

# **An Economic Perspective on the Regulation of Legal Service Markets**

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**Evidence submitted to the Justice 1 Committee's Inquiry into the Regulation of  
the Legal Profession**

1. Much of the evidence which the Committee will receive in its inquiry into the Regulation of the Legal Profession will be concerned with the detailed mechanics of regulation of the various legal professions and legal service markets. The present submission, however, is concerned with the more general issue of whether there is a need for a specific regulatory regime for legal service markets distinct from general competition law. The Director General of Fair Trading recommended in March 2001 that the exclusion of certain professions, including the legal profession, from the application of general competition law be removed<sup>1</sup>. This would have the effect of opening the rules of such professions to investigation by the competition authorities under Chapter I of the Competition Act 1998. The present submission draws on the author's research on professional regulation and the wider economic literature on the topic<sup>2</sup>.

### **Market Failure in Professional Service Markets**

2. Economists generally begin from the premise that any economic activity should be free of regulation (or at least regulated only by the market) unless it can be shown that it is subject to *market failure*: left unregulated it will not generate socially efficient levels of output. The socially efficient level of output is usually taken to be that which maximises the sum of the net benefits of the activity to producers and consumers. Market failure arises when the sum of these net benefits is below the maximum attainable with the existing level of resources in the economy.
3. Market failure can arise from a number of sources which can be brought together under two main headings: (i) Structural Reasons; (ii) Missing or Incomplete Markets. The types of market failure most relevant to legal service markets come under the heading of structural reasons. The main structural reasons for market failure are the existence of *market power* and *incomplete information*.
4. The competitive process which generates efficiency requires that no single producer of a good or service (or group of co-ordinated producers) controls a sufficiently large share of that market that it can determine, by its own decision, the equilibrium combination of price and output for the market. The market power exerted by such a dominant producer (or group of producers) results in prices being higher and output lower than in a truly competitive market. A major function of competition policy in modern market economies is that of forestalling the creation of a market structure which generates market power (through mergers or collusion/restrictive practices) or where the potential already exists due to historic or technological reasons (e.g. economies of scale) restraining its exercise.
5. A less obvious source of market failure for structural reasons is incomplete information. The competitive process will only generate an efficient outcome for

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<sup>1</sup> The recommendation is contained in OFT (2001) which consists of the DGFT's report on a review of restrictions on competition in the professions and a consultant's report by the Law & Economics Consulting Group Ltd. The review is strictly speaking concerned only with England & Wales. However, the Director General makes clear in paragraph 54 of his report that '... the lessons learned will inform our work on the professions in Scotland and Northern Ireland'.

<sup>2</sup> This literature is reviewed in more detail in Stephen and Love (2000), a copy of which has been provided to the Committee's Clerks

a market if all actors in that market have full information as to market possibilities and alternatives. Producers require access to the same technology (and hence costs) while consumers need to have well ordered preferences over the alternatives. In particular, consumers must know what is available from different producers in the market and be in a position to make judgements about the nature of the goods or services provided including the price/quality trade off. For some types of goods and services the latter condition is difficult to meet. Potential consumers do not have the technical or expert knowledge to make judgements about the quality of what is being offered to them or in some cases whether what they are being offered will satisfy their requirements. Indeed, in the extreme, a situation can exist where even after the service has been provided the consumer is unable to judge whether what was supplied was appropriate. The term credence good has been used to describe this situation. Professional services fall into this category.

6. The consumer of a professional service needs the professional precisely because she/he does not have the specialist knowledge of the professional. There is an information asymmetry between professional and client. This asymmetry can have two consequences: adverse selection and moral hazard.
7. Adverse selection affects the client's choice of professional. If clients are unable to distinguish between high quality and low quality providers before engaging one, the price they are willing to pay for the services will be lower than what they would be willing to pay to a high quality provider if they could identify one. If the cost of providing the high quality service is greater than for a low quality provider, the price consumers will be willing to pay may be insufficient to keep high quality providers in the market. Consequently, high quality providers will exit the market reducing the average quality of suppliers in the market. This will lead to consumers revising downwards the price they are willing to pay, possibly generating a race to the bottom or a 'lemons market'. The typical solution to this problem has been, historically, to regulate entry to professional markets by some form of certification or licensing. In most European and North American jurisdictions this has taken the form of giving monopoly rights over some legal services to those who are members of a professional body requiring an educational qualification and a period of professional training<sup>3</sup>. The professional body reduces the adverse selection problem by setting and policing a minimum quality standard.
8. Moral hazard arises after a client has selected a supplier. As discussed above, the client is often not in a position to judge whether the service being provided by the professional is necessary or adequate. Indeed, most professional services involve two separate functions. First, there is the diagnosis of the problem and the identification of the services necessary to deal with it. Secondly, there is the supply of these services. In some fields these are separate activities e.g. architects are employed to design buildings to satisfy a client's specified needs but they do not provide construction services. On the other hand, when a party to a dispute consults a solicitor, the latter will usually diagnose the legal problem, suggest a remedy and implement it. In such circumstances, a solicitor motivated solely in

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<sup>3</sup> It should be noted, however, that in Sweden and Finland there are no restrictions on who can provide legal advice and representation in the courts while in Spain only a university law degree is required.

terms of financial gain may be tempted to suggest an expensive remedy in the knowledge that he/she will receive a higher fee for providing that remedy. By definition the client is not in a position to judge whether that remedy is the only one possible or even if it is likely to be successful. In the economic literature on the professions this is often described as giving rise to as 'supplier-induced demand'. In these circumstances a market for professional services is likely to generate a level of professional services which is above the optimal (or efficient) level and thus there will be market failure. This suggests that such markets in professional services require regulation to ensure that suppliers do not exploit their informational advantage.

9. However, it can be argued that this is too sweeping a conclusion. Not all clients of professionals are necessarily at an informational disadvantage. Clients who are repeat purchasers of a particular professional service will gain experience of a professional's diagnostic efficiency. Such repeat purchasers may also be able to use different professionals at different times and compare their relative efficiency leading to the choice of the most efficient supplier over time. Alternatively, the frequent purchaser may be in a position to generate competition between purchasers resulting in a more efficient specification of service and price. If frequency of demand by the purchaser is sufficiently high, direct employment of a professional may also be an option. In the legal field such repeat purchasers are likely to be large commercial organisations or public bodies. This suggests that there is no need to regulate the supply of legal services to such organisations. The market can be relied on to generate the efficient level of service and cost.
10. On the other hand, individuals and households require legal services less frequently. For them purchasing a house, writing a will or disputing a contract are relatively infrequent occurrences. Individual expertise and experience cannot be built up. These are the clients who suffer from an informational disadvantage with respect to the professional. Thus there is a *prima facie* case for regulation of the market for such legal services. However, the fact that individual clients lack expertise and information on quality does not mean that the market will inevitably fail. What if such information can be transferred between clients? If such experience can be easily transferred between purchasers, reputation will play a role in disciplining suppliers. In particular, if repeat purchasers can easily transfer their experience to inexperienced clients (by acting on their behalf in the selection of the professional, perhaps) information asymmetry may be overcome<sup>4</sup>.
11. The foregoing suggests that there is the potential for oversupply in the legal service markets for those categories of service sought by infrequent purchasers (usually individuals) where the mechanism of reputation or the use of experienced agents do not operate. In such cases an unregulated market cannot be relied upon to generate efficient levels of output and prices.

### **Regulating Legal Service Markets**

12. The discussion thus far suggests that behaviour in markets for professional services cannot be left to market forces. The market needs to be regulated, but how and by whom? Generally it has been the case that the regulation of markets

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<sup>4</sup> This is done through legal expenses insurers and through organisations such as trades unions but is not yet widespread in the UK.

for legal services has been given over to the profession itself through a professional body such as the Faculty of Advocates or the Law Society of Scotland. In many continental European countries this function is carried out by a national or local legal *Ordre* (or bar council).

13. It seems curious to many economists that the regulation of a market should be given over to those who act as suppliers in that market rather than to an independent body. They would argue that this effectively puts the members of the profession in the position of a cartel. Whilst there may be complex historical and political reasons for the common emergence of such arrangements some economists have argued that this system has arisen because it is the most cost effective. In particular, self-regulation may reduce the cost to the regulator of acquiring information and makes adjustments to regulations easier. However, these benefits need to be compared to the potential efficiency losses due to the potential for cartel-like behaviour. Even where regulation by a professional body is deemed an appropriate solution some have argued that the public interest would be protected best by having a number of professional bodies in competition with each other. A more philosophical approach is to view the right to professional self-regulation as implying a social contract between society and the profession which mitigates the moral hazard problem. However, the terms of the social contract may need to be reviewed from time to time to ensure that cartel-like behaviour has not evolved. Perhaps, the Committee's current inquiry and the report by the Director General of Fair Trading should be seen in this light. The question to be addressed is whether or not the current arrangements achieve the balance between correcting for information asymmetry and creating a cartel.
14. Commentators have identified a number of instruments typically used by self-regulators of the legal profession which may work against the public interest: (i) restrictions on entry; (ii) restrictions on advertising and other means of promoting a competitive process within the profession; (iii) restrictions on fee competition; and (iv) restrictions on organisational form. A separate although connected literature has developed on restrictions on the nature of fee contracts between lawyers and clients. This particularly focuses on contingent fee contracts. Although this is an aspect of the regulation of legal markets it is not discussed in detail in this submission.
15. Markets for legal services have been the subject of varying degrees of deregulation in U.S.A., Europe and elsewhere. In several jurisdictions there have been proposals by government to remove the general exemption of professions from anti-trust or restrictive practices legislation as currently proposed by the DGFT. Many of the instruments used by professions to regulate the market have been removed or restricted in use in recent years.

### **Restrictions on Entry to Professional Markets**

#### *Entry to the Profession*

16. Economists have criticised restrictions on entry to a profession or restrictions on providing a particular service by persons not recognised by a particular professional body. This can undoubtedly lead to supply shortages and hence the earning of substantial economic rents by members the profession. However, it not only requires a monopoly right for the profession over a particular service but also

numerical restrictions on entry to the profession. Thus an excess demand for the services of the profession is maintained. The monopoly right ensures that an adjustment in supply from outside the profession cannot take place in response to the profession's high incomes. However, entry to the legal profession has continued to grow in most jurisdictions<sup>5</sup>.

17. However, the absence of severe restrictions on entry to the profession in general does not necessarily imply competition in specific service markets. Professional service markets, particularly of a personal nature, tend to be spatially localised. What may be important are geographical restrictions on movement which imply barriers to entry into specific service markets for existing members of the profession. Historically, in a number of jurisdictions lawyers have been permitted only to appear before courts in the local area to whose bar they have been admitted (U.S.A., Belgium, Germany, for example). These restrictions are now in the process of being removed throughout the EU. Indeed through the implementation of the Establishment Directive it is possible for lawyers qualified in one member state to become full members of the profession in an other member state without further examinations<sup>6</sup>.
18. Even when there are no formal restrictions on practising in a given locality, other restrictions on behaviour such as prohibiting advertising may raise the cost of entry (through an inability to quickly generate goodwill) and thus constitute a barrier to entering a specific spatial market. Alternatively prohibitions on 'undercutting' or 'supplanting' existing suppliers may reduce the incentive to enter a local market where rents are being earned. Thus, although there may be no formal barriers to entering a local market, such markets may not be contestable.
19. Economists' empirical studies of the effects of such mobility restrictions for the legal profession are largely restricted to the U.S.A. They find, for example, that lack of reciprocity between state bar associations leads to lower numbers of practising lawyers and higher lawyer incomes. However, one thorough empirical study finds little support for the view that licensing restrictions affect the price of legal services<sup>7</sup>. This evidence suggests that it is what is described as 'market forces' which are most important.

#### *Professional 'Monopoly Rights'*

20. The preceding paragraphs have focused on controls on entry to the legal profession itself. Often, these have been accompanied by the granting of exclusive rights to the legal profession over certain services (e.g. conveyancing in the UK). However, there is little published work by economists estimating the effects of such 'monopoly rights' and the impact of their removal. This may be due, in part, to the absence of data sets which allow variations in such 'monopoly rights' either over time or location to be studied. Even during the current deregulation wave there has been little empirical work estimating the effects of relaxing 'monopoly rights'.

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<sup>5</sup> Of course what is relevant here is the growth in supply relative to demand

<sup>6</sup> Paradoxically this does not apply to mobility between the several jurisdictions in the UK. The implication of the Establishment Directive for the future organisation of law firms in the EU is analysed in Stephen (2000).

<sup>7</sup> Lueck, Olsen and Ransom (1995).

21. Para-professions sometimes exist alongside professions with the right to provide services which overlap with some of those provided by a profession. A series of studies<sup>8</sup> of the deregulation of legal services in England & Wales between 1985 and 1992 which focuses on conveyancing services provides some insights on the relaxation of a professions 'monopoly rights' and the impact of a para-profession. Until the mid-1980s solicitors had the exclusive right to provide conveyancing services for financial reward. This monopoly was revoked in 1985 and by 1987 the first licensed conveyancers (non-solicitors licensed to provide these services) were offering services in competition with solicitors in some areas of the country.
22. Solicitors surveyed in 1986 were reducing fees in anticipation of licensed conveyancer entry. Later surveys, however, provide a more complex picture of the effects of entry. Survey data for 1989 revealed that solicitors' conveyancing fees in a sample of locations where licensed conveyancers had entered were lower than where there were no licensed conveyancers and were less likely to involve price discrimination. These results appear to support the conventional view that 'monopoly rights' will operate to the disadvantage of clients of lawyers. A subsequent survey conducted in 1992 and covering the same locations as the earlier surveys produced results less conducive to the traditional economic view. The conveyancing fees of solicitors in markets where there were licensed conveyancers and the fees of licensed conveyancers had risen between 1989 and 1992 by more than those in markets where there were no licensed conveyancers; in addition licensed conveyancers' fee practices were more like those of solicitors than before. There is the suggestion that the threat of entry is a more powerful restraint on solicitors' behaviour than actual entry.
23. One explanation<sup>9</sup> of these results is that licensed conveyancers produce a limited range of services and therefore have the same interest as lawyer conveyancers in maintaining high fees. Furthermore the business risks faced by independent licensed conveyancers are greater than those faced by solicitors<sup>10</sup>. These results are a caution against the presumption that multiple professional bodies necessarily benefit consumers. However, the limited effects of removing a monopoly in a restricted field, as in this case, may not carry over to a more general removal of 'monopoly rights'.
24. It has been suggested that competition in certain legal service markets might be enhanced by repeat purchasers in these markets acting as agents for inexperienced clients rather than relying on competition between solicitors and licensed conveyancers<sup>11</sup>.

### **Restrictions on Advertising**

25. The second tool used by self-regulated professions has been the restriction or total ban on advertising by members of the profession. This has often been accompanied

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<sup>8</sup> Reported in Love *et al.* (1992), Love, Stephen and Paterson (1995), Paterson *et al.* (1988), Stephen, Love, Gillanders and Paterson (1993), Stephen, Love and Paterson (1995), Stephen and Love (1996).

<sup>9</sup> Provided by Stephen and Love (1996).

<sup>10</sup> Indeed in both 1989 and 1992 more licensed conveyancers were employed by solicitors' firms than were in private practice competing with solicitors.

<sup>11</sup> For example, Stephen and Love (1996) suggest that banks and building societies be permitted to provide conveyancing services through approved panels of solicitors. The DGFT suggests a similar provision in OFT (2001).

by restrictions on other aids to competition such as quoting of fees in advance of carrying out the work etc.. During the recent deregulation wave, restrictions on lawyer advertising have been relaxed to varying degrees in many jurisdictions.

26. Economic analysis of restrictions on advertising by professionals has been carried out from an economics of information perspective. Producer advertising is taken to be equivalent to a large amount of search by a large number of consumers. Consequently, it reduces price dispersions and enhances competition. Writers on the professions therefore argued that restrictions on advertising by professionals imposed by self-regulatory bodies were designed to reduce competition by increasing the cost of consumer search. Removal of such restrictions would enhance competition and be in the interests of efficiency. In the 1960's and 1970's severe restrictions on advertising by lawyers was quite widespread. These have been removed or relaxed due to pressure from competition authorities and governments and in some instances as a result of court decisions.
27. An extensive empirical literature<sup>12</sup> has developed on the restriction of advertising of professional services and what happens to fee levels when such restrictions are relaxed. The general thrust of the evidence from this literature is that restrictions on advertising increase the fees charged for the profession's services and that the more advertising there is the lower are fees. There are a number of limitations to these studies<sup>13</sup>. One particularly sophisticated study contradicts this result<sup>14</sup>.
28. The early empirical studies of advertising by members of the legal profession found that law firms which advertise, on the whole, charge lower fees than those that do not advertise. More recent studies find the stronger result that the more advertising by lawyers there is in a locality the lower are the fees charge by *all* lawyers in the locality (at least for certain transactions)<sup>15</sup>. However, UK studies<sup>16</sup> have found that this result is only valid for some forms of lawyer advertising. Most studies do not distinguish between different forms of advertising.
29. Critics of professional advertising frequently assert that advertising will drive down the quality of services provided. Economists have examined the relationship between advertising and quality. It has been shown formally that even if price can communicate no information directly about quality, it can do so indirectly because price serves as a positive signal of quality *when price advertising is allowed*. Price advertising is therefore welfare enhancing because it improves consumer choice. A problem arises, however, if price advertising is undertaken exclusively, or at least principally, by low-price/low-quality suppliers. In these circumstances price advertising becomes an adverse signal on quality. This is a general argument, and does not depend on price being a clear signal on quality. It is reasoned that consumers who are unable to assess quality *ex ante* (and possibly even *ex post*) and who observe a low price for a non-standardised service may assume that more knowledgeable purchasers have assessed the service as being of low quality. Professionals are keen to avoid such adverse signals on quality, and so it is

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<sup>12</sup> This literature is reviewed in Love and Stephen (1996).

<sup>13</sup> These are discussed in detail in Love and Stephen (1996).

<sup>14</sup> This is Rizo and Zeckhauser's (1992) study of physician advertising in the US.

<sup>15</sup> For example Schroeter, Smith and Cox (1987)

<sup>16</sup> Love *et al.* (1992) for England & Wales and Stephen (1994) for Scotland.



concluded that price advertising will be uncommon in most professions. Thus not only may advertising have an effect on quality, perceptions of quality may have an effect on the form of advertising chosen by professionals.

30. The hypothesis that non-price advertising will be much more common than price-advertising is supported by evidence from the legal profession in the UK and in the USA. Within two years of advertising being permitted, 46 per cent of English solicitors' firms had advertised in the previous six months; but only 2 per cent of firms had advertised the price of any service. Six years later (in 1992), the proportion of advertising firms had risen to 59 per cent, but price advertising was carried out by just 4 per cent of firms<sup>17</sup>. In Scotland, within three years of being permitted to do so, over half of Scottish solicitors' firms engaged in advertising, but less than 3 per cent advertised the price of any service<sup>18</sup>. A US Federal Trade Commission study of attorney advertising found similar low levels of price advertising across US states.

### **Regulation of Fees**

31. The third weapon in the armoury of the self-regulating profession is the regulation of fees. Traditionally fees have been subject to control by the profession itself, by the courts or by the state through mandatory fee schedules. In some jurisdictions these mandatory scales have been transformed into recommendations. During the recent deregulation wave even these recommendations have been swept away and replaced by the market. Most self-regulatory bodies, however, have retained powers to punish those who charge 'excessively' low fees for bringing the profession into disrepute. In Germany fees are still determined by State regulation. In Belgium and the Netherlands a recommended fee schedule is produced by the profession and in Belgium there is a recommended minimum.
32. Observers of professional self-regulation are highly critical of scale fees even when they are recommended rather than mandatory<sup>19</sup>. It is argued that this is tantamount to cartel-like price fixing. However, economists are generally sceptical about the ability of cartels to avoid their members selling output at prices below those agreed by the cartel. One of the few studies of the impact of recommended scale fees concerns conveyancing fees in Scotland and Ireland<sup>20</sup>. Examination of conveyancing markets suggests that they do not meet the conditions for successful detection of deviations from a national cartel price fixing. However, they do meet the conditions necessary for successful detection of deviations from local collusive agreements. It is clear from the data that for the Scottish sample firms and Irish firms in general the recommended fee was not seen as mandatory.
33. However, this does not necessarily mean that fees were determined competitively. Whilst the data rejects a 'national cartel' in both jurisdictions that for Ireland is consistent with, at least, two other explanations: (1) local market competition; (2) local cartels. The study was unable to differentiate between these explanations.

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<sup>17</sup> Stephen, Love and Paterson (1994).

<sup>18</sup> Stephen (1994).

<sup>19</sup> MMC (1970), LECG (2001), 63 – 65.

<sup>20</sup> This is reported in Shinnick and Stephen (2000). The Irish data analysed relates to 1994 and the Scottish data to 1984.

34. Neither does it mean that scale fees do not influence actual fees. The national recommended fee may provide a focal point against which solicitors discount. Interviews with Irish solicitors provide some support for this view<sup>21</sup>. Scale fees may be used as a focal point from which to discount providing an anchor to ensure that firms do not engage in 'destructive' competition.
35. This research cautions against sweeping generalisations based on the view that professional self-regulation generates cartel-like behaviour. The conditions in the markets involved will determine whether such 'cartels' can successfully police 'chiselling'. These conditions may be such that only more localised collusive agreements can be successfully policed. It also suggests that the often expressed view of policy-makers that 'recommended scales are tantamount to mandatory scales' is too strong.

### **Restrictions on Fee Contracts**

36. In many jurisdictions lawyers' fees are regulated by prohibiting certain forms of fee contract between lawyer and client. In particular, lawyers may be prohibited from entering into *contingent-fee* contracts with clients. Under such contracts the lawyer's fee is contingent on the outcome of the case. The most common form of contingent fee contract is that used between lawyer and plaintiff in many civil cases in the United States. If the case is lost the lawyer receives no fee but if it is won the lawyer receives a percentage of the damage award to the client. Such contingent-fee contracts are prohibited in many European jurisdictions. A modified form of 'no win no fee' contract is used in the UK under which the lawyer receives no fee if the case is lost but an uprating on the normal fee if the case is won which is not related to the quantum of damages.
37. From a theoretical point of view such fee contracts change the nature of the moral hazard problem. Since the lawyer carries all the costs he/she will no longer be willing to continue the case beyond the point at which costs start rising faster than likely benefits (in terms of enhanced fee). The client's interests may lie in continuing the case beyond this point.

### **Restrictions on Organisational Form**

38. Thus far in this paper we have discussed the relationship between lawyer and client abstracting from the organisational form through which lawyers provide their services. We have focused on lawyer-client relations and relations between the profession as a whole and others in society. In most jurisdictions lawyers provide their services to the public through 'firms'. However the nature and form of these law 'firms' is regulated in many jurisdictions. Lawyers are not free in their choice of organizational form. Some organizational forms such as multi-Disciplinary Practices (MDP) involving members of more than one profession are prohibited. In this section we evaluate the economic rationale for such regulation of organizational form. We begin by considering the factors which might influence a lawyer's choice of organizational form.
39. Increases in firm size can be justified on a number of grounds. The most general of these is that economies of scale can be captured the greater the output of the

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<sup>21</sup> Shinnick (1998).

firm. Every introductory textbook in economics lists sources of economies of scale. Principal among these are those emanating from specialisation of labour and more efficient use of capital. The former of these may apply to legal services but the latter is more doubtful, at least where it is physical capital that is involved. The physical capital requirements of legal services are quite small and are likely to involve limited economies of scale. Legal services are essentially human (rather than physical) capital intensive.

40. Provision of legal services through group practice allows specialization of lawyers in particular aspects of law, therefore, lowering the cost of providing services. Practices of lawyers with different specialties have the further benefit of risk spreading. Different specialties may face different business cycles and thus fluctuations in specialist income may be smoothed across the group. Furthermore, economies of scope may exist when a client has a range of legal service needs which can be serviced by specialists within the firm or when a legal problem has dimensions involving a range of specialties. Economies of scope are available to the sole practitioner but in the multi-lawyer firm they are combined with economies of specialization. The more complex the issues the more likely that specialists will dominate because the benefits of economies of specialization outweigh the economies of scope to the sole practitioner. Economies of scope or benefits from risk sharing in the multi-lawyer specialist-firm will lead to multi-lawyer firms dominating.
41. Similar arguments apply where the specialists involved go outside the legal profession in what is often referred to as Multi-Disciplinary Practice (MDP). It has often been argued that clients would benefit from economies of scope where a professional firm included lawyers, accountants, surveyors etc.; so called 'one stop shopping'.
42. Thus far we have only considered production costs. We have not considered agency costs which may arise from the asymmetry of information between client and lawyer. The distinction between diagnosis and service supply discussed earlier in this paper may help in the analysis. Earlier we pointed to the moral hazard problem that arises after a lawyer performs the agency function in diagnosing a client's legal problem and recommending a course of action. This arises because it is assumed that the same lawyer will perform the consequent service function. The agency cost increases when it is recognized that there are economies of specialization. Many circumstances will arise under which the lawyer performing the diagnosis function is not the least cost supplier of the service function required. This may be particularly so in the sole practitioner firm.
43. In a multi-lawyer firm it is, perhaps, more likely that there will be a specialist within the firm who is the least-cost provider of the service function. The probability of this may increase the more lawyers there are in the firm. However, the fewer the number of partners and the more specialized the service function required the more likely that the firm will not be the least-cost supplier. This may even be the more so if the firm is an MDP. Nevertheless, it is likely that the lawyer performing the diagnostic function will pass the client to a specialist within the firm. First, because the lawyer providing this function will share in the income of the firm generated from the provision of the specialized services; secondly

because recommending the client to another firm may mean that the client's future business will also be lost. Thus the case for MDPs rests on whether the benefits from economies of scope exceed the gains from economies of specialisation.

44. Those within the legal profession who argue against MDPs are often concerned with the question of which professional rules or ethics should be applied to members of the MDP. It is observed that in the European Jurisdictions where MDPs are permitted the commercial law market is increasingly dominated by the legal arms of the major international accounting firms<sup>22</sup>.
45. In many jurisdictions there are restrictions on the organisational forms which can be adopted by providers of legal services. Traditionally these restrictions appear to have been motivated by a desire to keep at arm's length commercial or profit considerations on the part of lawyers, reflecting the moral hazard problem which has been a central consideration throughout this paper. Thus for many years lawyers in most jurisdictions could only operate as sole practitioners or in partnerships with other lawyers and could not incorporate. Furthermore, in Scotland providers of legal services are divided into two distinct professions with their own professional bodies and self-regulatory functions: solicitors and advocates. Until 1990 in the UK only barristers (advocates) could appear before the higher courts and they could only take instructions from a solicitor and not directly from a client. There is a limited economic literature which examines such restrictions on organisational form. We first examine the issues surrounded the divided profession before moving on to the issue of firm size and organisational form.

#### *A Divided Profession*

46. In England & Wales, Northern Ireland and Scotland as well as the Republic of Ireland and certain states in Australia what is elsewhere a single legal profession is split into two branches: solicitors and advocates/barristers. Solicitors provide legal advice to the public on the whole range of legal matters and have rights of audience in the lower courts. Advocates/barristers have rights of audience in the higher courts and provide consultancy services to solicitors. The rules governing each of the professions prohibits its members from practising as members of the other profession. Judges in the higher courts are drawn almost exclusively from the ranks of advocates/barristers. Although rights of audience in the higher courts in Scotland and England & Wales have changed recently as a consequence of legislation to allow solicitors who meet certain tests of experience in advocacy in the lower courts to appear in the higher courts, there has been no move to fuse the professions. From an economic perspective the question is whether the division into two professions is efficiency enhancing or is a mere restrictive practice.
47. It should be noted that specialisation in advocacy may exist within a fused profession. Within law firms some practitioners may specialise in court advocacy while others specialise in diagnosis and case management. Some firms may specialise in advocacy, particularly in the criminal field. Outside the criminal field in-house advocates may lack expertise in a particular area of law in spite of having

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<sup>22</sup> Stephen (2000) provides an explanation of this in terms of the internal efficiency of law firms in various jurisdictions.

enhanced advocacy skills. The issue then becomes whether or not any benefits from formally separating the roles outweigh the costs.

48. The separation into two professions can be analysed as a prohibition on vertical integration between successive stages in a production process: the preparation of a case and its prosecution through advocacy in the courts<sup>23</sup>. The conflict between the diagnostic function and the service function is seen to be particularly severe due to the large benefits which accrue from specialisation in trial advocacy. The existence of a cadre of specialist consultants and litigators (advocates) removes the temptation to supply higher cost in-house advocacy. Not only this, it may provide competition in the downstream market. Thus one benefit of a divided profession is that the client gets higher quality advocacy than would be available from an in-house advocate. However, this benefit is not costless. It may be argued that the cost will be the dead-weight loss to sophisticated buyers of legal services who do not require the intermediation of a solicitor. An additional cost might be the differential transaction costs associated with employing both solicitor and barrister rather than two solicitors within the same firm. This would be the case if economies of scope existed when the two legal advisors were from the same firm/office. An evaluation of the division in the profession cannot be resolved on these *a priori* arguments. It is a question of the relative magnitudes of the costs and benefits. However, their empirical measurement is fraught with difficulty.
49. Others clearly doubt that the balance lies in favour of division and adduce additional points against division<sup>24</sup>. If division were efficient why is it that when fusion is not prohibited we invariably observe fusion? Further, enforced division removes choice from informed consumers who might prefer lower quality but cheaper in-house advocacy to high quality but high price external advocacy. On the other hand it may be observed that in some Australian states where there is fusion there is *de facto* separation as some specialist pleaders operate, in effect, as barristers.
50. There are external effects which may have a bearing on the division issue. The first of these is that the division into two specialist branches allows more effective supervision of lawyer behaviour (particularly in the case of advocates) due to a 'club' effect. However, particularly in a small jurisdiction, this may lead to a conservative approach which is hostile to innovation. The division may also allow the monitoring of the performance of the members of each profession by the members of the other. A further external effect is public capital formation through the production of high quality precedent. The existence of highly specialised and qualified advocates should produce better argued cases and more valuable precedent. Furthermore the recruitment of the judiciary from the ranks of the best of these specialist advocates, not only ensures that those recruited to the bench have proven their worth as trial lawyers but should further ensure high quality precedents. A final external effect is the possible lowering of the cost of judicial administration. Here the main beneficiary is not the client but the trial judge. Poor advocacy places a burden on the trial judge to ensure that the decision reached is not influenced by inadequate advocacy. With highly specialised and skilled advocates this problem does not arise. Advocates can also act as gatekeepers to

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<sup>23</sup> Bishop (1989).

<sup>24</sup> Ogus (1993).

the courts. They ensure that cases are sifted and well-prepared before reaching the court thus reducing the cost of adjudication.

51. It is not easy to find empirical evidence to test these propositions concerning the separation of the legal professions. What there is tends to be informal and highly qualitative. It will only be where the stakes are high that the higher cost of specialisation may be worth incurring. This implies that rights of audience in lower courts should not be restricted to specialist advocates. It is an empirical question where the line should be drawn.

#### *Sole Practitioners, Partnerships and Incorporation*

52. A more common organizational restriction in many jurisdiction is that providers of legal services must operate as independent providers or in partnership only with other qualified lawyers. Even where incorporation is permitted restrictions are frequently imposed maintaining unlimited liability and that the directors of the firm must all be lawyers. However, some US states permit incorporation under limited liability and a form of limited liability partnership has been recently developed in the UK.
53. Some writers have argued that professional partnership accompanied by unlimited liability is a solution to the moral hazard problem posed by the asymmetry between client and professional<sup>25</sup>. The willingness of one professional to risk his or her wealth by entering into such a partnership with another professional signals to clients the trustworthiness of members of the partnership and provides a guarantee that there will be mutual monitoring among partners. However, it has been argued that little mutual monitoring takes place within UK law firms and that *ex ante* screening of prospective partners is likely to dominate *ex post* monitoring<sup>26</sup>. The persistence of sole practitioner firms in legal practice also seems to run counter to this signalling function of partnership: around 50% of law firms in the US are sole practitioners and around 40% of solicitors' firms in England & Wales. However, the proportion of sole practitioner firms in the US has been declining for a number of years.

#### **Conclusions**

54. This paper has reviewed the extensive economic literature on the regulation of the legal profession. The case for regulation has been seen to be based on the moral hazard and adverse selection problems which arises from the information asymmetry between the lawyer and the infrequent user of legal services. The justification for self-regulation is seen to be based on reducing the direct costs of regulation. Nevertheless, much of the economic literature on self-regulation sees it working in the interests of the members of the profession by raising fees and professional incomes.
55. A number of instruments through which self-regulation operates to restrict competition have been discussed above. Theoretical work by economists tends to point to these working in the interests of the profession and against the interests of clients. The empirical literature testing such predictions is limited but produces

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<sup>25</sup> Fama and Jensen (1983a, b)

<sup>26</sup> Stephen and Gillanders (1993).

mixed support for the theoretical predictions. For example, whilst there is some support from aggregate data for the view that restrictions on entry to the legal profession lead to higher incomes for lawyers, the microeconomic evidence on the effect of restrictions on fees runs counter to theory. The evidence from the removal of the conveyancing monopoly in England & Wales is at least ambiguous. Similarly, the limited empirical evidence on recommended scale fees for solicitors suggests significant deviations from these scales. The evidence on the effects of restrictions on advertising tends to support the theory, although it has been suggested that when different types of advertising are considered the evidence is less unambiguous. On the issues of contingent fees and restrictions on organisational form the empirical evidence is very limited.

56. The theoretical literature, on the whole, suggests fairly strong recommendations to policymakers regarding self-regulation. In recent years in the UK policymakers seem to have been persuaded by these arguments<sup>27</sup>. On the other hand, the limited empirical evidence does not always support such strong theoretical predictions. The question to be answered is whether the balance between the interests of consumers and the interests of the profession is still tilted too far towards the profession.

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<sup>27</sup> OFT (2001)

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