

Chapter 2

Convergence and Divergence, in Law and Economics and Comparative Law

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

This chapter takes a broader perspective on issues of convergence and divergence between legal systems.

First of all, it takes a more complex view of convergence by relaxing the assumption that language is unequivocal: the same words can mean different things to different people, what we will call “conceptual divergence”. In the case of explicit divergence mentioned in the previous paragraph, divergence literally springs to the eye, and actually in a number of cases it reflects a deliberate choice to diverge.¹ In contrast, “conceptual divergence” often lurks below the surface and is neither immediately perceptible nor entirely deliberate.² In a case of explicit divergence, there is no doubt in the minds of the agents that there is divergence, whereas in the case of conceptual divergence, it can be that the agents believe that they are indeed using the same concept, since they label it with the same term, while they are in fact using diverging concepts. We will come back to this point during this chapter: sometimes the standard analysis must be adapted to deal with conceptual divergence, but very often it makes no difference whether the divergence is explicit or conceptual.

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

² Prechal et al. 2008.

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

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

First of all, this chapter examines why different legal systems would diverge (2.1). That part illustrates the basic proposition that the existing state of affairs is not fortuitous and will usually turn out to be in equilibrium. In other words, it is the outcome of various forces. The “spontaneous”³ ordering of law (and of society) must at least be carefully studied on its merits, and if it is indeed in equilibrium, then it might be adequate. Note that in the context of this chapter, the existing state of affairs is the legal systems as they exist at a given moment, with whatever amount of divergence or convergence might be present. We are therefore not dealing with an issue of “unbridled” market forces versus “discipline” from the law, but rather with the higher level issue of variety amongst legal systems (each of which had to solve the first-level issue of whether and if so which law is appropriate to deal with various economic and social problems) and legal intervention to constrain that variety.

Secondly, this chapter touches upon methodology, i.e. what is divergence and how it can be detected (2.2). This part is not so much concerned with the economic analysis of the law, but rather with comparative law methodology. It illustrates a more general proposition arising from any multi-disciplinary (“Law +”) approach to the law, namely that it is crucial that the law be seen in a broader context, i.e. including both the policy choices underlying it and its practical outcome.

Thirdly, this chapter explains under which conditions divergence should be seen as a problem (2.3). Finally, it explores possible solutions to the problem (2.4). The last two parts rest on another fundamental proposition from economics: almost every change involves a trade-off. In the words of Friedman, “there is no such thing as a free lunch”. Jurists are notoriously weak here. We tend to focus on the

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

Table 2.1 Costs and benefits of legal change

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

downsides (disadvantages, costs) of the current situation and the upsides (advantages, benefits) of the envisaged change when deciding whether to change (Table 2.1), often ignoring the upsides of the current situation and the downsides of the envisaged change.

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

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

and not merely because

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

The cost/benefit analysis just outlined extends to all sorts of costs and benefits,⁴ not just to economic costs and economic benefits, which might be more easily quantifiable. Non-economic costs and benefits are equally important, and the mere fact that a choice also has non-economic implications—which is actually the rule more so than the exception—does not render a cost-benefit analysis superfluous, quite to the contrary.

2.1 Why Would Divergence Occur?

When browsing through the legal literature, one cannot escape the impression that jurists are slightly (at least) biased against divergence. Convergence, harmonisation and even stronger phenomena like unification are often perceived as positive developments in and of themselves. Even those who write in praise of divergence present it in such a fashion—calling upon irreducible cultural differences beyond apprehension⁵—that it seems to border on the irrational, a line of argument which ultimately feeds into the bias against divergence.

Without dismissing the cultural argument as a whole, it seems more satisfactory to investigate what is behind certain choices of legal rules.

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

⁴ The discussion on the goals of regulating is very wide. From the perspective of the economic analysis of law, see Kaplow and Shavell 2001.

⁵ Legrand 1996, 2004, 245; Teubner 1998.

2.1.1 Divergence as a Rational but Not Deliberate Phenomenon

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

2.1.1.1 Informational Imperfections

Firstly, divergence can be explained by *informational imperfections* (or asymmetries) as between various jurisdictions. The law progresses in great part as a result of outside pressure, which takes the form of new information about the world outside the law (e.g. a new case never seen before, technological developments, social evolution, etc.) that the law must then process. Legal systems evolve within different informational environments. The comparative scholar will often observe that certain areas of the law are more developed in certain jurisdictions as a result of specific historical occurrences.⁶ Similarly, larger jurisdictions tend to run ahead of cutting-edge legal developments because, statistically, novel cases will tend to arise there first. Furthermore, there will rarely be an obvious “perfect solution” to a given legal problem that can immediately be singled out. Therefore, much like in economic activity, when it comes to the development of the law, decisions taken under asymmetric (and imperfect) information may lead different actors onto different paths.

2.1.1.2 Network Effects

Secondly, network economics can also help to explain divergence. The starting point is the notion of *network effects*⁷ (also presented as demand-side scale effects): for certain products, the value of the product to the individual user increases as the number of users increases. The classical example is telecommunications: in the absence of interconnection, the value of a subscription to a network with 1000 subscribers is much less than that of a subscription to an otherwise identical service provided over a network with 1 million subscribers. In telecommunications, network effects are strong, but the theory can also be applied more loosely to other phenomena, including fashion and language. It can be ventured that the “market” for legal ideas is also subject to network effects⁸: the

⁶ For instance the doctrine of *Wegfall der Geschäftsgrundlage* in Germany as a result of the Great Depression.

⁷ Shy 2001; Lemley and McGowan 1998; Liebowitz and Margolis 1994; Katz and Shapiro 1985.

⁸ Anthony Ogus argued, for instance that “the acknowledged characteristics of ‘legal culture’, a combination of language, conceptual structure and procedures, constitute a network which, because of the commonality of usage, reduces the costs of interactive behaviour”. See Ogus 2002.

more members of the legal epistemic community subscribe to a given opinion, the more attractive it becomes, sometimes irrespective of its inherent validity.⁹ The effect is not as strong as in telecommunications, of course, since some jurists—fortunately so in many circumstances—can still decide not to be swayed by the mere fact that the majority holds a certain view, and try to reverse network effects by convincing their peers to espouse another view.

More specifically, two specific properties associated with network effects can explain divergence. The first one is called *tipping*¹⁰: a small movement in demand can trigger a snowball effect.¹¹ In the case of legal ideas, a single leading decision or a leading article at a given point in time can quickly lead to the emergence of a majority view. The second one is called *path dependency*: once network effects have worked to the advantage of one firm, it becomes very difficult to “change the course of history”.¹² In the case of legal ideas,¹³ here as well once certain choices have been made and are deeply imbedded in the shared knowledge of the legal community, they are difficult to reverse. Path dependency can show itself also in a slightly different manner: when faced with a new kind of problem that needs an immediate remedy, legal systems tend to choose solutions that are “familiar” to them; hence, different systems easily end up choosing different solutions.¹⁴

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

⁹ Hence the practice of pointing to the majority and minority views when there is a controversy.

¹⁰ Katz and Shapiro 1994.

¹¹ This lies at the heart of the commercial strategy of most firms active in sectors affected by network effects.

¹² The classical example (David 1985) is the QWERTY keyboard that once established itself as a standard, could not be replaced by a more efficient alternative: the users had been trained in the QWERTY system and could not easily switch all together to the other system. See Brian 1989; Liebowitz and Margolis 1999.

¹³ For earlier applications of these economic concepts to developments in legal rules, see Hataway 2001, Gillette 1988, Roe 1995. For a study of the effects of path dependency in corporate law, see Heine and Kerber 2002.

¹⁴ Mattei 2001.

2.1.2 Divergence as a Rational, Deliberate and Benign Phenomenon

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

In essence, the legal system reflects the consensus of the community (or at least of the ruling class) on the balance to be reached among competing policy interests. Some trade-offs are involved, and they are not always resolved in the same manner from one community to the other. For instance, in a given community, more emphasis will be put on ensuring that injured persons receive compensation, while in another one, the need not to overburden economic actors with liability claims will prevail. The laws of these respective communities will then most likely diverge.

2.1.3 Divergence as a Rational, Deliberate but Less Benign Phenomenon

A third line of argument builds on the previous one, but adds a twist. Whereas the previous account assumes deliberate decisions taken in good faith and with a view to the public interest, *public choice* theory¹⁵ would consider the production of law as a market responding to general economic principles, for instance demand and supply models, pricing theory and so on. Accordingly, the production of law will favour the interests who are best able to articulate their demand and offer a valuable counterpart to the producer of law. Public choice theory can be used to explain lawmaking in complex settings involving interest groups, lobbying and other features of modern-day democracies.

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

¹⁵ Stigler 1971; Becker 1983; Mueller 1989; Farber and Frickey 1991.

influencing the production of law (here administrative procedure) rather than the greater general good.

One of the most powerful interest groups is the legal profession: it can be argued that it represents, in fact, the main driving force for maintaining divergences, especially under the pretence of “legal culture”. The conceptual device of “legal culture” allows the legal profession to keep the tensions and debates alluded to above within its ranks, and hide behind a monolithic façade, which moreover is made opaque to outsiders by being presented as a “culture”. The legal profession can then protect and perpetuate its “monopoly” on its legal “culture”.¹⁶ This also helps explaining the lawyers’ asymmetric attitude towards “importing” foreign legal rules, as compared to “exporting” his or her own legal solutions.¹⁷

2.1.4 Concluding Note

Three different lines of argument were explored, all of which would explain why the law could be different from one place to the other, and would do so in a more convincing fashion than endless invocations of irreducible differences among legal cultures: it is inaccurate to consider that the state of a legal system at a given moment is the single and unavoidable outcome of a monolithic legal culture pertaining to that system. Rather, each legal system is rife with tensions and debates (at least at an academic level). Legal systems are open to many potential directions, and their state at a given moment is simply the outcome of certain policy choices—deliberate or not—that are neither pre-determined nor irreversible over time.

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

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

¹⁶ Ogus 1999, 2002; Hadfield 2000.

¹⁷ To be sure, if it can be argued that national lawyers prefer divergence for the sake of their own local interest, the same way and on the basis of the same public choice arguments, it can also be observed that comparatist lawyers represent another—albeit far less powerful—pressure group with the opposite interest in favouring harmonisation.

2.2 When is There Divergence?

In the light of the foregoing, there appears to be ample reason for divergence (explicit or conceptual) to appear. A foray into methodology is then necessary, to ensure that divergence will only be found where it really exists. First of all, a specific remark is made concerning conceptual divergence specifically and the “keyword trap” (2.2.1), before going more generally into the methodology used to assess divergence (2.2.2).

2.2.1 *The Keyword Trap*

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

Unfortunately, keywords tend to take a life of their own. They then cease to be treated as shorthand labels whose meaning is to be found by looking at the underlying subset of law which the keyword is meant to represent. Instead, jurists will then believe that the keyword has an inherent meaning in and of itself, i.e. that the meaning of the keyword resides in the keyword itself.¹⁸

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

It is, therefore, crucial that jurists beware of the keyword trap. The mere fact that the same keyword, the same shorthand label, is found in two different systems (or appears to be found once translated), does not imply convergence. To use the example given above, “discretion” as a keyword is found in most administrative law systems. It does not take extensive research to notice that it has significantly different meanings from one system to the other.

¹⁸ See on this point Hart 1954; Ross 1957.

On a proper view, one must consider keywords as shorthand labels and look beyond them to the subset of the legal system which they are meant to represent. Only then can a conclusion be reached as to whether there is convergence or not. Presumably, the same keyword used in two different legal systems will often actually represent a different subset respectively in each system. Does that then necessarily imply conceptual divergence?

2.2.2 A Functionalist Methodology to Ascertain Divergence

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

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

Sometimes, comparative law would take a point from within the law (typically a keyword) as a basis for comparison. Each legal system will be entered into from that point. Typically, that point will be put in context with its immediate surroundings and even with the whole legal system.¹⁹ Very often, a finding of divergence will be returned. The conclusion will tend to be that (even if there is an apparent similarity in keywords), the underlying legal concepts and the legal reasoning differ. An even more radical approach would go further into “legal cultures” as a source for irreducible divergences. Very often, the civil law/common law divide will bear the blame for this (when the sample of legal systems under study allows for it).

¹⁹ In the case of conceptual divergence, this amounts to looking beyond the keyword and retrieving the subset which this keyword represents.

Yet ascertaining differences in legal concepts, reasoning and “culture” should not be enough to warrant a finding of divergence. After all, such an inquiry offers no objective test to support its conclusion. A more solid methodology is needed. Such a methodology was developed in comparative law, namely functionalism.²⁰ Even if functionalism suffers from serious limitations,²¹ for the purposes of the current discussion they are not material. Functionalism involves looking beyond the “rules and principles” layer of legal concepts and reasoning to incorporate also the “lower layer” of practical outcomes. Instead of beginning the inquiry via an endogenous point in the law, the starting point is rather found outside the law, by way of a practical problem, for instance. That practical problem is common to all legal systems under study (e.g. “two cars collide at an intersection”). The aim of the inquiry is then to ascertain whether legal systems, seen broadly with their respective three layers, produce the same or a similar outcome. Whether the legal concepts and reasoning used in doing so are similar should not be of prime relevance. Only when the outcomes differ is there a sufficient basis for a finding of divergence.²²

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

It is true that functionalism covers a number of different and sometimes conflicting concepts, as was pointed out by Michaels.²³ Yet what is put forward here is a methodology, without any teleological element: in this sense, it falls under what Michaels describes as “equivalence functionalism”, namely the idea that “similar functional needs can be fulfilled by different institutions”.²⁴ Only through a functionalist method, which seeks to ascertain how various legal systems deal with a similar functional need, can the scope of convergence or divergence be properly assessed: if legal systems reach different outcomes (as mentioned above, often because of different policy choices), then there is truly divergence. If they do not

²⁰ The functionalist method is discussed in greater detail *infra*, in [Chap. 10](#) of this book, [Sect. 10.3](#).

²¹ *Ibid.*, [Sect. 10.3.2](#).

²² As is discussed further in [Chap. 10](#) of this book, [Sect. 10.3.2.1.](#), differences in outcome are often to be explained by policy differences, and functionalist comparative law has tended not to pay enough attention to the policies and principles underlying the law.

²³ Michaels 2006, 339.

²⁴ *Ibid.*, 357.

reach different outcomes, then the systems are functionally equivalent. Differences in the path to that outcome matter of course, but they do not result in a significant divergence. Beyond enabling a more accurate assessment of convergence or divergence, the functionalist method advocated here cannot provide guidance at a more normative level, as regards what should be done about the divergence.²⁵ This is a weakness of functionalism, which is dealt with elsewhere in this book.²⁶

Some critics deny the very possibility of defining an exogenous starting point for the comparison. According to that view, problems do not exist in the abstract. Either functionalism is circular, in that its exogenous point is not truly exogenous but actually a construct of the same community of meaning which administers a legal system to deal with that problem.²⁷ On that account, it is impossible to find a starting point which would be common to different communities. Alternatively, functionalism is value-laden and simply substitutes an exogenous rationality to the one which would be found within the system²⁸: it is then impossible to deliver on the promise of a comparison which would allow each system to “express itself” and would separate significant divergence from functional equivalence.

On the one hand, this criticism stands as a warning to, and a challenge for, the researcher. The functionalist method must be used cautiously, and great care must be taken to ensure that the exogenous starting point is stripped as bare as possible from any influence from the legal systems to be studied. Yet on the other hand, when taken to its logical extreme, this criticism would deny functionalism and ultimately comparative law altogether.

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

2.3 What is Wrong with Divergence?

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

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

In the first part of this chapter, three lines of argument were set out to explain why divergence can occur. It can be noted that of the three, only the “local

²⁵ A point which Michaels, *Ibid.*, who also considers equivalence functionalism as the most robust version of functionalism, also underlines at 373 and ff.

²⁶ *Infra*, Chap. 10.

²⁷ This would be in line with the autopoietic theory put forward by Teubner 1993 on the basis of the work of N. Luhmann.

²⁸ See for instance the criticism directed at Marxist functionalism by Castoriadis 1975, 159 and ff.

preference” argument—the second one—provides a stable (and strong) explanation for divergence. Still, local preferences can evolve. The first line of argument (rational but not deliberate) implies that divergence can disappear over time, if information imperfections are removed. Network effects can work in favour of one or another outcome and would not prevent divergence from disappearing.²⁹ The third line of argument (rational, deliberate but not benign) implies that divergence results in part from different power configurations which are not necessarily stable.

Even then, the mere fact that divergence is not stable over time does not mean that it is undesirable. Beyond purely legal arguments against divergence (2.3.1), which are not conclusive, there are some economic reasons why divergence should be addressed (2.3.2).

2.3.1 Convergence as a Value in and of Itself

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

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

Secondly, jurists sometimes put forward rights-based arguments for convergence: it would be everyone’s right to have similar situations be treated in the same way across legal systems or communities. Given the arguments made above to explain why there might be divergence, we do not think that a mere assertion of rights is sufficient to trump the cards.³⁰ In the same line of reasoning, it is equally somewhat hasty to advance the political argument that the call for a uniform law is dictated by the need to support a common European identity.³¹

A third but related argument is very present in EU law, namely the need to ensure the effectiveness of the law (here, EU law). This argument pertains more to conceptual divergence within a larger system such as EU law: it would be essential to ensure that EU law is interpreted, applied and enforced the same way

²⁹ In fact, in network markets, network effects can be overcome and a new solution can replace the one previously in place, not necessarily by means of a top-down intervention, but also through bottom-up provision of incentives to transition.

³⁰ Bhagwati 1996, 9 and ff., a survey of the arguments against diversity is presented, by highlighting (1) the philosophical arguments (basic human rights beyond national borders, distributive justice and fairness), (2) the structural arguments (globalisation), (3) the economic arguments (domestic decisions impairing international trade; distributive concerns and predation) and (4) the political arguments (protectionism and the need for a common set of standards within an integrated union).

³¹ A discussion of this point with respect to drafting a European Civil Code can be found in Grundmann and Stuyck 2002.

throughout the EU, lest it lose its effectiveness. After all, the ECJ has construed the Treaties in a very purposive fashion, which naturally leads to emphasising effectiveness.

At the same time, throughout its case law, the ECJ is also willing to accept a degree of divergence in the laws of the Member States. For instance, it might appear that the case law on the internal market is naturally favourable to convergence, given the ease with which the ECJ will conclude, often without empirical evidence, that a specific provision in a given Member State constitutes a barrier to the free movement of goods, workers, services, capital or the freedom of establishment of firms and self-employed persons. At the same time, the “rule of reason” developed to save restrictions on the free movement of goods in *Cassis de Dijon*³² and subsequently extended to other freedoms enables vast areas of law to remain divergent across Member States. Similarly, in the line of case-law including *Keck*³³ and *Gourmet International*,³⁴ the ECJ retreats on its earlier statements and leaves potentially divergent Member State laws outside of the realm of Article 34 TFEU.

In addition, the judgment in the *Tobacco Advertising* case³⁵ provides a useful reminder that convergence is not a value in and of itself. Writing about the availability of Article 114 TFEU as a legal basis, the Court stated that³⁶:

[i]f a mere finding of disparities between national rules and of the abstract risk of obstacles to the exercise of fundamental freedoms or of distortions of competition liable to result therefrom were sufficient to justify the choice of Article [114] as a legal basis, judicial review of compliance with the proper legal basis might be rendered nugatory.

In *Tobacco Advertising*, the ECJ laid down the bases for a more economic approach to the use of Article 114 TFEU as a legal basis. Indeed from an economic perspective, the mere fact of divergence is not undesirable.

In order to come to a normative conclusion, the assessment must look more broadly at the costs and benefits of divergence (and in a later step, discussed below under part IV, at the costs and benefits of removing divergence).³⁷

³² ECJ, 20 February 1979, Case 120/78, *Rewe-Zentral v. Bundesmonopolverwaltung für Branntwein* [1979] ECR 649.

³³ ECJ, 24 November 1993, Cases C-267/91 and C-268/91, *Keck* [1993] ECR I-6097.

³⁴ ECJ, 8 March 2001, Case C-405/98, *Konsumentombudsmannen (KO) v. Gourmet International Products AB (GIP)* [2001] ECR I-1795.

³⁵ ECJ, 5 October 2000, Case C-376/98, *Germany v. Parliament* [2000] ECR I-8419. Following a series of cases where that judgment seemed to have been weakened, the ECJ (Grand Chamber) has reaffirmed its approach on 12 December 2006, Case C-380/03, *Germany v. Parliament* [2006] ECR I-11573.

³⁶ *Ibid.*, at Rec. 84.

³⁷ An obvious point for economists. See, for example, in the context of discussions concerning harmonisation: Sun and Pelkmans 1995.

2.3.2 *The Costs Associated with Divergence*

2.3.2.1 Starting Point: Benefits, but No Costs

The benefits of divergence flow from the lines of argumentation put forward earlier. They are strongest when divergence is explained by local preferences. Each legal system is then better attuned to its respective reality: when they reflect differences in preferences of different communities, divergences are in principle preferable to a unified solution since the latter will not, by definition, match every community's needs equally well.³⁸ Since variety increases utility, social welfare is enhanced.

Moreover, since the most suitable solution is hardly, if ever, known in advance, the existence of different solutions can enable a learning process toward the discovery of the most appropriate one.³⁹

In principle, divergence as such does not create costs. To be sure, in presence of a divergence among legal systems, acknowledging it and being aware of alternative solutions can help highlighting the possible costs associated with a certain legal choice within a given legal system. However, in such cases, costs are not due to divergence but are caused by unsatisfactory choices made in the past. This is especially true when divergence is explained not by local preferences but rather by non-deliberate factors (information asymmetries, network effects) or via public choice theory (pressure of interest groups).⁴⁰ In such cases, the existence of divergence does not constitute a ground for harmonisation, but may prompt a domestic revision of one's own inefficient legal choices and eventually lead to a change.

2.3.2.2 The More Realistic Case: Benefits but Also Costs

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

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

1. *Externalities*: Normally, the state of the law should reflect the choices made in a given jurisdiction, in the light of the various tradeoffs involved. It is possible, however, that the choices made in a jurisdiction impose costs which are borne

³⁸ Save for what is discussed in the subsequent section.

³⁹ Hayek 1978, 179.

⁴⁰ See *supra*, Sect. 2.1.

by another jurisdiction, in which case the choice of the first jurisdiction is not based on a complete picture of costs and benefits (tradeoffs) involved. A typical example is environmental legislation in the presence of cross-border effects (water and air flows across boundaries). In the presence of externalities, there is no reason to respect divergence arising from local preferences (e.g. minimal pollution controls upstream), since they can result in sub-optimal results overall (e.g. unwanted pollution downstream). A similar problem may arise if a state has a lax competition policy that allows the formation of cartels which then negatively affect consumers in other jurisdictions to the benefit of domestic firms.

2. *Transaction costs*: When there is trade between jurisdictions, divergence creates transaction costs. Indeed participants in trade—sellers as well as buyers—must acquire knowledge about the legal situation in other jurisdictions in order to engage into trade efficiently (otherwise, they incur risks). They must incur the costs necessary to draft contracts according to each legal system in which they are doing business and they must incur the costs of possible litigation under multiple legal regimes. The risks associated with unexpected changes in each of the legal systems concerned by the transaction also represent costs for cross-border economic actors and so on.⁴¹

On the seller side, for example, this means that products, terms and conditions, etc., must be adapted to meet the legal requirements of a number of jurisdictions, thereby increasing the cost of production and consequently the price. On the buyer side, not only is the price higher due to the just mentioned extra costs, but also the cost of buying can be increased; more likely, however (especially with consumers), buyers would refrain from buying outside of their jurisdiction. The same applies to business transactions other than sale and even to personal endeavours (employment, family matters). Besides these “static” effects, also dynamic ones can be identified on a macroeconomic level, namely the reduction in the international trade volume, in the level of investment, consumption and income and ultimately in the economic growth.⁴²

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

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

⁴¹ On the costs of diversity, see Ribstein and Kobayashi 1996, 138 and ff.

⁴² More extensively on this, see Wagner 2005.

In addition, a third type of cost could be associated with conceptual divergence only, namely costs arising from *information imperfections*. Indeed conceptual divergence differs from explicit divergence in that, on the surface, the same term is used, but with diverging concepts. Ideally, if acquiring information was costless, individuals and firms would dedicate sufficient resources to ascertain the legal situation and they would come across conceptual divergences as well. Since, unfortunately, obtaining information is costly, parties will invest resources in such activity only until its marginal cost equals the marginal benefit.⁴³ There is therefore a risk that they will not look beyond the surface and will then take decisions based on the assumption that the same term is conceptualised in the same way in every jurisdiction, only later to find out that their assumption was wrong (at their cost, but perhaps also to their benefit). They could thus be misled into taking decisions which they would not have taken with complete information on the status of the law. This can lead to inefficiencies, in the form of unsuspected losses or extra costs to undo mistakes. In the end, the uncertainty and the risk of hidden conceptual divergences arising only after the transaction has been entered into, if too extensive, could result in economic actors refraining from cross-border trade.

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

2.4 What can be Done About Divergence?

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

2.4.1 *Do Nothing and Leave the Market to Deal with it*

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

⁴³ This is referred to as rational ignorance: I will spend on information only to the point when the last bit of information I have acquired allows me to reap net additional benefits.

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

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

Thirdly, in commercial but also in consumer relationships, the insurance market can offer a possibility to translate divergence into quantitative terms, i.e. an insurance premium. In the case of liability laws, in particular, insurers have superior knowledge of the state of the law in each market and can provide a lower cost alternative to endless inquiries, product modifications and so on. If a firm wants to keep relatively uniform prices, it can then equalise the cost of insurance over all of its customers.

Fourthly, large and multinational companies are generally familiar with dealing with multiple legal systems and have developed the necessary structures for cost-minimising information gathering, thanks also to economies of scale. In fact, they might find worthwhile to develop international standards for contracts and products; those standards could bring about some sort of “harmonisation”.⁴⁴ In such cases, the interest of Member States (or of the European Commission) would rather lie in making sure that such standard-setting activities do not conceal competition law infringements.

These solutions can only work in certain cases: for instance, divergences in administrative procedure cannot be compensated via contract or insurance. Moreover, for SMEs⁴⁵ and consumers, such solutions might be less affordable or practicable. In situations where they are available, however, these market-based solutions can be attractive, especially if there are no externalities involved and the costs associated with divergence (transaction costs, information imperfections as the case may be) are limited in comparison with the value of the overall activity.

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

⁴⁴ In this sense, see Wagner 2005, and the references contained therein.

⁴⁵ It has been noted, however, that in the debate launched by the Commission on the harmonisation of contract law at the European level, some associations of SMEs have expressed their opposition to full harmonisation.

2.4.2 *Top-Down Harmonisation*

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

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

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

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

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

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

As mentioned at the outset, however, jurists tend to ignore the benefits of the current situation and the costs associated with change. Even if divergence leads to costs, it is conceivable that harmonisation would generate even higher costs.⁴⁶

2.4.2.1 A Superficial Cost-Benefit Analysis of Harmonisation

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

⁴⁶ There is a shared presumption in the literature that full harmonisation generally brings about higher costs than those caused by maintaining diversity.

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

2.4.2.2 A More Complete Cost-Benefit Analysis

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

Harmonisation generates costs of its own, which must also be taken into account. First of all, the production of the harmonised legislation is costly, involving as it does extensive background studies and discussions. Costs also arise because of the need to “develop... new bureaucracies or demolish... old structures”.⁴⁷ Costs are also incurred in order to adapt to the new rules, in terms of information spreading and re-training.

Secondly, and more fundamentally, it is a rare occurrence where the area to be harmonised is relatively autonomous within the law as a whole. More frequently, this area interacts with the rest of the law. For instance, product liability or State liability for breaches of EU law are part of the law of liability and more generally of private and/or public law. Ahead of harmonisation, each legal system is in an equilibrium of sorts: the various areas of the law are supposedly seamlessly integrated into the legal system. Top-down harmonisation, coming from the outside, implies a break within the legal system, i.e. the creation of a specific “harmonized area” which co-exists with other remaining areas. In the ideal situation, implementing (incorporating) the harmonised law should be done seamlessly, without distorting the legal system. For instance, under EU law, the very mechanism of the directive is meant to allow Member States some room to adapt the harmonised law to their legal system and thereby minimise distortions. The ideal being an ideal, more often than not harmonisation will generate distortions within the legal system or miss its goal because harmonisation is undone at the implementation stage (as mentioned above), or even both.

When faced with such distortions as a result of harmonisation, legal systems can react in two ways. Firstly, via a kind of ripple effect, the changes introduced in the harmonised area can induce further changes outside of the harmonised area in order to restore the system to a seamless equilibrium. There are numerous examples of Member States using the implementation of a directive as an opportunity to change a broader area of their law (often in a spirit of “cleaning up”). Such a ripple effect generates costs, but they are limited in time. Secondly, the legal system can treat the harmonised area as a form of foreign body (*Fremdkörper*) and seek to isolate it. For an example, see the reaction of German

⁴⁷ See Wagner 2005.

courts and writers to the introduction of State liability for breaches of EU law via the *Franovich* and *Brasserie du Pêcheur* judgments. The ensuing tension within the legal system generates costs on a lasting basis.

Moreover, the need to legislate in many languages—leading to often lamented inaccuracies, even within the same language⁴⁸—may facilitate the reproduction of the divergence in the implementation phase.

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

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

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

2.4.3 Bottom-Up Alternatives: “Legal Emulation” and the Marketplace of Legal Ideas

Between doing nothing and introducing top-down harmonisation, there is a third option, namely relying on bottom-up processes to bring about convergence when needed.

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

Of course, if divergence echoes local preferences, one could object that local law will remain in place even after the comparison. However, in many cases, the need to reduce transaction costs and improve trade will act as a counterweight and

⁴⁸ See, for example, Pozzo 2003.

will provide an incentive to move away from a law based strictly on local preferences.⁴⁹

Law and economics scholars have tried to modelise this phenomenon, giving rise to the theory of regulatory competition.⁵⁰ Regulatory competition is discussed in greater detail in [Chap. 10](#), but a few general remarks can be made here.

Regulatory competition makes a parallel between product markets and law making: they consider legal rules as a sort of “product” and depict law makers in the different legal systems⁵¹ as the suppliers of such product. On a given topic,⁵² different law-makers compete with each other for the provision of the legal rules that are more attractive to their “customers”, intended as individuals as well as firms. Those “customers”, in turn, respond by relocating in the jurisdiction whose set of rules best suits their preferences. This way, law makers are pushed to experiment and try to find out the best legal rule. This process of trial and error can lead to a certain amount of convergence, as soon as “good” rules are being discovered and can be replicated. In such case, convergence will not have been imposed by any superior authority but chosen bottom-up by the legal systems on the basis of their own costs and benefits analysis of changing an existing rule. This way, some of the costs of top-down harmonisation are avoided.

The theory of regulatory competition has been used extensively to explain developments in American corporate law,⁵³ as one of the topical legal fields where legislators compete to attract businesses to incorporate within the boundaries of their jurisdiction.

In practice, regulatory competition suffers from the restrictiveness of its assumptions.

Actually, as mentioned at the beginning of this section, the form of bottom-up solution suggested in this chapter is broader than “regulatory competition”. It extends also to a “marketplace of legal ideas” where law is central and members of the legal community are looking for the best solution to the issues they are confronted with. It broadens the idea of regulatory competition to a more general phenomenon of legal emulation,⁵⁴ by touching directly the problem of circulation of legal ideas not among the economic actors but among the legal actors and the regulators. With legal emulation, legal rules do not evolve as a sort of “side effect” of the choices of economic actors and citizens, but they are compared and chosen directly by legal actors.

⁴⁹ It has been remarked, however, that some areas of law might be deeply connected with local preferences and therefore less subject to “regulatory emulation” and that this might in particular be the case of “interventionist” law, as opposed to “facilitative” law. See [Ogus 2002](#).

⁵⁰ [van den Bergh 2000](#); [Esty and Geradin 2001](#); [Ogus 1999](#).

⁵¹ Or at different levels in a single legal system with a federal structure.

⁵² This is generally the case for legislators that, each within their geographical borders, have the power to regulate the same kind of situations.

⁵³ [Romano 1985](#).

⁵⁴ Legal emulation is developed in greater detail *infra*, [Chap. 10, Sect. 10.4](#).

Legal emulation can help explaining the move towards convergence in the field of competition law: Member States of the EU have very similar competition laws today but it has not always been so. This convergence was not the effect of an harmonisation effort⁵⁵ and perhaps the previous regimes were possibly better attuned to local preferences; yet the benefits of convergence in terms of reduction of transaction costs (including administrative costs) have played an important role in the drive towards change.

2.5 Conclusion

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

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

If the divergence problem is, in fact one of transboundary externalities, then, as it has been highlighted, non-coordinated actions might result in failures. In such cases, therefore, both explicit and conceptual divergence is probably best cured by harmonisation. This does not necessarily imply that a uniform substantive rule be imposed upon for all the involved jurisdictions. As mentioned, there are various degrees of inter-jurisdictional cooperation that can be established, relative to the problem at hand and to the jurisdictions involved. Thus, harmonisation could also take the form of a procedural framework,⁵⁶ within which to come to an agreement, or aim at establishing an appropriate (uniform) private international law rule.⁵⁷

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

“Legal emulation”—a broader version of regulatory competition extending to the “marketplace of legal ideas”—offers a valid alternative to the abovementioned solutions. It could bring about a certain degree of convergence without many of the costs of a top-down harmonisation and only where this appears to be desirable, because economic actors have revealed their preferences for a superior legal rule

⁵⁵ Of course this is not meant to deny that some adaptations were not the fruit of choice but rather the consequence of certain obligations, but the described convergence was certainly not a deliberate act of harmonisation.

⁵⁶ In this direction, Barnard and Deakin 2002, 220.

⁵⁷ In favour of this alternative, Alférez 1999.

or because regulators have been exposed to (or forced to take into account) a legal rule in force in a different jurisdiction.

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

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