ARTICLE IN PRESS
JID: INDOR [m1L;June 4, 2016;16:52]

International Journal of Industrial Organization 000 (2016) 1–27

Contents lists available at ScienceDirect

International Journal of Industrial Organization

www.elsevier.com/locate/INDOR

Regulatory decision errors, Legal Uncertainty and welfare: A general treatment[☆]

Yannis Katsoulacos[a,1], David Ulph[b,*]

[a] *Department of Economics, Athens University of Economics and Business; Patission 76, Athens 104 34, Greece*
[b] *Department of Economics, University of St Andrews, St Andrews, Fife KY16 9AL, Scotland*

ARTICLE INFO

Article history:
Available online xxx

JEL:
K4
L4
K21
K23

ABSTRACT

We provide a general treatment of the implications for welfare of various sources of legal uncertainty facing agents about the decisions made by a regulatory authority. We distinguish the legal uncertainty from the *decision errors* made by the authority. While an increase in *decision errors* will always reduce welfare, for any given level of *decision errors*, information structures involving *more* legal uncertainty can im-

☆ We have presented a number of Discussion Papers on legal uncertainty and its implications since 2009. We are grateful for the comments of participants at the IMEDIPA Santorini Workshop, May 28th 2009; the CRETE Conference, Tinos, July 9–12, 2009; the INTERTIC Conference, Milan, September 15, 2009; the OFT Meeting on the ESRC Project on "Optimal Enforcement Procedures", January 11, 2010; Workshops in the Office of Fair Trading and French Competition Authority in January 2011; the MaCCI Workshop on Competition Policy, Speyer, 13–17 June 2011, Seminars at the University of Sussex, September 2011, the Higher School of Economics, Moscow, April 2013, the University of Venice, May 2013 and the IIOC, Boston, 17-19 May 2013. Over this period we have benefited in particular from the comments of Mathew Bennett, Amelia Fletcher, Kai Huschelrath, Kai-Uwe Kuhn, Massimo Motta, Volker Nocke, Martin Peitz, Anne Perrot, Patrick Rey, Anastasia Shchepetova, Yossi Spiegel, Jean Tirole and Thibaud Verge. We are also most grateful to two anonymous referees for their very useful comments. Of course, all errors and ambiguities remain solely our responsibility. Our research on legal uncertainty has been supported by a research project on optimal enforcement procedures funded by the Economic and Social Research Council (ESRC, UK) under grant RES-062-23-2211. Research on the current paper has been supported by the research grant 2591 of the Greek Ministry's of Education Program "Excellence in Research (ARISTEIA)".
* Corresponding author. Tel.: +44 1334 462440; fax: +44 1334 462444.
E-mail addresses: ysk@hol.gr (Y. Katsoulacos), du1@st-andrews.ac.uk (D. Ulph).
1 Tel.: +30 2108203348.

http://dx.doi.org/10.1016/j.ijindorg.2016.04.013

Please cite this article as: Y. Katsoulacos, D. Ulph, Regulatory decision errors, Legal Uncertainty and welfare: A general treatment, International Journal of Industrial Organization (2016), http://dx.doi.org/10.1016/j.ijindorg.2016.04.013

Keywords:
Optimal law enforcement
Optimal penalties
Legal uncertainty
Decision errors

prove welfare. This holds always when sanctions are set at their optimal level. This transforms radically one's perception about the "costs" of legal uncertainty. We also provide general proofs for two results, previously established under restrictive assumptions.

1. Introduction

Legal Uncertainty –the inability of economic agents to predict with certainty whether a privately beneficial action that they would wish to undertake would be judged by a regulatory authority to be socially harmful, and so be treated as illegal and potentially subject to a penalty–has been the subject of analysis by economists and other social scientists for a long time. The impact of legal uncertainty on the optimal enforcement of economic regulations, the demand for legal advice and the incentives for compliance have been the subject of attention in the Law and Economics literature for at least three decades and, more recently, the literature on the enforcement of Competition Law.[2]

Essentially, traditional literature distinguishes three potential sources of legal uncertainty. The first is uncertainty that agents may face about the *type of their action* - about whether the action is genuinely socially harmful. The second is uncertainty regarding the *liability standard* which we can think of as the threshold level of harm caused by an action such that if the authority perceives the harm caused by a firm's action to be above this threshold it will disallow and penalize the action, while if the perceived level of harm is below this threshold then the authority will allow the firm's action. The third source of legal uncertainty, which has received extensive attention in the literature arises because authorities are unable to determine the actual harm caused by an action and so have to form some estimate of the harm, and an action is disallowed if the *estimated* value of harm is above the liability standard.[3] Since these estimates contain errors this gives rise to possible Type I and Type II *decision errors* whereby actions that should be allowed are disallowed and actions that should be disallowed are allowed. In their analyses, Craswell and Calfee (1984, 1986) focus on the second and third sources of legal uncertainty and examine their welfare implications considering more specifically how under-compliance and over-compliance are affected. Other very important papers in the Law and Economics tradition that examine the implications of legal uncertainty, arising from the first and third sources above, for the optimal enforcement of economic regulations and the demand for legal advice are those by Kaplow (1990), Kaplow (1995) and

[2] For a review of contributions to these literature strands see also Katsoulacos and Ulph (2015).
[3] For example, the papers (mentioned below in the text) in the Law and Economics literature and the more recent contributions in the enforcement of regulatory law literature including: Schinkel and Tuinstra, (2006), Kwak (2010), Lang (2012), and Strausz (2011).