



A welfare analysis of the principle of mutual recognition

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ABSTRACT

Countries set norms to protect consumers against ill-functioning products. In the absence of coordination, countries can set different norms and still achieve the same level of consumer protection. Such differences in specifications create barriers to trade because exporting firms incur adaptation costs. The principle of mutual recognition addresses the problem by ensuring that products lawfully manufactured in one country are acceptable in other countries, even without adaptation. The principle shifts the transaction costs of adapting to several norms from firms to consumers. We identify the winners and the losers, and we show that this principle is a source of disparity.

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1. Introduction

Countries can choose to set norms to protect consumers against ill-functioning products and services. In pursuing the same general objectives when setting their norms, two countries can reach the same level of consumer protection. However in the absence of coordination, legislation developed in each country may differ, yielding different norms. Therefore, a company wishing to export must adapt its product to the norms of the export market. Adaptation is expensive even if the non-adapted product provides consumers with the same level of protection as an adapted product.

This problem has long been recognized by the EU (European Union), which has attempted to address the costs of regulation heterogeneity via regulation harmonization. However, harmonizing regulations across a large set of countries can be extremely slow if it requires unanimous approval by member states (see [Brenton et al., 2001](#)). About 25 years ago, the European Commission addressed this problem by adopting the *principle of mutual recognition*, which ensures that *a product lawfully manufactured in one member state does not need to be adapted for sale in another member state, provided that both legislations provide the same level of consumer protection*.¹ When interpreted with sufficient flexibility, the appropriate application of the principle reduces production and export costs, providing consumers with access to a wider range of products.

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¹ In February 2009, the Committee on Economic and Monetary Affairs of the European Parliament advocated gradually integrating EU and US markets through mutual recognition combined with a degree of convergence of the current regulatory frameworks ([European Parliament, 2009](#)). There is also a rapid spread of mutual recognition agreements between the EU and its major trading partners, within APEC and in other regional arrangements. See [Baldwin \(2000\)](#).

However, non-adaptation to local specifications increases costs to consumers who are not familiar with foreign specifications. These costs are probably low for goods, but they could be much higher for services, for which the principle of mutual recognition is also applicable. As pointed out by Pelkmans (2005), it is more difficult to assess the quality of a service than that of a good, which explains the numerous norms set to ensure the proper functioning of service markets.

As an illustration of the costs experienced when consuming services provided according to unfamiliar foreign norms, consider the service provided by architects in countries A and B. To protect buyers, governments set norms on several dimensions of the service, including the responsibility of each party in the event of construction delays and, the type of the after-sale service available to buyers. Suppose that Country A guarantees excellent after-sale service while providing few protections to consumers in the event of delays and that Country B guarantees the opposite. Consumers benefit from the same global protection in both countries and may end up being indifferent between both sets of norms *if they completely know both sets of norms*. However, consumers from A probably either know the norms in A, or know how to obtain information about these norms. By contrast, they are probably more ignorant of norms in B, even more so if these norms are numerous and/or written in a language foreign to country A. In case of construction delays, a consumer from Country A – who has purchased a contract operated under norms in Country B by application of the principle of mutual recognition—may not believe that he benefits from good protection, which prevents him from taking advantage of the full benefits of his contract. For this reason, a consumer who does not know foreign norms discounts the utility of consuming a good that complies only with foreign norms. Such outcomes yield a *consumer adaptation discount*. That is, for a given price, the consumer prefers a good/service provided under known local norms than the same good/service provided under unknown foreign norms. The alternative for the consumer is to learn the norms of B, which allows him to take full advantage of goods produced under foreign norms. However, learning foreign norms is costly.

To further illustrate such costs, consider a non-English speaking consumer. He is likely to prefer a good provided with a manual written in his own language to a good that only comes with an English-language manual. By application of the principle of mutual recognition, some firms supply goods with English-language manuals to markets in non-English speaking countries, reducing the utility of consumers in those countries. Indeed, applying the principle of mutual recognition in this scenario shifts the transaction costs of adapting to several norms from firms to consumers (Nicolaidis and Schmidt, 2007).

We use a two-country monopolistic competition framework to identify the winners and losers in applying the principle of mutual recognition. The basic trade-off is clear. On the one hand, firms reduce costs by using the principle of mutual recognition because they are not forced to adapt their products to foreign markets. This reduction of costs prompts new firms to enter and new varieties to be produced, which is beneficial to consumers who exhibit preference for variety. On the other hand, products are less adapted, which is detrimental to consumers who discount the utility of consuming non-adapted products.

Because the disutility from consuming non-adapted products is experienced only when consumers are unaware of foreign norms, we consider two scenarios, one in which the consumer can choose to learn those norms and one in which the consumer cannot. In the scenario in which consumers cannot learn foreign norms, firms disproportionately comply with the norms of the more populous country because these norms are familiar to the larger population. More precisely, we identify three equilibria that depend on the consumer's disutility from unfamiliar norms:

1. If the consumer adaptation discount is small, all firms choose the norms of the more populous country. For instance, cars registered in France have been required to have yellow headlights since 1936. However, white headlights – the norm in the rest of Europe – have been available for sale in the French market since the early 1990s. Consumers apparently have negligible adaptation discounts for headlights, and nearly all cars sold in France today are equipped with white headlights.
2. For an intermediate consumer adaptation discount, some firms comply only with the norms of the more populous country whereas other firms make products compliant with both countries' norms. For example, English-language manuals are almost universally provided with multi-media products and software. Sometimes, but not always, a manual written in the local language is also provided. The decision to translate a manual depends both on the size of the market (e.g., French translations are more often provided than Hungarian translations) and on the usefulness of the manual (i.e., the consumer adaptation discount).
3. Firms disregard the mutual recognition agreement if the consumer adaptation discount is large. That is, they prefer to make products compliant with two sets of national norms in order to maintain a large export market. A large consumer adaptation discount is consistent with the EU insurance market, in which consumers care about the exact specifications of their insurance contracts. As such, the market share of life and non-life insurance in Germany in 1997 was smaller than 1% for non-German EU companies operating under their home norms (Schmidt, 2002).

Under the “non-learning” scenario, consumers from the more populous country always gain from mutual recognition agreements because they have access to a broader range of product varieties—most of which are compliant with the norms of their country either exclusively or in combination with the foreign rules. By contrast, consumers from the less populous country unambiguously lose if the consumer adaptation discount takes intermediate values: while they benefit from greater varieties of products, fewer products are adapted to their norms. The second effect is stronger than the first

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