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Wolfgang Kerber

**European System of Private Laws:
An Economic Perspective**

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European System of Private Laws: An Economic Perspective

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1. Introduction

Similar to legal scholars, economists also have based their theories on public policy on the fundamental difference between the (sovereign) nation state and the international (or global) level. The policy aim was the promotion of the welfare of the population in the nation states; therefore the nation state was the "natural" place for the competences of economic and social policies. Beyond the level of nation state, economics has always emphasized the importance of the international division of labour, based upon economic theories of international trade. Although the need to have an institutional framework for international trade (esp. for enforcing free trade) has always been stressed, these international rules, based upon international treaties, have been seen in economics as very special rules - in much the same way that international law has been viewed from the perspective of the legal systems of the nation states. This paradigm of the strict separation of the national level and the international level has been increasingly questioned since the 1990s, because it no longer seems to grasp the recent economic, social, and legal developments in a globalised world.

In political science, the law, and economics, more or less elaborated notions of multi-level governance or multi-level systems of jurisdictions have been suggested as an alternative approach.¹ This is also linked with the thesis of the decreasing importance of the traditional nation state. This change of perspective seems necessitated by several major developments of the last two decades:

(1) Through liberalisation and technical progress the mobility of firms and productions factors (esp. capital) has increased tremendously. This mobility leads to a vigorous competition of states, regions, and communities (as territorially defined jurisdictions) for firms and investments and thus to interjurisdictional and regulatory competition. Due to this mobility, the jurisdictions have lost much of their traditional monopolistic power. This loss limits their scope of economic, social, and legal policies considerably.

(2) The nation state has also lost its exclusive regulatory powers through the emergence of a multi-level system of jurisdictions. Regulatory powers are increasingly allocated to different jurisdictional levels within a multi-level system of governance, as e.g. to international bodies, the EU, the traditional nation state, and regional and local jurisdictions.

(3) Another development contrary to traditional notions is that regulatory powers are not only exerted by states and public agencies, but can also be applied by private organisations or by

¹ See, e.g., Marks, Hooghe, and Blank (1996), Heritier, Stolleis, and Scharpf (2004), Cafaggi (2006b), Cafaggi and Muir Watt (2007), and Feld and Kerber (2006)

complex mixtures of public and private agencies (private regulation, private-public partnership). This also implies a blurring of the traditional strict separation between public and private law (Cafaggi and Muir Watt 2007).

Although these developments are also very important at the global level, the concept of a multi-level system of governance is especially crucial for European integration. The completion of the internal market through the enforcement of the fundamental freedoms has increased the mobility of persons, firms, and capital within the EU to an unprecedented extent. This has led to a serious limitation of the regulatory powers of the Member States, shifting many competences from the Member State level to the EU level. It has triggered a very controversial discussion about the appropriate degree of centralisation / harmonisation or decentralisation, and whether and under what conditions interjurisdictional and/or regulatory competition might have more positive than negative effects. This new approach of a multi-level system of jurisdictions can be very helpful for the discussion about the future development of the EU. It can help to avoid the fallacy in shaping the EU according to the old model of a nation state, because this would imply that the "natural" place of all relevant policy competences and regulatory powers is on the EU level. From the perspective of the proponents of a multi-level governance approach, this solution would be much too simple and crude for the complex structure of problems that have to be solved within the European Union.

This paper aims to develop a theoretical framework for the analysis and design of a European System of Private Laws from an economic perspective. Based upon this multi-level governance approach, it will use criteria from economic theories of federalism and regulatory competition to analyze the optimal degree of centralisation / decentralisation of legal rules for markets within a two-level legal system consisting of legal rules on the EU and the Member State level. Since private laws also encompass a considerable amount of mandatory legal rules, leading to the increasingly fuzzy distinction between public and private law, the legal rules I am focusing on in this contribution encompass both traditional private law rules that facilitate market exchange as well as mandatory (public or private law) rules for the regulation of markets. Also, new forms of regulation as sophisticated market solutions (as private regulations) or self-regulation will be considered. This contribution aims to elaborate a set of economic arguments that should be taken into account for the shaping of an European System of Private Laws and Regulations. In other contributions (with Stefan Grundmann) this approach has been applied to the more specific problem of a European System of Contract Laws.²

The normative perspective used in this contribution is based upon the approach of constitutional economics (Buchanan 1986; Vanberg 2005), which views consent and thus the preferences of the citizens as the decisive normative criterion. In contrast to mainstream welfare economics, the approach of constitutional economics allows for a much broader and more differentiated set of normative reasonings. In addition to an increase of economic welfare through an improvement of allocative efficiency (static efficiency) and innovations (dynamic efficiency), the aim of ensuring individual freedom (private autonomy) and some kinds of redistribution (as ensuing from notions of "social justice"), and therefore certain economic and social rights, can also be derived from the perspective of constitutional economics.

This contribution claims that economic theory is able to provide a number of theoretically sound and/or empirically confirmed criteria capable of addressing the problem of how a consistent two-level system of private laws and regulations that is oriented to the preferences of

² See Grundmann and Kerber (2002); Kerber and Grundmann (2006).

the citizens of the EU might look like. Of course, this approach allows that it might also be advisable to apply additional (non-economic) approaches and criteria. The following economic theories are seen as particularly important: (1) Law and economics, (new) institutional economics, market failure theory, and economics of regulation.³ (2) Economic theories of federalism, interjurisdictional / regulatory competition, and legal federalism.⁴ (3) Economic theories of economic integration and international trade.⁵ (4) Constitutional economics and public choice / political economy.⁶

The paper is structured as follows: The question as to whether and to what extent markets need rules and regulations is analysed in section 2. A broad set of (private and public) solutions for the most appropriate institutional framework of markets exists, which must be analysed comparatively in order to minimise the problems of market and state failure. Section 3 introduces the notion of a multi-level legal system. It begins with an overview of the most important criteria for the vertical allocation of regulatory powers and follows with a discussion about the different types of regulatory competition as well as their attendant advantages and disadvantages. General conclusions about the typical problems and results of an application of these economic approaches follow. The problem of the appropriate governance of a European two-level system of private laws and regulations (rules of the allocation of competences and conflict of law-rules) is analysed in section 4. This includes both the problem of ensuring the innovativeness and adaptability of the two-level private law system as well as its responsiveness to the preferences of the citizens. Some general conclusions follow in section 5.

2. Private law and regulation

From a traditional economic perspective there is a strict dichotomy between the market as the place for the free exchange of goods and services on one side and the state as the agency that can apply legitimate power to enforce mandatory rules for regulating markets, to levy taxes and to offer public goods and redistribution. This dichotomy between free markets and the state is reflected in the traditional dichotomy between private law and public law. Also, from an economic point of view the core of private law primarily consists of the protection of property rights, entrepreneurial freedom, and freedom of contract as central ingredients of private autonomy. Private law should help the free cooperation of the private parties, e.g. by reducing transaction costs through facilitative contract law (default rules, civil courts as arbitrators, enforcement of claims) and through protection of property rights (protective state). By contrast, public law has been accepted as necessary for solving problems of market failure and achieving all kinds of politically determined non-economic aims. However, from an economic perspective public law has always been viewed with suspicion, due to its dangerous potential

³ See, e.g., Eucken (1952), Cooter and Ulen (2004), and Furubotn and Richter (1997).

⁴ For the economic theory of federalism see Breton (1996), Inman and Rubinfeld (1997), and Oates (1999); for theories of interjurisdictional competition see Tiebout (1956), Kenyon and Kincaid (1991), and Feld (2000); for theories of systems competition and regulatory competition see, e.g., Vanberg and Kerber (1994), Bratton and McCahery (1997), Sun and Pelkmans (1995), Esty and Gerardin (2001a); for an economic approach to legal federalism see Easterbrook (1994), Van den Bergh (1996), Kerber and Heine (2002), and Grundmann and Kerber (2002).

⁵ See, e.g., Balassa (1962), Alesina and Spoloare (2003), Alesina, Spoloare, and Wacziarg (2000).

⁶ See, e.g., Buchanan (1975, 1986), Mueller (2003), and Vanberg (2005).

to impede or even eliminate the working of markets and competition. These suspicions have been confirmed by extensive historical experience in the 20th century with the devastating consequences of many interventionist policies, most of which used public law instruments. In response to these negative experiences, deregulation, liberalisation and privatisation appeared with more frequency across the globe, beginning in the 1970's.

There is a broad consensus in economics that markets always need a stable institutional framework to ensure proper function. Therefore, the often mentioned notion of "free markets" can be misleading. It is not true that deregulation implies the step-by-step abolishment of all mandatory rules for markets, leading to a "market", in which sellers and/or buyers do not have to abide by any mandatory rules. Markets as places for the free production and exchange of goods and services between sellers and buyers require a set of mandatory rules. In particular, the German approach of Ordoliberalism (Freiburg School of Law and Economics) was among the first to clearly postulate the necessity of an institutional framework for markets. The ordoliberals claimed that the state has the task to create and enforce a stable set of legal rules for the market ("competition order"), but after implementation the state should refrain as much as possible from additional policies that intervene in the market process (Eucken 1952, Vanberg 1998). In particular, Vanberg reformulated this ordoliberal idea by applying the approach of constitutional economics (Buchanan 1986). Using the differentiation between the "rules of the game" and the "moves (of the players) within the game", the problem of the appropriate institutional framework for markets can be reformulated as the question of the optimal set of legal rules for the market game, which would lead to the best outcome in regard to the preferences of the market participants as the players of the game. From Vanberg's perspective, the question of the proper rules of the market is a constitutional question ("constitutional liberalism").⁷

In order to ensure the proper working of markets, economics can provide a number of recommendations about suitable institutional frameworks. The legal framework of an economy should encompass an appropriate definition and protection of property rights in regard to all kinds of goods and resources as well as their protection against theft, destruction and other kinds of infringements (protective state; Buchanan 1975). The legal order should also ensure private autonomy in the form of entrepreneurial freedoms; freedom of contract is the basic precondition for the decentralised system of a market economy. From an economic perspective, the protection of property rights, private autonomy, and freedom of contract facilitates cooperation and exchange between private parties by reducing the costs of defending one's property, life, and freedom, and the costs of transactions for bilateral and multilateral cooperation and exchange. The *facilitative (or enabling) function of the legal order* of the state serves to reduce transaction costs. It also provides the services of courts as arbiters in conflicts (about property rights or contracts), it regulates standard contracts (as default rules with low transaction costs allowing the saving of ex-ante negotiation costs) and implements coercive measures for the execution of claims.

However, mandatory legal rules are not only necessary for the protection of property rights and private autonomy (as, e.g., the prohibition of theft and fraud), but are also needed for

⁷ See, in particular, Vanberg (1999, 224): Such an approach " ... assumes that the working properties of market processes depend on the nature of the legal-institutional framework within they take place, and that the issue of which rules are and which are not desirable elements of such frameworks ought to be judged as a *constitutional issue*, i.e. in terms of the relative desirability of relevant constitutional alternatives" (emphasis in the original). See also Vanberg (2005); it should be noted that here the term "constitutional" does not necessarily imply that this must be a matter of constitutional law, as it is understood by legal scholars.

solving a broad set of market failures. Welfare economics has developed a sophisticated theory of market failures which serves as the central theoretical basis for policy recommendations. The most important kinds of market failures are competition problems (natural monopolies and private restraints of competition: sector regulation and competition law), information problems (leading to a wide scope of mandatory information regulations and other consumer regulations), negative externalities (environmental law, tort law), and positive externalities (leading to the incentive problems for new knowledge: intellectual property law). In all of these (and other) cases of market failure, economic theory can show that mandatory legal rules might help to reduce the negative welfare effects (*regulatory function of legal rules*). If other aims than economic welfare should be pursued in a society, as, e.g., individual freedom or some kind of distributional aims (social justice), then regulations as mandatory legal rules might also be an appropriate instrument for achieving these additional aims. However, economics recommends a careful analysis of the economic effects of regulations in pursuit of non-economic goals in order to ensure that the welfare costs of these regulations do not exceed the benefits.

From the perspective of economics all mandatory legal rules (as all other coercive measures of the state) are a dangerous kind of policy measure. This is not only true because they interfere with private autonomy, but primarily because they can be misused by self-interested politicians, bureaucrats and interest-groups. In economics the institutional approach of public choice has analysed since the 1960s the dangers of *rent-seeking behaviour* of interest-groups. In the economics of regulation the problem that all kinds of regulations are prone to be influenced by regulated industries (capture theory) is well confirmed both by theoretical analyses and empirical studies (Mueller 2003). Another important type of state failure is caused by *knowledge problems*. The outcome of policy measures often differs significantly from the expected and intended results. The reason is that the state, public agencies, and courts often have only a very limited knowledge about the effects of policy measures or legal rules. Therefore, regulatory policies always have to take into account the possibility of regulatory failure due to serious limits of knowledge (Hayek 1973, 1996; Wegner 1997).

The consequence of the emergence of the problem of state failure is that policy-makers have to balance the negative effects of market failures on welfare and other aims with the negative effects of state failures due to rent seeking and knowledge problems. Nearly 40 years ago, Demsetz (1969) analysed the problem of balancing the costs of market and state failure very clearly. His methodological solution is the well-known approach of *comparative institutional analysis*. To solve a certain problem or achieve a certain policy aim, policy-makers should make a comparative analysis of alternative institutional options and take into account the problems of both market and state failure. If the costs of a public policy solution exceed the costs of the market failure, non-remedy of this market failure is the best policy option. An important advantage of comparative institutional analysis is that it is very open to a broad set of institutional solutions that can be compared with each other. From this economic perspective, it is not very important whether the legal solutions (even regulations) are part of the traditional realms of private or public law. Therefore, the observed recent blurring between private and public law (and even combinations of both) does not present a serious problem to the economic approach of comparative institutional analysis.

A fascinating development of the last two decades is the manner in which the range of institutional solutions in regard to solving problems of market failure and other problems has broadened significantly. The dichotomy between market and state solutions has dissolved considerably, and a number of intermediate solutions as new modes of governance have emerged. So far, not all of these new types of institutional solutions have been analysed thoroughly by

economists. In the following, a brief enumeration of important types of institutional solutions is presented:⁸

- *Market solutions / private regulation*: In market failure theory, the so-called "market solutions" encompass a broad number of institutions and strategies, which firms in the market can use (or which emerge spontaneously in the market) for solving or at least reducing market failure problems. Particularly in regard to information problems, the reputation mechanism, (voluntary) certification solutions, or the emergence of information intermediaries are examples of such self-remedying powers of the market. The term "private regulation" can be associated with a number of these market solutions.

- *Self-regulation / corporatist solutions*: An industry or a trade can also attempt to solve certain problems by establishing their own rules for this sector. They can be entirely voluntary (as some codes of conduct), or fully mandatory as corporatist rules for professions or somewhere in between as, e.g., self-commitments of industries. These solutions are often called "self-regulation", they have, however, some similarities with well-known corporatistic solutions. The basic idea is that these rules replace public regulations. Their enforcement, however, is often supported by the state, or at least by the threat of enacting public regulation ("shadow of the law").

- *Facilitative law*: As already mentioned, facilitative (or enabling) law encompasses the entire supply of non-mandatory legal rules and institutions that private parties can use for facilitating their transactions. These legal services are offered by the state, but the private parties can choose to use the default rules of standard contracts instead of writing detailed contracts. Therefore, these legal rules and institutions are fully compatible with freedom of contract.

- *Mandatory legal rules / regulations*: They entail all kinds of public and private law rules that are mandatory for private parties. Mandatory substantive regulations refer to all mandatory rules that restrict freedom of contract or the design or composition of products or services that are offered on the market. By contrast, mandatory information regulations are rules that regulate the information duties of the parties in regard to the product or service of the transaction. Although the latter are also mandatory, they interfere to a much lesser degree with freedom of contract, because they do not restrict the contract or the transaction itself, but only oblige the parties to disclose proper information.

- *Regulatory agencies and enforcement*: The institutional structure of regulatory activities and the enforcement of regulations can be very different. Besides traditional public authority (competition authorities) private agencies can also fulfil the task of regulating certain activities, and might even be authorised to exert coercion. Similarly, public regulations can be enforced through private parties, e.g., through private litigation. In particular, combinations of public and private solutions are possible.

- *Conflict resolution*: It is a remarkable development that private arbitration has received increasing importance for solving conflicts, esp. in regard to contracts between private parties on the international level. In some respects, private arbitration replaces traditional courts, in other respects, it complements current institutions, because in certain cases the judgments of arbitration courts still need judicial recognition of the states.

⁸ For a very interesting, rich analysis of new modes of governance regulation, see Cafaggi (2006a).

The optimal institutional solution to market failure problems must not provoke too many state failures. In order to arrive at such a solution, one must analyze each problem separately. In particular, it is possible that sophisticated combinations of different solutions might be most suitable. For example, for certain problems private regulations supported by minimum mandatory information regulations can be the best solution; in other cases some kind of self-regulation in combination with a public authority for impeding its abuse for rent seeking interests might be optimal. In reality, we already can observe a large range of complex combinations of different solutions. Due to the above-mentioned knowledge problem, we cannot expect that the existing solutions are inevitably superior. For many legal rules and regulations, economic and legal discussion speaks to a number of unsolved problems, hinting at the necessity of improvement. Technologies and problems are bound to change so even currently adequate solutions must ultimately be adjusted, making innovativeness and adaptability essential. In addition to the problem of appropriate institutional framework for markets, the next question, discussed in the following section, addresses at which level of a multi-level legal system certain kinds of regulatory problems should be solved.

3. Multi-level systems of private laws and regulations

3.1 Multi-level legal systems: An introduction

In reality a kind of multi-level legal system already exists. Legal rules on the international level are enacted through international treaties (including different kinds of international courts or conflict resolution mechanisms). In Europe, the EU level contains primary and secondary EU law as well as the European Court of Justice. The traditional national legal systems of the Member States with their own systems of civil, public and constitutional courts are located a level below. Depending on the extent of federalism in the Member States, regions and communities might be able to enact and enforce legal rules. In the following, we mostly focus on a two-level system of private laws and regulations at the EU and Member State level. However, legal rules on the international level as well as self-enforcing private rules and regulations beyond the legal orders provided by states can be important for the working of the entire multi-level system of legal rules and regulations.⁹

Theoretically, a multi-level system of (territorially defined) jurisdictions can be assumed to have the following characteristics (Feld and Kerber 2006): Each of these jurisdictions has a territory (with geographical boundaries), a population (as citizens) as well as a political system with a constitution, parliament (as legislator), government, and a judicial system (with courts). From the perspective of economic club theory, each of these jurisdictions can be interpreted as a club, in which the citizens as members of the club decide on the membership fees (taxes) and the collective goods and services the management of the club provides for the club members.¹⁰ In a multi-level system of jurisdictions a citizen is simultaneously a member of several (hierarchically connected) clubs, e.g., the author is a citizen in the city of Marburg, in the Bundesland Hessen, in the Federal Republic of Germany, and in the EU. A citizen has rights as well as duties in each of these jurisdictions. Since each jurisdiction can have its own

⁹ For a broad and theoretically very interesting analysis of consumer law on the international and global level, which also takes into account transnational law and private ordering, see Calliess (2002; 2005).

¹⁰ For a sophisticated application of economic club theory to interjurisdictional competition, see Vanberg (2004).

legal system, a more or less complex multi-level legal system can emerge. In relation to a multi-level system of jurisdictions, the more narrow approach of a multi-level legal system focuses only on legal rules and regulations, i.e., their legislation and enforcement as well as the court system for conflict resolution.

Difficult problems arise for a multi-level legal system when delineating the competences of the legal orders in order to avoid conflicts between legal rules. Conflicts between legal orders can emerge horizontally between legal orders on the same jurisdictional level, e.g. between German and French regulations. There can also be vertical conflicts of competences between two different jurisdictional levels, as, e.g., between EU law and legal rules of the Member States. On the horizontal level, the traditional rules of international private law attempt to solve this task of delimiting the competences (conflict of law-rules). Rules for allocating competences on different jurisdictional levels, depending on the extent of centralisation or decentralisation, determine the vertical allocation and delimitation of competences. However, citizens as well as jurisdictions have rights within such a multi-level legal system. In particular, citizens can have rights to choose between jurisdictions (rights of mobility as, e.g., the fundamental freedoms in the EU) or between legal rules of different legal systems (free choice of law). A crucial question is whether a multi-level legal system has a supreme court, which has the authority to decide on all conflicts between the different legal orders, or what alternative mechanisms for dispute settlement exist.

There might be a broad consensus that this approach of multi-level legal systems can be helpful for analysing the recent developments of the international and European structure of legal rules. A much more controversial question is whether such multi-level legal structures should only be seen as a transitory phenomena, which in the long run will be superseded by a unitary legal order with the optimal uniform legal rules. From this perspective, multi-level legal systems might be temporarily inevitable due to the inability of jurisdictions to agree on uniform rules. However, a process of convergence and harmonisation should be pursued in order to achieve an integrated legal order with fully harmonised legal rules. Economic theories of federalism would support a fundamentally different perspective: In the long run complex multi-level legal systems can be appropriate legal structures with more advantages than disadvantages compared to a centralised legal order with uniform legal rules. From that perspective the crucial research question aims to find the optimal structure of such a multi-level legal system. In the next sections, the economic theories of federalism and regulatory competition are used to derive assessment criteria for searching for the optimal vertical allocation of competences for legal rules and regulations within a multi-level legal system. This perspective also implies that convergence and harmonisation of legal rules need not be an appropriate strategy.

An important example is the discussion on contract law in the EU. The current situation is characterised by the parallel existence of a number of fragmented EU rules on contract law and the traditional contract laws of the Member States. In recent years, an intensive discussion has emerged about the development of contract law in Europe. This was propelled by a Communication on European Contract Law in 2001, in which the EU Commission (2001) claimed that the differences of contract laws between the Member States can be an impediment for the internal market. In this context, the project of an Optional European Contract Law Code appeared as one of the possible solutions. One of the crucial questions in this discussion is whether the future development of contract law within the EU should be seen as a long-term process of convergence and harmonisation, in which, ultimately, European contract law will replace the national contract laws of the Member States completely. Alternatively, should the final solution resemble an optimal combination of harmonised EU contract law and different national contract laws? On the basis of economic arguments, Grundmann and Kerber

have pleaded for a two-level European System of Contract Laws, which combines the advantages of centralised and decentralised rule-making as an appropriate long-term solution. From that perspective, an Optional European Contract Law Code (with considerable rights for choice of law for private parties) could be an important element within such a long-term two-level system of contract laws, whereas from the perspective of a uniform contract law the optionality of this European Code would only be temporary until the abolishment (or full harmonisation) of the national contract laws.¹¹

3.2 Economic theory of legal federalism I: Criteria for the optimal vertical allocation of competences for legal rules and regulations

The economic theories of federalism and interjurisdictional competition provide a broad set of criteria for the problem of the optimal degree of centralisation and decentralisation of competences (for public goods and services, public policies, and taxes) in a multi-level system of jurisdictions.¹² Traditionally, the economic theory of federalism has focused on public goods and taxes, neglecting the issue of legal rules and regulations. However, arguments of federalism theory, law and economics as well as some recent literature on regulatory competition, have been combined to develop the first approaches for an economic theory of legal federalism (or multi-level legal systems).¹³ In this context, a broad set of economic criteria were elaborated, in order to address the question raised above: What is the optimal design of a multi-level legal system? This includes the optimal degree of centralisation or decentralisation of legal competences as well as the optimal type and extent of regulatory competition and free choice of law in such a multi-level legal system. Figure I lists seven groups of economic criteria, deemed potentially relevant for this problem. The first five groups of effects (I to V) refer to positive or negative effects on (static or dynamic) welfare. The sixth group allows for the consideration of additional normative criteria and is therefore an open group that can be supplemented by additional aims. Group VII takes into account the effects of regulatory competition, effects which will be examined further in the next section.

¹¹ For this discussion on the future development of European contract law, see EU Commission (2001), Grundmann (2004), Weatherill (2004), Kerber and Grundmann (2006), and Röttinger (2006).

¹² See, e.g., Oates (1999), and, as a recent survey, Feld and Kerber (2006).

¹³ See, e.g., Easterbrook (1994), Van den Bergh (1996, 1998, 2002), Bratton and McCahery (1997), Trachtman (2000), Kerber and Heine (2002), Grundmann and Kerber (2002), Kerber and Grundmann (2006).

Figure 1: Economic Criteria for the Optimal Vertical Allocation of Legal Competences in a Multi-level Legal System¹⁴

<p>Group I: Costs</p> <ul style="list-style-type: none"> - static economies of scale - informations (and transaction) costs - geographical scope of problems (externalities) - consistency of legal order - barriers of trade / distortion of competition 	<p>Group III: Knowledge and innovation</p> <ul style="list-style-type: none"> - decentralised knowledge - Innovation and adaptability
<p>Group II: Heterogeneity</p> <ul style="list-style-type: none"> - heterogeneity of preferences - heterogeneity of problems 	<p>Group IV: Political economy problems</p> <ul style="list-style-type: none"> - Rent seeking problems - politische transaction costs
	<p>Group V: Path dependence</p> <ul style="list-style-type: none"> - historical status quo-situation - dynamic economies of scale
	<p>Group VI: Additional normative criteria</p> <ul style="list-style-type: none"> - distributional criteria - individual freedom / private autonomy
	<p>Group VII: Regulatory competition</p>

The first group "costs" encompasses a broad set of criteria, which refer to different kinds of costs and welfare losses that might be caused through the vertical allocation of legal rules or regulations. *Economies of scale* can emerge both in the process of the production or application of legal rules and regulations. For example, the enactment of legal rules through parliament entails set up-costs, which have the character of fixed costs, i.e. they have to be borne independently of the scope of application of a law. For the question of centralisation or decentralisation this implies that in a multi-level system with more decentralised competencies the set up-costs multiply compared to a centralised system. Therefore, in a harmonised system the economies of scale of the application of the law, which emerge because the marginal costs of additional users of the law are very low or even zero, can be utilised much better. Economies of scale can also be relevant in regard to the use of the legal knowledge (human capital) of lawyers and judges. Another important type of costs are *information and transaction costs* for private parties that are caused by the existence of different legal orders within a multi-level legal system. In regard to a number of legal initiatives, the EU Commission (2001) has argued that differences in contract laws leads to additional information costs and thus to higher transaction costs, which, in regard to cross-border transactions, might be considerably lower if the legal rules were harmonised.

The criterion *geographical scope of problems (externalities)* refers to the idea that the geographical scope of a problem does not coincide with the geographical scope of the legal rules. One example is merger policy: The effects of a merger on competition can extend beyond the jurisdiction in which the merger takes place. Therefore, the positive or negative merger decision of a competition authority affects markets in other countries and can lead to positive or

¹⁴ See for similar lists of criteria and their discussion, Kerber and Heine (2002), Grundmann and Kerber (2002), Van den Bergh (2002), and Kerber and Grundmann (2006, 221).

negative externalities. The discussion about international competition problems demonstrates that externalities can lead to welfare losses due to an insufficient consideration (i.e., internalisation) of external effects on other countries through the domestic competition authority.¹⁵ Federalism theory concludes that the competence for solving a problem should be allocated to that jurisdictional level on which the geographical scope of legal rules and the regulatory problem coincide best.

Large costs in a multi-level legal system can also emerge through conflicts between the different legal orders within this system. One important aspect of this criterion *consistency of legal order* is that problems that legal rules from different legal orders are not compatible, which also entails the problem of legal transplants (Legrand 1997). Theoretically, a unitary legal system should create less problems for the consistency of legal order. Often it is argued that negative welfare effects can emerge through different legal rules and regulations within an integrated market, because this might imply additional transaction costs impeding cross-border transactions or cause different levels of costs for competing firms through different legal rules (implying distortions of competition). This criterion *barriers to trade and distortion of competition* leads to "levelling the playing field"-arguments and is therefore an argument for harmonisation. From the perspective of economics, however, it is very controversial, because the different conditions of different countries is also the main rationale for international division of labour and thus for international trade (Van den Bergh 2002).

The criteria of group I mainly emphasize various additional costs which might be connected with the more complex multi-level legal systems in comparison to a unitary legal system, which has a much simpler structure. In contrast to that, group II ("heterogeneity") provides a number of sound arguments about important advantages of decentralisation and therefore supports a more decentralised approach. A well-known argument in economic theory of federalism is that a decentralised legal system, which allows for the enactment of different legal rules and regulations in lower-level jurisdictions, is much better able to fulfil the preferences of citizens of different regions. It should be noted that the economic term "preferences" is a very broad concept that encompasses all kinds of values and policy aims. If within a multi-level legal system a multitude of different values and cultural traditions should be maintained, economists would interpret this as a claim for fulfilling the regionally different preferences of the citizens. Since in a centralised legal system the uniform legal rules or regulations can only correspond to some kind of average preference, high "frustration costs" can emerge, because these regulations do not fulfil the preferences of the citizens. However, not only the heterogeneity of preferences but also an *heterogeneity of problems* between different regions can lead to the conclusion that a decentralised system might be superior in providing more efficient regulations for solving the different specific problems. Economic theory can show that in the case of different conditions (as, e.g., different income levels or densities of population) in the Member States, different regulations (e.g., in environmental law) are efficient; a uniform regulation would lead to inefficiencies and hence to welfare losses. Consequently, a more decentralised multi-level legal system would be able to respond much better to the different preferences and problems of the citizens.

The constraints that limited knowledge places upon problem solving through legal rules and regulations and the consequent state and regulatory failure was mentioned in section 2. Group III of the economic criteria ("knowledge and innovation") focuses on this problem. Closely connected to the issue of heterogeneity of problems is the fact that often knowledge about

¹⁵ For an analysis of this problem see Kerber (2003), and, in particular, Budzinski (2006).

specific problems and their solutions only exists on the local or regional level. In this case of *decentralised knowledge*, only a decentralised multi-level legal system can use local knowledge to enact appropriate legal rules. A still more important aspect of the knowledge problem is that we cannot assume that the best legal rules for solving a regulatory problem have already been found. Section 2 depicted the complexity of appropriate institutional solutions. Lack of theoretical and empirical knowledge creates a knowledge problem. Another important aspect is that regulatory problems evolve over time due to technological innovations and other changes of relevant circumstances.

Uncertainty about the proper institutional solutions for regulatory problems leads to a continuous search for new and better solutions, i.e. in regard to legal rules and regulations there is a large need for *innovativeness and adaptability*. The economic theory of federalism claims that in federal systems both the innovativeness and adaptability of policies might be much higher than in a centralised system ("laboratory federalism"; Oates 1999), because the decentralised competencies allow for parallel experimentation with new policies (here: new legal rules and regulations) and mutual learning. Therefore, in a multi-level legal system, different solutions for similar problems can be tried out simultaneously, leading to new insights from the experiences with these solutions from which all jurisdictions can learn.¹⁶ Theoretically, these arguments are supported by the insights of evolutionary economics and innovation economics, which demonstrate the importance of variety, parallel experimentation, and learning from experience, all of which contribute to the evolution of technological and institutional knowledge.¹⁷ An important implication of these considerations is that in a decentralised system, inappropriate legal rules and regulations are detected and replaced more rapidly than in a centralised system. Centralisation impedes the correction of errors due to the lack of available comparisons as well as institutional rigidities. These pitfalls are often connected with centralised solutions, especially if they are made through complicated negotiation processes as in the EU. In the next section we will see that regulatory competition in decentralised multi-level legal systems can further facilitate the innovation and imitation of new institutional solutions.

The economic criteria of group IV ("political economy problems") address the problem of what degree of centralisation or decentralisation in a multi-level legal system is more suitable for solving state and regulatory failures caused by political economy problems. Importantly, what effect does the allocation of regulatory powers to higher or lower levels of a multi-level legal system have on the negative welfare effects of *rent seeking problems*? The economic theory of federalism cannot provide a general answer to this question. It cannot be disputed that the "capture" of regulatory agencies or the influence of interest groups on regulations often seems to be greater at lower-level jurisdictions. If, however, rent seeking activities succeed on a central level, the negative welfare effects can be much larger; it is also more difficult for citizens to control central level politicians. The economic literature on political economy problems emphasizes that interjurisdictional (or regulatory) competition is only capable of limiting rent seeking behaviour in a decentralised system. The criterion *political transaction costs* encompasses the problem of potentially high consensus costs which arise from complex decision-making procedures. These often occur on the central level of a multi-level

¹⁶ This argument is also closely connected with the "Open Method of Co-ordination" as a new method of governance in the EU (see below section 4.3).

¹⁷ For literature that emphasizes the advantages of decentralised experimentation see Easterbrook (1994), Oates (1999), Van den Bergh (2000, 2002), and Kollman, Miller and Page (2000); for a systematic application of evolutionary economics and innovations economics to federalism theory, see Kerber (2005).

system of jurisdictions. However, the problem of political transaction costs is not only a problem of centralisation or decentralisation: Cases can be found, in which a number of political actors on different jurisdictional levels have to consent to decisions about legal rules and regulations, leading to deadlock problems (Scharpf 1988). Dissolution of the vertical mixture of competences allows each jurisdictional level to independently decide their legal rules and regulations.

The optimal vertical allocation of competences depends also on the historical legal development and therefore on processes of "path dependence" (group V). The economic concept of path dependence means that the future legal evolution depends on the development of the legal order in the past. Particularly, North (1990) emphasized the importance of path dependencies in institutional evolution. One important reason for path dependence is that in the *historical status quo-situation* a lot of set up costs and human capital might already have been invested in well-established legal rules and regulations. These costs are lost if the legal rules are abolished in favour of new rules on another jurisdictional level. For example, if for a certain problem already well-established regulations on the level of Member States exist, the loss of this invested capital through the introduction of new EU rules might cause the costs of the new rules to outweigh the benefits. Legal path dependence also arises from *dynamic economies of scale*, which emerge in the application of the law (Klausner 1995). In the legal literature, it is well known that the quality of legal rules (and regulations) increases with the number of decided cases, because the differentiation between allowed and prohibited behaviour becomes clearer (leading to rising legal certainty). From an economic point of view this has an ambiguous effect: On the one hand, old well-established legal rules can have a very high quality, which would favour the established vertical allocation of legal competences. On the other hand, dynamic economies of scale can also lead to so-called lock in-effects, making it very difficult for new, more efficient legal rules to replace the old rules due to their first-mover advantages (Roe 1996, Heine and Kerber 2002). Therefore, path dependence effects do not favour more centralised or decentralised competences, but emphasize the necessity to carefully analyse the historical starting-point and the long-term dynamics of legal evolution in order to make appropriate decisions on the vertical allocation of competences.

The sixth group of criteria encompasses additional normative aims which might be pursued through private laws and regulations. One important subgroup refers to *distributional criteria*, which might be derived from aims of "social justice" or the aim of protecting "weak" parties. Although there is an intense discussion among legal scholars as to what extent social justice considerations should be taken into account in private law (Cafaggi and Muir Watt 2007), economists are much more sceptical as to whether private law rules are a suitable instrument for redistribution in order to achieve goals of social policy. Most economists prefer to solve problems of redistribution through taxation, because this leads to less welfare losses. There can be no doubt that distributional concerns can be taken into account, especially in regard to mandatory regulations. However, very careful analyses of the effects of these regulations should be made, because often real and intended effects differ greatly. The question becomes whether the intended social policy goals can be better achieved through centralised or decentralised legal rules and regulations. Unfortunately, there is no comprehensive answer. Another subgroup refers to aims of *individual freedom and private autonomy*. In that respect, it can be presumed that in most cases individual freedom and private autonomy might be more endangered by centralisation and harmonisation than in a more decentralised multi-level legal system. Individual freedom and private autonomy are also used to argue in favour of the strengthening of mobility rights (fundamental freedoms) and of choice of law (party autonomy).

3.3 Economic theory of legal federalism II: Regulatory competition

The last group VII of economic criteria ("regulatory competition") refers to the issue that in a decentralised multi-level legal system different types of competition among legal rules or regulations can emerge. In the more general notion of a multi-level system of jurisdictions the following conclusion is very important: If in a multi-level system of jurisdictions the lower-level jurisdictions have competences (i.e., there is a minimum extent of decentralisation) and private parties are allowed to be mobile between these jurisdictions, then these jurisdictions compete with each other, because the private parties will choose the most attractive jurisdiction. Decentralisation and mobility lead inevitably to interjurisdictional competition (Kerber 2000). The conclusions for the EU are clear: Since removing mobility barriers (enforcement of fundamental freedoms) has been a strategy of the EU, competition among jurisdictions (Member States, regions etc.) should result, as long as not all important competences for taxes, public goods and services, legal rules and regulations are centralised. In a system containing various levels of government, the jurisdictions on each level compete amongst the others. This system has also been described as competitive federalism.¹⁸ The extent and kind of competition depends on the degree of decentralisation and the extent of mobility rights.

The same considerations are relevant when considering multi-level legal systems. To the extent that individuals within a multi-level legal system are allowed to choose between different jurisdictional regimes, (by, for example, moving to other jurisdictions) the regimes on offer will compete with each other. Private parties will choose rules, which are deemed best for their interests. If they choose between the rules of legal orders of the same jurisdictional level, this can be called horizontal regulatory competition. Vertical regulatory competition is also possible, if private parties are able to choose between the rules of the member state and those of the EU.¹⁹ A puzzling problem is the following: If private parties can choose between mandatory regulations, then the latter have somehow lost their characteristic feature as mandatory regulations. This implies that the introduction of the option to choose between legal rules can change the character of the legal rules.

In the literature on regulatory competition the main focus of research has been on the problem of the advantages and problems of regulatory competition. Important potential advantages of regulatory competition are a higher efficiency of legal rules and regulation (in terms of a better fulfilment of citizens' preferences as well as lower costs for the setting up or application of the rules), more innovativeness and adaptability in regard to new problems and changed circumstances (especially through parallel processes of experimentation) and less negative welfare effects through rent seeking-activities. In the literature, a number of sound arguments were also presented as to why regulatory competition can lead to serious problems. Most important are problems of circumvention of mandatory rules, too high information and transaction costs, path dependence, lacking incentives for politicians as well as the danger of race to the bottom-problems, i.e. that regulatory competition can lead to an inefficient low level of regulation. This controversial discussion on the merits or defects of regulatory competition has become well-known in the literature as the question whether there is a "race to the top" or

¹⁸ For competitive federalism see Kenyon and Kincaid (1991), Breton (1996), Frey and Eichenberger (1999), and Kerber (2000).

¹⁹ For an example of vertical competition in the EU in regard to corporate law, see Röpke and Heine (2005).

"race to the bottom". Another, more recent critical discussion focuses on the question whether a dynamic process of regulatory competition is triggered at all.²⁰

It is difficult to draw general conclusions about regulatory competition. Its success depends on the type of regulatory problem, the rules or regulations at issue, and the ability of private parties to jurisdiction swap (Esty and Gerardin 2001b, Kerber and Grundmann 2006). Party mobility is important as it will decide the type of regulatory competition that emerges in a multi-level legal system. Four basic types of regulatory competition are briefly distinguished and analysed (Heine 2003a, Kerber and Budzinski 2003).

Regulatory competition as yardstick competition: For this type of regulatory competition, only the mobility of information between jurisdictions is important. It can also work if the countries are otherwise isolated from each other, i.e. that there is no mobility of goods, firms or production factors (as capital) between the jurisdictions. The basic idea of the mechanism of yardstick competition is that citizens (as voters) assess the performance of their government and compare it with other countries. Lack of information prevents voters from directly assessing the performance of their government. Consequently, they use the performance of other countries as a "yardstick". Yardstick competition can help control rent seeking problems of domestic governments (Wrede 2001). Perhaps more important, this mechanism gives incentives to governments to learn from the superior policies of other countries. This approach starts with the assumption that the optimal legal rules and regulations are not known yet and tries to solve this knowledge problem through searching for better solutions in other countries (as a search for "best practices"). Therefore the concepts of "policy learning" and "policy transfer", both widely discussed issues in political science, are important in this regard (Lundvall and Tomlinson 2002). The idea of learning from other legal orders has traditionally motivated studies of comparative law. This knowledge-generating aspect of regulatory competition has many similarities with the evolutionary approach of competition as a process of parallel experimentation and mutual learning (in analogy to Hayek's concept of "competition as a discovery procedure"; Hayek 1978).²¹

Regulatory competition via international trade / mutual recognition: If, additionally, the mobility of goods and services is introduced, as in the traditional theory of international trade, then the legal rules and regulations of countries enter into indirect competition due to their influence on production costs and therefore the international competitiveness of the domestic firms. However, neither firms nor consumers can choose between different regulations. If, as a further step, the principle of mutual recognition is introduced (as in the EU for product regulations through the Cassis de Dijon-Judgment), then producers will be allowed to export products adhering to domestic regulations without having to comply with the regulations of the destination country (country of origin principle). In this case, regulatory competition occurs when consumers choose between the products of different countries. The fear of a race to

²⁰ For this broad discussion on regulatory competition, see Oates and Schwab (1988), Revesz (1992), Vanberg and Kerber (1994), Woolcock (1994), Sun and Pelkmans (1995), Bratton et al. (1996), Sinn (1997), Vogel (1997), Van den Bergh (1998, 2000, 2002), Garcimartin (1999), Ogas (1999), Trachtman (2000), Esty and Gerardin (2001a), Heine and Kerber (2002), Marciano and Josselin (2002, 2003), Kieninger (2002), Ott and Schäfer (2002), Kerber and Budzinski (2003), and Kerber and Grundmann (2006).

²¹ For yardstick competition in the economic theory of federalism see Salmon (1987), Besley and Case (1995), Wrede (2001), and Bodenstein and Ursprung (2005). For the knowledge-generating effect of regulatory competition see Vanberg and Kerber (1994), Van den Bergh (2000), and Kerber and Budzinski (2003), and Kerber (2005).

the bottom ignited E.U. discussions about regulatory competition while spotlighting the need for (minimum) harmonisation. A key aspect of this type of regulatory competition is the fact that consumers can choose between regulations but producers cannot.²²

Regulatory competition through interjurisdictional competition: Regulations can also compete with each other because firms and production factors (esp. capital) are mobile between jurisdictions. Firms choose jurisdictions with the most attractive conditions. Tax rates, public goods, labor markets, court systems and the quality of legal rules and regulations are all important determinants for the overall quality of a jurisdiction. Improving the efficiency of legal rules and regulations can be one strategy used by jurisdictions to attract firms and capital. This is a direct form of regulatory competition because when firms choose between locations they are choosing between legal regimes. However, competitive pressure that can be exerted on particular legal regimes can be limited because they are often only a small part of the entire list of factors that influence locational decisions. The negative impact of inferior legal rules can be mitigated by other advantages of this location. It is also necessary to differentiate between process and product regulations. This kind of regulatory competition can work particularly well in the case of regulations for the production process. Choosing a jurisdiction based on favourable product regulations, however, only benefits a firm on the international market if the regulations are also accepted in import countries.

Regulatory competition via choice of law: A much more direct and effective type of competition among legal rules and regulations emerges if private parties are allowed to choose directly between legal rules of different legal orders without having to move into different jurisdictions (Parisi and Ribstein 1998). On the international level private parties have always been able to choose freely between contract laws of different legal orders when conducting cross-border transactions. Competition amongst the various corporate law regimes operating within the United States is an example of this type of regulatory competition (Romano 1985; Easterbrook and Fischel 1996). The Centros-Judgment of the European Court of Justice triggered the development of mutual recognition of national corporate laws amongst EU states. Thus, a similar market of corporate law regulatory competition is emerging in Europe (Heine 2003b). However, forum shopping can be used to circumvent mandatory regulations. If the primary task of the legal rules is to facilitate private party transactions, it can be argued that choice of law improves welfare because parties can choose legal rules with the lowest transaction costs. In the case of regulations which mainly protect third-party interests (competition law) free choice of law often will not be an appropriate solution (for competition law, see Kerber and Budzinski 2003).

3.4 Applying the criteria to multi-level systems of private laws and regulations: a complex problem

Based upon the economic reasoning of section 2 and sections 3.2 and 3.3, it becomes clear that the format of an appropriate multi-level system of private laws and regulations will be necessarily complex. The problem has two different dimensions:

²² See for an analysis of this kind of regulatory competition (through the country of origin principle) Sun and Pelkmans (1995) and critically König, Braun, and Capito (1999), Kerber (2000), and Kerber and Van den Bergh (2007).

(1) What institutional solutions are best suited to solve potential market failures (or achieving additional aims) without ignoring the potential pitfalls caused by state failure? In section 2, we saw that a wide range of possible solutions exists: market solutions, private regulation, self regulation, and different kinds of mandatory regulations can be combined with private and/or public enforcement agencies as well as arbitration or court institutions to resolve conflicts. Often, the optimal solution depends on specific circumstances. There are no easy and clear answers.

(2) The second dimension concerns the appropriate vertical allocation of competences. Problems that should be solved by legal rules might have a small or large geographical scope, they can be different in kind or in different regions, knowledge about them and their best solutions might only exist on a regional level, the preferences of the citizens whether it is a problem at all and what aims should be considered for solving it might be different etc.. Therefore, from an economic point of view, the competences for legal rules and regulations should be allocated to different jurisdictional levels, i.e., either to the EU level, the Member State level, or to lower-levels. In sections 3.1 to 3.3 a broad number of criteria have been presented that should be considered when addressing the appropriate vertical allocation of competences in an European multi-level legal system of private laws and regulations. We have also seen not only that the vertical allocation of competences is important but also that the extent and conditions of mobility rights and choice of law can lead to different types of competition among legal rules and regulations.

These analyses lead to multi-dimensional trade off-problems because in many cases centralised and decentralised rule making both present advantages and disadvantages while regulatory competition simultaneously creates positive and negative effects. The most appropriate solution might be highly complex. This implies that for different regulatory problems, different institutional solutions are presumably most appropriate. Therefore, regulatory problems require specific and precise analyses to find the most appropriate solution, both in regard to the optimal regulatory solution as well as to the optimal allocation of regulatory powers within the multi-level legal system. The following examples of contract law and competition law in the EU illustrate this point.

The issue of the future contract law in the EU was already mentioned. Applying an economic approach to the problem of the optimal structure of a two-level European System of Contract Laws, Kerber and Grundmann (2006) argue that in regard to the optimal degree of (de)centralisation and the feasibility of regulatory competition, different solutions should be implemented for different kinds of contract law rules. In section 2, we distinguished (1) mandatory substantive regulations that substantially restrict freedom of contract between private parties, (2) mandatory information regulations which should only remedy information asymmetry problems without substantially interfering with freedom of contract, and (3) facilitative contract law rules which double as standard solutions (default rules) helping to save transaction costs without restricting freedom of contract at all. In our analysis, we could show that the advantages and disadvantages of centralisation and decentralisation are different for these three kinds of contract law rules: In the case of mandatory substantive regulations, a decentralised solution in combination with a (low) minimum harmonisation might be most appropriate. Heterogeneous preferences, the advantages of parallel experimentation with different institutional solutions, and the dangers of a centralised limitation of freedom of contract balance the potential "race to the bottom"-problems created by regulatory competition.

For the most important mandatory information regulations, however, a centralised solution might be easier to defend. It is less likely to infringe upon freedom of contract and creates

lower information and transaction costs for cross-border transactions. However, since knowledge problems and considerable heterogeneities of preference between Member States may obtain, only a core of mandatory information regulations should be harmonised, i.e., most of these regulations should remain on the level of the Member States. The EU level should provide facilitative contract law rules in addition to the law of the Member States and private parties should have the unrestricted right to choose between the contract law rules of the EU and of the Member States. This approach leads to different policy recommendations concerning the appropriate extent and type of regulatory competition (Kerber and Grundmann 2006).

Additionally, it should be noted that different combinations of centralised and decentralised solutions exist regarding (1) legal rules and regulations, (2) enforcement agencies, and (3) courts. For example, competition law fights market failures that result from private restraints of competition. In recent years, the EU has witnessed national competition law become increasingly superseded by European competition law, leading to a process of centralized rule-making. Simultaneously, the Commission has embarked on a strategy of strengthening the decentralised enforcement of European rules through national competition authorities and national civil courts. The recent Green Paper on "Damages actions on the breach of EC anti-trust rules" (EU Commission 2005) takes a further step in this direction by suggesting to strengthen (the so far underdeveloped) private litigation in competition cases in the EU. Here an institutional structure is sought, which combines the centralised rule-making of competition policy with the (considerably decentralised) two-level system of competition authorities for public enforcement ("European Competition Network"). The promotion of private enforcement of EC competition law can be seen as part of this institutional structure.²³

4. Governance of a European System of Private Laws and Regulations

4.1 Governance of multi-level legal systems: An introduction

Does a European System of Private Laws and Regulations need a governance structure? The answer is clearly affirmative. A multi-level legal system needs a set of meta-rules or an institutional framework to fulfil the preferences of the citizens. To express it differently: A multi-level system of governance needs itself a governance structure.²⁴ An important characteristic of multi-level legal systems is that the legal orders within the system do not work independently from each other. Rather, the multi-level legal system has to function in an integrated manner. Regarding a European System of Private Laws and Regulations, the overall institutional framework has to define the rights and competences of all jurisdictions to enact and enforce private law rules and regulations on both levels. It has to solve conflicts between the legal orders by clearly delimiting competences and by providing conflict resolution mechanisms such as the European Court of Justice. It also has to define the rights of the citizens in regard to the regulatory powers of the jurisdictions, particularly their mobility rights (fundamental freedoms) or right to choice of law. From a broader perspective the governance struc-

²³ For the general problem of a multi-level systems of competition laws see Kerber (2003) and Budzinski (2006), who also analyses the developments within the two-level system of competition law in the EU. Another important aspect is that the courts can play a very different role in the enforcement of competition law as a comparison between US antitrust law and EU competition law shows.

²⁴ See, generally, Kerber (1998), Van den Bergh (2000), Feld and Kerber (2006) and Cafaggi and Muir Watt (2007).

ture of a multi-level system of private laws and regulations is, of course, a part of the overall (constitutional) governance structure of the entire multi-level system of jurisdictions.

4.2 Rules for competence allocation, conflict of law, and choice of law

The problem of solving horizontal and vertical conflicts between the legal orders and regulatory regimes within a multi-level legal system has already been mentioned. First, rules are necessary for the vertical allocation and delimitation of competences for legal rules (or regulatory powers). Within a federal state, the constitution usually determines the powers of the central state and the lower-level jurisdictions. Within the EU, the European treaties entail provisions about those competences, which were transferred to the EU level. The judgments of the European Court of Justice regarding the fundamental freedoms of the EC Treaty are an important mechanism used to fine-tune the vertical allocation and delimitation of regulatory powers between the levels of the EU and the Member States.

Secondly, the horizontal delimitation of competences also needs rules. Traditionally, conflict of law rules and choice of law rules (international private law) have the task of solving conflicts between legal rules of different national legal orders (O'Hara and Ribstein 2000, Muir Watt 2003). Importantly, private parties have the right to choose between different private laws for their international transactions. The parties agree on the legal rules (and courts) that should govern their transaction, avoiding conflict between different rules. However, only some potential conflicts between legal orders can be solved by choice of law. As far as legal rules and regulations have the task of solving market failure problems or of achieving other regulatory objectives, choice of law need not lead to the appropriate solutions. Other conflict of law rules are necessary to solving the horizontal conflicts that occur between different regulatory powers. At first glance it puzzles the economist that, traditionally, conflict of law rules are rules of the national legal orders, not international rules. Theoretically, it is clear that only common conflict of law rules (and choice of law rules) can consistently delimit the legal order. Therefore, these rules must be part of the institutional framework for the whole multi-level legal system.

The decisive implication of this economic approach to multi-level legal systems beyond the traditional notion of conflict of law rules is that the set of rules for the vertical and horizontal allocation and delimitation of competences now has an entirely different task. In section 3, we saw that a set of economic criteria can be used to search for the optimal structure of a multi-level legal system, the optimal vertical allocation of competences, the appropriate extent and type of regulatory competition and choice of law of private parties. The appropriate combination of these vertical and horizontal competence allocation rules and conflict of law rules, can create an optimal multi-level legal system. Therefore, these rules are the main instrument for the governance of the multi-level legal system. Consequently, their task is not the avoidance or resolution of specific conflicts between legal rules from different legal orders. Rather, they play a crucial role in the governance of the multi-level legal system. Hence, conflict of law rules are important for ensuring the functioning of the whole multi-level legal system in regard to the fulfilment of policy aims, which have to be derived from the preferences of the citizens. In that respect, it is correct to emphasize the regulatory function of conflict of law-rules (Muir Watt 2003, 399). Economic analysis can help search for the appropriate set of conflict of law-rules that fulfils this task of governance.

4.3 Multi-level legal systems as dynamic and innovative systems

Although the optimal degree of centralisation or decentralisation must be analysed in regard to specific problems, a crucial contention of the economic approach to legal federalism is that in many cases the advantages of decentralisation are so large that the appropriate legal system in Europe is at least a two-level legal system in which a considerable part of private law rules and regulations should remain allocated to the Member States. This approach also supports the thesis that such a multi-level legal system should not be seen as a transitional phenomenon but as a sustainable long-term institutional solution.

However, some attention should be given to the long-term dynamics of multi-level legal systems. Particularly, two problems must be considered. First: is a multi-level legal system inherently stable or does its vertical allocation of competences lend itself to centralisation or, alternatively, decentralisation? For example, many academic scholars are sceptical about the ever-increasing competences for legal rules and regulations on the EU level. For an institutional economist, the question becomes whether or not institutional safeguards are necessary to impede centralisation that endangers the appropriate long run mix of centralisation and decentralisation (Vaubel 1996). However, there is a second problem: Technological and economic evolution will require an evolution of the vertical allocation of competences for legal rules and regulations or the appropriate extent of choice of law and regulatory competition. Under different technological and economic conditions and changing preferences of the citizens the analyses according to this economic approach will also lead to different optimal multi-level legal systems. Therefore, a multi-level legal system needs additional procedural rules to shift regulatory powers between the jurisdictional levels as well as for the development of the regulatory regimes in general. These meta-rules for adapting and changing the rules for competence allocation, conflicts of law, and choice of law are an important part of the governance structure of a multi-level legal system. They are closely connected with the so-called "competence-competence", i.e. the competence to change competences.

The evolution of technologies, economic conditions, and preferences of the citizens does not only imply an evolution of the structure of multi-level legal systems; it also implies a change of the number, kind, and extent of regulatory problems that legal rules and regulations need to address. New kinds of market failure problems emerge, others might become less important, previously satisfactory solutions might erode, or new legal instruments might create new regulatory options, etc.. Therefore, both the set of regulatory problems and the set of legal and regulatory instruments (or the extent of their effectiveness) changes over time. Additionally, the optimal institutional solution for both old and new problems is often not known due to the knowledge problem discussed in section 2. These reasonings emphasize the permanent necessity to search for newer and better legal and regulatory innovations. One of the crucial advantages of a multi-level legal system is its greater capacity for innovation and adaptability compared to a centralised unitary legal system (Oates 1999, Kerber 2000, 2005). One of the important insights of federalism theory states that a decentralised allocation of competences allows for parallel processes of experimentation with different institutional solutions. More experiences with different legal rules and regulations is acquired leading to quicker knowledge generation and broader diffusion of appropriate solutions. Decentralised experimentation and mutual learning is a powerful institutional device used to ensuring the long-term innovativeness and adaptability of a multi-level legal system. By contrast, centralised legal systems tend to be much more rigid, making them less innovative and adaptable.

This basic mechanism of decentralised experimentation and mutual learning between lower-level jurisdictions in competitive federalism is also used to some extent in an important new

governance instrument of the EU, the "Open Method of Co-ordination" (OMC). This form of governance was introduced at the EU's 2000 summit in Lisbon in order to improve policies of the Member States by establishing a process of mutual learning about appropriate public policies. The OMC applies to a number of policy fields (as social and labour market policies), in which competences still rest mainly with the national level. The basic idea of the OMC is that different policies of Member States are evaluated on the EU level in regard to their ability to fulfilling a number of policy aims. Superior policies should be identified and then recommended to the Member States as "best practices". This process differs from the traditional "hard" governance methods of the EU (Directives or Regulations) in that Member States merely receive policy recommendation, after which they can decide whether or not to comply.²⁵

The OMC also uses the mechanism of decentralised experimentation and mutual learning. Different from laboratory federalism, this evaluation and benchmarking process is carried out on the central level of this two-level structure of jurisdictions; in a system of competitive federalism the processes of experimentation and mutual learning take place on a purely decentralised level. The OMC provides an interesting forum for fostering the generation and diffusion of new knowledge about appropriate policies (as well as legal rules and regulations) in a multi-level system. The main problem of the OMC in this regard is that many proponents of the OMC seem to view it less as a long-term institution for generating and spreading new knowledge but as a device for fostering the convergence and harmonisation of the public policies of Member States. The danger is that the OMC focuses solely on the diffusion of "best policies", leading to a process of convergence and harmonisation, thus impeding and perhaps even eliminating future processes of experimentation. Ongoing improvement of legal rules and regulations needs ongoing experimentation and mutual learning (Lundvall and Tomlinson 2002, Eckardt and Kerber 2007). The example of the OMC provokes an important insight for multi-level legal systems: Lower-level jurisdictions and legal orders need a free scope to experiment with new legal and regulatory solutions. Acceptance of a certain extent of diversity and heterogeneity is also required. From that perspective, aims of convergence and harmonisation can be problematic and counterproductive.

5. Conclusions

The traditional notion of a strict dichotomy between national legal orders and international law has been increasingly superseded by a multi-level legal system. The aim of the paper was to develop a theoretical framework for the analysis and design of a European System of Private Laws and Regulations from an economic perspective. In section 2, the relation between private law and regulations was clarified, leading to the insight that markets always need an institutional framework (rules of the game). For solving a number of market failure problems (and for achieving other non-economic aims), a broad set of institutional solutions (private regulation, self-regulation, facilitative law and mandatory regulations, regulatory and enforcement agencies, courts) exists. Choosing the appropriate policy solution requires a careful comparative institutional analysis that considers both market and state failures. An important result of this analysis is that often complex institutional solutions encompassing combinations of public and private law solutions might be optimal. In section 3, based upon economic theo-

²⁵ For the OMC and its analysis as a governance method see, e.g., Lundvall and Tomlinson (2002), Arrowsmith, Sisson, and Marginson (2004), Borrás and Jacobsson (2004), and Kerber and Eckardt (2007) with additional references.

ries of federalism and regulatory competition, a set of criteria was presented, which can be used to search for the optimal structure of a multi-level legal system. The analysis refers to both the question of the optimal vertical allocation of competences for legal rules and regulations in a multi-level legal system and to the desirable extent and type of regulatory competition and choice of law. The most important conclusion is that the optimal structure depends on the specific regulatory problem and detailed analyses are necessary, because complex trade off problems between manifold positive and negative effects of centralised and decentralised solutions can emerge. In the last section 4, it has been shown that a multi-level legal system is in need of a governance structure. Such an institutional framework consists of rules for the allocation of competencies and the solving of conflicts of law. Therefore, an appropriate shaping of conflict of laws- and choice of law-rules is crucial to ensure the proper function of a multi-level system of private laws and regulations. An important dimension of the effectiveness of a multi-level legal system is its capacity for innovativeness and adaptability in order to allow for an appropriate evolution of legal rules and regulations according to changing circumstances and preferences. The theoretical analysis of the advantages of multi-level legal systems, especially in regard to their innovativeness and adaptability, suggests that the EU should be more cautious in pursuit of legal harmonisation than they have been in the past.

Such a theoretical framework can be used to develop the general principles of an European System of Private Laws and Regulations as well as to analyse appropriate solutions for specific regulatory problems. It would encompass both the question of the optimal allocation of regulatory powers within the EU and the problem of the optimal regulatory response to market failure problems and other regulatory aims. This paper has deliberately focussed on the design of a multi-level legal system within the EU. However, beyond the legal and regulatory system of the EU the question of an international or global system of governance is on the agenda. An appropriate application of such a theoretical approach of multi-level legal systems must also take into account the global level and therefore analyse the problem of global governance.²⁶ Since on the global level an integrated legal order is missing, global governance raises much more difficult problems, esp. in regard to implementation and enforcement, as within the European Union.

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²⁶ See, e.g., Heritier, Stolleis, and Scharpf (2004), and Kingsbury et al. (2005).

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