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Regulation of the legal profession and access to law

An economic perspective

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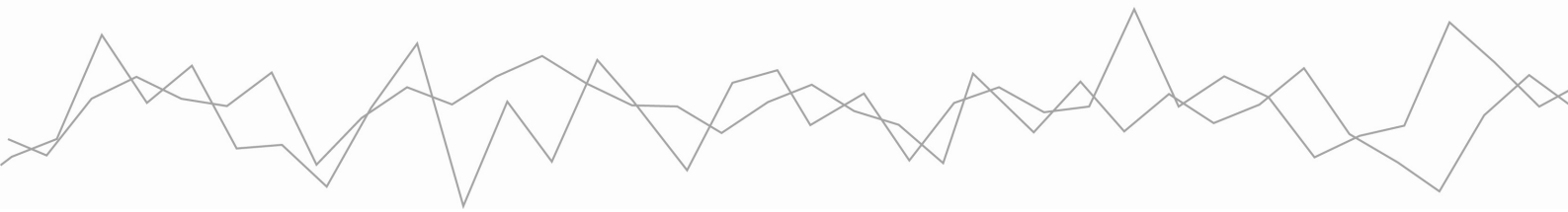

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Executive summary

This report gives an economic perspective on the regulation of the legal profession and access to law. A legal framework, which safeguards fair, easy and efficient access to law for all citizens and businesses, is, of course, of utmost importance for every country. The effect of regulation on access to law is, therefore, a very relevant topic. We hope this report stimulates an informed dialogue between jurists, economists and other social scientists involved in the debate on the regulation of legal services. Instead of resulting in criticism of the methodology at hand, we hope our findings provoke an open discussion of the costs and benefits of the current levels of national regulations. Our first finding is that high regulation is not necessary to achieve sufficient access to law. Secondly, governments should be able to justify high levels of regulation by indicating that social benefits in terms of better access to law are higher than the social costs of this regulation. In practice the net benefit of high regulation is not clear; meanwhile our findings indicate that regulation comes at a cost. These results are strong and robust enough to start such a policy discussion.

Governments want to safeguard legal security for all those seeking justice. In order to guarantee this public interest most European governments have given certain exclusive privileges to lawyers, among which is the monopoly on the conduct of a case. Much of this regulation or self-regulation is aimed at preserving professional quality, but it may also restrict competition. Consequently, the prices paid for the legal services provided by lawyers may be too high and this decreases access to law – precisely the opposite of what governments intended.

The International Association of Legal Expenses Insurance (RIAD) commissioned SEO Economic Research to conduct a study into the effect of the regulation of legal services and legal professions on access to law in several European countries. The central research question is:

> **'What is the effect of the regulation of the legal profession – predominantly lawyers – on access to law?'**

We answer this question for civil law, not punitive or public law. Moreover, we focus on the effect of national monopoly when it comes to conducting a case. As this monopoly is given to lawyers, the analysis predominantly looks into the regulation of lawyers. The research analyses the effects this monopoly and accompanying self-regulation have on consumers (households as well as small and medium-sized firms). We also look at the effects on competitors (legal expenses insurers, trade unions and other legal counsels).

In this report we take an economic perspective when analysing the regulation of the legal profession. This involves answering the following three questions:

1. The 'what' question: Is there a problem? Why is it a problem? What is the public interest?
2. The 'how' question: How can one take action as effectively and efficiently as possible? What instruments are suitable for solving the policy problem in question?
3. The 'if' question: Is the welfare of society enhanced if action is taken with a certain instrument or instruments? Is the cost of intervention higher or lower than the benefit?

The economic perspective departs from a situation in which there is no government intervention and subsequently looks for justifications for government regulation. Viewed from an economic perspective, problems arise the moment that markets aren't functioning properly – a phenomenon known as 'market failure'. Thus, from an economic perspective the burden of proof rests on the government (or the Bar) to prove that more regulation creates more net benefit for consumers. From the public interest perspective, government regulation aims at obtaining social benefits by correcting market failures or by attaining particular political goals. At the same time, government regulation can entail social costs as a result of information problems, high transaction costs, regulatory insecurity and economic inefficiency. Economists describe this as 'government failure'. The benefit of correcting market failure and attaining political goals should be weighed against the cost in terms of government failure. The economic perspective does not depart from a bias towards a presumption that there is too much regulation.[1]

The ideal way to answer the central research question is to test whether access to law is more expensive or cheaper in highly regulated countries compared to less regulated countries. Because of the lack of data on the costs of the judiciary system and also because judiciary systems differ fundamentally between countries this question cannot be answered in this report. However, based on the data available that was also comparable between the countries in our sample, we conclude that the German situation stands out as quite expensive. This may be due to the fact that most cases are dealt with in court by lawyers; few out-of-court settlements and no external competition from non-lawyer legal experts.

In spite of the data limitations, an analysis of the level of regulation of the legal profession is very relevant when thinking about improving access to law. Our analysis focuses on regulatory differences of the legal profession and therefore leaves out the regulations and institutions that determine the performance of the judiciary system as a whole.

Below we answer the three questions: what, how and if.

'What' question (Chapter 1)

In policy practice, the 'what' question is often neglected and regulators move immediately on to the 'how' question. The disadvantage of skipping the first question is that it is left unclear if and to what extent the problem in question requires *government* intervention. In some cases regulation by *private parties* will suffice. For instance, in Finland lawyers do not have a monopoly on the conduct of a case. Access to law is guaranteed, instead, by private regulation of legal expenses insurers who place all insured persons under the obligation to engage legal advisers who possess certain qualifications (mainly, advisers must have a law degree).

The answer to 'what is the public interest at stake' is safeguarding legal security. Legal security encompasses access to law, the fair and orderly conduct of legal proceedings and an efficient judicial process. It requires the availability of good quality legal services at reasonable prices. In

[1] We also looked for public interest arguments in favour of more regulation of legal services, but found no clues pointing to too little regulation – not in the documents studied, nor in the Bars surveys or in our analysis of alternatives to fee regulation. For instance, in our view fee regulation is not an efficient option because it evokes too many government failures. This approach imposes a rigid boundary upon the market, with a negative effect upon innovation, flexibility, and other incentives to improve efficiency. Moreover, it entails high regulation costs and there is a danger of cases being crowded out: The more complex and time-consuming cases are not taken up.

order to safeguard legal security, there is a need for some degree of regulation of the legal profession. The need to regulate, however, is less urgent than usually assumed by government agencies and Bars. Our analysis of market failures merely justifies the following regulation of the market of legal services:

- Information problems between consumers and providers of legal services can be addressed by a certification system in the case of one-off consumers or private regulation in the case of repeat consumers. Also, the provision of poor quality service that also affects the general public (e.g. legal misinterpretation) can be prevented with a quality certification system. Note that a certification or licensing system is not the same as a monopoly position for *lawyers*. It merely means that *anyone* who meets particular requirements is allowed to provide the monopolized service.
- Private provision of information concerning the quality of legal services provided by certain professionals may be inaccurate and inefficient. The public-good aspect of information on quality justifies mandatory disclosure with respect to professional quality.
- Network effects occur if the profession of lawyers becomes more valuable (i.e. the average fee rises) as more lawyers enter the profession. These effects imply either high fees or a shortage of legal service providers. A monopoly position of some legal experts (i.e., lawyers) would increase the problem of network effects. Therefore, abolishing the monopoly or admitting non-lawyer legal specialists to the monopoly would be the best option from this perspective.
- If court procedures are not followed properly, for example, there is a cost to the judicial system in time and hence money. However, these effects are not priced. The existence of non-priced sections in the judiciary system calls for some sort of mechanism to filter out cases in dispute that could be resolved more efficiently (out-of-court settlements).[2]

In reality most governments regulate the market for legal services much more strictly than the above-mentioned regulation.

In addition to economic rationales for government action, two non-economic, political rationales exist. One important political reason for imposing compulsory legal representation in court is to protect the vulnerable, inexperienced party to a case. By requiring everyone to hire a lawyer under certain circumstances, the paternalistic government hopes to achieve 'equality of arms' for all parties to legal proceedings. A second political rationale is income redistribution. To prevent low income groups from having less access to legal services, the government has introduced a system of subsidized legal aid.

In practice regulation is often aimed at serving both public and private interests. Although 'rent-seeking' behaviour is intrinsically difficult to identify, we conclude that the conditions for successful rent-seeking are met in most national markets for lawyers' services. If we combine this conclusion with the conclusion from the public interest perspective – namely that the need to regulate is less urgent than usually assumed by government agencies and Bars – we conclude that the overregulation of the legal market also stems from safeguarding the private interests of legal professionals.

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[2] Although we focus on access to law in so far as it is linked to the quality of legal professionals (lawyers), we include this fourth market failure related to the administration of justice because in those cases the legal professions are also affected.

'How' question (Chapter 1 and Chapter 4, section 4.1 Error! Reference source not found.**)**

Now that we have defined the public interest at stake, the subsequent question is how can the government best intervene to safeguard this public interest? The legal services market can be regulated in various ways – by either government regulation, self-regulation or private regulation. We have compared the level of three important regulatory instruments: entry restrictions, fee restrictions and restrictions on advertising. We have constructed regulatory indices using the insights from assessment frameworks developed in earlier comparative studies of national markets of legal services. Our comparison shows that the level of regulation differs remarkably among the 12 countries in our sample. These indices show that Finland and England/Wales are the least regulated markets. In Finland lawyers have no exclusive tasks and do not have to be a member of the Bar. In England/Wales the regulation level of solicitors is relatively low (please note, however, that barristers in England/Wales have a much higher regulatory index). Germany, France and Italy have the most regulation.

Actually, this is a surprising result. While the public interest at stake (guaranteed legal security) is exactly the same in all of these countries how can it be that they guarantee legal security in such remarkably different ways? From the fact that, for instance, the Finnish or English governments regulate the market of legal advisors far less stringently than, for example, the German or French, we cannot assume that the former governments are any less concerned with the legal security of their citizens than the latter.

Based on our surveys, data analysis and the literature we conclude that access to law is sufficiently guaranteed in each of the 12 countries in our sample. Access to law is not safeguarded to any greater or lesser degree in those countries subject to more stringent regulations than those where it is less so. Access to law depends also on the availability of a legal aid system. All 12 countries, except for Italy, have a legal aid system. The way in which this system functions in each of the 12 countries differs significantly, for example, in terms of the case numbers and expenditure. Our findings show no relation between the function and scope of the legal aid system and the level of regulation. We also measured access to law in terms of the ease of enforcing a business contract. However, we did not find a link between them. According to the surveys and data from desk research there is no identifiable relation between access to law on the one hand and the level of regulation on the other.

There is one exception to this finding. The number of lawyers differs substantially among the 12 surveyed countries and there is a positive relation between the regulatory index and the number of lawyers per inhabitant. In less regulated countries the number of lawyers per inhabitant is lower than in highly regulated countries. Partly this is due to the fact that external competition exists in less regulated countries (England/Wales, Finland, Hungary, Netherlands), whereas no external competition exists in highly regulated countries with relatively high numbers of lawyers (Germany, Italy and Spain).[3]

From that the fact that the market for the services of lawyers is segmented and – in the view of many of those seeking justice – it is broader than the legal profession alone, we conclude this means that the public interest can best be safeguarded by regulating *services* rather than groups of

[3] External competition is competition from outside the profession, such as professionals from abroad or new providers, e.g. qualified jurists from trade unions or legal expenses insurers.

professionals. Recognizing this and asserting the importance of examining the different segments of legal service markets separately is an important part of a mature debate on the role of the legal profession in legal service markets.

'If' question (Chapter 1, section 4.2)

Answering the 'if' question involves looking into the potential welfare effects of the regulation of the legal profession, that is, compulsory legal representation in court and the lawyers' monopoly over that representation.

The most important benefits of monopolization include lower search costs, improvements in service quality and a more adequate supply of information on the quality of professional services. These quality related benefits are – however – not back up by the literature. Another aspect is the reduced risk of meeting poor service. When consumers are risk-averse to poor service, perchance because it can lead to unbearably large losses, regulation of quality becomes a substitute for the theoretical possibility of insurance against poor service.

Besides these potential benefits, monopolization by lawyers has a negative effect in that the high cost of hiring a lawyer restricts the accessibility of the legal system. Why do lawyers cost so much? First, because their service is complex and demands sophisticated, careful reasoning. The exercise of careful judgement also takes time. Secondly, becoming a lawyer requires substantial intellectual training and sufficient practical experience. More importantly, however, is the market power of lawyers have over their clients. Most current regulation has clearly replaced market failure with serious government failure: monopolization is an attempt to solve an information problem. This has four causes.

- Compulsory representation in court is by lawyers only. An obligation to use services from only one type of supplier tends to lead to high prices and a lack of innovation.
- The barriers to access erected by the Bars are high and so reinforce the monopoly held by established lawyers (consider, for example, the restrictions on the authorization of salaried lawyers). We cite an empirical study by Winston and Crandall (2007) showing that this kind of self-regulation in the US does indeed give rise to supra-competitive rents.
- The client is effectively locked into their relationship with the lawyer because of high sunk cost and the tournament nature of competition among lawyers.
- The indirect effects of the procedural monopoly. The status which statutory protection affords the lawyer extends beyond the scope of the actual monopoly itself. In a market with insufficient competition, this 'reputation' effect can be converted into an additional premium for lawyers.

Because of these reasons a lawyer has market power over his clients and is thus able to set a price above marginal cost and make more than a reasonable profit.

In addition to analysing these general qualitative costs and benefits we quantify the cost of regulation of lawyers by comparing the cost incurred by legal expenses insurers when a case is conducted by an external lawyer and what these costs are when the same case is conducted by an internal lawyer or non-lawyer legal expert. Based upon their experience with lawyers, legal

expenses insurers often select their preferred supplier (network lawyers), a status which provides the policyholder with a certain indication of quality. We have sampled the population of these insurers to produce an indication of the price differences.

On an average case basis, a network lawyer costs two to three times as much as an insurer's jurist (paralegal) or salaried lawyer, while an external lawyer costs four to six times as much. From an economic point of view, there seems much to gain by (further) deregulating the national markets. The results indicate particularly that liberalizing the legal profession by allowing certified non-lawyer jurists to enter the monopoly may have a substantial impact on the prices in the legal profession.

The next question is whether the more stringent form of legal professionals regulation leads to greater costs to society than benefits, thereby reducing economic welfare? Due to the lack of available data we were unable to test whether the price for gaining access to law (for instance, the extent of the overcharge) is higher or lower in the more stringently regulated countries. Of course, our methodology may be criticized. Still, the fact remains that the level of regulation differs remarkably among the states in our sample whereas the level of access to law does not; it is considered sufficient in all states. Criticism remains a luxury if alternatives are unavailable; in this case there is a lack of empirical studies. Governments and Bars themselves are unable to prove that the benefits of regulating access to law are higher than the costs.

The report also describes alternatives to the widespread level of regulation. Currently in most European countries there are three ways of changing the monopoly: (1) restricting the domain it covers; (2) extending the group of legal practitioners to whom it applies; and (3) abolishing compulsory legal representation in civil cases (introducing, meanwhile, some covering measures).

Policy recommendations (Chapter 4, section 4.1 and Chapter 5)

What is needed is a broader economic perspective that weighs the pros and cons to welfare, that is, the benefit of correcting market failure versus the cost of government failure and the protection of public versus private interests. This weighing has not yet been done; it is merely asserted by governments and Bars that the benefits of the restrictions are large enough to justify current policy, without reference of the cost of this policy. The benefits of regulation (which are only possible and not quantified) dominate the discussion; any possible gains of re-regulating the market for legal services in consumer surplus are only mentioned in passing, if at all, and they are not discussed. Since cost-benefit analyses of various – less and more restrictive – regulatory schemes are lacking in all countries we recommend that national regulators should analyse the specific public interest in their national markets of legal services. Subsequently, we recommend that governments list various regulatory options next to the current regulatory scheme. We then recommend that a cost- benefit analysis be performed on the current level of regulation compared to other levels of regulation that also guarantee the public interest at stake. In this respect, our conclusions support the European Commission's 'Better regulation of professional services project'.

There are at least two approaches that policymakers could take to improve access to law. From economic theory we know that prices will fall if demand is reduced or if supply is increased. One way, then, is by reducing the demand for lawyers. In the long term, civil court proceedings and regulations should be redesigned (simplified, made more understandable for lay people) to reduce

costs and increase accessibility. In the long term, then, the greatest benefits can be expected from a combination of changes to procedural law, radically simplifying it, implementing private quality regulation, and the abolition of the representation requirement.

Another way may be to increase the number of qualified legal advisers by allowing qualified non-lawyers to conduct cases. Important steps forward include replacing excessive licensing requirements by other mechanisms such as certification, fully liberalizing advertising, and removing quantitative entry restrictions. Our research shows that opening up the monopoly to others than just lawyers, namely legal expenses insurers, trade unions and other legal counsels, is beneficial to the consumer in at least two ways:

1. The individual seeking access to justice has more choice; he or she can pick from different kinds of professionals to have the case solved. Therefore, the individual is better able to find the level of advice needed for a particular problem (more quality differentiation; different quality levels for different legal problems). Consequently, the average price will lower as these individuals pay only for what they need and no more. Moreover, external competition (from new providers) is an effective manner of excluding rent-seeking and regulatory capture.
2. Due to these price decreases insured parties pay lower premiums for their legal expenses policy (on condition that the market for legal expenses insurance is sufficiently competitive to pass these cost reductions at least partly on to consumers).

Of course, these new counsels would have to satisfy the same minimum requirements that lawyers do, where these requirements will have to be set by an independent body. An option in line with easing the monopoly would be to allow for employed lawyers. If lawyers employed by non-law firms are allowed to operate in a country, it becomes important to give them the same rights and duties as self-employed lawyers.

Raising the statutory financial threshold below which no mandatory legal representation exists would not in itself solve the problem of mandatory representation by lawyers. Therefore, it is not to be recommended. Yet, this alternative does result in a greater freedom of choice for a larger part of the market, namely all those cases between the old threshold and the new one. More cases would be dealt with by the lower courts, resulting in faster and simpler proceedings.

In the following box we sum up our main results.

Box: Main results

- Access to law is sufficiently guaranteed in each of the 12 countries in our sample. It is not safeguarded to any greater degree in countries subject to more stringent regulations. Still, Levels of regulation differ remarkably among the 12 countries. The number of lawyers per inhabitant also differs substantially among the surveyed countries. In less regulated countries the number of lawyers per inhabitant is lower than in highly regulated countries.
- Governments and Bars should be able to show what the social costs and benefits of these different levels of regulation are and why they picked the level they did. Regulators simply assume that the social benefits of regulation are higher than the social costs. We hope that this report provokes discussion on this assumption.
- This study shows that in terms of increased or better access to law it is not at all clear that more stringent forms of regulations of legal professionals lead to higher benefits to society than costs. No proof can be found in the literature that in strictly regulated countries, lawyers perform better than non-lawyers legal experts. On the other hand, we did find some evidence that the costs of hiring a lawyer are high compared to the costs of hiring a non-lawyer legal expert.
- The cost of the regulation of lawyers can be estimated by comparative analysis of the costs incurred by legal expenses insurers outsourcing a case to an external lawyer as opposed to insourcing the same case to an internal lawyer or non-lawyer legal expert. On the average case basis, a network lawyer costs two to three times more than an insurer's jurist (paralegal) or salaried lawyer, while an external lawyer costs four to six times as much.
- From an economic perspective, there seems much to gain by (further) deregulating the national markets. The results show that liberalizing the legal profession by allowing certified non-lawyer jurists to enter the monopoly may have a substantial impact on prices in the legal profession.
- Freedom of choice for consumers is likely to be the method to reduce the cost of access to law.

Source: SEO Economic Research