Legal harmonization is a process that aligns legal rules either within a federal framework (that is, in the presence of a superior, rule-making entity with respect to the federated entities), through the adoption of regulatory models agreed at a multilateral level (such as conventions adopted within the OECD or UN) or through the unilateral adoption of a foreign sovereign state’s legal system by a different sovereign state.

The economics of legal harmonization can be considered as a complement to the economics of federalism. Legal harmonization should be applied when a regulatory solution reached through the competition of political units is not optimal or when the economies of scale and scope, externalities and the provision of public goods prevent a decentralized approach to regulation. However, this interpretation denies the autonomy of legal harmonization from the economics of federalism. Two reasons justify why there should be a second definition for legal harmonization.

First, federalism consists of the distribution of legislative and judicial powers between local and central authorities. Legal harmonization consists not only of federal level harmonization, but also of sovereign state harmonization. Unilateral adoption by a sovereign state of the legal system of another sovereign state is defined as “legal transplantation”. Legal transplantation reduces or potentially eliminates differences between legal systems through the unilateral non-cooperative effort of one system. The wholesale transplantation of the 1900 German Civil Code to Japan is an example of the unilateral adoption of legal rules belonging to another system.

Second, the research subjects of the two areas are different from an economic point of view. The economics of federalism focuses on those goods and services that are offered in sub-optimal quantity within a federal context, such as public goods, goods with externalities and markets with economies of scale and scope. The literature on legal harmonization consists mainly of the study of contract and corporate law.

Federalism and legal harmonization use the same theoretical model. This model is based on the subsidiarity principle, which states that the federal solution (harmonization) is accepted whenever the initiative from local authorities is inefficient. For instance, since 2004 the European Commission is required to
accompany every legislative proposal (directive or regulation) with a study that shows that the objective pursued may not be adequately obtained at a decentralized level.

Although legal harmonization may be studied without reference to the efficiency of its solutions, the economics of legal harmonization aims at verifying whether harmonization produces efficient results. Ribstein and Kobayashi (1997) list the benefits from harmonization and transplantation, specifically stating that a more uniform legal regime decreases litigation and information costs because it is easier to ascertain each state’s laws. Harmonization also reduces externality problems from state laws, such as local laws that favor domestic consumers and investors, while hurting foreign producers and issuers.

Scholars of legal harmonization tend to conclude that harmonization promotes efficiency. However, this conclusion appears to be valid only for contract law, while corporate law and securities law have arguments in favor of competition among jurisdictions.

Finally, while there is a tendency to study legal harmonization with reference to a specific subject, a small group of scholars have adopted a global approach to legal harmonization (Parisi and Carbonara 2007, 2009).

**Legal Harmonization in General**

Generally, harmonization of standards produces two negative effects that cannot be eliminated. First, harmonization restricts the possibility of an exit strategy, because there are fewer possibilities for leaving the current legal order for another if legal orders are harmonized (Ribstein and Kobayashi (2006) themselves acknowledge this). Second, harmonization drives interest groups to ask for the introduction of mandatory rules to benefit themselves, which creates inefficiencies (Ribstein and Kobayashi 2006). Mandatory rules are less detrimental when there is competition among the legal orders, because subjects can evade the mandatory rules by changing legal orders (the exit strategy).

Alesina, Angeloni and Etro (2005) state that the benefits of centralization consist in the possibility of exploiting economies of scale through the central allocation of policy responsibility. Their paper characterizes the costs of harmonization as principally deriving from the heterogeneity of preferences across regions. Balancing the benefits and costs of harmonization, the optimal degree of harmonization should ensure that all the functions where economies of scale are predominant should be held at the central level and all the functions with high heterogeneity of preferences should be left at local level. This point is illustrated in a related paper (Alesina, Angeloni and Schuknecht 2005), where the authors provide empirical evidence of the expansion of the policy-making role of the European Union between 1971 and 2000. They find that the European Union’s process of allocation of powers is far from optimal. Substantial harmonization has occurred in areas where heterogeneity of preferences is
predominant (such as social protection or agricultural policy), but other areas with strong economies of scale have remained in the local domain (such as defense and environmental protection).

By studying the effects of the harmonization of contract law, Parisi and Carbonara (2009) depart from a position where harmonization is usually efficient and arrive at two important conclusions. First, they affirm that when switching costs are exogenous, a cooperative solution leads to greater harmonization compared with non-cooperative solutions. Second, they reveal that the equilibrium that is reached by means of cooperative solutions is a Nash equilibrium that does not allow for total elimination of the legal distance among legal orders.

The most surprising solution results when considering the hypothesis that switching costs are endogenous. In that case, when considering an operation in two steps, of which the first is characterized by the preparation of the agreement, a state can act to bind itself so that it will not be able to change the standards of its legal order for reasons such as the constitutional relevance of a legal principle or a public commitment by stubborn politicians not to change a specific feature of their national legislation. (These actions can be considered to be “hand-tying actions”, in the sense that the cost of introducing a change to the legal order is greater than the benefits of harmonization.) In doing so, a state places the full burden of harmonization on the other state. According to Parisi and Carbonara, this result is worse than the result that would come from harmonization that is not guided by possible international agreements, because states would autonomously move toward a certain level of harmonization without following strategic behavior.

The position of Parisi and Carbonara does not always appear to be justified. Even in the case of a two-stage process, that is, when two states adopt measures for harmonization and then move on to stipulate the agreement, a country might autonomously bind itself without the sure prospect of a treaty, hoping that this would drive the other nation to bring its law into conformity.

Parisi and Carbonara’s idea of self-binding behavior is based on the strategic nature of a country’s efforts to reduce legal differences with other countries. Such efforts are strategic substitutes, which means that the marginal benefit from increasing one country’s effort reduces another country’s effort. This leads each state to decrease its efforts when the other country increases its efforts.

The dynamic occurrence of legal harmonization among several countries depends on various factors, among which is the original choice of law regime. Imagine a case in which countries have introduced binding standards, in which the standards of the A states are more efficient than the standards of the B states. You might suppose that the B states would conform to the A states’ standards, but this is not necessarily true. The result would depend on the percentage of states that originally adopt the two standards. If the inefficient B states constitute such
a majority that they can take advantage of externality networks in conforming and the switching costs are not high, then it will be the efficient A states that conform to the standards of the less efficient B states.

Under the opposite hypothesis, that the number of A states is larger than the number of B states, and if the switching costs are not too high, it might be convenient for the B states to conform to the law of the A states. This would lead to state laws that are harmonized and efficient. The same line of reasoning may be followed if there is a single A state that is sufficiently large to make it convenient for the B states to conform to the laws of the single A state.

The final hypothesis is that interstate exchanges cannot take place so no country changes its own law.

Normally, liberal choice is considered the best choice of law regime to produce efficient laws. Liberal choice means a regime in which the parties choose or lay down their preferred law. In reality, this conclusion does not always seem to be correct. Imagine that a state C has adopted the standards of the B states, while its businesses have chosen the law of the A states. There are few incentives for state C to adopt the rules of the A states, because its businesses can resolve the inefficiency problem by opting out of the inefficient law altogether. Parisi and Carbonara (2009) also consider a third model of a choice of law regime, which they define as semi-restrictive, according to which businesses and individuals must adopt the national law if they belong to the same state, while they are free to choose the law that is most suitable to their interests if they belong to different states. Even in that case the solution depends on the initial situation, on the switching costs and on the benefits of a particular law. In one or more states, an inefficient law might prevail.

For the majority of scholars, harmonization of standards is believed to be the necessary consequence of competition among states. This is especially valid in the fields of contract and corporate law. There are often insufficient incentives for a country to change its own laws, since the businesses in the liberal choice of law regime choose their own law. However, under some hypotheses, the incentives for changing the law do exist. There are authors who recognize a race to the bottom, meaning a downward harmonization toward inefficient rules, in the competition among legal orders to attract businesses or legal parties. Other authors recognize a race to the top, that is, a race that leads to the harmonization of efficient standards. This theme has mainly been dealt with in regard to corporate law. That does not mean that competition necessarily leads to harmonization. It is possible that a federated state will make no changes following a state laying down new standards (Parisi and Carbonara 2007).

Finally, scholars of public choice have pointed out that it is necessary to keep in mind the effects that interest groups have on the creation of standards. Therefore, a regime of liberal choice of law may reduce the incentive to introduce laws favorable to interest groups that formerly benefited, for example,
from inefficient rules in a regime of restrictive choice of law (Ribstein and Kobayashi 1997).

The model of Parisi and Carbonara can be useful for understanding the results obtained from Alesina’s et al. analyses. They provide a model that shows which sectors are subject to inefficient legal harmonization: those selected by the group of B states (or by one large B state). This choice conditions the A states to conform and accept the harmonization of one inefficient sector (for example, agriculture).

There is another possibility, which may not have been considered by Parisi and Carbonara in their work. This is an “exchange” between A and B states, in which the former proposes to the latter the harmonization of some sectors with the laws of A in exchange for the harmonization of other sectors with the laws of B. The same line of reasoning can be applied to the choice not to harmonize in order to maintain a competition among legal orders. The A states could be interested in maintaining competition between legal orders for some sectors (for example, taxation), and they might obtain this concession from the B states in exchange for accepting the latter’s priority of maintaining competition among the legal orders of other sectors (for example, defense).

Corporate Law, Legal Harmonization or Competition?
Since the 1960s, the question addressed in relation to legal harmonization or competition has been whether it is preferable to allow each state to be free to lay down its own corporate law, or if the central government should dictate a law that is effective for all states.

The idea of a race, either upwards or downwards, is reflected in the American reality in which Delaware changed its law in such a way as to induce businesses to incorporate there. By doing this, Delaware, one of the smallest states in the United States, obtained fees for incorporation which guarantee 25% of its state revenue. At times, other states have followed Delaware’s actions, even if, adopting the liberal choice of law regime, it is not necessary to modify the law but to leave businesses free to adopt the law they prefer. On the other hand, for larger states like California, legal incorporation fees are a tiny part of its revenue, and therefore such states may not have had a strong incentive to corner such legal fees. But Delaware was interested in the fees and produced new legislation according to the needs of businesses. Was this process a race that pushed toward efficient laws (a race to the top), or did it drag the laws toward inefficient solutions that were to the exclusive advantage of managers (a race to the bottom)?

In the 1970s, Cary held that the race was downwards because states forced themselves to make laws to protect board directors (Cary 1974). In reality, this question should be examined with reference to two distinct periods. In the first period, the business goes public. In the second period, the established business
Legal harmonization carries out extraordinary operations like mergers and acquisitions to bring about the transfer of its headquarters to another state.

In the initial stage, the issuer has an interest in maximizing the value of the securities it issues – that is, the value of the firm – and will look for a law that lays down efficient standards that do not produce deadweight loss. In this way, the state’s race to offer the best law will be directed at providing legislation to ensure the issuer’s incorporation there. But during the lifetime of the firm, other choices must be made. For a series of reasons, these choices are taken by managers without being influenced by stockholders in an efficient way. Will these choices be carried out in order to maximize the value of the firm or to guarantee privileges for the directors? In the period between the 1970s and 1980s, there was a wave of takeovers to which states reacted by introducing anti-takeover standards. More specifically, directors defended themselves by introducing standards that, in various ways, blocked takeovers or made them extremely difficult. The aim was essentially to protect company workers present in each state because of the fear that a successful takeover would cause mass layoffs. Not even Delaware was immune from this trend, even if it reacted later and more gently compared with other states. This result reinforced the opinion of those who envisioned a race to the bottom among states in corporate law. However, there was also proof that companies were not interested in these changes and actually sought to avoid laws that exclusively protected incumbent managers. The loss in value of listed companies because of these laws may have been severe. Therefore, when Pennsylvania issued anti-takeover statutes that blocked takeovers in a nearly total manner, many companies abandoned Pennsylvania and reincorporated in other states that were less restrictive with regard to takeovers (Romano 1993).

According to Winter (1977), companies continuously seek efficient laws because they must accumulate capital, and if the company is under a legal framework that penalizes investors, the investor will be willing to pay less for its bonds and stocks. The cost of capital for these companies will increase to such an extent that such companies will find themselves in a disadvantaged position compared with those companies that have an efficient organization and a lower cost of capital.

However, such conclusions do not always apply, and even Roberta Romano (1993), who supports the usefulness of competition among states, hypothesizes that in some specific cases harmonization by the federal government may be necessary. In the last few years, the federal government intervened to carry out a partial harmonization of corporate law with the Sarbanes-Oxley Act. Some authors believe Sarbanes-Oxley to be a downward harmonizing intervention (Easterbrook 2009). But other law and economics scholars maintain that mandatory rules are necessary, given existing distortions in the charter amendment process and in decisions to move the registered office, because
directors are able to introduce rules in charters that benefit themselves to the detriment of owners (Bebchuk 2005).

**Legal Harmonization in the EU**

The organization of the European states known as the European Union (EU) developed from the idea of some politicians to ensure that citizens of Europe had access to four freedoms: the free movement of goods, individuals, services and capital.

It should be said that the bulk of legislative provisions (directives and regulations) adopted within the EU are such as to configure a process of legal harmonization. Besides, this process is not limited to contract and company law (the two fields most often investigated by the economics of legal harmonization), but also includes many other fields, such as: telecommunications, air transportation, medical standards, and others. EU law today is the most important case of legal harmonization in a (sort of) federal context. It impacts many new fields compared with the two that are mainly examined in the literature of legal harmonization.

The four fundamental freedoms of the EU pose a problem as to whether competition or harmonization among states is preferable.

The free movement of individuals poses a problem that is widely discussed: for contract law, is it preferable to proceed with harmonization rather than with competition among Member States?

Many scholars have stated that, in the field of contract law, harmonization is socially efficient because it eliminates the costs of studying different laws and excludes a conflict of laws. This facilitates the free movement of individuals because they can stipulate contracts without committing the error of believing the contract is governed by a different state’s laws. The EU has issued some regulatory acts to harmonize contract law. The EU has harmonized parts of contract law in which a party is a consumer (for example, Directive 93/13 EEC). An important step toward partial harmonization took place with a regulation that was intended to harmonize international contract law (Regulation (EC) 44/2001). Nevertheless, it can be argued that the laws of the various Member States concerning contract law remain different (Bussani and Werro 2009).

The free circulation of goods developed through an unforeseeable step by the European Court of Justice. The EU tended to prefer a harmonization of the standards that regulate the characteristics of the goods that can circulate within EU territory. In 1979, with the *Cassis de Dijon* verdict (case 120/78), the Court affirmed that goods can circulate across the EU on condition that they respect the legislation of the Member State where they were produced. This verdict left space for competition among Member States to attract producers to their country. A race to the bottom could have occurred, that is, a race by Member States to pass progressively inferior requirements for goods produced in their
Legal harmonization

country. But that did not happen. One explanation is that products are also sold to citizens of the country where they are produced, and therefore the legislators preferred not to reduce the requirements too greatly in order not to harm their own citizens.

After the Cassis de Dijon verdict, the EU headed in a direction that targeted (so-called) “harmonized competition”: the EU laid down certain ground rules that goods must satisfy in order to circulate in the European market, leaving Member States with the ability to introduce further requirements, allowing for de facto regulatory competition.

In the context of corporate law, European legal harmonization was carried out to integrate the incomplete provisions of the Treaty of Rome regarding the subject of freedom of establishment of companies. Although the Treaty recognized freedom of establishment for companies as well as for people, it did not define the concept of a company. As a result, there was no clear definition of whether company mobility – one of the consequences of the freedom of establishment – referred to the possibility of moving a registered office independently of the actual headquarters. Moreover, the lack of a definition did not permit cross-border mergers. These problems created the need for legal harmonization. Faced with the possibility of introducing rules that could bring about competition among Member States in the field of company law, until the mid-1980s the European Union instead focused on achieving a harmonization that would exclude such competition. This process of harmonization halted due to the impossibility of identifying a common European model for the mandatory participation of workers in the management of companies and for discipline of groups (Santella 2010).

Later developments have produced, among other things, the introduction of cross-border mergers and in general they have created a legal situation that is characterized by a partial harmonization supported by the freedom of competition among Member States, which we define as harmonized competition. The European Court of Justice also contributed to this result: since the 1999 Centros verdict (Case C-212/97) for companies of initial formation the Court recognized the right to locate the registered office in a different Member State than the actual headquarters. It is difficult to formulate a judgment in terms of the efficiency of the choices carried out by the European Union. It could be that the competition introduced among states in company law is for the most part efficient, as has been seen with regard to American law. But more likely, the directives and regulations that make up European company law must be evaluated individually, since they probably contain both efficient and inefficient provisions.

The discipline of financial services is also an integral part of the freedom of movement of capital. A first wave of legislation in the 1970s and 1980s introduced minimum harmonization in some financial services, leaving ample space for
Production of legal rules

Member States to adapt EU legislation to national specificities (European Commission 1999). The impetus for further integration in the direction of the completion of a single market for financial services in the EU came through a series of directives and regulations adopted following the Financial Services Action Plan of 1999. This aimed to tackle three strategic objectives: (i) a single market for wholesale financial services; (ii) open and secure retail markets; and (iii) advanced prudential rules and supervision. The issue of harmonized competition was also dealt with in the adoption of an Action Plan through a new institutional arrangement (the so-called Lamfalussy Procedure) to coordinate the design and implementation of some of the directives within the Action Plan, with the aim of restricting, but not eliminating, Member States’ discretion (Maes 2007). The financial crisis of 2008 has elicited a general revision of the entire legislative framework concerning financial services. These changes are aimed at introducing more harmonization through (i) the redrafting of the existing legislation with less discretion for EU Member States; (ii) expanding the regulatory perimeter to include new areas of the EU financial market (i.e. hedge funds, short selling, and the post-trading infrastructure) and (iii) the introduction of new agencies in charge of providing a more uniform approach to the enforcement of EU financial legislation (European Commission 2009).

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