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Institutional competition of optional codes in European contract law

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Abstract The Common European Sales Law (CESL) is the European Commission's most recent policy initiative for European contract law. It aims to address the problem that differences between the national contract laws of the Member States may constitute an obstacle for the European Internal Market. This paper develops a model of the institutional competition in European contract law and uses it to addresses the question as to whether an optional European contract code and the CESL are economically desirable for European contract law. To do so I examine the transaction costs involved in the process of choosing an applicable law that European businesses face when they conduct cross-border transactions in the European Internal Market. I then describe how these transaction costs shape the competitive environment, i.e. what I refer to as the "European market for contract laws" in which the contracting parties choose a law to govern their cross-border contracts. Having identified this environment and the competitive forces operating within it, I propose a model, the "Cycle of European Contract Law". I use this model to analyze the competitive processes that take place in the European market for contract laws. Based on my results I make recommendations for the optimal implementation of an optional European contract code and the CESL in European contract law.

Keywords Law and Economics · Institutional competition · European Union · European contract law · Common European Sales Law · Choice of law

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1 Introduction

On October 11th, 2011 the Commission published the "Proposal for a Regulation of the European Parliament and of the Council on a Common European Sales Law".[1] The Common European Sales Law (CESL) is the Commission's most recent policy initiative for European contract law. It is the latest out of a number of different options that the Commission has discussed over the past decade to address the problem that differences between the national contract laws of the Member States may constitute to an obstacle for the European Internal Market.[2] The proposal is less ambitious in scope than, for example, the optional European contract law originally under discussion. The CESL was sceptically received and is controversial for different reasons, mainly because of its material content[3] and the question as to whether the European Union is in fact competent to adopt such a legislative measure.[4] The discussion on the CESL remains politically charged and it is not clear whether the proposal will succeed, since there is little political support from the Member States.[5] The CESL can nevertheless be regarded as a milestone in the development of European contract law as it may be the first step towards a European contract law, albeit a modest one.[6] For this reason and because the introduction of a comprehensive optional European contract code has been the main policy option under discussion for European contract law in the past decades the idea of such a code remains relevant.[7]

[1] Commission of the European Union 2011.

[2] In 2001 the Commission initiated a broader discussion on the future of European contract law, see Commission of the European Communities 2001. The Commission then issued two communications in which it has presented measures for approaching the different problems it identified in the consultation process that began in 2001, among others the optional instrument for European contract law (OI), see Commission of the European Communities 2003; Commission of the European Communities 2004. Until the end of 2009 it was not likely that the Commission would proceed with the development of an OI but this changed in 2010, see Commission of the European Union 2010. The OI is now referred to as the CESL, see note 1, above.

[3] E.g. Eidenmüller et al. 2012; Faust 2012; Vogenauer 2013a.

[4] E.g. Grigoleit 2012; Hähnchen 2009; Kuipers 2011; Max Planck Institute for Comparative and International Private Law 2011; Remien 2011; Rutgers 2011; Schmid 2001; van Gerven 1997; Vogenauer and Weatherill 2005; Weatherill 2004; Weatherill 2005; Zeno-Zencovich and Vardi 2004; Ziller 2006.

[5] Dannemann and Vogenauer 2013: 14. Some of the Member States believe that the Commission's proposal for a CESL and its choice of Article 114 as the legal basis are highly controversial. See, for example, the German Bundestag's 2011a subsidiarity objection; see also German Bundestag 2011b; German Bundestag 2011c; Sensburg 2012. For the opinions of the parliaments of other Member States which also consider the CESL to be incompatible with the principle of subsidiarity see Austrian Federal Council 2011; House of Commons 2011.

[6] Lando 2011: 728; Eidenmüller et al. 2012.

[7] In what follows I will use the terms "optional European contract law" and "optional European contract code" rather than "CESL" when I am referring to the general idea of an optional European contract law that has been under discussion for the past decade, but not when I am considering the Commission's concrete proposals. I will use the term "existing optional codes" or simply "optional codes" to refer to the UNIDROIT Principles of International Commercial Contracts (PICC), the Principles of European Contract Law (PECL) and the United Nations Convention on Contracts for the International Sale of Goods (CISG).

Among other things, the discussion in the literature on European contract law has focused on the institutional competition between the national contract laws of the Member States and the Commission's proposals. However, the conclusions reached have not been unequivocal for all aspects of this competition. In fact, there has been disagreement on many of the most important parameters of institutional competition. These disagreements range from whether institutional competition in European contract law takes place at all[8], whether this competition is beneficial or detrimental to welfare and the European economy[9] and whether it renders the Commission's harmonization efforts superfluous or, on the contrary, makes them all the more necessary.[10] Nevertheless, one unambiguous outcome is that there is some sort of competitive relationship between the contract laws of the different Member States. Legal diversity has fostered legal innovation and thus made a positive contribution to the development of European contract law. The various contract laws therefore better satisfy the diverse preferences of the citizens, but this legal diversity also increases transaction costs on the single European market. There is a lack of consensus as to whether harmonization efforts should be pursued to reduce transaction costs or whether the diversity of laws should be maintained to sustain legal innovation and optimal satisfaction of preferences. These disagreements are mainly rooted in differences in the weighing up of the benefits and costs of harmonization versus those of institutional competition.[11] The Commission claims that its proposed optional instrument for European contract law combines the advantages and disadvantages of both: it can reduce the transaction costs associated with cross-border transactions without diminishing the beneficial effects of institutional competition in European contract law.[12] However, to date no comprehensive model has been developed that analyses the effect of an optional European contract code and the CESL on institutional competition in European contract law. Even though it is not clear to what extent institutional competition in European contract law actually takes place,[13] such an analysis is indispensable if we are correctly to predict the economic effects that the introduction of either of these instruments would have.

This paper develops a model of the institutional competition in European contract law and uses it to addresses the question as to whether an optional European contract code and the CESL are economically desirable for European contract law. In order to do so I apply deductive, conceptual economic reasoning. I examine the transaction costs involved in the process of choosing an applicable law that European businesses face when they conduct cross-border transactions in the

[8] For arguments supporting the existence of institutional competition between the contract laws of the Member States see, for example, Eidenmüller 2011. For arguments against the existence of such a competition see the comprehensive and profound analysis by Vogenauer 2013b. See also Kieninger 2002a and b.

[9] E.g. Wagner 2002.

[10] E.g. Kieninger 2008; see also Eger 1999.

[11] de Geest 2002: 373.

[12] Grundmann and Kerber 2002: 305.

[13] Vogenauer 2013b.

European Internal Market. I then describe how these transaction costs shape the competitive environment in which the contracting parties choose a law to govern their cross-border contracts. This competitive environment, i.e. what I refer to in what follows as the "European market for contract laws" is made up of the national contract laws and the optional contract laws from which the contracting parties can choose the legal instrument to govern their contract. Having identified this environment and the competitive forces operating within it, I propose a model, the "Cycle of European Contract Law". The model includes, in particular, existing optional contract laws, namely the UNIDROIT Principles of International Commercial Contracts (PICC), the Principles of European Contract Law (PECL) and the United Nations Convention on Contracts for the International Sale of Goods (CISG), as these can serve as proxies for an optional European contract code. Based on these results I will assess the desirability of an optional European contract code and conclude with my recommendations for its implementation in European contract law. I find that no political interest should directly or indirectly influence or dictate the choice of law decisions of the contracting parties. Only if this principle is respected can the policies pertaining to the European contract law help to reduce transaction costs in the long term, thereby increasing cross-border trade and in effect leading to a creation of wealth in the European Union. I conclude with the thought that an unofficial standard may emerge as a result of the competitive processes between the national contract laws, the PICC, the PECL, the CISG and a possible optional European contract code endorsed by the Commission. This unofficial standard could serve as a European contract law, legitimized by its popularity among the contracting parties.[14]

2 The European market for contract laws

This section introduces the concept of a European market for contract laws, i.e. a competitive environment in which the contracting parties choose a law to govern their cross-border contracts. It is based on the assumption that there is an analogy between legal products and economic products. According to this analogy, the drafters of contract laws are suppliers of legal products. Their products are the contract laws and the consumers are the contracting parties.[15] Thus the European market for contract laws is the market where the supply and demand for contract laws that govern cross-border transactions within Europe come together.[16] The contracting parties "consume" a contract law by choosing it as the law applicable to their contract. Both parties are driven by their interest in maximizing profits. The suppliers aim at maximizing the market share of their products, hence to increase the number of contracts governed by their contract laws. A positive association

[14] Berger 2001, 1999.

[15] The terms "suppliers" and "consumers" are used to illustrate the analogy between legal and economic products. To avoid confusion with other concepts, in what follows I will use the terms "users" instead of "consumers" (of contract laws) and "drafters" instead of "suppliers" (of contract laws).

[16] O'Hara and Ribstein 2009.

between the market share and the (monetary and non-monetary) profits of the suppliers (i.e. drafters) is a fundamental element of this assumption. The drafters do not necessarily gain direct monetary profits from the use of their contract laws, but rather indirect economic benefits from their popularity due to their increased use. The consumers (i.e. users) also aim to maximize their profits. They will, therefore, choose those contract laws which minimize their transaction costs most. Both drafters and users act consciously to realize this end, i.e. the maximization of their profits. On the basis of the analysis and understanding of these actions, an economic theory on the institutional competition can be developed.[17]

An aspect of this analogy that is worth discussing[18] is that the drafters' profits are generally indirect economic benefits, i.e. the users' choice of a contract law does not lead to direct monetary profits for the drafters but only to an increase in market share. However, economic analysis can be applied as long as the actors behave rationally towards the realization of a certain goal. This goal does not necessarily have to be monetary.[19] It is therefore possible to have a competitive relationship between national contract laws, an optional European contract code and the two existing, privately drafted optional codes (PICC and PECL) despite the absence of direct monetary gains for the drafters.[20] As regards private drafters of the existing optional codes, for example, the UNIDROIT Institute in Rome, economic behaviour which is identical to profit-seeking behaviour of firms may occur due to the organization's motivation to realize its own statutory goals: the harmonisation and unification of international private law.[21] In the study of non-profit organizations this is a well accepted principle: the motivation to realize non-monetary goals leads to economic actions that are similar or even identical to profit-seeking behaviour.[22] In regard to the Member States, economic behaviour of legislatures that is identical to profit-seeking behaviour may occur for several reasons. These reasons include the motivation to promote the national contract laws in order to attract business for the national legal service industry; to create a competitive advantage for the country or simply to improve the image of the national civil justice system.[23] All this benefits a Member State's economy, leads to increased tax revenues and is therefore advantageous for the government.

[17] Kirchner 2004.

[18] Faust 2008 points out that for economic analysis "it becomes necessary to decide how much of the regulatory framework (…) must be taken into account. (…) If economic analysis neglects rules that influence the behavior of people coping with the real-life problem studied, the results are likely to be seriously flawed".

[19] Eichhorn 2000: 131–136.

[20] Hondius 2002: 28; see also Zimmermann 2009: 510.

[21] §1 Statute of UNIDROIT: The purposes of the International Institute for the Unification of Private Law are to examine ways of harmonizing and coordinating the private law of States and of groups of States, and to prepare gradually for the adoption by the various States of uniform rules of private law.

[22] Kotler and Andreasen 1991.

[23] O'Hara and Ribstein 2009: 73–77; Eidenmüller 2011; see also Kötz 2010; Rasmussen-Bonne 2009; The Law Society of England and Wales 2007; Bundesnotarkammer et al. 2008; Association des Juristes Français et Allemands et al. 2011.

3 The theory of transaction costs for the choice of law

This section develops a theory of the transaction costs incurred in the process of choosing a governing contract law in the European market for contract laws. This theory is an important part of the theoretical foundations that underlie the Cycle of European Contract Law model. The model must take transaction costs into account because these drive the institutional competition in European contract law. The transaction costs resulting from the choice of a specific contract law as the law applicable to a contract can be described according to their two main elements:

1. Information costs and
2. Suboptimal choice of law costs arising from provisions of the chosen contract law that fail to fully meet the requirements of the contracting parties in the given case.

The two types of costs added together give the total amount of transaction costs related to the choice of a specific contract law.[24] Assuming that the parties to a contract will act with the motive of maximising their profits and hence try to reduce their costs, they will choose the contract law which minimizes total transaction costs.

3.1 Information costs

Information costs have two main elements. First, they result from the effort involved in comparing different contract law regimes and finding the optimal contract law for a specific contract. This kind of information cost is incurred because the contracting parties have to choose the law which is optimal for their contract. As there are a large number of different contract laws, all of them have to be taken into consideration in order to select the one which is most beneficial for the parties' contract. Second, information costs result from the parties' need to reduce legal uncertainty regarding the choice of a specific contract law. The availability of different contract laws results in uncertainty and unpredictability concerning the outcome of cross-border transactions. Contracting parties can reduce the uncertainty involved in cross-border transactions by obtaining costly information about a foreign contract law. Where a certain law is chosen by the contracting parties or where a neutral law is decided upon, both parties have to invest a substantial amount to obtain the information needed to reduce legal uncertainty.[25] Information costs

[24] Like all economic models, the theory of transaction costs developed here and the model that is based on it must necessarily simplify reality. Only by isolating the main variables that are most relevant to the phenomena at stake, will it be possible to derive correct predictions that contribute new insights into the competitive relationship between national contract laws and an optional European contract code. The model does not therefore include all costs that could possibly be related to the choice of law for a cross-border contract (e.g. the negotiation costs that arise during the contracting parties' bargaining process for the applicable contract law to a transaction, etc.). To do so would complicate the model unnecessarily, reduce its predictive power and render it less useful for the intended policy analysis. Instead the focus is on the two main variables introduced above.

[25] Wagner 2002: 1010–1011.

could be reduced if the contract was governed by a contract law known to both parties. For example, the information on a single European contract law would be accessible at a lower cost than that on different individual contract laws of the Member States. Harmonization therefore reduces information costs and fosters economic activity and is thus desirable as regards information costs.[26]

3.2 Suboptimal choice of law costs

Suboptimal choice of law costs arising from provisions of the chosen contract law that fail to fully meet the requirements of the contracting parties in the given case are the second element included in the total transaction costs for the choice of law in a cross-border contract. This element of the transaction costs assumes that for a given cross-border contract there is a theoretically optimal contract law solution. This optimal contract code would represent the contracting parties' interests exactly and would meet all their legal requirements for a given transaction. It would therefore govern the cross-border contract at the lowest possible cost. However, this optimal contract code only exists in theory, and in practice the contracting parties do not have the option of choosing such an optimal contract law solution. Instead the contracting parties have to choose one of the existing contract laws, none of which are "tailor made" for the given transaction. These laws do not therefore represent the contracting parties' interests perfectly and are hence less economically efficient than the theoretical optimum. This divergence between the chosen contract law and the theoretically optimal contract law gives rise to suboptimal choice of law costs arising from provisions of the chosen contract law that fail to fully meet the requirements of the contracting parties in the given case (referred to in what follows as suboptimal choice of law costs). The contract laws available to the contracting parties can be ranked according to how well they fulfil the contracting parties' needs. If a law that comes close to the theoretically optimal contract law solution, i.e. those laws that best represent the contracting parties' interests, is chosen as the governing contract law for the given cross-border transaction the suboptimal choice of law costs will be low. Conversely, a law whose provisions diverge greatly from the theoretical optimum will be associated with high suboptimal choice of law costs.

If a business can choose between varieties of contract laws it will therefore be in a position to select the contract law that best represents its interests, thus reducing the suboptimal choice of law costs that will arise. The reduction or abolishment of this variety by means of harmonization would raise suboptimal choice of law costs, as a single, standardized contract law is less likely to fit the individual needs of the contracting parties. In effect, the contracting parties have to resort to costly additional private arrangements to compensate for the deficits of the contract law. A further factor needs to be taken into account in order to understand the suboptimal choice of law costs, and this is the extent to which the contract law is innovative—its ability to create and incorporate legal innovation. The constant development of new legal solutions reduces the suboptimal choice of law costs, as the legal innovations ensure that the rules and regulations specified in the contract law

[26] Basedow 1996: 1184.

represent the changing economic behaviour of the contracting parties. Based on the assumption that a market for contract laws exists, the ability of a contract law to operate efficiently is fostered by competition between different contract laws. Contracting parties may influence the alternatives open to them by moving their place of residence, by voting for a government acting on their behalf or simply by exercising their right to party autonomy. Both parties act in such a way as to maximize their profits and will choose the contract law which minimizes total transaction costs. This behaviour leads to competition, since every Member State and private drafter has an interest in promoting its own contract law. The competition that arises is mutually beneficial. It fosters the development and optimization of each contract law by means of a constant stream of innovation. Harmonization or the enactment of a single European contract law by the European legislature would abolish this competition and suppress the process of innovation. In the long run the prevention of competition could lead to European contract law becoming less efficient and thus result in an increase in the suboptimal choice of law costs arising, whereas if the contract laws of different Member States and private institutions were in competition with each other these suboptimal choice of law costs could be reduced.

3.3 The relationship between information costs and suboptimal choice of law costs

Transaction costs consist of information costs and the suboptimal choice of law costs arising from provisions of the chosen contract law that fail to fully meet the requirements of the contracting parties in the given case. The contracting parties aim to reduce the overall transaction costs, which include both these elements. As these two kinds of cost are strongly interlinked and interdependent, parties are not able to reduce transaction costs below a theoretical minimum, which is the optimal ratio between the two kinds of costs. Hence, once the parties have reached the theoretical minimum amount of total transaction costs, they are not able to further reduce them, but can only change their structure: If parties reduce the information costs, the suboptimal choice of law costs will rise and if they reduce the suboptimal choice of law costs, the information costs will rise. If the information costs are high because the parties have invested much time and effort in familiarizing themselves with the application and usage of the regulations contained in a contract law, the chosen contract law is likely to govern the contract in a manner which matches the interests and expectations of the parties. The suboptimal choice of law costs are then low. If, in contrast, less effort and funds are invested in choosing and becoming familiar with the applicable contract law and the information costs are therefore low, it is likely that the applicable contract law will not govern the contract in such a way that the interests of the parties are furthered; hence suboptimal choice of law costs are high. The information costs incurred by comparison and familiarization with certain codes can be regarded as fixed costs. These investments need to be made initially to prepare the ground for a certain contracting behaviour. The corresponding suboptimal choice of law costs can be regarded as variable costs, since they are incurred each time the contracting behaviour is repeated. Once the investment in

obtaining the relevant information has been made, the information is available to the contracting parties. In effect, these fixed costs may be spread over numerous transactions. The willingness to invest in information costs tends to be higher, the more often the contracting behaviour recurs and the information can therefore be reutilized in order to reduce suboptimal choice of law costs. In such a case the parties are likely to invest heavily in finding a contract law which fits their specific needs exactly, as their objective is to minimize the overall transaction costs of all multiple transactions taken together. If, in contrast, a certain contracting behaviour is expected to take place only rarely or only once, the parties are likely to choose to minimize the fixed investment required to obtain costly information and instead to accept high variable costs, i.e. high suboptimal choice of law costs. In such a case the law chosen might be, for example, a well-known standard code that is widely recognized and applied, but contains only general provisions which do not exactly fit the intent of the parties.

4 The theory of legal order and legal innovation

In terms of Hayek's theory on order we can say that a national code drafted by a legislature, a possible optional European contract law endorsed by the Commission and either of the two existing optional codes drafted by independent institutions can be described as centralized orders.[27] The drafting processes of these codes are fundamentally different, but they have one characteristic in common, which is that they are consciously designed by a central authority employing scientific knowledge. In addition to this similarity, the two types of codes have very little in common. The interests and procedures of a legislative code drafter differ widely from those of an independent institution (see above). Moreover, a national code is drafted with the intention of being ultimately binding within the state's territory (and in the case of the mandatory provisions, even beyond the state's own territory). In contrast, the existing optional codes were not drafted with the intention of making them binding unless the contracting parties voluntarily agree to be governed by one of them. These basic differences are of no consequence for the application of Hayek's theory on order. However, it is the key similarity between their developments which makes it possible to classify them as centralized orders. Both types of contract laws are designed by a central authority with the conscious intention of creating a contract law which fulfils a certain purpose. It is on the basis of this characteristic that both can be included in the group of centralized orders.

The idea of regarding the European market for contract laws as a decentralized order is somewhat abstract and requires theoretical elucidation. The term European market for contract laws refers both to the possibility of choosing a national contract law, an optional European contract law or either of the two existing optional contract codes as the law applicable to a contract and to the resulting competition in

[27] Hayek 1983, 1945; for an application of Hayek's theory of legal order and his theory on knowledge and order to the European contract law see Smits 2006. For a comprehensive discussion on Hayek's theory of legal institutions see Backhaus 2005.

which a standard contract law, i.e. European contract law may evolve. In short, this market is where the supply and demand for contract laws meet. By definition this decentralized order is antithetical to a single contract law and not designed by only one central authority. It is created by the actions of different individuals, i.e. the national legislatures, the European Commission, the institutions drafting the existing optional codes and the contracting parties choosing the different contract laws as applicable law. This order is of fundamental importance for the economic entities performing cross-border transactions within Europe. It fulfils a certain purpose, as it leads to a legal environment in which contracting parties can facilitate economic transactions between Member States.

We can use the innovation theories of Schumpeter[28] and Hayek[29] to gain a comprehensive understanding of the role of competition for the innovation process. By applying these theories to the European market for contract laws we can analyze the legal innovation process taking place in this environment. The European market for contract laws consists of multiple contract laws which parties can choose to govern their contracts. The institutions which draft these contract laws compete with each other for customers, i.e. contracting parties. The measure of success in this competition is the market share of the products, hence the popularity of each contract law. The emerging competition between the different contract laws leads to legal innovation. Drafters of contract laws can be separated into two types: innovators and imitators. The innovators try to gain a competitive advantage by incorporating legal innovations into their contract laws. These innovations are likely to affect the cost structure of the users. Since the legal innovation satisfies the interests of the contracting parties better and thus governs their contracting behaviour more efficiently, the suboptimal choice of law costs arising from provisions of the chosen contract law that fail to fully meet the requirements of the contracting parties in the given case are reduced. However, since the legal innovation is unknown, and thus there is no case law, precedent or legal commentary on it, the users' information costs increase. Innovation creates legal uncertainty, which only can be reduced by obtaining rare and therefore costly information. For the small group of users who initially adopt the legal innovation, the total amount of transaction costs is reduced, as they have an unusual contracting behaviour, which is especially well addressed by the new innovation and has only been insufficiently covered by the previously existing contract laws.

It is important to note that the legal innovation can only reduce the total transaction costs of a small group of users on the market. For most users, the adoption of the legal innovation would result in an increase in the total amount of transaction costs. The variation in the propensity of the legal innovation to reduce transaction costs for different user groups has to do with the nature of suboptimal choice of law costs. In contrast to the increase in information costs, which is roughly the same for all users, the decrease in suboptimal choice of law costs depends on their contracting behaviour. The users whose contracting behaviour is very specific and as such particularly well addressed by the new innovation will largely benefit

[28] Schumpeter 1949, 1975.

[29] Hayek 2006: 40; see also Hayek 2002: 19.

from the innovation and gain a reduction in suboptimal choice of law costs. In contrast, the behaviour of the majority of users on the market is more or less average and thus not specially addressed by the new legal innovation. Their contracting behaviour still benefits slightly from the new innovation; however, the increase in information costs outweighs the suboptimal choice of law costs reduction. Adopting the legal innovation would result in an increase in their total transaction costs. In contrast, the small group of initial users wins a large reduction in suboptimal choice of law costs which outweighs the increase in information costs. Overall they have a decrease in total transaction costs.

Because the small group of users already greatly benefits from the new legal rules, knowledge and awareness of the innovation spreads within the legal community. The first cases decided on the basis of the new legal innovation reduce the uncertainty involved in its application and the legal jurisprudence comments on it. The legal innovation gains in importance and information costs involved in adopting the innovation therefore decrease. Economically, it makes more and more sense for other users to choose a contract law that incorporates the new legal innovation as the law applicable to their contract. In effect, it also starts to make economic sense for parties whose contracting behaviour is not essentially covered by it to adopt the new legal innovation. Now, the decrease in suboptimal choice of law costs is offset by only a slight increase in information costs and thus the total transaction costs are also reduced for these users. The contract law drafter who integrates the legal innovation into her contract law gains a temporary monopoly. Her market share rises because she is the only supplier who can offer the new legal solution to her customer. The more users adopt her contract law because of the new legal solution, the greater the increase in her share of the market. This attracts other contract law drafters to imitate her legal innovation. The innovator therefore loses her temporary monopoly to the imitators. To regain it, she is likely to come up with a new legal innovation, which again secures her a competitive advantage and thus a large share of the market. The innovation process recommences.

In conclusion, customers stand to benefit greatly from this innovation process. Since the new legal innovation will spread, the efficiency of all contract laws will rise. This will lead to a decrease in suboptimal choice of law costs for all users on the market. As the information costs also decrease over time, the overall transaction costs of all users are reduced. In sum, in the long term legal innovations lead to a decrease in total transaction costs for all users and hence promote social welfare, since economic activities increase. There may be cases in which legal innovations introduced onto the market prove to be inefficient, thus leading to higher suboptimal choice of law costs than the codes previously employed, or at least fail to reduce suboptimal choice of law costs sufficiently to offset the higher information costs initially incurred. In this case the legal innovation is likely to be rejected by the market forces. As users do not benefit from adopting the legal innovation, it will never contribute to an increase in the market share of the innovator's contract law. Other contract law drafters will also not imitate the legal innovation and the innovator is likely to remove it from her code.

5 The Cycle of European Contract Law model

The users' desire to reduce transaction costs and the drafters' desire to increase their share of the market are the dominating forces in the European market for contract laws. The reduction in one component of the transaction costs, the suboptimal choice of law costs arising from provisions of the chosen contract law that fail to fully meet the requirements of the contracting parties in the given case, can only be achieved by the supply side. Users can only reduce suboptimal choice of law costs indirectly by creating an incentive for drafters to increase their share of the market, which in turn motivates the drafters to reduce suboptimal choice of law costs by means of legal innovation. Based on the theory of creeping codification, the contracting parties' desire to reduce the other component of the transaction costs, the information costs, will result in the emergence of a standard contract law for Europe.[30] The explanation for the rise in a standard contract law is that the more contracting parties in Europe choose a specific contract law to govern their contract, the more widely the information on this code is available and hence the more attractive it becomes for other contracting parties to choose this code, since the information costs connected with the selection of this code decrease. Since a contract law gains a dominant market share due to the competitive advantage of having the lowest information costs for the average user in the market its popularity is self-reinforcing: The popularity of a code results in an even greater competitive advantage, as the information costs continue to fall and its popularity rises again.

The disadvantage of the popularity of an emerging standard contract law is that due to its generality it results in higher relative suboptimal choice of law costs for the user than other contract codes in the market. First, the provisions of the code are too general and do not fit the special needs of a certain contracting behaviour. Overall, the transaction costs therefore show a high proportion of relative suboptimal choice of law costs and a small proportion of information costs. Second, the standard code is less likely to incorporate legal innovation. Its competitive advantage results more from the low amount of information costs associated with it than from low suboptimal choice of law costs. The benefit of gaining a temporary monopoly by creating legal innovation and reducing the relative suboptimal choice of law costs will not be significant for this code. The drafters will already gain (direct and indirect) monopoly profits because it occupies the lowest cost position due to its minimal information costs. Hence, the code will be competitive by virtue of the low information costs rather than as a result of a reduction in relative suboptimal choice of law costs. In contrast, less popular contract laws will have a strong need to integrate legal innovation in order to attract users. This is because they can only compete with the dominant standard code by reducing the suboptimal choice of law costs, thus offsetting the high information costs users will face when opting for such a less popular code. Thus, in contrast to the popular standard code the less popular codes will compete on the basis of low

[30] According to Berger 2001: 21 the development of privately drafted optional contract laws such as the PICC and the PECL may lead to a creeping codification of European contract law—"the idea that slowly and gradually by reference to such principles a uniform private law will emerge". See also Berger 1999: 206–224.

suboptimal choice of law costs rather than low information costs. Due to this reduced incentive for legal innovation the relative suboptimal choice of law costs of a standard contract law will at some point in time be higher than the reduction in information costs gained through its wide popularity. In this case the contracting parties will look for more innovative codes which reduce total transaction costs more than the current standard. If a competing code incorporates more legal innovations, contracting parties will switch more and more from the old standard to the new, innovative code. With its increasing popularity the new code will become more and more popular and the information costs involved in its adoption will be reduced. Consequently, the innovative code will become the new standard, while the old standard will be ousted from its leading position.

The described process is an ever-repeating one which brings us to an important conclusion: The competition between different national contract laws, an optional European contract law and the existing optional codes in the European market for contract laws can be described as a cycle, a Cycle of European Contract Law.[31] This cycle resembles the process of creative destruction described by Schumpeter.[32] The recurrent process of newly emerging codes and their subsequent destruction due to the introduction of more innovative codes leads to an ongoing progress of innovation in contract law which should foster social welfare. This cycle will lead to the emergence of a European-wide standard contract law for cross-border transactions. The more the popularity of such a standard grows, the more beneficial the positive effect of the reduction in information costs will become and the more severe the disadvantageous effect of increasing suboptimal choice of law costs caused by its generality and lack of innovation. In the final analysis, the competitive position of the European-wide standard contract law will deteriorate in relation to the other, less popular national contract laws, a possible optional European contract law endorsed by the Commission and the other existing optional codes. The developed standard will decline in popularity and a new, more innovative code will become the new standard. In theory, the cycle is characterized by a constant movement between two extremes, one being a single, dominating contract law and the other being multiple competing contract laws, all having similar market shares. If the cycle moves towards a single contract law in the market, the average user's information costs are minimized and the suboptimal choice of law costs are maximized. If the cycle moves towards the other extreme, where several codes with similar market shares exist, the amount of suboptimal choice of law costs will be minimized and the stake of information costs maximized. This cycle is socially beneficial and it will result in the creation of wealth, as it leads to a constant fall in transaction costs. Even though the information costs and the suboptimal choice of law costs are likely to rise and fall, depending on whether an emerging standard is moving towards its peak or its decline, the overall long term suboptimal choice of law costs will always decrease. This steady decline in overall transaction costs is

[31] Note that the term "cycle" has been taken from Schumpeter's innovation theory and his work on the business cycle. Metaphorically the Cycle of European Contract Law could also be described as a downward-turning spiral that leads to constant, long-term decreases in transaction costs for cross-border transactions across Europe.

[32] Schumpeter 1975: 83.

caused by the beneficial effect of legal innovations, which will raise the efficiency of all competing contract laws.

The cycle theory helps to understand that deliberately designing European contract law will lead to suboptimal results. To ask for the enactment of a single European contract law or to rely instead on efforts to achieve partial harmonization is to rely on a centralized order for European contract law. This will ultimately exclude the specific knowledge spread among the numerous contracting parties from contributing to the design of a European contract law. If a European market for contract laws with many competitors and hence strong competitive forces is created, the cycle of the European contract law can take place, as described above. This cycle utilizes a far wider range of knowledge, as it is in fact a decentralized order which brings the knowledge of multiple drafters and, most importantly, also that of users into the process of developing a European contract law. As a result of the cycle, legal innovation will ensure constantly increasing efficiency of the contract laws used in the European Union and suboptimal choice of law costs will therefore always decline in the long term. Further, the emergence and decline of standards will lead to an optimization of the information costs. Most importantly, the ratio between information and suboptimal choice of law costs is not fixed, but is rather subject to change, depending on the choices of the contracting parties in Europe. This provides the flexibility the code needs to adapt to the changing economic needs of the contracting parties.

6 The Common European Sales Law and the restraining effect of consumer protection rules on institutional competition

In business-to-consumer cross-border transactions party autonomy, i.e. the free choice of law, is limited due to consumer protection concerns. The Commission's main economic argument in favour of the Common European Sales Law is that under the current legal framework for business-to-consumer cross-border transactions in Europe the law would help businesses to avoid the costs associated with having to deal with multiple mandatory provisions in the consumers' home jurisdictions. This would particularly help businesses to conduct cross-border transactions with consumers in small Member States. This section analyses how consumer protection rules governing the choice of law currently affect institutional competition in European contract law. In general, the results of the analyses for business-to-business transactions presented in the sections above are also applicable to business-to-consumer cross-border transactions. However, some aspects differ as a result of the effects of consumer protection rules on the contracting parties' choice of law. In order to avoid redundancies the analysis presented above for business-to-business transactions will not be repeated. This section focuses only on those aspects in which the choice of law situation for business-to-consumer cross-border transactions differs from that for business-to-business transactions. The consumer protection rules relevant to the choice of law in a business-to-consumer cross-border contract are laid down in the Rome I Regulation. According to Article 6(1) of the Rome I Regulation, when a business pursues its activities in or directs its activities

to another Member State and a consumer cross-border contract is concluded as a result of these activities, in principle the contract law of the consumer's habitual residence applies. According to Article 6(2) of the regulation the contracting parties may also choose another contract law, but this choice may then not deprive the consumer of protections granted to her by the mandatory provisions of the law of her habitual residence. The section begins with a summary of those characteristics of business-to-consumer contracts that are most decisive for the following analysis.

Business-to-consumer cross-border contracts differ from business-to-business contracts in that the consumer will typically not have any influence on the content of the contract, since it is usually dictated by the business's standard terms. These standard terms are, in turn, strictly regulated by EU consumer protection laws and judicial clause control.[33] In the conclusion of such contracts the business will generally be well informed while the consumer will as a rule be less well informed. The business will normally be in a position to make an informed choice of the law to be applicable to the contract, whereas the costs of making an informed choice of law decision are too high for consumers.[34] In effect, businesses will generally dictate to consumers which law is to be applicable to a cross-border contract. It will therefore suffice to investigate only those parameters that affect businesses' choice of law for business-to-consumer cross-border contracts. Consumers will rarely, if ever, be in the situation of having to decide on the law to be applicable to a contract and their interests can therefore be left out of the analysis. As in the analysis for business-to-business transactions, the contracting business that is faced with having to choose between laws can be described as the user of contract laws that is motivated to choose the contract law that is associated with the lowest total transaction costs. The situation differs only with respect to above-mentioned consumer protection rules. The contracting business now has to take the mandatory provisions of the other contracting parties', i.e. the consumers' home jurisdictions, into account. This influences the competitive processes that take place in the European market for contract laws as follows.

The information and suboptimal choice of law costs incurred in the process of choosing a contract law to govern a business-to-consumer transaction tend to be higher than those associated with a comparable business-to-business cross-border transaction. In addition to the information costs associated with a business-to-business transaction, the contracting business now has to make additional investments to find out about the mandatory provisions of the consumer's home jurisdiction. It needs to determine whether these mandatory provisions provide a higher level of protection than those of the chosen law and if they do it must comply with these. Similarly, in a business-to-consumer transaction the suboptimal choice of law costs arising from provisions of the chosen contract law that fail to fully meet the requirements of the contracting parties in the given case also tend to be higher than those that accrue in a comparable business-to-business cross-border transaction. The contracting business cannot freely choose the contract law that most efficiently governs the given transaction since its choice is limited to the extent that

[33] Schäfer and Leyens 2010.

[34] Ott and Schäfer 2002: 209–212.

the level of protection granted to the consumer may not drop below that laid down by the mandatory provisions of the contract law of the consumer's home country. As a result, suboptimal choice of law costs increase because the business has to opt for a less efficient, i.e. suboptimal contract law solution in order to comply with the consumer protection requirements. This does not, of course, apply where the contract law of the consumer's home jurisdiction is also the contract law that most efficiently governs the given transaction. In such cases the information and suboptimal choice of law costs will generally be the same as for a comparable business-to-business transaction. Using the Cycle of European Contract Law model it is now possible to analyse how these consumer protection rules affect institutional competition in European contract law.

Article 6(2) of the Rome I Regulation acts as a restraint on institutional competition in European contract law. When choosing the law to govern a contract, contracting businesses must now also take consumer protection regulations into account, in addition to financial considerations. As it is not possible to avoid being subject to the mandatory provisions of the consumer's home jurisdiction, a business choosing any other contract law will have to comply with the mandatory provisions of both laws. This makes it a financial disadvantage to choose a contract law other than that of the consumer. For this reason, a contracting business is not likely to choose the contract law that best fits the given transaction but rather that of the consumer. As a result, institutional competition in European contract law is biased in favour of those contract laws that belong to jurisdictions with large consumer markets. These contract laws gain a competitive advantage due to the increased popularity arising from the above mentioned restraint on competition. Thus, Article 6(2) of the Rome Regulation acts as a restraint on institutional competition. It therefore also hampers legal innovations which could ensure the long term efficiency of European contract law and weakens the other positive effects of institutional competition predicted by the proposed Cycle of European Contract Law model.

7 Conclusions

The Cycle of European Contract Law model reveals that the task of European contract law is a dynamic one rather than static one. This cannot be accomplished at a single point in time, but needs to be realised in a continuous fashion. It is precisely this characteristic of dynamic change that leads me to conclude with the insight that the creation of European contract law is clearly a task of such a vast complexity that it cannot be accomplished by a central order. Only the contracting individual herself has knowledge of the circumstances in which she is choosing the law to be applicable to her contract. The individual's decision will depend on multiple variables which cannot be sufficiently taken into account by anyone but that individual. This situation calls for a decentralized approach to the European contract law. To choose a decentralized order means to follow the insight of Hayek that from a certain complexity onwards, this type of order is more efficient in organizing the

task than the centralized order.[35] European contract law is clearly a task of such a great complexity. It can only lead to an optimal reduction in transaction costs if it is able to adjust dynamically to the constantly changing contracting behaviours of the economic entities in Europe. This is also in line with the general finding of Backhaus who states that:

> "in passing a law, the legislature has to make sure that, while binding, it leaves individuals (and firms) enough flexibility to react to it differently, to opt for legal ways not to be bound by the law. The law must offer alternatives to individuals, to take either one choice or the other, depending on their particular circumstances. The procedure of implementing the law must be such that adverse (and unforseen) consequences, not intended by the legislature, can be avoided by the citizen"[36].

Therefore only freely competing national contract laws, a possible optional European contract law endorsed by the Commission and the two existing optional contract laws contribute to the generation of social welfare and individual freedom in Europe. The benefits of centralized and decentralized order mechanisms can be combined and the maximum available knowledge in the society utilized to promote an innovative European contract law. The European market for contract laws will then govern contracts at a lower cost to society and the contracting parties than any other means of harmonization can do. The Commission should pay attention to the insights gained with this model. In the best case the Commission's design of an optional European contract law would foster competition between the national contract laws and the already existing optional codes and therefore lead to the benefits postulated by the Cycle of European Contract Law. The optional European contract law should therefore be treated in the same manner as other national contract laws and the PICC, PECL and the CISG, and compete among equals without the help of any competitive advantages backed by the Commission. It should be emphasized that from the viewpoint of institutional competition there is no economic need for the Commission's proposed optional European contract law. In the field of business-to-business cross-border transactions there is already almost unlimited competition. An additional player in the market for European contract laws might intensify competition and hence increase its beneficial outcomes. However, it would not be the Commission's optional European contract law itself that would generate welfare for society, but the free and extensive institutional competition. In the field of business-to-consumer transactions Article 6(2) of the Rome regulation acts as a restraint on competition. Cross-border transactions are

[35] Cole 2005 has drawn attention to the similarities between the theories of Hayek and Coase. If we add Coase's thoughts to Hayek's theory of legal order we can conclude that it is efficient to rely on a centralized order mechanism until the complexity of the task to be accomplished exceeds the theoretical maximum that can be efficiently processed with a central order. This maximum is determined by the kind and amount of knowledge needed for the accomplishment of the task. If a very large amount of specific knowledge is needed, a centralized order is inappropriate and will therefore become inefficient. In such a case it is necessary to resort to a decentralized order mechanism, which can accomplish the same task more efficiently.

[36] Backhaus 2005: 97; see also Backhaus and Stephen 1998: 24.

subject to mandatory national provisions of consumers' home jurisdictions and this seriously limits institutional competition. As a result legal innovations which could ensure the long term efficiency of European contract law are suppressed.

I shall now use the above results to formulate my advice to the European Commission for future policy in the field of European contract law. The main goal that the Commission purports to pursue in harmonizing European contract laws and abolishing the obstacles to the European Internal Market arising from having different contract laws in different Member States, i.e. to reduce transaction costs, can be efficiently realized by allowing free competition between national contract laws and the existing optional contract laws such as the PICC, the PECL and the CISG. What is essential for the realization of this goal is not, as the Commission argues, simply to introduce the CESL, which was previously referred to as the OI, or an optional European contract law. The welfare of society can only be generated by free and intensive institutional competition in European contract law. This competition already works well in the field of business-to-business transactions that are not subject to national mandatory provisions. From the perspective of institutional competition in this field there is therefore no economic need for an optional European contract law endorsed by the Commission.

The Commission may nevertheless decide to implement an optional European contract law that covers business-to-business transactions. It should then take into account the following recommendations. One option would be for the Commission not to opt for the legally binding form of a regulation, but simply to publish an optional European contract law without supporting it at the level of the European Union.[37] This would ensure that an optional European contract law did not gain a competitive advantage over other optional, privately drafted contract law codes due to its having a different legal form. However, the Commission may nevertheless decide to pass a regulation setting up an optional European contract law.[38] If it does so this will likely be for other political reasons rather than in order to reduce transaction costs for cross-border transactions in the long term. An example of such a goal with a higher political priority would be the fostering of the European integration process by creating a symbol of European integration and unity. Whatever its reasons may be, if the Commission chooses to pass a regulation setting up an optional European contract law, its implementation should be carried out in such a way that the optional European contract law does not gain an artificial, competitive advantage from being backed by the Commission. Rather, the Commission should aim to create a legal environment in which all national and existing optional contract codes can compete on an equal footing. If there is no such environment, an optional European contract law would differ from the existing optional contract laws in that it would have a legally binding character, while the PICC and the PECL would not. This characteristic of an optional European contract law would give it a significant competitive advantage over the existing optional contract laws. This would again lead to the above-mentioned negative effects predicted by my Cycle of European Contract Law model. To avoid these, the

[37] See Commission of the European Union 2010: 7.

[38] See Commission of the European Union 2010: 9–10.

Commission should amend Rome I Regulation in a way that it recognizes the existing optional codes as valid choices for cross-border transactions in Europe. The Commission did discuss this option in regard to the optional instrument's relation to international private law in its 2004 "Way Forward",[39] but due to political opposition by the Member States it was unable to implement this solution when the Rome Convention was converted into a community instrument. Furthermore, the mandatory provisions of national contract laws should be put to the test and only upheld if they are really necessary. One should evaluate to what extent restricting contracting parties' choice of foreign and optional contract laws for purely domestic and consumer transactions is really necessary. These solutions would reduce the negative effect that introducing an optional European contract law would have on competition between contract laws in Europe and also strengthen the position of the existing optional contract codes vis-à-vis the national contract laws. Finally, how it can be ensured that an optional European contract law and the existing optional contract codes will be applied in a uniform way in courts across Europe remains an open question to be addressed by future research. This will ultimately be necessary to ensure that these instruments are fully competitive alternatives to national contract laws for cross-border transactions in Europe and that transaction costs can be permanently reduced to foster the European Internal Market.

I will now conclude with an evaluation of the Common European Sales Law in the institutional competition between European contract laws. I have shown that in the field of business-to-consumer transactions Article 6(2) of the Rome I Regulation acts as a constraint on institutional competition in European contract law. When choosing the law to govern a cross-border contract, businesses must take consumer protection regulations into account. The Commission's main economic argument in favour of the Common European Sales Law is that it would help businesses to avoid the costs associated with having to deal with multiple mandatory provisions of the consumers' home jurisdictions. In terms of the proposed Cycle of European Contract Law model this means that by using the CESL contracting businesses can reduce information costs, i.e. part of the transaction costs for the choice of law in a consumer cross-border transaction.[40] The extent to which using the CESL can reduce the overall transaction costs would then also depend on how effectively it governs a given transaction, i.e. how it affects the other main element of transaction costs, the suboptimal choice of law costs arising from provisions of the chosen contract law that fail to fully meet the requirements of the contracting parties in the given case. In order to assess the overall economic desirability of the CESL for European Contract Law it is necessary to include the institutional perspective. The main economic advantage of the CESL is its ability to permit businesses to avoid having to deal with the mandatory provisions of different European jurisdictions. This gives it a competitive advantage vis-a-vis the other competing contract codes.

[39] Commission of the European Communities 2004.

[40] However, this assumes that the CESL is effectively implemented in European contract law. Eidenmüller et al. 2012 point out that according to the Commission's current legislative proposal, consumers have to explicitly accept that a given cross-border contract be governed by the CESL rather than by their home jurisdictions' contract laws. This means that businesses may not profit from the intended reduction in transaction costs if consumers reject the option of using the CESL.

This competitive advantage does not spring from the quality of the provisions of the CESL, but rather from its implementation in international private law. It offers a set of fully harmonised mandatory provisions to the contracting parties which quasi gives it a statutory monopoly and it will therefore, as is well-known, have a weakening effect on institutional competition because its competitors have no such comparable ability. Thus, Article 6(2) of the Rome I Regulation already acts as a restraint on institutional competition in European contract law and the introduction of the CESL would further add to this restraint on competition.

In a scenario where the CESL has such a statutory monopoly, i.e. in which it can offer fully harmonised mandatory provisions to the contracting parties, the information costs associated with selecting the CESL will be lower than the costs which would be incurred in a scenario in which it does not have this ability. In effect, other contract laws can only compete if they offset the reduction in information costs afforded by the CESL by reducing the suboptimal choice of law costs associated with their selection. The reduction in suboptimal choice of law costs needs to be at least as high as the reduction in the information costs brought about by the CESL's statutory monopoly, i.e. the costs that businesses save because of not having to deal with multiple mandatory provisions. Only those codes that can bring about such a reduction in suboptimal choice of law costs will be able to compete with the CESL in business-to-consumer cross-border transactions. However, other codes might still be able to compete in a scenario where the CESL does not have a statutory monopoly, i.e. in which it cannot offer fully harmonised mandatory provisions to the contracting parties. This would be because the legal innovations and regulations that they incorporate into their contract laws were efficient enough to reduce suboptimal choice of law costs to the extent required to undercut the information costs that would exist in a competitive scenario without a statutory monopoly for any code. Ultimately, the CESL's ability to offer a set of fully harmonised mandatory provisions to the contracting parties would be detrimental to competition since contract laws which could still compete in a competitive regime without such a statutory monopoly would no longer be able to compete under a competitive regime with such a statutory monopoly. Thus, the CESL's ability to offer a set of fully harmonised mandatory provisions to the contracting parties in business-to-consumer cross-border transactions could weaken competition and ultimately discourage legal innovation. Average suboptimal choice of law costs in the market would be higher than the average suboptimal choice of law costs in a regime in which the CESL did not have such a statutory monopoly.

For these reasons introducing the CESL would reduce average information costs by offering fully harmonised mandatory provisions to the contracting parties. However, at the same time it would lead to a long-term increase in average suboptimal choice of law costs due to its weakening effect on institutional competition in European contract law. It is tempting to attempt to calculate how far this reduction in information costs would offset the long term increase in suboptimal choice of law costs in order to assess the economic desirability of the CESL. However it is doubtful whether this is in fact possible due to the complexity of the task. It might be better to examine how far the consumer protection rules laid down in Article 6(2) of the Rome I Regulation are in fact necessary. It is because of these

rules that businesses currently have to deal with the multiple mandatory provisions of their consumers' home jurisdictions, i.e. they are the main obstacle to business-to-consumer cross-border trade that the Commission is in fact aiming to overcome by introducing the CESL. Despite the significant impact that these rules have on transaction costs in the European Internal Market, the Commission's impact assessment for the CESL does not include a discussion whether they are really necessary to prevent businesses from making choice of law decisions that would lead to a decline in the level of consumer protection provided for by contract codes across Europe. This therefore remains an open question. Future research should investigate whether such a "race to the bottom" is likely to occur in the competition between European contract laws if these consumer protection rules for the choice of law are weakened or abolished. If this is not the case, weakening or abolishing these rules may be the most practical solution to facilitate consumer cross-border trade in Europe. This approach might also be preferable from an institutional perspective, as it would not hamper the institutional competition in European contract law.

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