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Member States Liability for Infringement of the Free Movement of Goods in the EC: An Economic Analysis

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**JEL Classification, K3 Law and Economics, Other Substantive Areas of Law, L5, Industrial
Organization, Regulation and Industrial Policy**

1. Introduction

In several judgements¹ the European Court of Justice (hereinafter: the Court or ECJ) has established the requirements which must be satisfied for individuals to claim compensation from Member States who fail to observe their community obligations. The duty to compensate losses suffered by firms and individuals may constitute an effective remedy for the enforcement of community obligations imposed upon Member

States. However, problems arise when it must be established whether legislative bodies of the Member States (parliaments and governments) have breached their community obligations. In such cases, it is not always perfectly clear whether superior rules of EC law have been violated. Whereas the failure to implement a community directive by the Member State concerned within the time-limit prescribed by the directive is a very obvious infringement of EC law, other breaches may flow from the misinterpretation of open-ended, and therefore vague, or ambiguous rules and general principles of European law. Under EC law restrictions on the free movement of goods, persons, services and capital can be justified on a number of specified grounds. In the area of free movement of goods, article 36 EC Treaty mentions *inter alia* grounds of public security and the protection of health and life of humans, animals or plants. In addition, the Court has introduced a “rule of reason” for assessing indistinctly applicable measures which allow to accept national regulations, which do not discriminate on grounds of nationality, in so far as those provisions are necessary to satisfy “mandatory requirements”, such as consumer protection². Given these vague rules, national legislators may commit errors in assessing their community duties. It is not always clear whether regulations may be saved by the “rule of reason”. In the Court’s judgements, Member States’ liability for infringement of the principle of free movement of goods has been made dependent on the showing of a “sufficiently serious breach” of a Community obligation.

Legal commentators have criticised the Court’s case law as too restrictive. Firms and individuals would not get sufficient legal protection from a rule which makes compensation dependent on showing a “sufficiently serious breach” of a community obligation. These criticisms seem unjustified if arguments of economic efficiency are incorporated into the discussion. Given the uncertainty about whether regulations are in conformity with the principle of free movement of goods, national legislators are confronted with an imprecise standard of care. In addition, private losses of firms that result from rules hindering free movement of goods will generally exceed social losses. This may lead to overdeterrence, i.e. national legislators may choose a level of care which is a way above the efficient level. To avoid inefficient outcomes, this article suggests to lower the standard of care (by introducing a rule of “obvious negligence”), in cases where infringements of the EC Treaty by legislators and governments have given rise to pure economic losses exceeding total social losses and standards of care are imprecise. This proposal comes close to the “sufficiently serious breach”- requirement advanced by the Court. An example is helpful to illustrate: A well-known case is *Brasserie du Pêcheur*, in which a claim was brought by a French company against the German government. The company was forced to discontinue selling beer into Germany because the German authorities considered that the beer did not comply with the purity requirements laid down by German law. In a 1987 judgement the European Court of Justice held that this prohibition was contrary to the principle of free movement of goods enshrined in Article 30 of the Treaty.³ The damage suffered by the plaintiff was thus caused by the failure of the German legislature to amend a law which was contrary to EC law. The French company sought damages for losses of 1.8 million DM

1 Joined Cases C-46/93 and C-48/93, *Brasserie du Pêcheur SA v. Federal Republic of Germany and The Queen v. Secretary of State for Transport ex parte Factortame Ltd.* (1996) ECR I-1029, *The Queen v. Ministry of Agriculture, Fisheries and Food, ex parte Hedley Lomas (Ireland) Ltd.* (1996) ECR I-2533.

² See among others: Steiner and Woods, *Textbook on EC Law*, 5th ed., London, Blackstone, 1996, 121-156 with further references.

suffered between 1981 and 1987. If these damages had been granted, all other non-german producers of beer would have had strong incentives to claim similar compensation.

This article is structured as follows. After this introduction, the far-reaching implications of the divergence between private losses and social losses will be made clear. The economic effects of liability for pure economic losses will be described and its possible negative effects on efficiency will be highlighted. First we will look at the case of a cost minimizing firm. Thereafter, the analysis will be extended to states. It will be shown that in both cases full compensation of private losses exceeding total social losses may lead to overdeterrence if - as is often the case under EC law - standards of care are imprecise. To avoid inefficient outcomes liability should be restricted to cases of “obvious negligence“. In the next part of the paper some general normative lessons from the economic analysis will be presented and the cases brought before the Court will be reconsidered taking account of the economic insights.

2. Non-Compliance with European Law from an Economic Perspective

The ECJ has made compensation for pure financial losses dependent upon the showing that a Member State committed a “sufficiently serious breach” of a rule of Community law conferring rights on individuals. The ECJ has thus formulated a liability rule, which comes close to gross negligence on the part of a Member State disregarding European law. At first sight it seems that this rule cannot lead to efficient outcomes. It is a well-known theorem of the economic analysis of tort law, that a tortfeasor will be given the right incentives to take care, only if the courts set the legally required level of due care equal to efficient care. If the courts use a lower standard of care in deciding negligence cases, injurers will choose a level of care which does not equalise marginal abatement costs and marginal damage reductions. From this point of view, it seems that the European rule on Member States’ liability, which restricts liability to “sufficiently serious” breaches of Community Law, is toothless and leaves ample space for opportunistic and nationalistic deviations from the four economic freedoms laid down in the EC-Treaty. We maintain, however, that a rule of ‘obvious negligence’ (*Evidenzhaftung*⁴) is defensible and might even be necessary on efficiency grounds. This is due to three reasons which, when taken into account, alter substantially the conventional economic analysis of accident law.

First, in all cases brought before the ECJ the harm consisted of pure economic or financial losses. Second, in cases where one of the economic freedoms guaranteed by the EC Treaty was violated, it is difficult for any Member State from an *ex an te* point of view, to foresee which types of national regulation the ECJ would hold contrary to the vaguely formulated principles of the EC Treaty and which sorts of rules it would still accept as being in conformity with European law. A national legislator thus faces an uncertain European legal standard when making decisions on the enactment or retention of national regulations. Third, the costs of a regulator to comply with European law are different from the usual abatement costs

³ Case 178/84, *Commission v. Germany* (1987) E.C.R. 1227 (“Reinheitsgebot“)

of tortfeasors to avoid accidents. These factors, especially when they are combined, change the analysis and lead to conclusions different from the conventional economic analysis of accident law.

3. Overcompensation as a Result of Liability for Pure Economic Losses

There is a fundamental difference between those effects of noxious behaviour which destroy or incapacitate an economic resource and those which lead to pure financial losses⁵. If a house burns down, the value of the capital stock of the society is diminished by the value of the destroyed house. Therefore, the damage of the victim is equal to the damage of the society and, if negligence was shown and causation proven, compensation would be equal to the losses of the society. This equality of the victims' damage, the loss of the society at large and the amount of damage compensation, however, is no longer existing in cases of pure financial losses.

Assume that a national regulator infringes the principle of free movement of goods by enacting a food quality standard, which allegedly serves a goal of consumer protection. Assume further that the effect of this standard is ambiguous for the consumers as a group. On the one hand, it prevents foreign suppliers from entering the relevant Member State's market, thus increasing monopoly power and the product price. On the other hand, the national regulation might generate some benefits for the consumers as well. How must the damage to be compensated be assessed in such a case? How large are the social losses? It is evident that, unlike in the case of the burnt house, private losses and social losses are not equivalent.

The social losses or gains, resulting from the enactment of the national quality regulation, must be calculated taking into account the combined change of consumer and producer surplus. The social loss is almost necessarily different from the damage suffered by the foreign would-be exporters. Assume that as the result of the regulation consumers lose 10, domestic producers gain 100 and foreign producers lose 105. The social losses from infringing the economic freedom of free movement of goods then amount to 15. Losses of consumer surplus cannot be compensated in most European legal orders. If, however, the foreign producers are entitled to damage compensation they will claim 105, which is seven times the social losses. Overcompensation, in the sense that total damage compensation might (substantially) exceed the amount of the total social loss, is thus an unavoidable risk of liability rules which grant compensation for pure economic losses. This can lead to overdeterrence and to the choice of an excessively high level of care.

The need to restrict the award of damages for purely economic losses, shown by economic analysis, is partly reflected in the actual legal treatment of economic losses. As far as economic losses are caused by accidents (such as the interruption of the supply of electricity or collisions at sea cutting off from the mainland an

⁴ This term is used by Erich Schanze in an unpublished paper, in which he discusses different kinds of - mostly - pure financial losses. SCHANZE (1996) refers to § 44 of the German *Verwaltungsverfahrensgesetz*.

⁵ SHAVELL (1986); BISHOP (1982); LANDES and POSNER (1987, 251-255).

island on which businesses are located⁶, there are remarkable differences across legal systems. Whereas the English and the German legal system take a restrictive position, the French system adopts a much broader view. Pure economic losses, such as wages paid when no work could be done owing to the lack of current following a power interruption due to negligent earth-removal operations, are not recoverable under German law, since they do not relate to one of the legal interests protected under § 823 I BGB⁷. The solution in English law is similar, albeit for different reasons⁸. By contrast, there are no special doctrines restricting liability for economic losses in French law, but such liability may be limited by standards used for proof of causation and for the certainty of losses⁹.

For the purposes of this paper it is not necessary to dwell at length on these differences, since the economic losses concerned are not the consequence of an accident, but flow from legislative acts or omissions violating superior rules of law for the protection of individuals. The facts of the cases discussed in this paper show similarities with economic losses suffered by businessmen, whose competitors engage in unfair competition by breaching economic laws (requirements as to production and regulations restricting or prohibiting certain selling arrangements). Indeed, many Member States' regulations violating the fundamental economic freedoms of the EC-Treaty have been enacted for protecting domestic trade from foreign competition. In cases involving economic losses due to the breach of legislative provisions, the differences between legal systems are less dramatic. According to German law compensation for purely economic losses can be claimed if a protective norm ("Schutznorm") is breached by those whose interests are protected by the protective statute infringed¹⁰, such breach gives rise to an action for damages to the extent that some fault can be imputed to the wrongdoer (§ 823 II BGB). In addition an intentional breach of *boni mores* leads to recovery of pure financial losses (§ 826 BGB). In some cases, for example consultancy, courts require that the tortfeasor was fully aware of his negligent act.¹¹ In the common law of England breach of a statutory duty may allow compensation for purely economic losses if the statute breached can be constructed as giving an action for damages for the benefit of the injured plaintiff. The normal criteria for the action for breach of statutory duty include the need to prove that Parliament intended to create private rights and that the damage was of the kind that the statute was intended to guard against. In contrast with German law, there is no further requirement for a showing of fault¹². In sum, compensation for pure economic losses as a consequence of a violation of statutory duties is available in each of the major legal systems (France, Germany, United Kingdom), but the group of plaintiffs who may bring an action for damages may be limited (Germany, United Kingdom).

⁶ For a discussion of such cases, see SHAVELL (1986, 135-140), LANDES and POSNER (1987, 251-255), SCHÄFER and OTT (1995, 246-253).

⁷ BGH, 4 February 1964, BGHZ 41, 123; NJW, 1964, 720.

⁸ *Spartan Steel & Alloys Ltd. v. Martin & Co. (Contractors) Ltd.* (1973) 1 Q.B. 27. See VAN GERVEN (1996, 508-509) for a discussion British, German, French and Dutch cable cases.

⁹ ZWEIGERT and KÖTZ (1996, 21). The legal situation is the same in Belgium and the Netherlands.

¹⁰ For example, § v1 UWG which prohibits unfair trade practices (*inter alia* violations of economic statutes, giving an unfair advantage to competitors) is considered a Schutznorm in the relation between competitors, but not between businessmen and consumers. See EMMERICH (1995, 384 and 412-415).

¹¹ "bewußt leichtfertig"

¹² VAN GERVEN (1996, 510-511).

4. State liability for breach and for “sufficiently serious breach” of European Law, The Case of the Cost Minimizing Regulatory State

Can a rule which leads to member state liability only in case of an evident or obvious violation of European law be defended against a liability rule depending on violation per se? This question will be analysed in the following chapter.

To make the alternative rules of state liability as clear as possible, look at the following time path.

(1) A national government imposes a foreign trade related regulation for reasons of consumer protection, health protection or environmental protection, which leads to losses of foreign exporters from other countries of the community.

(2) One of these exporters claims abolishment of the regulation at the ECJ on the grounds that it violates European law.

(3) The ECJ decides either that the national regulation is in accordance with European law or declares it a breach of European law. In the latter case the national government has to immediately uplift the regulation.

(4) An EC Individual having suffered damages from a -now uplifted- regulation claims damage compensation for the period in which the regulation had been effective.

(5) This compensation can be granted either on the grounds of a breach per se or on the grounds of a sufficiently serious breach of European law¹³. For further analysis we proceed in 4 steps.

-In the first step the socially optimal level of foreign trade related regulation¹⁴ (r^*) of a national regulator is determined.

-In the second step it is analysed, which level of regulation a member state would choose without the threat of state liability.

-In the third step a state liability rule based on violation per se of European law is analysed.

-In the fourth step a liability rule depending on a “sufficiently serious breach” is discussed¹⁵.

4.1. The Efficient Regulatory Level, Restrictions of the Economic Freedoms of the EC by Wealth Increasing Regulation

The first step is to find the socially optimal regulatory level. National legal rules deviating from EC principles of free movement of goods or freedom of establishment can lead to an increase in social welfare.

¹³ This makes clear that the options under debate are not between some specified version of negligence and strict liability. Strict liability of a member state would lead to compensation of any harm to foreign suppliers no matter whether a violation of European law occurred or not. Such a rule is not debated. Until some years back foreign exporters could only force a member state to uplift -in the future-a foreign trade related regulation which was against European law. Now they can also collect damages but only in case of a sufficiently serious breach of a member state. The ongoing debate is between this rule and a rule which leads to damage compensation already in case of a breach (without the qualification of “sufficiently serious”).

¹⁴ Note that the term r is mapped into political costs to the state

¹⁵ We call this a rule of “obvious negligence” to emphasize its resemblance with obvious negligence in fields of civil liability.

For further analysis we use a competitive market model with domestic consumers and domestic as well as foreign producers. Without regulation domestic consumers suffer some –however small- disadvantage from the imported good of which they are unaware before the buy, for instance because product information of foreign suppliers is not in the local language. But transaction costs are too high to perceive this and reduce the willingness to pay accordingly. Some German consumers might for instance prefer beer brewed according to the traditional purity requirement (Reinheitsgebot) and mistakenly believe that this is a universal rule pertaining to imported beer as well. Some of these very particular consumers might even regard any other beer as not beer at all but a mixed drink. For further analysis it is assumed that regulation, when introduced, imposes costs on the foreign but not on the national producers. The regulation is assumed to have some benefit -however small- to the consumer (or to third parties).

The market is modelled by the following set of equations. Let p be the price of the representative good and x the quantity of goods, then we get for the demand in the domestic market:

$$(1) \quad x=f(p), f'(p)<0;$$

The supply function for the domestic (h) producer is

$$(2) \quad x_h=g(p), g'(p) \geq 0.$$

The level of foreign trade related regulation is r . $r=0$ means no regulation, a high value of r means tough regulation of foreign producers, e.g. tough information requirements on the exact content of drinks, special labels etc. Then foreign supply becomes a function of the degree of regulation (r) and of the price (p).

$$(3) \quad x_f=h(p,r), \delta x_f/\delta p>0, \delta x_f/\delta r <0.$$

Total production (x) is the sum of domestic and foreign production.

$$(4) \quad x=x_h+x_f$$

For further analysis it is assumed that foreign producers cause some adverse effects either to uninformed consumers of their goods or to bystanders, which can be reduced by regulation. Let the adverse external effect to consumers be Ex , then Ex is a function of the supply of foreign producers (x_f) and the degree of regulation (r).

$$(5) \quad Ex=f(x_f,r) \geq 0, \delta Ex/\delta x_f>0, \delta Ex/\delta x_f=\text{const.}, \delta Ex/\delta r<0, \delta^2 Ex/\delta r^2>0.$$

Adverse effects to consumers (Ex) increase linearly with foreign supply and decrease with the level of regulation, however less than proportionately.

It is now possible to determine the optimal level of foreign trade related regulation (r^*). For any r the equilibrium values of p, x, x_h and x_f can be computed. For any set of equilibrium values depending on r there exists a total surplus (S_t), consisting of the consumer surplus (S_c), the foreign producer surplus (S_f) and the domestic producer (S_h) surplus:

$$S_t = S_c + S_f + S_h$$

As any increase of r increases costs and shifts the total supply function upwards, it is clear that total surplus is maximized without any foreign trade related regulation ($r=0$). With increasing regulation total surplus is reduced and reaches the lowest possible level, if it increases the costs of foreign suppliers to such an extent, that they are excluded from the home market altogether (at $r=r^h$). In that case total surplus consists of the consumer surplus plus the producer surplus of domestic suppliers.

Therefore we get

$$S_t(r) > 0, S_t'(r) < 0 \text{ if } r < r^h \text{ and } S_t'(r) = 0, \text{ if } r \geq r^h.$$

Total net welfare (W) generated on the market is the total social surplus minus the adverse effect (Ex) to consumers.

$$(6) \quad W = S_t - Ex$$

Regulation reduces disadvantages or damages of consumers and bystanders directly -for instance by way of better and more transparent consumer information- and indirectly. The indirect effect occurs as regulation reduces foreign supply (x_f) and thereby also negative effects to consumers. We get the following expression for the damage at any particular equilibrium:

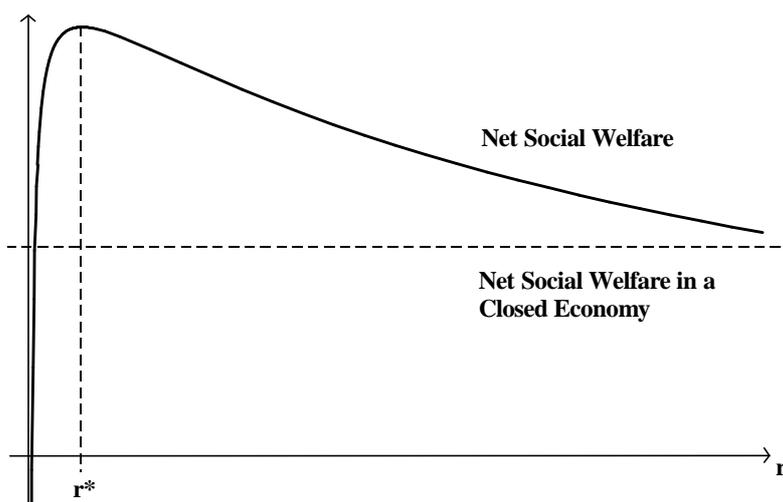
$Ex = f(x_f(r), r)$, with the total derivative

$$\frac{dEx}{dr} = \frac{\partial Ex}{\partial x_f} \frac{dx_f}{dr} + \frac{\partial Ex}{\partial r}$$

Maximizing the welfare function (14) with respect to r leads either to no regulation ($r^*=0$) or to a regulatory level which effectively bans the foreign product from the home market ($r^*=r(\text{prot})$) or to an interior solution ($0 < r^* < r(\text{prot})$). The following graph depicts the net welfare (W) in (14) as defined above as a function of the regulatory level for a particular set¹⁶ of supply and demand functions and a function for the external effect.

Fig. 1 Total Social Welfare as a Function of the Regulatory Level

¹⁶ Demand: $50 - 0.5 * x$, domestic supply: $p = 1 + 2 * x_h$, foreign supply: $p = 0.1 + r + 0.5 * x_f$, Adverse effect to the consumer: $Ex = x_f / r$



In Fig. 1 at r^* the welfare function for the community ($W=S_f+S_h+S_c-Ex$) is maximized.

4.2. The Decision to Regulate without Liability, the National Regulatory Bliss Point

Which regulatory level will a national government choose without state liability for the infringement of European law, if the only sanction to be feared by the member state is the uplift of regulation by the ECJ for the future? This depends crucially on the behaviour of the political system (government and parliament) or in more technical terms on what the government maximizes. It is possible to take three opposing views.

- (1) The national government maximizes the welfare of the (European) community
- (2) The national government maximizes its own interests (public choice perspective)
- (3) The national government maximizes national welfare, disregarding the welfare of foreigners but giving equal weight to the interest of all national individuals

4.2.1. The National Government maximizes the community's welfare.

According to the public interest theory of regulation the government fixes the degree of regulation (r^*) which maximizes total welfare ($W=S_f-Ex$). Deviations from r^* are random numbers resulting from lack of information. The bliss point of the government r_b is then equal to r^* . Efficiency is reached without liability.

4.2.2. The National Government maximizes a distorted National Welfare function (minimizes political costs of regulation)

According to the public choice theory of regulation the political decision makers maximize their own utility. They disregard foreign interests completely and due to various reasons take decisions more in favour of domestic producers rather than consumers. This theory would predict a preferred regulatory

level $r_b > r^*$ in case of no state liability. r_b represents the bliss point of the political decision makers, the amount of regulation that minimizes the (political) costs of regulation for the political group in power. Any deviation from the bliss point r_b either towards more or less regulation is associated with a cost for the political decision maker.

To model the national bliss point -in the absence of state liability- more precisely, it is assumed that the national government maximizes a politically distorted social welfare function (DW), which disregards completely the foreign producer surplus (S_f) and puts an extra low weight α , with $0 \leq \alpha \leq 1$ on the consumers' interest (Consumer surplus S_c surplus minus external effects (Ex))

$$(7) \quad DW = \alpha(S_c - Ex) + S_h \text{ with } S_c'(r) < 0, Ex'(r) < 0, \text{ and } S_h'(r) > 0.$$

If an interior maximum for this distorted welfare function exists, we get some regulatory level ($r_b > r^*$), at which the function is maximized. This level (r_b) is the bliss point of the government and would be chosen as the regulatory level without any state liability. For a proof see that r_b must be higher than r^* , because S_f decreases at r^* , and therefore $S_c - Ex + S_h$ must increase at r^* by the same amount because the total change of welfare at r^* is zero. The distorted welfare function which disregards foreign producer interests and discounts consumer interests must therefore increase at this point. This proves that at the efficient regulatory level the distorted national welfare function is not yet maximized.

We can now model the political costs of regulation (C_p). They can be regarded as the difference between the value of the distorted welfare function at the bliss point (r_b) and its value at any other regulatory level r .

$$(8) \quad C_p = DW(r_b) - DW(r) \text{ or}$$

$$(9) \quad C_p = DW(r_b) - (\alpha(S_c(r) - Ex(x_f(r), r)) + S_h(r))$$

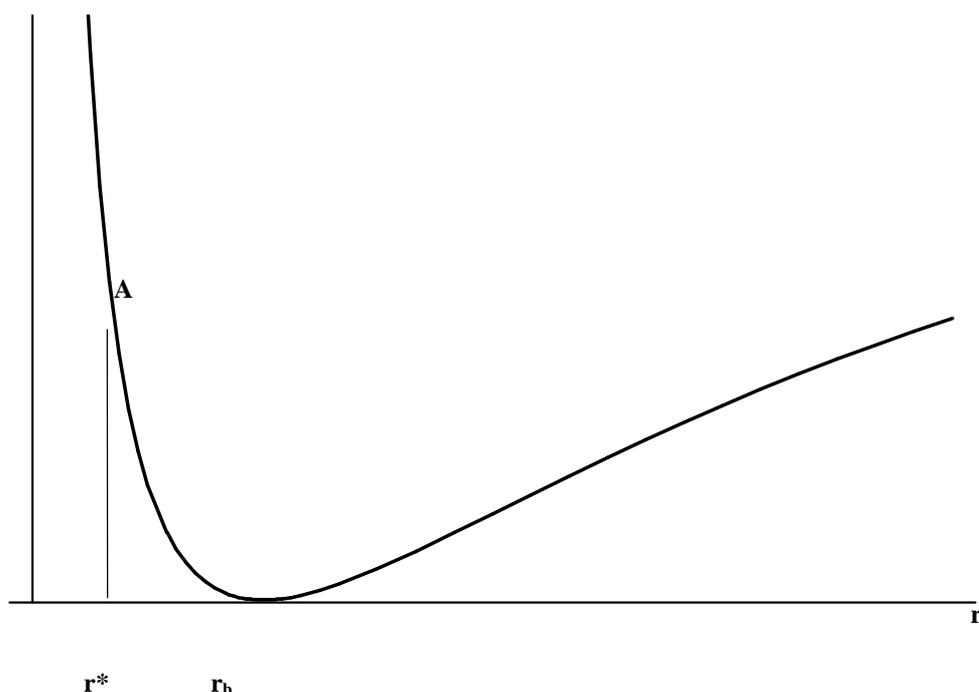
By definition $C_p = 0$ at $r = r_b$, and $C_p > 0$, if $r \neq r_b$. $C_p'(r) > 0$, if $r > r_b$ and $C_p'(r) < 0$, if $r < r_b$

Hence political costs of regulation are 0 at the bliss point and positive at any other level of regulation.

Fig.2 Political Costs of Deviating from the regulatory Bliss Point as a function of the regulatory level¹⁷

C_p

¹⁷ To plot this graph, the same set of functions was used as above, see footnote 23.



In Fig. 2 the political costs resulting from regulation are expressed as a function of the regulatory level r , which reaches a minimum of zero at a regulatory level (r_b) the bliss point. In the absence of liability this point must be higher than the optimal regulatory level (r^*). Thus we have political costs as a function of regulation in a comparable way as we had the costs of care as a function of the level of care for the cost minimizing firm.

4.2.3. The National Government maximizes national welfare

The same considerations apply, if the national government does not discount the interest of the consumers but disregards foreign suppliers. In that case $\alpha=1$, and instead of (9) we get

$C_p = DW(r_b) - (S_c(r) - Ex(x_f(r), r)) + S_h(r)$ Again for the same reasons already explained the national bliss point of regulation r_b must be higher than r^* .

4.3. The Cost Minimizing Regulatory Level with State Liability for Economic Loss of Foreign Producers

Without liability the national regulator can simply choose his bliss point and wait and see whether his regulation will be upheld by the European Court at some future date. In case of liability it is necessary to differentiate between a precise and an imprecise liability standard.

4.3.1. State Liability for Economic Loss under Precise Standards

Assume now a precise and predictable maximum standard of foreign trade related national regulation to be compatible with European law. Assume further that the ECJ chooses the efficient level of regulation (r^*) for the legal standard and assume that the member states have to compensate for the lost profits of

foreign producers whenever they chose a foreign trade related regulatory level, which is higher than this standard.

To how much damage compensation are foreign producers entitled in case of overregulation? Compensation is then the difference between the foreign producer surplus at the efficient and approved (by the European Court of Justice) level of regulation ($S_f(r^*)$) and the foreign producer surplus at the level actually chosen by the national regulator ($S_f(r)$), with $r > r^*$. Damage compensation (DC) is then

$$(10) \quad DC = S_f(r^*) - S_f(r) \text{ if } r > r^* \text{ and } DC = 0 \text{ otherwise.}$$

Which regulatory level will the national regulator choose under this liability rule? This depends again on what the political system maximizes or -respectively- on the political costs, the political system tries to minimize.

4.3.1.1. The National Government maximizes the community's welfare.

Consider first the public interest case in which the government acts efficiently in the interest of the whole community. Then -as has already been shown- in the absence of liability the government is maximizing the social welfare function i.e. acting efficiently for the whole community. Making the government liable may seem to distort the decision, but upon closer inspection the government is magnanimous enough to note that each Euro that it has to fork out for damages is one Euro of benefits for the foreign producer and one Euro of costs for the domestic taxpayer. Disregarding costs of taxing and redistribution, any liability payment cannot change the value of the welfare function which is therefore maximized at r^* . Hence the upshot here is an irrelevancy result: every liability rule is as efficient as any other one¹⁸.

4.3.1.2. The National Government maximizes a distorted National Welfare function (minimizes the sum of political costs and liability costs of regulation)

Next, let us turn to the public choice model. Now compensation payments to foreign firms create no benefit to the government. Hence for the national government liability payments are costs. These costs, as depicted in (10) however are monetary not political costs. Thus the question arises how the government maps these monetary costs of state liability into political costs to make them comparable to the other political costs. If the government can spread these costs among all taxpayers political costs of liability might be small even though monetary costs are high. It would therefore be defensible to assume that the political costs of liability are lower than the monetary costs and have to be discounted by the same factor (α , with $1 > \alpha > 0$) as the interests of the national consumer versus the national producer¹⁹.

On the other hand voters can easily detect misbehaviour of their government if it has to pay damage compensation and if this is made public. Therefore governments might face high political costs of liability,

¹⁸ The hint of one of the referees pointing to this result is gratefully acknowledged

¹⁹ Again we have to thank one of the referees for this suggestion.

even if monetary costs of compensation are low. To avoid one Euro of state liability might therefore be politically more valuable for a national government than to simply avoid one Euro of losses for the national taxpayer. It seems therefore to be defensible in the absence of any elaborated theory to equate the political costs of state liability with its monetary costs.

Under this assumption total costs of the regulator (C_i) are his political costs plus the costs of damage compensation.

$$(11) \quad C_i = C_p(r), \text{ if } r \leq r^* \text{ and}$$

$$(12) \quad C_i = C_p(r) + S_f(r^*) - S_f(r), \text{ if } r > r^*$$

At the socially optimal level of regulation (r^*) state liability is zero and the state faces only the political costs of deviating from the regulatory bliss point ($C_p(r^*)$). At the regulatory bliss point ($r_b > r^*$) however the political costs are zero but liability costs ($S_f(r^*) - S_f(r_b)$) are positive. Whenever the regulator chooses a regulatory level between r^* and r_b he faces some political costs and some liability costs. Political costs decrease with r , and expected liability costs increase with r . Depending on these two cost functions, the regulatory level with the lowest total costs can be either, the regulatory bliss point, the socially optimal regulatory level or some interior minimum ($r^* < r < r_b$) between these two levels²⁰.

Whether liability leads to efficiency can again be seen by calculating the first derivative for (12) at the efficient level of regulation (r^*).

$$(13) \quad C_i'(r^*) = C_p'(r^*) - S_f'(r^*),$$

$$(14) \quad C_p'(r^*) < S_f'(r^*)$$

is then the condition for efficient deterrence. Note that (14) is not an equality. The reason is that for any foreign trade related regulation $r < r^*$ liability is –by assumption– zero. The national regulator will therefore chose a regulatory level, which is at least r^* but never one which is below r^* , as this would increase his political costs but not decrease liability.

Proposition 1. With a precise maximum standard of national regulation which is regarded as compatible with European Law, state liability for lost earnings of foreign exporters leads to a regulatory level which is equal or higher than the efficient level (r^*) but not higher than the bliss point (r_b).

This proposition is somewhat ambiguous, as any regulatory level with r^* and r_b as the lower and upper bound is possible. It is however plausible to argue that state liability with a precise standard will often lead to optimal deterrence. Whenever overregulation reduces foreign producer surplus much more than it

²⁰ This disregards the possibility that at every regulatory level between r^* and r^+ the sum of liability costs and political costs are constant.

increases domestic producer surplus, when the interests of consumers are heavily discounted and whenever the political costs of liability are not too low compared with their monetary costs, optimal incentives are given. It is therefore plausible to assume, that state liability based on precise standards will deter grossly inefficient trade related regulation. Take the following example, in which the government would -in the absence of liability- prefer the high and inefficient level of regulation and would prefer the efficient level of regulation, if state liability is introduced and damage compensation is the difference between the foreign producer surplus at the efficient level of regulation and the chosen level of regulation (200-50=150).

	Optimal level of regulation (r^*)	chosen level of regulation ($r > r^*$)
Foreign producer surplus	200	50
Domestic producer surplus	100	200
Consumer surplus ($\alpha=0.2$)	100	80
External effect ($\alpha=0.2$)	-20	-10
Damage compensation to Foreign producers	0	150
Value of the distorted welfare function. (Foreign producer surplus does not enter this function, consumer surplus and external effects are discounted by 80 percent. The political costs of damage compensation are equal to its monetary costs)	116	without liability:214 with liability:64

4.3.1.3. The National Government maximizes National Welfare

A special case emerges, if the regulator takes the position of a nationalistic benevolent dictator and maximizes national welfare ($\alpha=1$), but disregards the interests of foreign producers completely. In this case liability must lead to efficient deterrence and the regulator will choose r^* . This result holds because under this condition the first derivative and consequently the first order condition for minimizing the cost function of the government (12) is the same as the first order condition for maximizing the (community) social welfare including foreign producer surplus. Reaching a regulatory level higher than r^* would always increase the total costs of the government. Hence a nationalistic government will choose the efficient regulatory level²¹.

Proposition 2. If the European Court takes the efficient regulatory level as the legal standard and if this standard is known ex ante, and if the national government maximizes national welfare, member state liability must lead to an efficient regulatory level.

4.3.2. State liability with Imprecise Standards

We now analyse a per se liability rule under which the member state has to compensate for the lost profits of foreign producers, after the ECJ declares a particular level of regulation a violation of European law. It is however now assumed, that the regulatory level which the court regards as a violation of European law is not known ex ante, but that only its probability distribution is known. We believe that this is the most important practical case. It is also assumed that a member state can avoid liability with certainty, if the level of regulation is equal or lower than some low benchmark level (r_l) and that regulation leads to liability with certainty, if a very high level $r \geq r_h$ is chosen by the regulator. It is again -as in the case of the cost minimizing firm- assumed that the ECJ only erroneously deviates from the efficient level without having a bias against efficiency, when deciding, whether a regulatory level violates European law.

4.3.2.1. The National Government maximizes community welfare

Let us again first look at a government, which maximizes the community welfare giving equal weight to the interests of consumers, local producers and foreign producers. It is then obvious that in the absence of liability the national government chooses the optimal level of regulation (r^*) thereby maximizing the welfare of the community. If liability is introduced this cannot change this regulatory decision, as long as the government regards liability payments as a zero sum game between groups whose interests it gives equal weight to. Again we get an irrelevancy result with respect to any liability rule.

4.3.2.2. The National Government maximizes a distorted National Welfare function (minimizes total costs)

The situation changes, if we again use public choice theory and assume that the national government completely disregards the interests of foreign producers and heavily discounts the interests of local consumers as compared with those of local producers.

The expected costs of damage compensation (DC) are then

$$(15) \quad DC=0, \text{ if } r < r_l$$

If $r_l < r < r_h$, the following considerations apply. The probability of being held liable at any particular level of r is given by a distribution function (F).

$F=F(r)$, with $F(r_l)=0$, $F(r_h)=1$, $1 > F(r) > 0$ if $r_l < r < r_h$, and $F'(r) > 0$. $F'(r)$ is the probability density function.

²¹ Note however that this result is dependent on the assumption that 1 Euro is equal to 1 unit of political costs. If the government discounts liability payments when mapping these payments into political costs undercompliance with European law may result

Damage compensation is then the difference between the profits of foreign producers if they had not been discriminated minus the profits they actually made under the discriminating regulation. From an ex-ante point of view the expected damage compensation (DC) of foreign exporters is then equal to the difference of their profits at the expected maximum regulatory value which the ECJ is supposed to tolerate and their profits at the chosen regulatory level multiplied with the probability of being liable at this level.

$$(16) \quad DC = \int_{r_1}^r F'(\sigma)S_f(\sigma)d\sigma - F(r)S_f(r), \text{ if } r_1 < r < r_h$$

If the chosen regulatory level is equal or higher than the upper threshold (r_h), the expected compensation is

$$(17) \quad DC = \int_{r_1}^{r_h} F'(\sigma)S_f(\sigma)d\sigma - S_f(r)$$

The total cost of the government (C_t) is then the sum of political costs and expected liability.

$$(18) \quad C_t(r) = C_p(r), \text{ if } r \leq r_1 \quad \text{and}$$

$$(19) \quad C_t(r) = C_p(r) + \left(\int_{r_1}^r F'(\sigma)S_f(\sigma)d\sigma - F(r)S_f(r) \right), \text{ if } r_1 < r < r_h \quad \text{and}$$

$$(20) \quad C_t(r) = C_p(r) + \left(\int_{r_1}^{r_h} F'(\sigma)S_f(\sigma)d\sigma - S_f(r) \right), \text{ if } r \geq r_h$$

Does the minimization of these costs lead to an inefficiently low level of regulation?

This can be seen by evaluating the value of the first derivative of the total cost function (19) of the government at the efficient regulatory level (r^*). In other words we ask whether at r^* the regulator has incentives to increase or to decrease the level of regulation, given the liability rule according to which the violation of European law leads to liability per se.

Thus we differentiate (19) at point r^* .

This yields $C_t'(r^*) = C_p'(r^*) + F'(r^*)S_f(r^*) - (F(r^*)S_f'(r^*) + F'(r^*)S_f(r^*))$ or

$$(21) \quad C_t'(r^*) = C_p'(r^*) - F(r^*)S_f'(r^*)$$

If the value of (21) is lower than zero, total costs of the government will decrease by reaching a higher than efficient level of regulation. If it is higher than zero, the state will reduce liability to a less than efficient level.

$$(22) \quad C_p'(r^*) < F(r^*)S_f'(r^*)$$

It is easy to see that $C_p'(r) < 0$ at $r=r^*$, because $r^* < r_b$. As at r_b total political costs are zero and minimized, any regulatory level smaller than r_b leads to positive political costs of regulation and a negative slope of this cost curve (see the graph in Fig. 2). $F(r^*)$ in (31) is always positive and $S'_f(r^*)$ is always negative as any additional regulation decreases the foreign producer surplus.

The result of an inefficiently low level of regulation as a consequence of state liability is consequently not necessary. Incentives for a regulatory level higher than r^* are also possible²².

Incentives to undercomply (i.e. choose a higher than optimal level of regulation) depend on following factors

- The political costs of deviating from the national bliss point of regulation must not be very high as compared to those of the expected state liability. The higher the lost earnings of foreign producers are from overregulation in comparison with the benefits of local producers and the more the regulator discounts the interest of the consumer, the more likely is it that this condition is fulfilled.

- The level of regulation which is regarded as a violation of European law and consequently leads to state liability with certainty r_h must not be extremely high. Otherwise the probability of damage compensation and with it the deterrence effect of liability is low even at the bliss point.

Let us add some further considerations regarding the cost minimizing level of regulation.

If $r_b \leq r_h$, it is easy to see by comparing (19) and (20), that the regulator will never choose a regulatory level higher than r_h . The right term of the right hand side of (20) (in brackets) is at least as high as the equivalent right term in (19), if $F(r)=1$, otherwise it is higher. Consequently $r > r_h$ is never a cost minimizing regulatory level.

If, as assumed throughout this study, the bliss point is higher than the optimal level of regulation ($r_b > r^*$), the total cost minimum for the government can also not be higher than at r_b . If $r_h > r_b$ any regulatory level higher than r_b leads to both higher political costs and higher expected liability costs as compared to the r_b level. The cost minimizing regulatory level can therefore not be higher than r_b . If $r_h < r_b$, any regulatory level above r_b leads to the same liability costs as in r_b , but the political costs are higher than in r_b . Therefore again the chosen regulatory level cannot be higher than r_b . Furthermore the regulator will never choose a regulatory level below r_1 , because at that level and at any other level lower than r_1 , damage compensation is zero, whereas the political costs are higher than at r_1 at any level of $r < r_1$. Consequently the cost minimizing level of regulation is between r_1 and r_b .

Proposition 3. If a trade related regulatory level violates European law, if this level leads to state liability, if the regulatory level which violates European law is unknown ex-ante but an upper and a lower threshold level and a probability distribution of liability is known, the cost minimizing level of regulation for a

²² This would make liability for “normal breach” together with punitive damages a better rule, as one of the referees has rightfully stated.

member state can be any regulatory level in the range between the lower threshold level (r_l) and the regulatory bliss point (r_b). Both overdeterrence and underdeterrence might result as a consequence of a per se liability rule.

4.3.2.3. The National Government maximizes national welfare

What will the result be in case of a nationalistic government, which maximizes total national surplus and disregards the interests of foreign suppliers? Inequality (22) still holds but deterrence must be less than efficient. At the efficient level of regulation the national gains from additional regulation must exactly outweigh the losses to foreign exporters. As it is not certain but only probable with probability $F(r^*)$ that the government has to pay for these losses the increase in expected damage compensation is lower at r^* than the certain decrease of the political costs. Thus underdeterrence and undercompliance results and in spite of liability the state will choose a higher than efficient level of regulation.

4.3.3. Some arguments in favour of state liability for “sufficiently serious breach” of EC-law

All in all we get a complicated result from the economic analysis of state liability. Overdeterrence becomes a possibility only if the state heavily discounts local consumers' vis a vis producers' interests (public choice model) if the legal standard is imprecise, and if the gain from regulation for the local producers is small in comparison with the losses of international producers.

If the state maximizes the community's interest efficiency is always reached, with and without liability. If the state maximizes a national welfare function, the result is either efficient deterrence, if the ECJ chooses the efficient regulatory level as the precise legal standard or it is undercompliance if the legal standard is unclear. Overdeterrence can become a general problem for a government maximizing national welfare only, if a money unit of liability is higher than a unit of political costs.

These results suggest that, under certain conditions, overdeterrence is a real problem, whenever damage compensation is not reduced to obvious cases of violation of the European law.

Obvious liability means that the value of r_l is higher than under a rule dependent on breach of the Roman treaty per se. Consequently under a rule of sufficiently serious breach less deterrence is caused as a result of liability for any chosen level of regulation. This must hold, because at any regulatory level the probability of liability (F) is lower than under a per se rule. And therefore also the expected liability is lower. Therefore incentives are given to reach a higher regulatory level under a sufficiently serious breach than under a “simple breach” rule, which leads automatically to liability whenever the ECJ declares a certain regulatory level as a breach of European law.

Is this defensible? The economic analysis completed by intuition and the knowledge of cases and materials still support the “obvious negligence” rule for pure financial losses. Take the case of the “Reinheitsgebot” (purity requirement). This led -in Germany- to import restrictions for all foreign beer producers adding other substances than water, hop and malt. Under the German regulation they would have been allowed to import these products, but not under the name of beer, which in practice came close to an import ban. This foreign trade restriction was defended by the national government on the grounds that German consumers associated with “beer” a certain quality. By decision of the Court this was qualified as an infringement of the treaty of Rome. After the decision this discriminating practice was uplifted. Until this point of time it was however unclear whether this import restriction violated European law. The court decision might as well have been different, legalizing the then current practice.

Had *Brasserie du Pêcheur* won the case and received damage compensation for lost earnings, on the ground that the German government had violated the treaty of Rome, all other breweries in the EU could in principle have claimed the same for their lost earnings from 1957 onwards (treaty of Rome) to 1987 (uplift of the purity requirement). Such a rule might lead national governments to reduce their levels of consumer, health or environmental protection to an unnecessary low level. If however liability is restricted to cases in which governments violate the treaty of Rome “with open eyes”, by imposing trade related regulation, this effect is avoided.

This example illustrates that pure financial losses higher than the total social losses, combined with an uncertain standard often lead to overdeterrence and to an inefficiently low regulatory level. The economic analysis indicates the conditions under which liability rules effectively lead to overdeterrence. Applying these results to the legal practice, however, needs some knowledge of cases as well as intuition with regard to the size of the relevant parameters.

5. Conclusion and Final Remarks

This article has proposed to make compensation of pure economic losses resulting from infringement of the EC Treaty by Member States dependent upon the proof that the Member State violated a sufficiently precise and reasonably clear superior rule of EC law (“obvious negligence”). An infringement of Community law should *per se* not be sufficient to establish the existence of a serious breach for the purposes of damages liability. The effect of a *per se* rule in cases of pure economic losses may lead -not necessarily as the economic analysis has shown, but under plausible assumptions- to overdeterrence. If the relevant norm of EC law is imprecise and reasonably capable of bearing the construction given to it by the Member State, even if this interpretation is not adopted in later judgements of the Court, Member States should not be liable in damages.

This paper has not investigated other methods than restricting the scope of liability to avoid the inefficiencies resulting from the compensation of private losses exceeding total social losses. Another solution to this problem may be to limit the amount of the compensation, so that it reflects the social

losses rather than the private losses of individuals and firms²³. Furthermore, to achieve efficient deterrence fines to be paid by the Member States may be more appropriate than tort liability. The question which legal remedy is most efficient to give incentives to Member States to abide by their Community obligations must be left for future research.

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²³ Compare GILEAD, "Tort Law and Internalization: The Gap between Private Loss and Social Cost", *International Review of Law and Economics*, 1997, to be published.