) As a slight variant, conditions differ among the actors that are subject to regulation. What is optimal for one pair of transactors, for example, may not be optimal for another, and regulatory competition may allow them to pick the regime that maximizes their welfare. (c) The optimal regulatory policy is unknown, and regulatory competition will allow experimentation that reveals information about what is optimal. (d) Regulation is

subject to capture and rent-seeking that leads it toward suboptimality, and such wasteful regulation can be disciplined by capital movements under regulatory competition. This list is not necessarily exhaustive.

To say that 'regulatory competition' is desirable, however, is not to say that regulatory cooperation is undesirable. Consider securities law as an illustration. A number of scholars have argued powerfully for regulatory competition in this area, contending that firms and their investors should be allowed to choose the system of securities regulation that they feel will maximize the value of the firm. Because there are no obvious externalities to the investment contract, and because sophisticated investors will arguably protect the unsophisticated, the argument for freedom of contract over the applicable regulatory regime is indeed compelling.

Can this form of freedom of contract emerge in an entirely noncooperative environment, one of pure regulatory competition? The answer is almost certainly no. For part of pure regulatory competition, by definition, is non-cooperative decisions regarding such matters as choice of law when a dispute arises in a domestic court between domestic citizens and foreign citizens. If firms and investors are to be allowed to choose the applicable regulation, and investment crosses borders (as it surely does in practice), then *every* nation must adopt a choice of law rule that honors the regulatory choice made by the parties to the original investment contract, and further honors the results of dispute resolution that may well take place abroad. It seems exceedingly unlikely that all jurisdictions will arrive at this rule noncooperatively (to my knowledge, not one has arrived at it yet). Thus, even in this area where the case for regulatory competition is especially powerful, a formal agreement to defer to foreign regulation when selected by firms and investors will likely be required.

Agreement on such a rule may be exceedingly difficult, as many regulators will fear a loss of influence should firms and investors choose to take their regulatory business elsewhere. But even high-minded regulators interested only in the welfare of their citizens may resist agreeing to respect firms' and investors' choice of regulation if they view that choice as fundamentally inadequate to achieve the basic goals of their domestic regulation. If a corporation and its investors appear to have chosen a regulation that affords no protection to the investors against corporate fraud, for example, regulators may see the choice as so obviously flawed that it should not be respected. More precisely, the absence of some regulatory principle widely perceived as essential will signal to many that freedom of contract has gone awry; and whether or not this perception is accurate, the political pressures to deviate from any promise of deference can become enormous.

Hence, if an agreement to defer to foreign regulation when firms and investors choose it is to be sustainable, it will likely have to do one of two things. Either it will have to enumerate the specific national regulatory systems that are deemed worthy of deference, or it will have to specify the

properties that any regulatory system must have (such as basic anti-fraud protection) in order to be eligible for deference. Implicitly or explicitly, therefore, an indispensable part of any agreement to defer to foreign regulation is likely to be a proviso that the foreign regulation in question must contain certain minimal substantive rules, along with some minimal process to make them enforceable.

Summarizing to this point, I have argued that even in the securities area where the case for regulatory competition is perhaps as powerful as anywhere, the benefits of regulatory competition probably cannot be achieved without formal agreements on mutual deference and on the minimal substantive and procedural requirements that each regulatory system covered by the agreement must satisfy. But even more may well be required. Imagine, for example, that the securities laws of some country systematically disfavored foreign parties to a dispute through some substantive or procedural rule that had the effect of discriminating in favor of domestic nationals. It seems exceedingly unlikely that such discrimination could be efficient, and equally unlikely that government officials abroad would be willing to respect the outcome of dispute resolution under such a law as a political matter.

Accordingly, to sustain the mutual deference that is necessary to secure the benefits of regulatory competition, it will likely also be necessary to agree on certain things that regulation may *not* do (such as discriminate against foreigners). And because facially nondiscriminatory policies can have a disparate impact under some conditions (imagine a rule that required all firms to be audited by a particular set of auditors who cannot read documents in a foreign language, for example), the rules necessary to prevent discrimination may need to be rather elaborate, extending to least restrictive means requirements, transparency requirements, and the like.

Putting it all more succinctly, I suspect that to secure the benefits of regulatory competition over securities law, a formal international agreement rivaling some of the WTO agreements in detail and complexity might well be necessary. The alternative would be a series of bilateral negotiations over mutual deference that would implicitly check whether the rules that an in-depth agreement would embody are satisfied by both parties. Whether one believes that such agreements are normatively necessary perhaps depends on one's prior beliefs about the ability of investors to take care of themselves. But their necessity as political matter seems much more obvious – regulators cannot be expected to defer to foreign regulation that is seen as profoundly inadequate to protect their domestic constituencies.

Although I have developed this argument using the example of securities laws, the point is much more general. For almost any sort of regulation that touches international trade or investment, regulatory competition is likely to produce regulatory conflict. Cooperative agreements to address the unproductive consequences of that conflict will be valuable. Banking regulators (or their political superiors) can cooperate on establishing minimal prudential

standards in support of mutual recognition, so that international banks do not become subject to inconsistent or redundant national regulatory requirements. Environmental regulators can cooperate so that legitimate environmental objectives are not pursued through means that raise the relative costs of foreigners and achieve protectionism. Prescription drug regulators can cooperate to facilitate reliance on drug testing done abroad, and so on.

Of course, much of this cooperation already occurs – the Basel Accord in the banking sector and the WTO technical barriers codes speak to the issues just mentioned in considerable detail. But much valuable cooperation remains to be undertaken. Antitrust regulators are under no general nondiscrimination obligation presently, for example, so there is nothing in international law to discipline domestic rent-seeking at the expense of global welfare (for example, export cartels permitted under US law by the Webb Pomerene Act). WTO negotiators have only begun to scratch the surface in reducing regulatory impediments to services trade in many sectors. The potential for valuable mutual recognition agreements regarding food and drug regulation is enormous.

To this point, I have focused on the first three types of cooperation noted in Section 1: mutual deference agreements, minimal requirements agreements, and regulatory forbearance agreements. Some mix of these devices is likely to be valuable in almost any imaginable area of regulation that has cross-border effects. But when should cooperation proceed further, either to the point of cooperation on non-homogeneous regulatory targets, or to the point of complete regulatory harmonization?

My answer to this question will seem entirely old hat, at least to economists. Cooperation on ultimate regulatory targets is likely to be useful when a tendency toward underregulation arises because of cross-border non-pecuniary externalities. The United States has little incentive to put an end to the acid rain that it is causing to fall in Canada, for example, and vice versa, absent reciprocal promises to curtail it to specified levels. The problems caused by the discharge of greenhouse gases and chlorofluorocarbons into the global commons raise serious free rider concerns that likely require agreement on emission levels if a solution is to be found.

Of course, to say that the opportunity for valuable cooperation arises here is not to say that valuable cooperation will necessarily arise in practice. Political impediments to a deal may prove insurmountable; any deal that is reached may be highly imperfect and even make matters worse depending on the interest group process involved. But in the absence of nonpecuniary cross-border externalities, one can certainly doubt that cooperation on ultimate regulatory targets will be necessary or productive. The skepticism of most economists toward calls for international labor standards follows immediately from this proposition.⁴

⁴ See generally Jagdish Bhagwati and Robert Hudec, *Fair Trade and Harmonization Vol I: Economic Analysis* (MIT Press 1996).

Even where cooperation on ultimate regulatory targets is valuable, however, it will be the exceedingly rare case where those targets should be identical, at least at the global level or the level of the large nation-state. Heterogeneous incomes, cultures, risk preferences, and other tastes will generally justify heterogeneous regulatory targets as well.⁵

Exceptions may occasionally arise. On matters of technical compatibility (railroad gauges, communications protocols for fax machines), for example, where the issue involves a largely arbitrary choice among competing standards, a single choice for all markets can exploit all conceivable economies of scale and avoid wasteful incompatibilities. And perhaps the occasional case will arise where some substance is so harmful to the environment that it is optimal to ban it everywhere (chloroflourocarbons?). But these are limited classes of cases, and for the most part regulatory homogenization is undesirable.

None of this is to deny, however, that some degree of homogenization is needed simply to exploit regulatory economies of scale. It would make little sense for ambient air standards to vary block to block within a city, or for water pollution standards to vary mile by mile along a river. But since most of the debate about regulatory competition involves regulation that is already occurring at a fairly high level of government (states of the Union; countries of the EU or of the WTO), this complication need not seriously detain us.

In sum, the 'choice' between regulatory competition and regulatory harmonization involves not a dichotomous choice in the usual sense, but a selection from a lengthy menu.⁶ When the cross-border effects of regulation are important, the pure regulatory competition of economic theory, and the complete regulatory harmonization that lies at the other end of the continuum, are almost never sensible. Rather, some sort of legally constrained regulatory competition will make sense in many areas, while a higher degree of collaboration on regulatory targets may be called for when important cross-border non-pecuniary externalities arise.

These propositions are to a significant degree supportive of those who favor regulatory 'federalism' and who invoke 'subsidiarity' notions in favor of decentralization. To the degree that regulation at a higher level of government would be accompanied by regulatory homogenization, there are good reasons to doubt its wisdom at least at the global level or the level of the large nation-state (or regional confederation). And as modern experience suggests, the required degree of cooperation can often be achieved by treaty or by constitutional oversight depending on the context. Of course, nothing in principle

⁵ For a fuller treatment, see Alan O. Sykes, 'The (Limited) Role of Regulatory Harmonization in International Goods and Services Markets', 2 *J Int'l Econ L* 49 (1999).

⁶ Other authors have made similar points in particular regulatory contexts. See Daniel C. Esty and Damien Geradin, 'Environmental Protection and International Competitiveness: A Conceptual Framework', 32 *J World Trade* 5 (1998).

requires that regulation at a higher level of government entail homogenization within the jurisdiction of that government. In that important sense, the mapping between the analysis here and the federalism/subsidiarity debate is imperfect.