
The regulation of quality in the market for legal services: Taking the heterogeneity of legal services seriously

Camille Chaserant*, Sophie Harnay†

Abstract

Reviewing the public and private interest approaches to the regulation in the market for legal services, this article points out their mutual inconsistency and their empirical and theoretical limits. It then argues that heterogeneous legal services should be considered when (de)regulating the market. Drawing upon the distinction between credence, experience, and search goods, we distinguish various legal services according to the degree of asymmetric information on quality characterizing the relationship between lawyers and clients. We argue that the heterogeneity of legal services impacts on the desirable level of regulation, implying that not all the markets for legal services should be regulated or, conversely, deregulated. Furthermore, when regulation is needed, the degree of asymmetric information between the regulatory authority and lawyers partly determines the choice between external and self-regulation.

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Introduction

During the last decade, the DG Competition of the European Commission (EC) has promoted the “need to modernise the professions in Europe” within Member States (EC, 2005, p. 11), including lawyers’ services¹. Such modernisation of legal services involves enhancing competition in this market “usually characterised by a high level of regulation” (EC, 2004, p. 3). Indeed, in all European countries, the provision of legal services is regulated by a mix of governmental regulation and self-regulation by a professional body. Although applicable rules and their scope may vary across countries, in all of them, becoming a lawyer requires to fulfil education and training obligations and to comply with rules of professional conduct. Most of these rules consist of

* Camille Chaserant, Université du Havre, and Université Paris Ouest Nanterre La Défense, EconomiX – CNRS UMR 7235; 200, avenue de la République, 92001 Nanterre Cedex, France. E-mail: camille.chaserant@univ-lehavre.fr

† Sophie Harnay, Université Paris Ouest Nanterre La Défense, EconomiX – CNRS UMR 7235; 200, avenue de la République, 92001 Nanterre Cedex, France. E-mail: sophie.harnay@u-paris10.fr
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¹ Precisely, the EC reports focus on six professions: lawyers, notaries, engineers, architects, pharmacists and accountancy (including tax advisers).

exclusive rights to perform specified services, of limitations on the pricing of services, on advertising, and on forms of business organization.

Now, the EC (2004, p. 7) observes that “in countries with low degrees of regulation, there are proportionally higher numbers of practising professionals generating a relatively higher overall turnover”. It then considers that “[a] light regulation is not a hindrance but rather a spur to overall wealth creation”, consequently urging Member States “to reform or eliminate those rules which are unjustified” (*ibid.*, p. 4). A greater competition is expected “to lower prices, to increase quality or to offer innovative services” (*ibid.*, p. 7), and to improve “the availability of better and more varied professional services, [that] could increase the demand, which in turn would have a positive impact on job creation” (EC, 2005, p. 4). The OECD (2007) adopts a similar point of view, stating that “the quality and the competitiveness of professional services have important spill-over effects since they affect the costs of necessary inputs for the economy and business” (OECD, 2007, p. 17).

These reports both rest on and result in an abundant economic literature on legal services². Using the traditional law and economics analyses of regulation, they build upon two main approaches, respectively the public interest and private interest approaches to regulation (Den Hertog, 2000; Ogus, 2004). First, following up the public interest point of view, both reports underline that “certain regulations are in the public interest as a remedy to market failures”. Second, they next embrace the private interest line, stressing that “regulation and self-regulation at times appear to serve mainly the private interests of the profession” (OECD, 2007, p. 10). Recalling that competition law applies to professions, they consequently deplore rules on fees, advertising and business structures, as well as the existence of exclusive rights and entry regulations.

This article criticizes this way of analyzing the regulation of legal services. Indeed, the public and the private interest approaches do not only lead to opposite theoretical propositions but also to policy recommendations that are limited to the sole debate between regulation and deregulation. Such a debate may nevertheless be endless. Indeed, according to the public interest view, market failures justify regulation in the market for legal services. Now, according to the private interest approach, regulation may be captured by private interests. Furthermore, the public interest analysis usually pays little attention to asymmetric information between regulator and regulatees. It thus fails to analyze its consequences on the efficiency of regulation. Besides, the private interest approach does not explain how the market for legal services, once deregulated, could mitigate market failures and achieve efficiency. Finally, “the public interest approach, which assumes that law is made exclusively to generate aggregate social welfare is too naive; and the private interest theory which relates it entirely to the furtherance of personal and group welfare is excessively cynical” (Ogus, 2004, p. 42). In other words,

² E.g. Bishop (1989), Garoupa (2004), Maks and Philipsen (2005), Stephen and Love (1999), Stephen and Burns (2007), Trebilcock (2001), Van den Bergh (2008).

because the public and private approaches mainly endorse standard tools that have been developed for the study of other goods and services markets in the fields of public and industrial economics, they also fail to account for the specificity of legal services.

Indeed, legal services are usually characterized as credence goods, that is, goods for which consumers are unable to assess quality either *ex ante* or *ex post* (Darby and Karni, 1973). As shown by Dulleck and Kerschbamer (2006), market mechanisms thus perform poorly, and regulation may be required to guarantee quality. In the market for legal services, a client may not be able to ascertain that a lawyer has provided him or her with the optimal service, making it necessary to regulate the provision of legal services. Now, not all the legal services fall within the category of credence good but some of them rather exhibit search or experience characteristics. Considering the ontological diversity of legal services (Karpik, 2010), we suggest that different governance structures should be associated with different types of legal services, calling for a pluralistic regulation of the market for legal services. Hence, we argue that “one-size-fits-all” deregulatory recommendations may not be relevant in the legal market, but various types of institutional arrangements governing the regulation of dissimilar legal services should rather be distinguished. This, we think, should be taken into account when discussing the deregulation of legal services in the EU.

The article is organized as follows. The first section presents the public and the private interest approaches to the regulation of legal services successively and discusses some of their empirical and theoretical caveats. The second section first introduces the distinction between legal services with credence, experience and search characteristics, and compares it with the distinction commonly made in the law and economics literature between occasional and regular consumers. It then argues that market mechanisms like individual reputation may perform well with search or experience legal services, whereas services with credence characteristics may require a higher level of regulatory protection. The third section argues that the degree of asymmetric information between the regulatory authorities and lawyers partly may determine the choice of the best institutional arrangement.

1. The traditional approaches to the regulation of the market for legal services

Traditionally, the public interest approach explains the regulation of legal services by market failures (1.1). By contrast, the private interest approach sees the legal profession as a producers’ cartel oriented towards the promotion and defence of its members’ interests (1.2). Empirical studies are inconclusive and do not help to decide between incompatible regulatory recommendations (1.3).

1.1 The public interest approach

The public interest approach focuses on asymmetric information between lawyers and clients (1.1.1), externalities, and public goods (1.1.2). Following up that line, it accounts for most regulations that currently apply in European countries (1.1.3).

1.1.1 Asymmetric information between lawyers and clients

Since Arrow (1962), legal services are considered to fall within the scope of “the knowledge economy”. Indeed, lawyers are experts whose specialized skills and knowledge result from formal learning and the use of abstract concepts (Freidson, 1986). Consumers do not have such skills and are thus less informed than lawyers. Consequently, the lawyer-client relationship is flawed by information asymmetries. First, a moral hazard problem arises from the client’s lack of information about the type of service that is required for his or her case. Second, adverse selection occurs since the client also lacks information about the quality of the legal service.

More precisely, the client can observe the action of the lawyer but does not know whether this action is appropriate to his or her case. Hence, the lawyer may engage in opportunistic behaviour and may not deliver the optimal service to the client. He or she may encourage clients to purchase more services than necessary, generating a supplier-induced demand. (S)he may also overtreat the case at hand in order to charge a high price, thereby delivering excess quality to a client whose interests would have actually required a simpler service. Moral hazard is increased by the fact that a lawyer performs two functions (Quinn, 1982). (S)he first performs an agency function when making a diagnosis, *i.e.* when defining the client’s needs and determining the required legal services. Second, (s)he also performs a service function by providing the previously determined services³. Hence, the problem is here to grant lawyers with the incentives to behave in the best interest of their clients at both stages.

Furthermore, because consumers are not able to assess the quality of legal services *ex ante*, adverse selection also occurs. Lawyers providing low-quality services are able to charge low prices, whereas lawyers supplying high quality charge high prices. However, consumers are not willing to pay high prices for unobservable quality. According to the well-known “lemons” problem (Akerlof, 1970), the “good” lawyers are driven out of the market by the “bad” ones.

Hence, adverse selection occurs because of consumers’ lack of information *ex ante* on the quality of legal services, and moral hazard occurs because they still lack information *ex post*: they are not able to assess whether the price they have paid matches the quality they have purchased. Asymmetric information therefore yields market

³ In the UK, the two functions have been split between solicitors and barristers, in order to reduce hazard moral effects. Barristers are not hired by clients directly but are instead instructed by solicitors, who cannot appear before the higher courts. However, such a separation is costly: regular consumers may need the sole service function (implemented by a barrister) without the intermediation of a solicitor. Therefore, the solicitors’ access to courts has been widened in the mid-90’s (“solicitor advocate”).

inefficiencies, which justifies regulations intended to improve and guarantee the quality of services.

1.1.2. Other public interest motives: external effects and public goods

The lawyer-client relationship also creates externalities that are at the root of further market failures. Indeed, the actions undertaken by lawyers on the account of their clients may impact on third parties. For example, a low-quality advice on a labour contract provisions may be detrimental not only to the manager requiring the lawyer's advice, but also to his or her employees and subcontractors. Furthermore, lawyers' activities create externalities on the whole legal system (Grajzl and Murrel, 2006). High-quality services enhance legal security and promote an efficient administration of justice, for the benefit of the whole society. Conversely, low-quality services increase the costs of justice, which are borne not only by lawyers and clients, but also by all taxpayers. Since the market price does not take neither the costs of negative externalities nor the benefits of positive externalities into account, unregulated markets usually lead to an excessive supply of low-quality services while high-quality services are under-supplied. Hence, regulating the quality of legal services allows the internalization of the externalities associated with the lawyers' activities.

Related to this argument is the idea that regulation is all the more needed as justice is a public good. Indeed, the proper administration of justice and maintaining the rule of law are both essential foundations of a democratic society (Scassellati-Sforzolini, 2006)⁴. In this view, litigation services create externalities on the development of case law, which may be considered as a public good because it yields free information available to all in posterior similar cases (Landes and Posner, 1976). Here again, absent quality regulations, unregulated competition does not guarantee that the optimal amount of public good be produced.

Eventually, market failures generate a reduction in quality. Self-interested lawyers are indeed expected to rationally reduce their effort and to supply low-quality services (moral hazard), thereby pushing "good" lawyers out of the market (adverse selection). Such a cheating on quality is detrimental not only to clients but also to the society as a whole, through the production of negative externalities affecting the quality of both law and the legal system. Hence, according to the public interest approach to regulation, free market may not be the optimal arrangement in the market for legal services. Rather, regulation may be recommended.

1.1.3. Professional regulations against market failures

Although the public interest approach justifies the need for regulation in order to mitigate market failures, it remains very evasive about the specific regulations that

⁴ The resolution adopted by the European Parliament on the legal professions and the general interest in the functioning of legal systems (23 March 2006) states that "any reform of the legal professions has far-reaching consequences going beyond competition law into the field of freedom, security and justice and, more broadly, into the protection of the rule of law in the European Union" (P6_TA(2006)0108).

should be used for that purpose. Nonetheless, four main classes of professional rules may offer remedies against market failures: entry requirements and monopoly rights, fees regulation, advertising limitations, and rules on business structures and multidisciplinary devices.

Entry requirements and monopoly rights are expected to enhance the quality of legal services. Indeed, screening and signalling are solutions commonly prescribed to reduce adverse selection (Spence, 1974). Diploma, minimum education, training requirements, and professional standards are means intended to signal the high quality of services delivered (Leland, 1979; Ribstein, 2004). In many European countries, market entry also involves reserved rights to provide certain services⁵. All these qualitative restrictions aim at ensuring that only professionals with appropriate competences deliver legal services. This does not ensure however that they *do* provide the optimal effort level once in the market. Some additional mechanisms are therefore needed.

More developed in the literature is the issue of fee regulations that also deals with the effects of adverse selection and moral hazard⁶. According to Van den Bergh and Montangie (2006), fee scales ensure lawyers providing high quality and bearing high costs to get high fees rewarding their effort. Recommended or fixed prices also inform consumers about the average cost of legal services, thereby improving their information (Rizzo and Zeckhauser, 1992; Stephen and Burns, 2007). Prohibition of contingent fees in most European countries also intends to protect consumers against lawyers' opportunism. Extensively used in the United States in civil cases, contingent fees entail the lawyer's fees to be paid only in case of a successful lawsuit⁷. The lawyer receives no fee if the case is lost, but receives a percentage of the damage awarded to the client if it is won. Then, the lawyer bears all the costs of the legal action. Although the law and economics literature often considers contingent fees as a mean to achieve incentive compatibility between lawyer and client, such a fee design implies a partial transfer of litigation rights that may lead to a conflict of interests for the lawyer, since (s)he is expected to have no personal interest in cases⁸. *Ex post* control mechanisms of fees can

⁵ In France for instance, lawyers have the duty to register within a local bar association in order to appear before the courts of the same geographic area. Although it restricts geographical mobility, such a rule is expected to enhance proximity and confidence by promoting trust-based relationships.

⁶ See Danzon (1983), Lynk (1990), Gravelle and Waterson (1993), Rubinfeld and Scotchmer (1993), Rickman (1994), Hay (1996), Emons and Garoupa (2006).

⁷ Although contingent fees are prohibited in the majority of European countries, complementary fees are frequently observed. They are distinguished from contingent fees inasmuch as they are paid before knowing the outcome of the lawsuit.

⁸ Prohibition of contingent fees is also put forward to prevent an increase in unnecessary litigation. Nevertheless, the economic literature does not come to any clear-cut conclusion on this issue. Contingent fees improve access to justice for people who may not be able to pay *ex ante* for a lawyer otherwise. They expect to win the lawsuit, and then to be able to pay *ex post* (e.g. class actions in the

also be observed, like the capacity granted to courts to revise excessive fees charged by a lawyer downwards.

Regulating ownership structures of law firms also reduces moral hazard issues (Fama and Jensen, 1983). Indeed, when they are the owners of legal firms, lawyers become the residual claimants of their effort. This gives them incentives to supply high-quality services and to supervise their staff efficiently. According to Matthews (1991) that unlimited liability structures and restrictions on capital holdings yield the least expensive and most effective incentives to discipline lawyers' behaviours.

Lastly, regulation of advertising protects consumers against false and misleading advertising (Attanasio, 1984). Such a regulation relies on the persuasive conception of advertising according to which advertising mainly creates artificial product differentiation, increasing barriers to entry, and thereby reduces competition in the market (Galbraith, 1967; Solow, 1967). Inasmuch advertising most frequently focuses on prices rather than on quality, allowing lawyers to advertise may generate strong competition over prices at the expense of quality. According to Rogerson (1988), the costs associated with this lower quality might easily exceed the benefits from lower prices.

Finally, not only does the public interest approach explain the regulation of legal services by market failures at a general and theoretical level, but it also accounts for most rules actually applying to the legal profession in Europe.

1.2. The private interest approach to the regulation of the market for legal services

The private interest approach to the market for legal services sees the legal profession as a producers' cartel oriented towards the promotion and defence of its members' interests (1.2.1). In that view, lawyers' collusive behaviours impede competition on the supply-side of the market and regulations artificially create rents accruing to the members of the profession (1.2.2).

1.2.1. The current rules serve private interests

By contrast with the public interest approach to regulation, the private interest approach emphasizes the costs associated with regulations in the market for legal services. Thus, lawyers' education, training obligations, and the rules of professional conduct are analyzed as the outcome of rent-seeking behaviours, whose alleged purpose is to create barriers to entry into the market and to organize a supply shortage, therefore resulting in higher prices and the earning of supra-competitive incomes for incumbent lawyers, at the expense of consumers.

United States). Some authors thus associate contingent fees with more needless litigation, while others defend the opposite view (Miceli and Segerson, 1991; Rubinfeld and Scotchmer, 1993; Gravelle and Waterson, 1993; Miceli, 1994).

From that standpoint, educational requirements limit the entry into the market to the number of qualified practitioners, creating unjustified barriers. Lawyers' membership to a single local bar association limits their mobility and restricts the entry into specific local markets (Pashigian, 1979). Monopoly rights over particular services, such as representation and pleading, and the French "postulation", also prevent entry from competitors. It thus reduces the set of available substitutes from para-professionals, thereby increasing lawyers' rents. Dismantling these barriers to entry into the market for legal services may increase competition and enhance social welfare. The argument is twofold. On the one hand, removing monopoly rights and relaxing educational requirements are expected to enhance supply and to lower prices. On the other hand, it may also solve the excess-quality problem – from this latter perspective, the entry of lawyers delivering low-quality services at lower prices is welfare-improving (Shaked and Sutton, 1981).

Restrictions on fees are also interpreted through the lens of cartel-like behaviours as an instrument to reduce price competition among lawyers (Arnould and Friedland, 1977). Most economists consider that fee schedules, either mandatory or recommended fee scales, prevent lawyers benefitting from lower costs from engaging in price competition and innovation (Domberger and Sherr, 1989, 1992). Also, the prohibition of contingent fees deprives consumers from using an efficient incentive device in a moral hazard situation: as the lawyer receives no fee if the case is lost, (s)he is encouraged to exert the right amount of effort necessary to win that case.

Restrictions on advertising also seem anticompetitive as they increase search costs for consumers (Benham and Benham, 1975). According to the informative conception of advertising, it provides consumers with the necessary information enabling them to make rational choices. Removing restrictions on advertising is therefore expected to improve consumers' access to information on legal services and to reduce price dispersion (Telser, 1964; Nelson, 1970; Love and Stephen, 1996).

Finally, restrictions on organisational forms of law firms are considered as inefficient because they are costly and deter innovation. Opening the capital of law firms to third parties could yield a higher specialisation of lawyers' labour, generating scale and scope economies. A more efficient use of capital consequently increases concentration and the size of law firms, generating economies of scale, and multidisciplinary practices yield economies of scope.

1.2.2. Self-regulation as the ultimate form of regulatory capture

Consistent with the theory of capture (Stigler and Friedland, 1962; Stigler, 1971; Posner, 1974; Peltzman, 1976), the private interest approach underlines that lawyers, acting as a well-organized industry, exert pressure on the regulatory authorities issuing professional rules. Regulations may thus be the outcome of a successful pressure intended to obtain anti-competitive protective measures. Following up this line, self-regulation facilitates lawyers' rent-seeking behaviours. Indeed, it may be all easier for lawyers to benefit from favourable rules as the legal profession itself issues those very regulations that apply to its members. Self-regulation is thus the ultimate form of

regulatory capture, leading to inefficient market equilibrium (Shaked and Sutton, 1981; Ogus, 1995; McLean, 2004). Commonly endorsing this negative view of self-regulation, the economic literature on legal services mainly analyzes professional bodies such as bars, orders, and law associations, as producers' organizations dedicated to the promotion and the defence of their members' private interests (Kay and Vickers, 1988; Van den Bergh and Faure, 1991; Van den Bergh, 2008).

Therefore, the private interest approach emphasizes the social cost of regulation. Regulation, and all the more self-regulation, distorts competition in the market, thus creating a deadweight loss for the society as a whole. EC recommendation to deregulate Member States' markets for legal services rests on this ground. The restrictive effects of self-regulation on competition also account for partial deregulation in the U.S. and British markets for legal services (Bishop, 1989; Stephen, Love and Paterson, 1994; Clementi, 2004; Stephen and Burns, 2007). Eventually, the same economic reasons that explain deregulation in all markets for goods and services also explain the deregulation of the market for legal services, and the arguments justifying the deregulation of the legal profession hardly depart from those developed in the fields of industrial organization and competition policy for standard goods and services. Along this line, lawyers' professional bodies and associations are the exact counterpart of cartels in other industries⁹, and this justifies their dismantling.

Finally, the policy recommendations issued by the EC or the OECD on the legal profession frequently stick to the old opposition between the public and private interest theories of regulation. They provide incompatible regulatory prescriptions that lack any definitive empirical support and they both disregard actual institutional arrangements.

1.3. Beyond both approaches – empirical limits and theoretical flaws

The public and private interest approaches to the market for legal services support incompatible policy recommendations. Whereas the public interest approach promotes regulatory intervention as a remedy against market failures, the private interest approach mostly endorses deregulatory recommendations intended to enhance competition and efficiency in the market for legal services. Now, empirical studies provide no conclusive evidence on the effects of professional regulation on competition in the legal market. Therefore, they are poorly helpful in deciding between the two sets of regulatory propositions (1.3.1). Furthermore, we show that both the public and the private interest approaches do not pay enough attention to the nature of the institutional arrangements needed to face asymmetric information (1.3.2).

⁹ The conflicting interests at stake in the legal profession, *e.g.* between small and big law firms, are not considered as a factor of instability for the "cartel" of lawyers. On the contrary, "[T]he legal professions satisfy all criteria to be qualified as powerful interest groups: they are small, well organized and able to cope with the free riding problem through compulsory membership of the professional bodies" (OCDE, 2007, p. 25).

1.3.1. Inconclusive empirical evidence

It is beyond the scope of this article to review the empirical literature on the effect of professional regulation exhaustively¹⁰. Our purpose here is only to point out the ambiguous effects of regulatory and deregulatory measures in the real world, stressing that no empirical evidence supports either approach conclusively.

Empirical studies generally show higher salaries for professionals when professions are regulated (Kleiner, Gay and Green, 1982; Kleiner, 2000). Lawyers are no exception in that view. Indeed, where practising lawyers are less numerous, legal fees are usually higher (Abel, 1989; Pashigian, 1977). For instance, Lueck, Olsen and Ransom (1995) find that the higher the rates of admission (to the Bar exam), the lower the legal fees. Pagliero (2010) observes that incomes earned by new entrants into the legal profession are all the more important since the profession is more regulated. He also finds that professional licensing increases salaries and decreases the availability of lawyers, therefore reducing consumers' welfare (Pagliero, 2011). Furthermore, Stephen and Burns (2007) find an increase in the number of solicitors in the UK following the liberalization of the market for legal services in the 1980s.

However, an increasing number of lawyers does not imply more competition in the market (Lueck, Olsen and Ransom, 1995; Stephen and Love, 1999). Indeed, qualitative entry restrictions are not unavoidably associated with a reduced number of lawyers. As most legal services tend to be personalized and spatially localized, mobility restrictions rather than entry requirements may lead to a reduced number of suppliers. Hence, the effect of deregulation on the quality of services may be less than expected.

Moreover, little empirical work has been done to estimate the effects of professional monopoly rights on social welfare. Domberger and Sherr (1989) find that the conveyancing prices fell in England following the removal of the exclusive rights of solicitors to provide such services in the mid-80s. According to Paterson *et al.* (1988), solicitors then reduced their fees to adapt to the entry of new conveyancers into the market. However, once the latter ended, a new raise put the 1992 prices back to their pre-reform level. According to Stephen, Love and Paterson (1994), this suggests that solicitors and new conveyancers share a collusive interest in maintaining fees at a high level.

The few empirical studies on fee regulation mostly focus on fee scales. The pioneering work of Arnould and Friedland (1977) states that, for a simple transaction, lawyers' incomes increase with the recommended fees. Yet, Shinnick and Stephen (2000) show that recommended fees are not tantamount to mandatory fees, and may thus not preclude competition. They rather provide a focal point for professionals to discount and collude at a lower level. According to Stephen and Love (1999, p. 1001), "the limited empirical evidence available suggests that the strong conclusions on scale fees

¹⁰ Stephen and Love (1999) provide a very complete review of empirical studies in the market for lawyers.

arrived at on the basis of *a priori* reasoning by academic observers and competition authorities reported above may not have empirical support”.

Empirical works on legal services advertising also find mixed results¹¹. Consistent with the informative conception of advertising (see *supra*), studies on routine legal services find a negative correlation between advertising and prices (Cox, De Serpa and Canby, 1982; Schroeter, Smith and Cox, 1987; Stephen, 1994). Now the impact of advertising on quality appears much more ambiguous. Whilst some empirical studies find a negative relationship due to adverse selection issues (Murdoch and White, 1985; Cox, Schroeter and Smith, 1986), other works find that the price reduction allowed by advertising is not matched with a decrease in quality (McChesney and Muris, 1979a, 1979b; Domberger and Sherr, 1989). However, conclusions strongly depend on how quality is measured (Love and Stephen, 1996). In addition, advertising effects are analyzed without any further investigation on the relevance of advertising to inform consumers, although Well, Smith and Meyer (1980) find that advertising may not be a key factor for consumers to choose an attorney.

Lastly, only few studies deal with the regulation of business organizations. Comparing states enforcing various liability regimes (*i.e.* limited *vs.* unlimited liability), Carr and Mathewson (1988) find a smaller size of law firms under the unlimited liability regime. They conclude that unlimited liability increases the cost of capital, explaining why limited liability may be an attractive system, as it reduces the cost of partnerships.

Thus, the limited empirical evidence available on the effect of the regulation of the legal market does not allow deciding between the opposite prescriptions promoted by the traditional approaches to the regulation of legal services. Furthermore, we argue that these approaches do not pay sufficient attention to the institutional arrangements supporting their policy recommendations.

1.3.2. Asymmetric information and institutional regulatory arrangements

On the one hand, the public interest approach justifies regulation by market failures, especially by asymmetric information between lawyers and clients, acknowledging characteristics of legal services that create moral hazard and adverse selection issues. This approach, however, takes the efficiency of regulation for granted, assuming that the regulatory authorities maximize social welfare. Hence, “*who regulates*” is not really an issue: insofar as the regulatory authority is assumed to be both perfectly informed and interested in the sole social welfare, it may as well be the government, some independent agency (either public or private), or the profession itself. Yet, by focusing on asymmetric information between lawyers and clients, the public interest approach overlooks asymmetric information between the regulatory authority and the

¹¹ Most empirical works on advertising have been made right after 1977, following *Bates v. State Bar of Arizona*, 433 U.S. 350, when the Supreme Court allowed lawyers to advertise their services. Additional works have been made following the deregulation of advertising in England and Wales at the beginning of the 1980s. Recent studies on advertising are scarce.

regulatees that may lead to inefficient regulation. Thereby, it fails to encompass major recent advances in the economics of regulation taking into account that inefficient regulation may result from imperfect information (Laffont and Tirole, 1993; Ogus 2004). Now, acknowledging asymmetric information between the regulatory authority and lawyers may impact on the choice of the regulatory arrangements in the realm of legal services. Recent law and economics literature highlights the informational advantages of self-regulation, arguing that it entails potential efficiency gains due to superior information of the profession on the issues at stake, and the associated lower transaction costs of the self-regulatory process (Gehrig and Jost, 1995; Ogus, 1995, 1999; Grajzl and Murrell, 2007). Yet, policy prescriptions of the EC and OECD reports hardly echo those institutional concerns. The nature and the identity of the regulatory authorities the most able to cope with asymmetric information in the best interest of clients and society remain largely unspecified.

On the other hand, the private interest approach recommends deregulating the market for legal services in order to avoid regulatory capture, especially by the professional group of lawyers. Such deregulatory prescriptions implicitly assume that regulation, rather than market failures, is at the root of imperfect competition in the legal market. Dismantling regulations may then improve competition, as it may reduce regulatory capture. Nonetheless, the private interest approach leaves the issue of asymmetric information between lawyers and clients unanswered and neglects that a deregulated market poorly performs in moral hazard and adverse selection situations. Deregulation provides no remedy against market failures, nor prevents opportunism in an asymmetric information setting. Hence, it may well enhance price competition on the one hand, while reducing the quality of legal services to the detriment of clients and society on the other hand.

Moreover, like the public interest one, the private interest approach does not really question the nature and the identity of regulatory authorities – the issue of *who* regulates – in depth. It tends to dismiss all regulations as inefficient, whatever the regulatory authority issuing them. Thus, government as well as an independent agency or a self-regulatory body may altogether be affected by regulatory capture. In addition, whereas deregulation and liberalization in the markets for standard goods and services has been backed up usually with a discussion on new forms of regulations, this is hardly the case for legal services. With the major exception of the Clementi report (2004) in the U.K., little attention has been paid to the issue of the governance of the profession in practice, and the EC (2004, 2005) and OECD (2007) reports fail to examine that issue.¹²

Considering the general disregard of the public and private approaches to the regulation of legal services for the issue of the institutional arrangements that should

¹² The *Review of the Regulatory Framework for Legal Services in England and Wales (2004)*, also known as Clementi Report, and the ensuing debates, have given rise to the Legal Services Act resulting in a major reform of the governance of the legal profession in the U.K.

sustain policy prescriptions, the following sections claim that the choice of institutional arrangements should rather be driven by the heterogeneity of nature of legal services.

2. Taking the heterogeneity of legal services seriously

The economic literature frequently mentions the credence good nature of legal services. Most of the time, it does not draw any lessons from it. We claim that the ontological heterogeneity of legal services may raise specific regulatory issues (2.1) and parallel the distinction between heterogeneous services with the one between different types of consumers that is commonly made in the law and economics literature (2.2).

2.1. The heterogeneity of legal services

Legal services, like most experts' services, are traditionally defined as credence goods: customers are unable to assess their quality either *ex ante* or *ex post* (Darby and Karni, 1973) and barely know, even after purchase, if they have been under or over served by the expert (Dulleck and Kerschbamer, 2006). In the realm of legal services, problems are threefold. First, clients cannot tell with certainty whether they need legal services, creating a hidden information problem (Wolinsky, 1993; Taylor, 1995; Emons, 1997). Second, they are not able to assess the quality of the needed service *ex ante* (Darby and Karni, 1973). Third, they do not know *ex post* whether the service they bought involves the right level of effort by the lawyer, creating a hidden action problem (Holmström, 1979). These situations open the door to either under- or over-treatment, or overcharging.

Undertreatment happens when a customer receives a low-quality (or simple) service whereas his or her case optimally requires a high-quality (or complex) one. By contrast, overtreatment means that a consumer receives a high-quality service whereas a low-quality one is actually needed, yielding additional costs that exceed the benefits for the consumer. Finally, overcharging occurs when a high price is charged for low quality, which may induce consumers to postpone their purchases because of the high price of services (Dulleck and Kerschbamer, 2006).

The uniqueness and the exclusivity of legal services explain their credence features. Indeed, clients may be unable to assess quality even *ex post* because most of the time, purchasing services from a lawyer is associated with a *unique* event in their private or economic life (bankruptcy, accident, industrial dispute, divorce, etc.). Having no prior experience of the service, they cannot compare the quality of the service they are currently buying with the quality of a similar service they may have purchased previously. Thus, they may also be unable to convey information to other consumers. Moreover, a legal service is merely produced once a consumer has expressed a legal need, and this service is tailored to meet this particular need. Hence, the *exclusivity* of legal services also accounts for their credence nature. Eventually, most legal services can be depicted as “singularities” (Karpik, 2010), whose quality is both multidimensional and non commensurable.

Complex legal services obviously fit in this category. However, some of them rather display search characteristics. Then, consumers are able to evaluate quality before purchase through a search process (Nelson, 1970). This is the case for some highly standardized legal services for which no genuine expertise of lawyers is required – for instance because procedures are strongly standardized and can be supplied by any lawyer indifferently or because a lawyer’s presence is needed only in order to comply with mandatory legal requirements. Then, lawyers do not actually perform any “singular” role, and they cannot benefit from any informational advantage at the expense of clients.

Furthermore, some other legal services may also fall within the scope of experience goods when quality can be discovered at no cost after purchase (Nelson, 1970). For instance, clients purchasing a lawyer’s services for an uncontested divorce or to form a simple corporation are usually able to appraise quality *ex post*. For simple and routine services, consumers may have similar needs and share a similar valuation, being then able to convey information to other consumers.

2.2. Heterogeneous legal services v. heterogeneous consumers

Hence, three types of services can be distinguished in the legal market, according to their search, experience, or credence characteristics¹³. The law and economics literature usually overlooks such heterogeneity and more commonly relies on the distinction between two types of consumers of legal services, respectively occasional and regular ones (Darby and Karni, 1973; Paterson *et al.*, 2003; Garoupa, 2004; EC, 2005; OECD, 2007). Occasional or one-off consumers like households are defined as “inexperienced individuals who do not buy these services regularly” (OECD, 2007, p. 9). Regular or repeat consumers are “big business” and the public sector. Occasional and regular consumers are assumed to differ in their information on the actual quality of legal services. Whereas occasional consumers are only poorly informed, regular ones are better informed about quality – for instance, firms may benefit from in-house counsels informing their legal choices. Thus, regular consumers are able to supervise lawyers’ behaviours for the benefit of occasional consumers and to convey reliable information. Although the distinction between regular and occasional consumers may hold, we argue that it entails two main flaws. First, the delineation between the two types of consumers may not be obvious, as not all the consumers of legal services are clearly either one-off consumers or big firms. EC (2005, p. 4) specifically recognizes that “it is less clear how small business fits into this picture” and that “further economic analysis is needed to consider in more detail the[ir] needs”. Second, a necessary condition for regular consumers to convey information to occasional ones is that the needs of both types of

¹³ The delineation between credence and experience goods may not always be sharp, in particular when consumers of legal services are able to discover actual quality, but only after the lapse of a long period of time.

consumers be homogenous. However, such condition may not be satisfied, as firms and individuals may not share similar legal needs.

Distinguishing between legal services according to their characteristics does not require this assumption of homogeneous legal needs to be met. Furthermore, it also fits more closely to the economic way of defining markets by determining the characteristics of the exchanged goods at first. Taking into account the heterogeneity of legal services according to their search, experience, and credence characteristics, allows us to define as many (sub-) markets as types of legal services. This also allows us to draw regulatory implications for each of these markets instead of issuing “one-size fits all” policy recommendations for all markets and legal services.

3. Regulating heterogeneous legal services

We first argue that the heterogeneity of legal services may impact on the socially desirable level of regulation (3.1). Hence, market-based solutions may perform well as far as legal services characterized by search and experience features are concerned (3.2). Legal services with credence features may require specific institutional arrangements so as to induce lawyers to supply high quality to uninformed consumers (3.3).

3.1. To regulate or not to regulate according to the heterogeneity of legal services

“One size fits-all” regulatory recommendations appear irrelevant when taking heterogeneous legal services into account. On the one hand, the public interest approach to the regulation of legal services acknowledges the credence good nature of legal services. Now, its pro-regulatory prescriptions usually omit that some services exhibit search and experience characteristics that allow consumers to make an informed choice on their own. On the other hand, the deregulatory recommendations endorsed by the private interest approach overlook the credence features of some legal services that may allow some lawyers to cheat, therefore leading to inefficient outcomes in the market for legal services.

Taking heterogeneous legal services into account may rather support a more balanced view promoting either regulation or deregulation according to the features of the legal services at stake. Indeed, market mechanisms are most often inefficient to ensure the provision of high quality in credence goods markets. Precisely, Dulleck and Kerschbamer (2006) show that the free market leads to high quality only when three specific conditions are met: (i) suppliers face homogeneous customers; (ii) the professional and the client are tied together once the needs of the latter have been defined (diagnosis), due to large economies of scope between diagnosis and treatment (*i.e.*, delivering the service); and (iii) either the quality of the service is verifiable or a liability rule actually protects consumers from undertreatment. Yet, these conditions are hardly met in the market for legal services.

First, condition (i) means that consumers are identical in their valuation of a high-quality service or in their probability to need such a high-quality service. Obviously, the homogeneity condition is not met in the case of legal services. For instance, the probability to purchase legal assistance or legal representation before a criminal court dramatically varies across consumers. Hence, heterogeneity induces inefficient rationing for consumers or the provision of low-quality services for at least some groups of consumers (Dulleck and Kerschbamer, 2006). Second, for condition (ii) to be met, search costs incurred by consumers have to be high enough to tie the lawyer and the customer together for the treatment stage (the enforcement of the service function). Although this may happen sometimes in the market for legal services¹⁴, this may not be verified usually. Indeed, consumers can consult several lawyers for a same legal problem. Professional bodies even encourage consumers to do so, and to this end offer free assistance and advices together with non-profit legal associations. Also reducing the cost of consulting a lawyer for clients, the first appointment is given without charge in most of the European countries. Hence, separabilities of information (diagnosis) and service (treatment) are usually verified in the market for legal services, leading to minor economies of scope. In that case, according to Dulleck and Kerschbamer, two inefficient equilibria may emerge, one with overcharging and the other one with inefficient specialization. Both equilibria involve high search and diagnosis costs to be borne by consumers consulting more than one professional. Third, like the previous one, condition (iii) clearly does not hold for all legal services in the market. Assuming that overcharging is verifiable implies that consumers are able to observe quality *ex post*, which is not the case for credence goods. However, liability rules apply to the legal profession. Both statute laws and ethical rules included in the lawyers' code of conduct make lawyers liable for the provision of inappropriate low quality. A non-satisfied customer can thus sue a lawyer for professional misconduct relying on these rules. This requires however the client to be able to detect misconduct, which may not be the case with credence goods.

In the end, when legal services exhibit credence features, consumers may not be homogenous, economies of scope between the diagnosis and treatment functions of lawyers may be rather small, and the non-observability of quality may prevent consumers to detect undertreatment and overcharging. As a consequence, free market mechanisms may lead to inefficient outcomes such as rationing, low quality, inefficient specialization, etc. However, following Dulleck and Kerschbamer (2006), market mechanisms may discipline suppliers if search and experience goods – whose quality is at least verifiable *ex post* (condition iii) – are supplied in a market that is narrow enough to meet homogenous consumers (condition i), and where economies of scope between information (diagnosis) and service (treatment) are large enough (condition ii).

¹⁴ For instance, this may be the case when defining the client's legal need requires the lawyer to engage a high level of effort and thus to incur high costs.

Obviously, in the market for legal services, most simple and routine services, presenting search or experience features, verify those conditions.

Eventually, the regulatory choice in the realm of legal services may not be between regulating and not regulating those services, but rather between *those* legal services that need regulation and *those* that do not. Put differently, the desirable level of regulatory protection does not rest on the type of the consumer, but rather on the type of the legal service that a lawyer is delivering.

3.2. Market-based solutions for search and experience goods

Market-based solutions may perform well as far as highly standardized and routine services are concerned. In that case, informational transfers between clients, through word-of-mouth and other clients' referrals, are informative, conveying valuable information on actual quality to consumers (Kim, 2009). Therefore, the individual reputation of a lawyer functions as a "surrogate for quality" (Abel, 1989, p. 183) or "an *ex ante* indicator of quality of service [consumers] can expect" (Galanter and Palay, 1991, p. 90). It gives the lawyer high-powered incentives to supply high quality: a lawyer who delivers high quality will build up a good reputation that will result in more clients and higher incomes in the future, as (s)he will be able to charge a higher price than lawyers with a bad reputation.

Hence, investing in reputation may be a valuable strategy for lawyers individually. Indeed, not only may regular clients infer quality from repeated interaction with a lawyer and from the observation of his or her past individual behaviours. But occasional clients may also derive information from other clients when they purchase standardized and routine legal services. Then, even though not faced with regular consumers able to assess the actual quality of legal services, lawyers may have an incentive to provide the right level of quality so as to build a good individual reputation and to secure future relationships. Individual reputation performs here as a substitute for the repeat-purchase mechanism. For search and experience services, quality regulations are therefore unnecessary and deregulatory recommendations are thus relevant.

For credence goods, however, informational transfers between consumers are poorly informative as quality is not verifiable. For instance, information on quality is poorly transferable when clients are aware of the uniqueness of their case. The quality of a legal solution provided by a lawyer within a given case is also strongly contingent on a specific setting, and it may reflect the general level of quality of this lawyer only weakly. Always supplying high quality in order to build up a good individual reputation may therefore not be a valuable strategy for a lawyer. Then, quality regulations may be necessary to deter cheating on quality.

3.3. External v. self-regulation of legal services with credence good features

Claiming that the market for legal services requires regulation when legal services are credence goods raises the question of the very form that such a regulation should take, keeping in mind that the efficiency of regulation may be undermined by asymmetric information between the regulator and the regulatees. This requires studying the costs and benefits associated with the two main forms of regulation that prevail in the market for legal services, *i.e.* external regulation by governmental or private agencies and self-regulation by a professional body.

First, the cost of acquiring information on quality and issuing regulations may be lower with self- than with external regulation. On the one hand, the latter is usually considered as rather costly due to asymmetric information between the regulatory authority and lawyers. Indeed, a regulatory body external to the legal profession would at least have to duplicate the cost of effort and of information that lawyers, whose services are being assessed, have already incurred while delivering the scrutinized service in a complex, individualized case. In other words, external regulation – either by governmental or private independent agencies – may be rather costly inasmuch as regulators have to invest in specialized legal capital in order to assess the actual quality that has been delivered by lawyers to their clients. On the other hand, self-regulating agents only bear a lower cost to acquire information on quality and to issue quality regulations. Then, asymmetric information between the regulator and lawyers is reduced because the former is aware of the actual preferences and behaviours of the latter. Accordingly, the law and economics literature expects the legal profession to be less costly and, thereby, more efficient than an external regulator to control lawyers (Miller, 1985; Gehrig and Jost, 1995; Ogus, 1995, 1999). As a consequence, self-regulation of the legal profession may be all the more relevant as legal services are credence goods: especially in that case, legal experts belonging to the profession observe quality supplied by members more easily and at a lower cost.

Second, the informational gains associated with self-regulation have to be balanced against its collusive costs. The private interest approach to regulation points out the high risk of regulatory capture when regulations are issued by professionals themselves. One may thus expect that regulators – being also lawyers – may be particularly sympathetic of lawyers, as they typically share common interests and, as members of the profession, may take benefit from biased quality regulations. Such collusion may also take the form of covering-up fraud by lawyers (Nuñez, 2007). Hence, self-regulation may represent an efficient institutional arrangement only when its informational advantages exceed these collusive costs.

This is not to say however that self-regulation should always be dismissed on that ground. Against the public approach to regulation assuming welfare-maximizing regulatory authorities, the economic theory of capture shows that external regulators are not immune from capture and collusive behaviours either. Just as self-regulators,

external regulatory authorities may also be captured by private interests. Further, due to asymmetric information, they may also have to rely on the information provided by lawyers and the legal profession to issue their reports and regulations, which may thereby facilitate pressure from the latter. Hence, external regulation could entail not only the cost of inefficient regulation due to capture, but also the cost of designing collusion-proof contracts aimed to prevent collusion between the regulatory authority and the regulated agents.

Additional costs and benefits associated with regulation can also be included into the analysis. It is usually argued that self-regulation incurs lower costs of drafting commitment and establishing and activating enforcement systems. Such a cost saving explanation is put forward to account for the emergence of self-ordering arrangements within groups that are small enough to perform control of their members by other members, like the Maghribi Traders (Greif, 1989), the Law Merchant (Benson, 1989; Milgrom, North and Weingast, 1990), and various professions like lawyers, architects, physicians and pharmacists (Maks and Philipsen, 2005). Furthermore, self-regulation is also considered to be a more flexible mechanism than external regulation. When innovation in dynamic markets requires costly legal adaptation, it allows the costs of legal change to be borne by the profession itself (Miller, 1985). In addition, the legal profession also has a long-term interest in maintaining high quality that politicians or independent agencies may not have. Hence, self-regulation may help to achieve high quality in the market for legal services when the collective rent accruing to the legal profession grants lawyers with high-powered incentives to build and maintain a good collective reputation and, therefore, to supply high quality in a market where clients are unable to detect cheating (Chaserant and Harnay, 2011). Lastly, self-regulation by a profession independent from political decision-makers also yields various social advantages (Jordana and Levi-Faur, 2004). Precisely, self-regulation may help to prevent political inference into the field of justice.

Eventually, when comparing external and self-regulation, not only the informational costs and rewards associated with alternative institutional arrangements, but also the social net effect of collusion generated by private interests – including the cost of designing collusion-proof contracts – should be considered. Therefore, the net gains from external regulation may either be higher or lower than the gains from self-regulation, and no institutional arrangement should be claimed to be more efficient than another in all situations. Instead, we argue that the choice of institutional arrangements in the markets for legal services should be made on a case-by-case basis and grounded on a comparison of their relative costs and benefits considering the characteristics of the services at hand.

4. Summary and conclusion

Against the “one-size fits all” policy prescriptions promoted by the traditional economic analyses of regulation in the market for legal services, this article argues that the heterogeneity of legal services should be taken into account when discussing

regulatory issues in this market. First, we claim that a distinction should be made between legal services with search, experience and credence characteristics, leading to a pluralistic regulation of the market for legal services. We thus depart from most policy prescriptions by arguing that the features of the legal service considered impact on the regulatory *vs.* deregulatory choice. This implies that not all the markets for legal services should be regulated or, conversely, deregulated. Second, we argue that when regulation is needed, the degree of asymmetric information between the regulatory authority and lawyers at least partly determines the choice between external and self-regulation. Two levels of asymmetric information, respectively between client and lawyer, and between regulator and lawyers, should therefore be considered when discussing regulatory issues in the market for legal services.

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