Lawyers' Reputation and the Quality of Legal Services:

An Economic Analysis of Self-Regulation

Camille Chaserant[1], Sophie Harnay[2]

Abstract:

Against the law and economics literature that focuses on opportunistic behaviours by lawyers in a self-regulated market, we show that a high-quality steady-state exists in a market for legal services and that the likelihood of high quality increases when the market is self-regulated by the legal profession as compared with the situation where there is no self-regulation. Indeed, absent self-regulation in the market, individual reputation is the only informative and disciplinary device which operates. Introducing collective reputation of the legal profession into the analysis provides additional information to clients when legal services are credence goods. The profession has an incentive to maintain a good collective reputation as this increases the clients' willingness to pay for legal services and, therefore, the rent that accrues to lawyers as a whole. We conclude that self-regulation of the legal profession may help to regulate quality when clients are faced with opportunistic lawyers.

Keywords: reputation, self-regulation, credence goods, lawyer, legal services, legal profession.

JEL codes: K2, K4, L14, L15, L44, L84

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[1] 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

[2] 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

In most countries, self-regulation of legal services and lawyers by professional bodies is the regulatory form organizing and controlling the admission and licensing of lawyers and legal practices. However, self-regulation remains rather overlooked in the economic analyses dealing with the market for professional services. With few exceptions, the debate almost exclusively focuses on the regulation *vs* deregulation opposition and mainly endorses standard approaches and tools that have been developed for the study of goods and services markets in the fields of public and industrial economics. This approach does not pay attention to any peculiar feature of legal services and, therefore, fails to grasp any regulatory specificity of legal activities. In particular, little attention is paid to the key question of the authority that is, or should be, in charge of regulating the legal profession – *i.e. who* regulates? – and to the issue of self-regulation.

In the few cases where self-regulation is actually considered, it is treated in an unsatisfactory, simplifying way that mainly develops along two lines. On the one hand, a rather optimistic conception of self-regulation considers that it reduces regulation costs (that is, the cost of drafting commitments and the cost of establishing and activating enforcement systems) because it reduces asymmetric information between the regulator and the regulated agents: as in a self-regulated situation the regulator is aware of the actual preferences and behaviour of regulated agents, a self-regulating authority is expected to be more efficient than an external regulator to control the profession (Miller, 1985; Gehrig and Jost, 1995; Ogus, 1995, 1999). 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). On the other hand, the economic literature overwhelmingly promotes a negative approach to self-regulation that is mostly seen as a modern form of corporatism and the ultimate form of regulatory capture by a professional group (Stigler, 1971). Along this line, self-regulating organizations issue anticompetitive rules that regulate their own activities and protect their own interest at the expense of clients. The outcome is a reduction of competition on the supply-side of the market and artificially created rents for the members of the profession. Commonly endorsing this pessimistic view of self-regulation, the economic literature on lawyers and legal services mainly analyzes professional bodies such as bars, orders, and law associations as producers' organizations oriented towards the promotion and the defense of their members' private interests through a wide array of regulatory restrictions. In this view, entry restrictions, monopoly rights, advertising restrictions, fee regulation, and limitations on organizational forms are seen as various instruments intended to establish and to defend professional cartels rather than to serve public interest (See for instance Kay and Vickers, 1988; Van den Bergh and Faure, 1991; Van den Bergh, 2007, 2008; for an exhaustive review of theoretical and empirical literature, see Stephen and Love, 1999).

Self-regulation is then mostly considered as inefficient and socially costly. Positive effects of self-regulation on the quality of legal services and the performance of the market are disregarded. This negative view supports deregulatory recommendations in the market for

legal services. For instance, partial deregulation in the domestic markets of legal services in the USA and UK has been justified by the restrictive effects of self-regulation on competition (Bishop, 1989; Stephen, Love and Paterson, 1994; Clementi, 2004; Stephen and Burns, 2007). Several recent reports also recommend deregulating the market for legal services in Europe on this ground (European Commission, 2004, 2005; OCDE, 2007).

This article intends to reconcile those antagonist views of self-regulation and suggests an economic rationale for the self-regulation of lawyers which takes into account both the costs and benefits associated with self-regulation in the law and economics literature. We argue that self-regulation may perform some specific functions, at both the individual and collective levels. Indeed, legal services are usually characterized as credence goods, *i.e.* goods for which customers are unable to assess the quality either *ex ante* or *ex post* (Darbi and Karny, 1973) and barely know, even after purchase, if they have been under or over served by the professional (Dulleck and Kerschbamer, 2006). Hence, consumers' lack of certitude concerning the quality of legal services may encourage lawyers to adopt opportunistic behaviours detrimental to their clients' best interests. Now, it also opens up the possibility of reputational concerns (Holmström, 1999), especially collective ones (Tirole, 1996). On the one hand, word-of-mouth and other clients' referrals provide consumers with imperfect information about the individual reputation of a particular lawyer. On the other hand, the collective reputation of the legal profession provides additional information to clients. This article argues that the profession has an incentive to maintain a good collective reputation as this increases the clients' willingness to pay for legal services and, therefore, the rent that accrues to the group. Our model shows that self-regulation of the legal profession promotes the interest of lawyers in the collective reputation of the profession and, thus, may help to regulate quality when consumers are faced with opportunistic lawyers.

The first section discusses the issue of individual and collective reputation in the market for heterogeneous legal services. The second section presents the assumptions of the model. The third section develops the model and its propositions. The fourth section discusses the effect of self-regulation on the quality of legal services and its policy implications. The fifth section concludes and provides extents for further research.

1. Individual and collective reputations in the market for legal services

The individual reputation of a firm refers to the quality of the goods it has produced in the past (Kreps and Wilson, 1982; Milgrom and Roberts, 1982; MacLeod, 2007). Models of reputation typically assume that customers imperfectly observe a track record of the firm's past actions and use this information to update their current beliefs about the quality they are buying. When past quality is observable either *ex ante* – for search goods – or *ex post* – for experience goods – individual reputation provides suppliers with high-powered incentives to

deliver high quality. Then, high quality is sustained by the capacity of high-quality suppliers to charge an above-market clearing price, so that their present value of future income is higher than the one-shot gain from opportunism (*i.e.* to deliver low quality) (Klein and Leffler, 1981). This guarantees that high-quality suppliers derive a positive rent, representing a return of reputational capital; price is then interpreted as a signal of quality.

In the market for legal services, a lawyer is interested in having a good individual reputation as it attracts clients and increases future incomes. This concern incentivizes lawyers to supply high quality in the market for routine services, such as uncontested divorce services or simple wills[3]. Indeed, such services are rather experience than credence goods and consumers may be able to evaluate quality *ex post* (Schroeter *et al.*, 1987). Then, individual reputation of a lawyer derives from word-of-mouth and informational transfers between clients where current clients are almost always both referees and referrers (Kim, 2009). Consumers use reputation as a "surrogate for quality" (Abel, 1989, p 183) or "an *ex ante* indicator of quality of service [they] can expect" (Galanter and Palay, 1991, p. 90). Moreover, individual reputation also plays a key role for regular consumers of legal services (most often firms). Indeed, they are able to observe past individual behaviour of lawyers more precisely than occasional consumers, as they interact with a given lawyer on a regular basis and, therefore, can infer quality from past interactions with this lawyer. Hence, for routine legal services and regular consumers, the repeat-purchase mechanism induces lawyers to provide the right level of quality so as to build and keep a good individual reputation and to secure future relationships.

Now, in a market for credence goods, consumers are not able to evaluate the quality of the services either *ex ante* or *ex post*. This is the case for complex, individualized legal services. Hence, investing in individual reputation may not be a valuable strategy for a lawyer. Indeed, informational transfers between consumers are poorly informative and price may not be a signal of quality. Further, most consumers of legal services are occasional ones and, therefore, cannot rely on the repeat-purchase mechanism to discipline lawyers. Therefore, due to the heterogeneity of both consumers and legal services, individual reputation may give low-powered incentives to deliver high quality services.

This does not mean however that reputation is unlikely to play any role in the market for legal services. Indeed, we argue that the *collective reputation* of the whole profession provides consumers with information on legal quality. The collective reputation encapsulates consumers' beliefs about the average quality of the services which have been delivered by the profession in the past. Consumers are willing to pay a higher price for the service when the profession has a good reputation because they expect a higher quality in average. Conversely, a lower price is associated with a bad collective reputation. Therefore, a higher (lower) rent accrues to the profession when it has a good (bad) collective reputation. Hence, it is in the profession's interest to maintain a good collective reputation and to deter the provision of low-quality services by opportunistic lawyers. Thus, collective reputation may play a key role

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[3] A routine service is defined as a service for which the time needed to complete this service has a small variance (Schroeter *et al.*, 1987).

for legal services when they are credence goods. Indeed, the profession is more able to assess the actual quality of the legal services provided by its members than consumers on their own. By contrast, collective reputation may be of lesser importance when legal services at stake are routine services, whose quality can be assessed by consumers more easily. The following sections develop this argument.

2. Assumptions

We consider a stationary market for a legal service with credence good features. Then routine legal services and/or regular consumers are only limit cases of our analysis. The population of lawyers is assumed to be constant. We assume that the probability for a lawyer to remain in the market up to the next date is $\lambda \in [0; 1]$, the proportion of newcomers being therefore $(1-\lambda)$ at each date. All the agents share the same discount rate δ. At each date, a customer chooses a lawyer and buys the service. Three types of lawyers are considered: "good" lawyers in proportion h, "bad" ones in proportion l and "opportunistic" ones in proportion u, where $h + l + u = 1$. These proportions remain the same at each date and therefore for each cohort of newcomers.

Good lawyers always provide high quality. Bad ones always provide low quality. Opportunistic lawyers rationally choose to deliver high quality only if the cost of effort e incurred when producing high quality is offset by expected gains. Lawyers know which type they themselves are, whereas clients only know the proportions h, l and u, but not the actual type of the particular lawyer they are matched with. The price they are willing to pay depends on the expected quality which in turn depends on the type and the effort of the lawyer. We assume for the purpose of simplicity that the client's payoff is 1 when (s)he receives high quality and 0 otherwise. Following Tirole (1996), we distinguish two forms of reputation and consider that clients derive information on quality from (1) the individual reputation of the lawyer and (2) the collective reputation of the legal profession.

Individual reputation

The individual reputation of a lawyer refers to the quality of the services that this lawyer has delivered in the past. Given the very imperfect information on quality due to the credence nature of the legal service considered, π_k denotes the probability that the client will observe that the lawyer has produced low quality in the past at least once when (s)he has in fact cheated on quality k times. We assume that:

Assumption 1: $\pi_0 = 0 < \pi_1 < \pi_2 < ... < 1$ and $\pi_{k+1} - \pi_k < \pi_k - \pi_{k-1}$ for all k.

The more frequently a lawyer has produced low quality in the past, the more likely it is that the client is informed about him or her having delivered low quality at least once. Thus a

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lawyer has an all the better reputation as π_k is close to $\pi_0 = 0$ ((s)he has never been observed delivering low quality); by contrast, (s)he has an all the worse reputation as π_k reaches 1, meaning that (s)he has been observed delivering low quality nearly the k times (s)he did it. This likelihood increases at a decreasing rate, inciting a professional producing low quality at date k to cheat again at date k + 1.

The detection of poor quality by a customer at date k implies that (s)he does not purchase the legal service from the lawyer (s)he is matched with at this date. In other words, the lawyer is excluded from the market for the current period. Now, since information on individual reputation is very imperfect, a client is most often unable to convey the information on bad quality to other clients. Hence, the sanction incurred by a low quality supplier is only temporary: although this lawyer has been detected providing low quality by a consumer, (s)he will be matched with a different one in the next period. We denote g_k the probability for a lawyer of having a good reputation whereas already delivering low quality.

$$g_k = (1 - \lambda) \sum_{t=0}^{k} \lambda^t (1 - \pi_t) \tag{1}$$

g_k is very high in the market because of the consumers' lack of information on individual past quality – π_k is very low for credence goods. It is decreasing in λ : an increase in the probability for a lawyer to remain in the market up to the next date reduces the renewal of the population, and makes it easier to observe cheating. Of course, g_k also decreases with the clients' information.

Collective reputation

Consumers obtain additional information from the collective reputation of the legal profession. The profession has an incentive to maintain a good collective reputation as it increases the consumers' willingness to pay for legal services and, therefore, the rent that accrues to the group[4]. Furthermore, it can observe the quality produced by its members. Now, the individual track records of members can be observed by the profession only imperfectly. Let π^P_k be the probability that the profession will observe that a lawyer has provided low quality at least once in the past when (s)he has in fact produced it k times:

Assumption 2: $\pi_0^P = 0 < \pi_1^P < \pi_2^P < ... < 1$ and $\pi_{k+1}^P - \pi_k^P < \pi_k^P - \pi_{k-1}^P$ for all k.

Assumption 2 simply means that the more frequently a lawyer has produced low quality in the past, the more likely it is that the profession is informed about him or her having supplied low quality legal services at least once. This likelihood increases at a decreasing rate, giving a lawyer producing low quality at date k an incentive to cheat again at date k + 1.

We also assume that the profession is better informed than consumers within a market for credence goods.

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[4] As it increases the willingness to pay of clients, a good collective reputation increases the rent of the profession and, therefore, the individual rent or the share that a lawyer may expect to appropriate individually as an outcome of membership. This article does not consider distributive problems within the profession.

$\pi_k^P > \pi_k$ for all k.

Assumption 3 reflects the higher expertise of peers in assessing the actual quality of the legal services provided by a member of the profession. This is consistent with the literature on self-regulation according to which the profession is better informed about the actual behaviours of its members than non-members[5]. We also assume that the profession strikes off a lawyer anytime it has evidence of him or her providing low quality, with no cost involved either in striking a member off or in replacing him or her; thus at each date the size of the professional group is constant. In that setting, a function devoted to the profession in our analysis is to exclude "bad" lawyers as they reduce the collective rent that accrues to the legal profession as a whole. The threat of exclusion from the profession, implying exit costs and deprivation from the professional rent, is expected to provide individual lawyers with the right incentive to supply high quality so as to maintain a good collective reputation. Exclusion based on detection by the profession is considered to be permanent and, therefore, precludes any transaction with future consumers, in contrast with the individual reputation framework.

We assume that there are no informational transfers between consumers and profession. Indeed, consumers cannot report an individually observed low level of quality to the profession. This assumption echoes the credence good nature of legal services – within a market for credence goods, consumers cannot determine whether they have been under- or over-treated by a professional or whether overcharging has occurred; such uncertainty and the cost of complaint filing may restrain them from engaging in report behaviours. This also reflects the small numbers of reports of low quality that are observed in practice[6]. We also assume that the profession cannot inform consumers about individual quality directly. However, membership of the profession can be observed by consumers perfectly and at no cost. It signals to consumers that a lawyer has not (or not yet) been observed to be delivering low quality by his or her fellow members.

We define G_k as the average probability for low-quality lawyers to remain undetected by both the profession and consumers at date k. Among the $(1-\lambda)$ newcomers at date t (who have not produced yet and therefore have not been given the opportunity to cheat on quality), λ still belong to the profession at the next date if they have not been detected by the profession, which occurs with a probability $(1-\pi_0^P)(1-\pi_1^P)...(1-\pi_t^P)$. In addition, the probability that a lawyer consistently delivering low quality will remain undetected by consumers at date t is $(1-\pi_t)$. Therefore, within the population of lawyers, the average probability of having a good reputation when already delivering low quality (because low quality production remains unnoticed by the customer and the profession) is:

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[5] We do not consider type I errors: bad suppliers can be misinterpreted as being good ones but good suppliers cannot be mistaken for bad ones.

[6] For instance, in France, dissatisfied clients willing to complain about low quality of the service provided by a lawyer can report alleged low quality to the *Bâtonnier* (i.e., the "Head" of lawyers within a given Bar) and professional authorities in charge of professional discipline. In practice, however, only a very small number of reports are filled.

$$G_k = (1 - \lambda) \sum_{t=0}^{k} \lambda^t (1 - \pi_t)(1 - \pi_0^P)(1 - \pi_1^P) \dots (1 - \pi_t^P) \tag{2}$$

G_k decreases according to how well-informed both the profession and the consumers are. Moreover, it decreases with λ: an increase in λ reduces the rate of renewal of the population, and makes it easier to observe cheating. When clients derive information only from the individual reputation of lawyers, that is when $\pi_k^P = 0$, then $G_k = g_k$.

3. Reputation and quality of legal services

We now determine the conditions under which high-quality services are delivered in the market for the legal service. As we focus on the institutional arrangements that favour high-quality legal services, we restrict the analysis on pure strategies and do not study mixed strategies by agents and the issue of multiple steady-states. For that purpose, we define a high-quality steady-state (and conversely a low-quality steady-state) as the situation in which all opportunistic lawyers always choose to produce high (low) quality. Studying the high quality steady-state, we first determine the price that a consumer is willing to pay for the legal service at period t, given both the individual and the collective reputations. A sufficient condition for the existence of a high quality steady-state is that the consumer's willingness to pay is high enough to give opportunistic lawyers incentives to deliver a high quality service. We then show that this condition is more easily satisfied when the market for the legal service is self-regulated than not.

3.1. The high-quality steady-state of the market

Given the definition of G_k, lG_k gives the proportion of bad lawyers having a deceptively good reputation. Thus, the customer's willingness to pay for the legal service depends on the average quality in the market that equals to the probability for the client to purchase high quality (from the assumptions, the payoff of high quality is 1 and 0 otherwise):

$$p_H^* = \frac{1 - l}{1 - l + lG_k}$$

$$\tag{3}$$

The highest p_H^* is obtained when all opportunistic lawyers have an incentive to supply high quality. That is to say, their expected gains are greater than their cost of effort. On the one hand, by consistently providing high quality, an opportunistic lawyer avoids the risk of being excluded from the profession and the risk of losing an informed customer at date t. On the other hand, (s)he incurs the cost of effort e. His (her) expected payoff is then:

$$p_H^* - e + \delta(p_H^* - e) + \delta^2(p_H^* - e) + \dots = \frac{p_H^* - e}{1 - \delta}$$

Let us suppose instead that this opportunistic lawyer chooses to consistently produce low quality. In this case, (s)he runs the risk of either being detected by the profession and struck off, or not being detected by the profession but by a customer and therefore losing this customer for the current period. Thus, his (her) expected payoff is:

$$p_H^* + \delta p_H^* \left(\frac{1}{1-\delta} - A* \right)$$

A* denotes the present expected probability for the opportunistic lawyer of being detected either by the profession or by a customer at any future date due to low quality service:

$$A^* = \pi_1^P + (1 - \pi_1^P)\pi_1 + \delta[\pi_1^P + (1 - \pi_1^P)(\pi_2^P + (1 - \pi_2^P)\pi_2]$$
$$+ \delta^2[\pi_1^P + (1 - \pi_1^P)\pi_2^P + (1 - \pi_1^P)(1 - \pi_2^P)(\pi_3^P + (1 - \pi_3^P)\pi_3] + \cdots$$

A* increases with π_k and π_k^P respectively; furthermore, given that $\pi_k^P > \pi_k$, A* increases faster with π_k^P than with π_k.

From equations (3), (4), and (5), we get a necessary and sufficient condition under which the high-quality steady-state exists in the market for the legal service:

$$p_H^* + \delta p_H^* \left(\frac{1}{1 - \delta} - A^* \right) \leq \frac{p_H^* - e}{1 - \delta}$$

Rearranging equation (6) yields the following proposition.

Proposition 1: In the market for a legal service with credence good features where both individual and collective reputations operate, a necessary and sufficient condition for the existence of a high quality steady state is:

$$\frac{e}{1 - \delta} \leq \delta p_H^* A^*$$

This condition requires that the expected gains from a good (individual and collective) reputation ($\delta p_H^* A^*$) be high enough to deter opportunistic lawyers from cheating on quality. This is the case if the cost of effort e is not too high and/or p_H^* is high. This occurs when the (given) proportion of bad lawyers in the population is sufficiently low: in order to increase consumers' willingness to pay, the profession is interested not only to exclude bad lawyers but also to screen among candidates at the hiring stage in order to reduce the proportion l of bad lawyers. Condition (5) is also fulfilled whenever A^* is high and for low values of G_k - that is, for high values of π_k and/or π_k^P), meaning that low quality production is not too badly

detected. In the extreme case of perfect information ($G_k = 0$ and $A^* = 1$), the high-quality steady-state defined here is the unique equilibrium and reputational considerations play no role.

When the profession plays no role in regulating the quality delivered by members (that is, when there is no self-regulation in the market for legal services), then $G_k = g_k$. Hence, the present expected probability for the opportunistic lawyer of being detected by a customer (and only by a customer) at any future date due to low quality production is given by $A° = \pi_1 + \delta\pi_2 + \delta\pi_3 + \cdots$, where $A° < A^*$. Thus, the clients' willingness to pay for the service decreases. Let us denote p_H^o this particular level of p_H^* :

$$p_H^o = \frac{1-l}{1-l+lg_k}$$

(3')

Where g_k is defined by (1)

A similar reasoning as above yields proposition 2.

Proposition 2: In the market for a legal service with credence good features where collective reputation does not operate, a high-quality steady state still exists. A necessary and sufficient condition for the existence of the high quality steady-state is:

$$\frac{e}{1-\delta} \le \delta p_H^o A°$$

(7')

Now, condition (7') may not be easily satisfied. Indeed, without any concern of the profession for its collective reputation, *i.e.* without the possibility to sanction the quality delivered by its members, clients expect to receive low quality services. As they are mostly unable to assess legal quality, both $A°$ and p_H^o are very low, and g_k tends to 1; consumers are then unwilling to pay a high price for the low quality that may prevail. By contrast, condition (7) may be more easily satisfied than (7'). Indeed, from assumption 3, the profession is better informed about the actual behaviours of its members than clients and is able to costlessly strike off those members who have been detected cheating. Therefore, when the profession is concerned by its good collective reputation, $A° < A^*$ and $p_H^o < p_H^*$: when condition (7') is satisfied, condition (7) is also satisfied. Proposition 3 is straightforward.

Proposition 3: In the market for a legal service with credence good features, the high-quality steady-state is more easily achieved with collective reputation than with individual reputation. Indeed:

$$\frac{e}{1-\delta} \le \delta p_H^o A° \le \delta p_H^* A^*$$

(8)

3.2. The low-quality steady-state

Alternatively, a low-quality steady state is defined as a situation in which all the opportunistic lawyers consistently provide low quality. In this case, the proportion of lawyers providing low quality but having a deceptively good reputation is $(u + l)G_k = (1 - h)G_k$. The price that clients are willing to pay is therefore:

$$p_L^* = \frac{h}{h + (1 - h)G_k} \leq p_H^*$$

(9)

Then, the lowest p_L^* is obtained when all the opportunistic lawyers supply low quality. Then, customers are willing to pay no more than p_L^* since they expect the average quality in the market to be low. Let us remark that p_L^* and p_H^* tend to 1 when G_k tends towards 0, meaning that the profession and consumers perfectly detect low quality. Following the same reasoning as above, proposition 4 derives a necessary and sufficient condition for the existence of a low-quality steady-state:

Proposition 4: In the market for a legal service with credence good features, a necessary and sufficient condition for the existence of the low-quality steady state is that:

$$\frac{e}{1 - \delta} \geq \delta p_L^* A^*$$

(10)

Hence, the low-quality steady state exists when the expected gains derived from a bad reputation are too low to offset the present cost of effort.[7] This is the case when the cost of effort is sufficiently high and/or when p_L^* is low, *i.e.* when the (given) proportion of opportunistic and bad suppliers is sufficiently high. Here again, the vested interest of the profession is to screen entrants at the hiring stage in order to increase the proportion h of "good" lawyers, raising consumers' willingness to pay, and therefore the rent that accrues to the profession.

Proposition 4 is also met when A^* is low, *i.e.* whenever low quality production is not easily detected by the profession and the consumers. In the extreme case of no information at all $G_k = 1$ and $A^* = 0$, a unique low-quality stationary equilibrium exists and the consumers' willingness to pay only depends on the proportion of good professionals on the market.

Following up a similar reasoning as for the high-quality equilibrium, we find that when the profession plays no role in regulating the quality delivered by its members, then the low quality steady-state more likely occurs. In that case, indeed, $G_k = g_k$, and the probability

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[7] Further, as conditions 7 and 10 are not mutually exclusive, multiple steady states may exist.

of being detected is low and equals $A°$. The price that consumers are willing to pay then decreases to p_L^0. p_L^0 is the lowest price that consumers are willing to pay and $p_L^0 < p_L^*$.

$$p_L^o = \frac{h}{h + (1-h)g_k}$$

Proposition 5 is straightforward.

Proposition 5: In the market for a legal service with credence good features, the low-quality steady-state is more easily achieved when only individual reputation operates. Indeed:

$$\frac{e}{1-\delta} \geq \delta p_L^* A^* \geq \delta p_L^0 A^0$$

(11)

4. Discussion and policy implications for the regulation of the market for legal services

Several results can be drawn from the simple model above.

First, we find that a high-quality steady-state exists in the market for legal services – even when consumers are poorly informed. From propositions 1 and 2, this equilibrium can be achieved with or without self-regulation. Indeed, proposition 2 stands that market mechanisms can induce lawyers to provide high quality. This is the case when the cost of effort associated with high-quality delivering is low. This is also the case when consumers are not "too poorly informed" – *i.e.* when $A°$ is high enough. This result is consistent with the analysis of Dulleck and Kerschbamer (2006) showing that, under some conditions, the market is efficient to regulate the provision of credence goods. In particular, they show that three conditions must be met: (a) consumers are homogeneous; (b) professionals and consumers are committed once the diagnosis has been made (the consumers' legal needs have been defined) because of economies of scope between diagnosis and treatment (the service production); and (c) the quality of the service is verifiable or a liability rule protects consumers from overcharging. When these assumptions are verified, especially assumptions (a) and (c), then the professional services display experience good features and market mechanisms are efficient to regulate quality. As discussed in the first section, in the market for legal services, this is the case for regular consumers and routine legal services. Due to repeated purchases, regular consumers may be able to assess quality *ex post.* Furthermore, homogeneous consumers are expected to be not too poorly informed as to the quality of routine legal services, as informational transfers between them convey relevant information on actual quality. Individual reputation therefore plays a disciplinary role.

Nevertheless, with credence goods (*i.e.* when the three aforementioned assumptions are not verified) a deregulated market may be a low-powered incentive mechanism to supply high

quality, as the condition for the high quality equilibrium (equation 7') is not easily met. Indeed, without self-regulation, individual reputation is the only informative and disciplinary device which operates. As consumers' information is by definition very limited in the case of credence goods, a lawyer delivering low quality only faces a low probability of being detected. Then, the average probability to keep a deceptive good reputation is high. Therefore, individual reputation only provides low-powered incentives to supply high quality. Without self-regulation, then, low quality can be expected to prevail in legal service markets, as shown by propositions 2, 3, and 5.

According to proposition 2, high quality is easier to obtain with collective reputation than without. This is due to the rent that accrues to the profession when its collective reputation is good. Indeed, when quality is low, consumers are only willing to pay a low price for the service they purchase (p_L^*), and the individual rent that accrues to suppliers tends to 0. By contrast, consumers have a higher willingness to pay, resulting in a positive rent to the profession, when they expect to receive high quality, that is, when the profession has a good collective reputation. As consumers derive information about quality not from the individual but mostly from the collective reputation of the profession, a higher price, and therefore a higher rent, is derived from a good collective reputation. Therefore, the share that a professional expects to appropriate individually from his or her membership to the profession is higher when collective reputation is good. Now, consumers are unable to observe the quality of a professional directly, but they can observe membership to the profession perfectly and at no cost. Hence, the profession as a whole has an incentive to exclude those members who are observed to be cheating in order to maintain a good reputation. The threat of exclusion and the corresponding exit costs (*i.e.* the potential loss of income) provide lawyers with incentives to supply high quality. Furthermore, due to its expertise, the profession has better information about the actual quality delivered by its members than consumers and can detect cheating more easily, although it can observe individual quality only imperfectly. This is consistent with the law and economics literature according to which the regulation of the profession by its own members reduces the cost of informing consumers.

Second, policy implications and recommendations on the institutional organization of the provision of legal services can be derived from our analysis. We show that high quality provision of professional services may be more likely with a self-regulated profession than in a deregulated market. This result is not trivial: the literature usually insists on the rent-seeking behaviour of self-regulated professions and, therefore, on its negative impact on social welfare. From that standpoint, self-regulating organizations are seen as issuing rules allowing them to appropriate rents. Then, it is straightforward to recommend deregulating self-regulated activities on this basis. Quite the reverse, our analysis shows that the rent also gives incentives to the profession to build and to maintain a good collective reputation. This means that the legal profession has an interest in high quality because of the higher rent it can thus derive. In other words, this is precisely the rent allowed by self-regulation that gives lawyers incentives to supply high quality in a market in which they may easily be tempted to supply low quality without being detected by their clients. Let us emphasize that this conclusion does not refer to professional deontology and values of the legal profession, nor does it rely on

intrinsic motivation of lawyers in order to explain high quality delivering. It relies on the economic assumption of a self-interested profession. Ultimately, our model encompasses and combines both economic views on self-regulation – as a way to capture rents and as a device economizing on informational costs. Such an approach to self-regulation supports a non-Manichean view of self-regulation.

Third, although our analysis supports self-regulation of the legal profession, it does not imply that *all* the markets of legal services should be self-regulated. In particular, we find that collective reputation and self-regulating organizations play a role that is all the more important for high quality provision than clients are poorly informed. This suggests that only those legal services that display credence goods characteristics should be self-regulated. As we have seen, some legal services, such as routine services are homogeneous or "standardized" enough to allow regular consumers of such services to assess quality correctly or to convey relevant information on quality to other clients. In this case, our model meets the traditional result that individual reputation may provide lawyers with high-powered incentives to supply high quality. Eventually, we suggest that "one size-fits-all" regulatory recommendations may not be relevant in the markets for legal services, but various types of legal services should rather be distinguished. This, we think, should be taken into account when discussing the deregulation of legal services in the EU, against the univocal view that is mostly endorsed by the law and economics literature on self-regulation.

Fourth, our model adopts a narrow conception of self-regulation. Indeed, it only considers membership issues, at the expense of additional functions of the self-regulating organization, and almost exclusively focuses on the disciplinary role of the legal profession. In particular, our model does not endogeneize the selection of new entrants, although such screening would impact on the prior distribution of "good", "bad", and "opportunistic" lawyers. However, it showed that as long as the legal profession is assumed to be concerned by its good reputation, allowing lawyers to screen new entrants may be expected to increase quality in the market for legal services, at least until the reputational gains are compensated by the costs of screening. The various functions of self-regulatory organizations should thus be taken into account when discussing the deregulation of legal services: whereas some professional regulations may be exclusively driven by the interest of lawyers, without positive counterpart for consumers, some others could in fact support high quality.

5. Extents and conclusion

Several issues remain beyond the scope of our analysis. First, we do not consider the dynamics of the model and the possibility of multiple steady-states. In particular, we do not study the issue of the origin of a good collective reputation and the way a profession may move from the low-quality to the high-quality steady state. Let us simply remark that it may be difficult and costly to leave the low reputational state and to build up a good reputation. Indeed, the dynamics of the low quality steady-state suggests an adverse-selection mechanism: a bad collective reputation leads to a low rent resulting in low incentives and then a low quality in average, producing the poor reputation of the profession. Once having a bad

reputation, it may be impossible for the profession to improve it and it may be stuck in the low-quality equilibrium. A dynamic model could shed light on such a possible vicious cycle.

Second, our analysis could be extended to introduce the tradeoff made by the legal profession between covering-up and disclosing the information about the opportunistic behaviours of its members (Nũnez, 2001). The professional body might have an interest not to communicate the exclusion of a member if it damages its collective reputation. A rough way to take this into account in our model is to assume that exclusion is costly not only for members but also for the profession. When observing low quality delivering by a lawyer, the profession will now face a choice: if it excludes the member and informs consumers about exclusion, it does not only increase average quality, collective reputation and its rent. But it also supports the cost of exclusion. If this cost is very high, the profession will rationally choose not to exclude the member and to cover-up his or her low quality production. This clearly reduces the scope of our argument towards self-regulation.

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