Legal Uncertainty – Is Harmonization of Law the Right Answer?
A Short Overview

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A Short Overview

There are strong forces who strive for harmonization of law within the European Union and beyond. For instance, in April 2008 the EU commission published a White Paper which primary objective is the improvement of the legal conditions for victims of violations of the European community antitrust rules (cf. EC, 2008). To date these victims rarely get a compensation which is mainly due to various legal and procedural hurdles (EC, 2005). Demands for a more comprehensive harmonization of law between legal areas are generally based on the assumption that legal diversity causes transaction costs and lowers economic trade and welfare, in particular by creating legal uncertainty. It is argued that legal diversity 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

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\(^1\) With “cross-border legal uncertainty” I mean uncertainty concerning cross-border transactions.
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.

1. The Role of the Legal System

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 behavior so that negotiation and coordination costs are reduced.

Not only is the actual existence of institutions regarded here as being important, but also, and above all, their stability. 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 a global or a regional 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.
2. 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.

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.

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.

- “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.

2.2. **Theoretical Derivation of the Costs of Legal Uncertainty**

**Types of costs**

Legal uncertainty generates the following transaction costs:

(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.

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.
Static versus dynamic costs of legal uncertainty

Static or level costs 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.

More important, however also more difficult to prove, are dynamic or growth effects of legal uncertainty. In the theory of growth, “technical progress” is regarded as the central engine for economic growth. Several effective channels can be derived through which legal uncertainty can have a negative impact on economic growth: 2 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. In a recent theoretical contribution Dinopoulos and Kottaridi (2008) analyze the growth effects of patent policies in a two-country (innovative North and imitating South) model with endogenous growth. The authors show that a reduction of the uncertainty about trade-related intellectual property rights based on unilateral patent harmonization leads to an acceleration of long-run global rates of innovation and economic growth; but the resulting global growth path is suboptimal. However, in the case of a common global patent harmonization global long-run growth is maximized and the rate of international technology transfer is increased.

2 Beyond that, we can try to introduce legal uncertainty endogenously. On the theoretical derivation of the costs of legal uncertainty see, in more detail, Wagner (2005; 1997)) and Wagner (ed. 1995).
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.³

A first approach of measuring the quality of (legal) institutions uses easily observable characteristics of formal institutions such as written law. For example, La Porta et al. (1999) discovered that formal legal protections for investors correlate with the size and depth of capital markets and hence with investment levels.

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 (cf. Barro (1991)). 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.

³ 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.
An early attempt stems from Knack and Keefer (1995). 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 save.4

Apart from these studies, there are also studies that explicitly analyze the effects of cross-border legal uncertainty. In a recent study, Turrini and van Ypersele (2006) consider two variables to measure the effect of cross-border legal uncertainty. The first variable is an index of legal similarity; the other is a dummy variable amounting to 1 if a pair of countries shares the same origin of their legal system and 0 otherwise. The estimation of a standard gravity equation augmented by one of these two variables show that trade flows are higher by about 65 per cent if a pair of countries has identical legal procedures or, respectively, by 47 per cent if a pair of countries shares common origins for their legal systems. These results are in line with the results of den Butter and Mosch (2003) who find for a sample of 25 OECD countries that a pair of countries with a similar legal system trades some 46 to 84 percent more with each other than countries with a different legal system. Den Butter and Mosch (2003) re-estimate their gravity function using instrument variables in order to control for problems with omitted variables and confirm the results of the OLS estimation. Hence on average a country pair with a similar legal system trades almost 50 percent more with each other. Using firm-level data of 11 European countries, del Gatto et al. (2006) simulate that a 5 per cent reduction

4 These difficulties should also be a warning that a “panacea” for the “right” institutional design of an economy does not exist. For this reason “transferring the formal political and economic rules of successful Western economies to third-world and Eastern European economies is not a sufficient condition for good economic performance” (North 1996).
in international trade barriers – which could, for example, be induced by legal harmonization – results in a 2.13% increase in productivity due to a more competitive environment. In a similar approach Kneller et al. (2008) estimate the importance of foreign trade costs for the export intensity and additional market entry of exporters of UK manufacturing firms in the period of 1988 till 1998. The overall effect of a reduction of one unit in foreign trade costs leads to a 3.5% increase in export intensity and an increase in the probability of additional market entries of 0.6 percentage points. Among the different components of the overall foreign trade costs indicator the legal structure and property rights have the second largest impact on the export intensity and are far more relevant for trade than direct policy instruments such as tariffs, quotas or exchange rate restrictions.

3. On Desirability and Feasibility of Full Harmonization of Law

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. The question then arises whether this is really (a) desirable, and (b) practicable.

3.1 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.
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. For this reason alone, harmonization of the legal system in an integration area with heterogeneous countries would not be appropriate. 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. 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. \(^5\)

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\(^5\) 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 1997).
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.\(^6\) 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.

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 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.

Although the remarks above are in favour of – at most – only partial harmonization of law due to possible advantages resulting from system competition, full legal harmonization could be more desirable on a regional level. According to Malang (2007) it is crucial to consider the optimal geographical area for legal harmonization when defining the scope and depth of

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\(^6\) 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.
harmonization. For regions with a higher degree of international trade, e.g. like the ASEAN countries, Malang concludes that the costs of non-harmonization can be higher than they are for the world as a whole and a deeper regional harmonization of law is therefore needed to promote regional development through gains from deeper economic integration.

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

As mentioned above, attempts towards a broad harmonization of law are currently under way (particularly within the European Union). However, 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. Imperfect matching hampers international trade, too. 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 civil justice and of judicial administration in civil matters. Den Butter and Mosch (2003) tried to capture this effect by estimating an augmented gravity equation adding a variable of “informal trust” which they build from the Eurobarometer 1996. Their estimation results indicate that a change of one standard deviation of this variable leads to a change of 24 to 34 percent in trade volume.

Another argument put forward by Carbonara and Parisi (2007) points to substantial switching and adaptation costs as a possible hindrance or delay in full legal harmonization. Due to these costs a free-riding problem results in that “each country prefers legal harmonization by way of exportation of their own legal rules” (Carbonara and Parisi, 2007, p. 5) because in that case solely the importing country, that means the country transplanting the foreign legal system, has to bear the switching costs. As the authors show this strategic incentive can lead to the following paradox within their model: countries which engage in cooperative efforts prior to
the full legal harmonization solution can end up with less harmonization than countries which proceed with independent transplantation efforts.

4. A Case for Partial Harmonization of Law

In contrast to small companies and to consumers, large companies 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. 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. 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 legal

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7 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).
uncertainty by creating desired harmonization on their own, consumers and small companies cannot do this to the same extent. 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 usually goes along with legal uncertainty and, hence, with a rise in costs. The reason is that legal diversity may imply

- 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 countries.

Legal uncertainty can be regarded as a non-tariff trade barrier. But from this it does not follow that full harmonization is necessary, because harmonization itself generates substantial costs.

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8 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.

9 See Wagner (2002), p. 1014, as well. For a detailed analysis concerning the nature of such costs see, for example, Ribstein and Kobayashi (1996).
These include not only direct costs for developing new bureaucracies or demolishing old structures, but also costs arising from a loss of the 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, it might be better to adopt a step-by-step approach. One 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, one could then turn to a more comprehensive harmonization at a later stage if this then is assessed as being desirable. However, legal harmonization only makes sense if it is accompanied by a thorough reform of the system of civil justice and a harmonization of procedural law.
References


