

REGULATORY POLICY INSTITUTE

Understanding the economic rationale for legal services regulation

A report for the Legal Services Board prepared by:
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Summary

This Report examines the *economic* rationale for regulation of legal services markets and the legal service professions. It takes a step back from the existing regulatory framework in England and Wales, to take a wide view of various ‘in principle’ arguments that may suggest a requirement for the regulation of the supply of legal services (the Report does not evaluate the empirical evidence in any detail).

As in other areas of regulation, legal services regulation can be directed toward various broad public policy objectives, including the classic economic concerns about issues of efficiency and of equity. In the context of legal services, the latter issues are sometimes discussed in terms of access and affordability; protection against abuses of power; and other broader issues of fairness.

The most compelling economic rationale for some form of oversight of legal services relates to issues regarding ‘quality of service’ (in a broad sense), and, in particular, to issues associated with information asymmetries between suppliers and consumers, which can affect the ability of consumers to assess quality. A commonly observed response to asymmetries of information in markets is via the development of reputation, and self-regulation can be seen as a collective attempt among suppliers to maintain certain reputational standards of conduct/performance. However, well-recognised problems can arise when the remit of self regulation moves beyond what is necessary to certify quality. In the limit, these can lead to some of the familiar adverse consequences associated with monopolisation and cartelisation.

The structure of supply of legal services can also have direct implications for service quality and for competition, and it suggests another reason for legal services regulation. Specifically, professional restrictions or practices (such as fixed or minimum prices, bans on advertising, restrictions on organisational form, and exclusive rights) can result in restrictions of new entry and the stifling of innovation, including in relation to different ways of doing business. Where these rules or restrictions do have adverse effects on competition, or where they represent an exploitation of market power, they are addressable via competition law. However, some restrictions may potentially have countervailing ‘public interest’ benefits, and in these circumstances there could be a rationale for an element of

regulation incremental to competition policy focused on specialist scrutiny of legal services market rule-books.

The potential alternative structures for legal service regulation should be assessed on the basis of their ability to address, and balance, the possibly beneficial effects of specific rules, in terms of ensuring quality in service provision, with the potential for such rules to be used in anti-competitive ways and thereby adversely to affect economic welfare. The paper examines the appropriateness of self-regulation and public regulation from this perspective. Finally, the Report considers questions of choice of the broad regulatory approach to the relevant economic activities, and of the processes by which rule-making occurs. These are likely to be highly relevant when considering a framework for the analysis of regulation in legal services

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1. Terms of reference

We have been asked to produce a Report for the Legal Services Board (LSB) which considers the *economic* rationale for regulation of legal services markets and legal service professions. In particular, we have been asked to consider, on the basis of the relevant economic literature, the circumstances in which regulation might be expected to have benefits, and why it may be rational (in economic terms) for consumers of legal services, providers of legal services, regulators, government and society to seek to regulate these services.

More specifically, we have been asked to:

- Take a step back from the existing regulatory framework – ignoring the current reserved activities and titles – and consider the economic rationale for regulation of the sector on a ‘clean-sheet’ basis.
- Survey various arguments and assessments of the economic issues surrounding the supply of legal services, and indicate the conclusions to which this body of work points concerning where regulation is most likely to be beneficial and where it is not.
- Take a wide view of the provision of legal services, highlighting the broad areas where economic issues and concerns might arise.
- Pull together the analysis by concentrating on the most important of the inefficiencies that might arise in the absence of regulation, and considering what features of legal services and what circumstances can be expected to contribute most to the likelihoods and magnitudes of any such adverse effects.
- Finally, we have been asked to bring together the main themes from the economics literature into a framework for the analysis of regulation in legal services.

The primary focus of the Report is, therefore, on exploration of the theoretical, or ‘in principle’, basis for regulation of certain types of legal service provision; and, in this task, we have been specifically asked to draw upon existing academic work (including economic and socio-economic studies of legal services). We have not been asked to evaluate the empirical evidence in any detail, although, in a Postscript to the Report, we do note some of the empirical questions that might arise from a number of the points that we make.

Structure of the Report

The discussion in this Report is organised as follows. Section 2 begins by setting out some relevant contextual considerations relating to the nature of legal services, and considers the meaning of regulation in its various forms. It also briefly introduces different approaches, or schools of thought, in the economic literature which are relevant to discussion of the economics of regulation of legal services. In section 3, we consider the various public policy objectives that regulation has traditionally been directed toward, including the classic economic concerns of efficiency and of equity, before turning in sections 4 and 5 to consider more specific policy rationales for the regulation of legal services. Section 4 discusses a number of the economic characteristics of legal services provision, particularly issues concerning quality of service, and concludes that these characteristics can provide a rationale for some or other form of regulatory oversight of legal services markets. In section 5 we examine characteristics of the structure of supply of legal services, including the way in which lawyers have historically organised themselves (and the rules, customs and practices adopted by professional organisations), and discuss how these can potentially affect the supply of legal services, including their implications for service quality and for competition. Section 6 then briefly discusses the attributes of the various alternative regulatory structures, including issues surrounding the development of an analytic framework capable of addressing, and balancing, the effects of specific rules in terms of ensuring appropriate service quality, with the potential for such rules to be developed and applied in anti-competitive ways. Finally, section 7 contains some concluding remarks.

The discussion that follows is, in accord with the Terms of Reference, pitched at a general level: we do not purport to cover every aspect of the existing or potential rules that may be relevant, and nor *a fortiori* do we assess whether or not they are justified by an economic rationale. Rather, our approach has been to examine the general *tendencies*, in terms of economic incentives, of the types of rules and types of organisational structures that have been, or may in the future be, observed in the supply of legal services, and to discuss the possible implications of these incentive effects for economic and social welfare.

2. Introduction: an overview of economic concepts and schools

Legal professionals occupy a unique and important role in society. Like some other professions they are required to apply specialised knowledge and skills in matters that are of considerable importance to individuals, to business and for the fabric of society more generally. There are, therefore, a multitude of reasons why a society may want to ensure that those entrusted with the relevant responsibilities, and whose work can directly affect aspects of an individual's rights, property and liberty, operate within an appropriate framework of accountability and supervision.

In this Report we consider some of the *economic* reasons why a society might want to establish a framework for the oversight and regulation of the legal services profession. In so doing, and consistent with our terms of reference, we have stood back from the existing rules and structures of legal regulation in England and Wales to explore the extent to which arguments in the relevant economic literature point toward the existence of benefits from regulatory oversight of the legal profession.

2.1 The importance of law and its differentiating features

There are differing views regarding the distinctiveness of legal services relative to other professional services. Some view such services as merely another area of specialist knowledge, while others attach a 'special' or elevated status to these services.

Legal services frequently deal with matters that can have high importance for the consumer who is acquiring the service: they address matters that may directly affect an individual's rights (eg: inheritance, divorce and custody matters), property rights (eg: house sales/purchases or business contracts) and liberty (eg: many criminal aspects of the law).

Such services are also part of the broader social-political-moral landscape that comprises a society's legal system, or "The Law". The importance of these broader systems is the subject of substantial work in legal and moral philosophy, in sociology and political science. While it is not within our remit to consider this work, we nonetheless recognise that the potential magnitude of the adverse effects of legal services being improperly provided (for example, in the economic sense of quality of service being poor), along with the need for legal services to contribute to a stable, authoritative, broader legal system, may be held to give a special complexion to legal services, as compared with other professional services. Indeed, even when focusing upon narrower economic concerns, it is relevant to note that key ideas

in the *Wealth of Nations* were first developed in Smith's Lectures on Jurisprudence; that the *Theory of Moral Sentiments* came next, indicating the underlying ethical linkages in the fields of jurisprudence and political economy; and, that, a hundred years or so later, economics teaching at Cambridge (which became, through Marshall and Keynes, the most influential of UK based schools of thought) originated within the Moral Sciences Tripos (where it sat alongside the teaching of general jurisprudence).

To recognise these points, however, does not have any immediate and direct implications as to the appropriate form of regulatory oversight of such services, or even whether such oversight is warranted. Many goods and services – and not just in other professional areas such as medicine – have the characteristic that failures to apply relevant skills and/or to exercise due care can lead to substantial consumer harm. For example, the bus driver on a school trip bears great responsibilities for the physical welfare of the children who are being transported.

Recognition of the points does, on the other hand, indicate that an unduly narrow economic assessment could fail to take account of relevant evidence concerning social, political, cultural and symbolic aspects of the practice of law. At a minimum, these matters interact with more basic economics, and they both affect and are affected by the latter; which, as always, cannot properly be understood outside the particular context in which it is being used. An obvious example here concerns how to interpret practices that have, on an initial economic assessment, no obvious economic effects at all. Should they be treated as suspicious, on the ground that, having no immediately explicable benefits to consumers, the likelihood is that they are actually contrary to consumers' interests? Or should it be recognised that the relevant practices may have social functions or serve social purposes that are simply not captured in typical cost-benefit analyses?

While our focus in this Report is quite narrow – the economic rationale for regulation of legal services – we have kept these broader questions in mind throughout. Indeed, one of the points we make in section 6 is that a regulatory framework should be broad enough to be able to encompass both narrower economic reasoning and those broader considerations that may have fundamental/irreducible relevance to legal services, and which may distinguish them from other professional services.

2.2 Regulation and market rules

An immediate issue that arises when discussing the economic rationale for regulation is: *precisely what is meant by the term regulation?* Across the relevant literature in this area

the word 'regulation' is often used loosely and imprecisely to refer, in some cases, to private or self-regulation by the profession, and at other times to public or government regulation of the profession (including independent, statutory regulation).

Although the meaning of the term is sometimes contentious in academic scholarship and practice, with different disciplines adopting slightly different notions, for our purposes regulation, in its totality, is usefully viewed as the 'rule books' (there may be more than one) governing social and/or economic interactions/transactions in a particular area of economic activity. This captures both formal rules such as statutes, but also informal rules and norms and behaviours (ie: customs and practice).¹

On this definition of regulation, the distinction between self-regulation and public regulation becomes one of *who* is responsible for the development and enforcement of the relevant 'rule-book'. In the case of self-regulation by professionals the rule-book is most usually developed, and enforced, by a professional association. In the case of public regulation, the rules are established and enforced by the State or by a statutorily empowered commission.²

At its widest, regulation could be defined to encompass all 'rules' associated with a defined set of economic transactions, which, for our purposes, can be taken as the basis for defining the relevant market or markets (here legal services). The 'rules' constitute the institutional superstructure that governs the interactions/transactions between economic agents. Recognition that regulation, in this sense, is a central characteristic of virtually all markets, is an important first step toward realistic economic analysis, since it helps avoid a very common, and widely believed, fallacy, to the effect that regulation is something that is brought into markets from some ill-defined outside, like a *deus ex machina*.

It is a central proposition of economics that market rules exert a considerable influence on the behaviour of market participants and on economic performance. The relevant linkages

¹ This raises a series of related questions as to how a rule or a norm becomes incorporated into a rule book or is seen to be valid, in a specific area of economic activity. These issues are touched upon in section 6.3 below in the context of legal services regulation and in particular when considering the framework for the assessment of rule changes. However, at the more general level we note that there are parallels here with work in legal theory, particularly that of HLA Hart and his 'rule of recognition'; the need for a meta-rule through which other rules promulgated within a system are seen as legitimate and valid. HLA Hart (1965) *The Concept of Law* (Clarendon Press Oxford) p 97.

² This distinction dates back to early work. Max Weber distinguishes between the different forms of 'regulation of the market' including: by the actors, by convention, by law or by voluntary action. M Weber *Economy and Society: An outline of interpretative sociology* in G Roth and C Wittich (eds) (Univ. California Press Berkeley 1978) p 82.

appear in a variety of different parts of the economics literature. For example, in the theory of games, which tends to contain some of the most abstract, mathematical analysis to be found in the discipline, the 'rules of the game' are a key factor in determining strategies (conduct) which in turn determine outcomes/performance.³ In the older, broader literature of industrial organisation, the linkages are spoken of as involving market structure, conduct and performance, where the notion of 'structure' encompasses the regulatory structure governing the market (as well as other things, such as degree of concentration among suppliers and barriers to entry).⁴ In the economic study of regulation itself, the emphasis is on theoretical and empirical exploration of the impacts of different rules/regulations on market outcomes.⁵

Since much market analysis rests upon assumptions about competition, or the lack thereof, and since the technical economics definition of competition (as a process) is very similar to the ordinary language definition⁶ – the notion of rivalry is central to both – everyday examples of competition can be used to illustrate the importance of rule-books in determining behaviour. Thus, if we are told that two teams of eleven people are competing with each other, in order to say very much about how the individuals and teams are conducting themselves, we will need to know whether they are being governed/regulated by the rules of association football, or of hockey, or of cricket, or of whatever. The point is that conduct will be very different in each case. Further, the fine detail of the specific rules can sometimes have major impacts on outcomes, as illustrated by the effects of the offside rule in association football (it would be a rather different game without it).

It follows that the processes by which rules of competition and market governance are established, enforced and changed are themselves properly described as regulatory processes, since the relevant rules and conventions – whether established/enforced by

³ Kreps notes: "Game-theoretic techniques require clear and distinct 'rules of the game'". DM Kreps *Game Theory and Economic Modelling* (Oxford University Press 1990)p 94.

⁴ See for example: JS Bain (1951) 'Relation of Profit Rate to Industry Concentration: American Manufacturing, 1936-1940' 65 *The Quarterly Journal of Economics* 294; JS Bain (1954) 'Economies of Scale, Concentration, and the Condition of Entry in Twenty Manufacturing Industries' 44 *American Economic Review* 15.

⁵ See, for example, the survey in P Joskow and N Rose 'The effects of economic regulation' in R Schmalensee and RD Willig (eds) *Handbook of Industrial Organization*, Volume 1 (Elsevier Science Publishers Amsterdam 1989).

⁶ An authoritative economic definition of competition is provided by Professor George Stigler in the New Palgrave Dictionary of Economics: "... a rivalry between individuals (or groups or nations), and it arises whenever two or more parties strive for something that all cannot obtain." G Stigler 'Competition' *The New Palgrave Dictionary of Economics*, Second Edition, 2008.

public bodies or by private 'agreement' – will 'regulate' the relevant economic activities. The main participants in football may be the spectators and the players, with rules enforced by the referee and his assistants, but the outcomes are also functions of the rule-makers in the various leagues, in UEFA, and in FIFA,

The football analogy is useful in illustrating another point about the effects of rules/institutions: these are not instruments for ensuring particular outcomes. Particular outcomes are determined by the interactions governed by the rules, whether those be the playing of a football match or the purchases and sales of goods and services. However, without being able to predict the actual outcomes of competitive processes (whether Manchester United will beat Chelsea at their next meeting), it is, through reasoning and, more importantly, through accumulated experience, possible to make evaluative judgments about the likely effectiveness of alternative rules (e.g. the offside rule makes for more interesting and exciting matches). This is the most that can reasonably be expected of the economic analysis of alternative regulatory structures in general: while there may be specific circumstances where it is possible to go further, and to achieve greater precision (e.g. in football it is possible to make reasonably informed estimates of the probabilities of the various outcomes), the tendency to claim more usually turns out, on close inspection, to lack supporting reasoning and substantiating evidence.⁷

While these points may appear to be obvious once stated, we consider that they are nevertheless, worth articulating here because they are so often neglected in academic discourse and policy discussion. Furthermore, looking back at the development of regulation over the last twenty years or so in sectors such as energy and communications, it becomes clear what a critical role the development of rule-books has played; and also what a major role sectoral regulators have played in the development of those rule-books. The advances made in the conduct of public policy have not just been about the abolition of statutory entry barriers (formal market opening), for example, or simply about the development of economically more sophisticated price regulation (eg. RPI-X). To take but one example, the use of codes of various types, setting out rules for access to and use of network facilities and services, has been very important in facilitating market developments, as have the rule-books of (privately owned) commodity exchanges for the trading of electricity and gas.

⁷ See F Hayek (1989) 'The Pretence of Knowledge' Nobel Memorial Lecture December 11, 1974, reprinted in *American Economic Review* 79 p3.

2.3 Alternative economic perspectives on regulation

No introduction to a general discussion of the economics of regulation in a particular field of economic activity (here legal services) would be complete without noting the existence of different approaches, or schools of thought, on the relevant issues. We briefly summarise the two most important of these here, and comment on their standing in the light of available evidence.

Modern neo-classical economics (MNC)

The term neo-classical economics is generally applied to the textbook (micro) economics taught in most UK universities, although the term is something of a misnomer. Originally it was used to describe a group of schools of economic thinking that emerged in the late 19th century, and which tended to be geographically centred at particular universities. Thus, for example, the Austrian school (known chiefly to current generations of students through the work of Schumpeter and Hayek) is a neo-classical school, yet is highly critical of today's conventional (teaching⁸) wisdoms. In deference to the older and more accurate use of the word, we will refer to 'modern neo-classicism' (MNC) to refer to the 'product' supplied to their students by most universities under the heading 'microeconomic theory'.

The dominant characteristic of MNC is its abstraction. The structure of its logic is based on a number of assumptions that are relatively remote from reality, and it has no room for economic institutions other than by way of a minimum, skeletal set of assumptions required as pre-conditions for exchange to take place (e.g. the existence of very basic forms of property rights). Among the things that MNC abstracts from are rule-books.

It should be clear from this description that the approach is not well adapted to analysing alternative institutional structures or alternative rule-books, which are the kinds of issues that arise in the economics of regulation. It is not so much that the theory is wrong, it is rather that, as explained by Nobel laureate Ronald Coase, it is irrelevant to the problems at hand:

⁸ In the hands of master craftsmen, the techniques are more flexible, and the results more interesting than most things appearing in the lecture room.

[In] modern economic analysis ... the growing abstraction of the analysis... does not seem to call for a detailed knowledge of the actual economic system, or, at any rate, has managed to proceed without it ... What is studied is a system which lives in the minds of economists but not on earth. I have called the result 'blackboard economics'. The firm and the market appear by name but they lack any substance. The firm in mainstream economic theory has often been described as a 'black box'. And so it is. This is very extraordinary given that most resources in a modern economic system are employed within firms. ... Even more surprising, given economists' interest in the pricing system, is the neglect of the market, or more specifically of the institutional arrangements which govern the process of exchange. As these institutional arrangements determine to a large extent what is produced, what we have is a very incomplete theory.⁹

This irrelevance has not deterred economists, however, and much of the (albeit rather limited) literature on the economic rationale for regulation of legal services, is in the MNC tradition (indeed, the inappropriateness of the approach is one possible explanation for the relative paucity of relevant work in the area). We therefore consider some of this specific work in later sections of the paper. Here we examine some general features of the approach.

Market failure and public interest theories of regulation

One of the achievements of MNC is the *fundamental theorem of welfare economics*, part of which states that, under a rather long list of unrealistic assumptions, perfect competition¹⁰ will lead to an equilibrium that is efficient in the sense that it is impossible to make one person better off without making someone else worse off. The reasoning is relatively trivial,¹¹ but it is easy to see why it became a major focus of intellectual discussion: it was massively over-interpreted because of the nature of its bottom line, linking competition and efficiency.

⁹ R.H. Coase, 'The Institutional Structure of Production', in RH Coase, *Essays on Economics and Economists* (The University of Chicago Press Chicago 1994) pp. 5-6.

¹⁰ Broadly this notion refers to a market structure where: there are many sellers of a product; no seller has control over the market price; all sellers supply an identical product; consumers have perfect information; there are no costs of transacting; all firms have equal resources and technology; no barriers to entry or exit; and no externalities in production or consumption exist.

¹¹ The theorem works in two directions: it also says that, under the relevant assumptions, any efficient outcome can be sustained as a perfectly competitive equilibrium, which is a much stronger claim, resting on much more subtle reasoning.

If, under a specific set of assumptions, two of which are zero transactions costs and perfect information, the mathematics implies an efficient equilibrium, then, if one of the assumptions is changed, the result can be expected to be a reduction in economic efficiency. Such an economic inefficiency has, over the last few decades, come to be labelled a 'market failure' and the cause of the implied inefficiency, the changed assumption in the economic modelling, has come to be described as a source of market failure (rather than, say, a fact of life).

This use of the term 'market failure' – to refer, in fact, to the change implied by a change in modelling assumptions – is well recognised at the technical level. In perhaps what is the classic article in the economics literature on the subject, *The Anatomy of Market Failure*, Bator drew a distinction between 'failures' of the competitive price system arising from perturbations to the set of unrealistic assumptions used in the fundamental theorem of welfare economics,¹² and 'failures' that arise because of a more general lack of correspondence between these assumptions and the real world, noting:

Many things in the real world violate such correspondence: imperfect information, inertia and resistance to change, the infeasibility of costless lump-sum taxes, businessmen's desire for a 'quiet life', uncertainty and inconsistent expectations, the vagaries of aggregate demand, etc. With most of these I am not here concerned: they have to do with the efficiency of "real life" market institutions operated by "real life" people in a non-stationary world of uncertainty, miscalculation, etc.¹³

It could hardly be clearer: the concept of market failure was not developed to analyse real life market institutions, operated by real life people, in a world of limited information (the real life position). Rather, it is an exploration of how the implications of a particular model change as its assumptions are varied. As already stated, the assumptions of this model are remote from economic realities and, in most academic disciplines, if a model does not correspond to reality, any application of the word 'failure' would be to the model, not the reality. However, in common usage of the term 'market failure' in large areas of public policy discourse, Bator's point has been ignored, and, when reality and abstract theory diverge, it is, in Queen of Hearts fashion, reality that is said to 'fail'.

¹² About technology, tastes, initial endowments and producers' motivations

¹³ FM Bator (1958) 'The Anatomy of Market Failure' 72 *The Quarterly Journal of Economics* p 352.

In regulatory economics, the market failure approach, derived from welfare economics, is most closely associated with what are generically labelled *public interest theories* (of regulation), which assume that *public* regulation seeks to correct market failures.¹⁴ Although the starting point is in theoretical welfare economics, the focus on policy issues, and in particular on the evaluation of changes in market rules, in this literature tends to bring the economics closer to reality: there is a greater tendency to work with 'before and after' comparisons, rather than on comparisons with idealised outcomes such as a perfectly competitive outcome with zero informational and transactions costs. Practice has, therefore, brought the approach closer to the *comparative institutions* approach discussed below.

Nevertheless, as a framework for understanding how regulation works in practice, the public interest theories have severe limitations. A considerable body of empirical work, from a whole range of different regulatory contexts was surveyed by Joskow and Noll, who concluded that, when considered as positive theory (rather than as normative guidance), the public interest theories were wrong: they were generally inconsistent with available evidence.¹⁵ For example, the effects of regulation were not infrequently nearly the opposite of what was claimed to be intended, and of what the public interest theories indicated should be the aims.

Institutional economics

An alternative school of thought that has been influential in recent decades goes under the broad label of institutional economics. In its modern development (the 'new' institutional economics) it can be traced to the work of Ronald Coase, and in particular to two classic economic papers of the twentieth century, *The Nature of the Firm* and *The Problem of Social Cost*.¹⁶ The approach abandons the restrictive assumptions about information conditions and transactions costs that characterise MNC, and asks questions of how institutions and organisations develop so as to improve efficiency in the face of (a) the division of knowledge

¹⁴ Typically, the analysis assumes that public regulation does this on a piecemeal basis; which raises the question whether other 'market failures' should be ignored or should be taken as a relevant given (as in 'second-best theory').

¹⁵ P Joskow and R Noll (1981), "Regulation in Theory and Practice: An Overview," in Fromm, ed., *Studies in Public Regulation* (MIT Press) p 36.

¹⁶ RH Coase (1937) 'The Nature of the Firm' 4 *Economica* p 386; RH Coase (1960) 'The Problem of Social Cost' 3 *Journal of Law and Economics* p1.

– the fact that different transacting parties know different things – and (b) the existence of significant costs associated with the making of economic transactions. By institutions is meant the ‘rules of the game’¹⁷ – what we have above called the rule-books – which contrast with organisations, which are groups of people who organise in teams for the purpose of playing the relevant ‘game’.

It should, we hope, be obvious that the preoccupations of this strand of economics are much closer to issues raised by the question *What is the rationale for legal services regulation?* than is MNC. Many of the techniques of MNC are nevertheless used by those favouring the more realistic approach, what is dropped in this analysis are the unrealistic assumptions about information and transactions costs, and the notion that the characteristics of a world without such costs provides any useful guide for practical policy making.¹⁸

Notwithstanding the convergence on aspects of technical detail, the difference in the way of looking at the world can be profound. Those trained in MNC tend to see asymmetric information and the existence of externalities (uncompensated economic effects on third parties) as sources of market failure which signal potential opportunities for matters to be improved by public regulation. Indeed, much more frequently than should be the case, analysts tend to jump straight from a finding of ‘market failure’ to a conclusion that intervention is not just potentially warranted (depending upon what further exploration of the issues indicates) but actually warranted (irrespective of any other matters that may be relevant).¹⁹

¹⁷ See, in particular, the work of Nobel laureate Douglass North, including his lecture: ‘Economic Performance through Time’ *Nobel Memorial Lecture*, December 9, 1993. Also, DC North (1990), *Institutions, Institutional Change, and Economic Performance* (Cambridge University Press Cambridge England).

¹⁸ There are, of course, critics of this approach. A common criticism from ‘mainstream/theoretical’ economists is the absence of mathematical models to support the reasoning and provide testable predictions, and that as a result the approach places an over-reliance on case studies which raises problems of interpretation (in the absence of robust theory) and can cause confusion about the appropriate use of empirical proxies for the key variables of interest. On the other hand, the approach has also been criticised by some heterodox economists, particularly economic sociologists, on the basis that it pays insufficient attention to the role and impact of social relations on institutions and behaviour: a position which is largely derived from Granovetter’s criticism of New Institutional Economics as being based on an *undersocialised* conception of human action. See: C Ménard (2001) ‘*Methodological Issues in New Institutional Economics*’ (8) *Journal of Economic Methodology*; and M Granovetter (1985) ‘*Economic Action and Social Structure: The Problem of Embeddedness*’ *The American Journal of Sociology* pp 481.

¹⁹ As Noll observes: “The importance of the first component is that in literally every circumstance the adoption or extension of regulation has been defended by its proponents on the basis of allegations (sometimes

In contrast, the institutional approach sees the existence of asymmetric information and externalities as almost *necessary* features of an efficient market, since it would typically be much more costly than it is worth to attempt to eliminate all such phenomena. Eliminating asymmetric information would, if taken literally, mean ending the division of labour in activities that contain an information provision component; which is simply not feasible, and, if it were feasible, would be impoverishing. Similarly, seeking to eliminate all externalities would, if feasible (which it isn't), be highly inefficient because of the very high costs that it would incur.

Rather than compare with an idealised and unrealistic outcome, the approach is rather to ask whether there are more or less efficient ways of doing things. Professor Harold Demsetz has explained matters as follows, characterising the MNC tendencies as the 'Nirvana fallacy':

The view that now pervades much public policy economics implicitly presents the relevant choice as between an ideal norm and an existing 'imperfect' institutional arrangement. This *nirvana* approach differs considerably from the *comparative institution* approach in which the relevant choice is between alternative real institutional arrangements. In practice, those who adopt the nirvana viewpoint seek to discover discrepancies between the ideal and the real and if discrepancies are found, they deduce that the real is inefficient. Users of the comparative institutions approach attempt to assess which alternative real institutional arrangement seems best able to cope with the economic problem; practitioners of this approach may use an ideal norm to provide standards from which divergences are assessed for all practical alternatives of interest and select as efficient that alternative which seems most likely to minimize the divergence.²⁰

It can be noted here that, while the final part of the statement indicates how the different perspectives can potentially be reconciled, it nevertheless remains the case that, in practice, the ideal norm is typically derived from unrealistic assumptions, that the introduction of the common ideal norm does not actually add anything substantive to the analysis, and that it is likely only to affect things by being a source of error.

implausible) of market failure." R Noll 'The politics of regulation' in R Schmalensee and RD Willig (eds) *Handbook of Industrial Organization*, Volume 1 (Elsevier Science Publishers Amsterdam 1989) p 1255.

²⁰ H. Demsetz (1969) 'Information and Efficiency: Another Viewpoint' 12 *Journal of Law and Economics* p. 237–8.

2.2 Summary

We will discuss below all major contributions to the economic literature on the rationale for regulation, from whatever school of economic thinking that they come, but it will be clear from what is said above that we have little doubt that, particularly given how ‘institutions’ are defined – in terms of rule-books or sets of rules – that the comparative institutions approach offers the better way of framing the underlying issues in relation to the regulation of legal services. The question then is, in relation to any defined change in regulation: can things be expected to work better with the change (according to the relevant assessment criteria) or without the change? And, the evaluation to answer this question is to be conducted against the relevant, real world factual context.

3. Regulation and the relevant policy objectives

Economic theorising traditionally divides public policy concerns into issues of efficiency, (roughly to do with maximising the value of total production) and of equity (to do with the distribution of economic resources), and many policy controversies have centred on the nature of the trade-offs between the two, and on the appropriate resolution of such trade-offs as might be determined to exist. Sectoral regulation (of communications, energy, transport, etc.) is a policy area where these issues have, historically, been to the fore; and there are clear arguments to the effect that they are also of considerable significance in the provision of legal services, although the reasoning is much less developed than in utility sectors.

In this section, therefore, we will first focus first on a discussion of the trade-offs and their resolution in sectoral regulation (by asking the question; *why do we regulate utilities?*), as a prelude to considering similar, though not identical, issues in a legal services context. We also discuss certain policy issues with particular relevance to the provision of legal services, namely the impact on efficiency and equity of knowledge and power imbalances in the provision of legal services, and the impact of broader equity issues on participation in legal services markets.

3.1 Efficiency, equity and access

Why do we regulate utilities?

The textbook economics answer to this question is that there are elements of natural monopoly in utility sectors, which, if they are in private hands and are unregulated, will lead both to allocative inefficiency and to excessive/inequitable consumer prices.²¹ Price regulation is therefore seen as an instrument that is capable of simultaneously improving economic efficiency and equity, and it is in this context in which notions such as ‘incentive regulation’ tend to arise.²²

²¹ See for example the description in DW Carlton and JM Perloff *Modern Industrial Organization* (3rd edn Addison Wesley Longman Reading Mass 2000).pp 664-666.

²² Incentive regulation is a broad term, which encompasses diverse approaches that range from very modest attempts to introduce marginal incentives to improve the performance of service providers to much more radical approaches that seek to establish strong links between financial returns and performance, similar to those to be found in competitive markets.

The limitation of this textbook account of things is that it does not always fit the relevant facts very well. This has led Professor Sam Peltzman of University of Chicago²³ to argue that a more ubiquitous correlate of utility regulation is cross-subsidisation: prices are 'levelised' so that some consumers pay more and others pay less than they would if prices were fully cost reflective.²⁴ The economic rents earned from low cost-to-serve consumers are then dissipated by cross-subsidy of high cost-to-serve customers; and a classic example is the cross-subsidisation of rural electricity customers by urban electricity customers.²⁵

In terms of policy objectives, the preference for cross-subsidisation is typically expressed in terms of a desire to provide access for most, if not all, households to what are regarded as 'basic' requisites for modern living. If prices were fully cost-reflective, so the argument goes, large numbers of households would not be able to afford connection to electricity and water networks (because it is so costly to provide connections in some locations).

One criticism of cross-subsidisation is that it is an inefficient way of achieving the distributional objective: it would be better to redistribute income and then let rural households themselves decide whether access was worth it.²⁶ A broadly equivalent redistribution through tax and benefit systems would, however, require some linking of taxes and payments to what might be a complex geography (of cost differences), which would raise feasibility and administrative efficiency issues. And a less elevated counter-argument is that a tax and benefits approach would amount to a much more transparent redistribution of resources than cross-subsidisation. Notwithstanding modern guidelines on

²³ S Peltzman, *The Control and Performance of State-Owned Enterprises: Comment*, in MacAvoy, Stanbury, Yarrow and Zeckhauser (eds), *Privatization and State-Owned Enterprises*, Rochester Studies in Managerial Economics and Policy, Kluwer Academic Publishers, Boston Mass., 1989.

²⁴ Similarly Joskow and Rose note: "The effects of economic regulation often differ considerably from the predictions of 'public interest' models, which assume that regulation is intended to ameliorate market imperfections and enhance efficiency....The structure of prices and distribution of revenues across classes of customer often reflect distributional and policy objectives...rather than efficiency objectives". P Joskow and N Rose 'The effects of economic regulation' in R Schmalensee and RD Willig (eds) *Handbook of Industrial Organization*, Volume 1 (Elsevier Science Publishers Amsterdam 1989) p 488.

²⁵ There is little doubt that Peltzman is right on the empirics of the association between regulation and cross-subsidisation in the utilities: there is, for example, still extensive geographic cross-subsidisation in the UK's liberalised energy sector; and it would be impossible to understand the Australian telecoms debate about that country's proposed national broadband network, including its role in the formation of the new government, on the basis of economic efficiency considerations alone.

²⁶ See M Friedman (1962), *Capitalism and Freedom* (Chicago University Press 1962). Friedman was a pioneer of the idea of a negative income tax, which in turn has spawned various, less ambitious 'tax credit' policies.

better regulation to the contrary, there is a strong tendency within regulatory and political systems to reveal only the benefits of policy interventions, and to keep the costs opaque – which, of course, implies that the re-distributional effect as a whole (taking account of costs as well as benefits) is kept opaque, at least for a while.²⁷

One aspect of the cross-subsidisation argument that is of interest in the current context, is the potential extension of the reasoning to other (non-utility) sectors. Peltzman, writing in 1987, himself did so in relation to the banking sector, where he noted (a) the policy preferences of governments for cheap credit in general, and cheap credit for favoured purposes (such as housing) in particular; (b) the tension that this creates with prudential banking regulation; and (c) the consequence that the next sector to see a significant increase in state ownership might be banking (since only in that way could the flow of cheap credit be maintained when the crunch comes). As a twenty year ahead forecast of developments in the banking sector, it is pretty good; and a vivid illustration of the value of clear economic reasoning (or at least of the value it would have if policy makers paid attention to it).

The question here is, is any of this of relevance to the provision of legal services? The existence of legal aid is a *prima facie* indicator that it is, suggesting, for example, that access to at least some legal services is considered sufficiently important that it be provided for directly, and not just through general income re-distribution that would make it, or at least associated insurance premiums (as in private medicine), affordable for all (see further at sub-section 3.3 below).

At the same time, it is quickly obvious that there are some significant differences in the nature of the relevant distributional/equity issues, and in the ways in which they are approached in relation to legal services. To illustrate, consider the argument that there is similarity between policy objectives aimed at ensuring affordable access to basic utility services in high-cost-to-serve areas, and objectives aimed at ensuring that there are readily available, affordable legal service providers across the country as a whole, and not just in major cities and conurbations. Given that (per-unit) costs (of legal services) are likely to be higher in less densely populated areas, it might be argued that measures such as minimum prices in the relevant markets can have beneficial effects in supporting access in less favourable (from a cost perspective) geographies.

²⁷ R Posner (1971) 'Taxation by regulation' *Bell Journal of Economics* 22.

However, whatever the merits of small legal practices in smaller communities, major differences with the utilities approach can be noted. In particular, price regulation to support local legal service providers does nothing to reduce the price paid by the consumer and make the service more affordable: there is no cross-subsidisation from larger, lower-cost providers of services in other locations. The local provider is assisted, but only in so far as the price regulation prevents undercutting by lower cost providers (and thus actually harms local consumers, at least in that (price) dimension of provision). Far from cross-subsidising others (i.e. having some of their economic rents removed), low-cost providers would benefit from larger economic rents.

Thus, there would only be a reasonably close analogy with utilities if legal services rule-books provided for the 'taxation' of low-cost providers, so as to support the continued, commercial existence of higher-cost providers.²⁸

Further points on access to legal services

Two further points on access/affordability as a public policy objective can be noted at this stage.

First, the issues obviously stem from a particular notion of distributive justice. Whilst it is sometimes translated into economic terminology via the concept of a 'merit good' (in respect of which society will intervene to make the product/service available to those unable to afford it),²⁹ it is not really an *economic* rationale for regulation, in the sense that economics, as an intellectual discipline, has something distinctive to contribute. The contribution of economics is more likely to be relevant when it comes to considering *how* such a policy could be most effectively implemented, and at *what cost*.

Second, in some circumstances a political concern about access might nevertheless interact with economic concerns about factors that contribute to lack of access for some consumers. For example, to the extent that access to legal services is compromised or restricted by

²⁸ Legal aid does not work in this way, since the funding is derived from general taxation. Arguably, however, *pro bono* work is closer to the typical patterns of resource transfers in utilities insofar as fees earned from some legal services customers are used to cross-subsidise provision of services to other customers. What remains different (from utilities) in this case is the relative magnitude of the economic transfers involved: the extent of *pro bono* work tends to be limited.

²⁹ RA Musgrave 'Merit goods' *The New Palgrave Dictionary of Economics*, Second Edition, 2008. See also: J Tobin (1970) 'On Limiting the Domain of Inequality' 13 *Journal of Law and Economics* p. 263.

services because they are excessively priced, or because they are being inefficiently rationed (because, say, of gold plating in service quality), the affordability issues become linked to issues of monopoly, market power and competition. That is, whereas the affordability issues in utility sectors discussed above may have derived from the *unavoidably* high costs of supplying particular customers (in remote areas, say), affordability issues in legal services may raise questions about the *avoidability* of the costs in question.

To the extent that access/affordability issues are significant drivers of public policy, it is important for the development of policy that the sources of the problems are clearly identified. If it is simply a matter of services being provided and priced efficiently, but some members of society not being able to afford 'essential' services at those prices, then legal aid is an obvious 'remedy' for the perceived problem. On the other hand, if services are gold plated and/or legal charges are excessively high, reliance on legal aid alone becomes an unattractive option, since it would, in the hypothetical conditions, involve taxpayers making excessive payments to suppliers.

Issues of competition and market power are discussed in section 5 below, but, since lack of affordability might also be caused by provision of an high quality ('gold plated') service, it will be also be addressed in passing in section 4, where quality of service issues are examined in detail.

3.2 Imbalances of knowledge and power

At the root of the substantive issues in the provision of legal services is the 'division of knowledge' in the economy, which raises problems that were central at the birth of political economy. The opening chapter of the *Wealth of Nations*, and indeed the opening page, introduces the notion of the division of labour, which is then shown, via the effects of specialisation on productivity, to be a central aspect of economic progress. The logic leads on to arguments to the effect that larger markets allow greater division of labour, and that removal of barriers to trade, by expanding markets, will lead to greater prosperity.

These arguments are still largely familiar in economics (though often translated into algebra that impedes access to them), but other aspects of those early explorations in public policy have been mostly forgotten. Smith and the Scottish *Literati* of the time were also greatly concerned about the possible consequences for social fragmentation that might accompany the division of labour, and advocated policies as diverse as universal state education and participation in local militias in response. Unsurprisingly perhaps for ways of thinking about

public policy that were developed in the Enlightenment, there was a strong element of ‘universalism’ (or what in modern jargon might be referred to as ‘inclusivity’) to much of the thinking.

In today’s information-based economies, the notion of the division of labour translates easily into the division of knowledge. Specialization in certain skills always had this component, but its significance relative to things like dexterity and physical strength has grown. For all the reasons given by Smith, and in more recent times emphasised by Hayek,³⁰ the division of knowledge is an indispensable aspect of economic progress: it is an indicator of market success, not, as MNC writers tend too often to imply, of market failure.

On the other hand, for reasons explored by Smith and his colleagues (but, in this case, not to anything like the same extent by Hayek and the Austrian School) the division of knowledge is not an unmitigated benefit: it brings problems as well.

Perhaps the principal problem with the specialisation of knowledge, recognised both in the economic literature and in work in other disciplines (sociology and political science), is that it can create power imbalances – roughly, knowledge can be power – including between the specialised providers of specific, knowledge-base services, and the consumers of those services. In broader social science work on the professions, knowledge in areas of medicine and law often attracts the term ‘elite knowledge’; it is by nature unfamiliar and impenetrable to many people, and discourse based upon it is not open to the active participation of all.³¹ Use of this knowledge is sometimes described as being an ‘act of power’.³²

Principal-agent theory

In the relevant economic literature the most frequently adopted framework for analysing some of the surrounding issues is that of ‘principal-agent’ theory.³³ In this framework, the principal (e.g.: consumer) does not have the same goals/objectives/preferences as the agent

³⁰ F Hayek (1937) ‘Economics and Knowledge’ 5 *Economica* p.33.

³¹ We do not consider in this paper questions of the extent to which legal professionals themselves deliberately contribute to the impenetrability of law, so as to increase power and income; but have more than enough evidence to say, with great confidence, that that happens in economics!

³² For example, see Friedson’s classic work on the professions: E Friedson *Professional Powers: A study of the Institutionalization of Formal Knowledge* (University of Chicago Press Chicago 1986) p 6.

³³ R Rees (1985) ‘The theory of principal and agent Part I’ 37 *Bulletin of Economic Research* p.3; DEM Sappington (1991) ‘Incentives in Principal-Agent Relationships’ 5 *The Journal of Economic Perspectives* p.45

(e.g.: the lawyer), and also lacks information about the relevant trade-offs faced by the agent. These differences between the parties in terms of their objectives and their information can, depending upon the precise details of the context, lead to a number of outcomes, including situations where the agent either over-supplies services, or supplies services that are not of direct relevance to the client. For example, in the case of legal services, a solicitor could potentially present a case to a client as being more complex than it actually is, advising that it will therefore require more time and lead to more cost than is really necessary. In the economics literature, some of the potentially adverse behavioural patterns tend to be ascribed to categories such as 'moral hazard' and 'adverse selection' (see discussion below).³⁴

Whilst theoretical economics work has concentrated mostly on individual principal-agent interactions, issues of imbalances in economic power, associated with the division of knowledge, also occur at more aggregative levels. Problems of this latter type, where specialists can collectively exploit information differences between themselves and others, are not unique to law, and may be of concern in any circumstances where a collective, technical body is responsible for the diagnosis of problems in the first instance, and then for the subsequent remedying of those problems.³⁵

Broadly similar arguments can be developed in relation to highly specialised and technical areas of the law, where lawyers collectively contribute first to the structuring of the relevant knowledge, and are then called upon both to diagnose a problem and execute a plan of action ('a cure') for resolving it.³⁶ On this basis, one rationale for the regulation of legal services that appears to emerge from the literature is that regulation can potentially act to prevent consumers (particularly uninformed consumers) being exploited by suppliers who

³⁴ See, for example, R van den Bergh (2007) 'Towards better regulation of the legal professions' Background Paper in *Competitive Restrictions in Legal Professions* OECD Policy Roundtable, p 21.

³⁵ An illustrative (albeit controversial) example has been put forward by the French philosopher Michel Foucault in relation to the collective methods used by psychiatrists, first in structuring, and then in applying (through diagnosis, and subsequent treatment) knowledge about 'the sickness of the head'. Arguably, many economists use the concept of market failure this way. M Foucault *The Archaeology of Knowledge* (Routledge Oxford 1989) p 197-203.

³⁶ The position appears to be similar to what Steven Lukes has in mind in talking about the 'third dimension' of power. See S. Lukes, *Power: A Radical View*, Macmillan London 1974.

have superior information,³⁷ and are collectively and individually involved in both the elaboration/formulation and resolution of the problem.

In simple terms, regulation in some form or another may be required to ensure that this power asymmetry between suppliers of a highly technical service and consumers of that service is not exploited, for example by seeking to ensure that the operative objectives (in the relevant context) of suppliers and consumers are generally in accord. 'Ethical' professional regulation can be seen as one way to bring the objectives of the lawyer into closer alignment with those of the customer/client than they otherwise might be.

Power and special responsibilities

At this point, we note the similarity between these concerns about power imbalances, at the very micro level of a legal service provider and a single client, and the approach to dominance under European Competition Law. A dominant company is one that, because of its *market power*, can behave independently of its customers and competitors, and arguably this is similar to the way in which *some* legal service providers can behave, *relative to a single client, once a relationship with that client has been opened*. That is, for reasons considered further in the next section, it is difficult for occasional purchasers of legal services to switch around among alternative providers.

It is notable that, in these circumstances of power imbalance, competition law speaks of the *special responsibilities* of dominant firms not to behave in ways that can be expected to have harmful implications for competition and consumers,³⁸ and, in relation to competition effects, competitors are sometimes said to be in state of *dependence* vis-a-vis the dominant firm. In effect, competition law embodies *standards of conduct*, which suppliers need to meet in *defined circumstances* (market dominance).³⁹ Although economists tend to interpret competition law in terms of its potential efficiency effects, it can equally well be

³⁷ See R Noll 'The politics of regulation' in R Schmalensee and RD Willig (eds) *Handbook of Industrial Organization*, Volume 1 (Elsevier Science Publishers Amsterdam 1989) p 1257.

³⁸ See for example the European Court of Justice decisions in Case C-322/81 *Nederlandsche Banden-Industrie Michelin NV v. Commission* [1983] ECR 3461 para [57]; and Joined cases C-395/96 P and C-396/96 P *Compagnie maritime belge transports SA (C-395/96 P), Compagnie maritime belge SA (C-395/96 P) and Dafra-Lines A/S (C-396/96 P) v Commission of the European Communities* [2000] ECR I-01365 paras [112]-[119]

³⁹ The usual caveat can be noted: the special responsibilities are in relation to the competitive process, not to competitors. Even though rivals may be dependent on a dominant firm, there is no implication that the dominant firm has to assist their survival. Rather, it simply has to ensure that it does not compete in an abusive way.

interpreted as an implementation of an elementary ethical principle: with greater power comes greater responsibility.

A case for ethical regulation in the supply of legal services can, fairly obviously, be developed along similar lines, around the notion of client dependence (see later), and for the moment we simply note the similarities with aspects of competition law.⁴⁰

3.3 Equity and market participation

The discussion above raises the question of whether, in addition to the notion of universal, or at least 'wide' access, notions of equity and fairness might provide rationales for regulation in other, less specific ways.

On the whole economists have, in their analytic work, exhibited a strong propensity toward focusing on efficiency as the touchstone for judging the performances of markets, and against getting drawn too far in to assessing equity or fairness.⁴¹ This is not because fairness and equity, or issues related to human sympathy, are seen as uninteresting matters,⁴² but rather because that, in relation to the judgments required, the economist cannot lay claim to any great expertise.⁴³ Mapping the distributional effects of given practices and policies is one thing; reaching conclusions to the effect that regulation is warranted in the name of 'improving' the distribution of income is another.

⁴⁰ There are differences too, of course. In the legal services case, the imbalances are between a supplier and a customer, so the 'special responsibilities' of the supplier can be defined in terms of the interests of the client – an equation that cannot be made in relation to a dominant firm and its rivals, precisely because they are competitors.

⁴¹ George Stigler referred to "the rule of near silence on the redistribution of income" in economic analysis. GJ Stigler (1980) 'The Economist as Preacher' Centre for the Study of the Economy and the State Working Paper Series, Working Paper no. 011, University of Chicago, p 16.

⁴² On this point see: AK Sen (1977) 'Rational Fools: A Critique of the Behavioral Foundations of Economic Theory' 6 *Philosophy and Public Affairs* p.317.

⁴³ See, for example, W Baumol (1986) *Superfairness: Applications and Theory*, (MIT Press 1986) p 1. More generally, some mainstream economic analysis supported its detachment from issues of equity or distribution on basis of the notion of the *Wertfreiheit* scientific method. Loosely speaking, this refers to the doctrine of 'value free' research and analysis in economics, and the social sciences more generally. See IM Kirzner 'Philosophical and Ethical Implications of Austrian Economics' in EG Dolan (ed) *The Foundations of Modern Austrian Economics*, (Kansas City: Sheed and Ward, 1976).

Regulation, then, has rarely been advocated by mainstream economists in order to address issues of fairness and distributive justice.⁴⁴ Rather, as noted above, the general position has been that distributive and equity issues are best dealt with through the tax and welfare systems, and that regulation should not be directly involved.⁴⁵ However, this position sometimes involves assuming the existence of an alternative solution (to a perceived distributional problem) that does not exist; and there are also a number of contexts in which the implications of fairness and of efficiency criteria are strongly intertwined.

The strand of economic research that might most directly support a role for regulation in terms of addressing issues of equity and fairness in the legal services markets is work that focuses on third-party effects (or externalities). This work might suggest that, if the legal market is structured in such a way so as to only provide access to legal services to specific groups (ie: the rich or educated), this may inadvertently have the effect of causing large numbers of members of society to feel disenfranchised or excluded from the legal process. Put differently, the way in which the legal system is structured could be argued to impose a social cost on those who are unable to participate in the system. This may potentially have detrimental economic (and social) effects in terms of the legitimacy of the legal system, which could reduce the willingness of certain parties to participate in, or engage with, the system, with corresponding, harmful effects on economic/social welfare.

These latter, 'participation effects' are, however, economic efficiency effects. Reduction in participation in a market which is consequential on a lack of legitimacy of, or lack of confidence in, market institutions is, very obviously, an economic effect – the level of market activity is lower in consequence – and can potentially give rise to an 'economic rationale' for regulation. Such legitimacy/confidence is, for example, potentially very significant in international capital markets, since investors will, for obvious reasons, tend to avoid markets where there is a prospect that, having committed substantial resources, they will not subsequently be treated fairly in the event, say, of disputes.

⁴⁴ There are exceptions. Jones and Mann, for example, argue that a focus on fairness dates back to the origins of public utility regulation in the United States. DN Jones and PC Mann (2001) 'The fairness criterion in public utility regulation: Does fairness still matter?' *Journal of Economic Issues* p. 153. This is the Peltzman point again, and the question is simply whether we are dealing with positive (like Peltzman) or normative economics.

⁴⁵ The arguments are similar to those which suggest that the legal system should be directly involved in matters relating to redistribution and distributive equity. L Kaplow and S Shavell (1994) 'Why the legal system is less efficient than Income Tax in Redistributing Income' *Journal of Legal Studies* p 667.

In what follows, we will consider these legitimacy/confidence effects in the context of potential uncertainties about the 'quality' of legal services, since certain aspects of equity and fair dealing can be viewed, from the consumer perspective, as aspects of a broadly defined notion of 'quality of service'. It is to be remembered, therefore, that, in the later material, 'quality' is used in this very broad way, and can potentially encompass a range of different factors.

3.4 Summary

The policy objectives of regulation frequently invoke the economic rationales of economic efficiency and equity. These sometimes competing rationales can involve trade-offs in different areas of economic activity: for example, the classic pricing arrangements in utility regulation have been at least as closely correlated with cross-subsidisation (for reasons of equity) as with issues cost-reflectivity (frequently aligned with efficiency). Moreover, the resolution of these issues can take a different complexion in different areas of economic activity. In the provision of legal services, issues of access and affordability are not typically considered within this cross-subsidisation perspective/paradigm, but rather from the perspective of whether services are excessively priced or inefficiently rationed. The regulation of legal services raises other relevant trade-offs in relation equity and efficiency: for example, how to balance the efficiencies associated with knowledge specialisation; issues of equity associated with the power imbalances such specialisation can create; and how broader issues of equity can impact on market participation.

4. The nature of legal services and the importance of quality

The institutional structures of markets, including any regulatory arrangements, can be affected by a wide range of factors, but some of the most fundamental and universal of these concern the nature and characteristics of the relevant product or service. For example, the complexities of electricity market arrangements are closely bound up with aspects of the generation and transmission of electric power, such as the requirement for a dedicated distribution system (of wires) and the need to maintain physical equilibrium at all points in the system at each moment of time. We start, therefore, with an examination of some of the salient economic characteristics of legal services provision. This examination leads immediately and directly to a number of issues that concern quality of service, where, as indicated, we are using the word quality in a broad sense to mean all aspects of what it is that a purchaser of legal services gets for her or his money.

4.1 The characteristics of legal services as a ‘product’

One characteristic of legal services as a product, which it shares with many other professional services, is that it often combines the supply of specialist knowledge with a specialist skill in the application of that knowledge. For example, an understanding of a specialised area of law may be combined with articulating the point in oration before a court or tribunal, or in the drafting of legal documents.

In terms of purchasing legal services, this combination of specialist skill and application is likely to mean that some (though not all) consumers will be unable to assess the qualities and specific attributes of the product they will be obtaining prior to purchase. Simply put, it may be difficult for a consumer to know if they are obtaining quality or reliable advice in a particular area of law prior to committing to purchase the service.

This is far from a unique attribute – it is shared not only with other professions, but with many other products/services as well – and there are mechanisms that can allow consumers to obtain at least some information about what it is they are paying for; such as seeking out information on the reputation of particular providers or through obtaining opinions from others. As discussed below, however, while these mechanisms can potentially allow consumers to become more informed about their purchases, any requirement for such actions can also raise the costs associated with acquiring the services. Moreover, at least

some legal services also have a more distinctive characteristic: that it may be difficult to evaluate the quality of service *even after it has been received* (see below).

A further distinctive characteristic of some types of legal service is the mechanism for redress in the event that a customer is dissatisfied with the performance of the service. In other cases, in seeking redress for negligence, say, the customer will be able to call upon the services of an expert in ways of obtaining redress, namely a lawyer, who is not in any way professionally connected with the allegedly negligent party. This is not the case when the redress sought is from another lawyer, which inevitably raises questions about potential conflicts of interest.⁴⁶

Legal services are sometimes classified in the economics literature as being an example of a 'credence good';⁴⁷ a service for which a consumer may never know if they are obtaining a quality product or not, because quality is difficult to assess *ex post* as well as *ex ante*. However, while this characterisation may apply to some legal services, it is not correct for all legal services. For example, some services, supplied to some consumers, could also arguably be characterised as 'experience goods': a service for which the consumer becomes aware of the quality as it is being consumed (ie: the consumer realises during the drafting of a contract, or during a trial, whether or not they have a good lawyer). Moreover, for those consumers who are repeat/frequent consumers of legal services, and are in regular touch with other, repeat purchasers, or who are otherwise well-informed, some services could also be characterised as a form of 'search good' meaning that consumers are able to make an assessment of quality prior to purchase.

Indeed, the same type of service may warrant different categorisations (credence, experience, search) according to the type of customer. Large, well informed commercial organisations that buy legal services on a frequent basis may be very well informed indeed, and may even be able to exert a degree of buyer power. To the extent, therefore, that different information conditions (i.e. what is known by each party) are likely to be found for different types of buyers, rationales for regulation may differ as between different types of consumers. We note, by way of comparison, that these differences among customers/consumers were recognised, and played a major role, in the development of regulation in

⁴⁶ PA Grout, I Jewitt and S Sonderegger (2007) 'Governance Reform in Legal Service Markets' CMPO Working Paper No. 07/170.

⁴⁷ FH Stephen and JH Love (1999) 'Regulation of the legal profession' *Encyclopedia of Law and Economics* p. 989.

energy and communications. Thus, for example, price regulation tended to be withdrawn first from supplies made to very large commercial/industrial customers.

If, for some customers, legal services are examples of 'credence goods', the issues that this raises in terms of a rationale for regulation are, as indicated, clearly not confined to legal services (there are other credence goods).⁴⁸ The more specific question, therefore, is whether issues of information asymmetry and imbalances of power between the consumer and supplier tend to have any special complexion in the context of legal services.

Information asymmetry and quality of service

The presence of significant information differences (or asymmetries) between suppliers and consumers of specific services and products is a commonly cited rationale for the regulation of particular economic activities, particularly those related to consumer products and services. The underlying reasoning is that, in markets where there are significant and material differences in the quality and quantity of information available to different market participants (such as suppliers and consumers), the classic argument to the effect that transactions that are entered into voluntarily can be expected to benefit both parties is subject to qualification. A consumer may purchase a product/service and then discover that, because of the quality of provision, they are actually worse off than before: it was not worth it. Alternatively, if the quality of the service is difficult to ascertain even after the event, the consumer may be worse off without even knowing it, at least for a significant period.⁴⁹

Perhaps more important in the legal context than this possibility of 'over-selling' is the possibility that slightly more sophisticated customers might recognise the risks involved in the transaction, and, to avoid those risks, not make the purchase. In this case the perceived risks will tend to lead to a restriction of the market overall: less of the service will be produced, and some transactions will not be made that would be made if the risks (of encountering low quality provision) could be reduced. We think that this 'confidence in the market' factor has been generally understated in the economics literature.

⁴⁸ Other examples of credence goods that have been suggested include the services provided by: surgeons, optometrists; computer engineers, car mechanics and taxi-drivers.

⁴⁹ See on these points: M Darby and E Karni (1973), 'Free Competition and the Optimal Amount of Fraud', 16 *Journal of Law and Economics* p.111.

A closely related, general argument is that, in some cases, information that would contribute to more informed decisions may be available, but it would, with a given institutional set up, be too costly or complex for consumers to obtain it. That is, in cases where the effort and costs involved in searching for information or knowledge about a product or service is considerable (or in more technical terms, the search costs are too high) there may be a role for institutional/rule-book changes that facilitate the provision of relevant information at lower cost.

This issue is discussed in greater detail below, particularly in relation to issues surrounding access to the legal system. Here it can be noted that we are looking at one of the most fundamental general issues in economic organisation. A classic argument in favour of competitive markets is that they economise on the information that is required to make economic decisions: prices, for example, convey information to consumers and suppliers alike, which the former use in deciding what and how much to purchase, and the latter use to determine what and how much to supply. In the case of perfect competition, for example, a market price tells the consumer all he/she needs to know.

As always in economic theorising, however, it is necessary to look behind the economic results to see the assumptions that have been made along the way. In much analysis, the assumption is that consumers have full information about the product.

Where there is a quality assessment problem, price does not tell consumers the full story; and there is a challenge to establish institutions that will strike a reasonable balance between the supply of extra, relevant information to consumers and the costs of so doing. In the limit, for example, it would be possible to load consumers up with all manner of information about product and service performance, but it could be expected that, past a certain point, which may be at a quite low threshold, such an exercise would run into rapidly diminishing returns, and become uneconomic. Taking things to the limit – insisting on the provision of large quantities of information to each and every one of a large number of consumers – would be sort of demand side equivalent to the central planning policies of the Soviet era. The inability of the planners to process, interpret and make use of the information, and the distorted incentives to which the arrangements gave rise, are now well understood and documented, as are the impoverishing effects.

Information burdens will tend to be less where the policy is simply one of making information available to the market as a whole – for example, by requiring publication, in accessible form, of details of the relevant products, services or supply arrangements –

rather to each potential consumer; leaving more of the search initiative with the consumer. The format and accessibility of the information will nevertheless continue to be significant: complex, non-transparent and difficult-to-find material may not be helpful.

Regulation/rules intended to reduce information asymmetries between suppliers of legal services and consumers of those services may, therefore, have a beneficial economic effect,⁵⁰ but, if taken too far, can have precisely the opposite effect. Ideally what is wanted are arrangements that can effectively reduce the risks of consumers receiving a lower quality service than they had reasonably expected, without imposing unduly large information costs on suppliers or customers.

4.2 Market solutions to the asymmetric information problem

The most commonly observed response to asymmetries of information in markets is via the development of reputation. Reputation is a way of signalling the quality of service that a customer can expect from a particular provider.⁵¹ Once a reputation is established, a higher quality provider will be able to charge a higher price for service, and still expect to attract customers. On the other hand, customers will not be willing to buy from low quality providers, or from those lacking a reputation one way or the other, at the higher price; a process that has been called *direct exclusion* by the industrial economist Jean Tirole,⁵² since the supplier is excluded from the business of the customer by decision of the consumer.

Once a reputation is established, there are corresponding incentives to maintain a high quality of service: if standards drop, reputation can be lost, and with it the ability to achieve a higher price. In some cases, the incentive effects can be sharp, as reflected in the saying that “reputation takes years to build, but can be lost in a day”.

In the absence of an ability to achieve reputation, customers may be unable to distinguish between different qualities of legal service provision. To the extent that the *only* distinguishing feature (for the consumer) is price, the result is likely to be an adverse selection problem; the most frequently cited example of which in economics concerns the

⁵⁰ R Noll ‘The politics of regulation’ in R Schmalensee and RD Willig (eds) *Handbook of Industrial Organization*, Volume 1 (Elsevier Science Publishers Amsterdam 1989) p 1257.

⁵¹ A Wolinsky (1993) ‘Competition in a Market for Informed Experts’ *Services* 24 *Rand Journal of Economics* p.380.

⁵² J Tirole (1996) ‘A theory of collective reputations (with applications to the persistence of corruption and to firm quality)’ 63 *The Review of Economic Studies* p 1.

market for used cars.⁵³ If buyers in this market make their decisions based on price, a seller who knows that her/his car is in particularly good shape for a vehicle of that type and age will not be able to obtain a realistic value for it on second hand markets. Higher quality products will therefore tend to be withheld from the market, and the average quality of vehicles on the market will decline, being biased toward ‘lemons’. The reduction in the average quality of vehicles on the market then leads to a general fall in prices for second-hand cars, which leads to a withholding of a further tranche of supply, and so on. The end result of such a process would be a low volume, low quality, low price market, or, in the limit, to no market trading at all.

The adverse selection argument has been deployed in relation to the supply of legal services,⁵⁴ with the implication that an unregulated market would be dominated by a preponderance of low priced, low quality suppliers of legal services. The plausibility of such an outcome invites immediate scepticism: in reality, second-hand car markets do not collapse to low level equilibria – they are characterised by large volumes of transactions – and there is no reason to think that legal services markets would collapse either. Indeed, some analysts have suggested that, rather than a race to the bottom, the problem in legal services is that uninformed consumers might end up with rather higher quality services, at higher prices, than they would want to purchase if better informed, or that providers use the information asymmetry to persuade clients that they require a greater quantity of service than consumers would want if better informed.⁵⁵ On these latter views, the issue may be a quality of service level that is too high, at least for some consumers, or a volume of output that is too large.

Markets, then, typically deal with quality of service information problems by means (development of reputations) that allow for *direct exclusion* in the event of failure to perform to an adequate standard; and this leads on to the question of how such reputations can be established, and the costs of doing so. For, if there are major obstacles to the development of reputations, then some of the restrictive effects noted above may become market realities.

⁵³ G Akerlof, (1970) ‘The Market for Lemons: Quality Uncertainty and the Market Mechanism’ 84 *Quarterly Journal of Economics* p. 487.

⁵⁴ See, for example, R van den Bergh (2007) ‘Towards better regulation of the legal professions’ Background Paper in *Competitive Restrictions in Legal Professions* OECD Policy Roundtable, p 21.

⁵⁵ Ibid, also more generally: W Emons (2001) ‘Credence goods monopolists’ 19 *International Journal of Industrial Organization* p. 375.

The formation of reputations

The economics literature contains a number of highly sophisticated, mathematical models of how reputations are developed, most of which are based upon the notion of repeated interactions between buyer and seller, modelled by the playing of a repeated 'game'.⁵⁶ In micro-economics, for example, there are convincing theoretical accounts for how an incumbent firm can obtain, enhance and sustain a reputation as a 'predator' or aggressive competitor, in order to deter new entry into markets in which it operates. Examples of the role of repetition are to also to be found in analysis of central bank behaviour. Thus, for example, when first established the Monetary Policy Committee of the Bank of England needed to develop a reputation that it would take measures necessary to control inflation, and sought to do so by repeated demonstrations of its commitment to control inflation in the way in which it set interest rates, month by month.

Three immediate points can be made in relation to such repeated observations of behaviour:

- Whether or not a reputation can be established in this way depends upon the ease of repeated observations. In legal services, repeated observation of performance may be straightforward for large commercial customers, but not for customers who may only be active in the relevant markets on a very occasional basis.
- There can be limits to the scope of the reputation that can be developed, since repeated observations of how a provider operates in a narrowish range of contexts may not necessarily give a very clear indication of likely behaviour in a more radically different context. What if, for example, there is some particularly large distraction, or temptation, that comes in the way of effective service provision in a particular instance? Do observations of past behaviour necessarily tell us much about how the legal services provider will respond to the unusual circumstances? Might the greater temptation/pressure lead to opportunistic behaviour which has adverse consequences for the customer?

⁵⁶ Generally, see: GJ Mailath and L Samuelson (2006) *Repeated Games and Reputations: Long-Run Relationships* (Oxford University Press Oxford 2006).

- Repeated observation is not the only way in which reputation can be developed. The central banking example above draws attention to factors relevant in the development of the reputation of the European pioneer of independent central banking in the modern period, the Bundesbank: the horrors of earlier hyperinflation in Germany in terms of its economic, social and political effects gave strong credibility to the ‘never again’ promises of later German monetary policy.⁵⁷ Similarly, in the early stages of the industrial revolution, the reputation of Quakers as ‘honest dealers’ initially arose less from repetition of honest transactions (although that consolidated matters) but rather from inferences drawn from their religious beliefs and practices.

Since the development of reputation can be influenced by a very wide range of social factors, the relevant issues cannot adequately be addressed by economics alone. It is simply not possible to say, on the basis of economics alone, whether or not a particular market can be expected to work well: market functioning will depend, in important ways, on the effectiveness of reputational mechanisms, which in turn will depend upon a potentially wide range of social and cultural influences.

Delegated exclusion

Notwithstanding this conclusion, it is possible to draw from the economics literature some indicators of where the mechanism of *direct exclusion*, based on provider reputations, might run into problems; and the obvious starting point is that section of the public who purchase legal services infrequently.

As noted above, repeated experience of supply from a particular provider is not the only way in which reputations can be won and lost, but it remains an important way, and one whose absence necessarily weakens the *direct exclusion* mechanism to some extent. The issue here is not of an all-or-nothing variety: infrequent purchasers of legal services are members of communities; members of communities are (in aggregate) frequent consumers; and members of communities communicate with one another (more than ever now that mobile telephony and the internet are available). Provision of an excessively high or a deficiently low level of service can therefore be communicated by word of mouth or other means, so that it is not necessary to have experienced a service to have knowledge of it. There also exist organisations such as the Citizens Advice Bureau which provide information

⁵⁷ D Marsh (1994) *The Most Powerful Bank: Inside Germany's Bundesbank* (New York: Random House, 1994).

relating to legal matters, and which can serve to improve information conditions in the market as a whole.

That said, there are limitations to the effectiveness of these mechanisms. For those consumers for whom the relevant legal service is a credence good, there may be no strong appreciation that they have been badly served, and hence no reputational message to communicate to others. The relatively limited number of consumers expressing dissatisfaction may, therefore, be read by others as a signal that performance standards are somewhat higher than they actually are. Ironically perhaps, this effect could actually be greater in a culture where dissatisfied consumers have a higher general propensity to complain about service, since, in consequence of the credence issues, legal services complaints might then appear particularly modest in their numbers.

Similarly, whilst the internet has been a great boon in allowing for greater interchange of customer experiences in relation to service providers such as restaurants and hotels, information drawn from it is necessarily treated with some wariness. Facts, opinions, prejudices, deceptions, etc. often come in highly tangled ways, and views expressed are often (rationally) heavily discounted.

There can, therefore, be a case for supplementing the standard *direct exclusion* mechanism with institutional arrangements (i.e. an extended market rule-book) developed to identify and 'weed out' from the markets those suppliers who provide substantially inappropriate quality of service to their customers. Competitive markets are sometimes likened to the natural selection process of biological evolution, and one way of expressing the potential issue identified is to say that the problem comes when the exclusion/extinction pressures are not sufficiently high as to ensure the survival of only the fit. In circumstances where that is the case, there is scope for developments in the commercial environment that make it a harsher place for the unfit.

Tirole refers to *delegated exclusion* to indicate situations where there exist organisations with the capacity to exclude suppliers from the market, for example by authorisation or licensing procedures which allow for the "striking off" of suppliers who have operated outside acceptable performance boundaries.⁵⁸ This could be for the provision of excessively high quality of service, as well as for deficient quality, although the latter is the more frequent concern.

⁵⁸ J Tirole (1996) 'A theory of collective reputations (with applications to the persistence of corruption and to firm quality)' 63 *The Review of Economic Studies* p 1.

Self regulation

Like for other professional groups, and indeed for craft guilds in earlier times, where there are economic benefits from the establishment of *delegated exclusion*, there are incentives for legal services providers themselves to expand market rule-books to establish the necessary mechanisms. For reasons given, weaknesses in reputational mechanisms will tend to lead to a contraction in the volume of transactions in the relevant market as a whole. Customers will be wary of becoming active in markets where they think that there is a significant possibility that they may be 'ripped off', and it will be more difficult to discount this prospect where there is uncertainty about the quality of supply that will be obtained.

'Quality' in economics is a demand-expanding factor, at both the level of the firm and the level of the market; and uncertainties about the quality which can have adverse consequences for all providers of the services, not just those whose performance is actually poor (although the latter can be expected to suffer more). In demotic language, markets where one can expect to be mugged tend to deter participation, even though muggers may be in a small minority. Alternatively, it can be noted that although markets for 'pigs in pokes' may have existed in economic history, the sizes of those markets were highly limited. In such circumstances, and as the market for lemons example shows, lack of confidence in the market may depress the prices that can be achieved for high quality supplies, as well as reducing the demand for legal services overall.

Self regulation can arise from the recognition among suppliers of a particular service that there may be a collective interest in ensuring that specific standards of conduct/performance are maintained, so as to promote confidence in, and hence demand for, the services they supply.⁵⁹ Put differently, among the purposes of self-regulatory professional bodies is to provide a certification, or a 'quality stamp', to consumers. Alternatively, self regulation might be seen as a response to circumstances where, because direct reputational mechanisms are weak and it is difficult for consumers to distinguish between the qualities of different service providers, failures of performance by any providers are liable to have adverse consequences for the reputations of all providers (i.e. the muggers give the district a bad name), and hence adverse consequences for market demand.

⁵⁹ For some legal services consumers may face no choice, which can have a weakening effect on the collective incentives for quality. On the other hand, the very fact of such dependence may increase public sensitivities to performance failures, and may lead to 'retribution' via different social and political routes.

At a minimum, the scope of self-regulatory activity may be simply to eliminate the worst cases of inappropriate quality of service from the market, by targeting the ‘tails’ of the performance distribution. ‘Striking off’ (withdrawal of necessary licensing or certification) may be a sufficient mechanism for this purpose. Or matters might be taken further, for example, by seeking to establish minimum service standards, or to raise average service standards, by means of training and entry restrictions.

In practice, several types of self-regulatory measure may be adopted. Quality of service is difficult/costly to measure, so regulatory mechanisms that rely on comprehensive quality monitoring are likely to be disproportionate. Training and entry requirements might be efficient in raising general standards because they are more easily measured and monitored than quality itself, although the impacts are less direct since the relevant measures amount to regulation of inputs rather than regulation of outputs.⁶⁰ They also do not provide direct incentives to maintain quality, once a service provider has met the necessary requirements. In contrast, ‘striking off’ in the event of inadequate performance does provide such incentives; but it is restricted in scope by high, associated, ‘transactions’ costs, and therefore limited in the scale on which it can be applied, which is likely to be restricted to a relatively small number of egregious performance failures.

Summing up, there is a clear economic rationale for self regulation when the activities of some suppliers have the potential to have adverse consequences for suppliers as a whole, by reducing confidence in the market and thereby leading to a contraction in market demand. ‘Self certifying’ groups of suppliers can potentially insulate themselves from the adverse effects, by distinguishing themselves from others and, in effect, establishing a collective reputation. Problems can arise, however, when the remit of self regulation extends beyond the minimum necessary to address a particular problem (e.g. by establishing a self certifying group), not least because, if the self-regulation comes to covers the whole of an activity, (delegated) exclusion from the market is, in effect, achieved via a monopoly process; and the mischiefs that can follow from monopolisation have been a major theme in economics since the *Wealth of Nations*.

Whilst the reason for the establishment of self-regulatory bodies in the legal profession may be to address quality issues in supply to relatively unknowing customers, there may also be other motivations and effects, including the desire to monopolise certain legal activities, to

⁶⁰ R van den Bergh (2007) ‘Towards better regulation of the legal professions’ Background Paper in *Competitive Restrictions in Legal Professions* OECD Policy Roundtable p. 23.

the detriment of consumers.⁶¹ These monopolisation issues are discussed in more detail in section 5 below, in relation to the structure of supply of legal services. Here we focus on the quality of service implications of the more general point that an institutional adaptation aimed at addressing weaknesses in direct, reputational mechanisms, may be used for other, more partial purposes, precisely because it is controlled by *private interests*.

4.3 Aspects of self regulation

There has been some interesting theoretical work in recent years on the economics of self regulation of the legal profession,⁶² and we will outline and discuss some of the highlights in this sub-section, after first making a general point about deviations between private and social cost/benefit trade-offs and incentives in self-regulation.

The envelope theorem and the incentives of self-regulation

Consider, in an abstract way for the moment, a regulatory body which uses a number of different economic instruments to maximise some measure of general social welfare, and which successfully does so. Under fairly general conditions (particularly when account is taken of uncertainty), at least some of the relevant instruments will be chosen so that doing a bit more, or doing a bit less, would each lead to a decrease in social welfare, and such that the rate of change of social welfare with respect to changes in the relevant instrument is therefore zero.⁶³ One way of expressing this last point is to say that, at a social optimum, the first-order effect of small changes in any one economic instrument is negligible.

On the other hand, the effects of changes in at least some economic instruments on income distribution at a social optimum are likely not to be negligible, and may be quite considerable. Thus, while small changes in regulation may not affect overall efficiency very

⁶¹ Max Weber observed the principal historical motive for the closure of groups was the maintenance of quality, but that such motive could also be combined with other motivations such as interests in prestige and the consequent opportunities to profit. M Weber *Economy and Society: An outline of interpretative sociology* in G Roth and C Wittich (eds) (Univ. California Press Berkeley 1978) p 46,112.

⁶² There has also been increasing interest in the economics of self-regulation by some public authorities. For example, the Office of Fair Trading recently published a particularly lucid discussion paper which focuses on the role that self-regulation can play in terms of addressing consumer quality issues. See: "*The economics of self-regulation in solving consumer quality issues*" OFT Economic Discussion Paper 1059 (March 2009). <http://www.offt.gov.uk/shared_offt/economic_research/oft1059.pdf>

⁶³ We say 'some' because it might be optimal not to use some available instruments at all.

much, they may lead to significant transfers of income between suppliers and their customers. Self regulation, controlled as it is, by suppliers is, therefore, vulnerable to such adjustments; in particular because, close to any notional (social) optimum point, even a small weight attached to private interests, which has little effect on the economic efficiency of outcomes, can lead to a significant transfer of economic income from customer to suppliers.⁶⁴

The resulting problem, then, is not principally one of overall economic efficiency of the markets, which is not much affected, but is principally one of equity. Suppliers can use regulation to increase their own incomes above levels necessary to remunerate an efficient supply, and to increase the prices paid by their customers to above the levels necessary to remunerate efficient supply. Among other things, this can have immediate consequences for the level of participation in legal services markets: some consumers may not be able to afford the legal fees. And this illustrates the general point that, just as in the case of any monopoly, suppliers will have a joint interest in expanding the market up to a certain point, since higher volumes of sales initially contribute to higher profits, but not past the point where joint profits are maximised, which will typically correspond to a smaller market size than is the case under competitive conditions.

The general arguments are illustrated in a particular case in a much cited paper by Leland.⁶⁵ Leland considers minimum quality standards or licensing requirements as a possible solution to the informational problems discussed above, and shows that the introduction of such standards increase social welfare in a number of the cases that he considers. However, the paper indicates that, if the quality standards are set by the profession to which they apply, the likely result will be that they will be set too high. In another early paper, Shapiro also suggested that licensing and certification can lead to beneficial effects for consumers, but

⁶⁴ A simple formalisation of these points is as follows. Suppose a 'public interest' regulator would choose a decision variable, x , so as to maximise overall economic efficiency, $S(x)$, where S indicates a social objective. Let the decision that does this be x^* , where $S_x(x^*) = 0$. Now suppose a regulator maximises a weighted average of social and private payoffs, $(1-\alpha)S(x) + \alpha P(x)$, where $P(x)$ is the private payoff, and α is a parameter that reflects the relative weight given to private interests. When $\alpha = 0$ we are back to the case of a public interest regulator. The envelope theorem says that, at $\alpha = 0$, $dS/d\alpha = 0$. That is, there is approximately no effect on economic efficiency of a 'little bit of capture' by the private interest. On the other hand $dP/d\alpha > 0$, the effect on private payoffs is not zero. Other private interests will, therefore, face deteriorations in their positions. In the case of supplier capture, for example, consumers will lose out. One way of putting this is to say that, at a public interest optimum, incremental change becomes a zero-sum for different interest groups.

⁶⁵ HE Leland (1979), 'Quacks, Lemons, and Licensing: A Theory of Minimum Quality Standards', *87 Journal of Political Economy* p. 1325.

these are principally concentrated on consumers who particularly value high quality services at the expense of those who do not.⁶⁶

Further results from the theoretical literature

To provide more flavour of theoretical economic reasoning on the pros and cons of self-regulation, we here summarise and discuss some of the most notable theoretical contributions.

Shaked and Sutton consider possible competition to professional lawyers from a paralegal profession offering services at lower prices and lower qualities.⁶⁷ The model is therefore concerned with *vertical* product differentiation (a topic on which the authors were pioneers), a situation in which suppliers compete with products of different qualities (e.g. microprocessors with different speeds), in contrast to horizontal product differentiation, where preferences between two products offered at similar prices may be mixed (e.g. red cars vs blue cars). Typically, lower income consumers are attracted to the lower quality, but cheaper product. Shaked and Sutton mention conveyancing as the sort of service they have in mind.

If paralegals are excluded from the market, a self regulating profession might set quality standards for itself that exclude those unable to meet a designated quality level (delegated exclusion). However, it might be expected that the chosen quality level will tend toward that which would maximise the economic rents (actual income less the minimum income required to secure the relevant level of service) of the profession as a whole. The resulting price and quality level will then tend to be at levels that are too high for lower income groups, who will therefore not participate in the market.

Allowing paralegal entry allows (in the model) for a market with two qualities of service, offered at different prices. This expands the market as a whole, since it brings in consumers who would not otherwise participate, and introduces some competition for the higher quality professionals (some customers, who could just afford the higher quality service, might be tempted to switch to much cheaper paralegals if professional prices are not lowered). The overall result of the new entry of paralegals, therefore, is a larger market, lower prices, and higher efficiency/welfare.

⁶⁶ C Shapiro (1986) 'Investment, Moral Hazard, and Occupational Licensing' 53 *The Review of Economic Studies* p. 843.

⁶⁷ A Shaked and J Sutton (1981) 'The Self-Regulating Profession' 48 *The Review of Economic Studies* p. 217.

The results here are clear enough, but, at least in part, that is a result of one or two key aspects of the modelling framework, in particular the assumption that consumers have full knowledge of the quality of the different services on offer. In a sense, therefore, Shaked and Sutton have assumed away the underlying problem. Grout, Jewitt and Sonderegger suggest that that the two-quality level equilibrium is only sustainable if there is some means of unambiguously signalling or certifying the higher quality service.⁶⁸ In the absence of that, so they argue, distinctions will become obscured and the market situation can be expected to revert to that of direct exclusion.

Iossa and Julien consider a market in which the relevant profession operates a rule-book that does provide for a two-tier service, with clear certification that distinguishes the two.⁶⁹ They develop a model in which lawyers make an initial investment to increase their ability to understand legal issues. The most able lawyers can then acquire a costly qualification to certify that their quality is above a certain threshold. When there is a dispute, litigants choose whether to hire a certified lawyer or not.⁷⁰

The authors specifically discuss QCs and junior barristers as an example of the situation they have in mind, and go on to identify positive and negative effects of this type of arrangement. Although the model is highly abstract, it nevertheless has enough structure to exhibit some of the subtleties and complexities of the trade-offs involved in this type of certification process. To illustrate this, we can do no better than to quote the first part of their conclusions.

We have studied the value of information on the quality of legal services by analyzing how quality certification affects the incentives of litigants to hire high-quality lawyers, the incentives of lawyers to invest in training and the decision-making behaviour of adjudicators. We have shown that quality certification is more likely to be beneficial when the social value of a correct decision is high or when training costs are low or when appeals cost is low.

To the extent that the social value of a correct decision is higher in systems based on precedent, such as the common law system, our results suggest that a QC system is more

⁶⁸ PA Grout, I Jewitt and S Sonderegger (2007) 'Governance Reform in Legal Service Markets' CMPO Working Paper No. 07/170.

⁶⁹ E Iossa and B Jullien (2007) 'The Market for Lawyers: The Value of Information on the Quality of Legal Services' Institut d'Économie Industrielle (IDEI), Toulouse Working Paper 485.

⁷⁰ In the model, a dispute is resolved through an initial stage where a lower-court adjudicator makes an initial decision, and, if the losing litigant appeals, an appeals stage where the appeals court makes a final decision.

likely to be beneficial in a common law system than in a civil law system. This is in line with casual observation that quality certification in the form of a QC system is prevalent in countries with common law tradition rather than in counties with civil law tradition of codified law.

Alternatives to self regulation

Self regulation of legal services provision is one possible response to the informational challenges set out earlier in this section, but it is not the only response. One, alternative line of policy direction would be seek to make legal services markets better by strengthening the effectiveness of *direct exclusion*.

Grout, Jewitt and Sonderegger explore the possibilities here, at the theoretical level, in some detail. The principal measures that they seek to model are labelled: de-licensing, certification, transparency and accountability. Although the regulatory details are not discussed in the paper, the general drift of the reasoning is de-regulatory in nature, pointing toward a restriction of the reach of existing regulatory bodies, although presumably on the basis of a transitional period of supervision by public regulation.

Public regulation is also an obvious alternative to self regulation, in the sense that it could simply take over any of the roles that might be played by self-regulation in relation to the quality of service issues discussed above, although it can also be used as a complement to self-regulation provided that there is clarity in the roles and responsibilities of the different bodies involved in developing and enforcing market rules. We consider it further in the next section.

4.4 Summary

In this section we have explored some of the economic reasons why the nature of legal services as a product might suggest that some or other form of regulation could be beneficial. Briefly, regulation may be advantageous when there exist(s): significant information differences between suppliers and consumers; high costs associated with assessing the quality of legal services; potential for suppliers of legal services to exploit information and power differences between themselves and consumers; legitimacy and confidence concerns that can depress the size of the market and may have wider social and political implications. As discussed, all of these factors do not automatically point to benefits from public regulation, as self-regulatory systems often develop to address at least some of these issues; and the assessment of the relative merits of self-regulation and public

regulation is an exercise in comparative institutional analysis. Each form of regulation has its drawbacks, which we will consider, in a more context-specific fashion, in section 6.

5. The supply structure of legal services

In the previous section we examined some of the characteristics of legal services as a product and considered how, and the extent to which, these characteristics might provide a rationale for some or other form of regulatory oversight of legal services markets. In this section we assess some of the characteristics of the supply of legal services. Specifically, we examine how the way in which lawyers have historically organised themselves, and the various rules, customs and practices that have been adopted, can potentially affect the supply of legal services.

As noted in the Introduction, this discussion is not intended to present a full and detailed examination of the possible adverse or beneficial effects of every rule that currently governs the supply of legal services in England and Wales, but rather to examine in a general way how various forms of restriction on commercial conduct can affect economic welfare.

5.1 The role of professional associations

Legal professionals typically enjoy above average levels of education, skills and pay, and are seen to play an important role in society and to contribute to overall economic welfare and competitiveness. It is a characteristic aspect of many professions that they are ‘closed’ or ‘exclusive’ in one form or another. Indeed, it is often suggested in academic work that it is the way in which groups controls their knowledge and skills that determines a profession.⁷¹ Specifically, it has been argued that the essence of a profession is the ability of a group of individuals to maintain ‘jurisdiction’ over an area of activity in the face of competition.⁷²

An important feature of many professions – including the legal profession – is the professional association. In some academic work, professional associations, including those of the legal profession, have been compared to historic medieval guilds, insofar as they represent closed economic associations of persons in the same business/craft or plying the same trade. There are a number of general arguments that have been presented as to why the organisation of individuals into professional associations may be beneficial to society. For example, Max Weber saw an important role for professions, in particular the English

⁷¹ A Abbott *The System of the Professions: An Essay on the Division of Expert Labour* (University of Chicago Press Chicago 1988) p 8.

⁷² *Ibid*, pp 87 and 111.

legal profession, in terms of ‘professional guardianship’ of the law.⁷³ The collective autonomy and independence of the legal profession was seen, at that time, to be an important insulation against state power, and against those powerful interests that sought to control such power, a view that reflects earlier political discourse about checks and balances, the separation of powers, and the rule of law.

Typically, one of the central roles of a professional association is to establish various forms of *control* over the profession or trade. This control can be exercised through formal and informal measures such as rules, norms and standards of acceptable conduct and behaviour. In practical terms, this control can manifest itself in a number of ways, and can potentially have both beneficial and adverse effects on economic welfare.

It is, however, widely recognised, including by Weber, and Adam Smith before him, that the closed and exclusive nature of professional organisations provides an opportunity for the relevant profession, including the legal profession, to collectively corner the market and effectively operate as a cartel.

5.2 Incomes and the determination of prices

An obvious way in which a profession can collectively exercise control over its members is by limiting the freedom that members have in determining, and setting prices for their own services. An early empirical study of incomes from professional practice in the United States by Kuznets and Friedman found that the average earnings of professional workers, including in the legal profession, were substantially higher than the average earnings of non-professional workers (even allowing for various ‘equalizing’ differences, such as training).⁷⁴ While this did not itself show that the professionals were systematically exploiting collective market power (since relative skills, ability and qualifications are obviously also highly relevant as determinants of earnings) the authors did go on to conclude that, in some cases, differences in the average incomes across similar professions could not be explained by

⁷³ Germanely, Weber has discussed the historical development of guilds of English lawyers, and the ‘strict professional etiquette’ attached to such guilds, as providing a form of empirical and practical training in a manner not dissimilar to the craft guilds. However, he was also aware that placing legal education and admission to practice in the hands of the guild monopoly lead to an ‘economic factor’, namely pecuniary interest having a strong influence on the development of English common law and forms of procedure. M Weber *Economy and Society: An outline of interpretative sociology* in G Roth and C Wittich (eds) (Univ. California Press Berkeley 1978) pp 784-788.

⁷⁴ M Friedman and S Kuznets (1945) *Income from Independent Professional Practice* (New York, National Bureau of Economic Research).

underlying differences in terms of ability and cost of training, and to conjecture that 'purposeful interference' by governmental bodies and professional associations relating to entry may explain the differences in average incomes.⁷⁵

Kuznets and Friedman were concerned with average earnings in professions, but this may mask a number of factors that are influential in determining the earnings of individual practitioners. For example, there may be a wide divergence of incomes for legal service professionals depending on their area of specialisation, location, and level of stature, etc. It is a characteristic of the supply side of legal services markets that, as well as being populated by some large firms, a large number of practitioners operate in small firms.

Interpretation of the level of earnings of lawyers has been a hotly contested issue for centuries. Adam Smith took the favourable view that:

Among the lawyers there is not one among twenty that attains such knowledge and dexterity in his business as enables him to get back the expences of his education, and many of them never make the price of their gown, as we say. The fees of lawyers are so far from being extravagant, as they are generally thought, that they are rather low in proportion. It is the eminence of the profession, and not the money made by it, that is the temptation for applying to it, and the dignity of that rank is to be considered as a part of what is made by it.⁷⁶

On the other hand, John Stuart Mill, in his own, classic exposition of the principles of political economy, took a rather dim view of lawyers:

The advantage to mankind of being able to trust one another, penetrates into every crevice and cranny of human life: the economical is perhaps the smallest part of it, yet even this is incalculable. To consider only the most obvious part of the waste of wealth occasioned to society by human improbity; there is in all rich communities a predatory population, who live by pillaging or overreaching other people; their numbers cannot be authentically ascertained, but on the lowest estimate, in a country like England, it is very large. The support of these persons is a direct burthen on the national industry. The police, and the whole apparatus of punishment, and of criminal and partly of civil justice, are a second burthen rendered necessary by the first. The exorbitantly-paid profession of lawyers, so far

⁷⁵ Ibid, the professions examined were dentistry and medicine.

⁷⁶ A Smith *Lectures on Jurisprudence* (Glasgow Edition of the Works and Correspondence of Adam Smith, Vol. 5) p 495.

as their work is not created by defects in the law, of their own contriving, are required and supported principally by the dishonesty of mankind.⁷⁷

A modern master, George Stigler, argued on a more general basis that collective institutions and other forms of close economic organization provide comfort to consumers that there is a reputable service, and that the institution can command a price premium for this service insofar as it provides assurance to consumers and reduces search costs.⁷⁸ This is similar to some accounts of the role of ‘branding’ in markets more generally, where observed price differentials (over non-branded goods) tend to be significantly greater than can be explained by differences in supply costs, yet where there is no question of horizontal coordination among competing suppliers.

Regulation of prices

Until relatively recently, some form of mandatory collective fee setting, or guidance, has been a characteristic feature of the legal profession in the provision of some services. This has included mandatory fixed fees or the setting of minimum, maximum or recommended fees. In such circumstances, there is no very clear reason in economics to expect that the outcome of such collective control over prices will be any different from the normal outcome of horizontal price coordination, namely higher prices to consumers.

There have, nevertheless, been a number of general arguments that have been deployed in support of certain type of fee restrictions in the legal profession. These include arguments (to each of which we have added a commentary) that:

- *Minimum fee restrictions may, in certain markets, help to maintain quality by preventing firms who do not provide an acceptable level of quality from undercutting those that do.*

If adverse selection is considered to be a major problem, the imposition of minimum prices would certainly help prevent a race to the bottom in terms of quality. Notwithstanding its popularity as a concept in the ‘market failure’ literature, however, we earlier expressed some scepticism as to the significance of adverse selection in legal services markets; and two general qualifications should be

⁷⁷ JS Mill *Principles of Political Economy: with some of their applications to social philosophy* (7th edn Longmans Green & Co. London 1923) p.150.

⁷⁸ GJ Stigler (1961) ‘The economics of information’ *Journal of Political Economy* p 224.

attached to its use in 'maintaining quality' arguments. First, if the problem is quality of service, a 'pricing remedy' may be poorly targeted, and hence not the least restrictive, or most effective, way of addressing the issue. Second, there is the 'envelope theorem' point. Even if price maintenance is an effective way of preventing quality deterioration, we would expect, on general principle, that a collective organisation with a private interest in higher prices would 'take things too far'. That is, there is a strong basis for an expectation that minimum prices would be set higher than was optimal simply to address any quality of service issue.

- *Maximum price recommendations can assist in preventing legal service providers from exploiting information differences between themselves and consumers, by setting a ceiling on acceptable prices for certain types of legal services.*

In general, there is much less basis in economics for concerns about maximum prices than about minimum prices, for the obvious reason that each supplier is left free to compete by cutting prices. For this reason, in vertical supply arrangements the setting of maximum resale prices is not subject to the same kinds of prohibitions as setting minimum resale prices.

Nevertheless, the collective nature of the practice in the current context necessarily means that it raises suspicions of anti-competitive effects. The most immediate objection is that maximum prices might become focal points for actual pricing, serving co-ordinating functions for the profession as a whole that help keep prices high. And, again, it seems likely that there will be less restrictive ways of achieving the notional objective of protecting less well-informed customers against rip-offs, including requirements for greater transparency in pricing coupled with *ex post* professional sanctions where standards of conduct have been violated.

- *Recommended fees can act to address the issues associated with the information asymmetries discussed earlier, by providing consumers with information about the average prices that should be charged for particular types of standard legal services.*

Similar points apply here as apply to recommended maximum prices. There is nothing inherently wrong with the practice, but it can potentially facilitate horizontal co-ordination and there appear to be less restrictive alternatives that would better serve the public. It doesn't require a professional body to compile statistics on average prices: if there is reasonable price transparency, such an exercise can be conducted by any one of a number of consumer or market research organisations,

where there can be no suspicion that the prices published are intended to be focal points for co-ordination.

On balance, in the context of legal services, it can be expected that professional association requirements to set fixed or minimum prices for standardised services are likely have an adverse effect on competition. It is for good reason, therefore, that the various professional associations in the legal sector in England and Wales no longer set such requirements.⁷⁹

'Tacit' or implicit coordinated fee setting

Although it is no longer the case that formal restrictions on fees are imposed by the professional associations, a related concern, often expressed, is that, because of the degree of concentration in supply, there is usually potential for some form of 'tacit' or implicit coordination of fees among different suppliers. So, for example, it is not uncommon to hear complaints that legal professionals in a particular area of practice (the magic circle) or in a specific geographic area (a small town) are, without any explicit arrangement, effectively coordinating their prices.

Whether or not this is the case is a matter for investigation under the relevant competition laws, and the possibility of such conduct cannot, in our view, provide a rationale for regulation over and above that which is contained in existing EU competition law. As John Vickers noted in his report on *Competition in the Professions* (when he was Director General of Fair Trading), should the OFT receive evidence of such behaviour it would be able to use its powers under the relevant competition laws.⁸⁰ In a report commissioned as part of its review of Competition in the Professions, the OFT's consultants searched for evidence of cartel behaviour in relation to solicitors and barristers. They concluded that while there are

⁷⁹ However, we note that one of the major recommendations of the recent Review of Civil Litigation Costs by Lord Justice Jackson was the introduction of a 'fixed costs' approach for fast-track litigation (ie: value less than £25,000), and a dual system approach for other litigation cases whereby the costs are fixed for certain types of cases, and in other cases there is a financial limit on the costs recoverable (for example, £12,000 for pre-trial costs). Fixed costs are defined in that Report to embrace '(a) costs for which figures are specified and (b) costs which can be calculated by a predetermined means, such as a formulae in CPR 45'; See R Jackson '*Review of Civil Litigation Costs: Final Report*' December 2009.
< <http://www.judiciary.gov.uk/publications-and-reports/reports/civil/review-of-civil-litigation-costs>>

⁸⁰ Office of Fair Trading (2001) *Competition in the Professions* A report by the Director General of Fair Trading para [50].

certain areas of significant market concentration, there was no evidence of cartel activity in professional legal services.⁸¹

The relevant economic theory in this area indicates that assessments need to take careful account of a number of factors. Chief among those factors would be the well recognised point that similar or identical prices can be consistent with markets that are highly competitive as well as with markets that are subject to collusion. This is because in collusive markets all firms/practitioners may agree to set prices at a particular level, while in a highly competitive markets each firm/practitioner is restricted by the competition in its ability to set a price that, except on a transitory basis, is significantly greater than its rivals (hence prices tend to converge). An observation that different suppliers charge similar prices for similar services does not, therefore, advance matters greatly.

A related point is that the economic harm caused by tacit or implicit collusion is a result of prices being *higher* than they would otherwise have been, not by prices being the same for different suppliers. That is, the principal concern in classic price-fixing cases is not so much that the prices are similar, but rather that the level at which prices are set is above that would prevail in a competitive market.

Finally, any investigation of alleged tacit collusion would need to take account of various criteria that have been identified in the relevant economic theory, and in European case law, as having the potential to signal where suppliers are tacitly coordinating their behaviour, rather than simply responding to a market structure of oligopolistic interdependence.

These are difficult issues, and specialist institutions are already in place whose task it is to address any problems on an economy-wide basis. In consequence, there is little basis for arguments that the possibility of horizontal price co-ordination in legal services provides a rationale for specialist regulation of the relevant markets.

5.3 Restrictions on advertising

Another traditional, historic restriction imposed by legal professional associations was to limit the ability of their members to advertise their services. This restriction has taken various forms, from total bans on advertising to more specific restrictions on comparative

⁸¹ LECG (2000) *Restrictions on Competition in the Provision of Professional Services* A Report for the Office of Fair Trading, pp 228-234 (solicitors) and pp 302-306 (barristers).

advertising, or to advertising related to fees. Like control of prices, this too is now a thing of the past in England and Wales.⁸²

Advertising restrictions have sometimes been supported by arguments to the effect that they can have a positive effect of quality of service. The most basic of such arguments is that advertising restrictions ensure that consumers (particularly uninformed or ‘vulnerable’ consumers) are not misled into acquiring services that may not be suitable, or which may be of a poor quality.⁸³

On the other hand – and this is very much an area where the economics is two (or three, or four, ...) handed – there exist theories that advertising can help in signalling quality to consumers: for example, suppliers of a higher quality service have greater incentives to advertise, since a new customer gained is more likely to be a repeat purchaser, or more likely to spread a good message about performance, and consumers can therefore infer something about quality by observing levels of advertising (although we note that, for many consumers of legal services, the repeat purchase mechanism may not be a significant, operative factor, on account of the ‘credence good’ points made earlier).

The balance of analysis and evidence tilts strongly toward a conclusion that advertising tends to have pro-competitive effects, implying that, much more often than not, restrictions on advertising can be expected to have adverse consequences for competition and consumers. Among the relevant points are:

- Advertising assists consumers in making better informed and more informed decisions by providing relevant information. Even where the marketing does not itself contain substantive information about the nature of the services and their prices, the messages will at least let consumers know that the relevant supplier exists and wants to be considered when the consumer is making purchase decisions.

⁸² Although it is our understanding that the prohibition on ‘doorstep selling’ remains. Doorstep selling can, like referral fee arrangements, be viewed as an alternative (to advertising) means of ‘acquiring customers’ or of marketing a relevant service. Many of the arguments surrounding the advantages and disadvantages of advertising legal services also apply in relation to these other marketing practices, and it is clear that there are some detailed questions to be examined as to where appropriately to draw a line between permitted and non-permitted practices.

⁸³ While laws on misleading and deceptive advertising may address some of the most blatant of issues here, the point relates more to the subtle impressions provided in advertising which could influence the behaviour of consumers.

- Advertising by suppliers can reduce search costs for consumers, allowing them to reduce the time and resources spent investigating the various attributes of different services.⁸⁴
- Advertising is a potential way for suppliers to differentiate themselves from other service providers with consequent positive effects on innovation and market entry (ie: a new innovative provider can use advertising to effectively communicate to consumers that it is offering a new service).

As in the case of collective price setting, collective agreements to restrict advertising are largely a matter for the competition law authorities, and they do not therefore provide a rationale for additional regulation of legal services markets.

5.4 Entry requirements

A characteristic feature of many professions, including the legal profession, is the exercise of some form of control over who is allowed to practise within that profession. This may take the form of specifying minimum qualifications or skills; requirements that a specific period of training or experience be completed; or a need to undertake a specific test or examination before being allowed to practise. In addition, entry rights to a profession may be partly based on specific individual characteristics, such as the absence of a criminal record, or admission to the bar in a particular jurisdiction. Requirements for entry into a profession can also take the form of a simple, quantitative restriction on the number of people allowed to be admitted to practice in a particular area, or at a specific rank.

The use of entry requirements of some form or another is familiar from the operation of the medieval guilds, where the practice was partly motivated by desires to establish standards of workmanship and ensure that the craft and labour were performed to a particular quality standard. In effect, restrictions on who may practice represent a form of certification and, as discussed in the last section, there can be legitimate economic reasons why they may be introduced: to address information asymmetries between consumers and producers by providing clear signals and, in some cases, guarantees of service quality.

Nevertheless, in relation to entry restrictions, we come back again to the envelope theorem, which provides a reasoned basis for a general concern that entry requirement restrictions will be used by a self regulatory body to artificially limit the number of suppliers of legal

⁸⁴ GJ Stigler (1961) 'The economics of information' *Journal of Political Economy* p 216.

services, thereby restricting supply and raising prices. This can occur either through setting the requirements in terms of training, education and experience at too high a level, or, in the case of quantitative restrictions, by unduly limiting the number of licences that are available

5.5 The granting of exclusive rights

A characteristic of the legal profession related to the entry requirements discussed above is the granting of exclusive rights that allow only certain members of the profession to supply particular services.

Generally speaking, there are two forms of exclusive rights. First, there are exclusive rights to specific titles, such as reserved titles, which allow only certain professionals to lay claim to practise under that title. Familiar examples are the titles of ‘solicitor’ and ‘barrister’, and the requirements that restrict who can classify themselves as such. Second, exclusive rights can pertain to who, within the profession, is permitted to practise and supply legal services in particular areas of law. In England and Wales these are referred to as reserved areas, and examples include: exercise of rights to an audience; conduct of litigation; reserved instrument activities; probate activities; notarial activities; and the administration of oaths.⁸⁵ In each of these areas, only certain members of the legal profession are permitted to supply services.

Many of these activities appear to have evolved into reserved areas for largely historic reasons.⁸⁶ However, as is the case with requirements for entry into the legal profession as a whole, there may, in principle, be arguments that favour the continuation of these restrictions for the purposes of maintaining quality in supply. The general, positive argument here is a familiar one: to ensure that certain standards of quality are maintained in areas where law can become highly specialised. For example, the historical, exclusive rights of barristers to appear in court have been justified on the ground that oration of this type is a highly specialised task requiring specific skills and experience. Accordingly, it is argued that imposing restrictions on who can provide these services will result in better

⁸⁵ These six activities are noted in the Legal Services Act (2007). Other reserved activities under separate legislation include: immigration work and claims management compensation.

⁸⁶ Generally, see: Legal Services Institute (2010) ‘Reserved Legal Activities: History and Rationale I’ Strategic Discussion Paper.

argued cases, produce more valuable precedent, and, could lead to the more efficient operation of the court system.⁸⁷

Similar arguments might be made in respect of the use of exclusive titles. Whilst some of these titles have evolved for historical reasons which may no longer apply (the title of Queen's Counsel being a notable one),⁸⁸ to the extent to which the titles are used to denote quality, or provide a certification stamp, they could, for the reasons already discussed, act to mitigate some of the information problems associated with legal services. They may also provide comfort to consumers that the legal practitioner they are dealing with is governed by a code of conduct and ethics.

As was the case with entry requirements, however, a principal concern with the granting of exclusive rights is that they can be used as a method to artificially restrict the supply of legal services in particular areas, which can permit a collective increase in prices for particular practitioners (eg: Queen's Counsel), or to increases in prices in specific areas of practice, to levels that are significantly above those required for efficient provision. Alternatively, exclusive rights could lead to degradation in quality, because of the muting of competitive challenges from those who are excluded. The distinction between entry requirements and exclusive rights is that while the former can act to prevent existing legal professions as a whole from being challenged by the threat of competition from outside the profession, the latter restricts competitive challenges from those working *within* the profession itself.

The question of the economic impacts of specific entry requirements or of reserved area restrictions, and in particular of whether any adverse effects are sufficient to warrant some form of specific regulatory intervention, is one for empirical investigation. As noted, such requirements can serve a positive function in ensuring that quality is maintained, but can also be used to limit competition and new entry. The limited empirical research that has been conducted on these issues, taken as a whole, has, thus far, led to mixed conclusions.⁸⁹

⁸⁷ W Bishop (1989), 'Regulating the Market for Legal Services in England: Enforced Separation of Function and Restrictions on Forms of Enterprise' 52 *Modern Law Review* p. 326.

⁸⁸ Office of Fair Trading (2001) *Competition in the Professions* A report by the Director General of Fair Trading para [46].

⁸⁹ Examples include: D Lueck, R Olsen and M Ransom (1995) 'Market and Regulatory Forces in the Pricing of Legal Services' 7 *Journal of Regulatory Economics* p.63. Contrast with general conclusions of: C Cox and S Foster (1990) 'The costs and benefits of occupational regulation' Bureau of Economics, Federal Trade Commission. As regards exclusive rights in conveyancing see: J Love and F Stephen (1996) 'Deregulation of Legal Services Markets in the UK: Evidence from Conveyancing' *Hume Papers on Public Policy* p 53.; I Paterson,

5.6 Restrictions on organisational form

Another area where legal professional associations have imposed restrictions is in relation to the forms of business organisation or structures within which legal professions can trade and operate. Historically, these restrictions have included requirements pertaining to (1) permissible organisational and business structures; (2) management of legal professionals; and (3) the financing of business organisations that provide legal services.

In relation to organisational and business structures, it has generally been the case that legal professionals have not been able to form partnerships involving lawyers with different reserved titles, such as partnerships between barristers and solicitors (so-called legal disciplinary partnerships), or partnerships that include lawyers and non-lawyers (so-called multi-disciplinary partnerships).

Alongside these restrictions on business structures, there have often been restrictions on business form, such as restrictions on the ability of lawyers to operate as a limited liability company. Moreover, in some cases, the management of legal practices has been restricted to management by lawyers.

Restrictions have also been imposed on the ability of legal services firms to obtain external financing or capital. That is, there have been restrictions on external parties (i.e.: non-lawyers) becoming equity holders or otherwise investing in legal services practices.

These types of restrictions are typically justified on the basis that they ensure the accountability and independence of the legal profession thereby maintaining consumer confidence in the law. So, for example, it is sometimes argued that allowing multi-disciplinary partnerships could lead to conflicts of interest, which would undermine the integrity of the legal profession to the ultimate detriment of consumers.⁹⁰ Similarly, it is argued that allowing legal services to be provided through business structures that limit the liability of the providers will remove the threat for partners of legal service firms that they could be personally liable should their advice, or the advice provided by their partner colleagues, be found to be negligent. The implication is that incentives to ensure that the quality of advice provided is of a high standard would be weakened to at least some extent.

M Fink and A Ogus (2003) *Economic Impact of Regulation in the Field of Liberal Professions in Different EU Member States* (Vienna, Institute of Advanced Studies).

⁹⁰ On this point, see: Opinion of Mr Advocate General Léger in Case C-309/99, *Wouters* [2002] ECR, I-1577 para [185]. Also the judgement itself: Case C-309/99, *Wouters* [2002] ECR, I-1577 paras [97]-[110].

It is also clear that restrictions on business structures of the type described can also have adverse economic impacts insofar as they can act to limit entry, and innovation, in the supply of legal services. For example, to the extent that legal services may increasingly come to rely on developments in information technology (for example, through e-discovery in litigation), efficiency gains and innovation could be facilitated by allowing legal service providers and IT firms to combine their activities. Allowing such combinations could also have other potential benefits such as allowing legal service firms to diversify risk across a range of activities, and reducing transactions costs by allowing firms to exchange information/knowledge regarding a specific client internally. Finally, it is sometimes argued that, allowing firms access to external sources of financing and capital would increase their ability to invest and innovate beyond the level which they may be otherwise capable of achieving.

In terms of the underlying economics, the restrictions on business structures, and hence on business models, described above touch on a number of potential areas of analysis, such as the relative efficiency and risks associated with:

- the ‘bundling’ of the ownership and operation of legal services with other professional services, and the impacts this may have on pricing and potential cross-subsidies;
- the potential size of any gains from economies of scope associated with allowing firms to provide a variety of different professional services; and
- in relation to legal-disciplinary partnerships, the potential for the elimination of any ‘double marginalisation’ effects that may exist between solicitors and barristers (these being effects that occur when complementary services are purchased separately, each selling party takes no account of the benefit to the other party of securing extra business, and consequently prices are higher than they would be if jointly priced).⁹¹

In general terms, economic analysis does not provide any clear-cut, *a priori*, answers to the question of what is the most efficient way to bundle economic activities. In utility regulation there has been a trend toward requiring separation of business activities in the name of promoting more level playing fields for competition in some activities; and business fashions change over time concerning the extent to which businesses do better by seeking

⁹¹ JJ Spengler (1950) ‘Vertical integration and Anti-Trust Policy’ 58 *Journal of Political Economy* p. 347.

diversification or by sticking to their core activities. The underlying trade-offs are set out in institutional economics as it has developed from Ronald Coase's classic paper *The Nature of the Firm*, but how those trade-offs are best resolved will depend upon the particular, relevant factual context, and this is, ultimately, an empirical matter.

Given this, in our view, the only general argument that carries weight – which it does precisely because efficient institutional structures depend upon context, and therefore have to be discovered in each context, including the changing contexts that occur as economic circumstances change – is that competitive processes should be allowed to operate, since competition is the best discovery procedure that we know.⁹² Restrictions on business structures preclude/prevent such competition in discovery of alternative ways of doing business, and are therefore liable to be restrictive of competition.

Whilst this argument is arguably strong enough to warrant a presumption against market rules that place strict restrictions on forms of organisation, as mandated unbundling in other sectors indicates, it is not sufficient to be determinative in all cases. That is, there should be scope for rebuttal; and this is where the debate in legal services is, or should be, centred. We do not, for example, think that a general conclusion to the effect that restrictions on business structures are clearly *always* anti-competitive is warranted.⁹³

Restrictions on forms of business organisation may, therefore, be justified when they are a response to some clearly defined problem, but a general scepticism is in order, and the burden of proof should be with those claiming a restriction is desirable. This appears to be the broad approach taken by the European Court of Justice, and it follows from what we have said that there is no significant divergence between the Court's approach and the general implications of the relevant economic and social science literatures.

As discussed earlier, it is highly likely that a range of non-economic factors may be relevant in any balancing assessment, and, as recognised by the European Court Of Justice in *Wouters*, it may be necessary to identify and balance any potential anti-competitive effects of a restriction (or groups of restrictions) on organisational structures against the possible

⁹² FA Hayek (1968) 'Competition as a Discovery Procedure' 5 *The Quarterly Journal of Austrian Economics* p 2.

⁹³ R van den Bergh (2007) 'Towards better regulation of the legal professions' Background Paper in *Competitive Restrictions in Legal Professions* OECD Policy Roundtable, p 49. However, on the next page of this paper it is noted that: "There is very little empirical evidence confirming any of the arguments presented in favour or against the restrictions on business organisation".

benefits it provides, for example in terms of the ‘integrity’, or of the overall collective reputation and quality, of the legal profession.

This approach appears to be consistent with the position outlined by the Office of Fair Trading (OFT) in its submission to the *Clementi Review*. In that document the OFT noted that it was not their role, or the role of any other regulatory body, to seek to specify how professionals should supply services, and that the manner in which services are supplied are best determined by the suppliers acting to satisfy the interests of consumers through the forces of competition.⁹⁴ Rather than seeking to mandate what might be perceived the most efficient structure in a particular industry *in abstracto*, the OFT’s role was to identify those specific restrictions which may act to impede competition while not providing any broader countervailing economic or social benefits.

This seems entirely sensible, although we note that restrictions on business structures in the legal profession cannot be said to have been determined under pressure from the “forces of competition”. It is precisely because the restrictions were determined collectively that it is appropriate to require some burden of proof concerning the claimed advantages of the restrictions on business structures.

As already stated, this is ultimately a matter for detailed, empirical assessment – the issues rest on fine detail of the factual context – which is beyond the scope of this paper. It does seem to us, however, that the strength of the case for the retention of restrictions on forms of business organisation is bound up with the strength of the proposition that certain organisational arrangements will likely undermine or weaken the ethical standard that a legal service provider has special responsibilities not to abuse a position of power over a ‘dependent’ client, and should rather act in the best interests of that client.

5.7 Summary

The characteristics of the supply structure of legal services can raise a number of potential issues from an economic perspective in so far as they have implications for quality of service and for competition. In particular, there may be issues of degradation in quality of service, restrictions of new entry, and stifling of innovation, including in relation to different ways of doing business. In specific relation to the supply of legal services in England and Wales, the

⁹⁴ Office of Fair Trading (2004) ‘Consultation on the future regulatory framework for legal services in England and Wales’ Response from the Office of Fair Trading OFT722 para [1.6].

types of restrictions and practices that have given rise to such concerns are those related to pricing, advertising, restrictions on organisational form, and the granting of exclusive rights.

It is important to recognise, however that, from an economic perspective, there are generally no *a priori* anti-competitive practices (i.e. practices that have anti-competitive effects in *all* circumstances). Consideration must in each case be given to the *effects* of the practice or restriction in the particular contexts in which they occur. Some practices tend to have adverse effects on competition in the great majority of the circumstances in which they occur, and hence warrant a presumptive initial approach, subject to the possibility of rebutting the presumption; and that is about as far as one can go on the basis of general economics.

For the most part, supply-side restrictions in legal services markets that have adverse effects on competition, or represent an exploitation of market power, are addressable via competition law. This is particularly true where the ‘remedy’ for a particular practice is to abolish it, as was the case in relation to fee-fixing and prohibitions of advertising. In such cases, the Office of Fair Trading and competition authorities elsewhere have had significant successes in the past.

Things are a little more difficult where a measure is warranted in terms of benefits to consumers of legal services or to some other aspect of the ‘public interest’, however that is defined. Where the measures are imposed by a self regulatory body, or by a body that is effectively ‘captured’ by supply side interests, we have argued that the envelope theorem suggests that there will be a tendency to come to decisions that go further than is necessary for the wider good, so as to achieve ‘private’ benefits.

This tendency too could be policed by the competition authorities, but the issue are of a more quantitative nature (going ‘further than necessary’, or ‘not far enough’), and the ways in which ‘going further than necessary’ can occur may be quite subtle. There could, therefore, be a rationale here for an element of public regulation – incremental to competition policy, without in any way substituting for competition policy – focused on specialist scrutiny of market rule-books. We therefore consider this issue further in the next section.

6. Structures of regulation

In the discussion so far we have noted that, generally speaking, the economic rationale for some form of regulatory oversight of the legal profession is premised on the need to maintain quality, and to address an information asymmetry between consumers of legal services and suppliers. In addition, regulation may be premised on the need to provide access to affordable legal services, and to ensure that consumers are not exploited where they are in a position of significant weakness relative to suppliers.

We have also examined the characteristics of the way in which legal services have historically been supplied, noting, in particular, the role played by professional associations in imposing various requirements and restrictions on who can provide legal services, how they are provided, and in what areas of practice. As discussed, these restrictions may, in part, have represented ways in which the profession seeks to collectively ensure that a certain standard or quality of service is maintained, and that the profession maintains its independence. However, as previously noted, such restrictions also create opportunities for the profession to exploit its position of collective power over an area of important specialist knowledge, which can be detrimental to economic welfare.

In relation to many of the relevant restrictions, it is not possible to determine whether or not they will be harmful (in an economic sense) in the abstract, without considering the specific context and circumstances in which they are being applied. Accordingly, the most appropriate approach is to undertake empirical assessment, on the basis of a fact-based investigation, of the likely anti-competitive impacts of particular rules as well as any countervailing benefits.

This naturally leads to questions about the adequacy and general attributes of different regulatory structures, and in particular the extent to which the regulatory arrangements can be expected to address, and balance, the possibly beneficial effects of specific rules in terms of ensuring quality, with the potential for such rules to be used in an anti-competitive way and thereby adversely affect economic welfare.

6.1 Self-regulation by the professional associations

The primary institutional mechanism responsible for regulatory oversight of the legal profession has, until recently, been self-regulating professional organisations. These

organisations have been responsible for establishing the rules for entry into specific areas of professional practice, as well as outlining rules that govern the on-going conduct and ethics of existing professionals.

There are a number of well-recognised benefits associated with self-regulatory forms of organisation. First, in principle, they allow for a profession, or a specific area of practice, to be governed by rules and other customs which are made by people who are generally intimately familiar with the legal profession and have the necessary technical skill and knowledge. This can have obvious advantages in terms of an ability to recognise and fashion rules that are appropriate to specific issues, and can reduce the information costs associated with regulation by non-specialists.

A second, and related, advantage is that self regulation can reduce the costs of monitoring and enforcement associated with regulation. This is because those who enforce the regulations are likely to be specialists themselves, and therefore to be able to distinguish quality. Moreover, they will typically possess the technical expertise to be able to identify precisely which elements of a specific piece of advice may be deficient or negligent (which is particularly important in areas of highly complex, intangible advice). It is also postulated by some analysts that, because of a collective desire to maintain the reputation of the profession, self-regulating bodies can actually be more rigorous and thorough in the monitoring and identification of instances of low service quality than a public authority might be (in practice, if not always in theory).

There are a number of other general arguments that have been offered in support of self-regulatory arrangements. Among these:

- self-regulatory bodies tend to be more flexible, and adaptive as they are not required to work through the formal machinery of government or statutory bodies;
- there are incentives to be more responsive to market changes so that service quality is maintained; and
- self-regulatory bodies are typically funded by members of the sector being regulated, and are therefore not a burden on the taxpayer.

There is, however, one rather big, potential disadvantage of self-regulatory arrangements: a self-regulating profession can have an incentive to act like a monopoly by enacting rules and processes, as well as other forms of norms and acceptable conduct, which operate in the interests of the profession, to the detriment of competitive processes and economic

welfare. A number of the general types of rules and restrictions which could potentially have these effects have been discussed in the previous sections.

We have explained why self-regulatory bodies have a natural incentive to promulgate rules that serve to improve their own positions, at the expense of consumers, particularly when such a shift in resources can be achieved with limited adverse effects on economic efficiency (the envelope theorem). This means that even self-regulatory objectives that are heavily weighted towards promotion of the general good, and only very modestly weighted towards professional self interest, could have significantly adverse implications for consumers. Others have made similar points in different, though not contradictory, ways. For example, Shaked and Sutton set out the issue as follows:⁹⁵

If a profession is "self-regulating", in the sense that its current members, being the sole suppliers of a certain type of service, are free to determine, in one way or another, whether or not to admit a potential recruit, then it might seem *prima facie* that such a profession could simply be regarded as a monopolistic seller of the service in question, so that the effects of self-regulation would appear to involve an unambiguous welfare loss. The whole rationale for self-regulation, however, rests on the notion that it provides a vehicle through which the quality of the service may be maintained in markets where the consumer cannot readily measure this quality himself. It is the analysis of the interplay of these two elements, the enhanced price of such services associated with the monopolistic power of the profession, and the improved quality of the service which may accompany a reduction in supply, which forms the focus of the present paper.

Of course such theoretical propositions regarding the incentives of self-regulatory arrangements need to be balanced against other analytic work on the inherent or natural incentives of other forms of regulation, such as regulation by government-appointed or statutory regulatory bodies. As we argued at the outset, the most appropriate economic framework in which to assess the rationale for regulation in general, and for specific types of regulation in particular, is that of comparative institutions.

What we find in this part of the economics literature, and in the related, but generally more abstract area of public or collective choice theory, are propositions that regulators and regulatory agencies are themselves motivated by a collective self-interest rather than the 'public interest', and are liable to be captured by various sectional interest groups or

⁹⁵ Shaked and J Sutton (1981) 'The Self-Regulating Profession' 48 *The Review of Economic Studies* p. 217.

ideologies.⁹⁶ The net result, it is posited in some of this work, is that external regulation inevitably comes to resemble a form of ‘taxation’ whereby the regulatory task involves moving rents between various competing interest groups (industry, consumers, sectors of society etc),⁹⁷ whilst at the same time promoting expansion in the size of the relevant organization and its budget.⁹⁸

6.2 Other structures of regulation

These remarks lead on to questions about what economics has to say about the likely effectiveness of regulation, since, in seeking to understand the rationale for regulation, it must be the case that what is in contemplation is a practical, institutional arrangement, warts and all, not an idealised, perfected regulatory agency.

The likely weaknesses of self-regulation have been discussed throughout the preceding discussions, but can be summarised in broad terms by the notion of capture of the regulatory process by the regulatees. What, then, can be said about other forms of regulation?

The alternatives to self regulation of legal services range from major changes, such as the removal of the regulatory functions from the professional associations entirely, with the functions being transferred to an independent external body, to more hybrid regulatory structures that seek to combine the beneficial elements of self-regulation, within a broader institutional framework aimed at mitigating any potentially adverse effects of the conflict between professional objectives and, speaking very roughly, the ‘public interest’. This may involve the introduction of a lay element to the self-regulatory arrangements, or the establishment of strong consumer bodies that can challenge any rules and practices of the profession which are judged to be harmful to consumers.

We note that, in England and Wales, there has been a move away from self-regulating professional associations. While historically the Law Society (in relation to solicitors) and the

⁹⁶ GJ Stigler (1971) ‘The Theory of Economic Regulation’ 2 *Bell Journal of Economics and Management Science* p 3.

⁹⁷ The classic references here are: G Becker (1985) ‘Public policies, pressure groups and dead weight costs’ *Journal of Public Economics* 329; R Posner (1971) ‘Taxation by regulation’ *Bell Journal of Economics* 22.

⁹⁸ WA Niskanen *Bureaucracy and Representative Government* (Aldine Atherton Chicago 1971).

Bar Council (in relation to barristers) both represented their members and also regulated their practices, the regulatory function is now fulfilled by two independent regulatory bodies (the Solicitor's Regulation Authority in relation to solicitors and their practices, and the Bar Standards Board in relation to barristers and their practice).⁹⁹ The boards of these bodies are comprised of a balance of practitioners and lay members and are tasked with taking decisions independently, in the public interest and not prejudiced by the relevant representative bodies. Moreover, these regulatory bodies (and a number of others) are themselves subject to oversight by the Legal Services Board (LSB), whose members also comprise a mixture of lay and practising members, and which has a public and consumer interest remit. In addition, the Legal Services Consumer Panel (which is an independent arm of the LSB) exists to provide independent advice to the LSB about consumer issues, and to represent the interests of the users of legal services.

It is not the purpose of this paper to assess the relative merits of specific alternative structures of regulation. Rather we highlight two aspects of any regulatory structure which invariably require close consideration: the approach to regulation; and the process by which rule-making occurs.

Approach to regulation: 'prescriptive rules' or 'standards'

A significant first question in relation to regulatory arrangements is whether they will be structured in such a way so as to develop and enforce a set of prescriptive rules, or whether they will be based around standards of conduct, with regulatory intervention only where activities demonstrate harm or risk of harm. By 'prescriptive rules' what is meant is a set of behavioural constraints that is set out, *ex ante*, in a relatively precise way. Conceptually, the difference between 'prescriptive rules' and 'standards' (which are rules in the more general sense used throughout this Report) can be considered in terms of whether or not a regulatory requirement is given substantive content *ex ante* or *ex post* and the degree of specificity, or generality, associated with the regulatory requirement.¹⁰⁰

Generally speaking, a prescriptive rule is forward-looking, anticipates the adverse effects of particular types of conduct, and therefore limits the ability of firms/individuals/professional

⁹⁹ There are a number of other approved regulators, such as the Council for Licensed Conveyancers.

¹⁰⁰ The discussion here is based on work in the area of law and economics. See, for example; L Kaplow (1992), 'Rules versus Standards: an economic analysis' 42 *Duke Law Journal* p.557; C Diver (1983) 'The Optimal Precision of Administrative Rules' 93 *Yale Law Journal* p.65; L Kaplow, (1997), 'General characteristics of rules' in B: Bouckaert and G. DeGeest (eds.), *Encyclopaedia of Law & Economics*, Edward Elgar: Cheltenham.; S Shavell, (1993) 'The Optimal Structure of Law Enforcement' 36 *The Journal of Law and Economics* p. 255.

associations to engage in that conduct *ex ante*. As such, the approach sets out what conduct is permissible or not permissible in advance of that conduct occurring. In general terms, the approach is better suited to contexts where, in the absence of such a restriction, the adverse conduct might be expected to occur frequently, or where the potential damage from such conduct occurring could be irreversible and substantial.

In contrast, a standards-based approach is an example of an *ex post* method for controlling and influencing behaviour. Typically, it is a backward-looking, or harm-based, approach and involves the regulator only intervening in the market where past, or current, conduct is suspected to have had adverse effects. In general terms, this approach tends to be better suited to settings where: conduct is subject to substantial variation; potentially adverse conduct occurs relatively infrequently; and market conditions are subject to considerable change (such as in a process of market liberalisation).

There are obvious similarities between the points made here and some aspects of discussions about the relative advantages of 'risk-based' regulatory approaches. In both the 'standards' and 'risk-based' cases, the regulatory approach shifts the focus away from the determination and enforcement of an elaborate set of pre-determined rules, and towards an enforcement framework that takes much more account of the risks associated with that activity in terms of harm (adverse effects) and the frequency with which such events/effects are expected to occur.

The process of rule-making

A related set of issues concerns the process by which general rule-making occurs, and the ways in which such a process is overseen, and potentially challenged, in the relevant regulatory structure. Among other matters, this encompasses questions about:

- Who can participate in the rule change process? For example, can rule changes only be initiated by the regulatory body, or can third parties initiate a rule change?;
- How any proposals for rule change are assessed - that is, the criteria employed to evaluate proposals, and the evidence that is collected and assessed;
- The transparency and openness of the rule change mechanism;
- The possibilities for appealing any rule change decisions.

To the extent that there are different regulatory bodies, as in legal services, the question also arises as to whether it is appropriate to have a common assessment process for rule

changes across the different regulatory organisations. In circumstances where there are concerns that such assessment might not be conducted evenly and impartially, there may be a case for either an external body to oversee the implementation of such a framework, or to act as an appeals body.

In this respect, we note that there are a number of institutional possibilities that can be observed in practice. One involves the separation of responsibility of high-level rule making from the regulation and enforcement of the rules. Such a structure can potentially combine self-regulatory professional associations with some form of external oversight. For example, an external, public body (such as an independent regulatory agency) could be responsible for high-level rule making and for overseeing consideration of general issues of market development, whilst enforcement functions are entrusted to self-regulatory bodies. Under one option, the public body might not be empowered to initiate rule change proposals itself, but might be able to recommend a rule change as part of its market review function. An aspect of the role of the public body in this structure might be what we have referred to as elsewhere as ‘prodding’; encouraging the self-regulatory bodies to act, when opportunities for improvement arise but no ‘first-mover’ appears.¹⁰¹

Alternatively, the function of rule making and assessment could be jointly entrusted to the self-regulatory bodies in the first instance, whilst the external, public body is given the task of ensuring the processes are applied within a common framework based on reasoned and empirically well-supported decision making. Whilst no adjudicating powers are assumed for the public body in this structure, it might act as a form of ‘prodder’ in relation to the relevant regulatory processes. A further extension here could involve consultation reports on specific rule changes having to be ‘signed off’ by the public body, to ensure that self-regulatory bodies take proper account of the views of stakeholders. Alternatively, the public body could act as an appeals institution, established to review the decisions taken by the professional regulators.

As a final example of potential options, the oversight function could be undertaken by a competition authority, rather than by a specially constituted public body. If this model was selected there would be a need to ensure that the competition authority had the necessary technical skills and resources to balance the competition aspects of rule making in the

¹⁰¹ C Decker, A Jeunemaître, T Keyworth and G Yarrow (2003) ‘Study on the implementation rules of economic regulation within the framework of the implementation of the Single European Sky’ Report of the Regulatory Policy Institute for European Commission Directorate-General of Energy and Transport (TREN/f2/28-2002) p.43.

profession with other, broader public interest objectives. Moreover, given some of the earlier discussions about the significance of equity and 'confidence' issues in the provision of legal services, there might also be questions about whether the bundling of the tasks with the more general enforcement of competition law might lead to particular, unintended biases in the way that assessments would be conducted.

Ultimately, questions about the approach to regulation, and the processes by which rules are assessed, will depend on matters beyond the scope of this review. We note them here only insofar as these issues are likely to be relevant considerations when assessing the attributes of alternatives to self-regulation.

6.3 A framework for the assessment of the effects of rules

As part of our terms of reference we have been asked to bring together the themes from the economics literature into a framework for the analysis of regulation in legal services.

The appropriate on-going institutional framework for assessing the regulation of the legal profession can, in our view, only be fully determined by examining the properties, and likely effects, of the various rules enacted by the professional associations (or, in the case of England and Wales, their approved regulators) in specific areas. This implies that some form of assessment framework needs to be developed which allows for specific rules, or groupings of rules, to be identified and then assessed in terms of their likely impact on competition and consumers, and on other regulatory objectives (including non-economic objectives). As Shaked and Sutton have suggested, the policy-maker's problem may reduce in practice to the question of whether the profession should, or should not, be allowed to retain certain rules or practices that have been promulgated.¹⁰²

In this respect we note that regulatory theory and practice suggests that there are a number of aspects to designing a framework in which this type of assessment can occur.

- First, any assessment framework should have at its heart questions about whether existing rules or restrictions are necessary and proportionate to the various professional and public objectives they are intended to help achieve. The relevant issue is whether a given rule or restriction is actually required to achieve the aims of regulation (for example, is there a causal link or reasoning which suggests that it will

¹⁰² Shaked and Sutton's original quotation is: *The policy-maker's problem, we shall argue, reduces in practice to the question of whether the profession should, or should not, be allowed to retain monopolistic powers.* Shaked and J Sutton (1981) 'The Self-Regulating Profession' 48 *The Review of Economic Studies* p. 217.

act to improve the quality of service provided), and if so, whether the way in which the rule is structured is the least restrictive in terms of its impacts on competition and economic welfare. That is, for example, could the rule be modified so as to lessen the potential impact on competition, while at the same time still ensuring the objective to which it is directed is satisfied? This type of assessment framework is conceptually similar to that which occurs under European competition law in respect of the assessment of agreements which could potentially be restrictive of competition, but may have countervailing economic benefits.¹⁰³

A related aspect of the assessment framework is whether the framework should be focused on the removal of *all* unnecessary rules and practices, including those which are found to have no clear, direct impact on competition or economic welfare, or whether it should be focused only on addressing those rules which have a direct and manifest impact on competition and economic welfare.

This raises the general issue of whether rules and practices which appear to be unnecessary or purely ornamental in economic terms (requirements for particular forms of dress to be worn by legal professionals in Court is an example) do, nevertheless, contribute to fulfilling a broader function as part of ensuring some or other desirable feature of the legal system. In addition, it raises the related issue about who should be responsible for identifying rules which may be unnecessary and disproportionate. This touches on the matters already discussed about the rule-making process (should a regulatory body be pro-active or reactive), and also to matters of regulatory approach (ie: the appropriateness of a risk-based approach).

- Second, the scope of application of any *general* assessment framework will need to be considered, and in particular the extent to which all rules should be assessed within a common framework across *all* legal services; or whether the assessment framework should be tailored to the different activities and services provided by the legal profession (or by whoever provides these services). This highlights a potential problem under the current regulatory arrangements, where it is our understanding that, in some cases, the same or similar types of legal services are subject to different rules depending upon whether the person providing that service is governed by one professional association or another.

¹⁰³ See Article 101 of Treaty on the Functioning of the European Union.

- Third, given the particular characteristics of legal services, and their importance to society and individuals (see the earlier discussions), the assessment framework will need to allow for the explicit identification, assessment and balancing of the different potential justifications for a specific rule being in place. Put differently, the framework might reasonably be expected to allow for, say, any restrictions on competition that are identified in the course of assessment of professional rules to be balanced, in a reasoned way, against the anticipated implications of those rules for other social, economic and political objectives. In effect, this involves designing a framework which allows for the types of considerations identified by the European Court of Justice in *Wouters* to be addressed.

The considerations that would be relevant to any balancing exercise are likely to differ according to the context in which a specific rule is being applied. So, for example, while a particular market entry requirement may appear unnecessary and disproportionate in a specific area of legal service that is highly standardised, and where the risks of consumer harm from poor quality are minimal, the same entry requirement may be more appropriate in contexts where the legal services being provided are highly technical and complex, or where the risk of harm to consumers from poor quality advice is significant, or where the integrity of the legal services is sustained by allowing only high quality professionals to practise in this particular area. There are obvious parallels here with other ‘vital’ professional activities such as medicine, and the admittance of less qualified staff (para-professionals) to undertake the more routine tasks where the risks are relatively minor. The ability of nurses to provide routine injections, but not the more complex ones that can have more serious side effects (ie: epidurals), is an example.

All of these points suggest the need for the development of an analytic framework which has the flexibility to allow for such contextual aspects to be considered, but, at the same time, applies a common, general set of principles across the different areas of legal activity. There are precedents in regulatory practice for such a general assessment framework which allows specific objectives to be balanced off, and can be tailored to specific market contexts. Examples include the requirement under the European Commission Merger Regulation to balance any potential anti-competitive effects of a merger identified against potential efficiencies. This framework has an ability to be applied at different levels of specificity (for example, at one extreme in examining the worldwide market for platinum, or at the other extreme in examining the Danish market for pork sold through supermarkets). Another example is the use of Regulatory Impact Assessments across government departments in

England and Wales, which in principle, require all government departments explicitly to identify and assess the various impacts of any new regulations across a range of specified dimensions (eg: competition, small businesses, etc) prior to that regulation being introduced.

6.4 Summary

Relevant theory and practice suggests that any analytic framework for assessing the regulation of the legal profession needs to balance the possibly beneficial effects of specific rules (in terms of ensuring quality in legal service provision, or of meeting other public interest objectives) with the potential for such rules to be used in ways that adversely affect the interests of consumers of those services, whether directly (eg: by making services more expensive) or indirectly, by restricting competition. This requires consideration of issues of necessity and proportionality, as well as more general questions regarding the appropriate regulatory approach (e.g prescriptive rules or standards, standardised or area-specific, proactive or re-active?). Assessment approaches adopted in other areas, such as European competition law and regulatory impact assessments, provide some useful templates in this respect.

7. Concluding remarks

In this paper we have surveyed some of the major contributions to the literature on the economic rationale for legal services regulation. Here we briefly summarise the central points, and main conclusions of the discussion.

- There are a variety of reasons why a society may want to ensure that legal professionals, who are entrusted with significant responsibilities, operate within an appropriate framework of accountability and supervision. This paper has considered some of the *economic* reasons for establishing a framework of regulation of the legal services profession.
- Various conceptual and theoretical ‘frames’ can be used to examine the economic rationale for regulation of legal services. We gave as examples the modern neo-classical approach and the comparative institutions approach. In our view, the comparative institutions approach offers the most fruitful way of approaching the underlying issues, being based on more realistic assumptions about the chief characteristics of the relevant economics contexts, and placing a heavy emphasis on the comparative analysis of alternative ‘rule-books’ or sets of rules.
- Like other areas of regulation, legal services regulation can be directed toward various public policy objectives. In economic theorising it is common to separate policy objectives into issues of efficiency and of equity: in utility regulation, for example, whilst theoretical pricing arguments have been centred on issues of cost-reflectivity and efficiency, issues of cross-subsidisation (concerning equitable access to services) have been of considerable importance in practice. In legal services the most significant equity/access issues are less to do with cross-subsidisation, and more to do with whether services are excessively priced or inefficiently rationed.
- Moving on from consideration of policy objectives, there are particular characteristics of legal services as products which might point to the desirability of regulation and oversight of some form. Chief among these are issues relating to ‘quality of service’ (in a broad sense), in contexts where there can sometimes be significant information asymmetries between suppliers and consumers in terms of the ability to assess quality. A commonly observed response to information asymmetries in markets is the development of reputation, for example as a high

quality supplier. Self regulation can arise from the recognition among suppliers of a particular service that there may be a collective interest in ensuring that certain standards of conduct/performance are maintained (i.e. that a *collective* reputation for quality of service be developed and maintained). More specifically, there is a clear economic rationale for self regulation when the activities of some suppliers have the potential to have adverse consequences for suppliers as a whole, for example by discouraging consumer participation in the relevant market.

- The economic literature also includes papers that recognise that problems can arise when self regulation is motivated by a collective self interest that comes into conflict with the interests of consumers and the maintenance of effective competition. Self-regulation is typically a monopolised activity, and general economic reasoning suggests that self-regulating suppliers, like monopolists more generally, will have an interest in expanding the market up to a point of joint profit maximisation, but not beyond that point, and hence that market size may be smaller than under more effectively competitive conditions. We argue, via a piece of analysis generally referred to as the ‘envelope theorem’, that it may take only a small, extra weight to be unduly afforded to the ‘private’ interests of suppliers in regulatory decisions for there to be significant, adverse consequences for consumers of legal services.
- Where professional associations enact rules or practices related to pricing, advertising, restrictions on organisational form, and the granting of exclusive rights, these decisions can, in theory, result in provision of inappropriate quality of service (which can be too high, as well as too low), restrictions of new entry, and the stifling of innovation, including in relation to different ways of doing business. To the extent to which these supply-side rules or restrictions potentially have adverse effects on competition, or represent an exploitation of market power, these are addressable via competition law. However, it is recognised that some supply-side rules/restrictions may have alternative rationales (e.g.: in terms of sustaining the public legitimacy of legal frameworks), and may lead to countervailing benefits that can sometimes offset any adverse competition effects. In these circumstances there can be a rationale for an element of public regulation, incremental to competition policy, that is focused on specialist scrutiny of market rule-books.
- This naturally leads to questions about the adequacy and general attributes of different regulatory structures, and in particular the extent to which alternative structures can be expected to address, and balance, the possibly beneficial effects of

specific rules in terms of ensuring quality of service against the potential for such rules to be used in an anti-competitive way, with adverse effects on economic welfare in general, and on consumers in particular.

- Historically, the primary institutional mechanism for regulatory oversight of the legal profession in England and Wales has been self-regulating professional organisations. Economic theory and practice suggest that while there are a number of benefits associated with this form of regulatory structure, there are also weaknesses, which can be summarised in broad terms by the notion of the potential for capture of the regulatory process by the regulatees.
- Public regulation is one obvious alternative to self regulation, in the sense that it could simply take over any of the roles that might be played by self-regulation in relation to the quality of service issues. Public regulation can also be used as a complement to self-regulation, provided that there is clarity in the roles and responsibilities of the different bodies involved in developing and enforcing market rules.
- The weaknesses of public regulation are well recognised in economic theory and (more decisively) in empirical studies of the effects of regulation. They include the potential for regulatory agencies to be motivated by a collective self-interest (for example in the size and budget of the agency) rather than the 'public interest', and the potential for capture by various sectional interest groups or ideologies.
- Finally, related to questions of regulatory structure are issues associated with the appropriate regulatory approach, and the process by which rule-making occurs in relation to legal services regulation. These issues raise questions about necessity and proportionality; prescriptive rules or standards-based regulation; standardised or area specific regulation; and whether the regulator should be pro-active or re-active. All of these points are likely to be of high relevance when designing a framework for the analysis of regulation in legal services.

Postscript

As noted in the discussion of our Terms of Reference, this Report has been focussed on understanding the *economic* rationale for the regulation of legal services markets and the legal service professions. In particular, we were asked to take a step back from the existing regulatory framework, and to consider the intellectual case for the regulation of the sector on a 'clean-sheet' basis. Accordingly, the principal focus of the Report has been on exploring, at a general level, the theoretical basis for regulation in legal services; it has not been focussed on empirical issues, and is therefore necessarily bare of factual details and evidence of how legal services are actually provided in England and Wales, and the more specific arguments which may suggest that some form of regulatory oversight/intervention is warranted.

It is, of course, the case that, when applying the principles and ideas developed in this Report to practical settings, the specifics of the factual context cannot be ignored, and, indeed, will need to be centre-stage. On this basis, in this brief postscript, we attempt to identify a number of indicative issues and questions that we consider are likely to be relevant when seeking, in practice, to apply principles that have been identified in this Report. Examples of the types of indicative issues/questions include the following:

- The Report has highlighted the importance of tailoring regulatory interventions to the specific context of the legal services being provided having regard to: the nature of the matter (civil, criminal, small matter or large matter, etc); by whom the legal service is provided (barrister, solicitor, etc); and the typical characteristics of the consumer who acquiring the service (infrequent consumer, large and well informed consumer, etc). Each of these aspects can create a different *prima facie* case for regulation, which naturally impacts on the appropriate form of regulatory oversight/intervention required to address any problems identified.
- We noted that the most compelling economic rationale for some form of regulatory oversight related to issues associated with 'quality of service' (broadly defined), and in particular the information asymmetries between suppliers and consumers in some areas of legal services provision. This, we noted, can affect the ability of certain types of consumers to assess quality. It follows that, in a practical sense, it will be important when considering the need for regulatory intervention to fully understand

the precise nature of any information asymmetry between legal service provider and consumers in the relevant area of legal service provision. Among the types of questions that might be asked when applying this principle to practical contexts are: What types of information are available to the consumer? How knowledgeable is the client about legal services? How important is the client to the provider? What are the potential forms of consumer harm which might flow from consumers being unable properly to assess quality of service? How great is the potential for harm in the particular circumstances?

- Related to the above point, the Report noted that in general terms it might be expected there should be a collective incentive for legal services providers themselves to address at least some of the potential information asymmetries between suppliers and consumers, and to ensure that certain reputational standards of conduct/performance are maintained. However, in some provision of legal services contexts self-regulatory reputation effects may be insufficient, or inadequate, to fully address these issues, and that some form of additional regulatory oversight or intervention may be desirable. In such circumstances it will be necessary to identify, and assess the magnitude of, the risks of consumer harm from services being provided below standard. Questions of interest here when considering the case for regulatory intervention might include: What mechanisms exist to ensure quality in the provision of this specific legal service? Are these mechanisms sufficient/adequate, or is there a case for them to be supplemented by other external measures to ensure quality of service and to limit the potential for consumer harm? How do consumers obtain information about the reputation of different providers of legal services in this area of law?
- The issue of the relationship between entry qualifications and quality is a point discussed at length in the Report. While in many areas of legal services there may be strong grounds for ensuring that practitioners have high levels of specialist skills in order to preserve and maintain quality, this clearly does not universally apply to all areas of provision; and the minimum standards required to preserve quality are likely to differ significantly among the various areas of legal services activity. Accordingly, in considering specific regulatory measures in relation to training and skill requirements, it will be important first to assess whether the level of education/qualifications across different areas of legal services provision are

necessary and appropriate given the relative complexity of the relevant area of law, and the potential for consumer harm to arise from services being provided at unduly low levels of quality in that particular area. Among the questions that might be explored here are: What is the exact nature of the legal service being provided? How significant/expensive are the qualification requirements? What barriers to entry might these requirements impose? How closely do the required qualifications relate to the risk of consumer harm or detriment? Do these entry requirements automatically restrict other legal service providers from supplying these services?

- The relative experience of consumers in markets is a further practical issue that can have bearing on the appropriateness of the types and forms of regulatory intervention in relation to the various, different legal services activities. Questions that might be explored here include: How often does the consumer use legal services in general? How often have they used a particular type of legal service? What type of experience do they have with such services?
- Finally, the Report notes that the structure of the supply of legal services can have important implications for quality and for the relative intensity of competition. It was noted that the traditional supply structure is one based around a number of self-regulating professional associations, and that under such arrangements there may be natural incentives for such bodies to enact sets of rules or restrictions that can contain some provisions that have adverse effects on consumers. Recognising that some rules/restrictions may be necessary to ensure that certain 'public interest' objectives are maintained, the relevant types of questions that arise in this area include: What rules exist for each body? Do these rules appear proportionate and reasonable given their stated objective or purpose? Do the rules differ between different sectors and activities, if so how? What form do the rules take? What is the process for rule-changes to be proposed and considered?

In conclusion, we emphasise that the above points are intended to be no more than indicative examples of the types of issues and questions that may be relevant when seeking to undertake regulatory assessments in the specific factual context of the supply of legal services in England and Wales.