Economic Analysis of Cross-Border Legal Uncertainty
- The Example of the European Union -

by

Helmut Wagner

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0. Introduction

Demands for a more comprehensive harmonization of law between legal areas are based on the assumption that legal diversity causes transaction costs and lowers economic trade and welfare, in particular by creating legal uncertainty. For example, in its Communication to the Council and the European Parliament on European contract law of September 2001, the EU Commission argued that legal diversity within the European Union (EU) increases the transaction costs of cross-border contracting and discourages consumers and small entrepreneurs from engaging in such transactions. Consumers as well as producers tend to refrain from contracts in foreign legal systems if the costs of information (about the law, about administrative procedures, about competent legal advice) and/or the costs of enforcement (by way of litigation or alternative forms of dispute resolution) seem too high or unpredictable. This unpredictability or uncertainty about the costs of cross-border transactions may stem from the diversity in the formal legal system or diversity in judicial administration across the individual member countries.

The purpose of this contribution is to make some basic considerations on the macroeconomic costs of legal uncertainty, particularly on the effects of cross-border legal uncertainty\(^1\) on economic performance, and to ask whether legal harmonization could be an appropriate solution to this problem, or why not. As will be argued, full harmonization may (at first sight) seem to be an adequate instrument for reducing the costs of cross-border legal uncertainty; however, full harmonization itself tends to imply high economic costs, so that it is not generally recommendable. Nevertheless, a gradual (partial) harmonization process could, in some circumstances, be beneficial in the European Union.

The structure of the chapter is as follows. Section 2 starts with a methodological introduction of the concept of legal uncertainty and of an estimation of its costs and continues with an elaboration of the advantages of a reduction of cross-border legal uncertainty by means of harmonization of law within in the EU. This is done by focusing on the macroeconomic effects of legal uncertainty, particularly on economic growth, both theoretically and

\(^1\) With “cross-border legal uncertainty” I mean uncertainty concerning cross-border transactions.
empirically. In section 3, the advantages and the disadvantages or costs of full harmonization of law, which is often propagated as a mechanism for reducing legal uncertainty, are worked out. In section 4 we argue that/why some groups may have a stronger interest in an international governmental-institutionalized harmonization of law than other groups. Section 5 concludes.

1. The European Union and the Role of the Legal System

The European Community is first of all an economic community (currently an economic union of 25 member states, and a monetary union of 12 member states). Sometimes it is also called a “community of Law” (e.g., Mock 2002). However, so far, Europe has no definite and precise constitutional status. The legal regime in the European Community builds upon a number of Treaties forming a compact that defines the European legal order. This set of treaties cannot be considered as a constitution itself.

The European Community does not aim (any more) at the creation of one European Law in contrast to the laws of its, currently 25, Member States. Instead, the European Community aims at harmonizing the national legal systems only to the extent that is required for the functioning of the Common Market (Art. 31h EC). In other words, harmonization of national legal systems in the European Community is not an end in itself or an ultimate goal but plays a functional role. This role is to foster the interplay of the numerous national (goods, labor, and financial) markets and thereby to raise the overall economic utility in the European Community. Hence, the main task in the EU is to find an optimal degree of international (partial) harmonization between the 25 national legal systems.

The legal system is one of the most important institutions of a society. Following North (1994), “institutions” are understood here as formal and informal mechanisms, which control social interaction in some form or other and in this way shape restrictions for individual

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2 Originally, the EC’s integration concept aimed at widespread harmonization of regulations in its member states. However, in the 1980s there was a clear reversal of direction in the Community’s integration strategy (for details see section 3 below).

3 This is also the basis of the “subsidiarity principle”, introduced in 1990, which implies that competition between legislators is the rule and centralized governance or harmonization (unification) the exception. However, this principle does not cover the full scope of EC policy fields, for instance it does not cover agricultural policy, external commercial policy, and parts of competition policy.

4 “A reliable legal system adds credibility to private economic exchanges, enforces contracts, protects economic freedoms and reins in arbitrary state power“ (Pitarakis and Tridimas 2003, p. 361). The “vigor” of markets “may depend on the establishment of an environment in which legal rights, especially property and contractual rights, are enforced and protected” (Posner 1998, p. 1). “A modernizing nation’s economic prosperity requires at least a modest legal infrastructure centered on the protection of property and contract rights” (ibid).
behavior so that negotiation and coordination costs are reduced. The sum of governmental-institutionalized rules is defined as the “legal system” of a country or union. It symbolizes “rules of the game”, which place limits on the leeway available to actors in the same way as technological restrictions. During the last decades, much greater attention has been paid in economics, and in macroeconomics as well, to such institutions.

Not only is the actual existence of institutions regarded here as being important, but also, and above all, their stability. On the one hand are those institutions that are stable in themselves, because participants feel themselves bound to them either for traditional, religious or ethical/moral concepts, or because all deviations would result in an intimidating sanction contained in the rule itself. On the other hand are those rules that do not contain this type of stimulus, which itself leads to the danger of individual deviation so that the institutions are not a priori stable. The state can only protect such rules by means of its monopoly of force, by determining these rules to be a legal system. Securing the stability of such a legal system is among the most important tasks of a government, since the instability of this type of legal system, or “legal uncertainty”, hinders growth and the stability of an economy.5 The dominating argument here is that legal uncertainty represents an investment risk for both domestic and foreign investors. Legal uncertainty can be caused not only by imperfect national legal systems, but also by the different natures of legal systems in the international spectrum.

Law is a fundamental instrument of all transnational economic integration. Different legal systems within an integration area increase transaction costs in cross-border business, because, on the one hand, costs occur through the provision of information about, and adapting to, the respective national regulations, and, on the other hand, the great number of legal provisions and processes increases the uncertainty which adheres to individual cross-border transactions.

The European Commission already noticed this danger in the middle of the 1990s.6 At that time, legal uncertainty was regarded by the European Commission as the main reason for the fact that the economic dynamics triggered by the process of European integration in the early nineties developed more slowly than expected and desired.7

5 The modern transformation and development economics provide unequivocal evidence for this (see, e.g., Chong and Calderón 2000, or Knack and Keefer 1997).


7 To be more precise, the hopes with regards to economic growth expressed in, and in connection with, the Cecchini Report in the context of the completion of the Single Market were not realized completely. The Cecchini Report (Cecchini 1988) was the central study for preparation of the Single European Market, which
2. Costs of Legal Uncertainty

The supposed advantages of a harmonization of law are derived in part from the costs of legal diversity and the legal uncertainty that possibly results from it for particular groups. Before turning to the costs of legal uncertainty, we first want to outline the term and the cornerstones of an estimation of the costs of legal uncertainty.

2.1. On the Term “Legal Uncertainty”

Legal uncertainty always occurs when individual actors are uncertain of the effects of the provisions of the dominant legal system on the results of their actions. In the wider sense, the term covers both “subjective” and “objective” legal uncertainty.

2.1.1. Subjective Legal Uncertainty

The term “subjective legal uncertainty” refers here to the subjective assessment of marginal costs and marginal utility, which differs from individual to individual. Subjective legal uncertainty can also be referred to as “uncertainty as to what the law is”. Because an improvement in individual knowledge of the law is bound up with, in part, considerable information and transaction costs, it is irrational to want to do away with complete legal uncertainty. With increasing marginal costs of acquiring information and the sinking marginal utility of additional legal knowledge, individual economic subjects will only spend so much on information and transactions until marginal costs and marginal utility are equal. Ignorance beyond this will remain in existence so that decisions will continue to be taken in uncertainty.

2.1.2. Objective Legal Uncertainty

“Objective legal uncertainty” describes an objective reality that has to be accepted to an equal extent by all involved. It is found where statutory regulations for certain sets of facts are either non-existent or do not form a reliable basis for decisions. Examples are:
- “Absence of law”: this term applies to areas for which there are (as yet) no statutory rules and regulations, e.g. areas not subject to national sovereignty, such as the seabed,
space, the environment (with cross-border air pollution), and legal areas which have not yet been determined, such as in some transformation and developing countries.

- “Legal instability”: this type of legal uncertainty occurs where regulations are unstable over and beyond consumption or investment periods, because amendments to statutes are frequent and unforeseeable, so that even experts are not clear about the current legal position and the continuance of subjective claims.
- “Denial of justice”: this is understood to be the obstruction or prevention of the enforcement of legal rights by state authorities or employees.

In the following we will assume a very broad meaning for legal uncertainty, one which includes all the aspects referred to. We will restrict ourselves here to an analysis of the costs of legal uncertainty with reference to cross-border transactions, because we have in particular the effects on European integration in view.

2.2. Theoretical Derivation of the Costs of Legal Uncertainty

On a plausibility level, “static costs” can be easily derived from legal uncertainty. Static costs are understood to mean a one-off loss of welfare or income as against the reference case with legal certainty. Some essential effect mechanisms are shown in section 2.2.2. In this way it can be shown that legal uncertainty generates a lower level of trade and a persistently lower level of income as against the reference case of legal certainty. This type of one-off fall in national income is a short-term negative growth effect. It is difficult to derive persistent growth effects in the meaning of a permanent loss of income with traditional macroeconomics. Only a more recent theoretical branch of macroeconomics, the so-called “new” or “endogenous” growth theory, provides a microeconomically founded set of analytical instruments for the explanation of this type of dynamic costs. Section 2.2.3 will contain sketches of what possible reasons for the long-term growth effects of legal uncertainty in the framework of the new growth theory could be. However, section 2.2.1 will first introduce some brief explanations of the costs generated by legal uncertainty.

2.2.1. Types of costs caused by legal uncertainty

Legal uncertainty generates the following transaction costs:

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9 For the fundamental difficulties, cf. e.g. Wagner (1997b), Chap. 2. See Klump (1995) for an attempt to derive growth effects from institutions within the traditional neo-classical growth model.

10 Detailed theoretical analyses of this type of static, and of dynamic, effects can be found in Wagner (1995) and in Wagner (ed. 1995).
(a) costs of collecting information, (b) costs of legal disputes, (c) costs of setting incentives for pushing through legal claims, and (d) other transaction costs. As explained above, it is obvious that costs are higher in international transactions than in domestic trade, and I will take this as given on the following pages.
On (a): Lack of knowledge of foreign statutes prevents international purchases or leads to the necessity of more or less expensive information collection.
On (b): In the event of international legal disputes the costs are much greater than in the case of a domestic legal dispute (cf. Freyhold, Gessner, Vial and Wagner (eds.) 1995, Part II).
On (c): This includes private attempts to speed up approval procedures, and legal procedures in the broadest meaning of the term. As is known, “beneficial charges”, which include bribes or pay-offs, represent an important cost factor for multinational corporations. (This applies in particular in developing countries.) No small part of this is probably the result of having to deal with legal uncertainty or legal instability.
On (d): The difficulties involved in complaining about goods, in making warranty claims, and in exchanging goods, should probably prove to be much greater in the case of international purchases in comparison with domestic purchases. The associated costs, including travel expenses, time spent (opportunity costs), and annoyance (negative utility), are then correspondingly higher, in particular if law suits are the consequence.

2.2.2. Static or level effects of legal uncertainty
Static or level effects of legal uncertainty occur above all in the form of trade and income effects. The derivation of trade and income effects is based on the following presumed causal chain: legal uncertainty implies higher transaction costs. These are reflected in higher prices or in reduced revenues or benefits for the entrepreneur or consumer. Both lead to lower investment, lower consumption and lower national income.
I will now provide some detailed explanations of this presumed causal chain. (The individual causal chains are also summarized in the Appendix in a figure.)
Even the expectation of the costs sketched in section 2.2.1 can lead consumers and entrepreneurs to pull back from international transactions. For consumers, greater legal uncertainty in international purchases means that foreign goods bring them fewer benefits. For entrepreneurs, on the other hand, these additional costs reduce profits. (The reduction in profits is caused not only by higher transaction costs but also by higher risk premiums.)

11 As noted above, it is not individually rational for economic subjects to eliminate all legal uncertainty by collecting information and setting incentives. Therefore, “real” uncertainty remains, and this is taken into
They have to increase prices in order to prevent a reduction in their return on capital in international transactions. Both, i.e. price increases and a fall in the return on capital, lead from the point of view of the economy as a whole to a reduction of international transactions and thus to a fall in international trade.

Lower levels of international trade usually mean that existing price differences – because of legal uncertainty in this case – are not fully utilized. This means that the price level (with a given demand) is higher than would be the case with more international trade (i.e. with legal certainty). Income-reducing effects can be derived from this, in certain circumstances intensified by capital effects and so-called Keynesian effects.

There is yet another impact channel through which legal uncertainty has an income-reducing effect. Legal uncertainty may simply lead to waiting. Waiting is a rational strategy, if imperfect information impairs the decision-making capability of the actors and at the same time either additional useful information can be expected in the following period, or legal uncertainty will be reduced (e.g. through unification of law). This aspect can be made clear with the help of the theory of options. From the point of view of this theory, legal uncertainty delays individual economic decisions and in this way reduces international supply and demand for consumer durables in particular. Put another way, legal uncertainty reduces international trade and thus leads to aggregate losses of income as well (as explained above).

2.2.3. Dynamic or growth effects

In order to be able to assess the consequences of legal uncertainty in international transactions for the growth dynamics of a national economy, we have first of all to be clear about the factors that determine these growth dynamics. In the theory of growth, “technical progress” is regarded as the central engine for economic growth; in the traditional neo-classical theory account in the calculation of profits in the form of an uncertainty or risk deduction. Some of the risk cover can be provided by internal reserves and by means of a risk pool in the scope of an insurance policy covering the consequences of legal uncertainty. But the latter also results in costs that are passed on in the price. It is impossible to be insured against all risks; and even if this were possible, a rational actor would not do it for cost reasons (see above).

12 Because/if cross-border legal uncertainty legal uncertainty applies to all countries of an integration area, it is a general phenomenon and, therefore, causes a general extra charge on import goods which, nevertheless, differs from country to country. From an analytical point of view this legal uncertainty can be seen as a general (non-tariff) trade barrier. In this article we concentrate on trade effects. However, the argument is also transferable to movements of factors of production.

13 The introduction of waiting as a possible reaction to legal uncertainty already presupposes a dynamic balancing of possibilities by the actors involved. Seen statically, legal uncertainty leads simply to transactions not being carried out. Whether this can be interpreted as a final decision or as waiting can only be decided in a dynamic approach. In so far, this aspect might also be placed in the following section on dynamic effects. However, it is mentioned here for reasons of content systematizing.
according to Solow this progress was exogenous, whereas in the modern approaches of endogenous growth models an attempt is made to explain technical progress endogenously. We can differentiate as follows between endogenous growth models depending on how the growth engine is modeled:

The *first class of models* is concentrated on the accumulation of capital (Romer 1986) or human capital (Lucas 1988) as the driving force in the process of growth, or regards the provision of state productive inputs as essential for long-term growth (Barro 1990). These models build on the assumption of perfect competition. In these models it is assumed among other things that investment (often) accompanies the production of additional new knowledge. Knowledge is regarded here as the central input in the production of technical progress. The conclusion can be drawn from this that lower investment levels are also combined with lower levels of technical progress and therefore with lower growth rates within the national economy. Alternatively, reductions in national incomes can be regarded as the reason for loss of growth, if less national income induces lower infrastructural investment, as is assumed in other branches of the new theory of growth, and a positive correlation can be assumed between infrastructure investment and technical progress.\(^\text{14}\)

The *second class of models* stresses the research and development of companies as the driving force behind growth. An attempt is made to make a model of Schumpeter's conception of the process of innovation. In these models, companies can either diversify existing consumer products or intermediate products with constant quality, or improve the quality of a constant number of products, whereby these may be investment or consumer goods. These innovation-driven models, which have been developed above all by Grossman and Helpman (1991) and by Aghion and Howitt (1992), abandon the assumption of perfect competition in favor of an oligopolistic market structure. Innovations can only be accounted for in a state of imperfect competition, because innovations are only carried out with appropriate (monopoly) profit expectations. And investment in research and development is worthwhile for companies for as long as the costs of an additional investment correspond to its expected yield.

For practical purposes, a difference should be made between two model types. *One type* assumes a closed economy. Legal uncertainty can be introduced here through the assumption of a risk surcharge. Since/if companies cannot pass this risk surcharge on fully in their prices, net profits fall. As a result, company profits are reduced, which itself leads to less investment in research and development. Less research and development reduces the rate of innovation, and this is accompanied by a reduction in the long-term growth rate of the economy. The

\(^\text{14}\) See also Wagner (2002).
other type assumes an open economy and combines aspects of the theories of endogenous growth and foreign trade. A multi-country model with different factor productivities appears to be particularly suitable for an analysis of legal uncertainty in an economic structure such as the EU.

To sum up, it can be stated that several effective channels can be derived from the approaches shown here for endogenous growth models through which legal uncertainty can have a negative impact on economic growth: Firstly, efficient use of existing capital is impeded because of reduced marginal yields, so that there is less knowledge-creating investment, innovative research is inhibited and state infrastructure is only insufficiently available. And secondly, international trade exchanges are obstructed, so that the knowledge incorporated in traded goods does not spread as rapidly and the deficient use of comparative advantages leads to the waste of innovative potential. This results in reduced growth dynamics not only for an economic area such as the European Union but also for individual states.

2.3. Empirical Analyses

Empirical research on the effect of legal uncertainty on economic trade and growth suffers from the difficulty of measuring the degree of legal uncertainty. Most studies derive legal uncertainty from factors such as political instability, juridical incredibility or a lack of civil liberty (see below). They concentrate on explaining cross-country variations in growth due to differences in legal uncertainty within a country in world wide samples or for developing economies. But there are only very few studies that analyze the effect of legal uncertainty in such a broad way as I have done in this article and between developed countries alone.

A first approach of measuring the quality of (legal) institutions uses easily observable characteristics of formal institutions such as written law. De Long and Shleifer (1993), for example, show that in medieval times western European cities that were under absolutist regimes (interpreted as being associated with high legal uncertainty because of insecure property rights) experienced a stronger retardation of their city growth than cities with other forms of political regimes. La Porta et al. (1999) discover that formal legal protections for

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15 Foreign trade can strengthen growth in different ways: by avoiding double R&D activity, through the diffusion of knowledge, and by the use of comparative advantages based on different factor productivities.

16 Beyond that, we can try to introduce legal uncertainty endogenously. This aspect of endogenization can be treated analytically by means of the theory of time inconsistency. For reasons of space we have left this out here. For an endogenous introduction of legal uncertainty in the framework of a model of this kind cf. Wagner (ed. 1995), Chap. 5.

17 Studies of these kinds mainly applied the method of Ordinary Least Squares (OLS) regressions and hence suffer the problems of mutual dependency and reverse causality due to the endogeneity of the institutional variable independently of how it is measured.
investors correlate with the size and depth of capital markets and hence with investment levels. Another recent study by Feld and Voigt (2003) concentrates on a crucial aspect of the rule of law, namely judicial independence, which is measured by (i) a de iure indicator based on the legal foundations as found in legal documents, and (ii) a de facto indicator “focusing on the factually ascertainable degree of judicial independence” (p. 1), e.g. the factual average term length of the members of the highest court or the number of judges. Their results show that the de iure judicial independence does not have an impact on economic growth, but there is a positive relationship between de facto judicial independence and real GDP growth per capita.

However, this approach has its limitations because it cannot capture the role of informal institutions nor take possible interdependencies with formal institutions into account. This may distort the findings.

Therefore, another approach uses proxy variables that measure the quality of institutions indirectly. For example, an often quoted study by Barro (1991) uses the number of revolutions and coups per year as well as the number of political assassinations as proxy variables for political – and hence legal – stability. Both variables are significantly negatively related to economic growth. A related study by Alesina et al. (1996) confirm that countries with less political and legal stability grow less. The quality of this approach clearly depends on the quality of the proxy chosen. It has to be guaranteed that the proxy variable does not influence the dependent variable through another channel it stands for. This sensitivity analysis is mostly missing in each of these studies.

A third approach in the empirical literature on the impact of legal uncertainty or institutions on economic growth is based on surveys of country risk experts or foreign and domestic investors. These surveys cover a series of questions about the business environment. An early attempt stems from Knack and Keefer (1995) who take the data from the International Country Risk Guide and analyze the relationship between institutions and economic performance in a cross-country-regression with 111 countries. The data covers five categories for measuring the quality of institutions: the rule of law, the corruption in government, the quality of the bureaucracy, the expropriation risk, and the reliability of the government in complying with agreements, which includes the risk of changes to agreements following a change of government. They find that institutions that protect property rights are crucial for economic growth and investment. Differences in institutional quality account for a major share of cross-country growth differences. Here the rule of law variable seems to be the most important determinant of cross-country variations.
In a more recent study, the IMF (2003) finds a strong positive relationship between indicators of governance and economic performance. The IMF augments the institutional indicators corresponding to six fundamental governance concepts, used by Kaufmann, Kraay and Zoido-Lobatón (1999), and proves their relevance in a global cross-country regression.

This third approach is not undisputed either. Rodrik (2004), for example, notes that the survey data used in this approach raises two difficulties. First the survey data is highly subjective and may depend upon other aspects than the actual institutional environment (e.g. investors may value the institutional quality highly when there is an economic upswing in the relevant country). The second difficulty is that this kind of data gives no policy guidelines because the results say nothing about which institutional design is superior but just that it is important to make investors feel safe.

Apart from these studies, there are also a few studies that explicitly analyze the effects of cross-border legal uncertainty. De Sousa and Disdier (2002), for example, examine the influence of different measures of the legal framework quality in Central and Eastern European countries on international trade. They assume that a weak legal framework limits contract enforcement by acting as an informal trade barrier. They find “that legal framework quality appears as a strong determinant of export decisions of EU producers. (…) In the opposite, the CEFTA producers seem less affected by this quality in their trade decisions” (p. 16).

De Groot et al. (2004) investigate the effect of institutional differences on bilateral trade flows within an augmented gravity model in a broad sample of more than 100 countries. They find that the quality of institutions (measured by the updated index of Kaufmann et al. (2002)) has a remarkable significant effect on bilateral trade volumes. They further test whether institutional homogeneity is a significant determinant of bilateral trade patterns, too. They find that only really large differences in the quality of institutions have a significantly negative impact on trade. These results confirm the earlier findings of Anderson and Marcouiller (1999), who build upon a structural model of import demand and estimate a 4%
increase in import volume for a 10% rise in the index of enforceability of commercial contracts.

3. Disadvantages of Full Harmonization of Law

There is a more or less widespread amount of legal uncertainty inside each country that is expressed in a lack of clear, unambiguous and stable legislation and/or in (expected or feared) realization problems. However, even more extensive problems occur in international transactions. There are legal trade or transaction barriers in the form of a lack of knowledge of the legal situation in foreign markets and in the form of uncertainty regarding the interpretation or the stability of legal regulations abroad. We have argued in section 2 that these barriers imply costs which are reflected in higher prices and lower output, and, possibly, in lower growth rates as well. The European Union is faced with this problem. Along with 25 national legal systems there exists the extensive and complicated set of rules and regulations of community law, with the constituent treaties, regulations and directives, so that the individual economic actor is often overstrained when it comes to finding out and understanding the regulations governing an individual case. Even where it is clear that a harmonized community regulation is to be applied to a defined case, implementation of the regulation is usually the obligation of the national authorities in the 25 member states. Different societal standards and practices will probably prevent objective legal certainty being achieved throughout the EU even in the long term.

The question arises whether there is any possibility of removing/reducing legal uncertainty without leading to new losses of growth or efficiency on the other side. One answer to the problems of legal uncertainty and lack of legal knowledge discussed might be to demand complete harmonization of national legal systems within the EU. With the achievement of uniformity of laws within the EU, transnational legal uncertainty would seemingly be impossible, because there would now only be EU law, and the complexities of 25 different legal systems would be reduced to a single uniform system. The question then arises whether this is really (a) desirable, and (b) practicable.

(a) Desirability

When economic policy conclusions are drawn, attention should be paid to more than just the costs of legal uncertainty. The (transaction) costs of eliminating legal uncertainty (i.e. pushing through a common alternative institutional regulatory framework) also have to be taken into
account, if a balanced cost-benefit analysis is to be carried out. Scientific costs analyses can easily be ideologically misused without this type of consideration of both sides.

From an institutional economics point of view, the above problem might be formulated as follows: a comparative institutional analysis must not estimate the costs of legal barriers only. The reference situation for this is implicitly a “Nirvana”. The costs of legal uncertainty play an important role even in national transactions; in so far, a comparison situation free of transaction costs is not realistic. Even on a national level, not all disposal rights have been clearly defined and are clearly executable, and in most cases safeguards going beyond contractual relationships will be looked for (family ties, reputation, etc.). The new institutional economics contradicts the widespread impression that production costs are legitimate and transaction costs superfluous. Transaction costs play an important part in the economics of modern societies and are just as difficult to avoid as “regular” production costs. In addition, it is often very difficult to differentiate between production and transaction costs (cf. e.g. Furubotn and Richter 1991).

In so far, precise institutional scenarios (e.g. harmonization of civil law, etc.) must be used to examine which costs can definitely be saved in individual sectors. In doing this, non-formal, socio-cultural restrictions must also be taken into account. The residual potential benefits must be contrasted in the first place with the costs of political decision-making. In addition there is even the danger that the result of the political process will not correspond to the original intentions, because lobbies are tempted to represent their intentions incorrectly to enable them to participate in public goods with as few costs as possible. Furthermore, the costs of the effective realization of the reforms must also be considered. If a positive benefit remains in this overall survey, a comparative institutional analysis comes to the conclusion that a planned reform is reasonable.

There is a good deal of evidence that complete harmonization would lead to substantial costs. These include not only direct costs for developing new bureaucracies or demolishing old structures, but also costs arising from the renouncement of the advantages of system competition, which appear in

(i) an adaptation to the variety of preferences,
(ii) efficiency advantages of regulative competition
(iii) the minimization of “rent-seeking” costs caused by bureaucrats/politicians.

On (i): economic structures in different countries are not identical. However, legal systems must in a sense “harmonize” with the respective economic and social conditions in a country.
This means that not every legal system “fits” into a country; put another way, because of its structural peculiarities, each country needs a special legal system as well.\textsuperscript{21} For this reason alone, harmonization of the legal system in an integration area with heterogeneous countries would not be appropriate. Implementation of perfect harmonization would not be politically possible, because it is at variance with the preferences and cultural habits of the respective countries, or of their populations. The central argument as far as economic systems are concerned is therefore: variety of regulations or laws reflects variety of preferences.

In other words: If states compete with their legal systems, more preferences may be satisfied. Consumers and firms in different countries may ‘vote by feet’ (Tiebout 1956) and choose the jurisdictions that in their views offer the best sets of laws. Furthermore, with such a competition between legislators, individuals could choose the legal rules that most efficiently regulate their problems by moving to the jurisdiction that offers laws best suitable to their preferences.\textsuperscript{22}

On (ii): In addition, variety of regulations also means competition among rules and therefore represents a process for discovering the regulations that fulfill the desired purpose with the lowest costs (Hayek 1968). Diversity in laws enables states to experiment in their search for efficient and workable rules of law.\textsuperscript{23} Competition between legislators may generate a learning process. Exaggerated harmonization would prevent such experiments and learning processes from arising and transaction costs from being lowered. Market integration would be inhibited. Moreover, dynamic competitive processes between legislators may produce voluntary harmonization (see section 5 below).

On (iii): Not only market failures, but also regulatory failures are possible. Bureaucrats/politicians serve their self-interest, too, by maximizing their budget or increasing their status and improving their working conditions. Competition is the most efficient

\textsuperscript{21} Individual institutions or regulations are part of a mature system with its specific requirements for consistency and stabilizing traditions; cf. Streit (1996), p. 7, as well.

\textsuperscript{22} National governments exposed to system competition are subject to constant control by the owners of mobile factors in that the latter are able to evade the sphere of influence of a government by moving to that of another government. This is also linked to the hope that system or regulation competition can reduce the influence of lobbies to eliminate welfare state incrustations or “institutional sclerosis” (Olson 1982). However, it must be taken into account that international legal uncertainty limits system competition (Wagner 1997a).

\textsuperscript{23} If the possibility of a faulty or unsuitable statutory provision is considered, competition between systems of rules permits a relatively low-risk and low-conflict method of correcting errors, compared with harmonized policies. The controlling effect of competition arises from private agents being able to compare different institutional attempts at solving problems and to sort out inferior ones. There does not necessarily have to be an exchange of the legal system itself, but there may also be, corresponding to the cultural peculiarities, efficient institutional innovations within the prevailing legal system.
mechanism to control politicians and to restrain their rent-seeking activities. In contrast, harmonization in a union can be considered as a restriction of competition analogous to a cartel, where non-member countries are outsiders.

With this in mind, there was a clear reversal in the integration strategy of the European Community in the 1980s (cf. European Commission 1985). While the Community’s integration strategy was previously aimed at widespread harmonization of regulations in member states, under the new strategy only particularly important regulations were to be harmonized, and there was otherwise to be joint stipulation of minimum requirements. Central regulations covering the whole of the EU are therefore only necessary where market integration would be hampered without them. The latter would be the case if transnational external effects were not allocated in accordance with their causes and collective goods were not offered in sufficient amounts and at reasonable prices.

(b) Feasibility (The chances of success of a strategy for full harmonization)

Nevertheless, attempts towards a broad harmonization of law are still under way (within the EU Commission as well). To justify unification or harmonization, the European Commission often argues that diverging legal rules create unequal conditions of competition within the Single Market, and that such differences should be minimized in order to create a ‘level playing field’ for industry. Another argument is that as long as Europe has not achieved a single legal system, economic interaction in the area is severely hampered. As argued above, transaction costs either increase the price level of exchanges of goods and services or hinder economic actors from taking advantage of markets in all member states. Economic actors – providers of goods and services as well as consumers – refrain from contracts in foreign legal systems if the costs of information (about the law, about administrative procedures, about

24 The governing principle was that national regulations were to be replaced as far as possible by uniform regulations so that basically the same provisions applied everywhere. This approach failed because of technical problems and above all because of the political resistance of member states to a waiver of sovereignty in the legal sector. Since 1990, the subsidiarity principle has therefore been applied. The “subsidiarity principle” states that the Community may only intervene if the aims of the treaty and the aims of individual measures “cannot be adequately achieved at the level of member states and can therefore be better achieved at Community level because of their range or their effects” (Art. 3b of the ECT).

25 However, this approach by the Commission was pushed into the background again by the Single European Act, which came into effect in 1987. “Under pressure from highly-regulated member states, basic harmonization had to make space for harmonization ‘at a high protection level’ for the protective aims of health, security, the environment and consumer interests (Art. 100a Section 3 ECT). In addition, even higher levels of protection were permitted as exceptions (Art. 100a Section 4 ECT)” (Streit 1996, p. 19, translation by H.W.).
competent legal advice) and/or the costs of enforcement (by way of litigation or alternative forms of dispute resolution) seem too high or unpredictable.

A further argument for legal harmonization is that interjurisdictional competition may lead to a lowering of standards to the detriment of citizens in need of protection against abuses (workers, consumers) or degrade important standards (environmental conditions, protection of health).\(^\text{26}\)

But an argument against fighting legal uncertainty by full harmonization says that only formal law can be adapted through a forced harmonization of legal systems. Harmonization of behavioral structures, and therefore of the forms of realization of formal law, cannot be ordered from above simply through a formal decree. In other words, uniformity of law cannot be created by just imposing rules through public policy. Compliance with the law requires more than just rules; it must match the (legal) culture of a country. But this is the real problem of reservation in the face of foreign transactions. General uncertainty regarding behavioral structures and their stability, which express “legal uncertainty in the narrow sense”, and the connected fear of the arbitrary implementation of regulations by the state or public authorities is (to a certain extent) ever-present, both nationally and internationally. But uncertainty, and the fear connected with this, is usually much greater with regard to transnational transactions. This hampers international trade. Formal harmonization decrees can only reduce this to a certain extent. A further reduction can only be achieved through “experienced integration” (by gradually overcoming ignorance and prejudice). This also includes a thorough reform of the European system of civil justice and of judicial administration in civil matters.

4. Politico-economic Aspects

In the introduction as well as in the flyer to this book there is the following statement: The view of the European Commission seems to be that diversity of law stands in the way of a proper functioning of the internal market, but this view does not seem to be shared by business: in the reactions to the Communication on European Contract Law (2001) it was striking to see that most companies do not consider the present diversity to be a true barrier to trade.

This may be regarded as an astonishing discovery; however, it can easily be explained, at least for the large companies. In contrast to small companies and to consumers, large companies

\(^{26}\) A good example for this is the current attempts in the European Community to harmonize company taxation. It is argued that tax competition leads to a vicious circle or is ruinous, insofar as it has detrimental effects on other countries or regions. For a critical analysis of this argument see, e.g., Wagner (2004). Another example is labor co-determination; see Gerum and Wagner (1998).
have the advantage of lower information and coordination costs per unit of output due to economies of scale when doing transborder business. In particular, they can more easily organize or coordinate their common interests. Insofar, it is easier (and/or less costly) for them to reduce legal uncertainty by privately organizing common rules or standards. For example, in an open market such as the European Single Market, product standards will likely be shaped by the activities of international coalitions of firms. Therefore it is sometimes argued that harmonization “will occur ‘from the bottom’, through the coordinated actions of private firms operating across borders, more quickly than through international treaties and bureaucrats’ interventions. Even where national governments must give the final approval, business groups will lobby their respective national authorities to support the privately developed international standards” (Casella 2001, p. 244). Because of the international nature of the business interests directly affected by the standards, business groups are willing to take upon themselves the costs of standards development and certification. Standards, as well as other legal rules, are public goods improving the functioning of the market. Two of the most important functions that they fulfill are providing information and compatibility. By sharing a common standard, anonymous partners in a market can communicate at all, and can develop common expectations on the performance of each other’s products. Hence, standards as well as legal rules are necessary for the efficient functioning of a market. As long ago as 1991, the OECD stated that “[r]ecent trends in all (OECD) countries seem to converge towards a greater emphasis on self-regulation and non-mandatory standards…[This] introduces an element of flexibility into national safety systems which may become more open to international harmonization” (OECD 1991, p. 55). Hence, it may be concluded that, contrary to the common view, the “problem is not how to orchestrate harmonization through government treaties; it is how to create the appropriate regulatory structure to prevent and if necessary discipline anti-trust violations in international markets” (Casella 2001, p. 262).

The above finding is typical for large companies. However, this finding cannot be simply applied to consumers, not even to small companies. Higher information costs and higher coordination costs of organizing their common interests may prevent consumers (and even small companies) from organizing efficiency-increasing standards or rules themselves (Olson 1965). Thus, while large companies may largely be able to help themselves in reducing

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27 Similarly it can be argued that “[t]he single market is indeed an opportunity for larger enterprises which are able to reduce legal transaction costs by establishing stable relationships across European borders. The risks of breaking contracts are small in this kind of repeated exchange. The situation is different in anonymous markets with small enterprises and consumers. They need institutions to defend and protect their property rights. The European Single Market has been conquered by these actors only to a limited degree due to a deficient institutional infrastructure of law enforcement” (Freyhold, Gessner, Vial and Wagner, 1995, Part A, p.5).
legal uncertainty by creating desired harmonization on their own, consumers and small companies cannot do this to the same extent.\textsuperscript{28} Therefore, it is the task of the governments to help consumers and small entrepreneurs particularly to reduce legal uncertainty in transborder exchanges through searching for and implementing/harmonizing the right standards or rules. However, because of the costs of full harmonization described above, the level of harmonization should be limited.

5. Conclusion

Legal diversity within an economic union such as the European Union usually goes along with legal uncertainty. The reason is that legal diversity there implies

- Additional costs for acquiring the information needed to write a particular contract in other legal areas,
- Higher costs for litigating issues under various contracts governed by different legal regimes,
- Costs of instability due to the fact that several contracts are subject to subsequent changes in the law,
- Diversity in judicial administration across the different member countries.\textsuperscript{29}

As not all of the individual consumers and entrepreneurs are able or willing to pay these costs, however all of them are subject to the (unstable\textsuperscript{30}) diversity of legal administration within the economic union, they have to act under increased uncertainty if they want to do transborder transactions.

Legal uncertainty, however, raises costs. Legal uncertainty can be regarded as a non-tariff trade barrier. It generates a lower level in trade and in income against the reference case of legal certainty, because some of the cross-border transactions cannot be done, or are done inefficiently, since the individuals have to act under increased uncertainty.

But from this it does not follow that full harmonization is necessary, because harmonization itself generates substantial costs. These include not only direct costs for developing new bureaucracies or demolishing old structures, but also costs arising from a loss of the

\textsuperscript{28} Nevertheless, during the consultation process on the Commission Communication on European Contract Law, business associations representing small and medium-size enterprises spoke against full harmonization being necessary to foster competition within the common market. However, as is known, the fact that particular interest groups reject reforms does not mean that reforms cannot be welfare-enhancing on an overall (macro)economic level.

\textsuperscript{29} See Wagner (2002), p. 1014, as well. For a detailed analysis concerning the nature of such costs see, for example, Ribstein and Kobayashi (1996).

\textsuperscript{30} ‘Unstable’ here means that the diversity of legal administration within the union is not stable over time, because procedural law in the single countries may change unexpectedly.
advantages of system competition, the advantages being an adaptation to the variety of preferences, efficiency advantages of regulative competition, and the minimization of “rent-seeking” costs caused by bureaucrats/politicians. Nevertheless, from the point of view of the economy as a whole, welfare gains could possibly be realized through more harmonization. Correspondingly, the EU could adopt a step-by-step approach. It could start with harmonization of contract law for international (transborder) transactions. This would give individuals time to get acquainted with the new regime and to evaluate it. A step-by-step approach would also allow the correction of errors at an early stage. Against the background of the experience gathered, the EU could then turn to a more comprehensive harmonization at a later stage if this then is assessed as being desirable. However, legal harmonization in the EU only makes sense if it is accompanied by a thorough reform of the European system of civil justice and a harmonization of procedural law.
References


Appendix Figure 1: Table of effects of legal uncertainty (macroeconomic costs) (on the explanation of single effects see Wagner 1995, 1997a)