AN ECONOMIC ANALYSIS OF HARMONIZATION REGIMES: FULL HARMONIZATION, MINIMUM HARMONIZATION OR OPTIONAL INSTRUMENT? \\

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‡ We are grateful to participants at the Comparative Law and Economics Forum in Madrid, the Latin American and Caribbean Law and Economics Conference in Barcelona, the SECOLA Conference in Leuven, and seminars at the Universities of Bologna, Bolzano, Tilburg, and Münster, for helpful comments and suggestions on earlier versions of the paper, to the Spanish Ministry of Innovation and Science for financial support, and to Marian Gili and Laura Alascio for excellent research assistantship. It must be disclosed that one of the authors (Fernando Gomez) is a member of the Expert Group on a Common Frame of Reference in the area of European contract Law set out by the European Commission, although the opinions expressed in this paper are strictly individual, and unrelated to the membership in that Group, and thus, are not those of the Expert Group, nor of any other of its members, nor of the European Commission.

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Abstract

At the current stage in the process of building a European Contract Law, the harmonization dimension -the scope and reach of the harmonizing effect of the European rules- appears as a crucial issue. We show how the harmonization strategy is as important a question as whether we should have European Contract Law at all. We present in informal terms a simple economic model of how to build optimal harmonized rules and standards in a setting of pre-existing separate and diverse national ones, and we systematically explore how the different harmonization regimes (maximum harmonization, minimum harmonization, and pure co-existence of harmonized and national standards) affect the outcomes of the harmonization process.
I. Introduction

The process of building a European Contract Law seems to be approaching a decisive phase. The time for general scholarly debates and competing groups reflecting on the ‘whether’ and ‘how’ of a substantive body of European Contract Law rules seems to have given way to more practical -or policy-laden- times.

For a start, there is a tangible and already widely publicized body of Model Rules (and Principles and Definitions that go with them) that is known as the Draft Common Frame of Reference of European Private Law (DCFR). The DCFR is not easy to characterize. It is undeniably an impressive output from an important academic and legal endeavour in the field of Private Law and, in particular, of Contract Law,¹ in the European context. It is intended to be, as it name proclaims, as a frame of reference for thinking, legislating and applying Private Law. It is also a toolbox, as the European Commission also labels one of its functions. Although largely academic in inspiration and spirit, and almost entirely in manufacture, the DCFR is not the typical academic product: it is not a commentary, treatise, collection of essays or papers devoted to European Private Law, or to Private Law generally. It is a body of proposed model rules, accompanied by a set of standard terms, or definitions, to facilitate

¹ Although the DFCR covers ground beyond Contract Law, and emphatically defends the choice of broad coverage (See, 23 and following of the Introduction to the DCFR in the Outline Edition), the fact is that both quantitatively and qualitatively the bulk of the DCFR is Contract Law. See on this, specially regarding the connection of the contractual dimension with others pertaining to ‘obligations’, S. Grundmann, ‘Grand European Code Napoléon or Concise Uniform Contract Law? Defining the Scope of a Common Frame of Reference’, in A. Somma (ed.), The Politics of the Draft Common Frame of Reference (Wolters Kluwer Law&Business, 2009) 22.
comprehension, use and application. Rules, with or without the addition of ‘model’ are intended to eventually govern real-world behaviour of individuals or firms, either directly, as an immediate source of legal rules, or indirectly, by the influence they can exert upon real-world law-makers in the drafting of rules that will directly govern the behaviour of economic agents in society. At least the indirect regulatory role through the EU or national law-makers is explicit in for the framers of the DCFR.²

On top of this, the European Commission appears to have taken very seriously the importance of the DCFR not only as a toolbox, but also as the basis of legislative action at the EU level that would produce harmonizing effects upon the existing situation of legal diversity in Private Law across Member States. Although the exact features and scope of that action is still undecided, the Commission has established an Expert Group³ to work over the DCFR in order to produce a streamlined text.

Moreover, the Commission has also launched a public consultation concerning the possible alternatives to which the result of that exercise may be put to use.⁴ The policy options spelled

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out in the Green Paper are the following:⁵ (1) The publication on the web of non-binding model contract rules which could be used in the Single Market; (2) a toolbox for current and future EU lawmakers; (3) a Contract Law Commission Recommendation that would call on EU Member States to include the European contract law instrument into their national legal systems; (4) an optional European Contract Law instrument, which could be chosen freely by consumers and businesses in their contractual relations as an alternative to the existing national contract laws for cross-border contracts, or also for domestic contracts; (5) Harmonisation of national contract laws by means of an EU Directive; (6) Full harmonisation of national contract laws by means of an EU Regulation; (7) the creation of a full-fledged European Civil Code, replacing all national rules on contracts.

Thus, at this moment the issue of the harmonizing scope and reach of the prospective body of European Contract Law Rules is at the forefront of the intellectual and policy debate. The importance of this dimension increases in view of the debates concerning minimum vs. full harmonization of important portions of the Consumer Acquis that has been raised by the new Directive on consumer rights, proposed by the European Commission⁶, which initially⁷ had

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⁵ Actually, there is an additional, option concerning the possible output of the Expert Group working over the text of the DCFR, that has been left unexpressed, namely to shelve it. It is unlikely that this will happen given the clear message of wasted effort (both in political and monetary terms) that such an entirely failed outcome would imply.


⁷ Due to later developments and views in the Parliament and Council the initial staunch full harmonization effect seems to be weakening towards some kind of quite undefined ‘targeted’ (ie partial or incomplete) full harmonization.
maximum or full harmonization in mind. In academic circles, the -not surprising- reception to the maximum harmonization design in a Directive with a broad material scope of application such as the Consumer Rights Directive has been overtly critical, as it would imply that pre-existing national standards -including also those more protective of consumers- would be entirely abrogated by the new European legislation, and the introduction or adoption in the future of national rules departing either way -increasing or decreasing the level of consumer protection- from the harmonized ones would also be entirely ruled out.8

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This harmonizing dimension of European Private Law has already been extensively analyzed from an economic perspective, or using economic arguments. In fact, it has attracted more attention by economists and economically minded lawyers than the content of the rules in the DCFR themselves. We have also written extensively on various dimensions and aspects of the process, and we do not intend to repeat ourselves, or not entirely, here.


In this paper, we intend to present a Law & Economic analysis of what we perceive to be the 
crucial decision dilemma facing the harmonization dimension in European Private Law, 
namely the option between 

(i) a minimum harmonization approach -traditional in the Consumer Acquis in the past- and 
which may fall under alternative (5) in the Green Paper; (ii) a maximum harmonization 
approach that would wipe out national rules and standards in falling within the material scope 
of application of the new European rules, which may correspond, with crucial differences in 
material scope, to be sure, with alternatives (6) and (7) of the Green Paper; (iii) an optional 
European Contract Law instrument that would co-exist side by side with the existing national

2009) 101; the different contributions on the content of the DCFR in G. Wagner (ed.), The Common Frame of 
Reference: A View from Law and Economics (Sellier, 2009), and in F. Chirico and P. Larouche, Economic 
Analysis of the DCFR (Sellier, 2009).

Draft Common Frame of Reference’, in F. Cafaggi and H. W. Micklitz (eds.) European Private Law after the 
Common Frame of Reference (Edward Elgar, 2009), 101; F. Gomez, ‘Some Law and Economics of European 
Economics of Private Law Harmonized Lawmaking: Mechanisms, Modes and Standards’, in R. Brownsword/ 
Harmonization, and Coexistence of Standards’ (UPF Department of Economics and Business, Working Paper, 
2010).
Contract Laws of the Member States, and which corresponds to alternative (4), and in a weaker form, (3), in the Green Paper.

Moreover, the decision about the harmonization dimension is not only important on its own, but also as a factor that has a bearing on the desirable content of the rules and standards. That is, the harmonization question and the content of the rules are not totally independent issues, as they mutually condition the optimality of outcomes. The structure of the paper is as follows: In Section 2 we present a summary of our theory of optimal harmonizing lawmaking in areas that may affect cross-border trade -such as, for reasons too obvious to elaborate, Contract Law and Consumer Law. In Section 3 we use that theory to analyze the likely consequences of the three broad harmonizing strategies outlined above, that is, if harmonized rules should entirely replace, set a floor to, or perfectly co-exist with the national rules that predated the harmonized ones. This is the theoretical debate underlying the controversies about maximum and minimum harmonization, and about the desirability of an optional instrument in Contract Law for Europe. Section 4 briefly concludes.

II. The optimal construction of harmonized European standards in Contract Law

Most of the debate, either from a Law & Economics perspective, or from other perspectives (politics, constitutional competences, comparative Law) on the process of constructing a significant body of European Contract Law, has focused on the pros and cons of the idea of harmonizing Contract Law across European countries through the use of European legislative tools. From a normative standpoint, the ‘whether’ question is not the only relevant one. The ‘how’ question is equally important, if not more. Not just in the implementation phase, but as
a crucial element to informedly answer the ‘whether’ puzzle: when one cannot find a way to build harmonized standards that seems promising or convincing enough, one would be reasonably inclined to answer the ‘whether’ question in the negative. Given the setting in which the harmonization of European Contract Law takes place, which necessarily has to be built largely upon the pre-existing and diverse national rules (already harmonized EU Law would not be comprehensive enough) to properly determine the content of the harmonized standard becomes a crucial issue, if we want the exercise to improve social welfare in European societies, and not to be just a challenging intellectual subject for academic lawyers.

For instance, should the new harmonized European standards and rules for the protection of one class of contracting parties (consumers, let’s say) simply reflect the current minimum level of protection contained in the Directives already in force, when they exist, or should they correspond to the minimum, to the average, or to the maximum levels of consumer protection now observed in the different national legal systems?

Surprisingly, the question of what factors one should take into account when building harmonized standards has not received a lot of theoretical attention neither in the legal nor in the economic literature. There is, to be sure, a very large legal and economic literature concerned with determining regulatory standards for consumer protection and in other areas of regulation, but the relationship to an explicit harmonization process seems to be lacking in the literature. In the remainder of this paper we will try to summarize the theoretical arguments that we have formally elaborated elsewhere.12

With social welfare in mind, it is very likely that the largest advantage of building and establishing harmonized legal standards of behaviour for contracting parties, in Europe as in other areas of the world, would be essentially to reduce the transaction costs in cross-border commercial activity, and thus to enlarge economic welfare arising from those increased economic interactions that cross the national borders. This may be specially true in the European context, since other obstacles (tariffs, regulatory measures with equivalent effect) have been eliminated, and one of the major policy goals in the EU is precisely to ensure a free area of trade and movement of goods, services, capital and people.

To be sure, there are costs involved in an exercise of transaction-costs-reducing legal harmonization, both in the process of constructing the standards and as a consequence of the actual implementation and imposition of the harmonized standards. These costs may well outweigh the benefits, so that the adoption of harmonized standards may reduce welfare, and not increase it, over the pre-existing scenario of diversity in legal regimes. But the positive effect, if any, of harmonized standards materializes through increased trade (which of course includes a reduction in the costs of all activities related to trade, and also the increase in the contract surplus from the interaction) by firms and consumers.

The thrust of the theory on building harmonized standards for economic transactions is that constructing optimal harmonized standards to induce trade across national borders essentially depends on the technologies (the cost functions of the firms that will produce the goods and services, on the one side, and on the preferences of the populations in the countries that build the unified standards, on the other. That is, the definition of the harmonized standards of behaviour in European Contract Law should consider the distribution of the costs of providing the products and services across the various European countries. And here the term costs does
not only refer to the material costs of production, but to any cost necessary to ensure the 
actual and satisfactory delivery of the product or service to the consumer.

The optimal building of standards should also consider the distribution of the societal 
preferences of consumers in the various Member States over the relevant issue affected by the 
behaviour that would be subject to the legal rule or standard, be it the safety of the product 
sold, the length of the seller's contractual warranty, or the level of detail on the content of the 
contract boilerplate clauses to be communicated in advance of the conclusion of the contract. 
In short, optimal standards should be essentially based on technological parameters of firms 
and preference parameters of those societies potentially harmonizing their laws.

It is of course true that weighing the effects of the considerations of the technologies and the 
societal preferences is a difficult exercise, and probably cannot be carried out in a detailed or 
specific way for many relevant areas of Contract Law or any other Law, for that matter. 
Despite these obstacles to implementing our theoretical proposal on how to build harmonized 
standards, the basic idea remains an important theoretical guidance, because it clearly points 
at the factors that an exercise in harmonizing rules and standards in Contract Law should 
consider essential, even if full information about the specific values of those factors is not 
available in many, even in most circumstances. Moreover, technologies and costs for firms, 
and consumer preferences are crucial, but also their mutual correlation, or lack thereof, is. It 
can be shown that whether the technological parameters and the parameters reflecting societal 
preferences for consumer protection are independent or correlated, and the sign of the 
correlation, if it exists, determine whether the optimal standard is intermediate between the 
pre-existing national standards, equals the more exacting standard, or even, counterintuitively, 
exceeds even the toughest standard among national Laws.
In order to better understand and assess the construction of the optimal harmonized standards it is advisable to start by considering what would be the extreme situation of no cross-border trade between the affected countries. For simplicity, let's assume that the number of countries is just two, although the theory can be extended to any larger number of countries and legal systems.

In a situation of autarky, the lawmakers in each country would ideally set the legal standards governing the relevant problem (let’s say, the extent of consumer rights vis-à-vis the seller in a given setting or contract) by looking at how costly compliance with the legal standard would be for the firms in the country, and how much and how strongly consumers in that country prefer to enjoy the set of rights corresponding to that level of legal protection. If the lawmakers in the national legal systems are benevolent and well-informed –and let's assume them to be that way, at least to compare their ideal standards with the ideal harmonized ones- they will come up with the best standards for each country, optimally balancing the costs for firms and the preferences of the consumers.

Imagine, then, that in order to allow trade to happen between the countries, so that the more efficient firms from one country –assume that these firms enjoy a cost advantage due to their technological development, or for any other reason- can enter the foreign market, it is necessary to build a single legal standard for both countries, because otherwise firms could not show that they are complying with the relevant legal requirements. The reasons for this ‘accreditation of compliance’ obstacle may be manyfold in practice, but in order to better grasp the effects of the different alternatives it is helpful to think that without some kind of common of harmonized rule or standard, it is infinitely costly to show compliance to the
relevant authorities of the foreign -to the firm- country, and/or to the foreign consumers. The next step is then to ask how should this unified standard be constructed and how it would compare to the pre-existing national standards.

As was the case with the national standards, the best way to handle the matter is to look at costs and preferences, now, due to the single and unified nature of the relevant legal standards, for the aggregate of both countries -that now would become one single market in terms of the legal requirements and accreditation of the compliance with them, and thus in terms of the firm that will serve consumers in both countries. We have to take into account the preferences in each country, weighted by the population in both of them, in order to get the aggregate magnitude.

The relationship between this new, harmonized standard and its national predecessors gives rise to different scenarios. We have essentially three of these.

(i) The single harmonized rule can be an intermediate one between the two pre-existing national ones: if country A had standard h, and country B had standard l, being h > l, the new unified standard would be:

\[ m, \text{ with } h > m > l. \]

This intermediate standard would be desirable when country A and country B have similar firms in terms of costs and technologies, but the preferences are quite different in one and the other country, and also when the country with the more efficient firms (A, in our example) also has consumers with stronger preferences for a higher legal standard. In both cases, the
adequate harmonized standard is an intermediate one between the national standard of the two countries.

(ii) The optimal unified standard can also coincide with the tougher of the pre-existing national standards, in the somewhat unusual case in which the countries have consumers with the same preferences for the level of protection, but one country has more efficient firms. If this is the case, if A had standard $h$, and B had standard $l$, the optimal harmonized standard $m$, would equal $h$, that is:

$$h = m > l.$$  

(iii) The more interesting and also the more counterintuitive case is when the two countries are diverse in firms’ costs and consumers’ preferences, so that the country with the more efficient firms (assume it is B) has consumers with weaker preferences for a higher legal standard than those of country A. Then, if A had standard $h$ and B had standard $l$, the optimal unified standard $m$ can be intermediate, but it can also be higher than $h$, if the population of country A is sufficiently large compared with the population of country B. That is, in this third scenario in which the preferences of contracting parties and the costs for firms of satisfying legal standards are positively correlated, or they are independent, the harmonized standard $m$, can be:

$$h > m > l$$  
or  
$$m > h > l$$
In other words, if the small country has the more efficient firms, and the larger country has the consumers who care more about their legal rights, it is possible to expect an efficient unified standard that is larger than any of the pre-existing national ones.

A natural corollary of the preceding analysis is that if one is concerned about reaching efficient solutions in building harmonized legal standards, the lawmaker’s task is not an easy one, since the details of the relationship between the costs for firms and the preferences of consumers are crucial for reaching the right level of the unified legal rules and standards.

III. Full harmonization, minimum harmonization and co-existence of standards

The basic theory outlined in the previous section implicitly assumes that harmonization for the purposes of improving cross-border trade requires strictly unified standards across the countries subject to the harmonization exercise. This is, of course, not necessarily true, and even it is probably untrue in many, if not most circumstances. Countries could build harmonized standards to facilitate trade, but these need not entirely replace the pre-existing national standards.

In fact, the fact that a new, harmonized standard, would co-exist or not, and under what conditions, with the national standard, is a crucial choice in the entire harmonization exercise, and one which does not have an obvious solution in theoretical terms.

In EU Law, this matter presents itself as the choice between full harmonization and minimum harmonization. As is well-known, in the context of the new Directive on consumer rights,
proposed by the European Commission,\textsuperscript{13} there has been heavy criticism in academic circles against the intention expressed in the initially proposed new Directive to make it a full harmonization Directive, which would imply that pre-existing national standards -including also those more protective of consumers- would be entirely abrogated by the new European legislation, and the introduction or adoption in the future of national rules departing either way -increasing or decreasing the level of consumer protection- from the harmonized ones would also be entirely ruled out.

Under minimum harmonization, the harmonized standard, as has mostly -though not always- happened in the past with EU Directives in Consumer Law, sets a mandatory floor in the relevant variable, parameter or behaviour, allowing the Member States to keep, or to create in the future, more exacting standards for protecting consumers, but wiping out pre-existing lower national standards, and preventing those lower standards from being adopted in the future. Under full harmonization, the harmonized standard entirely displaces and eliminates the national standards, pre-existing or future, and regardless of whether they are higher or lower than the harmonized one.

In theoretical terms, however, it must be noted that minimum harmonization is not at all equivalent to pure co-existence of standards, harmonized and national. Under minimum harmonization, standards lower than the harmonized ones are automatically eliminated, and replaced by the harmonized standards and countries with a higher standard are allowed not only to keep it, but essentially to ignore the harmonized standard, since firms operating in that national market would be forced to comply with the stricter national standard. Thus,

\textsuperscript{13} See n 6 above.
under minimum harmonization, unless there is some possibility of entry into the markets with standards that are different from the mandated by the national authorities, there would be no new cross-border.

It would be possible, however, to complement minimum harmonization with some possibility of entry, if firms using a standard that is at least as high as the national standard would be allowed to enter the national market. This would be a kind of imperfect or asymmetric “country of origin” regime that would allow trade cross-border only under standards that are higher than that of the import country, but not the reverse. Additionally, the complement to minimum harmonization may take the form of a full “country of origin” or “mutual recognition principle” which would allow firms from other countries (remember, now operating under a standard that is at least as high as the minimum harmonized standard) to enter the national markets of countries with higher standards, but not complying with these higher standards of the receiving country, but only with at least the harmonized-level.

In pure co-existence (or competition of national standards and the harmonized one, if one prefers to frame the case in this way) the harmonized standard would not replace the existing ones, regardless of whether they are higher or lower than the harmonized level.\(^{14}\) Again, two


Against the possibility of co-existence, arguing that it would eliminate all the benefits that may ensue from
versions of co-existence are theoretically possible, depending on whether the choice to adopt the harmonized set of standards or not, is given to the Governments or to the contracting parties themselves. Some argue that the latter would be equivalent to granting the choice to the firms who will be subject to them in their operations, since consumers would have no meaningful way to influence the decision by the firms. Although it is not as obvious as it may seem that consumers would "never" have a say in the choice of one or the other set of rules, for the purposes of the analysis it is not hurtful to assume that firms can decide to employ the European or their national body of rules -or both depending on the target market, if using both sets is feasible in technological and economic terms, something that will be considered below. For our theoretical analysis it is possible to disregard the legal complexities behind an EU optional set of rules in Contract Law and its technically -in the legal sense- hard to organize relationship with national mandatory rules and the Rome I Regulation.


In the first case, to have some bite in improving cross-border trade,\textsuperscript{17} this harmonized optional standard should allow the firms from the country adopting the harmonized level to be able to enter, under the harmonized standard, the national markets of other countries who have not adopted it. Otherwise, in the setting of our basic model, no country would have an incentive to adopt the harmonized standard.

The option to select the harmonized set of rules may be given to the firms themselves (or to the parties, through choice of Law in the Contract, but analytically both possibilities are very similar in our economic model of harmonization), who may decide to operate under their national standard or under the harmonized standard (or under both, if that is technologically or materially feasible). Again, if the standard has to have some bite in cross-border transactions, the firms using the harmonized standard would be allowed to enter any national market, regardless of the level of the national standard in place in such market. This model would correspond essentially to the “Optional Instrument” considered as Option 4 in the Green Paper from the European Commission, and also to the “blue button” proposal that some have advocated.\textsuperscript{18}

\textsuperscript{17} Remember, if no discernible effect over cross-border transactions takes place as a consequence of the harmonization process, this will be essentially moot, and thus essentially a waste of resources and energy, unless there are other benefits of an entirely different kind (intellectual spillovers over national legal orders, increased sense of a common destiny and even identity, and so on) which are beyond the scope of our economic theory of harmonization of legal rules, and whose magnitude, and even existence, is very hard to assess.

\textsuperscript{18} See n 14 above.
How these different ways to arrange the relationship between the harmonized standard and the national ones fare comparatively in terms of their effects on the level of the harmonized standard, on the level of cross-border trade and, ultimately, on social welfare?

The first and basic observation that will be apparent from the analysis that will follow is that the choice of harmonization regime (full, minimum, co-existence) matters for the determination of the level of the harmonized standard. This implies that one cannot treat separately the issue of the substantive level and content of the harmonized rules and standards from the question of whether these harmonized rules will constitute a new full harmonization regime, a minimum harmonization regime, or will co-exist alongside the existing national rules. They are distinct questions, but the answer to the second one conditions the first in a decisive way.

Full harmonization is analytically one of the simpler cases. In fact, it corresponds to the basic model of optimal harmonized standards outlined in section 5 above. What was summarized there with respect to optimal unified rules exactly matches the outcomes of full harmonization when the lawmaker responsible of the harmonized standards tries to reach the most efficient results given that the regime is full harmonization.
Under minimum harmonization, one needs to consider three different accompanying scenarios. The first one is that in which the adoption of a harmonized set of rules does not imply any opening up of markets for firms that do not use the national standard that, by definition, has to be higher than the harmonized one –lower national standards have been eliminated by the European standards. That is, national markets remain entirely separated. If this is the environment, then, optimal harmonized standards should correspond to the lowest pre-existing national standards, and in fact the entire harmonization exercise is useless. It is thus important to emphasize that the economic benefits of harmonizing rules and standards in Contract Law require as a necessary condition some opening of the national markets for entry of foreign firms, otherwise the efficiency gains will not appear, since national markets would still be served by the local firms, and for this scenario the diversity of national standards - reflecting the underlying actual diversity in consumer preferences and firms' costs in satisfying legal requirements - constitute a superior policy option.

Under full or maximum harmonization, given that the harmonized standard wipes out entirely the national ones, there is no room for strategic reactions by the national lawmakers in view of the new harmonized rules. Under minimum harmonization, however, given that only standards that are lower than the level imposed by the harmonized rules are eliminated, but higher ones remain always possible, national lawmakers could increase the existing standards in order to countereffect the harmonizing –and market-opening- effects of the agreed standards. If these reactions are possible, then the lawmaker in charge of the harmonization exercise should take this into account and react accordingly at the time of building the harmonized standards. In order to simplify the analysis, I do not allow for this possibility, even if not discarding the plausibility of this complication, and even its empirical relevance. It must be pointed out, however, that this opportunity for strategic behavior by national lawmakers that minimum harmonization allows would be a comparative disadvantage of minimum harmonization versus full harmonization and pure co-existence, where there is no room for these undesirable maneuvers by national lawmakers.
The second one is that of partial entry of foreign firms into national markets: foreign firms using a standard that is at least as high as the national standard would be allowed to enter the national market. That is, when minimum harmonization is combined with the possibility of entry of standards that are at least as high as the national standard, there is some chance of entry by the more efficient firms from other countries into the markets of other states. Here, let’s also assume that firms may operate under two different sets of rules, their own national standards, and the new harmonized ones, serving, for instance, their national market under the pre-existing—and higher than the harmonized one—national standard, and the foreign market under the new harmonized set of rules. I will later discuss the relevance of this assumption for the comparison between the different harmonization regimes.

What are the results in this setting of minimum harmonization with partial entry under higher standards? As under full harmonization, there are two interesting cases. In the first, the country with the more efficient firms (A, with the notation used in the previous section) also has consumers with stronger preferences for a higher legal standard. Here, minimum harmonization with partial entry would require a harmonized standard that is lower than that under full harmonization in the same case. At the same time welfare in both countries would be higher than with full harmonization: the efficient firms from country A would serve the markets of both country A and country B, but the first market (A) under the pre-existing national standard of A, and the second market (B) under the new harmonized intermediate—but lower than the equivalent standard under full harmonization—standard.

In the second case, the two countries are diverse in firms’ costs and consumers’ preferences, so that the country with the more efficient firms (B) has a consumer population with weaker preferences for a higher legal standard than those of country A. Now, under minimum
The third major scenario under minimum harmonization is that in which minimum harmonization is combined with the complete effects of the country of origin principle. The harmonized standard with the minimum harmonization effect actually eliminates the lower pre-existing standards, but the country of origin principle with full effect would allow firms to enter a foreign market under their own national standards - all of them equal to or higher than the harmonized level, by definition of minimum harmonization- and this possibility of entry will be true even if those standards are lower than the level required by the national Law imposed in the country where consumers are located, the receiving or importing country.

When minimum harmonization is coupled with full country of origin, the more interesting cases are again the two mentioned above. In the first of them, namely when the country with the more efficient firms (A) is the one with consumers showing stronger preferences for a higher legal standard, the level of the harmonized standard, and the outcomes in terms of trade exactly mirror those under minimum harmonization with partial entry. In the second case (B, the country with the more efficient firms at the same time has consumers with weaker preferences for a higher legal standard than those of the other country), the introduction of the full country of origin principle improves the performance of minimum harmonization in terms of opening trade, as one would expect, and allows higher levels of
welfare. Now, in this case, minimum harmonization with complete country of origin effect allows for intermediate harmonized standards, and simultaneously, allow that more efficient firms from the country with the pre-existing lower standard enter the market of the other country, a possibility that did not exist under minimum harmonization with only partial entry. These increased opportunities, in turn, expanding the range of optimal standards, allow us to obtain the welfare gains of increased cross-border trade with less distortion in the satisfaction of consumers’ preferences for the level of protection in the country that possessed the lower pre-existing standard.

Finally, let’s turn now the attention to the option of the regime characterized by the co-existence of (harmonized and national) standards. Again, let’s first assume that that firms may operate under two different sets of standards and rules, their own national ones, and the harmonized ones, although later it will be shown how significant are the consequences of modifying this important assumption for the outcomes of a harmonization process.

In this setting, the performance of the co-existence regime is excellent. It is always as good as minimum harmonization in many cases, and in the remaining important case, namely where the country with more efficient firms is also that with a population of consumers with lower valuation of the protection provided by higher legal standards, it outperforms minimum harmonization in any of the versions that have been explored above. In other words, it performs better than minimum harmonization, both uncoupled or coupled with partial entry or with full country of origin principle. The reason is that in this case, the optimal harmonized standard under co-existence of harmonized and national standards allows the more efficient firms to be fully able to serve all markets: the market with the pre-existing lower standard will be served with that national standard, and the other market –that of the country with a
previous higher standard—will be served with the harmonized standard, which will be exactly tailored for the consumers’ preferences of that country, given that it is being served by the more efficient foreign firms.

In fact, it can be shown that under the above explained assumption that firms are able to operate subject to more than one standard, a regime of co-existence of harmonized and national standards leads, if the lawmaker establishing the national standards strives for efficiency, to the first best solution for consumers and firms in all affected countries.\

To sum up the relative advantages and disadvantages of the various alternative regimes organizing the harmonization of rules in Contract Law (and in other areas as well, since the theoretical issues are likely to be similar) it is possible to conclude that full harmonization has the potential to produce significant gains in terms of reduction legal obstacles to cross-border trade, since the elimination of legal diversity is radical and complete.\


This is probably an exaggeration, since even under full harmonization of a given area of the Law, however ample this may be (such as Private Law) many important features and properties of the national legal systems will remain separate and diverse (procedures, courts, legal culture and tradition, and so on). This will obviously reduce the positive impact of full harmonization in promoting cross-border transactions. See, for this and similar arguments, F. Gomez, ‘The Harmonization of Contract Law through European Rules: A Law and Economics Perspective’ (2008) European Review of Contract Law, 89; G. Low, ‘The (ir)relevance of Harmonization and Legal Diversity to European Contract Law: A Perspective from Psychology’ (2010) European Review of Private Law, 288.
harmonization, however, forces important welfare sacrifices in terms of the appropriate matching of the level of the standard to the local preferences of the affected countries and societies, since all of them are subject to the same level of protective rules, disregarding the may be importantly divergent preferences across countries over the issues subject to the harmonized rules.

Thus, the existence of several standards –which will fall short of true full harmonization- may improve welfare since they allow a better match between consumer preferences and the level of the standard, even if they sometimes fail to realize the full potential gains from trade across the national borders. That is, it may be better to allow some barriers to cross-border trade in place as a consequence of legal diversity, in order to better adapt the standards to which products and services should be subject to societal preferences over the level of consumer protection that is deemed desirable. It is true, though, that softer forms of harmonization, such as minimum harmonization, unless one wants them to be entirely moot in showing some significant effect on improving cross-border trade activity, need to be supplemented by measures that guarantee some entry by the more efficient firms into the markets of other countries. That is, softer forms of harmonization require that the national standards do not remain entirely entrenched, and the markets continue to be totally separated.

Accordingly, a complete, or at least an attenuated version of the country of origin principle would allow for this improvement in cross border trade -although to a lower extent than full harmonization, but with better outcomes in terms of respecting variety in societal preferences for the level of the legal standards.
Minimum harmonization, however, may not be the optimal regime even if one is very concerned with preserving a good match between the level of the standards and the preferences of the citizens in each country. There may be even greater potential welfare gains in allowing that national and harmonized standards coexist, that is, in using an even softer approach than minimum harmonization. Thus, harmonized rules and standards in European Private Law could be thought as instruments to be deployed alongside existing national standards, and not replacing even the standards that are lower than the harmonized one, at the same time allowing the most efficient firms to exploit the gains from cross-border trade, given that, at least arguably, the harmonized standards could be able to overcome the existing barriers preventing active transactions serving consumers across national borders, while simultaneously being respectful of the real diversity in Europe, in terms of the preferences and the basic economic conditions of the societies in which the rules are to be applied. Indeed, when firms are flexible enough in their technologies and cost functions, so that they are able to operate under more than one set of standards, this regime allowing perfect co-existence of standards, national and harmonized (European, in our case) is the best strategy to go ahead with harmonization.

It must be clearly underlined, though, that the advantage the co-existence approach to harmonization crucially depends on the assumption already mentioned several times along this section, namely that firms are not forced (for technological, economic or other reasons) to provide goods and services only and solely subject to one single set of rules. If this assumption is not met, and firms can only do business under one single set of legal rules and standards, one is squarely back in front of the fundamental dilemma of harmonization as an instrument to reduce transactions costs in cross-border transactional activity, and namely the trade-off between gains from trade and the matching of legal rules and standards to societal
preferences and local conditions. One could argue, however, than in the different areas of the Law directly affecting contracting and cross-border trade, it is possible to distinguish between two kinds of rules and standards. Some -let's say, safety requirements of products, standards determining quality levels in goods and services- impact the behavior and decisions by the agents in a kind of durable or rigid way, so that it is difficult to act and serve markets under more than one set of rules and standards. For instance, probably economies of scale make it too expensive to build a production plant with diverse production chains depending on the standard of the market in which the goods will be sold. Others may have little or no impact on the fixed costs of the firm, and may affect behavior only after the fundamental productive decisions have been taken, allowing the firm to tailor the product or service to more than one governing standard. Plausibly a large part of traditional Contract Law may fall in the second category, because firms, even with the same product and service for all markets, may be able to adjust the terms of the contract with the other party to the requirements of diverse national or harmonized Contract Law rules and standards. Probably this would not cover the entire area of Contract Law, but arguably a major portion of it. This sub-set of Contract Law rules would be a natural candidate for harmonization in the form that I have labeled co-existence of standards, and the European Commission and others refer to as an optional Contract Law instrument.

At a general level, the fundamental dilemma between lower transaction costs in cross-border trade, and satisfaction of local preferences and conditions does not have a general theoretical answer. It brings to the forefront, however, the choice between full harmonization as the most powerful engine to ensure gains from trade, and co-existence of standards as the mode of harmonization that better serves to preserve and satisfy variety in societal preferences over the substance and level of the legal rules and standards. Minimum harmonization, although
being sometimes more appealing than maximum harmonization would be dominated by the softer and looser approach of allowing full co-existence of national and harmonized standards, regardless of their relative levels.

IV. Conclusions

At this stage in the construction of European Contract Law, after the DCFR, and in the face of the policy options described by the Green Paper of the European Commission, it seems uns escapable to deal with a crucial issue that appears to have been overlooked by the EU institutions, and by both lawyers and economists dealing with harmonization of Contract Law in Europe. It is the theoretical account of how to determine the harmonized standards in the presence of pre-existing national rules. We present here the sketch of a theory of optimal decision making in a harmonization process, a theory that extends to the various modes and regimes to organize the position of the harmonized rules and standards and the national standards of the countries affected by harmonization. The costs for the firms (the agents, in general, be they firms or not, although the most natural setting is that of firms) subject to the standards, and the preferences in the different societies regarding the substance and level of rules and standards are the key factors to take into account in building the harmonized rules. The choice of harmonization regime, that is, whether the outcome should be full harmonization, minimum harmonization or simply a co-existence of a new harmonized standard with the old national sets of rules, can be shown to be decisive for the substantive decisions over the standards.
The choice among regimes, moreover, should try to effectively reduce barriers for cross-border commercial activity while at the same time trying to preserve the alignment between the substantive standards actually applied in the different countries, and societal preferences in each of them. In this respect, the optional instrument solution appears as an attractive alternative, and it can be shown to be superior to minimum and maximum harmonization when it would be technologically and economically feasible for the firms subject to the legal rules to use both a national standard and a harmonized European one, arguably a scenario that can be applied to a significant fraction of Contract Law. When this is not the case, and only one standard at a time is feasible, the efficiency advantages of the optional instrument clearly decrease, and maximum or minimum harmonization increase their appeal.

In any event, from an economic perspective, absent clear and positive impact on cross-border trade, the harmonization exercise in contract Law would largely remain a pure intellectual enterprise, however fascinating it may be for its own sake.

**V. Bibliography**


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