Competition or Monopoly?

OCCUPATIONAL REGULATION AND THE PUBLIC INTEREST

Edited by
Robert Albon and Greg Lindsay

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CIS READINGS 5

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Robert Albon and Greg Lindsay

Contributions by
Michael Aitken, Don Anderson, Ray Ball
Christopher Findlay, John Logan, Frank Milne
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Preface

Restrictions on entry into a profession or occupation raise the incomes of practitioners by limiting their supply and, if the restrictions involve an increase in the real or perceived quality of the services offered, by increasing demand as well. Those pursuing the occupation at the time entry is restricted clearly benefit - especially since existing practitioners are invariably exempted from having to acquire the high qualifications usually required of new entrants. The case of the latter is different. Entry into the occupation has become a valuable right, and normally, one way or another, new entrants have to pay for it. The various ways of rationing entry, and their consequences, is a theme of several papers in this collection.

Where occupational licences are transferable, and eligibility requirements minimal, the method of entry is simple: one buys one's way in. Taxicabs are a case in point, which was analysed in Peter Swan's *On Buying a Job*, the first Policy Monograph of the Centre for Independent Studies. The price of a taxi licence reflects the expected rents from operating a cab. Hence the original beneficiaries from closure of the industry are able to retain their benefit when they leave the industry, while new entrants gain only a normal return on their investment. In some cities, the taxi industry has secured arrangements whereby existing owners not only receive the benefits of their licences, but also of the new licences that, with population growth and increasing demand, are issued from time to time. This is done by allocating new licences to non-owner drivers with long service. The prospect of gaining a piece of paper worth, perhaps, $30,000 induces drivers to work for lower wages and on a more permanent basis than they otherwise would, to the benefit of their employers.

If entry is restricted to those achieving high qualifications and serving some period of apprenticeship - as is common in the professions - the new entrant buys his job by submitting to a long training period in which earnings are zero or low. Educational institutions benefit from the increased demand for their services, as may members of the profession from the cheap labour of apprentices. John Logan

and Christopher Findlay, in their chapters dealing with doctors and airline pilots respectively, present evidence suggesting that the high earnings received by members of these professions are paid for in full in the form of high training costs. In the case of pilots, Findlay argues that the general aviation sector of the industry benefits from the considerable hours of experience required to qualify as an airline pilot: pilots are willing to work for less in general aviation when they hope their work will qualify them for a lucrative job as an airline pilot.

While it may seem preferable to allocate professional places to those with the motivation and ability to complete an arduous course of training, rather than by selling the places or by drawing lots for them, the question arises as to whether the resulting high quality of service is worth its cost, i.e. whether or not our pilots and doctors, as well as other professionals, are overtrained. Certainly critics of the medical profession often point to the considerable time doctors spend on relatively mundane tasks for which their high qualifications are not required.

The papers comprising this volume were originally delivered at a CIS conference on occupational regulation held at the University of New South Wales in March 1982. The tasks of organising the conference, getting the papers refereed and revised, and editing the volume have been performed admirably by Robert Albon and Greg Lindsay. The CIS is particularly grateful to Dr Albon for bringing together a formidable group of authors with wide expertise, and, of course, to the authors themselves for their stimulating contributions.

Ross Parish

INTRODUCTION

Robert Albon
and Greg Lindsay

Robert P. Albon lectures in economics at the Australian National University. Originally from Melbourne, he studied at La Trobe University and Monash University. Prior to joining the ANU in 1976, he worked with the Industries Assistance Commission in Canberra. His research interests are largely in the area of applied microeconomics and he has published a number of scholarly articles on applied monetary economics, milk marketing and the rental housing market. They have appeared in such journals as the *Economic Record*, *Australian Journal of Management*, *Journal of Money, Credit and Banking* and the *Canadian Journal of Agricultural Economics*. In addition he has a strong interest in public issues and has written for the popular press.

Greg Lindsay is Executive Director of the Centre for Independent Studies which he founded in 1976. He is a graduate of Macquarie University and Sydney Teachers' College, having studied philosophy and mathematics.

INTRODUCTION

Robert Albon
and Greg Lindsay

As Milton Friedman observes in *Capitalism and Freedom*, types of occupational regulation form a hierarchy in terms of degree of restrictions: from least to most, they are registration, certification, and licensing. These types of regulation are the principal subject matter of the first eight papers in this volume. However we have taken a rather wider view of occupational regulation, and this encompasses the final two papers, dealing with academics (by Frank Milne) and taxi operators (by David Williams and Michael Aitken).

The contents and organisation of this volume make a lengthy introduction unnecessary. The first paper, by John Nieuwenhuysen and Marina Williams-Wynn, is itself a good introduction to the topic, as it reviews many of the general issues involved in regulation of the professions. Other papers discuss the advantages and disadvantages of occupational regulation. This is particularly true of John Logan's study of the medical profession, Don Anderson's examination of the accounting profession, Ray Ball's review of regulation of stockbrokers, Robert Officer's paper on real estate agents, and Peter Swan's review of the issues surrounding the regulation of insurance brokers. All of these authors consider the arguments put forward to support regulation (for example, the asymmetric information allegation) and the basic case against regulation (that is, monopolisation).

Gary Sturgess's contribution will be of interest to many readers as it deals with the regulation of an extremely important profession - the practice of law. In reviewing and discussing the actual regulations of Australian lawyers and assessing the various arguments for government controls, Sturgess ranges a little more widely than some of the other contributors.

Christopher Findlay's paper is also of special interest as it examines a case of occupational regulation in the context of a highly regulated industry. Findlay argues that government intervention in the airline industry has given rise

to rents to airline pilots which in turn has evoked rent-seeking behaviour by pilots in general aviation. Findlay's paper contains descriptions of the various regulations, analysis of their effects, estimates of the rents and a discussion of the policy options.

The contributors to this volume are not too kindly disposed towards occupational regulation and tend to argue for significant deregulation in the occupations they consider. In each case the authors have performed an informal cost-benefit analysis of the regulation and have concluded, subject to some caveats, that the costs exceed the benefits.

It may be useful at this stage to set out, in general terms, the benefits and costs of occupational regulation. To this end we first examine the possible gainers from this type of government intervention.

One group of beneficiaries is those who are licensed. The licensing procedure results in state-imposed barriers to entry which allows operators to attain incomes above what would be available in their absence. However, it is usually prudent to make a distinction between existing and new agents. When regulation is introduced, existing operators usually receive a licence automatically, while new entrants are obliged to undertake training and/or satisfy other requirements before admission. Many existing agents would not satisfy these requirements. While these traditional operators definitely gain, there is some evidence that the entry requirements would be such as to negate all the potential rents to newcomers, who incur costs of entry equal to the present value of the rents. This issue is discussed at length in John Logan's paper on licensing of medical practitioners.

Another set of possible gainers are the bureaucrats who regulate the occupation. The issues here are very complex and are alluded to at a number of points in this volume.

Purchasers of the commodities supplied by persons in regulated occupations may gain from the information conveyed by the licensing procedures. This is the asymmetric information argument. Because information about the activities of certain suppliers of services is costly to attain, consumers may be advantaged by the knowledge that, for example, medical practitioners must have successfully completed a prescribed course of study in various aspects of health care.

Informational asymmetry is the most credible argument for occupational licensure. Where traders are thought to have a superior knowledge of service quality than their customers, the state, by licensing only competent suppliers, solves the problem for consumers who save on search costs when choosing a supplier.

However, the protection afforded the consumer by licensing is only partial. The setting of minimum entry requirements does not ensure that minimum standards of practice are maintained. Licensing does nothing to inform consumers about differences in practitioners' levels of competence, over and above the possession of minimum qualifications. In fact, professional ethics and regulations (such as bans on advertising) often seem designed to suppress information of this sort.

Further, it is not clear that licensing does anything that cannot be achieved by certification. As Swan points out in his analysis of the insurance brokers issue, certification (perhaps private) is sufficient in conveying information to consumers. Swan also notes that 'in a free market without licensing, consumers are likely to have many avenues for distinguishing the quality characteristics of doctors or . . . insurance brokers'.

Another possible argument for licensure has been mentioned by Friedman. This is the possible existence of externalities (or what Friedman calls 'neighbourhood effects') that may flow from incompetence. To quote from *Capitalism and Freedom*:

> The main argument that is relevant to a liberal is the existence of neighborhood effects. The simplest and most obvious example is the 'incompetent' physician who produces an epidemic. Insofar as he harms only his patient, that is simply a question of voluntary contract and exchange between the patient and his physician. On this score, there is no ground for intervention. However, it can be argued that if the physician treats his patient badly, he may unleash an epidemic that will cause harm to third parties who are not involved in the immediate transaction. In such a case, it is conceivable that everybody . . . would be willing to submit to the restriction of the practice of medicine to 'competent' people. . .

While it may be valid in some circumstances, this argument only seems to be of very limited application in that mistakes

by suppliers of services will not usually have effects beyond the immediate customer.

Against these possible advantages, it has to be noted that licensing has the adverse consequence of giving suppliers monopoly power not available under either registration or certification. Again to quote Friedman:

> The most obvious social cost is that any one of these measures, whether it be registration, certification, or licensure, almost inevitably becomes a tool in the hands of a special producer group to obtain a monopoly position at the expense of the rest of the public. There is no way to avoid this result. One can devise one or another set of procedural controls designed to avert this outcome, but none is likely to overcome the problem that arises out of the greater concentration of producer than of consumer interest. The people who are most concerned with any such arrangement, who will press most for its enforcement and be most concerned with its administration, will be the people in the particular occupation or trade involved. They will inevitably press for the extension of registration to certification and of certification to licensure. Once licensure is attained, the people who might develop an interest in undermining the regulations are kept from exerting their influence. They don't get a license, must therefore go into other occupations, and will lose interest. The result is invariably control over entry by members of the occupation itself and hence the establishment of a monopoly position.

Perhaps the best evidence in favour of the view that occupational regulation is for the benefit of the regulated comes from an examination of the demand for regulation. The demand does not come from users of services as might be expected if, as some suggest, it truly is in the interests of customers. Rather the pressure emanates from the groups who are regulated. This is a theme running through many of the papers in this volume. It is perhaps best exemplified in Officer's paper on real estate agents.

The private interest theory has a long tradition stretching back at least as far back as Adam Smith. The following oft-quoted passage from *The Wealth of Nations* contains an important warning.

> People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public; or in some contrivance to raise prices. It is impossible indeed to prevent such meetings, by any law which either could be executed, or would be consistent with liberty or justice. But though the law cannot hinder people of the same trade from sometimes assembling together, it ought to do nothing to facilitate such assemblies, much less to render them necessary.

The fundamental message is that 'conspiracy against the public' should not receive official backing in the form of the coercive power of the state. Under most circumstances private agreements without government support will either break down or serve a useful purpose (for example, private certification). The demand for regulation from self-interested groups should not find a sympathetic ear in government.

1

COMPETITION FOR THE PROFESSIONS

John Nieuwenhuysen and Marina Williams-Wynn

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Dr. Nieuwenhuysen has published widely in applied economics subjects such as competition, prices and wages policy, and has served as economic adviser in wage cases and trade practices matters involving major Australian companies.

COMPETITION FOR THE PROFESSIONS

John Nieuwenhuysen and Marina Williams-Wynn

I. INTRODUCTION

Professional association attitudes towards pricing, advertising and competition appear to be intimately linked with the view these associations have - and seek to project - of themselves and their members. Those who object to advertising (particularly price advertising) by the professions often do so on the grounds that it would be improper for individuals of integrity to so blatantly seek to sell services which call forth bonds of trust between practitioner and client. Most professional association codes of ethics in Australia suggest a widespread adherence to these sentiments. However, a strong case can be made for competition which in no way denies or decries the high degree of integrity and the personal loyalty that is called for in practitioner-client relationships.

On another level, there is an equally widespread view that a prosperous appearance is required to persuade the public that the members of a profession are capable. In *The Wealth of Nations*, Adam Smith observed that

> We trust our health to the physician, our fortune and sometimes our life and reputation to the lawyer and attorney. Such confidence could not safely be reposed in people of a very low or mean condition. Their reward must be such, therefore, as may give them that. [1]

As in Adam Smith's time, professions like law and medicine still enjoy high pay and status. Sir Henry Phelps-Brown takes the argument one stage further when he states that it may be necessary 'to pay consultants highly in order to be assured that we are getting value for our money.' [2]

Professional associations are able to build on the view that relative pay should enable the maintenance of a suitable

station in life. As Lady Barbara Wootton writes, 'pay and prestige are closely linked; and (in spite of some exceptions) it is the rule that the high prestige person should also be the highly paid person; and *vice versa*'.[3] If so, what better reason for organising to acquire prestige!

II. THE PROFESSIONAL IMAGE

It is with this object in view that professions try to create a special image of themselves. This image often includes the following supposed attributes:

1. Professions must be distinguished from trades.
2. Professions are not engaged in 'selling' but in providing a service.
3. Professions consider the client's (not the customer's) welfare first: professions are not primarily money makers.
4. Members of the profession are loyal to the group.
5. Members do not compete with colleagues by price cutting.
6. Members do not tout for business.
7. A member will usually not accept business offered which he knows, or with ordinary care could have ascertained, was in the hands of another member.
8. Members do not associate in practice with 'unqualified' persons.
9. Members conduct their personal and business life in ways reflecting no discredit on the profession.
10. Members submit to disciplinary procedures which in extreme cases may ruin them as professional persons.

To cultivate this image, professional associations regulate the behaviour of their members. Much of this regulation has been anti-competitive: it has restricted the behaviour of association members on fee fixing, advertising and other market activities; limited the availability of substitutes for the services of the group as a whole; and occasionally influenced market structure by limiting the effective supply of graduates to the profession.

The claim that professional association regulation is anti-competitive would probably not be denied by many of the associations concerned. The representations from professional associations to the (Swanson) Trade Practices Act Review Committee,[4] argues that they should be free to

engage in self-regulation. Certain agreements within professions were said to be meritorious *per se* and in the public interest, giving professions the right to fix or recommend fees or prices to be charged by members, and to establish and police codes of ethics.[5]

In a letter from the Australian Council of Professions to the Prime Minister in 1980, similar sentiments were expressed. The Council maintained that 'the provision of professional services is fundamentally different from the supply of other goods and services'; that 'the application of trade (practices) provisions to the delivery of professional services militates against optimal professional practice'; and that 'self-regulation is a cost effective way of maintaining professional standards and of progressively improving the quality of professional practice'.[6]

Another explicit view of professional regulation and competition was made by the Association of Consulting Actuaries of Australia:

> We agree that . . . codes of conduct interfere with competition. However we believe that the public interest is better served by members of the profession acting according to the principles of a code of conduct than by acting in unrestrained competition with one another. A professional relationship between the adviser and his client cannot be governed by the forces of competition alone; but should be conducted in a manner which encourages the adviser to give and the client to expect uninfluenced advice.[7]

The same report gives a telling example of a professional association's definition of professional conduct:

> We think that in the community's view the real difference between acting professionally and acting unprofessionally lies in whether or not the organisation actively promotes, markets, canvasses or sells its products. If a firm of consulting actuaries engaged in active promotion . . . of actuarial advice, its activities would be regarded as unprofessional, both by the community and the rest of the actuarial profession.[8]

The implication is that competition needs to be eliminated or severely confined where the professions are

concerned, even if it is socially beneficial when applied to producers in general. This theme recurs in very many regulations laid down by professional associations in different parts of the world. One classic statement comes from the British Optical Association. In answering the question 'What is professional conduct?' it says:

> A professional man will not accept another's patient while such a patient is receiving advice, without the previous practitioner's permission. He will not say one word to a patient or client to detract from another member of the profession. He practises singly or in partnership and submits to rigid control over advertising.

The Association added that the relationship between the consultant and patient must be one of

> . . . true confidence. To achieve this he must have consulted the practitioner because of his accredited knowledge. If his motive in consulting the practitioner is that he is cheaper or because he advertises better than someone else, he will not have his true confidence. Above all, the consultant will consider his patient and his welfare and only secondarily his fees.[8]

III. THE MYTH OF DIFFERENCE

Despite this image, however, it seems unjustified that the professions should be immune from the competition laws which Australian business corporations in general are directed to observe under the Trade Practices Act. One way of illustrating the myth of difference purveyed by the professional associations is to consider their arguments on pricing.

Professional associations argue that price competition among their members will erode standards. But why are professional services so different from others that 'cheapness' should imply poor quality? Competition in other markets does not generally induce a decline in quality. The association view probably fails to distinguish between average quality and dispersion about the average: restrictions raise minimum standards and constrain reward for outstanding performers, but competition raises average quality.

It is also claimed that competition on quality is

encouraged by the absence of price competition in the profession. But there are no reasonable grounds for saying that quality and price competition are mutually exclusive. And the absence of price competition can force too much quality on consumers by limiting their choice between difference combinations of price and service.

Another suggestion is that common fees prevent discrimination against smaller users of services. But if fees are based on a user cost-per-unit principle, there are sound economic grounds for discrimination between consumers who cost less to supply (say per hour of service) and those who cost more. A related issue is whether common prices reduce administrative costs - the expense of costing every transaction is said by professional associations to be so great that consumers would be worse off than under a flat-rate system. But administrative expenses are unlikely to be greatly increased, and any additional costs might lead to each practitioner devising a flat-rate system. The possibility of high administrative costs does not provide justification for a fixed fee scale.

The claim that price uniformity protects new entrants to a profession by preventing undercutting by established practitioners is a familiar one. But it is more likely that new entries would be encouraged by price competition, since lower advertised prices would presumably induce potential clients to consider trying a newcomer of unestablished reputation.

Professional associations also argue that fixed fees provide the consumer with certainty about transactions costs. It is presumably preferable for consumers to know in advance the cost of a conveyancing job, or of an appendectomy. But would price competition reduce this certainty? Under price competition, binding quotes on some services can certainly be provided. It is true, however, that if the consumer assumes all professional services to be equal in quality, the presence of fixed fees removes the need to shift from one practitioner to another. Since quality is difficult to judge, and services are often subject to fixed fees, mobility of clients between practitioners is reduced. But this outcome is more cosy than efficient. And consumers might prefer a combination of price flexibility with some uncertainty, to fixed prices and certainly, at least from some professional services.

A further argument concerns equity, and the cross-subsidisation often provided by fixed prices. In some services, such as conveyancing, it is predicted that costs as a

proportion of transaction value would fall relatively heavily on low income earners (who presumably purchase properties of low value). It is also claimed that if each transaction were separately priced, the more difficult would be 'unfairly expensive' to the buyer. But (to use the conveyancing example) it is both the property and its transfer difficulties which are being purchased. It is not clear why the purchasers of property which is cheap to transfer should subsidise other purchasers. Equity is probably better pursued by devices other than cross-subsidisation (such as unconcealed government subsidies). In particular, the practice of charging a relatively high fee for services used mainly by the rich and a relatively low fee for those used mainly by the poor distorts efficient resources allocation. It is not clear whether cross-subsidisation helps some consumers at the expense of others or instead assists providers of the service to reap a monopoly profit.

Another claim is that cross-subsidisation occurs under common fees so as to increase the number and geographical dispersion of those offering services. Client convenience is said to be increased by readier access to more supply sources. With price competition, it is said that some localities could suffer reduced service. If common fees increase outlet dispersion, the less mobile clients benefit, but at the expense of the more mobile.

It is also suggested that one service subsidises another - for instance, the returns of conveyancing are said to be used by solicitors to provide (sub-economically) other services of a 'worthy' or merit kind, such as legal advice to the poor. But this outcome seems to presuppose that professions have some non-pecuniary interest in providing certain services. Common scales do not alone ensure that the margin allowed on the service will actually be used to subsidise another. Rather, the over-generous rewarding of some services seems likely to encourage a concentration in their provision and the subsidisation of the profession.

In general, it is likely that professional fee regulation protects less efficient (and prevents expansion of more efficient) firms. It also makes available to consumers a smaller range of price-service combinations, and creates powerful inducements to set wide margins, since the price has to comprehend high and low-cost distributors. Price fixing can retard structural changes on which improved efficiency depends, and it can inhibit the creation of firms prepared to experiment with new methods.

IV. THE CASE FOR COMPETITION

The professions often claim that chaos and disorder will result if restrictions on advertising and price competition are lifted. However, competition is unlikely to impair either the special nature of professional skills or the personal nature of practitioner-client relationships. Competition is also unlikely to make practitioners feel a diminished sense of responsibility in the maintenance of standards, or to threaten safeguards on the life, health, safety, property or freedom of the individual client. (In any case, some professions are covered by compulsory indemnity insurance which offers adequate client protection.)

Competition for the professions does not imply complete freedom of entry. There is a clear need for qualifications which the public can acknowledge and recognise as prerequisites for professional practice. But, self-regulation has permitted professional associations to use entry barriers to serve monopoly profits rather than the public interest. The unqualified should be debarred from offering a service only where the risks concerned are especially serious, clients are unable to assess the danger of using the services of unqualified practitioners and insurance is not a viable option. Determination of the standard of qualification appropriate to a profession should not be affected by the presence or absence of unqualified practitioners.

The most effective restraint on competition is probably a collective obligation not to compete on price, including a bar on advertising. Economic reform in the profession must therefore aim mainly at price competition and individual advertising. One British study concluded, that the introduction of price competition in the supply of a professional service where it is not at present permitted is likely to be most effective single stimulant to greater efficiency and to innovation and variety of service.

The qualitative case for competition relates to the criteria of applied welfare economics: i.e. the extent to which prices reflect the resource costs of meeting consumer preferences (a notion of static allocative efficiency in which each firm is earning only normal or non-monopoly profits). It also concerns managerial efficiency sometimes referred to as x-efficiency or organisation efficiency, and dynamic efficiency which is achievement of technical change to lower costs again through the stimulation of competition.

But however strong the qualitative case for competition, it is difficult if not impossible to quantify these advantages.

For example, it is obviously hazardous to forecast the extent to which prices for dental services might decline following the introduction of individual advertising and price competition - it would be pure guesswork. Nonetheless the difficulties of quantification do not in my view detract from the case for an end to restrictive practices, including price fixing.

Fears of chaos and disorder if price competition and advertising are permitted in all the professions appear groundless. In the United States the introduction of negotiated rates of brokerage in the securities market really benefited the consumers and did not result, so we are told, in the harmful and disruptive effects anticipated by the opponents of competitive rates. Similarly the abandonment of accountants' agreed fee scales in Australia does not seem to have destroyed professional health or vitality in this field. There is an even more telling example, one that is written by Warren Pengilley on the Professions and Trade Practices Act, and that concerns the ACT lawyer who actually had the option of voting in the 1979 Annual General Meeting on the following motion:

1. That it is desirable and in the interest of both the public and the profession that a scale of costs be re-introduced for standard conveyancing matters.

This motion was defeated by 77 votes to 32. At least one group in the profession has decided that it prefers to live without what is elsewhere regarded as a sacred restraint.

V. HOW TO ESTABLISH GREATER COMPETITION

There are three ways in which greater competition might be established in the professions. Firstly, there might be constitutional amendment and the application of the Trade Practices Act to the professions together with court rulings accepting that the professions are engaged in trade and commerce. Secondly, change may come from the pressure of public opinion, media exposure and the various reform bodies such as the Law Reform Commission. Finally, there is the impetus of internal reform in the professional associations themselves.

At present, scope for application of the Trade Practices Act to the professions is limited. However, Commission and Tribunal guidelines indicate the treatment which could be expected if all professions came under the Act.

In 1981, the Trade Practices Tribunal confirmed a Trade Practices Commission decision to deny authorisation for the Association of Consulting Engineers Australia's code of ethics, scale of fees, conduct of professional practice and binding rules. This decision showed current regulations on fee competition, advertising, and available types of contract would generally be caught by Section 45. This prohibits contracts, arrangements and understandings which are likely substantially to lessen competition in a market for goods or services. Provisions for expulsion from professional associations are also likely to fall foul of Section 45. The Commission has commented that 'such clauses allow certain members of the organisation unfettered powers over other members for undefined or vaguely defined 'offences' and the code can thus be used to stop members engaging in price (or other) competition'.[10]

Section 45D on secondary boycotts could cover incidents such as the Roger Stevenson case. The Commission has determined that the Law Society of New South Wales and the Law Institute of Victoria would be in breach of Section 45D if they disciplined solicitors acting for the clients of discount conveyancing companies.[11]

Monopolisation is covered by Section 46: a corporation substantially in control of a market for goods and services may not take advantage of its position to eliminate or substantially damage a competitor, or prevent or deter entry to a market or competitive conduct in it. Many professional associations substantially control a market for services - much of the work of lawyers, doctors and dentists is reserved for them by statute. Professional associations undoubtedly engage in practices prohibited for corporations by this section: solicitors who advertise or make it known that they are willing to charge less than the schedule fee are liable to disciplinary action, including the cancellation of practising certificates. Another illustration is the de-registration that can result in medicine and dentistry from individual advertising. Entry of competitors can also be prevented by the medical and dental associations.

Bar associations rules seem likely also to contravene Section 46 of the Act (exclusive dealing) were competition law to apply to the legal profession. Section 47(6) prohibits third line forcing, i.e. corporations may not supply goods or services on condition that prospective purchasers acquire specified goods or services from another person. Bar association rules prevent barristers from taking instructions directly from clients, who are required first to obtain the

services of a solicitor. The rules also prevent QCs from working on a case unless a junior is employed as well.[12]

Resale price maintenance (RPM) is prohibited absolutely by Section 48. RPM cannot generally be practised by professional associations since they supply services, not goods. But some professions use fixed fee scales to similar effect.

Under Section 49 - price discrimination - corporations may not distinguish between purchasers of like goods in prices charged, discounts allowed or services provided if the discrimination is likely substantially to lessen competition. But some professional association fee scales such as the Victorian scale of conveyancing charges have precisely this effect. And in some courts (such as the County Court) the scale fee varies with the amount under contest.

VI. CONCLUSION

Competition law need not remove the right to professional self-regulation provided acceptable boundaries are recognised. As Dr Pengilley has pointed out, 'competition law, whether in Australia or the United States, has never hampered self-regulation aimed at achieving unambiguous and unimpeachable standards, widely accepted in the community, **and which are explicable in terms other than those of self-serving motive**'[13](his emphasis).

Competition law need not stop reasoned, impartial ethical standards suitable to any special aspects of supplier-client relationships. Unfortunately, however, many associations see self-regulation as a right to prevent individual advertising and price competition. But competition law cannot cross this border. As the Chairman of the Commission, Mr R.M. Bannerman, has said, 'it is hard to accept that professional integrity . . . needs to be based on restriction of competition which are the same time serves the collective self-interest of the group. This seems . . . to ascribe too much fragility to professional integrity . . . price should [not] be the sole criterion of selection for professional services . . . It does not happen elsewhere, and it would be least likely of all to happen with professions.'[14]

Prior to the introduction of the Trade Practices Act in 1975, industry spokesmen protested that the Act would undermine business confidence. The protests of these spokesmen are now history. The Trade Practices Act has not prevented scale economies or benefits of size. Calls for the retention of professional ethical restraints will increasingly

sound like the worn-out arguments of industry in the 1960s. They will eventually receive the same evaluation.

* Based on John Nieuwenhuysen and Marina Williams-Wynn *Professions in the Market Place*, Melbourne University Press, 1982, chapters 1, 3, 5. The book is a study of doctors, dentists, accountants and lawyers and their professional associations in Australia. It is prefaced with an introduction by the Chairman of the Australian Law Reform Commission, Mr Justice Michael Kirby.

Notes

1. Smith, Adam, *An Enquiry into the Nature and Causes of the Wealth of Nations*, Penguin, 1982, p. 207.
2. Phelps-Brown, Sir Henry, *The Inequality of Pay*, Oxford: Oxford University Press, 1978, p. 118.
3. Wootton, Lady Barbara, *The Social Foundations of Wages Policy*, London: Allen & Unwin, 1955, p. 68.
4. Report of the (Swanson) Trade Practices Act Review Committee, Canberra: AGPS, 1976, para. 1.29, p. 87.
5. This view was, however opposed by other submissions to the Swanson Committee, including some groups from within professions, which suggested that there was no reason why members of the professions should be treated differently from other sections of the business community. The Committee in its report (p. 88) took the view that there should be 'no distinction between professions and other persons engaged in trade or commerce . . . no section of the community is entitled to be the judge in its own cause'.
6. *Engineers Australia*, 13 June 1980. Quoted from W. Pengilley, 'The Trade Practices Act and the Professions', p. 30.
7. Submission by the Association of Consulting Actuaries to the Sub-Committee on Professional Conduct, p. 4, para. 2.6.

8. Submission, ACA, p. 14, para. 3.28.
9. Quoted from D.S. Lees, *Economic Consequences of the Professions*, London: Institute of Economic Affairs, 1966, p. 5.
10. *Australian Trade Practices Reporter*, Procedure in Cases of Determination of Clearance Applications for Agreements Constituting Codes of Ethics, Information Circular 9, 26 May 1975, p. 8455.
11. 'News Briefs', *Justinian*, 30 April 1980.
12. A less rigid full-line force applies in the medical world, though not necessarily only through the influence of the AMA. Patients may attend a specialist either directly or by referral from a GP first for all medical advice.
13. Pengilley, p. 31
14. Report, Swanson Commission, pp. 9-10.

2

PROCESS AND CONSEQUENCES OF REGULATION OF A PROFESSION WITH SPECIAL REFERENCE TO REAL ESTATE AGENTS

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PROCESS AND CONSEQUENCES OF REGULATION OF A PROFESSION WITH SPECIAL REFERENCE TO REAL ESTATE AGENTS

R. R. Officer

I. INTRODUCTION

What conditions lead to regulation of the professions? I propose to show that what starts out as an intent to regulate in the public interest often - some would argue inevitably - leads to the antithesis of the intent. Regulation serves the interest of narrow sectional groups and is to the general detriment of the public, particularly the clients of the regulated profession.

So that I do not appear to be simply 'knocking' the efforts of well-meaning citizens and politicians, I will suggest alternative ways of tackling the problem that is perceived to require statutory control. Finally, I will illustrate the general scenario by reference to the regulation of real estate agents, with specific reference to the regulation that occurs in Victoria.

II. THE CONDITION FOR REGULATION OF A PROFESSION

It is the sentiment that *caveat emptor* (let the buyer beware), when applied to clients of the professions, is unfair, even uncivilised, that has led to the public's acceptance of much of the regulation of professions that has occurred. It is considered that the public at large is at a distinct disadvantage because of the obvious skills of the other party - the professional - in the interchange of services for payment. To correct the imbalance, it is usually argued that the public needs to be protected by specific statutes regulating codes of behaviour (ethics) of the profession. To achieve this end, regulations often go to the extent of specifying training requirements for members of the profession.

When pressed to provide details of the problem, the regulators, politicians, spokesmen for the profession or public

(sometimes these all emanate from the same source), give specific instances of fraud and/or deception of clients by members of the industry. The examples usually involve a fringe member of the profession (almost never a member of the professional association) and the victim is often someone whose financial or intellectual circumstances are causes for compassion. It is not long before countless other examples of fraud or deception or simply a poor quality of service are documented in the press and elsewhere. The *cause celebre* is taken up by sensitive and/or perceptive politicians and regulation of the profession is the usual consequence.

Statutory regulation of the profession rarely develops from the groundswell of public opinion. As Stigler and others have pointed out,[1] the party responsible for the regulation is often the profession itself - the regulation is acquired - although this is certainly not the only route by which the process of regulation is instigated. Sometimes, political figures will act as entrepreneurs for what they perceive to be the public interest, publicising deficiencies in the profession and then offering solutions by regulation. In other instances, social reformers may lead the cause for regulation.

III. STRUCTURE OF REGULATION

The drafting of the regulation

A government, recognising the political benefits of legislating in an area where there is little organised opposition (governments are never applauded for doing nothing, so that legislation *per se* is good), proceed to draft the bill or bills. In order to draft the legislation they will, of course, require expert advice on the substance of the legislation. The government typically can only get such expert advice from existing professional associations or their members. Further, no matter how well intentioned, such experts inevitably will have a biased perspective of the problem, in that their experience has been as the seller of the service.

These biases are not offset, in most instances, by representations from consumer groups, simply because if they are made at all, such groups rarely have the authority or the depth of understanding of the industry that the experts possess. Nor can we expect the bias to be corrected by the politicians and lawyers who are responsible for drafting the legislation. They are untrained, as indeed are most experts, to recognise the ramifications of the regulations. Moreover,

the politician has little encouragement to recognise such ramifications when he perceives little or no formal opposition.

The board of experts

The legislation, once drafted, will require managing and once again the government will turn to experts to make up a substantial component of the statutory board set up for this task. It is, of course, unusual for such experts, previous or existing members of the profession, to have a majority on the board. However, they do not require it to dominate the proceedings. This is particularly true when other members of the board come from similarly structured professions and the lay members usually have insufficient knowledge or confidence to oppose or even question the opinions of the experts.

The nature of the management task confronting the board means that often it is left with considerable discretionary authority. The power to enforce the legislation and also the discretionary judgments that can be legitimately made by the board resides with their ability to refuse or to terminate licences that they grant under the Act to members of the profession. However, governments, recognising the possibility of abuse of power by a board, have usually drafted into the Act appeals to some higher authority, such as the courts.

Specific constraints

1. Restrictions on entry

The problems of a profession, at least those that have been given public airing, will be attributed in large part to unscrupulous operators operating on the fringe of the profession and naive, unskilled, new entrants. The obvious solution is to control the conditions of entry into the industry, vetting each new entrant and barring from the industry those who do not abide by the regulations.

Under the new regulations, those who can show that they have operated in the profession for some specific time are usually automatically licensed. Demonstrating this professional experience is more difficult for those who are not members of existing professional organisations or who have practised in the profession only as an adjunct to other activities.

From the viewpoint of the profession, the full burden of the restrictions on entry fall on potential entrants. The restrictions inevitably require some formal training together with the appropriate qualifications (degree or diploma), and an apprenticeship. These conditions can be wrapped together in the one set of training.

Existing members of the profession and most social commentators agree that the higher the qualification, the more professional the graduate, and the better served the profession and its clients. Attention is rarely given to the fact that most of the existing members of the profession competently carry out their duties, without such qualifications. Any questioning of the need for such formal training is usually justified by 'the advanced state of the profession's development'. This is also supported by older members of the profession who vigorously complain of the lack of opportunities for 'that sort of education' when they entered. The apprenticeship is considered essential to show how the theory ('principles') can be put into practice.

In times of economic downturn, the entry conditions are often raised to slow the growth of the profession. Although this is often **not** publicly admitted, it is justified by arguing that a 'reasonable income' must be obtained for members of the profession, particularly in the light of their training and experience. Occasionally, the greater restrictions will be dressed up as a need to increase the standard of service offered, particularly in times of economic adversity.

2. The code of behaviour (ethics)

The customers or clients must be protected from zealous marketing practices by members of the profession. Therefore, it is common to find constraints placed on how professionals can market their services.

It is unseemly for a member of the profession to be involved in elaborate and attention-seeking forms of advertising. Moreover, as it was often pointed out at the Prices Justification Tribunal (PJT) enquiries, such advertising will usually only lead to customers or clients circulating within the profession without increasing the profession's client base; it is, therefore, wasteful. Similarly, marketing practices which involve a direct poaching of competitor's clients are also unethical as this can lead to 'excessive' competition amongst members of the profession to the confusion and ultimate detriment of the client. The statutory Board set up to monitor and guide the path of the profession

can be expected to regulate, limit or restrict these forms of behaviour.

In addition, members of the profession who work with non- or sub-professionals have the potential for subverting the code of behaviour adopted by the profession and enforced by the board. It is considered important that such relationships be closely controlled or preferably eliminated. It is also pointed out that such working relationships, including franchising, can effectively dismantle the restrictions on entry, to the obvious detriment of the standards of the profession. The boards can be expected to act against such developments.

3. Quality and price of service

In periods of intense price competition, it is inevitable that the quality of service will fall. Therefore, in order to maintain a level of service that the public requires (as interpreted by the regulators), it is essential that a 'reasonable' return be obtained by members of the profession. To protect against the consequences of this type of price or commission competition, the board can be expected to set a level for commissions that is commensurate with the level of service required, taking into account a reward for the skills of the profession.

It is also argued that a set price or commission will prevent uninformed clients from paying too much for services. This can lead to a board setting a maximum rate that the profession can charge. However, with the constraints on entry and specifications of quality of service, these maximum rates frequently become the set rate. The justification for the board setting the quality of service is that it simplifies the decision for the client so that he is less likely to be taken advantage of when there is little discretion in the range of service offered. Also, although it is rarely publicly admitted, where a standard of service can be set it makes the task of the board very much easier to monitor and regulate the profession.

4. The compensation fund

In situations where a profession's members are responsible for holding a client's money in trust, the legislation usually specifies how such money is to be held and managed. In the event of default by a member whose personal assets cannot compensate the client(s), a fidelity fund or indemnity

insurance scheme is used to make good the losses. These schemes or funds are often supported by contributions from members and by interest earned on money held in trust.

IV. THE SIMILARITY BETWEEN THE STRUCTURE OF REGULATION AND THE RULES OF A CARTEL

To recapitulate, the regulations usually invoked to control a profession include the following:

1. barriers to entry in the form of qualifications and apprenticeship;
2. constraints on advertising;
3. constraints on how clients may be approached;
4. constraints on price and quality of service;
5. the establishment of a fund to compensate clients who have suffered financially in dealing with members of the profession.

Economists would immediately recognise the similarity between this list and the usual requirements for a cartel to operate effectively and extract monopoly profit from its customers. The major difference is that an effective cartel will usually have to allocate production quotas to prevent members competing against each other and undercutting the monopoly power of the group. Also, a cartel will rarely have a compensation fund, although if it is concerned with its public image (it may derive its power from statutes), it will. However, where a cartel cannot effectively allocate production quotas - and in the case of selling services, it usually cannot because the quotas cannot be easily measured or policed - its rules will be almost identical to those above.

From the viewpoint of a cartel, the most critical requirement is effective barriers to entry that it can control or influence. Without these, the cartel will not be able to develop and extract the benefits of monopoly power. However, once these barriers are established, the main concern of the cartel will be to prevent competition amongst members from eroding the benefits of the monopoly and this is ultimately tied up with allocating the monopoly profits of the cartel amongst members. If quotas for members can be effectively set and policed by the cartel, it will have little need to police other areas of members' behaviour since no other activity of members can increase their individual share of the profits. However, if these quotas cannot be set then

the cartel will have to accept rules for members that limit competition between them and prevent them from dissipating the monopoly profits in competition. Such rules usually relate to how clients are to be approached, charged, the type of service to be provided, and constraints on advertising - the same type of rules we have discussed above in relation to regulation of a profession.

V. THE SOCIAL COSTS OF REGULATING PROFESSIONS

Having considered the supposed benefits, let us now examine the possible social costs of the rules typically imposed by professional regulation. These are additional to the direct costs of managing and policing regulations.

Restrictions on entry

The higher the education and apprenticeship requirements, the fewer entrants, and the greater the compensation required by entrants, with the inevitable result of a greater cost to clients of the profession. These costs will be imposed on clients irrespective of whether or not they want a benefit from the increased standards for entry. Moreover, existing members of the profession - those who did not have to meet the new requirements - are able to capitalise on the higher costs of duty and service. We do not find older members of the profession decrying the increased standards; quite the reverse, they applaud them because they stand to benefit from them in a way that neither the consumer nor the new entrant benefit: they do not pay for them.

Constraints on attracting clients, including advertising

The costs to the community are reflected in a number of ways when there are restrictions on the marketing of services. Firstly, it disadvantages new entrants to the profession to the benefit of older members. If new entrants are prevented from attracting clients in the most effective way, the existing members of the profession, who have established a client base, benefit. Also, this inhibits the attractiveness of entering the profession to the benefit of the existing members.

Constraints on advertising restrict the information available to consumers. It is argued, of course, that much of this advertising is misleading or even unnecessary. Even if

the charges are true, it denies the consumer the option to decide for himself. It is the sort of paternalistic attitude taken by socialist and totalitarian regimes that implies the regulators know what is better for the consumer than he does himself; it denies consumer sovereignty. In a competitive market, information (advertising) that is not valued by the consumer will be a cost to the producer without any compensation: in short, unprofitable. Such advertising could be expected to disappear; to argue otherwise is to impose ethical and value judgements that are inconsistent with consumer behaviour. The only time we can justifiably question this stance is when the marketing strategy imposes costs on those not involved in sale and purchase of the service.

Constraints on price and quality

Such constraints prevent the consumer from being offered a full range of services, another example of diminishing the sovereignty of the consumer. He can only purchase that range allowed by the regulators. It does, of course, make it easy for the regulators to police their regulations but at this level the debate reduces to whether regulation is an end in itself.

The establishment of a compensation fund

This will have a social cost if the contributions by members or the general funding of the fund is not related to the risks (probability) of default or other fraudulent practices that may be perpetrated on the public. In many cases where the fund is regulated without meeting market tests of similar 'insurance' schemes, this will indeed be the case.

VI. ALTERNATIVES TO SPECIFIC REGULATIONS

The above-mentioned costs are rarely discussed when regulation of a profession is considered. If they were, it is likely that the problems as perceived by the regulators would be tackled in other ways which would ameliorate or preferably eliminate these costs. With this in mind let us turn to possible alternative solutions to the problem of clients suffering unnecessarily at the hands of the providers of professional services.

If we accept the principle of consumer sovereignty (that is, we do not accept that the state through regulatory autho-

rities knows what is better for us than we know for ourselves), then there are alternatives to imposing regulations of the type described.

There are several generalised circumstances where there is justification for intervening in the market for professional (or any other) services. Firstly, there may be a market imperfection such that the efficient flow of resources into and out of the industry is impeded. Typically this occurs when, for one reason or other, an individual or group achieves market power that is not commensurate or consistent with its efficiency of operation. An example is when the full costs of fraud and deception are not brought to bear on the perpetrators because the high cost of litigation discourages clients to seek redress. The efficient way of handling this problem is to reduce litigation costs, which could be accomplished by setting up a body comparable to the small claims tribunals that some states have established. It does not require the full and costly armoury of regulation.

Another justification for intervening - which involves a social judgment about welfare or income distribution - occurs when there is thought to be an imbalance in the bargaining power, not related to issues raised above, between the professional and his client. The typical example is when the client is much less well-informed about the services he is acquiring and their value, than the provider of these services. The most effective way of handling this is to subsidise the cost of informing the consumer. This may involve accreditation of professionals, even to the extent of different classes, but it does not require licensing with the attendant barriers to entry.

The final generic circumstance for intervention is when a group of professionals achieves a natural monopoly in the profession. Space does not permit me to discuss how to handle this complex problem. However, the solution is not for a set of regulations along the lines that one generally finds for a profession.

VII. HOW THE ESTATE AGENTS ACT 1980 (VICTORIA) FITS THE MODEL

The Estate Agents Board

Part II of the Act sets out the composition and terms of appointment for the Board. It consists of eight members, with six of the eight needing the following qualifications:

a. One shall be a barrister and solicitor of not less than five years standing.
b. One shall be a member of either the Australian Society of Accountants or the Institute of Chartered Accountants.
c. Two shall come from the Real Estate and Stock Institute (RESI) of Victoria.
d. One shall come from the Real Estate Agents Association (REAA) of Victoria.
e. One shall come from the Victorian Stock Agents Association.

The remaining two members will be appointed by the government, who also can specify the Chairman and Deputy Chairman.

With half the Board coming from the real estate profession, even though the Chairman has a casting vote, it is clear the Board fits the model outlined for the typical composition of such a board. It is inevitable, even with the most well intentioned of members, that such a board is going to have a perspective on conduct and events that is biased in favour of the profession to the cost of the public. The arguments supporting this statement have been outlined and some of the evidence is presented below.

Licensing: barriers to entry

Part III sets out the condition for licensing agents and sub-agents. In summary, these requirements for an agent are:

1. a. Resident of Victoria and over 18 years of age.
   b. Passed a course of prescribed instruction. These courses are equivalent to Certificate level courses at Colleges of Technical and Further Education (TAFE). In general, the Leaving Certificate is a pre-requisite for entry into the course. Typically, there are sixteen required units in a course, although an additional four units are required for a Certificate. The typical duration of the course is two years full time or four years part time study.
   c. Held a sub-agents licence for four years and been engaged in full time employment as a sub-agent.
2. Alternatively, held within the immediate five years, an estate agent's licence.
3. Under section 14(3), the Board can waive the requirements for someone they believe is fit to hold a licence.

The requirements for a sub-agent's licence are critical as it can be seen that this is the common, perhaps the only, route to becoming an agent. The requirements are also onerous; in summary, they are:

1. Passed the prescribed course.
2. Certification that an estate agent proposes to employ the applicant in full-time employment if the licence is granted.

The barriers to entry into the profession are considerable. The requirement for a sub-agent to spend four years in that capacity under a licenced real estate agent is particularly onerous as it constitutes an apprenticeship requirement of a duration that few other professions require. Difficulty in finding a position as a sub-agent can lead to licenced agents giving preference to those that are not necessarily the best suited for the job. One could imagine that nepotism would be rife in times of downturns in the housing market and, in so far as these occur at more frequent intervals than four years, one could generalise the statement to nepotism is likely to be common.

It could be argued that section 14(3) enables the Board to relax some of the severity in the licensing constraints, particularly for, say, interstate real estate agents or sub-agents who have been in practice for many years. From all reports, this is not the case; I believe there are cases of inter-state agents being told that they must do the prescribed course before they can be considered. Recently, the Board wrote to all sub-agents pointing out section 14(3). There immediately followed an outcry from licenced agents, including the executive director of the RESI (which has two members on the Board), objecting to the Board's initiative. Hearsay evidence suggests that there is considerable heightening of requirments and few, if any, will be licensed under section 14(3).

Specific powers of the Board (specific constraints)

Section 10 of the Act sets out many of the specific powers of the Board that correspond in large part to those outlined under Specific Constraints.

1. The Board has the power to prescribe maximum commission rates. I believe these are the standard rates for

nearly all house sales.
2. The Board has power to regulate advertising by agents and sub-agents.
3. It can prescribe standard form contracts and they can allow or prohibit variations in the terms of such contracts.
4. It can prescribe rules of professional conduct (unspecified) for agents and sub-agents.
5. Agents and sub-agents are prevented from sharing commissions except with licensed agents or sub-agents.

It is clear that the rules as they stand are perfectly consistent with the rules we could expect of a cartel. It is little wonder that politicians are so much in favour of professional organisations joining together - it makes them so much easier to regulate. What is surprising is that some (for example, the accountants) still elect to remain apart, as a pre-requisite for an effective cartel is almost always statutory control of members.

The Board is not unbounded in its powers. The government can revoke any rule of the Board and citizens, if aggrieved, can take their case to the County Court. However, to enforce these rules the Board can impose fines of up to $5,000 and, of course, cancel licences.

Estate agent's guarantee fund

The Act specifies in some detail (part VI) how an agent is to manage and have audited trust accounts.

Part VII of the Act outlines the funding and role of the Estate Agents' Guarantee Fund. The fund is to be used to compensate persons who suffer pecuniary loss by reason of defalcation committed by an estate agent or an employee of an agent. The fund is also used to pay the general expenses of the Board.

The Fund is financed by licence fees ($400 per annum for an agent), fines imposed by the Board and other moneys that accrue to the Board. It is clearly an intention that the Act be self-financing, although there are allowances made for funds to be advanced by the government.

The Fund, as a form of indemnity insurance, suffers from the disabilities already referred to. It is open to 'free-loading', in the sense that the cost to agents is not necessarily related to the risk of them being successfully sued by clients. An ideal indemnity insurance scheme would charge premiums according to this risk.

Whether the Act is self-financing or not does not directly affect the social costs of the regulation. Someone has to pay, whether one section of society or another. The social costs arise from the misallocation of resources through the constraints on the services offered or the options open to clients. Self-financing simply implies that the costs of the regulation are kept to the industry and its clients.

VIII. CONCLUSION

If we were to design rules for successfully operating a cartel, where it was difficult to monitor and allocate the quantity of goods sold by members, then we would finish up with a set of rules closely resembling those that are usually applied for the regulation of a profession. Such a cartel is never as successful as the one in which there can be strict quantity control, as members tend to compete with each other, reducing their profits in order to sell more. In order to limit the amount of competition between members of the cartel, it must establish and police rules on the amount of competition. Such rules include restraints on advertising, on poaching clients, on dealing with people outside the profession, and on setting prices and quality of service.

The cartel cannot exist unless there are significant barriers to entry. The most successful barriers are statutory ones. Because the state has substantial authority and power it is difficult in a well-developed economy to get around such barriers. Moreover, in many instances, the state bears the cost of policing and enforcing the rules of the cartel. Clearly, there are many benefits to a profession in inducing the state to act on its behalf, **providing** the profession keeps control. The Boards established by the Acts for regulating professions are usually dominated by members of the profession and, although they may genuinely believe they are acting in the best interest of the public, they inevitably perceive problems from the viewpoint of the profession. They fail to recognise the full ramifications of the rules they are required to administer.

The Estate Agents Act 1980 of Victoria, designed to regulate the activities of those involved in the real estate industry, fits the model for regulating a cartel remarkably well. This does not necessarily imply agents in Victoria are earning monopoly profits. We would expect new entrants to be attracted to the industry until the compensation is equal to what they might expect from alternative occupations - the

returns they expect to get from real estate are commensurate with their qualifications and skills. It is the agents who did not have to meet the increased requirements for entry who could be expected to earn higher than normal returns, i.e. the returns commensurate with their qualifications and skills.

However, the cartel structure of the industry, in particular the barriers to entry, will restrict the range of services offered and the range of costs. Also, the restrictions on competition can be expected to inhibit innovation and the amount of information available to clients, which together can lead to excessive costs relative to a more open and competitive system. The argument that these restrictions protect clients from malfeasance is true, to a degree, but it is a high cost to pay when there are better alternatives for tackling this problem that do not unnecessarily restrict competition.

Note

1. G.J. Stigler, 'The Theory of Economic Regulation', *Bell Journal of Economics*, 2, Spring 1971.

3

A BRIEF EXPLORATION INTO THE ANATOMY OF THE MEDICAL PROFESSION: THE MARKET FOR GP SERVICES

John Logan

John Logan lectures in economics at the Australian National University. He graduated from the University of New South Wales (Newcastle University College) in 1965 with a B.Comm. (Hons). He has also lectured at the University of Western Ontario. He recently became interested in the health economics area - in particular, the implications of government intervention for efficiency in health services.

A BRIEF EXPLORATION INTO THE ANATOMY OF THE MEDICAL PROFESSION: THE MARKET FOR GP SERVICES

John Logan

I. INTRODUCTION

This paper is concerned with some of the consequences of regulation by licensing in medical markets. In any market for skilled labour where successful entry requires the expenditure of resources to acquire the skill, the market clearing wage will, *ceteris paribus*, be competed to that level which just compensates for the cost of the skill-acquisition, all flows being capitalised to the date at which the decision to enter is made. If regulation of the market is in the dimension of certification, the result of which is to increase the cost to new entrants of acquiring the skill, then quasi-rents are created and accrue to established workers. Competition for access to the market redistributes part of the rent to those resource owners supplying the certification function, and part is dissipated in non-transferable rent-seeking costs such as the costs of extra time spent in seeking market entry. The net result is higher wages (or prices for services directly sold to ultimate consumers) which again just compensates, in terms of present value, the cost of the now regulated skill-acquisition. Ultimately sellers make zero economic profit, and receive virtually none of the market-closure rent.

It is claimed that the process of registration of medical practitioners has generated just such a situation - doctors earn 'high' current incomes, but in terms of wealth, are no better off than they would have been in some other occupation, all costs considered. Thus it is as sensible to blame the individual doctor for high fees and high incomes as it is to blame the taxi owner/driver for high cab fares and high incomes (gross of the opportunity cost of acquiring the licence), when the cause of each of these is the legal market-closure.

The material concentrates on the market for general practitioner (GP) services, since GPs constitute about half of

the registered medical practitioners, and there are enough of them to avoid running into open-ended discussions of oligopolistic price-setting. First, the market structure is described, and the informational problems associated with the particular kind of service which a GP provides are highlighted. Then follows an outline of the registration requirements, and the special difficulties with which the medical practitioner is confronted when seeking entry to the profession. The effects on variables such as price and wealth are derived, and this is followed by sundry comments on registration in the light of the (public interest) concern over consumer risk and uncertainty.

II. THE MARKET

The structure of 'the market' for medical services is itself highly complex. It can usefully be dissected into three broad sub-markets: markets for the services of general practitioners, specialists, and auxiliary health personnel (paramedics). Within each of the last two sub-markets there are again further levels of division into the various areas of specialisation, and, in addition, there is some overlap between the first and second markets as GPs themselves may gain post-graduate specialist qualifications in areas such as obstetrics. The three sub-markets are themselves linked in various ways through complementary relationships - for example the referral of a patient to one or more specialists, co-operation in surgical procedures, and so forth. For the remainder of this paper, I will myself specialise in exploring the economics of GP services.

TABLE 1: Doctor-Population Ratios

	Medical Practitioners(a)		Specialists		General Practitioners	
	Number	Ratio	Number	Ratio	Number	Ratio
1966	14083	1 : 829	5998	1 : 2907	6800	1 : 1706
1971(b)	17263	1 : 730	5007	1 : 2594	7376	1 : 1730
1976	21300	1 : 687	7361	1 : 1842	7810	1 : 1783
1977	22820	1 : 622	8006	1 : 1757	8377	1 : 1642
1978	23690	1 : 601	8446	1 : 1689	9368	1 : 1493
1979	24915	1 : 579	8626	1 : 1672	10739	1 : 1368

(a) Totals include those working in universities, public authorities, and defence etc.
(b) Between 1971 and 1972, some GPs were reclassified as specialists.

Source: Adapted from B.B. Scotton, 'Medical Manpower - Some Policy Issues', ed. P.M. Tatchell, *Economics and Health: Proceedings of the First Australian Conference of Health Economists*, AMU Press, 1980, p. 73; and *Social Indicators in Australia*, no. 3, 1980.

Approximate numbers of medical practitioners, specialists, and general practitioners for selected years since 1966 are shown in Table 1. From this it can be seen that GPs have constituted slightly less than one-half of the population of total medical practitioners, and have grown in numbers at an annual average rate of about 3.5 per cent since 1966, accelerating to 10 per cent over the three years to 1979. As GP numbers have grown faster than the population, the GP to population ratio has risen steadily over these years; a similar trend is apparent for specialists (see Table 1).

The 11,000 odd (1979 estimates) GPs in Australia are essentially organised as small businesses either as a solo practice or as group practitioners, with the distribution skewed toward the former. One regional study estimated that almost 90 per cent of practices had four or fewer doctors, and virtually no groups had more than five members.[1] The nature of general practice appears to involve low financial barriers to entry for the **registered** solo practitioner, apart from the purchase or establishment of 'goodwill', with many GPs choosing to operate from their own residences. In fact, the total practice cost for GPs has a large variable cost component (for example, about 50 per cent for salary and wages - see Table 2).

TABLE 2: Indexes of Practice Costs and Income - General Practitioners

	1968-69	1980(a)	1981(a)
Salaries and Wages		26.3	27.6
Motor Vehicle Expenses		3.7	3.9
Other Practice Costs		21.7	22.1
Total Practice Costs	43.6	51.9	53.6
Net Income	56.4	48.1	46.4
Gross Income	100.0	100.0	100.0

(a) 30 September

Sources: B.B. Scotton, *Medical Care in Australia: An Economic Diagnosis*, Sun Books, 1974, p. 138; and *Fees for Medical Benefit Purposes*, Canberra: AGPS, 1981.

Presumably there are some economies from group practice - for example, those realised from division of labour into areas of member-specialisation, and from some spreading of overheads etc. - but these evaporate rapidly as the size of the group practice expands. Thus the supply side of the GP market is characterised by a large number of small producers of medical services.

GPs are differentially distributed over the population by state, and by location in metropolitan areas or otherwise.

Table 3 shows that GP-population ratios differ between states and that GP density is relatively higher in 'city' (metropolitan) areas. One can hypothesize that GP density

TABLE 3: GP-Population Ratios, 1978

	Metropolitan	Non-Metropolitan	State
NSW	1 : 1060	1 : 1600	1 : 1214
Victoria	1 : 1506	1 : 1862	1 : 1593
Queensland	1 : 1513	1 : 1736	1 : 1626
SA and NT	1 : 1300	1 : 1838	1 : 1447
WA	1 : 1339	1 : 2222	1 : 1517
Tasmania	1 : 1513	1 : 1527	1 : 1520

Source: Adapted from R.B. Scotton, 1980, p. 79.

will be determined by doctors' locational decisions which, in the long run, can be expected to equalise net advantages across locations, taking into account non-pecuniary as well as pecuniary returns. Thus it can be predicted that GP density will be determined by expected local demand for their services, proximity to hospital facilities, non-pecuniary attributes of particular locations, all relative to anticipated practice costs, including the cost of acquisition. That is, we would expect GPs to gravitate, *ceteris paribus*, to areas with higher family income[2] and to those areas which possess modern hospital facilities.[3] The 'goodwill' component of established practices at present varies across different locations, with relatively higher values accruing to practices in the metropolitan and some coastal areas as compared with practices located in country towns. This may reflect disequilibrium in the current distribution of GPs over various regions, or, if it is relatively more difficult to establish a new practice *ab initio* in city areas, the goodwill component would constitute a return to investment in building up an established clientele.

The demand side of the market features considerable informational problems, which are common to a greater or lesser degree to other professional services, such as the services of lawyers and even economists. First, the buyer does not directly 'demand' a bundle of particular identifiable services from the supplier, but instead presents the professional with a 'condition' (illness, legal problem, etc.) which the professional is expected to redress. The professional then applies his/her expertise to design a set of actions intended to 'cure' the condition. The significant informational costs to buyers of acquiring anywhere near the same expertise as the professional(s) consulted over time means that it pays to rely on one's chosen professional's quality of service, and

therefore to spend resources in initially searching for that optimal professional. This search process will generally involve buyers specialising in acquiring information via word of mouth, searches of relevant literature, discovering the professional's track records (for example, a barrister's previous success rate) and so forth. In the case of professional services, the search process itself contains some interesting consequences. Here the product and the producers are not separated (as is the case, for example, for washing machines), and so the buyer searches primarily for higher producer 'quality' in a general sense rather than for high quality in any one specific product; and search for the former may well prove more costly than search for the latter. Of course, parameters such as price, locational convenience, expected queueing times etc. will all influence the buyer's ultimate choice. In addition, search is not made any easier in the case of professions where advertising is not permitted, as in medicine and law. Friends and neighbours may be consulted, and other more costly search procedures engaged in, but product quality itself can, in these cases, only be fully evaluated through experience. In the event that the experienced product is of lower quality than expected, the buyer has the option of engaging anew in search for an alternative professional. However, the fact that the search costs for one's current professional have already been incurred and hence are sunk, whereas the costs of search for an alternative supplier are avoidable (by not searching), lessens the incentive to search; the more so, the higher the search costs. From this we may predict that for professional services for which buyers have relatively high quality information and search costs, the elasticity of demand for individual sellers with respect to other variables such as net price to buyer, time costs, etc. will be lower than otherwise.[4] In addition, we should observe a closer, more durable relationship between individual buyers and sellers as compared with most other markets, that is, the professional-client 'relationship of trust'.

GP services qualify as just such a commodity; the majority of patients themselves (rationally) have little medical knowledge, search costs are high, and the product must be experienced for full buyer evaluation.[5] GPs' services are differentiated not only by location and 'quality' (however evaluated) but also by buyer-specific intangibles such as the doctor's personality and manner. In addition, there are a large number of sellers in the market, entry to which is restricted by law (see below). In current parlance, GPs can

be described as closed-market price searchers, selling a 'reputation good'.[6] As above, we predict low price elasticities and close doctor-patient relationships. In addition, surprisingly, reputation goods have the property that an increase in the number of sellers **may** result in higher prices as a consequence of less efficient consumer search; the so-called 'increasing monopoly' property.[7] We return to this briefly below.[8]

As for any price-searcher market with sizeable information and search costs, we would expect the market for GP services to clear, in the short run, by adjustments in queue-length and/or lengths of consultations, and in the long run by (sluggish) price movements, modified by entry/exit of medical practitioners. It is these long run market clearing adjustments which serve to eliminate the economic profits or losses which are generated by perturbations in the marketplace, as occurs, for example, when there are changes in government policy regarding the proportion of medical fees covered by third-party payers. These adjustments are also the means by which 'monopoly' rents created by market closure are redistributed amongst the competing claimants, as will be seen below.

One of the variables relevant to long run adjustment in the GP markets is, as mentioned above, the entry/exit of practitioners. Barriers to entry are low, **once the GP has succeeded in becoming a registered medical practitioner.** Gaining registration (the licence) essentially involves the aspiring practitioner in an intensive and lengthy process of acquiring education combined with practical experience. The aforementioned buyers' limited information as to practitioner quality is one of the justifications used for certifying medical practitioners in accordance with educational-practical background. We turn now to the registration process itself, and then look at some of the effects that this has on incomes prices, incomes and wealth, within the market for GPs.

III. PRACTITIONER LICENSING; REGISTRATION OF DOCTORS

Registration (licensing) of medical practitioners in Australia is over 100 years old, dating back to the first Medical Practitioner Acts in the various States.[9] Medical Practitioner Acts currently in force do not differ greatly from State to State. Each essentially lays down the following conditions necessary for registration, namely that a person must:

a) hold a degree in medicine or surgery;
b) have obtained the degree from an Australian university, or from one in the UK, Ireland or New Zealand. (Persons with degrees from other countries have the option of attempting the Australian Medical Examining Council's - AMEC - series of stringent examinations. Otherwise they are required to complete an Australian degree.);
c) have spent a pre-registration year as an intern;
d) be of 'good fame and character'.

The various Acts contain anti-quack sections which make it illegal for unregistered practitioners to sell medical services or to call themselves (medical) doctors. Finally, the Acts provide for de-registration in the case of, amongst other things, 'unprofessional conduct' - which is defined to include advertising in order to 'procure' patients (the anti-touting sections). Registration is administered by the Medical Board in each state which are composed primarily of registered practitioners.

Thus, the legal requirement of registration for entry into the medical profession imposes significant pre-registration training costs on the aspiring doctor. Courses in medicine at all Australian universities, with the exception of Sydney and New South Wales, are of six years' duration, at the end of which the medical student graduates with the coveted MBBS degree (Bachelor of Medicine, Bachelor of Surgery). In comparison with other university degree requirements, medicine is an intensive, exacting course of study. It would appear that, on average, students are required to work 'harder' for relatively longer hours in medicine, particularly during the last three (clinical) years. In addition to this, assessment procedures are relatively more stringent in that failure in part of a year's work may result in the student being required to repeat the whole year.[10] Entry to medicine is by quota and the minimum selection (school) aggregate is generally higher than for any other discipline. HSC aggregates for entry into selected 'professional' courses at the University of Sydney (1982) are listed in Table 4, from which it is clear that the HSC cut-off mark aggregate for medicine tops the list, and is significantly higher than it is for law. Thus the entry screen for medicine favours those who have performed very well at school, and thus would tend to select students who have or are willing to spend more resources (for example, time) in study to achieve these superior school scores. Failure and drop-out rates in medicine (at least at Sydney) are extremely low by comparison with other

disciplines, and so it would seem that the primary screen is the mark aggregate entry requirement.[11]

TABLE 4: Tertiary Education (University of Sydney) Selected Professions

	Minimum Selection Aggregates (1981 HSC)	Minimum Number of Years (Pass Degree)	Additional Requirements for Professional Registration
Medicine	423	5(a)	1 pre-registration year as intern.
Law	379	4	Additional exams plus practical work.
Dentistry	373	5	
Engineering	333	4	
Architecture	333	6	2 years practical work.
Economics/Commerce	332	3	

(a) Up to 1973, MBBS courses at all universities were of six years' duration. In 1974, the Universities of Sydney and NSW introduced five year courses; however, there is some movement towards a return to the six year course structure, at least at the University of Sydney.

Source: *University of Sydney Calendar*, 1982.

At the time of graduation, the student would already have undertaken part of his/her training in the practical side of medicine at one or more of the various teaching hospitals in the vicinity of the particular university. The Acts require that the graduand then spend another twelve months as an intern, generally at a hospital, at the end of which time registration as a medical practitioner is virtually assured (provided, of course, there is no intervening lapse of 'fame or character' etc.).

Following registration, the doctor may immediately go into private practice as a GP, or continue on at a hospital as a Resident Medical Officer (RMO) and eventually as a Registrar. In addition, he/she may acquire further post-graduate qualifications, ultimately entering one of the specialist areas. For example, RMOs aspiring to general practice are encouraged to take the four year (postgraduate) Family Medicine Program. Doctors in general, and GPs in particular, are in any case involved in a process of (voluntary) continuing self-education throughout their working life, in an effort to keep abreast of advances in medical knowledge and technology. The incentive for this is generated by competition in the dimension of quality which is prevalent in the kinds of markets in which medical practitioners sell their services (as outlined above).

IV. THE EFFECTS OF REGISTRATION

Registration effectively closes the supply side of the market(s) for medical services to all except those willing and able to complete the registration requirements as outlined above. Direct entry by immigrant doctors has been restricted to those with degrees from Commonwealth countries.[12] Unprofessional conduct, such as advertising, is prohibited; for example, telephone listings do not even provide the information as to which doctor is or is not a GP.

The practising of medicine (for a fee) by quacks is outlawed, although some sellers of 'fringe medicine' services such as homeopathy, osteopathy and so forth compete with the registered practitioners for custom.[13]

However, there is no regulation of prices, and GPs and other medical practitioners can charge 'what the market will bear'. This means that the long run effect of reduced doctor supply for given levels of buyers' information, will be higher prices.

Market closure of this kind, **when initially introduced** (complete with grandfather clauses), can be expected, therefore, to result in higher net incomes for established practitioners, and a **potential** market-closure monopoly rent to new entrants. In so far as new entrants behave so as to maximise their expected returns over the set of available alternative occupations, they will compete for this rent by investing in acquisition of whatever attributes permit them entry - in this case the registration requirements. This competition will result in redistribution and dispersion of the rent to the point that new entrants ultimately make no more than normal returns.[14] Registration has been around for long enough for this to be the case for medical practitioners.

Were doctors' licences freely transferable but restricted in number (just as are taxicab licences), then the market-closure rent would be revealed in the market-clearing price for the licences. However, this is not so for medical registration; the practitioner and the licence to practise are not separable in this way. In medicine, we would predict therefore that competition for the right to practise medicine will, in the short run, relocate part of the market-closure rents to the owners of resources providing the accreditation: that is, the teaching facilities (including perhaps the teachers) and the users of intern labour (that is, the hospitals). In the long run, to the extent that there are no fixed factors in the production of these facilities, costs there will rise until the entire rent is dissipated.[15] Of course part

of the rent could be captured by those whose fortunate choice of parents endowed them with a superior ability to attain the university entrance requirements determined under the quota system. The remainder will be dissipated as costs of extra time spent in attaining medical qualifications (as compared with an aspiring doctor's time costs in the next best choice of occupation), and in the administrative costs of the bureaucracy necessary to run the whole show. The point of this is that, apart from short run market perturbations, we can expect medical practitioners currently in the market to make no more than normal return (that is, zero economic profit). Short run disturbances, such as changes in government policy as to health insurance etc. will create quasi-rents only. Of course, the length of time necessary for training to acquire registration means that full long run adjustment to a new zero profit equilibrium may take several years.[16] On the other hand, long run adjustment might not only be by way of market entry, but also by the professional bodies responding to happier circumstances by raising 'standards' (for example, tighter restrictions on immigrant doctors, compulsory post-graduate training, etc.). The latter device would preserve rents for established GPs.

One other implication is that doctors' chosen (weekly) working time may tend to rise relative to 'other' occupations. This is so because the market-closure raises the net hourly (flow) income to practitioners, the cost of leisure is higher and thus less will be consumed at the margin, provided the substitution effect dominates.[17] This is relevant to GPs in private practice since they are able to choose their preferred working hours more easily than can, say, a salaried professional. The evidence is that the average working week for a GP is 50 to 53 hours.[18]

Registration of medical practitioners has been with us in its current form for long enough, one would think, for these adjustments in the markets for medical services to have been fully worked out. As indicated below, the student entering university with a view to eventually becoming a GP can expect **ultimately** to earn an income which may well be above that earned in the other professions to which he/she would otherwise have aspired, and it will certainly be above the 'average' income measured, say, by average weekly earnings. Against this, on the other hand, the student can expect an arduous and lengthy period of training and, if eventually entering private practice, additional costs (for example, leisure time given up, provision of 24-hour call facilities) will be incurred. The prediction is that the present value of these

streams of outlays and incomes will be just about equal to the present value of other occupations,[19] minus the value of any differential non-pecuniary attractions of practising medicine.

V. PRICES, INCOMES AND WEALTH

It is at present virtually impossible to obtain sufficient data - especially on GP incomes - to adequately test the hypothesis that doctors' rents, other than those to **differential** ability in medical practice, will be zero. However, some indications can be had from the information that is currently available. A glance at Table 5 reveals that in respect of average net incomes (after expenses, but before tax) calculated for tax purposes, medical practitioners head the list. It is interesting that the ranking by income of the professionals listed in Table 5 is the same as their ranking by the height of the market aggregate entry barrier to their respective university courses (see Table 4).

TABLE 5: Mean Net Incomes - Selected Professions

	1975-76		1979-80	
	$	% of Doctors	$	% of Doctors
Medical Practitioners	36,215	100.0	35,961	100.0
Lawyers	24,583	67.9	27,388	76.2
Dentists	22,529	62.2	25,676	71.4
Engineers	14,258	39.4	16,581	46.1
Architects	10,739	29.7	12,745	35.5

Source: Scotton, 1980, p. 71; and *Taxation Statistics*, 1979-80

Note also that medical practitioners' mean income level declined in real terms[20] over the four years to 1979-80 and also fell relative to the incomes of all the other professionals listed in Table 5. Over that period, the supply of newly graduated medical students rose sharply at the same time as the increase in the net inflow of immigrant doctors. At the same time, the well-known changes in government policy regarding its own subsidisation of health care expenditure and health insurance meant that there was a (small) rise in the part of gross medical fees directly paid by the patient. The consequent price effect on demand combined with the increase in supply should have resulted in a fall in the market clearing prices of medical services relative to other prices, with the low elasticity of demand resulting in reduced incomes. Net real incomes would have been further reduced by rises in practice costs, especially wages. Both the Medical

Benefit scheduled fees and the AMA listed fees in fact rose by a little more than 30 per cent over this period, but the proportion of medical services actually priced in excess of the MBS schedule declined by over 50 per cent (see Table 6).

TABLE 6: Percentage of Services where the Fee Charged was in Excess of the MBS Fee - General Practitioners

	Dec. 1978	Dec. 1979	Dec. 1980
New South Wales	46	25	17
Victoria	50	37	27
Queensland	66	37	30
South Australia	11	12	9
Western Australia	46	42	30
Tasmania	49	26	23

Source: *Hansard*, Commonwealth House of Representatives, 16 February, 1982, pp. 87-88.

It would appear that the market clearing price structure has not kept pace with the two 'official' schedules,[21] as is so often the case, and thus that market forces are alive and well. It is difficult to determine whether medical practitioners, particularly GPs, made economic losses in the late 1970s - thus auguring for a reduced future growth rate in GP numbers - or whether the adjustment has involved a reduction in GPs' (real) earnings back to their long run equilibrium level for the post-Medibank period. In the former event, (real) fees could well rise in the future, whereas this would not follow if the latter were the case.

One can attempt to estimate the present value, as at date of entry to university, of the expected life cycle costs and earnings of a representative GP by making guesses at these streams for a person who expects to spend six years in an intensive university course, followed by one year as an intern, and say, three to four years as an RMO before entering private practice. This person would expect low income for three to five years while the practice is being established and higher income thereafter until retirement at, say, age 65-70. Intern and RMO salaries are published awards, but the unknowns are the net earnings from private practice, and the other additional costs of general practice - such as the value of extra leisure given up. With respect to the first of these, close substitutes for GP private practice are the available salaried positions as Medical Officers in hospitals and sundry government areas, the salaries for which are obtainable. Rough and ready calculations yield the following guesstimates of (gross) present values using constant 1981 prices,[22] and assuming that 'most' of the direct

university training costs are funded by a combination of tax-financed subsidies and parental support.[23]

TABLE 7: Gross Present Value (Net of Tax) of Expected Lifetime Net Earnings as at Age 18

	(Real) Discount Rates		
	5 per cent	8 per cent	10 per cent
AWE	188,500	129,300	99,300
Economics Graduate (3 year Pass Course)			
low	241,200	146,900	111,100
high	259,800	157,500	118,400
GP retiring at age 65			
low	211,000	118,300	85,100
mid-range	270,836	128,121	91,278
high	291,100	135,100	96,500
Differences			
GP (mid-range) minus AWE	42,336	3,621	-8,222
GP (mid-range) minus Economics graduate (low)	-10,364	-18,779	-19,822

If these calculations mean anything, they indicate that the hypothesis that GPs' rents are zero **cannot** be rejected without further evidence to indicate the contrary. The GP income figures may well be biased downward, but on the other hand, the relatively arduous nature of both the training of a GP, and the length of hours that general practice entails, have been ignored.[24] In addition, private practice involves a greater risk than do salaried positions, but on the other hand, could yield rewards (for example, non-pecuniary returns, tax advantages) not available elsewhere. In any case, raising after-tax income during private practice by 50 per cent would add roughly $30,000 to mid-range present value - bringing the GP just up to the economist. This is because the higher income is postponed so far into the future. Extending the analysis to the case of specialists, one would expect that again, higher net incomes would, in terms of present value, just compensate for the additional training costs, ignoring differential rents to 'ability' as a specialist. It would be interesting to test this.

V. REGISTRATION, BUYER INFORMATION AND POLICY

As we have seen, the medical services are reputation goods sold in a closed price searcher market. One of the implications of this is that an increase in the number (rather than the doctor-population ratio) of GPs results in greater search difficulty on the part of buyers. Buyer search

becomes less efficient and, as a result, the demand schedules facing sellers become less price elastic. Thus, a **rise** in price is a possible consequence of an increase in GP supply.[25] This conclusion rests on the economics of information flows and consumer search patterns in these kinds of markets, and provides an explanation of the often observed non-negative relation between doctor-supply and price. It is thus an alternative to the 'supplier-induced demand' or 'target income' hypotheses.[26]

Another aspect of the informational peculiarities of these markets is, as we have seen, that buyers have limited knowledge of the quality of the producer, whereas the producer is relatively certain of his or her own expertise. This is referred to in the literature as an instance of 'informational asymmetry'. When informational asymmetry occurs, the market can fail to produce a socially optimal level of quality of service, in the sense that buyers' benefits from higher quality units that could be produced but are not, exceed the marginal cost of their production. To see this, imagine a market in which anybody could set themelves up as a 'doctor', but that patients cannot distinguish which doctor is of which quality, and that there is a range of qualities available from the 'best' to the 'worst'. The market clearing fee will then reflect the **average** quality available. High quality 'doctors' cannot command a fee different from the market clearing fee unless they can transmit (believable) information of their excellence to potential patients. If this is not feasible, then high quality 'doctors' will leave the market to the extent that their ability is transferable and can thus command a higher price elsewhere. In this way the average quality of remaining 'doctors' falls and so does the market clearing fee. This process, if stable, continues toward a 'quack-equilibrium' in which it does not pay higher quality 'doctors' to sell their services as doctors, even though the net social gain would be positive.[27]

Thus, one justification for the requirement that all GPs pass through a prescribed course of training is that this has the effect of raising the **average** quality of doctors, and thus the fee charged. This in turn attracts the entry of higher quality GPs. Minimum registration requirements also provide buyers with the information that all registered GPs possess 'quality' of at least minimal standard. To the extent that buyers trust that all GPs are alike in this respect, their gain from searching amongst alternative GPs is reduced. Location and other parameters become relatively more important determinants of buyer choice.

Unfortunately, there is no guarantee that the level of compulsory minimum standard chosen will be that which maximises net social gain. Leland, for example, shows that when standards are chosen by a body of rent-seeking professionals, the level of minimum requirements is likely to be excessive in relation to a socially optimal level, because of the influence of the market-closure quasi-rents potentially available.

Other justifications used for compulsory registration include the externality arguments pertaining to public health, and the paternalist arguments that: (a) people should be provided with high quality health care, even though they would have chosen lower quality care at lower prices; and (b) that, as the consequences of many medical services are sunk (the appendectomy, like the cashectomy, is irreversible), people should be prevented from choosing medical services supplied by lower-quality, high-risk sellers.

The extent to which the problem of limited buyer information can be met by the alternative course of (non-compulsory) certification has been discussed by Baird,[28] among others. Whether the net gains, from the introduction of this kind of certification, would be positive is a moot point - certainly the consumer choice set would be widened. Currently practising doctors would lose and we would observe intensive lobbying by the professional associations to prevent such a change from taking place.

Finally, the economics of the GP market has led to the conclusion that GP rents are competed to zero in the long run. The sources of high and rising health costs ('increasing monopoly' apart) are largely to be found first, in the separation of user and third-party payer under government subsidy schemes etc.; and second, in the standards of quality imposed by the Medical Practitioner Acts, monitored by the Medical Boards, and sustained by the practitioner-training industry. It is pointless to complain exclusively about too high doctors' fees and current flow incomes, while at the same time insisting that standards be compulsorily maintained. It is the latter which determines the former.

Notes

1. Royal Australian College of General Practitioners (RACGP), *General Practitioners in Three Regions of New South Wales: A Survey Report*, Research Committee, N.S.W. Faculty, 1977.
2. Studies reveal that medical service is a superior good. See J. Richardson, 'The Inducement Hypothesis: That Doctors Generate Demand for their Own Services', ed. P.M. Tatchell, *Economics and Health, Proceedings of the First Australian Conference of Health Economists*, ANU Press, 1980, pp. 94-134; Richardson, 'A Model of Doctor Practice: An Empirical Analysis using Sydney Survey Data', ed. P.M. Tatchell, *Economics and Health 1980, Proceedings of the Second Australian Conference of Health Economists*', ANU Press, 1981, pp. 17-53; J.P. Newhouse and C.E. Phelps, 'Price and Income Elasticities for Medical Care', ed. M. Perlman, *The Economics of Health and Medical Care*, Wiley, 1974, pp. 139-161; and the studies reported by P.J. Feldstein, *Health Care Economics*, Wiley, 1979, pp. 92-93.
3. Relocation of doctors towards areas initially perceived as relatively more advantageous should have the effect of competing down the level of fees there, relative to fees charged in other areas. If this mechanism does not fully operate, say by doctors' adhering to scheduled standard fees, then competition in the dimension of 'quality' (for example, longer available surgery hours) will raise practice costs. Either way, net returns tend to equality across regions, all factors taken into account.
4. Low price and time-cost elasticities of market demand have been observed for medical services; see the references cited in Note 2.
5. Also, as is well known, the 'condition' from which a patient suffers is often revealed not directly, but via symptoms. The GP must then provide a diagnosis (or failing this, referral to a specialist) and a course of treatment. GPs presumably differ in their diagnostic expertise, and this adds another uncertainty to the buyer's choice problem. One of the arguments put for the RACGP's Family Medicine Program is that less well-trained and less experienced (but risk-averse) GPs tend to refer more frequently, and thus use up more expensive resources, relative to FMP training.

6. M.A. Satterthwaite, 'Consumer Information, Equilibrium Industry Price, and the Number of Sellers', *The Bell Journal of Economics* vol. 10, 1979, pp. 483-502.
7. See Satterthwaite, 1979; and M.V. Pauly and M.A. Satterthwaite, 'The Pricing of Primary Care Physician's Services: A Test of the Role of Consumer Information', *The Bell Journal of Economics* vol. 12, 1981, pp. 488-506.
8. Because of limited arbitrage (it is difficult to re-sell an appendectomy), if individual demand elasticities are identifiable (for instance, by income), then we can also expect price discrimination. This was observed by R.A. Kessel ('Price Discrimination in Medicine', *Journal of Law and Economics* vol. 1, 1958, pp. 21-53) for the US. There is some evidence that this is also the case in Australia (sundry evidence given to NSW Price Commission Inquiry into medical fees), although this should be less frequently observed the less the proportion of the 'gross' price that is paid directly by the patient.
9. For example, see T.S. Pensabene, *The Rise of the Medical Practitioner in Victoria* Health Research Project Monograph no. 2, chap. 2, ANU Press, 1980. Attempts at licensing and regulating the profession in the UK date back to the time of Henry VIII, and the establishment of the Royal College of Physicians in 1551. As for surgeons, the Charter of 'The Mystery and Commonalty of the Barbers and Surgeons of London' (1540) introduced demarcation between surgeons and barbers; at this time, and earlier, 'operations' were often performed by the local barber, supposedly because he had the sharpest knives. Regulation by the state has an even more venerable history, dating back to fee and conduct regulation for Babylonian physicians (2000 BC) with quality control exercised via rather drastic sanctions against physician/surgeons whose operations had less than satisfactory results.
10. Or, at Sydney, the particular set of courses leading to one of the 'barriers' to further progress towards the degree.
11. This may well be efficient in the context of 'free' scarce education funded by the taxpayer-at-large, as compared with a policy of lowering the entry barrier and subsequently failing or excluding many more students at the end of, say, first year.
12. On the plight of immigrant doctors from post-war European countries, see E. Kunz, *The Intruders: Refugee Doctors in Australia* ANU Press, 1975.

13. Chiropractic is now a registerable practice in several States.
14. See A.O. Krueger, 'The Political Economy of the Rent-Seeking Society', *American Economic Review*, June 1974, pp. 291-303; and R.A. Posner, 'The Social Costs of Monopoly and Regulation', *Journal of Political Economy*, vol. 83, 1975, pp. 807-827.
15. Posner gives an analysis of this for regulated industries in general. It would be interesting to attempt to calculate the deadweight losses in our particular case, account being taken of the extent to which compulsory registration corrects for market failure.
16. This contention is supported by Leffler's findings for the US (K.B. Leffler, 'Physician Licensure: Competition and Monopoly in American Medicine', *Journal of Law and Economics*, vol. 21, 1978, pp. 165-186).
17. C.M. Lindsay, 'Measuring Human Capital Returns', *Journal of Political Economy*, vol. 79, 1971, pp. 1195-1215. This is also the case where access to any skilled occupations requires an investment in training.
18. The Karmel Report (Committee on Medical Schools, *Expansion of Medical Education*, 1973, pp. 37-40; evidence given to the NSW Prices Commission Inquiry into Medical Fees, 1979-80.
19. See Leffler for confirmation of this for US data.
20. The CPI rose by 50 per cent over this period.
21. As pointed out previously, there is no regulation of actual fees charged, except that changes in the Medical Benefits scheduled fees directly alter the proportion which the patients pay directly, for any given gross fee. Nor are there sanctions against doctors who do not follow the AMA listed fee schedule; rather, the preamble to the AMA list appears to exhort doctors to regard these fees as upper bounds. Thus, set against the dogma current in some quarters that the AMA attempts to somehow 'administer' prices in the medical profession is the alternative proposition that the AMA list is a device for signalling individual members the AMA's estimates of these upper bounds. Price-searcher information costs are thereby reduced and fewer mistakes are made by sellers in attempting to correctly guess the market clearing price.
22. Income streams are calculated net of tax, as progressive taxation will presumably affect occupational choice.
23. Using a combination of MO award salaries, anecdotal evidence and the tax data yields a range of $28,700 to

$36,000 for net income before tax but after expenses, with a mean income of $32,500 (1981-82). These could well be biased downwards because of non-reporting etc., but on the other hand, the calculation ignores the cost of extra leisure foregone and other hard-to-measure intangibles. The calculations of present values of 'GP mid-range' use an estimate of award salaries for MO positions which appear to be substitutes for private practice. The 'GP low' and 'GP high' calculations use the extremes of the above range, for purposes of comparison.

24. A rough estimate of the upper bound on the cost of leisure foregone can be found by multiplying the hourly return (net of tax and expenses at the margin) by the number of hours worked by GPs in excess of their best other occupation (for instance, as an employee of the public service). Considering only additional leisure given up while in practice (that is, ignoring that given up during the training period), the present values as at age 18 of this cost are $24,092, $11,684, and $7,511 at discount rates of 5, 8 and 10 per cent respectively. This places the aspiring GP at a further relative disadvantage, although the disadvantage is here overestimated because the figures are upper bounds on the cost of leisure foregone.
25. Satterthwaite, 1979.
26. See, for example, Richardson, 1980.
27. For an analysis of this, together with the implications of professional self-regulation, see H.E. Leland, 'Quacks, Lemons, and Licensing: A Theory of Minimum Quality Standards', *Journal of Political Economy*, vol. 87, 1979, pp. 1328-1346.
28. C.W. Baird, 'A Market Solution to Medical Inflation', *Journal of Human Resources*, Winter 1971.

4

INTEGRATION, COMPETITION AND THE AUSTRALIAN ACCOUNTING INDUSTRY

Don Anderson

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I. INTRODUCTION

It is a widely held belief among economists that regulation has been sought by, and operates largely for, the benefit of practitioners in a particular occupation.[1] In Australia, the provision of accounting services is not determined in a free and unregulated market. Instead of free interaction between producers and consumers, there is substantial interference by government, regulatory bodies and the accounting profession itself, relating to the nature of, and conditions under which, producers operate. These include the type of data, form and regularity of accounting reports for consumers. Further, it has been predicted by both regulators and the accounting profession that the degree of interference is likely to increase.[2]

The accounting industry in Australia then appears to operate on a mixture of government regulation and self-regulation. Entry to practice as an accountant is restricted[3] and practitioners choose to further restrict competition by imposing restrictions on advertising, by binding themselves to codes of ethics in the conduct of their service, by seeking essentially identical services under the ambit of 'accounting standards' and (if recent suggestions are correct) binding themselves to 'guidelines' for the setting of fees.[4] In so far as the producers of accounting services are acting in concert and barriers to entry are maintained, there exists the possibility of a cartel of producers with the potential to charge higher than competitive prices, to price discriminate and to restrict output to less than socially optimum. In a profession of allegedly rational, wealth-maximising persons, we would assume that individuals would react to the incentive structure they face; to this end any observable antisocial behavior of the cartel reflects the 'tolerance' of the rest of society in allowing that group to be antisocial.

While the avowed intention of regulation is frequently couched in terms of furthering the public interest on the basis that a freely operating market is apt to be fragile or ineffective, the view of regulatory authorities as costless or effective actors in markets has been increasingly discounted.[5] The recent theoretical work of Peltzman[6] which examines the behaviour of regulators who, it is presumed, maximise their utility, raises skepticism as to the singular relevance of either the public interest theory or capture theory (private) results of regulation. Peltzman hypothesises that 'regulatory agencies will not exclusively serve a single economic interest'.[7] In other words, the possibility exists that testing either the capture hypothesis or the public interest hypothesis in isolation may generally provide incomplete and misleading answers. On the other hand, it may be rather empty to demonstrate that members of the accounting industry simply react rationally to the incentives they face, however anti-social. There is merit, at least on *a priori* grounds, to analyse the structure of incentives and explain consequent actions if for no other reason than establishing a justification as to why a society might allow itself to bear such costs.

It can be argued that at a time of restructure or change within an occupational cartel (either exogenous inspired or endogenous inspired change), the incentive structure facing various parties becomes more observable in supporting or opposing the change. Rather than attempt to observe the progression to the present regulated structure, this paper seeks to analyse the incentive structure of the accounting profession by analysing the structure of interests in the recent attempt to amalgamate the profession from two bodies into one. The possibility of a competing 'competition' hypothesis will not be ignored - that is the existence of two bodies in the profession over a considerable period has reflected a desire for competition between producer groups.

II. INTEGRATION OF THE PROFESSION

Background

The accounting profession is organised into two main professional groups: the Australian Society of Accountants and The Institute of Chartered Accountants. The history of professional accounting associations in Australia has been characterised by a large number of amalgamations.[8] As early

as 1952, publicity was given to the need for only one accounting body, yet two recent attempts in 1976 and 1981 both failed to produce an affirmative result for integration despite strong statements from the executives of both bodies urging members to support the integration proposals. Typical of the type of argument presented over the period has been:

> Two professional bodies can only result in two definitions of the basic pattern of intellectual interest and emphasis; in two sets of entrance standards; and in two methods of maintaining ethical and moral codes. There is obviously a *prima facie* case for one profession.
>
> . . . It [integration] will strengthen the ability of our profession to meet the many challenges facing its members and facilitate effective action to develop and enforce the standards of accounting appropriate to the rapid economic expansion of Australia.[9]

In pursuing integration emphasis has been given by both bodies (frequently in the form of joint statements) to the need for protection of the public from imperfect knowledge of the accounting product ' . . . caused by different professional designations each claiming its own status'.[10]

It can be implied from statements of this type that the bodies - at least - believe there is a difference between Society members and Institute members and the services provided by each. This argument, if it is correct, would mean that consumers would be forced to bear search costs in an attempt to establish differences between the two groups, or alternatively, in accepting the services of any practitioner that they bear costs associated with any quality differences between the groups.

Consumers and quality

The idea of protecting consumers of accounting services by implementing a unified standard of product from one professional body may reflect a consumer demand for licensure of accountants under one organisation. While consumers face the considerable cost of organising themselves into an effective cartel, they do drastically dominate producers in numbers, wealth and votes. In short, to dismiss a public interest explanation outright may be dangerous when *a priori* it would be possible that integration could offer gains (losses) for the consumer as well as the

producer. At least three rationales based on public interest arguments have been made to explain why consumers might demand minimum quality standards: from Moore, these are 'Costly information as to quality', 'Consumption externality' and 'Society knows best' and are now briefly outlined.[11]

(i) Costly information as to quality. If the consumer cannot judge the quality of a complex good, particularly if it is purchased infrequently, then consumers will rationally expend resources in search of desired quality. With scarce resources, costly information also has the effect of shifting the equilibrium distribution of quality supplied to lower qualities directly as information costs rise. Implicit in the action of a self regulated (or state regulated) profession in guaranteeing minimum quality is that they have a comparative cost advantage over private entrepreneurs who might offer an information service.

(ii) Consumption externality. Consumers may demand minimum quality standards be set for all practitioners because they cannot internalise the external benefits of high quality. For example, if a firm chooses to use the services of a 'quick and dirty' accountant they may increase the probability that others may lose from not having the 'correct' financial information. In short, if there is a positive externality in the provision of accounting services, there will be under-investment in these services if this externality cannot be internalised under a non-regulated system.

(iii) Society knows best. A final rationale for demanding minimum quality constraints is based on the assumption that individuals underestimate the risks from consuming low quality services, but the same individuals correctly anticipate the expected results for the best of society. To illustrate, an individual (firm) may correctly estimate that 'improperly' prepared financial statements will result in capital being supplied to the wrong firm in x per cent of cases, but the same individual (firm) may evaluate his own chances of being disadvantaged at less than x per cent.

However, while it is possible that certain public interest rationales may manifest themselves in demand for minimum quality service, what is not obvious is why the system of licensure currently operating in the two professional bodies does not already ensure there are no 'quacks' in the accounting market and further, why those minimum standards of quality will not be provided in a freely operating market. The demand for quality standards *per se* may constitute neither necessary nor sufficient conditions for the regulation of quality standards because it has been implicitly assumed

that there is market failure. In a freely operating market for accounting services, there are a number of ways consumers are able to make decisions on the basis of quality even when the good is complex in nature and (possibly) purchased infrequently.

Firstly, the fact that accounting firms have organised themselves into professional organisations which impose and enforce standards is some guarantee of quality. In fact there is a positive incentive for like producers to form such organisations to share advertising costs about quality, particularly when consumer search costs are positive. In the case of the accounting industry, each professional group will have an incentive to advertise the quality of its product vis-a-vis that offered by different groups. If qualities are different, then consumers are better off in that they are able to purchase only the quality desired and not a minimum quality which might be greater than that desired. Therefore, if the accounting profession is interested in offering information about quality, it is difficult to understand why there exists an almost total ban on advertising.

Secondly, a purchaser may hire the services of an independent accountant to monitor the services provided by any hired firm. However, again the profession is active in discouraging this type of activity by the imposition of ethical rules which prevent this type of service being offered. In a free market, some accounting firms may specialise in this evaluation function and other firms may welcome the opportunity to be evaluated and advertise their 'ratings' to reduce the information costs of consumers.

Thirdly, consumers of accounting services can protect themselves through the contract they negotiate with the accounting firm whose services they employ. Clauses to cover such contingencies as specific performance, nonperformance, damages or rights of redress could be written into contracts between accountant and client and the price of accounting services would reflect the contractual obligations. In the same way, consumers could ensure against the risk of loss through quality being less than expected.[12]

Conspiring to compete?

While the avowed intention of integration may be to further the public interest, the actual effects by such proposals may be different. There exists *prima facie* evidence that the accounting profession has intended to further limit competition by raising barriers to entry. In another document

entitled *Integration Proposals* published jointly by the Institute and Society, it is stated explicitly that following integration:

> It is part of the spirit of integration to move towards the higher standard in each case. The rate of movement will be dictated by decisions of the National Council once Integration has been achieved.[13]

It is also interesting to note that existing members of either body would automatically be elevated to the status of the integrated body without having to satisfy the new entry requirements (grandfather clauses). It is not within the scope of this paper, however, to specifically record each instance of proposed increases in barriers to entry under the integration arrangements. Suffice it to say that the proposals do, in general, represent an increase over the status quo. Further, the existence of barriers to entry is a necessary, but not sufficient, condition for the generation of long run rents (excess profit) and, in the absence of detailed information on price and cost structures, to conclude that the members of the industry earn rents, whilst tempting, may be dangerous.

The accounting bodies give only tacit recognition to the possibility that two producers might facilitate the provision of a competitive environment in the industry. Instead, competition is interpreted by the profession as the process by which barriers can be erected to control 'infiltrators'. Under the heading 'Competition' in the *Integration Proposals*, the following policy statement appeared.

> It has been suggested that two professional bodies provide a degree of competition which is healthy in our free enterprise system. All accountants compete in their normal business activity, for more clients, better jobs, more efficiency. However, as a profession, all accountants are meeting increasing competition from practitioners in tax who are not bound by the discipline and ethics of the accountancy profession, and from merchant banking, trading banks, management consultants, even lawyers, and therefore the stronger and more united the profession is, **the less erosion there will be of business available to qualified accountants** and the better and more professionally served will be the general community.[14] (emphasis added)

The opportunity for the greatest producer benefit from integration is the possibility of a reduction (or elimination) in the costs of colluding to maintain a cartel arrangement between the two bodies. Cartels are inherently fragile arrangements because of the incentive for an individual to 'cheat' on an agreement and maximise his individual returns. The problem for the members is exacerbated by the fact that any agreement to collude cannot be written as an enforceable contract; the legal system imposes costs for the formation of stable agreements by both limiting the power of an industry to strike a collusive agreement (and enforce it against cheaters) and restricting communication among members.[15] Arrangements as a result tend to be more implicit than explicit.

From Machlup,[16] implicit forms of collusion may be supported in many ways: by tradition - a consistent pattern of responses to competitors actions permits competitors to expect continued adherence to the same pattern; by ethics - the implication is that one will adhere to a 'standard of fairness' in the conduct of trade; by 'informal' talks between competitors; by announcements of 'trade associations' of 'industry standards'; by announcements of firms indicating compliance with trade association announcements; and, by participation of competitors in trade association meetings, conferences etc.

The types of implicit collusion alluded to above are directly observable in varying degrees in the accounting profession. For example, both bodies maintain comprehensive codes of ethics for their members; the bodies co-operate on the running of the Australian Accounting Research Foundation whose principal function is to publish standards of accounting practice for use by members of the two bodies; the bodies prepare joint submissions for, and elect common delegates to serve on, government committees; and, the bodies jointly sponsor conferences. The conclusions of Machlup are important in offering some perspective to the type of collusion in accounting.

> None of these six forms of collusion includes 'agreement': at best they involve 'understanding'. But, it should be obvious, the most informal, impersonal understanding will often achieve far better compliance than the most formal and pretentious covenant.[17]

Colluding in an implicit way is costly and the more implicit the agreement the more costly enforcement will be. And so a cartel is inherently unstable as the opportunity for gain by a recalcitrant participant to the agreement is ever present. Stigler succinctly summarises the position.

> And this is the story of cartels' lives. When this rivalry does not take the form of investment, some other form achieves the same result. Thus some states have had laws that no one could sell liquor, or gasoline, or some other commodity at less than a designated price (or mark-up). A firm will then seek additional patronage by advertising more, giving better service, or some such device. As a result, the cost curves shift upward, and in long-run equilibrium, the long-run marginal cost eventually equals price.[18]

An advantage of the two bodies combining is that collusion costs could be avoided. The accounting profession has not, of course, overtly argued that it wishes to reduce collusion costs but instead maintains that integration would enable the profession '. . . to speak with one voice in the areas of accounting and standards research, legislation review, taxation submissions and professional development'[19] but admits: '. . . there can be no doubt that the joint approach of the two bodies speaking for the whole profession has been more effective than approaches by individual bodies would have been'.[20]

It also seems possible that the collusion costs argument might manifest itself in an argument by the profession about 'wasteful replication'.

> Aware of the degree of co-operation already existing, some members have questioned the need for integration of the two bodies. Such a view overlooks the inefficient administration inseparable from the reconciliation of the views of the two bodies, and the often almost insuperable difficulties achieving such reconciliation with the constraints of an often tight timing deadline. The separate preparation of submissions by the elected representatives or administrative staff of the two bodies must also be regarded as a waste of resources which would be employed in other fields.[21]

However, the 'wasteful replication' argument whilst providing an excuse for the reduction of collusion costs may represent a saving if the probability of the cartel breaking up is zero and the dead weight loss is regarded as a 'sunk' social cost.

The vote considered

While on *a priori* grounds it would appear that the effect of integration would be to further restrict competition (or, at least maintain the current restricted level at lower cost) and generate rents for the industry, the likely distribution of those rents between members of the cartel is important in hypothesising how individuals reacted to (and voted for) the integration proposals. Under the 1981 proposals, it was planned to establish barriers to entry on the basis of the higher of those of either the Institute or Society. In absolute terms this would mean that no members would be affected by a lowering of barriers, but more importantly the possibility exists that some members will be made **relatively** better or worse off after integration.

Certain interests were declared both officially and unofficially during the negotiations. On *a priori* grounds, it would appear that the executives of both bodies had good reason to open negotiations, notwithstanding the reduction in collusion costs considered above. From the executive position it would be easier (less costly) for governments to deal with one body and in turn easier for that body to lobby the government if it has minimised the costs of lobbying. The Society obviously would receive a considerable elevation in economic status in achieving barriers to entry of at least those of the Institute - which tend to be higher than those of the Society. The Institute on the other hand, it has been suggested, saw the considerable advantage in amalgamating with the member-rich (and fee-rich) Society as an opportunity to avoid an embarrassing financial situation. *The Financial Review* reported during the 1975 negotiations:

> A material factor that led the Institute council to seize the initiative in reopening integration discussion has been the Institute's weak financial position, but very little has been said about this at the Melbourne meetings.[22]

While the executives of the bodies might have incentives to maximise the present value of their memberships by an amalgamated body, this action does not guarantee that all

categories of members of either body are as well-catered for. One group which was vocal in its opposition to the amalgamation was those members of the Institute who had graduated from satisfying a professional year requirement of the Institute. Under the rules of the Institute, it is necessary for any person seeking admission to attend twelve discussion sessions of three hours' duration, complete an assignment prior to the session, and sit an examination all within a nine month period. The candidate must have worked for a chartered accountant for at least one year prior to the course and remain in his employ during the course. The achievement of the qualification is considered onerous and difficult.

The Society has nothing which compares with the Institute, with the exception of a very 'watered down' Professional Orientation Programme. Under the amalgamation, it was proposed that all existing members of the society would be elevated to a position in the joint body where they would be regarded as having attained the equivalent of the professional year requirements. As the professional year has been a relatively recent (since 1972) requirement for Institute membership, those having to bear the cost of passing the year look on the requirement as an investment from which they expect a return over the period of their membership. Opening the floodgates would effectively erode their relative position in the cartel. The rejection by the Institute of the recent integration proposals and acceptance by society may well be explained by the relative losses and gains to be borne by the respective bodies.

III. CONCLUSION

This paper has attempted a review of aspects of the incentive structure facing both producers and consumers of accounting information. A recent significant event - integration - was considered so that the incentive structure might become more apparent. In the absence of empirical research in the area there can be no clear answers on the magnitude of the regulatory effects. What does become apparent is that national producers and consumers will react positively to the incentive structure they face. While no support could be found on *a priori* grounds at least, for rejecting a market solution as an optimal production strategy for accounting information. Further, there is reason to believe (again on *a priori* grounds) that the regulation of accounting may be in equilibrium where the gains (and pains) of the regulation are shared between the regulated and consumer.

Notes

1. The economic theory of regulation was formulated by G.J. Stigler 'The Theory of Economic Regulation', *Bell Journal of Economics* 2, Spring 1971, pp. 3-21 and posits regulation as an economic good with specifiable demand and supply functions.
2. For example the Attorney General for New South Wales has warned: 'Accountants I speak to seem to be of the consensus that self-regulation is what they want. It is, of course, what they already have, but my thesis is that a continuation of life as it is in the profession can only guarantee that the profession will not be left alone - either by law enforcement agencies, by the judiciary, or bureaucrats or, eventually, by our legislatures.' (F. Walker, 'The Accounting Profession: a Case for Regulation', *Proceedings: Regulation and the Accounting Profession*, October, University of Queensland, 1979, p. 114) And the accounting profession, anticipating an increase in government regulation, has lobbied for involvement.
   'It was submitted that the competency of the two bodies, to undertake the responsibilities outlined, could be gauged by reference to the objectives which constantly remain their goal: . . .to develop mutually beneficial relationships with governmental, commercial, industrial and educational bodies: to assist governments in the formulation of legislation by analysis and examination of draft proposals and to advise members in relation to the interpretation of Acts and Regulations.' (Australian Society of Accountants and Institute of Chartered Accountants in Australia. 'The Accountant and Statutory Recognition', *Australian Accountant* July 1974).
3. For a full description of the barriers, see D. Anderson, 'The Accounting Profession in Australia', *Proceedings: Regulation and the Accounting Profession*, October, University of Queensland, 1979.
4. See for example *National Times*, 12 April 1982.
5. See R.A. Posner, 'Theories of Economic Regulation', *Journal of Law and Economics*, 5 Autumn, 1974, pp. 335-58 for a description of the general assumptions on which this, and other regulatory rationales are based.
6. See S. Peltzman, 'Toward a More General Theory of

Regulation', *Journal of Law and Economics*, vol. 19(2), August 1976, pp. 211-40.

7. Peltzman, p. 1.
8. See R.S. Gynther, *Practising Accountants in Australia: an Analytical Study*, St. Lucia, Queensland: University of Queensland Press, 1967.
9. Australian Society of Accountants and Institute of Chartered Accountants in Australia, *Integration Proposals*, 1967.
10. Australian Society of Accountants, 'Integration of the Accounting Profession', President's letter, 17 March 1975.
11. T.G. Moore, 'The Purpose of Licensing', *The Journal of Law and Economics*, III, October 1961, pp. 93-117.
12. For the original application of these arguments in the auditing profession, see F. Milne and R. Weber, 'Regulation and the Auditing Profession in the USA', *Accounting and Business Research*, Summer 1981, pp. 197-206.
13. Australian Society of Accountants and Institute of Chartered Accountants in Australia, *Integration Proposals*, November 1981.
14. *Integration Proposals*, 1981.
15. The Trade Practices Act (1974) specifically attempts to deal (among other things) with restrictive agreements. The applicability of the Act to both explicit and implicit agreements is still yet to be interpreted by the courts. However it does appear that a broad interpretation of 'restraint of trade' is intended. 'I think the Act covers exactly what it is meant to: i.e. any action which in this area is in restraint of trade. If it did less it would fail in its objectives.' (W. Pengilley, 'Trade Practices Act: Legal and Other Implications', unpublished, 1975) However the applicability of the Act to professions is still at question. In regard to the United Kingdom and United States, Richard L. Schmalensee (*Applied Microeconomics*, San Francisco: Day, 1973, p. 103) notes:

'Under the English common law, agreements to fix prices or to share profits (or markets) are not illegal, but they cannot be enforced in court. The likelihood of stable collusive action is reduced when judicial procedures cannot be used to punish cheaters.

Under the Sherman Antitrust Act, any overt agreement among firms which either directly or indirectly acts to restrict competition is illegal. U.S. firms can legally only attempt to implicitly or tacitly collude on price policies, and no legal sanctions can be brought to bear on cheaters. Thus the American legal structure works against the formation of stable collusive agreements both by limiting the power of an industry to maintain pricing discipline and by restricting communications among industry members. Under the common law, firms could meet to discuss and agree on prices: this is quite illegal under the Sherman Act.

16. F. Machlup, *Economics of Sellers Competition*, Baltimore: John Hopkins Press, 1952
17. Machlup, p. 441.
18. G.J. Stigler, *The Theory of Price*, 3rd edn, New York: Macmillan, 1966.
19. Australian Society of Accountants, President's Letter.
20. ASA, President's Letter.
21. *Chartered Accountant in Australia*, March 1981, p. 17.
22. *Financial Review*, 17 July 1975.

5

THE AUSTRALIAN STOCKBROKING CARTEL

Ray Ball

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THE AUSTRALIAN STOCKBROKING CARTEL

Ray Ball

I. INTRODUCTION

Stockbroking in Australia has more of the features of several colluding clubs than of a competitive industry. It possesses the classic machinery of a cartel. Recent decisions of the Trade Practices Commission suggest that some of the offending features will be removed, though it is by no means clear that the proposed changes will go far enough.

There are many offending features of stockbroking at present. Entry to each exchange is at the discretion of a committee elected by existing members; members adhere to a fixed schedule of fees and risk severe penalties for charging non-schedule fees; there are severe restrictions on advertising and on members competing for clients; competition from incorporated organisations is excluded; and the committees that run the exchanges are given a wide range of discretion in policing these rules without having to justify or even report their actions to the public. Such rules, contained in the Memoranda, Articles, Rules and Regulations of the exchanges, closely resemble the rules one would expect of a cartel.

In addition to their individual features, the stock exchanges have engaged in several forms of collective action. The affiliated exchanges might seem to be potential sources of competition for each other, yet they charge identical prices, offer essentially identical services and have almost identical rules and regulations. An important structure is the Australian Associated Stock Exchanges. Another is the Joint Committee of the Melbourne and Sydney Exchanges which, because those exchanges transact 92 per cent of all Australian turnover, is an extremely powerful body.[1] The Joint Committee presumably is a forerunner to the proposed merger of the Sydney and Melbourne exchanges. This merger would in effect create a monopoly on the business of operating stock exchanges in Australia.

To operate a stock exchange, approval must be obtained in terms of the Securities Industry Acts (SIA). In the past, the industry has acted as if such approval were difficult for new entrants to obtain. There has even been a belief that the 'affiliated' exchanges might exert political pressure upon aspiring entrants to the stock exchange industry.

The advent of the National Companies and Securities Commission (NCSC) probably adds regulatory pressure toward monopolisation of the business of running stock exchanges. The limited budget of that body and the distaste of the regulatory mind for the (administrative) untidiness and unpredictability of competition probably make it prefer to deal with a single body. A new entrant might experiment with a new exchange technology, with promise of improved efficiency or improved service, and might discover that the NCSC had adapted its regulatory procedures and its way of thinking to an obsolete technology. It might resist innovation, preferring the cosiness of a fixed 'club'.

The industry thus can be seen as a mixture of government regulation and self-regulation. From a social viewpoint, the incentives faced by members of the industry cannot be acceptable. There is an incentive to use the power of the cartel to establish monopolistically high prices, to price discriminate and to restrict output to levels that are less than socially optimal. Furthermore, sheltering the industry from the full force of competition reduces its incentive to innovate, to find efficient solutions to problems in production of its services, to try new types of services for its customers, to use resources to their utmost capability, and in general to meet the implications of change.

It is possible, I suppose, that members of the stockbroking industry are not concerned for their own well-being and are consumed by a passion for furthering the public interest. It is conceivable that they ignore the incentives of a cartel structure, at their own expense. It is possible that the apparently collusive practices of the industry are part of an elaborate public-interest structure in which the industry has expended its own time and resources over the years on charitable grounds. On the other hand, at least one coalition of consumers of broking services claims that it is the victim of price discrimination and that it has paid prices that systematically exceed cost by a large margin.[2] And in my view it would require a vivid imagination to invent a moderately plausible public-interest explanation of many of the industry's features.

Nevertheless, stockbrokers assure us that they have the public interest at heart. Brokers assure us that all of the temptations to exploit the industry's elaborate collusive machinery for private purposes are resisted. In the AASE's submission to the Trade Practices Commission, blanket authorisation of all of the agreements within and among exchanges was sought on public interest grounds.[3]

In viewing these assurances with considerable scepticism, care must be taken to distinguish deliberate, calculated self-interest from well-intentioned error and from non-deliberative, evolutionary adaptation. Even a well-intentioned group can be expected to evolve a set of practices over time that reflect the incentives it faces. No doubt many members of the stockbroking community genuinely believe that they act in the public interest, particularly those who are less enquiring. The purpose of this paper is not to demonstrate that individual stockbrokers are rational exploiters of the cartel structure, though again such people undoubtedly exist. Rather the purpose is to analyse the structure of the incentives in the industry, on the assumption that there is no social justification for tempting economic agents to behave in an anti-social manner, even if some of them can resist temptation from time to time.

II. AN INDUSTRY OVERVIEW

The operations of the industry are complex, so some definitions are in order. The focus of this paper is upon stockbroking in its purest sense of arranging for buyers and sellers of stocks to be matched. Excluded from the analysis are other activities of brokers, such as underwriting, cash management trusts, financial advice to corporations, advising corporations on acquisitions, and company valuations, which are activities that also are undertaken by merchant bankers and/or consultants.

Stockbroking itself is an operation comprising many activities. For convenience, they can be described as:

1. **a market mechanism,** in which an attempt is made to match aspirant buyers and sellers;
2. **a retail mechanism,** which locates and processes individual buyers and sellers whose offers are fed into the market mechanism;
3. **a title exchange,** in which the contract that is made in the market is executed (i.e. money and title are in fact exchanged as agreed), normally in a 'clearing house'; and

4. **related client services,** such as research and investment advice.

For the present purpose, client services are of interest only in terms of their role in non-price competition in the industry.

A vertically integrated structure is evolving. When the clearing house system planned by the Melbourne and Sydney exchanges is in operation, the first three activities listed above will be an integrated package - integrated not only as a package offered to the consumer but also in terms of ownership of production.[5] That is, the producers of title exchange, retail broking and market making will be vertically integrated. To be a retail broker, one will also have a position in title exchange and market making; to have a position in market making, one will also have a position in title clearing, and so on.

Vertical integration is not undesirable in its own right, but it could be a means of continuing monopoly power in stockbroking. To emphasise this point, it is necessary to provide a brief sketch of the development of the industry.

The early development of the industry was influenced by heavy costs of communication. Thus, we observe that stock exchanges in the late nineteenth century were located close to the geographical points at which listed firms and investors were located. The markets for stock exchanges were segmented by communication costs. As communication costs have declined, stock exchanges have survived in centralised locations, and the likes of Charters Towers, Ballarat and Bendigo have disappeared. The trend toward centralisation is obvious and unavoidable. A single national exchange is implied by the proposed merger of Sydney and Melbourne exchanges, the disappearance of many smaller exchanges, and the tiny proportion of rational trading done on the Perth, Hobart, Adelaide, and Brisbane exchanges.

Given the substantial fixed costs of establishing an exchange with physical facilities, computer systems, operating procedures and a complex set of rules that investors treat as defining a 'fair game', it is reasonable to view stock exchanges (qua markets rather than retail broking outlets) as 'natural monopolies' within their domains. Initially, communication costs segmented the markets served by the exchanges on a geographic basis, but the long-term decline in costs of both computing and communication has led to the breakdown of geographic segmentation; the domain is becoming (or has become) national.

Consequently, a 'natural monopoly' is emerging at the national level, due to the intersection of two trends:

1) declining unit costs of computing over time have caused an increase in optimum scale of operation; and 2) declining communication costs over time have led to a falling cost of pooling previously segmented markets into a large scale national market.

Institutionally, the AASE and the Joint Committee of the Melbourne and Sydney Exchanges reflect the scale economies in the market system. The planned national Clearing House reflects the scale economies in the title exchange system.

In addition to the 'natural' monopoly power of the incumbent due to persistent scale economies, an additional (unnatural?) source of monopoly power lies in the SIA. Under section 27 of that act, one cannot operate a regular market for securities (i.e. as distinct from a casual transaction) without approval of the Minister in the appropriate State. While it is not clear how this will operate in the future, it is however clear that in the past either there has been or there has been perceived to be a 'closed shop'.

Whether the perception is realistic or not, it is so widespread that it seems fair to say that most potential entrants to that activity see entry as being expensive, if not impossible, in the sense that the set of Ministerial approvals required under section 27 for a national exchange of any type would be difficult or impossible to obtain. The merchant banking community is understood to believe that entry to the business of running stock exchanges is not competitive, even for those who meet the standards of expertise, financial security, reliability etc. envisaged by the Acts.

The advent of the NCSC certainly adds to the entry costs. Most regulatory bodies find it easier and tidier to deal with one body. The Australian Associated Stock Exchanges, being well-established and administratively competent, would be a likely candidate. I certainly sense this in private discussions with the NCSC people. For example, there have been several disapproving references about the Ballarat, Bendigo, Hobart and Newcastle exchanges - which, while they provide an untidy regulatory landscape and might not be up to regulatory standards, do provide one of the few potential entry points for an aggressive intermediary and therefore offer at least a little promise for genuine competitiveness in an industry that has advanced no strong reason for being anti-competitive.

Regulators tend to regulate as if the world were fixed over time. They certainly do not individually possess the aggregate creativity and dynamism of a competitive market. Nor are they likely to comprehend and sympathise

with the risk-taking behaviour of competition. In orienting their rules, regulations and entire method of operation to a particular type of stock exchange, they incur costs of adjustment when forced to respond to an innovation in the market for stock exchanges. They also impose costs upon the innovator. No matter how lofty their intentions might be, their existence in the system imposes costs on entry and upon change that must reduce the likelihood of competitive innovation. Whether or not the NCSC fits this pattern of behaviour is too early to determine, but one would necessarily be sceptical.

This is not to say that the source of exploitable monopoly power is legislative and/or 'natural' monopoly in the **retailing** operations of brokers. Indeed, as is argued below, brokers have sought to restrict the scale economies at the retail level as a means of controlling industry output. The evidence of emerging 'natural' and 'legislative' monopoly power is at the market mechanism and title exchange levels.

III. SOME INDUSTRY RULES

Price fixing

Rule 2.2 of the Stock Exchange of Melbourne states:[5]

> No other rates of brokerage other than those prescribed shall be charged to buyers or sellers and no waiver or rebate of brokerage (which includes any allowance by way of rebate return commission or otherwise in respect of or in connection with the purchase or sale of securities as broker) shall be made except to such persons and upon such terms and conditions as shall be prescribed from time to time by Rule.

Rule 2.4 prescribes brokerage rates for all members; these rates are identical to those prescribed by all other AASE exchanges (i.e. all exchanges). The power of the exchanges to enforce these rates (see below) provides an incentive to monopoly-price.

Restrictions on competition

Melbourne Rule 7.2 states:

> A Member Firm may advertise provided that all such advertisements are in good taste and do not contain false or misleading information.

Advertisements that have appeared over the years reveal what the exchange defines as 'taste': they are small, obscure statements of broking firms' names and addresses. It would be difficult to construe the few advertisements we see as competitive, the inference being that the Committee that defines 'good taste' etc. views competitive advertising as violating Rule 7.2. They contain no information that would assist consumers in their choices among broking firms, the inference being that such information is seen by the Committee as being either 'tasteless' or invariably 'false or misleading'.

Melbourne Rule 7.9 states:

> The issue of a circular or unsolicited business communication by a Member or Member Firm to a person other than a client or an employer pursuant to Rule 7.4.4 is expressly prohibited unless the consent of the Committee is first obtained.

Because other parts of Rule 7 describe a client in terms that amount to 'existing client', the effect of 7.9 is to prohibit 'poaching' of, or competing for, the clients of other brokers. In other words, Rule 7.9 attempts to create a monopoly over each and every client.

Rule 7.3 does allow brokers to approach institutions for business. Presumably, the scale and wide range of needs of the institutions are inconsistent with the concept of an institution as the captive client of one broker. The notion of a single partnership servicing the needs of the AMP Society, for example, would not be workable.

Regardless of the intent of Rule 7, which brokers no doubt will say is to protect innocent investors from avaricious brokers, the effect of the rule is to give brokers an **incentive** to offer their clients less service than if they had competition. And if brokers indeed are avaricious, they will respond to that incentive.

Restricting entry to stockbroking

Among the provisions governing membership of the Melbourne exchange is Article 51:

> Without otherwise restricting the absolute discretion of the Committee to act in the public interest to decide whether an applicant for Membership has suitable qualifications and experience, a candidate must be not less than 21 years of age and must have been employed for at least four years aggregate in
> a) the sharebroking business of one or more Members;
> b) the sharebroking business of one or more Members of a Recognised Stock Exchange in any capital city of the Commonwealth of Australia; or
> c) the employ of the Exchange or of a Recognised Stock Exchange in any capital city of the Commonwealth of Australia;
> PROVIDED HOWEVER that the aforesaid period of employment may be reduced to not less than one year if the Committee is satisfied that the candidate has extensive experience in any one of the following -
> i) Accountancy;
> ii) Banking or Finance;
> iii) Financial Journalism;
> iv) Law; or
> v) Has successfully completed the examinations conducted by The Securities Institute of Australia;
> PROVIDED FURTHER that in exceptional circumstances and notwithstanding the above provisions the Committee, not less than eight Members concurring, may admit a candidate who has not completed a period of employment as specified above.

Article 51 gives the existing participants in the industry total discretion over entry.

This is an important feature of the industry. The ultimate power of any cartel lies in its ability to protect its members from entry. No matter how effectively the cartel polices the activities of its members in order to stamp out competitive pricing practices, it cannot enforce cartel prices in the long run unless it can eliminate competition from non-members.

In attempting to justify its exclusive control over entry to stockbroking, the AASE observes: 'In the last ten years, no Exchange has rejected an application for membership.'[6] Many interpretations of this interesting fact are possible. The AASE clearly interprets the absence of rejections as indicating the openness of entry. A more likely interpretation lies at the opposite extreme. This interpretation is that there is a heavy pre-screening of potential applicants, with accurate signals of the likelihood of success available in the system, so that unfavoured applicants never apply. One would expect stable organisations with a 'club' structure to provide accurate signals. Indeed, if the formal application process were to be taken seriously as the stage at which screening occurred, and if the Committee were seriously interested in maintaining standards, then it would be difficult to explain the perfect acceptance record at every exchange over a decade.

If there is a pre-screening as the evidence suggests, then the question arises as to the grounds on which screening is conducted. If applicants are screened on the basis of their past contributions to the welfare of existing members, or even expected future contributions, then the entrant is paying a monopoly rent to the incumbents. The mechanisms could be many: for example, to be nominated for membership one might be expected to have provided several years of solid service to an existing firm, without having taken all the rewards for one's effort (that is, having left a proportion with the firm). There thus is a likelihood that the true price of entry is considerably in excess of the cash payment that might be made at the point of entry.

The present aim is not to speculate on these matters, but to observe that entry to stockbroking is at the discretion of stockbrokers, who thereby have an incentive to use that discretion to restrict entry for their own benefit, and that the existence of this incentive is socially unacceptable.

Restrictions on legal form

Melbourne Article 69(1) provides: 'No Member shall carry on business unless he does so in partnership with another Member or a Member of a Participating Exchange'. In particular, this provision excludes incorporated stockbrokers. One possible explanation is given by the stock exchanges themselves:

> A stockbroker is personally liable to the extent of all his assets for not only his own acts but for the acts of

each of his partners. This unlimited personal liability is a constant stimulus to promote the highest standards of service and advice. This links intimately with another aspect of membership; namely, the requirement to deal. Mutual trust and confidence in each other as members is essential because a member is required to deal with all other members. This unique feature means that transactions must be executed whenever there is a matching buyer or seller. Any other arrangement would endanger the efficiency of the market.

A consequence of the present rules of each Exchange is that a corporation may not be admitted to membership of the Stock Exchange. Incorporation would require a number of amendments to the present Articles and Rules. The Stock Exchanges have reviewed the matter of corporate membership from time to time. Because it would constitute a fundamental alteration to the present operations of the Stock Exchanges and would have profound consequences, they have agreed that no one Exchange will change its rules to accept corporate members without the agreement of the other Exchanges. This matter has been considered seriously in the past but, for reasons spelt out at length in this chapter, the Exchanges have been wary of any relaxation in present arrangements.'

Unlimited liability can be a facade if brokers arrange their personal affairs cleverly, protecting their assets against claims arising from their broking business. Assets can be held in trusts and other devices, making limited liability a sham. Yet this is the incentive provided by the present rules of the game. On the other hand, limited liability companies can raise more capital and might well put more capital at risk than do partnerships. They certainly do elsewhere in the economy and there is no reason to see stockbroking as different.

An intriguing alternative explanation is that prohibition of the corporate form is a means of controlling the output of members. One cannot determine both the number of firms and price without also determining firms' output. Potential entrants, if incorporation were allowed, would include all of the financial institutions (finance companies, banks, building societies etc.) and retailers (Grace Bros., Myer etc., following Sears Roebuck in the USA) and any other organisation with a

dispersed retail network. The competition they would give brokers, at the retail level, could be formidable.

It seems reasonable to believe that the retailing of equities, bonds, personal finance, mortgages, insurance, cash investment vehicles, real estate and other financial phenomena are complementary. For example, stockbrokers now market 'cash management trusts', as retailers for merchant banking 'wholesalers'. Why cannot retailers of personal finance also retail equities? From the client's perspective the artificial separation imposed by failure to retail a range of securities in one network must be inefficient.

By restricting brokers to the partnership form, the industry could be restricting them to a small scale of output and therefore could be preserving the incumbent brokers from competition they cannot meet, and also restraining individual firms' outputs. The incentive certainly is there.

Powers to enforce provisions

Melbourne Article 45 provides:

> 1) If the Committee considers a Member should be charged with conduct (herein called 'prohibited conduct') which is contumacious, dishonourable, disgraceful or unbecoming a Member (whether such prohibited conduct constitutes or involves a breach of any Article or Regulation of the Exchange or any Rule made by the Joint Committee or not), it shall cause the Member to be given written notice of the charge and of particulars thereof and of the date (being not less than seven days after the date when such notice is served) when such charge shall be heard. The Member concerned shall, if he so desires, be heard by the Committee in answer to the charge.
> 2) In the event of any Member being found guilty by the Committee of prohibited conduct, the Committee in its absolute discretion may -
>
> a) censure the Member; or
>
> b) impose a fine not exceeding the sum of $10,000 upon such Member and/or suspend him from all or any of the privileges of Membership of the Exchange and/or prohibit him from transacting any business with or through any Member or any Member of an Australian Associated Stock Exchange for a period not exceeding three months

upon such terms and conditions as the Committee thinks fit; or

c) report the charge and the finding and the recommendation of the Committee to a Meeting of the Exchange specially convened for the purpose.

3) The Members present at a Meeting convened in accordance with the last preceding sub-paragraph may by resolution -

a) impose such fine not exceeding the amount recommended by the Committee as they think fit upon the Member concerned, and/or suspend the Member concerned from all or any of the privileges of Membership of the Exchange for a period not exceeding the period recommended by the Committee and/or prohibit him from transacting any business with or through another Member or any Member of an Australian Associated Stock Exchange for any period not exceeding the period recommended by the Committee upon such terms and conditions as the Members think fit; or

b) on the recommendation of the Committee expel the Member concerned from the Exchange.

Sub-article 45(7) confers powers of secrecy:

7) The Committee in its absolute discretion shall decide whether any announcement of the decision be made to Members and if so in what form and manner it should be made.

and sub-article 45(8) attempts to reinforce the discretion of the Committee by providing:

8) The Members of the Exchange undertake that they will not, in any action arising under this Article, take any legal proceedings either in equity or at law with reference to the grounds or effects of any decision of the Committee or of the Members, notwithstanding any irregularity or any informality in proceedings.

These provisions give stockbrokers considerable power, exercised through their elected representatives, to enforce their agreements to fix prices, restrict competition, fix

entry, restrict legal form etc. For all the public knows, this power could be even wider. The width of the discretion and the possibility of secrecy together imply the power to act upon an even wider range of issues, in addition to price fixing etc., and it is doubtful that the range of discretion that has been exercised in the past will ever be publicly known. Again, the incentive certainly is there.

These enforcement provisions resemble the classical policing function of a formal cartel. The survival of a cartel depends critically upon its ability to police its pricing, output and entry decisions. The provisions of Article 45 therefore are an important feature of the cartel structure of the industry. Even if they are not used in the private interests of stockbrokers, which seems highly doubtful, the incentive to exploit the investing public is there.

The Trade Practices Commission determination

The stockbroking community refers to its various agreements, articles, rules etc. as being determined on 'public interest' grounds. The credibility of these claims would be greater if industry rules did not so closely resemble the price-fixing, output-restricting and policing provisions of a cartel.[8] Is it public interest or self interest?

The recent determination of the Trade Practices Commission came down on the side of the 'self interest' explanation of the industry's present structure. The *Trade Practices Act 1974-81* automatically deems some of the industry rules to be anti-competitive, but has an escape provision if the rules are found to be in the public interest. The AASE sought relief from the Act, in the form of an authorisation of industry practices from the Commission. To the credit of the Trade Practices Commission, it resisted substantial political pressure in deciding not to grant authorisation. After all, the industry has been given a decade in which to maintain its cartel structure since the introduction of the Trade Practices Act.

III. 'COMPETITION POLICY' IN THE INDUSTRY

While the Trade Practices Commission has decided to phase in negotiated broking commissions, the question of rules of entry is unresolved and the policies that it should recommend are not obvious.

Here I do not refer to the issue of the financial and other qualifications required for entry: the various markets (including insurance markets) can sort that out, the AASE's views notwithstanding. I refer to the share market and the title clearing mechanisms.

The effect of vertical integration

It seems difficult to envisage what a simple prohibition on price-fixing at the **retail** level will achieve by itself, given the apparent natural monopoly and the perceived costs of entry at the **exchange** level. As noted above, entry to the business of running stock exchanges is not easy, as a result of section 27 of the SIA and the pervasive pressure of the NCSC, as well as the economies of scale.

The institutional feature that one immediately encounters is the existing tie between entry to retail brokerage and exchange membership. Those who can supply retail brokerage are members of the exchanges, and vice versa. The possibility therefore exists that one can appear to 'free up' competition at the retail brokerage level, but that existing brokers would nevertheless take out any monopoly rents at the stock exchange level.

For example, imagine that 500 brokers 'own' a monopolised (by fiat) central market system, which might or might not include a clearing house. They might vote (in committee or full membership) to establish terms, including prices, for access by others to the system. Imagine that one now prohibits restrictions on entry to retail broking, restrictions on advertising, and price fixing at the retail brokerage level.

Then the opportunity still remains for the 500 brokers who own the exchange to:

1. Set prices to all retail brokers for use of the central market system, that are sufficiently high to recoup their monopoly as suppliers of **system** services;
2. Set a pricing structure that allows them to act as a price discriminating monopolist (for example, an appropriate combination of fixed and variable components for transactions of different sizes); and
3. Sell 'ownership' rights to the monopolised system, however defined (for example, shares, debentures, membership, or some combination of these), at prices that capitalise the present value of the monopoly rents as a result of 1. and 2. above.[3]

Free entry to the retail brokerage business then would do nothing to alter the basic anti-competitive structure of the industry, including the price structure. There now would be merely an increased competitiveness in implementation of the monopolised system at the retail level - with possible gains in efficiency at that level. The basic monopoly would remain, however.

Further, free entry to the 'ownership' of the monopolised central market system would not eliminate the fundamental monopoly pricing and output structure. By point 3 above, new entrants would buy in at prices that reflected the share of capitalised monopoly rents being purchased. Each new 'entrant' now would be a new shareholder in an existing monopoly; there would be no **effective** entry; it would be akin to expanding the shareholding base in a monopoly producer; there is no reason to believe that 1000 'owners' of a monopoly central market system would run it in a more or less competitive fashion than would 500 owners.

Free entry at the levels with 'natural monopoly' characteristics would have the advantage of providing **potential** competition at those levels, thus restraining the behaviour of the monopolist. From a policy perspective, barriers to entry should be reduced.

Pricing the output of a natural monopoly

The economics suggest a two-tiered pricing system. The regulatory agency chosen to control the industry (conceding that there inevitably will be one) should encourage open access to the natural monopoly, via access to its services at the cost of providing them. Presumably, the agency will be the Trade Practices Commission. (Given the sympathies shown by the NCSC in the political wrangle over the introduction of negotiated broking commissions, and given the preference of brokers for the NCSC, one can only hope for the Trade Practices Commission.)

If the clearing house and market activities are natural monopolies, then the charge to users for the service should be the marginal cost of the service, thus ensuring provision of the optimal amount of service. However, to charge only marginal cost would be unfair on those who bore the fixed costs of developing the service. To cover these costs and to compensate those who developed the service, an initial entry fee would be required. For the service to cover costs, an annual licensing fee for all who operated on the service would be required, in addition to the fee for service (which would be set at the marginal cost).

Free or open entry into a market does not mean there should be no charge for resources used. It does mean that there should be no 'excess' charge or other impediment to entry. The difficulty in setting a fair entry price in the case of access to a natural monopoly is to ensure that the charge reflects only the 'true cost' of resources that went into establishing the natural monopoly. It should not reflect a capitalisation of monopoly profits being earned by the monopoly. To establish a true cost of these resources requires examining the cost of these resources in alternative uses, which is never easy. But if the Trade Practices Commission (or other body) decided this was the approach to take then a separate investigation or study should be able to at least set the bounds on a reasonable figure.

V. CONCLUSIONS

The Australian stockbroking industry possesses many structural features that resemble the rules and policing mechanisms of a classical cartel. Key rules in the industry fix prices on a national basis, restrict advertising, give complete control on entry, give the cartel wide policing powers, and essentially eliminate competition among stock exchanges. The incentive certainly is there for stockbrokers to use that structure for their private interest.

The brokers' application for authorisation of these practices by the Trade Practices Commission appears to have failed. The Trade Practices Commission has decided to phase in negotiated commissions, thus outlawing price fixing. However, the Commission will encounter several difficulties in implementing competition. Not the least of those difficulties is the problem of right of access and pricing of access to market and title clearing mechanisms, which show evidence of emerging 'natural monopolies'. Outlawing price fixing is one small step in dismantling the cartel. We hope the process will continue.

Notes

1. Turnovers for 1977-78 and 1980-81 are reported in Australian Associated Stock Exchanges, *The Role and Functions of the Australian Stock Exchanges: A Submission to the Trade Practices Commission*, Sydney: AASE, 1981, Table 1.2.
2. The Australian Merchant Bankers Association *Submission to the Trade Practices Commission Relating to the Application by the Australian Associated Stock Exchanges for the Authorisation of their Rules, Regulations and By-Laws*, Melbourne: AMBA, 1981, pp. 9-10), believes that brokers are extracting the rents associated with the superiority of on-market offers relative to Part A offers, to the tune of at least $6.4m in the CSR-Thiess acquisition alone.
3. AASE, p. 2.
4. Some details of the planning clearing house system are contained in *The Stock Exchange of Melbourne Limited, Annual Report 1981*, Melbourne: Stock Exchange of Melbourne, 1981, p. 10. See also, Joint Working Committee, *Report of the Joint Working Committee on the Law Relating to Accounting for and Safekeeping by Stockbrokers in Respect of Clients' Funds and Securities*, 1978.
5. References are to the *Memorandum and Articles of Association, Rules and Regulations*, Melbourne: Stock Exchange of Melbourne. Similar (often identical) provisions are made by other exchanges.
6. AASE, p. 118.
7. AASE, pp. 118-119.
8. The term 'cartel' is used as in Leftwich: 'a formal organisation of the producers within a given industry ... to transfer certain management decisions and functions of individual firms to a central association in order to improve the profit positions of the firms'. (R.H. Leftwich, *The Price System and Resource Allocation*, Hinsdale, Illinois: Dryden Press, 1979, p. 297.) See also, C.E. Ferguson and J.P. Gould, *Microeconomic Theory*, Homewood, Illinois: Richard D. Irwin, 1975: 'a combination of firms, whose object is to limit the scope of competitive forces within a market'.
9. While Clause III of the Memorandum of Association of the Stock Exchange of Melbourne Limited purports to disallow profit-making at the stock exchange level, such restrictions normally are avoidable and changeable.

6

LAWYERS AND THE PUBLIC INTEREST

Gary Sturgess

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LAWYERS AND THE PUBLIC INTEREST

Gary Sturgess

I. INTRODUCTION

The legal monopoly has a long and respectable history. Judicial supervision of the profession can be traced back to the late thirteenth century when in 1280, following a complaint that lawyers were inadequately trained, the authorities of the City of London declared that in future they would refuse audience in the Courts 'except to those whom they have admitted as knowing their work "reasonably well".' They divided the profession into three branches and prescribed the functions of each.[1] In 1292, Edward I sent a royal writ to the Chief Justice of Common Bench, Meetingham: 'Concerning Attorneys and Learners (Apprentices) the Lord King enjoyned Meetingham and his fellows to provide and ordain at their discretion a certain number, from every County, of the better, worthier and more promising students . . . , and that those chosen should follow the Court and take part in its business; and no others.'[2]

While there was greater freedom, and even competition, until much later in the courts of equity and in non-litigious areas, the serjeants (or barristers, as they were later known) early set the pattern in taking control of admission to their ranks and restricting supply.[3] Almost from the outset they sought to maintain the image of gentlemen untainted by the world of commerce.

That attitude persists even today. Barristers cannot enter contractual relations with their clients. They cannot sue, nor can they be sued, for breach of contract in relation to their work, and until recently could not be sued in negligence for work connected with litigation. Likewise, there is no contractual relationship between solicitors and the barristers they brief. The former are honour bound, but not legally obliged to pay the fees of the latter. In this the bar has maintained the ancient (traceable to the advocates of

Greece and Rome) and aristocratic idea that lawyers are above the market. The payment to counsel is 'a gratuity by way of honorarium over which he [has] no claim and for which, therefore, he [has] no right to sue.' The pocket-flap at the back of the barrister's gown is an archaic relic of this theory. It is there so that the client can slip counsel a gratuity without causing him the embarrassment of a discussion about fees.[4]

The courts have been keen to reinforce this aristocratic posturing by barristers. In an English case last century in which a barrister brought an action to recover his fees from a solicitor, the judge observed, in refusing the application, 'I will never willingly derogate from the high position in which a barrister stands, and by which he is distinguished from the ordinary tradesman.'[5]

Both branches of the legal profession are forbidden from advertising, the prime concern being that it is undignified.[6] As Nieuwenhuysen and Williams-Wynn have observed, this very common feature of professional snobbery strikes at 'the keystone notion of the sovereignty of the consumer'.[7] Price competition is also unethical. An English court has stated, 'There is nothing worse in any profession than that there should be open fee cutting . . . It is most undesirable in professions that . . . there should be competition among members of the profession to get or keep business by offering to charge less than others are entitled to charge.'[8]

It is no surprise, then, to find not only strict provisions restricting competition from outside the profession, but regulations and codes of conduct restraining competition between members of the legal fraternity.

II. THE MARKET FOR LEGAL SERVICES

Although this paper is concerned primarily with solicitors and barristers, the market for legal services is larger than this. Even if we can set aside as a separate market the demand for new statute law, it is not so easy to distinguish the market for judicial services from the market for secondary legal services.

For the intending consumer of medical services there is a decision as to the type of medical therapy, as well as the choice of individual practitioner. By the time he comes to decide about quality, the patient has already selected the kind of therapy he prefers - be it faith healing or traditional, chiropractic, or homeopathic medicine.

Likewise the legal consumer is not merely interested in the quality of his advocate, but in the quality of the justice he receives and the principles of substantive law by which he is judged. Under our adversary system of justice, advocates play an integral role in the court processes, and they not infrequently play an important part in the judicial law-making too. Landmark cases such as *Donoghue v Stevenson*[9] illustrate the role counsel play in the generation of new law.

By definition, law-making is a governmental function, though this does not preclude the possibility of private rule-making bodies[10] or of competing government agencies. It is customary in looking at 'private government' to seek out exotic examples among primitive societies. In fact we have a recent example among Western legal systems that has been little analysed and which deserves a great deal more attention - the New Hebrides under the British-French condominium government. The 1914 *Protocol Respecting the New Hebrides* provided that the 'citizens of the two Signatory Powers shall enjoy equal rights of residence, personal protection and trade, each of the two Powers retaining sovereignty over its nationals and over corporations legally constituted according to its law . . .' Paragraph 2 of Article 1 provided, 'The subjects or citizens of other Powers shall enjoy the same rights and shall be subject to the same obligations as British subjects or French citizens. They must opt within one month, by means of a declaration made either verbally or by letter to the Resident Commissioner concerned or his delegate, for the legal system applicable to the subjects or citizens of one or other of the two Powers.'[11] A system of native administration operated separately.[12]

This joint system of government survived until Independence in 1980, by which time it had come under considerable criticism. The failure of the French administration to act against the (mainly French) rebels on the island of Santo in the lead-up to Independence has been seen as a classic example of the weakness of this system. The two powers could not agree on action. However, given the possibility of electoral fraud and French fears of persecution under the new government (later borne out in part), this may be an indication of the system's greater effectiveness in representing the diverse interests of its members.

Purposes of the judicial market

The judicial market in fact provides two services: dispute resolution and rule creation. Both are important, though neither is frequently discussed in economic terms, and the idea of an unregulated market for these services is to some a difficult concept. Indeed, despite the rethink of the economics of regulation over the last two decades, there has still been little analysis of the regulation of the judicial market.[13]

Landes and Posner[14] see two problems in the private production of rules in the judicial process. The first is 'the difficulty of establishing property rights in a precedent'. What incentives would private judges have to produce precedents? One answer may be the reputation they would derive from such rule-making and the consequent economic gains.[15] Another, in the absence of a supporting public court system (such as we now have backing up commercial arbitration), may be the facilitation of appeals. Thus a comprehensive private judicial system might offer parties not just a one-tier court system, but appellate courts as well. Published reasons for decisions would be essential in such a system.

The second problem Landes and Posner describe as follows: 'There would appear to be tremendous economies of standardisation in the precedent market, akin to those that have given us standard dimensions for electrical sockets and railroad gauges.'[16] There are efficiency gains from a unified public system of law that is widely known and widely accepted. This is more the case with criminal law and tort on which no private agreement can be made in advance than it is with contract and family law. In private international law, parties can specify in their contract which legal system is to apply. There are also externalities in the creation of new law, which tend to favour a public system.

Dispute resolution, however, does not face the same difficulties. Again Landes and Posner identify two major problems. 'Public intervention may be required (1) to ensure compliance with the (private) judge's decision and (2) to compel submission of the dispute to adjudication in the first place.'[17] The first is no real difficulty providing the state is prepared to lend its coercive powers to certified private adjudication agencies. The second poses more of a problem, since there is an incentive on the part of the defendant to reject the plaintiff's choice of adjudicator, thereby delaying and perhaps putting off entirely, the determination of the case. This is, of course, a characteristic of many arbitrations.

The difficulties can be overcome in two ways: by specifying beforehand what forum will hear the dispute (as in contract); or within small societies or sub-cultures, through non-coercive discipline (excommunication in religious groups, de-registration within professional bodies). Nevertheless, in areas such as tort and criminal law, there would appear to be some difficulties for a private system of dispute resolution.

Adjudication in Australia

The problems are not as great as they may appear because, to a limited extent, we already operate under competing systems of adjudication and rule-creation. Again, although we can, there is no need to go to colourful anthropological illustrations of this process.[18]

The Small Claims Tribunals (in New South Wales, the Consumer Claims Tribunals) have jurisdiction over small commercial disputes between consumers and retailers, and to that extent, function in competition with the Magistrates Courts (Courts of Petty Sessions). The aggrieved consumer has a choice of forum and, in effect, a choice of systems of justice - the Cadillac model before the law courts, or a cheaper version in the administrative tribunals. A dispute arose in New South Wales in late 1981 over a solicitor, Warren Rosen, who advised members of the Council of Australian Spa and Pool Associations how they could avoid being brought before the Consumer Claims Tribunals. It was his belief that traders did not receive justice at the tribunal. In his opinion, the tribunal was biased towards consumers, and there was not equal access by both parties. There were no provisions for the review of decisions.[19]

The New South Wales Minister for Consumer Affairs regarded Rosen's remarks as unethical, but it is arguable that it was sound advice to traders, who are, after all, half of the consumers of the Consumer Claims Tribunals. This flight from what is perceived to be an unjust tribunal illustrates the kind of pressures that would be put on adjudicators in a competitive situation.

More generally, the growth of Administrative Law since the Second World War has in part been in response to the law's rigidity. In some areas, such as the consumer claims tribunals, this has meant direct competition for the common law.

A new challenge is being mounted in New South Wales from the recently opened Community Justice Centres, which provide another alternative to the Magistrates Courts.

Staffed by trained laymen, these bodies use conciliation in dispute resolution, a technique that has proved successful in the United States in coping with neighbourhood and workplace disputes. There is more of a sociological than a legal atmosphere in these hearings.

Commercial arbitration

Although regulated by Act of Parliament, commercial arbitration remains a fundamentally private system of adjudication. The arbitrator's jurisdiction depends on a contract between the parties, and may be agreed upon either before or after a dispute arises. However, the law does not view kindly arrangements to oust the jurisdiction of the courts, and although the common law has found nothing wrong with contractual clauses making arbitration a condition precedent of going to the courts, the legislatures have acted to give the courts wide powers to stay arbitration proceedings.[20] An Institute of Arbitrators has been established in Australia which is being increasingly specified in contracts as a nominator. Although there is no formal certification, the Institute does conduct courses and rarely nominates an arbitrator who has not been through this training.

The prime advantage of commercial arbitration is that technical experts (engineers, architects, loss assessors) can act as adjudicators, obviating the need for costly and time-consuming expert evidence. According to the Institute, arbitrations tend to be much shorter than comparable actions in the courts[21] and in a recent case where a small homeowner was burdened with a costly twenty-day arbitration, the Institute closely inquired into the actions of the arbitrator involved.[22] All such negative feedback is investigated, for the Institute's reputation as a nominator depends on the quality of its arbitrators.

To summarise, there is now competition in the judicial market in this country, limited though it is. It is by no means clear that the current arrangements are more efficient than a single adjudication system would be, but it is not so disastrously inefficient that government is being pressed to immediately abandon it. Indeed, the New South Wales government has recently passed legislation for a system of semi-private arbitration for civil disputes. Under this scheme, modelled on those operating in several American States, litigants in minor disputes will be compelled to submit to arbitration by state-certified arbitrators, lawyers in

private practice nominated by the Law Society. Appeals will still lie to the courts in the costlier cases. It would appear that, despite its limitations, arbitration is still in demand by the state for its advantages over the court system.

III. CURRENT REGULATION OF SECONDARY LEGAL SERVICES

The complexity of the dispute resolution processes has created a market for legal intermediaries. The layman needs not just an interpreter of the law, but an agent into whose hands he can commit his legal affairs. Although governments and private firms do employ their own lawyers, the majority of legal graduates practise in the profession proper as barristers or solicitors, or in some Australian States, as both. It is with these latter groups that I am primarily concerned in this paper.

Government vs voluntary regulation

At the outset it is important to distinguish between legal or other official regulation, and traditional or other voluntary methods of professional supervision. For the so-called 'private interest theory' of State regulation, it is the coercive power of the state that is of importance. Stigler so identifies this characteristic: 'The state has one basic resource which in pure principle is not shared with even the mightiest of its citizens: the power to coerce.'[23] It is this resource that interest groups seek to control in the private interest model. Voluntary controls are of lesser importance, because, unless supported by the state's monopoly on legitimate force, they will generally fail under the pressures of competition. Even traditions as ancient and firmly entrenched as the proscriptions on advertising and fee competition, and the conveyancing monopoly, have come under frequent challenge. These attempted inroads have been withstood in each case by recourse to the state's power of coercion.[24]

While recognising the need for a distinction between legal and voluntary regulation, the New South Wales Law Reform Commission in its 1981 inquiry argued that 'restrictive practices' among voluntary groups of practitioners should be exempted from its general policy of laissez-faire regarding internal regulation. Its recommendation on this matter was that:

> Restrictive practices within the legal profession should be regulated along the lines of section 45(2) (a) (ii) of the Commonwealth Trade Practices Act 1974. Thus, practitioners would be prohibited from making an agreement, or arriving at an understanding, which substantially affects competition in all or part of the legal services market, unless the agreement or understanding is authorised by a specific body as being in the public interest.[25]

Without wanting to enter into this debate here, the restrictive practices argument would only seem to apply where a professional association holds a monopoly or dominant position by tradition or by virtue of some unique feature of the market.[26] There appear to be no natural monopoly elements in the provision of ancilliary legal services and there is little evidence that the legal traditions are strong enough on their own to prevent competitive professional associations arising. In Western Australia, for example, despite the dominant, indeed monopoly, position of the Law Society of Western Australia, a Bar Association was established in 1980. This grew from the efforts of a single practitioner (now the Chief Justice) who in 1961 announced to the Full Supreme Court that in future he would practise solely as a barrister.[27] The South Australian and Victorian experiences are similar (though not as striking).

Similarly, the success of the Western Australian settlement agents in breaking the monopoly on conveyancing, suggests that the legal profession is not as close as is sometimes claimed.

In short, there is considerable doubt whether, in the absence of their recourse to the State's monopoly on legitimate coercion, the legal professional bodies would be in a position to substantially control the market for their services.

Types of regulation

In the legal profession, then, we can identify four types of regulation:

1. voluntary regulation
2. self-regulation supported by statute or the courts
3. direct regulation by the courts
4. direct regulation by statute.

Because of the plethora of government regulations surrounding the legal profession, it is difficult to find a truly voluntary regulatory system - closest, perhaps, are the Bar Associations in some of the States with amalgam practices. In South Australia, for instance, there are more than thirty practitioners who have signed the South Australian Bar Association's roll. By so doing they have undertaken to practise exclusively as barristers, though in law they are entitled to undertake the work of solicitors as well. Other rules forbid them practising in partnerships or accepting work directly from clients, but these restrictions have been voluntarily undertaken. While ultimate powers of discipline lie with the Law Society of South Australia, the Association has its own rules on professional conduct and disciplines its own members. There is no prohibition on other amalgam practitioners appearing in the courts, and there are few, if any, other official rules supporting the existence of the Bar. A similar situation exists in Western Australia.[28]

Distinguishing between voluntary regulation and self-regulation granted by statute is not always an easy task. In New South Wales, for instance, solicitors are not required to belong to the Law Society, but they are nevertheless legally subject to its regulations and are required by law to pay annual fees. Not surprisingly, most solicitors are members of the Society. Thus, although the monopoly of the Law Society is not directly based in law, supporting regulations give it legal status.

The position of barristers in New South Wales (and some other States) is even more complex. Again, membership of the Bar Association is not compulsory, nor is submission to its jurisdiction in disciplinary matters, but superimposed on this professional regulation is discipline by the Supreme Court, a more daunting proposition (and a more public form of scrutiny). Most barristers belong to the Association; those who do not submit to its rules and disciplinary powers in any case. A more blatant professional monopoly exists in Tasmania where all practitioners are required by law to belong to the Law Society.

In each of these cases, regulation is by a professional association either with a specific monopoly granted by statute, or an indirect one supported by statute or the courts. It should be noted that in the case of the NSW Bar Association, an alternative body could theoretically be established, but the rules it would be required by the courts to enforce would be so close to those of the Association, that there would be little advantage in belonging to it.

A unique feature of the legal services market is the role played by the courts. In all States, the Supreme Court exercises the final jurisdiction over admission to the profession and discipline, and although this jurisdiction is rarely exercised, it nevertheless has a major influence on practice and procedure. This is a difficult area, for under a private system of adjudication, the courts would have an economic interest in supervising those who appeared before them. This situation is complicated under our present system because of the near-monopoly of the state on adjudication services. But it is aggravated by the control the courts exercise not only over those appearing before them, but over the whole profession in most of its activities. It would be of small consequence to a private adjudicator if an advocate advertised his services or engaged in fee cutting, but there is little doubt that if a barrister in New South Wales undertook these practices and refused to acknowledge the jurisdiction of the Bar Association, he would be disciplined by the Supreme Court.

The most blatant form of regulation is that specified in statute. The prohibition on unqualified persons acting as solicitors is perhaps the most important of these, but in recent years compulsory professional indemnity insurance schemes and independent regulatory tribunals have been established in this manner too. It is the form of regulation that will most likely grow in the future.

In practice, all four types of regulation work together, and it is difficult to separate their individual effects. There is anything but a free market for legal services in this country. Overall it could best be described as a system of producer control. It is not even a case of a regulatory agency captured by the producers; the law gives the regulation of the profession substantially into the hands of the suppliers, and if the judiciary is included in the profession (and it does not seem unreasonable to do so), then control is almost completely theirs.

IV. RESTRICTIONS ON COMPETITION FROM OUTSIDE THE PROFESSION

Restrictions on Output

There is no legal prohibition on an individual undertaking legal work on his own behalf, as the do-it-yourself conveyancing and divorce kits attest. A litigant is not

compelled to employ an advocate unless his refusal would result in a significant waste of the court's time and resources. It is usual in such cases for the judge to assist the unrepresented litigant.

Undertaking legal services for another is in some cases permitted, but when done for reward, it is prohibited by law. For instance in Victoria, under section 93 of the *Legal Profession Practice Act*, unqualified persons are prohibited from drawing up, filling out or preparing any instrument creating or regulating rights between parties or relating to real or personal property. An exception is made when this work is carried out by an unqualified person with no expectation of fee, gain or reward. In Queensland, there is a similar prohibition in the *Supreme Court Act*, and breach of this provision is contempt of the Supreme Court. But the Queensland section is much less restrictive than those in other States, applying only to real estate, and not personalty. In most States there is also a general prohibition against acting as a solicitor.[29]

The courts have a discretion to hear lay representatives. In a Victorian case in 1972 the Full Supreme Court noted:

> It would not be right to impose too rigid a limitation on a discretion thus conferred, but it has long been regarded in the higher courts as proper to refuse to exercise the discretion in favour of allowing the appearance of non-qualified persons (other than on merely formal matters such as adjournments) when the assistance of qualified persons is available to give the courts help in the administration of justice. These contentions raise matters of policy as to the appropriate procedure for the administration of justice. If the contentions were accepted, they could produce far-reaching consequences. They would open the way to a vast field of litigation, associated with companies, being conducted through untrained and unqualified advocates. They would not merely encroach on the established practice, but they would destroy that practice, and perhaps, if extended further to include agents for litigants who are natural persons, destroy the whole system of the administration of justice in these courts.[30]

The court acknowledged the custom of permitting non-professional advocates in proceedings under the Commonwealth *Conciliation and Arbitration Act* but

considered that in matters before the Supreme Court and in particular before the Full Court, circumstances demand 'full technical assistance be provided for the court'.

While this leaves open the possibility of employing non-professional advocates in minor matters, and trained and qualified non-lawyers in more complicated cases, it is unlikely that the courts would countenance the development of an alternative Bar. Encroachment on the established practice of the existing profession would not be tolerated, as the Victorian Supreme Court suggested.[31]

In most States solicitors and amalgam practitioners not practising exclusively as barristers are required to have practice certificates, which are renewable annually and are under the control of the respective law societies. In New South Wales, for example, under the *Legal Practitioners Act* only a person who holds such a certificate is qualified to act as a solicitor. However, because of the other, stronger controls on competition, the practising certificate is rarely, if ever, so used. It is used by the law societies to obtain compliance with laws relating to trust moneys and other forms of internal regulation.

Restrictions on input

The major control over entry into the profession is through admission standards. In all States, ultimate supervision of entry rests with the Supreme Court, though in practice admission boards handle most of the actual applications. Thus the courts only generally become involved when the decisions of the boards are called in question, as happened in 1981 in New South Wales in the Wendy Bacon case. In that case, after having been refused admission to the Bar by the Barristers Admission Board, Bacon applied directly to the Supreme Court for an order that she be admitted to practice. Control thus rests either with the Supreme Courts or with statutory bodies substantially composed of judges and representatives of the professional associations.[32] According to the NSW Law Reform Commission, in practice, the admission boards attach considerable weight to the views of the professional associations.[33]

In addition to academic requirements, considered below, the NSW *Legal Practitioners Act* requires that prospective barristers and solicitors be fit and proper persons. In the case of barristers they are required to prove they are of 'good fame and character'. The difficulties with such a standard were manifest in the Bacon case where there were claims of

political discrimination on the part of the Barristers' Admission Board. Of course while government agencies with such powers of regulation exist, they will always be liable to capture by interest groups and to claims of bias. This is important in New South Wales at present where there is a power struggle between the traditional practitioners and a group which might loosely be referred to as law reformers (receiving strong support from the Attorney-General's Department). This struggle for power has been manifest in recent judicial appointments, appointments to Queen's Counsel, elections of the Law Society and the Bar Association, and appointments to the NSW Law Reform Commission. It is against this very political background that the Bacon case must be judged. (Wendy Bacon was then, and still is, involved with the reformers.)

Shortly after that case, the New South Wales Bar Association moved against two other 'reformers' John Basten and Peter Livesey. Basten, a University of New South Wales law lecturer, was accused of assisting an escaped prisoner, engaging in unprofessional conduct and touting. This matter was subsequently dropped.

In Livesey's case, which arose out of the Bacon hearing, the Court of Appeal unanimously decided that he should be disbarred. The comments of Reynolds J. are illuminating:

> . . . this case illustrates the dangers and difficulties that lie in the path of the barrister who ignores the conventions, traditions, safeguards and self-imposed restrictions under which the independent bar has functioned for centuries. This young man had no concept of the 'noblesse of the robe', the collegiate pride of a learned profession . . .[36]

No comment is made here on the correctness or otherwise of these disciplinary actions. What is important in the present context is that all three individuals were prominent 'reformers', a fact which raised questions of political bias in the media.

The other potential machinery for restriction on entry to practice is the educational conditions placed on entrants. The Admissions Boards determine these standards in NSW and, though universities may introduce new courses, the professional associations keep control of these standards nevertheless. In the early 1970s, the University of Queensland introduced greater variety into its Bachelor of Laws degree course. The admissions boards ignored that

change by specifying the subjects necessary for admission, so that, in practice, law studies at the university changed very little.

Control is also exercised over post-graduation conditions. These vary from articles and extended periods of study at practice-oriented institutions like the College of Law in Sydney, to pupillage (and in the United Kingdom, to the requirement than an applicant for admission to the Bar eat a specified number of dinners at the Inns of Court).

But despite their enthusiasm for quality control, lawyers have generally refrained from placing direct restrictions on entry. They have not pressed for university quotas; indeed, the NSW Law Society has encouraged the establishment of law schools. Periodic attempts by newly admitted barristers to close the rolls have been resisted, although competition with the senior bar from interstate has in some cases been viewed less liberally. The South Australian Board of Examiners in 1981 refused to allow five Victorian lawyers, including a senior Queen's Counsel, to practice in that State.

Because of the national uniqueness of legal principles, competition from Australia's growing immigrant population is not a problem to the legal profession as it is in medicine. Nevertheless, in mid-1983, the New South Wales Law Society opposed the admission of a qualified South African lawyer on the grounds that he had not completed the six month course at the College of Law, a restriction similar to that used by the doctors. He was admitted by the Supreme Court over the Society's objection.

The general reluctance to restrict entry into the profession would appear to be a major departure from the conditions of Stigler's 'capture thesis', but it is clear from the conveyancing field that lawyers have nevertheless been able to regulate supply substantially through internal, 'professional' controls.

V. REGULATION OF LEGAL PRACTITIONERS

Once admitted to practice, the solicitor or barrister is still faced with a maze of regulations governing form of practice, advertising, fee-setting, and how he may compete. The major controls are described briefly below.

The division of the profession

In New South Wales and Queensland, practitioners are admitted either as barristers or solicitors, never as both. The division is thus maintained by law, and although solicitors in all States do have rights of audience in all State courts, subsidiary laws and practices reinforce the barrister's monopoly over advocacy. Barristers, of course, are prohibited from undertaking solicitor's work in these States. In Victoria the profession is technically fused, but a strong Bar has existed for many years, supported by ancillary legislation which reinforces the division. In the other Australian States and Territories, the profession is fused and although some practitioners have undertaken to practise solely in the manner of barristers, this is a purely voluntary action and they still face competition from amalgam practitioners.

The New South Wales Law Reform Commission looked closely at the present inflexible system in that State and suggested a change to common admission. The Commission originally recommended 'The structure of the profession should leave the practitioner free to practise either in the present style of a barrister or a solicitor, or in a style which cuts across the existing division.'[35] With the exception of restrictive practices, the Commission indicated that it intended its recommendations only to apply to discrimination by law or official practice.

The Commission was of the opinion that voluntary Bars, such as exist in Western and South Australia, would grow up in the absence of legal controls.

> In our view, a strong and vigorous Bar should, and would, exist in a flexibly structured profession. We do not suggest that any style of practice, whether or not that of a barrister, should have an inalienable right to be preserved from the forces of fair competition and personal choice . . . The Bar need not depend for its existence on maintenance of a rigid division in the profession . . .[36]

But while critical of the current professional bodies, the Commission in its final report was not prepared to recommend the termination of its monopoly status.[37] And it did not favour the development of a similar role for the special interest associations (i.e. associations of lawyers, and perhaps others, interested in one field of practice, such as

family law). 'Special interest associations can be beneficial but they should not be permitted to become, in reality, the regulatory bodies for solicitors working in particular fields.'[38]

Forms of practice

Complex restrictions also exist on the style of practice lawyers may engage in. Some of these are based in law, others are established by the professional associations, backed by the probability of court enforcement against those who do not belong to the associations. For example the NSW *Legal Practitioners Act* prohibits solicitors from sharing professional costs with persons who are not practising solicitors (a consequence of which is that they cannot practise in partnership with barristers). NSW Bar Association rules also forbid partnership by barristers with solicitors and other barristers.

In NSW barristers do not employ other barristers (with the exception of a practice called 'devilling' which involves research work by other barristers) but this appears not to be due to any legal or formal Bar Association rule, but is a universally observed convention. Solicitors are permitted to employ barristers, but Bar Association rules forbid barristers from being so employed except with its permission and then under close supervision. Barristers who are members of the Association are prohibited from employment by a company for the purpose of their work as barristers.

Barristers also face special controls already mentioned regarding direct dealings with clients and suing for the recovery of fees.

Advertising

The constraints on advertising by legal professionals differ slightly from State to State, but there is a general prohibition in all States. This anachronistic rule has come under increasing attack in recent years and is finally giving way. New South Wales, Victoria and Queensland have introduced legal services directories listing legal firms and the type of work they are prepared to undertake, but this has not provided the information consumers need to improve decision-making.

There has been further pressure to allow individual practitioner advertising and the NSW Law Society several years ago submitted changes to its regulations to the Attorney-General for gazetting, which will permit limited

advertising. At the time of writing, the Attorney-General had not yet acted on this. In the meanwhile the Society has been individually approving advertisements which conform to those draft rules, although they are subject to considerable restraints. Only print advertising is permitted, and it must be less than 72 square centimetres in size and not in a type-face that will attract undue attention. Solicitors are still forbidden from advertising the fields of law they specialise in, although there are moves to liberalise this too. In general, advertising which is promotional rather than informational is frowned on by the Society as undignified. Barristers in NSW are restrained by the rules of the Bar Association.

The NSW Law Reform Commission has indicated its support for controlled individual practitioner advertising by both solicitors and barristers. In its 1981 discussion paper, the Commission suggested the following rules to govern such advertising:

1. Advertisements must not be false or misleading in any material particular.
2. They must not claim superiority for the advertising solicitor over any or all other solicitors.
3. While they may make clear the intention of the solicitor to seek custom, they must not be vulgar, sensational or otherwise of such a character as to be likely to bring the profession into disrepute.
4. They must not contain testimonials or endorsements concerning the advertising solicitor.[39]

In late 1982 the Victorian Law Institute Council introduced the most liberal rules on practitioner advertising to date. The new rules contain similar limitations to those recommended by the NSW Law Reform Commission, and advertisements can be up to 120 square centimetres in size. 'Touting' in the electronic media is still not acceptable, although a practitioner appearing on programmes can now be described by name and specialty. The old limitations on the sizes of signs outside practices have gone, although neon lighting is still unprofessional.

Fees

Statutory fees and scales regulate fee-setting in most areas of the legal profession, and in addition there is provision for independent review of solicitor's bills by court officers (a procedure known as 'taxing'). There is some discretion in

charging more or less than scale fees, but a practitioner who charges excessively is not likely to be able to recover his bill on taxation, and may face disciplinary action as well. On the other hand, the practitioner who undercuts acts unethically and offends the general prohibition on attracting business unfairly.

Barristers in general have greater freedom in setting their fees than do solicitors or those who practise in that style. There is generally no upper limit on what barristers may charge, taking account of the superior skills of successful counsel, and more freedom in the acceptance of lower than average fees.[48]

Consumer protection

In addition to the above-mentioned regulations there are a number of other provisions aimed at protecting the legal consumer. These include trust account regulations and compulsory professional indemnity insurance (at present applicable in most States only to solicitors or those practising in that style).

VI. THE EFFECTS OF THE LEGAL MONOPOLY

There is little doubt then that lawyers have control of the agencies which regulate their industry. With such limited competition, and with some control of the pricing of their services, it should come as no surprise to learn that the legal profession is less concerned about consumers than it would be under competitive circumstances.

To test this hypothesis, one area of legal practice - conveyancing - is considered. This is a fitting topic of study because conveyancing accounts for about 50 per cent of solicitors' work.

Conveyancing as an example

In all Australian jurisdictions except South Australia and Western Australia, the legal profession has a monopoly over conveyancing. In all cases this is based in statute. South Australia and Western Australia are anomalies. The monopoly was lost in the former case in the 1860s when the profession attempted to resist the introduction of Torrens Title, a system of land title registration which greatly simplified conveyancing procedures of the time. A new class of conveyancers called land brokers grew up, and they have

become so much a part of the industry that they now account for more than three-quarters of the conveyancing in that State.[41] In Western Australia, settlement agents have established themselves with the assistance of some members of the legal profession and have in recent years been licensed. They account for about 75 per cent of that State's conveyancing practice. There have been many claims over the years as to the relative efficiencies of these two systems - the legal monopoly and open competition. The Dawson Committee in Victoria looked at the issue in 1980 and concluded that 'the claim that conveyancing costs in South Australia are appreciably cheaper than in Victoria cannot be sustained . . .'[42]

Subsequent to that report two other, more detailed studies of the comparative situations were made. Both concluded that conveyancing charges in South Australia and Western Australia were cheaper. The Victorian Consumer Affairs Council produced a report in 1981 after the release of the interim report of the Dawson Committee which concluded that 'Even upon the most conservative approach, it is safe to generalise that conveyancing in Victoria (excluding government fees) costs the typical consumer more than double what it costs in South Australia and Western Australia'.[43] A separate but similar study by Nieuwenhuysen and Williams-Wynn using the data provided by the Dawson Committee concluded '. . . in 1978 the **maximum** amount payable in South Australia was less than the **minimum** amount payable in Victoria, the difference becoming progressively more marked for higher value transactions'.[44] Looking at a $40,000 transaction, the relevant ratios between the two States ranged from 2.5:1 to 2.2:1. These figures are confirmed by the charges of the non-legal conveyancers which have arisen in New South Wales and Victoria in recent years. The Land Transfer Company in Victoria charged half the scale fee, and, while they operated, the New South Wales cut-price conveyancers were charging about 60 per cent of the scale fees.

Who opposes this monopoly?

Predictably the challenge to the conveyancing monopoly has not come from consumers but from insiders (lawyers) and competitors. As Friedman observed in 1968:

> Each of us is a producer and also a consumer. However, we are much more specialized and devote a

> much larger fraction of our attention to our activity as a producer than as a consumer. We consume literally thousands if not millions of items. The result is that people in the same trade, like barbers or physicians, will have an intense interest in the specific problems of this trade and are willing to devote considerable energy to doing something about them. On the other hand, those of us who use barbers at all, get barbered infrequently and spend only a minor fraction of our income in barber shops. Our interest is casual. Hardly any of us are willing to devote much time going to the legislature in order to testify against the iniquity of restricting the practice of barbering.[55]

This is very much the case with conveyancing (and most other legal services). As consumers, we have only infrequent dealings with the legal profession. Most of us buy and sell property infrequently. Thus our frustration at the costs of conveyancing and the inconvenience of the present system is only rarely experienced, too infrequently to spur us to action in times of review or challenge. These comments remain valid in spite of the fact that the first and major NSW cut-price conveyancer, Property Transfer Company, was set up by the Law Consumer's Association and in spite of the heavy involvement of the Consumer Law Reform Association in Victoria. While it cannot be denied that the people involved in these organisations are legal consumers (which of us are not?) their motivation was ideological and political rather than merely commercial.

The challenge to the conveyancing monopoly has come from would-be competitors, with the assistance of rogue lawyers. Settlement agents have operated in Western Australia for more than fifteen years, and any defensive activities by the profession were confounded by the widespread involvement of lawyers in these agencies for tax avoidance reasons. Settlement agents were formally licensed in 1981.

In Victoria the first real challenge by the Victorian Conveyancing Company failed in December 1977 when the owners of the company decided not to contest a Supreme Court action brought by the Law Institute. The major challenger, the Land Transfer Company, was established in October of the following year and has fought a running battle with the Law Institute ever since. The Institute has not yet proceeded against the company itself (which has operated by

undertaking administrative work, while having the legal work done by a qualified practitioner to avoid offending the *Legal Practitioners Act*). Instead the Institute has successfully proceeded against the solicitors associated with the company. Two have been fined by the Solicitor's Disciplinary Tribunal. The first, Roger Stevenson, was found guilty on four charges of professional misconduct. The charges are interesting. He was found guilty of attracting business unfairly, of failing to stop advertising, and of holding himself out and allowing himself to be held out as willing to do work at less than the minimum fee fixed by the Solicitors Remuneration Order.

A week after Stevenson was fined in September 1980, a former law clerk, Pamela Clark, owner of the Bendigo Conveyancing Company, was taken to court by the Law Institute. She decided not to contest it because of the costs, and undertook not to act as a solicitor again.

But the Victorian conveyancing war is far from over. According to press reports, the Land Transfer Company has an adequate supply of solicitors willing to co-operate in undercutting the legal conveyancers. The Victorian Labor Government has also indicated a willingness to legislate to end the lawyers' monopoly on conveyancing.

In New South Wales the experience has been much the same. Many of the twenty or so cut-price conveyancers which set up in 1980 folded under economic pressure. Initially the Law Society had given consent for some solicitors to be involved with the non-qualified conveyancers, but this was withdrawn in February 1980 and in late 1981, the Society commenced legal proceedings against the two largest companies.

There is little doubt as to the basis of the legal conveyancing monopoly - direct access to the state's power of coercion. Without this resource it is clear that lawyers would long ago have lost their monopoly on conveyancing with the assistance of a significant section of the profession itself.

VII. THE JUSTIFICATION FOR REGULATION

If the conveyancing experience can be extrapolated, legal consumers are paying dearly for professional regulation of the legal market. Of course, alternative regulatory mechanisms can be devised and it is conceivable that the state could create an agency run entirely in the public interest to supervise the legal profession.

But before proceeding to ask what alternative regulatory mechanisms might be constructed, it should be asked whether regulation is necessary at all.

Most of the economists' arguments for government regulation rest on the proposition that, in certain circumstances, consumers do not know what is in their best interests. It can also be argued that the provision of some secondary legal services is so closely tied to the process of law generation and to the production of justice that it should be regarded as a public good.

For the purposes of this discussion, four primary arguments for government regulation are identified:

1. the high cost of information about the quality of legal services,
2. the potential conflict between the interests of the lawyer and those of his client,
3. underestimation by the individual of the probability and cost of fraudulent and negligent legal service, and
4. the public benefits generated by the provision of legal services which cannot be captured by the individual paying the bill.

The information problem

The law is necessarily complex, and the layman requires guidance in dealing with the problems this creates. There is rarely any advantage in the layman acquiring the legal knowledge himself because of his infrequent involvement in these matters. Instead, he seeks an expert.

However, because of his limited knowledge of the law, the layman does not know how to recognise a fraudulent or incompetent practitioner. The costs of learning from experience can be prohibitive; the costs of acquiring the necessary information beforehand, both in studying the law and in surveying all or a significant number of the available suppliers, will be exorbitant.

The traditional response to this alleged market failure is to assume that the least costly way of protecting consumers from this lack of information is through state regulation, preventing unskilled practitioners from offering their services in the marketplace.

This model assumes, however, that the only choice is between restrictive state regulation and a situation where individual practitioners refuse to co-operate voluntarily in excluding, or at least identifying, those with inferior skills.

One intermediate solution, not requiring state involvement, is private certification. Agencies such as the Law Institute and the Law Societies could provide much the same service they do now, but without the supporting power of the state.

Assuming several such bodies developed in each jurisdiction, the consumer would then face a choice, not between thousands of practitioners, but between several certifying bodies. This would require much less effort and expense than investigating all the lawyers individually, and would substantially reduce the information costs it is assumed would exist in an unregulated market.

It is doubtful whether the current system of exclusive licensing provides any more information than such a system would; indeed, it may provide less. The present regime provides little information about practitioners above the minimum entrance requirements and almost nothing of their expertise in various areas of the law.

Possible information solutions

The NSW Law Reform Commission proposed several innovations which would permit a state regulatory system to provide this greater detail, but it is far from clear that the detailed regulation required would be less costly to consumers than voluntary certification.

If government involvement is required, it is probable that state certification will be a cheaper option than granting exclusive licences to qualifying practitioners. In that way, if the government's standards are unrealistic and consumers are prepared to take the risk of dealing with lower quality lawyers in spite of the government's warnings, the costs of the regulatory distortions will be minimal.

Uniform fee scales also protect consumers from high information costs by eliminating the need for shopping around for price bargains. The Victorian Consumer Affairs Council has said of this argument, that 'the certainty of a high charge is of very doubtful utility to the consumer'.[46] Recommended fee scales published by the professional bodies would similarly lower information costs to consumers without the side-effects of loss of competition. The argument in favour of the advertising restrictions is often expressed in terms of information costs also. It is maintained that too much information would confuse consumers, and that by restricting advertising, the professional bodies are assisting consumers in making their choices. This argument also assumes no brand names (certification agencies) would appear in the legal

market. One of the valuable pieces of information a solicitor could advertise would be his membership of a particular certifying body. In any case the American experience since the *Bates* case is that most legal advertising is informational rather than promotional.[47] What promotional advertising did appear in an unregulated market would no doubt be dismissed as puffery in the same way that Peter Clyne's flamboyance is received.

Under the current system of self-regulation, it is also possible that attempts to maintain the professional image in fact protect lesser offenders and prevent the public from learning about weaknesses within the system. In this the legal profession does not appear to be as much of a closed brotherhood as the medical fraternity (which has protected not just minor offenders, but some real criminals). The Law Reform Commission did, however, suggest in one of its papers that such a brotherhood syndome does operate in the NSW legal profession.[48] Without buying into this debate, in cases of professional regulation, especially where that is reinforced by a State monopoly, such claims will always exist to trouble consumers.

Determining agency costs

But the legal consumer needs more than just an expert in the law. He requires a consultant, an agent into whose hands he can commit his business and legal affairs. This agency relationship creates problems of its own, for the interests of the agent are not identical with those of his principal. The reasons lie in human nature (solicitors with trust moneys in their hands sometimes have pressing personal priorities), and in the fact that the consumer's agent is usually also the supplier of the service, so that there is an incentive to recommend oversupply.

Establishing and maintaining an agency relationship is not a costless activity, and the question arises whether the present system of professional regulation or any alternative mechanism for state regulation, can lower these agency costs. The professional approach to the legal market eschews the treatment of lawyers as economic men. Professionalism is an attempt to lower agency costs voluntarily by having legal practitioners more closely identify their own interests with those of the client.

Professional codes of ethics stress the primacy of the client's interests; for example, the Code of Ethics of the International Bar Association states, in part, 'A lawyer shall

never forget that he should put first not his right to compensation for his services, but the interest of his client and the exigencies of the administration of justice'.

This socialisation process - an attempt to create 'professional man' who is nobler and less self-interested than 'economic man' - has been remarkably successful. It appears to make economists' arguments about the legal market in many cases appear irrelevant. Traditions about the undignified nature of competition and advertising, which look ridiculous on economic man, fit professional man remarkably well. One group of writers observe, 'Clearly, the agency relationship between professionals and clients cannot work satisfactorily if practitioners are not self-disciplined. In this context, it is hard to over-emphasise the importance of the "socialisation" process inherent in professional education and reinforced by professional norms.'[49]

The weakness of the 'professional man' approach is that it starts from such strong assumptions. The economist's assumption of the rationally self-interested individual (the utility-maximising individual) is better, not because it more accurately describes the majority of professionals but because it assumes less.

Professionals and personal temptation

The 1981 report to the NSW Law Reform Commission by trust account investigators revealed the weakness in assuming professionals are able to ignore their private interests. Listing the reasons for misuse of trust money, the investigators spoke of fraud, cupidity, gambling, philanthropy and laziness and concluded there was need for a psychological study to analyse the pressures on people in control of other people's money. 'Some of these weaknesses may have been inherent in the solicitors' characters; they may have been triggered by the many mental and physical ills which beset mankind, such as nervous disorders resulting in nervous breakdown and paranoia, alcoholism and drugs, marital problems, blackmail, accidents to themselves and their families. . .'[50]

The report also noted that 'Persons who appear to have deep religious convictions have not been immune from the temptations afflicting those with principles and morals of a lower standard. In fact, in our experience some of the worst offenders have been those who might well have been described as "pillars of the church", and otherwise esteemed and respected citizens'.[51]

This peculiar approach to trust account defalcation is unusual because the investigators seem to have assumed lawyers would always function as professional men. In contrast to this approach to breaches of trust, the economist's assumption of rational self-interest seems conservative indeed.

The discussion above on conveyancing suggests that even legal professionals with the intention of acting in their clients' best interests will be unable to meet those needs as well as they might under conditions of competition. The mere fact that lawyers intend to act in their clients' interests does not mean that they will always be able to do so as well as professional men as they would as economic men.

Agency costs are the costs of forming and maintaining a contract or trust relationship which will limit the agent's independence, including the expenses involved in monitoring the agent's performance. These costs can be lowered through trust account auditing, through fidelity funds and professional indemnity insurance, and while these services are now usually associated with state intervention, they were provided long before the state became involved. Professional indemnity insurance, for example, was first offered through the NSW Law Society in 1968 and by 1972, 85 per cent of Sydney city practitioners were covered. In 1974, when the Law Society voted to make this insurance cover compulsory for its members, it chose to do so through amendments to the *Legal Practitioners Act* and the *Solicitors Regulations* rather than through internal rule changes.[52]

The market seems to be quite capable of responding to the demands of consumers who seek such protection in order to enter these agency relationships with confidence. The question, then, is not whether the state should provide a service which the market cannot, but whether consumers who insist on consulting lawyers who are uninsured or who refuse to have their trust accounts audited, are capable of fully calculating the risks involved.

Public good

In the primary legal market, and perhaps in the provision of advocacy services, there is a public good argument for state intervention. The provision of a stable legal environment, and the generation of high quality legal rules for one individual automatically make those same goods available to every other member of the community. It is possible to exclude free riders from the adjudication process by making

determinations in private, but it is clearly not desirable to exclude outsiders from the benefits of law creation and justice. Law approaches the pure public good.

But it is questionable how applicable this argument is to practitioners in the legal market: it is irrelevant, for example, to conveyancers, and would seem to be limited to barristers and other advocates. On this reasoning, the state might have an interest in regulating the quality of advocates appearing in rule-generating court cases, to counteract the underproduction of law that would otherwise result.

Given the present system of Queen's Counsel, it is to be doubted if such regulation is, in fact, required. But if there is a public good argument for state regulation of the legal market, it justifies far less than the system presently in operation.

Society knows best

It is often argued that individuals underestimate the probability and costs of inadequate legal representation. In some way that is not made clear, society is assumed to be a better judge of risk. Moore comments: 'Occupations, we have found, are licensed because the public is believed to be overly sanguine. . . . social security, housing laws, and many sanitary statutes would appear to have been motivated by the same logic'.[53]

Moore, in looking at occupational regulation in the United States, found this to be the strongest explanation for the laws then in existence. But the strength of this argument for occupational regulation is far from clear. It assumes a great deal about optimum levels of risk; and our recent experience with social security laws suggests that society's wishes as expressed through the electoral process are inclined to be conservative when it comes to risk-taking. The social gain from increased risk-taking is not always obvious and a cost-benefit study would be very difficult. Society may not know best after all.

VIII. ALTERNATIVES

The above instances of alleged market failure may provide some justification for government intervention in the legal market, but it is doubtful that they give support to the present system of professional regulation backed by government sanction. The 'professional man' approach to the

legal market has proven to be less than adequate, particularly in price competition.

It is important to note, however, that the current system of professional regulation is but one form of government control, resting as it does on the coercive power of the state. Voluntary regulation at present is minimal, and it is clear that in some of the most lucrative areas of legal practice, most notably, conveyancing, legal practitioners have had to rely heavily on governmental sanctions to resist competition.

It is not difficult to dream up alternative regulatory regimes. The difficult question is to find one more efficient than the present arrangements, or the unregulated market. The New South Wales Law Reform Commission, for example, put up a number of proposals, initially favouring an 'independent regulatory body' established by statute with government and consumer representation. Under the Commission's first proposal, the general regulation of the legal profession was to be handled by a Legal Professional Council with 21 members, 9 of whom would have been elected by the profession, 5 nominated by a Community Committee on Legal Services, and the remainder appointed by the Government. The Community Committee on Legal Services was to have 24 to 29 members, with 8 nominated by the Crown and 10 by specified community organisations, including the Australian Consumers' Association, the Law Consumers' Association and the Council for Civil Liberties. [54]

Why this regulatory structure would be more 'independent' than a professional regulatory body was not made clear, and no real attempt was made to explain how this arrangement would better represent the public interest than alternative mechanisms. Indeed, since a number of the 'consumer organisations' nominated for inclusion on the Community Committee on Legal Services were in fact extremely ideological bodies with little public support, and since some of these had close ties with one of the most active Law Reform Commissioners, there was considerable doubt that this agency would either be independent or be able to escape its own set of private interests.

Moreover, no explanation was given why this mechanism, or any such 'independent' regulatory agency should not be liable to 'capture' by the legal profession in the same way that all such industry bodies are. In this case the economists did not have long to wait before the capture took place. Before it had produced its final report to Parliament, the Law Reform Commission radically altered its views on the general

regulation of the legal profession, finally supporting a system of professional regulation little different in substance from what presently exists. In the final report, the Commission recommended consumer representation on the Law Society Council and the Bar Council, but these lawyer-controlled bodies were to be unquestionably in charge. It is probable that the model finally accepted by the NSW Government will be even closer to the professional monopoly which now exists.

In the end, the government failures associated with each of the regulatory mechanisms may be greater than the market failures they are implemented to remedy. A careful cost-benefit analysis of each of these proposals must be undertaken to determine their value. There is good reason for believing that the most efficient solutions will be those with considerably less government regulation.

Competition within the legal market is not such a daunting prospect when it is considered how much exists already. Para-legals operate as industrial advocates (in NSW the first non-lawyer has been appointed to the bench of the Industrial Court), managing clerks have assumed some legal functions in Victoria, land brokers and settlement agents have moved into conveyancing.

Group legal services, similar to group medical practices, or health maintenance organisations, have operated for several years in the United States, but have yet to come here. These schemes will allow pre-existing groups (such as trade unions or specially formed co-operatives) to purchase bulk legal services for their members with all the bargaining power that such arrangements offer. We have yet to see in this country legal check-up services such as exist in the medical field, and shop-front law has only recently begun to appear here.

The options are, of course, endless. We simply do not know what price we have been paying for an inflexible, heavily regulated legal profession.

IX. THE PUBLIC INTEREST

What then of the public interest? According to the professional associations, they have been regulating the legal market in the public interest all along. The NSW Bar Association, for example, told the NSW Law Reform Commission inquiry that 'the interests of the Bar as a whole coincide with the public interest'. The Commission, on the other hand, considered its regulatory mechanism more likely to coincide with the public interest.

The Commission, at least, was prepared to acknowledge the subjectivity of this concept:

> No one has a monopoly of understanding (of the notion of the public interest); even a disinterested person approaches it with a limited viewpoint. As we have pointed out earlier, the problem is not merely one of the tendency to prefer one's own interests, consciously or subconsciously, when a conflict is perceived. The limitations of an individual's experience may make it difficult for him even to appreciate the existence and nature of different views and interests, or the possibility of an approach different from the one that is familiar to him.[55]

Crudely put, the Commission's view on the way to discern the public interest in such circumstances was to take a vote. In fact, the process it described for resolving this conflict of private interests was more complicated and less democratic:

> Assessment of the public interest is a complex value judgment involving the consideration of, and attempts to resolve, potential conflicts between the interests of members of a profession and the interests of the clients, and often other interests, for example the many interests in the administration of justice.[56]

How one distills the interest of the public from the conflicting interests, for example, of the NSW Law Society, the Property Transfer Company and the buyers and sellers of land, was not made clear by the Commission. Moreover, it did not explain how the particular group of representatives it recommended, chosen in the manner it suggested, voting in a way that was never described, could discover the public interest more successfully than an alternative set of arrangements. The public was simply left to assume that its interest would be discovered and put into effect.

Despite its continuing use among politicians, the notion of the public interest has lost its usefulness and should be discarded on the philosophical scrapheap where all such out-of-date concepts go. To attempt a reconstruction, either in terms of the consumers' interests or in terms of the majority decision on a democratic vote, is to risk the perpetuation of a confusing and generally misleading concept.[57] And, as suggested by Adam Smith more than 200 years ago, the use of

the term should be greeted as a sign that large-scale private interests are probably at stake. 'I have not known much good done', he wrote, 'by those who affected to trade for the public good'.

Notes

1. T. Plucknett, *A Concise History of the Common Law*, London: Butterworth & Co., 1956, p. 219.
2. Quoted in Plucknett, pp. 217, 218. See also A.K.R. Kiralfy, *Potter's Historical Introduction to English Law and Its Institutions*, London: Sweet & Maxwell, 1958, p. 83.
3. Plucknett p. 218 n. 1 reports that in 1455 'the judges were consulted on a petition to reduce the number of attorneys in Norfolk from 80 to 6 only . . .' See also S.D. Ross, 'Lawyers and the Public - How to Bring Them Together', *Australian Law Journal*, vol. 53, 1979, p. 184.
4. Michael Zander, *Lawyers and the Public Interest*, London: London School of Economics and Political Science, 1968 p. 1.
5. Vice Chancellor Kindersley in *Re May*, 1858 4 Jur. N.S. 1169, quoted Zander p. 1.
6. This was the essence of the 1978 submission on advertising by the Law Society of New South Wales to the NSW Law Reform Commission. See also A.J. Nicoll, 'Advertising Our Wares', *Australian Law Journal*, vol. 53, 1979, p. 438.
   It was also one of the six arguments put to the United States Supreme Court in *Bates* v. *State Bar of Arizona* (1977) 97 S.CT. 2691, a successful challenge to the professional proscription on advertising, based on the first Amendment (Freedom of Speech). Justice Blackmun, delivering the majority decision, found that the lawyer-client relationship was a commercial one, and that the reputation of lawyers would not be adversely affected by advertising. 'In this day', he wrote, 'we do not belittle the person who earns his living by the strength of his arm or the force of his mind. Since the belief that lawyers are somehow "above" trade has become an anachronism, the historical foundation for the

advertising restraint has crumbled.'
The Code of Ethics of the International Bar Association puts it directly: 'It is contrary to the dignity of a lawyer to resort to advertisement'.

7. J. Nieuwenhuysen and M. Williams-Wynn, 'Conveyancing: The Pitfalls of Monopoly Regulation Pricing', *Australian Economic Record*, 3rd quarter, 1980, p. 35.
8. Lord Goddard in *Re a Solicitor* (1951) 2 T.L.R. 265, quoted Zander, p. 185.
9. In *Donoghue* v. *Stevenson* (1932) A.C. 562 the English House of Lords defined and extended the duty of care in negligence. The case widened the liability of manufacturers to ultimate consumers and is seen as one of the clear cases of 'judicial legislation'.
10. See, for example, T. Anderson and P.J. Hill, 'An American Experiment in Anarcho-Capitalism: the Not so Wild, Wild West', *Journal of Libertarian Studies*, vol. III, no. 1, 1979.
11. *Protocol Respecting the New Hebrides*, Article 1.
12. Ibid, Article 8.
13. See W.M. Landes and R.A. Posner, 'Adjudication as a Private Good', *Journal of Legal Studies*, vol. 8, 1979, and the subsequent discussion of that reference.
14. Ibid, pp. 238-240.
15. Ibid, pp. 238-240 and Otto A. Davis, 'Public and Private Characteristics of a Legal Process: A Comment', *Journal of Legal Studies*, vol. 8, 1978, pp. 285-293.
16. Ibid, p. 239.
17. Ibid, p. 237.
18. As Landes and Posner did with the Yurok Indians and David Friedman, with the medieval Icelanders ('Private Creation and Enforcement of Law: A Historical Case', *Journal of Legal Studies*, vol. 8, 1979, p. 399-415).
19. Rosen's speech was published in the CASPA Magazine, September 1981.
20. See, for example, the Queensland *Arbitration Act*, p. 10 (2)
21. Conversation with Cullis-Hill of the Institute of Arbitrators, March 1982.
22. According to Cullis-Hill, the arbitrator in this case (which received wide press attention) had pleaded with both sides to shorten the proceedings, to no avail.
23. George J. Stigler, 'The Theory of Regulation', *Bell Journal of Economics and Management Science*, Spring 1971, p. 4.

24. Frank Milne, 'Regulation of the Professions: An Economic Analysis', undated MS, p.11 notes 'Unless this entry regulation is enforced by government, it is a dead letter'.
25. New South Wales Law Reform Commission, *The Legal Profession, Discussion Paper No. 4(1), The Structure of the Profession Part 1*, 1981, p. 27.
26. The NSW Law Reform Commission seems to have adopted this argument in its *Discussion Paper No. 4(1)*, p. 214, though it never establishes that such a dominant position would exist apart from curial and legislative support.
27. NSW Law Reform Commission, *The Legal Profession, Discussion Paper No. 4(2), The Structure of the Profession Part 2*, 1981, pp. 22-24.
28. See NSW Law Reform Commission, *The Legal Profession, Background Paper IV*, 1981, pp. 22-28.
29. For a summary of the situation in each State, see David A. Jones, 'The Role of the Layman', *Australian Law Journal*, vol. 53, 1979.
30. *Hubbard Association of Scientologists International* v. *Anderson and Just* (1972) V.R. 340.
31. On this, see Jones p. 463. NSW Law Reform Commission *Discussion Paper No. 4(1)* p. 65 concluded that 'in the absence of statute, neither employed solicitors nor employed barristers have rights of audience, whether they are employed in private practice or outside'.
32. In NSW the *Legal Practitioners Act* grants control of admission to the Bar to the Barristers Admission Board.
33. NSW Law Reform Commission, *The Legal Profession Discussion Paper No. 1 General Regulation*, 1979 pp. 36, 39.
34. Quoted in *Justinian*, No. 24, September 1982, p. 9.
35. NSW Law Reform Commission *Discussion Paper No. 4*, Summary of Suggestions, p. 24.
36. Ibid, p. 104.
37. NSW Law Reform Commission, *First Report on the Legal Profession: General Regulation and Structure*, 1982.
38. Ibid, p. 10.
39. NSW Law Reform Commission, *The Legal Profession, Background Paper No. 5*, 1981, pp. 137-8.
40. See NSW Law Reform Commission *Discussion Paper No. 1*, pp. 36-37, 40-41.

41. Victorian Consumer Affairs Council, *Report on Conveyancing*, 1981, p. 8. Another estimate places the figure at 95 per cent, Disney (1978) quoted in Nieuwenhuysen and Williams-Wynn p. 29.
42. Interim Report of the Victorian Committee of Inquiry into Conveyancing p. 7.
43. Victorian CAC p. 31.
44. Nieuwenhuysen and Williams-Wynn p. 30.
45. Milton Friedman, *Capitalism and Freedom*, Chicago: University of Chicago Press, 1962, p. 143.
46. Victorian CAC p. 17.
47. Nicoll p. 446.
48. NSW Law Reform Commission *Discussion Paper No. 1*, pp. 52-55.
49. A.D. Wolfson, M.J. Trebilcock, and C.J. Tushy, 'Regulation of the Professions: A Theoretical Framework', ed. Simon Rottenberg, *Occupation Licensure and Regulation*, Washington: American Enterprise Institute for Public Policy Research, 1980, p. 192.
50. NSW Law Reform Commission *Background Paper IV*, p. 131.
51. Ibid, pp. 132-133.
52. See the submission of the Law Society of New South Wales to the Law Reform Commission on Professional Indemnity Insurance (about 1978), and criticisms of the NSW Law Reform Commission *Background Paper IV*, based on the attitudes of accountants to the current audits.
53. Thomas G. Moore, 'The Purpose of Licensing', *Journal of Law and Economics*, vol. IV, 1961, p. 117.
54. NSW Law Reform Commission *Discussion Paper 4(2)*, pp. 535-538, and Paper 1, pp. 8-10.
55. NSW Law Reform Commission *Discussion Paper 1*, p. 122.
56. Ibid, p. 5.
57. Wolfson, Trebilcock and Tushy p. 182.

7

REGULATION OF INSURANCE BROKERS

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REGULATION OF INSURANCE BROKERS

Peter L. Swan

I. INTRODUCTION

In June 1981 the Federal Government announced its decision to reject the recommendations of the Australian Law Reform Commission (ALRC) and industry submissions from the Confederation of Insurance Brokers of Australia (CIB Aust.) and the Insurance Brokers of Australia (IBA)[1] which would have resulted in a system of occupational licensing for insurance brokers both to regulate and restrict entry into the profession.[2] Insurance brokers act as intermediaries between consumers and insurance companies by arranging policies and receiving premiums. The stated aim of the recommendations was to ensure competence and fairness, impartiality, accountability for clients' funds and some form of professional indemnity and fidelity guarantee against bankruptcy.

Since the industry had been lobbying for compulsory registration and licensing provisions for many years, the Fraser Government's rejection of the Law Reform Commission proposals (largely reflecting the industry's desire for regulation) gave rise to a sense of outrage in the industry organisations. This was evident in strong statements by an Opposition (Labor) backbencher and by the introduction of a private members bill by the then Opposition frontbencher now Attorney General, Gareth Evans, incorporating the Law Reform Commission recommendations. With strong support from several Government senators, this private member's bill was actually passed by the Senate in a move to put pressure on the Treasurer and Government in the Lower House.[3] The industry is continuing its lobbying campaign both at the Federal and States level to become regulated via statute rather than via voluntary self-regulation as at present. The new Hawke Government seems favourably disposed towards introducing the legislation. In Queensland, brokers are subject to control by the Insurance Commissioner (Qld.) and

there is a requirement that an applicant be 'competent to perform the duties of a broker' which goes beyond the kind of restriction on entry recommended by the Law Reform Commission.

II. DEGREES OF INTERVENTION

It is possible to categorise the degree of government regulation of a profession into three stages - registration, certification and licensing - which in practice may combine elements from each. In the first category, registration requires no more than a listing in an official register. There is no provision for restricting the right to undertake an activity so long as one is registered - and anyone can register, usually after the payment of a fee. There is also no provision for removing a person from the register for failing to reach set standards or for any other reason. Thus registration on its own appears relatively harmless, although it is usually the forerunner to a more restrictive form of control.

Certification of the competence of an individual or quality of a product can be carried out by a government agency or by a private-sector organisation. An example of the former would be voluntary Australian design standards and examples of the latter, recommendations by *Choice* magazine and automotive inspections carried out by the NRMA. The crucial feature of certification is that the consumer's choice is not restricted in any way since non-certified individuals or products are free to compete with the certified individual or product. There seems to be no particular reason why certification must always be provided by government agencies since private organisations are capable of providing such a service. In the case of insurance brokers, the two industry organisations - CIB Aust. and IBA - act as certifying agencies by requiring their members to meet conditions which are similar to the requirements recommended by the Australian Law Reform Commission. In fact the submissions to the Government by these two organisations recommended that a sufficient condition for official registration be current membership of either of these organisations.

Certification has the additional virtue that the opportunity for the non-certified suppliers to compete with certified suppliers provides a litmus test of the value of the information conveyed by the certification process. If the non-certified suppliers thrive at the expense of the certified

suppliers then this may be an indication that the cost of providing the higher quality certified product is greater than the benefit to consumers from the higher quality.

There are of course possible difficulties associated with certification. For example, who certifies the certifiers? Does the certifier have an incentive to cheat by providing false information? If it is a private certifying organisation, how is it financed? (If an organisation has a financial interest in the advice being offered, credibility may be lacking.) Will it be viable? Governmental certification in particular is usually the second step after registration towards full occupational licensing and compulsory minimum quality standards.

Licensing proper is far harder to justify than either registration or certification. A complete prohibition on entry into an occupation or profession of one's choice unless certain pre-conditions or standards are met is a restriction of one's economic freedom to choose one's occupation and a violation of the ability of individuals to contract freely for their mutual advantage. The usual argument put forward for licensing is the paternalistic claim that the consumer is incapable of judging for himself and is therefore incompetent in some way. This argument is carried to ludicrous extremes when certification is rejected on the grounds that consumers are sufficiently incompetent to be incapable of distinguishing between a certified and a non-certified supplier when it is allegedly in the consumer's interest to do so.[8] As we shall see the ALRC is forced to rely heavily on such paternalistic arguments without the support of hard evidence.

The effect of occupational licensing is usually to provide monopoly rents to the existing members of a profession or occupation when the supply restriction is imposed. New entrants who are able to satisfy the licensing requirements at some later date may not actually earn any rents because of the often huge cost and/or time spent in becoming suitably qualified. Nonetheless there is usually an initial gain for those in on the ground floor, so to speak. Moreover restriction of supply leads to monopoly pricing even if there are large numbers in the industry, so long as the threat of loss of registration can be used to discipline members who do not abide by the usual requirement for (uniform) pricing at a rate determined by the professional itself. This is not the end of the matter because prospective suppliers who are not permitted to enter the industry also suffer. Migrant and minority groups are often the major losers.

Milton Friedman presents very well the 'private interest' theory of the demand for occupational licensing, based on the creation of monopoly by a small concentrated group:

> In the arguments that seek to persuade legislatures to enact such licensure provisions, the justification is always said to be the necessity of protecting the public interest. However, the pressure on the legislature to license an occupation rarely comes from the members of the public who have been mulcted or in other ways abused by members of the occupation. On the contrary, the pressure invariably comes from members of the occupation itself. Of course, they are more aware that others of how much they exploit the customer and so perhaps they can lay claim to expert knowledge.[5]

Friedman's predictions seem to fit the case of insurance brokers perfectly.

III. ASYMMETRIC INFORMATION

The most plausible sounding case on 'public interest' grounds for government certification or licensing of professions arises from asymmetrical information.[6] For example, one doctor may be first rate and be well aware of it, while another may recognise that he is a 'quack'. However, suppose that patients have no way of distinguishing highly skilled doctors from poor doctors. In this case the market solution will dictate equal fees for all doctors instead of the ideal solution of fees related to the quality of service. Highly skilled doctors with opportunities elsewhere will leave the industry as a result of low average quality and low fees giving rise to even lower quality and fees and the loss of even more skilled doctors. This is an example of Gresham's law for doctors: bad doctors drive out good.

This kind of market failure resulting from inadequate information on the part of consumers may justify certification of doctors to allow pricing according to ability or even possibly licensing, both as second-best policies given that the ideal solution is to eliminate the asymmetry in knowledge. Certification would take the form of voluntary minimum quality standards and licensing, compulsory minimum quality standards. Leland points out that if standards are placed in the hands of the profession itself then it is likely that quality standards will be too high as a means of determining entry.

However, the weaknesses of this approach to rationalising minimum quality standards are obvious. In a free market without licensing, consumers are likely to have many avenues

for distinguishing the quality characteristic of doctors or of insurance brokers for that matter. There are referral and second-opinion, the value of degrees obtained and the university in question, word of mouth, court cases etc. Moreover, in the absence of occupational licensing, firms or group practices are likely to be set up in such a way that the firm's reputation acts as a means of certifying the quality of services provided. Certification, particularly private certification, may be a way of solving any such problems which arise. Licensing is not called for.

The assignment of liability and the use of optimal liability rules may also be a way of circumventing the problem. The removal of occupational licensing would make it much easier to sue doctors since a major obstacle to doctors giving evidence against other doctors would disappear. In the case of defective blood, for example, supplying firms and ultimately donors could be made liable. It is interesting to note that government agencies whose job it is to inspect work in progress on building sites or to inspect and approve registration for cars are notorious for their reluctance to permit consumers who are harmed by faulty inspection to sue for damages.

IV. INSURANCE BROKERS AND THE AUSTRALIAN LAW REFORM COMMISSION

The Law Reform Commission bases its case for regulation of entry into the profession on three guiding principles - protecting innocent purchasers, promoting informed choice, and encouraging competition - which are unexceptional in themselves although I personally would reverse the ordering. A case for government regulation and statutory controls to license entry is then made on the conventional grounds that they are in the general public interest:

> Broker insolvencies have been of sufficient frequency and have involved such amounts as to justify legislative action to control the two main practices which contribute to the risks of insolvency and consequent losses: the mixing of funds received on account of insurers (premiums) and insureds (return premiums and claims proceeds) with a broker's general business funds; and the retention of premiums, often for lengthy periods, and their investment by a broker, sometimes in a dubious investment, for the broker's own benefit.[7]

In the first place the significance of an alleged insolvency problem has been exaggerated by the Commission. The known insolvency losses totalling $7.3m[8] over the ten-year period 1970-79 are quite small in comparison with the $1110m in premiums handled by brokers **in just one year alone** 1977-78, and even in relation to brokers' debts to insurers totalling $329m at 30 June 1978.[9] It is true that there have been a number of insolvencies since the Law Reform Commission reported, but these do not change the nature of the overall picture. In the cases of insolvency which the Commission investigated it was found that 92 per cent represented premium debts owed to insurers,[10] and hence the insolvencies largely represented **transfers** from insurance companies to brokers rather than from customers to brokers directly. Thus, unless the affected insurance company can disallow policies on which the broker has defaulted, the cost of insolvencies will be spread over the bulk of policy holders rather than borne by the relatively smaller number of clients of the insolvent broker. This outcome would seem to be in keeping with the first principle laid down by the Commission.

Doubt has recently been cast on this outcome by the recent Palmdale Insurance case in the Victorian Supreme Court[11] in which the judge found that in certain but not all cases financial intermediaries would escape liability for premiums which had not been paid to the insurance company. Some brokers have since modified their legal arrangements to increase consumer confidence by assuming liability for premiums they have received but not passed on to the insurance company. The law may need to be clarified in the light of the Palmdale decision.

The implication of a finding that policy holders rather than brokers are liable for insurance premiums not received by an insurance company is that in the event of broker insolvency, insurance policies could be cancelled so long as the broker had not passed on the funds to the insurance company, although the client had paid the insurance premium to the broker. In such an instance the broker has really defaulted on an implicit loan from the insurance company. Moreover the insurance company is likely to be in a much better position to judge the financial probity of the broker than is the client.

Thus it would seem to me that the law should be altered so as to make the insurance company rather than the client liable for premium payments in the case of broker default when the client has paid the broker the requisite sum. Such a

law would still leave the client liable for the insurance premium which has not been paid to the broker. This is in effect a loan made by the broker to the insured. Also where no insurance contract has been entered into because (say) the broker has simply absconded, the client would remain liable except for his claim on the broker. In my opinion law reform along these lines would provide all the protection to clients that is necessary without involving registration or occupational licensing of insurance brokers.

Brokers do in fact provide important services for the insurance companies in connection with arranging cover and settling claims and are remunerated in turn by commissions paid by insurance companies and the income derived from the investment of premiums. Insurance companies extend credit to the brokers, presumably in lieu of higher commissions, and the brokers also extend credit to their insured clients, but to a lesser extent. The provision of credit by insurance companies is implicit when there is a failure to insist on prompt payment. The net funds available to brokers for the purpose of generating income are quite large and were about $108m at 30 June 1979. Interest and investment income derived from these funds amounted to $12m in 1977-78 out of a total income of $137.5m for brokers.[12] Just as the cost of the commissions paid by the insurers to brokers and the income forgone by extending credit to brokers form part of the cost of carrying on an insurance business, so also does the risk of default arising from broker insolvencies. The insurance companies clearly find it more economical to extend credit and take the risk of default rather than pay higher commissions to brokers for the provision of their services as intermediaries between the insurers and the insured.

The Commission is particularly concerned about money which is payable from the insurance companies to the insured which is temporarily invested by the broker:

> It is quite wrong for a broker to invest claims moneys and returns of premiums for his own benefit. He should be made strictly accountable to his client for funds held on his client's account and should not be permitted to use them for the purpose of making personal profit.[13]

It seems hardly justified to set up a system of regulation designed to separately treat clients' funds from other funds, particularly when the Commission does not provide any

evidence that these funds owed by brokers to the insured are anything more than relatively minor. Moreover, if special consideration is to be given funds held by brokers on behalf of the insured, why not give special consideration to the much vaster amount which the insured owe brokers? At 30 June 1978, credit extended to the insured amounted to $247m. Rather than referring to an alleged 'personal profit', a sounder analysis of the situation would note that brokers, as part of a highly competitive middleman sector with freedom of entry and exit, make only a competitive return commensurate with their skills. Any return which is obtained by an ability to invest clients' funds will be competed away by other brokers, and hence will be used to offer more and better services in order to attract more customers, or similarly will be used to compete for business by offering better credit terms to valued clients.

The Commission also recommends restrictions on the types of investments that general funds can be used for, as well as a prohibition on the use of clients' funds.[14] It notes with some indignation that it 'has even been known for a broker to use premiums for the purchase of real or personal property for his own use and benefit'.[15] However, the Commission forgets that the lower returns which will presumably result from severe controls on the brokers' portfolio of assets will be borne by consumers as a result of a fall in investment income combined with the inevitable rise in commission income to offset the fall, and will ultimately result in higher insurance charges to consumers.

I have argued that there is no basis for the 'public benefit' argument for regulation of entry arising from broker insolvency. If the risk of insolvency were an important issue with the consuming public, surely more complaints and demands for regulation would have come from the alleged victims due to the absence of occupational licensing? To be fair, I note that victims would most probably have difficulty in having their complaints registered and are unlikely to form a very powerful lobby. If considerations of the public interest were the real motivating factor in general regulation, the brokers and the industry generally would be doing everything in its power to prevent legislation which would presumably be costly to comply with. If compliance were not costly, the desired changes in the public interest would be brought about on a purely voluntary basis.

However, consistent with the 'private interest' view, the facts appear to be reversed. The Treasury Submission comments as follows:

> Although in recent years Treasurers have received numerous representations from (or inspired by) brokers in favour of a regulatory scheme, they have received very few complaints indeed from members of the public.[16]

State government bureaus do, however, receive complaints about insurance matters, but what proportion relates to insurance brokers I am unaware. Doubtless some consumers seeking insurance have been adversely affected by bankrupt or absconding brokers but the question remains: what price are taxpayers and the majority of customers of non-defaulting brokers willing to pay to reduce the probability of default by a tiny minority of brokers? Is it $1 for every $1 lost? $10 for every $1 lost? $1000 for every $1 lost? or is it even higher?

V. LICENSING VERSUS ACCREDITATION

Even if it were true that there is some merit in the Commission's case for government intervention based on broker insolvency, it is far from obvious that all the alleged gains to consumers could not equally be achieved by a system of accrediting brokers who meet the conditions of financial probity laid down by the Commission. If meeting these conditions truly provides benefits for consumers outweighing the costs, then the group of accredited intermediaries should thrive at the expense of the remainder, who would not be in a position to state or advertise that they have the 'seal of approval' from a government agency but would nonetheless be allowed to compete subject to this 'handicap'. The Treasury Submission[17] proposed the encouragement of a voluntary accreditation scheme which would allow the forces of free competition to go on acting in the interests of consumers. In fact such a scheme already operates for a major portion of the industry (up to 80 per cent).

The Commission, in rejecting the Treasury proposition, argued that:

> . . . preservation of freedom of choice between a broker who is bound to comply with standards considered necessary for the protection of the public and one who is not bound to do so would be of doubtful value even to those with the knowledge and

> understanding to appreciate the difference. Even if that were not so, the value of maintaining freedom of choice in this regard must be balanced against the need to protect those to whom the differences between the different types of intermediary, let alone those between the different types of broker, would remain a mystery.[18]

This reply misses the point that individuals including consumers in all walks of life have to make choices which are never perfectly informed and that balancing off risk against expected return is something which all of us do throughout our everyday lives. In fact very few clients of insurance brokers are naive little old ladies in need of protection against themselves, but rather many are mature businessmen used to making rational informed decisions. The Treasury Submission notes 'that brokers are probably used relatively little by the man in the street for the purpose of obtaining cover in respect of dwellings, vehicles etc'.[19] The Commission's paternalistic attitude, expressed in its views and recommendations, is not at all flattering to the intelligence and sophistication of consumers generally, and in particular, the clients of brokers who on the whole can be expected to be relatively well informed. To the extent that there is merit in the 'public benefit' approach, an accreditation system would provide the insuring public with additional and valuable information, as well as put the Commission's reforms to the market test of competition between the accredited and non-accredited sector.

Certainly the Commission cannot guarantee that its proposed solutions will prevent all future broker insolvencies or its various others aims via occupational licensing and the various other controls it recommends. Moreover, even if occupational licensing were capable of achieving its major objectives, the costs to the insuring public and society as a whole need not be negligible. In particular, occupational licensing results in barriers to entry which in turn can give rise to monopoly pricing. Monopoly pricing has an **efficiency cost** associated with it because of the reduction in real resources going into the industry and higher prices. On the other hand, losses sustained as a result of broker insolvencies may largely fall into the category of **transfers** ultimately from the insured to brokers with little in the way of efficiency costs or social loss. A dollar transferred from a taxpayer to a pensioner has a private cost to the taxpayer but is a private gain to the pensioner, so that the net social cost

may be zero, apart from the costs of actually achieving the transfer (or resisting it in the case of the taxpayer). Moreover, what the Commission neglects is that not only are insolvency losses largely transfers but that transfers are also made from the brokers to the insured public. These transfers are represented by the lower commissions and hence lower insurance charges which result because brokers can invest funds resulting from credit at relatively favourable rates of return, not merely 'misuse and speculation'.

VI. THE EXPLICIT COSTS OF REGULATION

The Law Reform Commission gave very little attention to the direct costs of regulation of the insurance broking industry, yet this factor was of considerable importance in the Fraser Government's decision to reject regulation. It was unfortunate for the broking industry that Cabinet consideration by the Fraser Government took place shortly after the cuts made by the Lynch Committee. The Treasury view was uncharacteristically opposed to increasing its power and influence via more regulation. Approximately 15 Treasury staff are required to regulate a handful of life assurance companies, 54 to regulate about 164 underwriters and general non-life insurance companies and presumably even more staff would be required to regulate and audit where necessary the over 550 insurance broking firms at a cost of millions of dollars annually. Of course it may be possible to introduce forms of regulation with a lower direct cost which would also satisfy the industry - for example, a ban on entry - but less detailed forms of regulation may be harder to justify as allegedly 'serving the public interest'.

VII. ALTERNATIVES TO FEDERAL LEGISLATION

Some States already have legislation or are planning to have legislation covering insurance broking. In fact some critics of the earlier Fraser Government's rejection of regulatory legislation argue that the net result will be legislation in the various States which may not be uniform in character. It seems to me that if such an outcome eventuates it would not be the ideal solution but at least would be preferable to uniform Federal legislation. Some States may choose to introduce regulations which have a high direct and perhaps also indirect cost of regulation to be borne by State taxpayers

and consumers while others may prefer to rely on accreditation schemes and market forces to provide whatever consumer protection is necessary. In a heterogeneous and pluralistic society, some degree of non-uniformity between the various state jurisdictions may in fact be a virtue rather than a liability. To some limited extent, population movements between jurisdictions may represent 'voting with one's feet' and thus provide an additional mechanism for matching preferences for degrees of regulation and bureaucratic control with particular political jurisdictions. At the State level, legislators may be under more pressure from voters and taxpayers to justify new programs in the area of occupational licensing and regulation. Moreover, where not every State adopts the same policies, conditions more akin to a laboratory experiment are set up and thus it becomes easier to evaluate the effects of different regulatory policies.

VIII. CONCLUSION

It would be naive to think that with the Cabinet rejection in 1981 the issue is over and done with. Over the next few years, I expect that intensified efforts will be made by the industry to gain what the industry regards as its rightful status as a regulated industry. They may well be on the verge of success even if, as I believe, regulation is not in the public interest. In the light of a recent court case, there is scope for an improvement in the law relating to insurance companies and brokers but the case for proceeding beyond accreditation to occupational licensing has not yet been successfully made.

The kind of legislative reform which appears to be required does not in fact involve regulation or licensing at all. My proposal is that insurance companies be made liable for unpaid premium income from defaulting brokers when the insured have paid the broker in question. In most but not all cases, this is the way the industry appears to have operated, at least up until the recent Palmdale case. Such a reform would mean that premium income received by the broker but not passed on to the insurance company is treated in law as a loan from the insurance company to the broker. Thus under the proposed arrangements an insurance company which extends credit to brokers by not insisting on immediate payment spreads any loss from defaulting brokers over all its clients via its premium charges. In return for extending

credit and bearing this additional risk, it is able to take advantage of smaller commission payments to brokers than would otherwise be the case. Insurance companies are clearly in the most favourable position to make judgments about the tradeoff between extended credit with lower commissions and higher default risk.

Author's Note:
This paper is an extended version of a portion of Peter L. Swan, 'Is Law Reform too Important to be Left to the Lawyers?: A Critique of Two Law Reform Commission Reports', in (ed.) R. Cranston and A. Schick, *Law and Economics*, Canberra: ANU Press, 1982.

Notes

1. During 1982 the two organisations decided to merge.
2. The Federal Cabinet's rejection of the proposals to regulate the insurance broking industry followed a strongly worded editorial in the *Melbourne Age*, 25 May 1981, and an article by Ross Gittins in the *Sydney Morning Herald*, 25 May 1981, entitled 'Small Sin Tempts Born-again PM'. Both items were opposed to regulation.
3. *Financial Review*, 2 November 1981.
4. However, if the initial contact with the broker is by telephone and no inquiry is made of a non-certified broker regarding membership of an industry certifying organisation, the prospective client may be initially unaware of the status of the broker. When the broker is certified, the prospective customer will presumably not only be informed, but may also be warned to be wary of non-certified brokers. Certified brokers have an incentive to make consumers aware of the distinction between themselves and non-certified suppliers. For example, there is a listing of local IBA members in the Sydney Yellow Pages Telephone Directory. If the prospective client does not feel it worthwhile finding out about the status of the broker, this may be because rightly or wrongly he does not value very highly the services of the certifying body.
5. Milton Friedman, *Capitalism and Freedom*, chap. 9, Chicago: University of Chicago Press, 1962, p. 140.

6. See G. Akerloff, 'The Market for Lemons: Qualitative Uncertainty and the Market Mechanism', *Quarterly Journal of Economics*, 84, August 1970, pp. 488-500; and H.E. Leland, 'Quacks, Lemons and Licensing: A Theory of Minimum Quality Standards', *Journal of Political Economy*, 87, December 1979, pp. 1328-1346.
7. Australian Law Reform Commission Report, *Insurance Agents and Brokers*, Canberra: AGPS, 1980, p. xx.
8. Ibid, p. 61.
9. Ibid, p. 64.
10. Ibid, p. 60.
11. *Financial Review*, 4 May 1981.
12. *Insurance Agents and Brokers*, p. 62.
13. Ibid, p. 67.
14. Ibid, p. 71.
15. Ibid, p. 65.
16. Treasury (Commonwealth), *Insurance Contracts: Treasury Submission to the Law Reform Commission*, Canberra: AGPS, 1979, p. 32.
17. Ibid, p. 32.
18. *Insurance Agents and Brokers*, p. 73.
19. *Insurance Contracts*, p. 33.

8

OCCUPATIONAL REGULATION IN A REGULATED INDUSTRY: THE CASE OF AIRLINE PILOTS

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OCCUPATIONAL REGULATION IN A REGULATED INDUSTRY: THE CASE OF AIRLINE PILOTS

Christopher Findlay

I. INTRODUCTION

Aviation in Australia is highly regulated but the degree of regulation varies between sectors of the market. The varying degrees of regulation and pilot unionisation, and the opportunity for pilots to earn rents in regular public transport markets but not in others creates some interesting rent seeking incentives for pilots. This involves queueing by working through the licensing system, which has some implications for licensing standards. These characteristics and effects are explored in this paper.

Questions examined here include: do pilots earn rents? what types of rent seeking occur? how do the regulators and the licensing standards respond to rent seeking? and does the licensing system act as a barrier to entry by pilots to some sectors of the product market?

Another question is whether government involvement in pilot licensing is justified. The view is taken here that some device will always be used to provide employers with information about pilots and their skills. The government mechanism is taken as given, but others can be imagined. The issue of which device is appropriate is beyond the scope of this paper.

In the next section the important characteristics of regulation in product markets and of the structure of the pilot market are described. In section III, some predictions derived from these characteristics are discussed, and data on rents, rent seeking and changes in the licensing system are presented. The question 'should we do anything?' is considered in section IV, and section V contains a summary.

II. CHARACTERISTICS OF PRODUCT AND LABOUR MARKETS

Product markets

The types of air transport offered in Australia are listed in Table 1. The categories used (regular public transport, charters, aerial work and private) correspond to those in the Air Navigation Regulations.[1] As shown in the Table, these categories can be combined into two broad groups of regular public transport and general aviation. Regular public transport is the operation of scheduled services for carriage of passengers and freight. General aviation includes the other categories; examples of 'aerial work' are aerial agriculture, training, ambulance work, aerial surveys and spotting, beach patrols, search and rescue work and aerial work ancillary to the aircraft owner's non-aviation business.

In Table 1, regular public transport is divided into four categories, one of which is international service. The national trunk service links major cities along trunk routes. Regional services provide air links between centres within a limited geographical area and other routes are served by local/commuter operators. Examples of firms of each type and the aircraft they typically use are listed in the Table.

Air transport is subject to a variety of State and Commonwealth regulation.[2] International and domestic trunk services are characterised by economic regulation by the Commonwealth - that is, control of entry, capacity and fares, the latter until recently on international routes. The Commonwealth also has some influence over entry to and capacity on regional routes by its control of imports of aircraft. The States (with the exceptions of South Australia and Victoria) impose economic regulation on intra-state regional and commuter routes. State licences must also be obtained for charter services. Control of entry and capacity in regular public transport appears to be less effective on inter-state regional (for example, Sydney-Maroochydore) and commuter (say, Melbourne-Wynyard) routes as well as commuter routes within states without economic regulation. All regular public transport fares are reviewed by the Commonwealth. Other types of general aviation (aerial work and private) appear not to be subject to the same degree of economic regulation. All types of air transport are subject to regulation of safety and operating standards by the Commonwealth.

TABLE 1: Types of Air Transport

Type		Examples: Operators	Examples: Aircraft	Pilot License
Regular Public Transport (RPT)				
(i)	International	Qantas	B747	Airline Transport
(ii)	Trunk	TAA, AAA	B727, DC9	Airline Transport
(iii)	Regional	East-West Airlines of NSW, of SA, and of WA, Northern Airlines	F27, F28 Twin Otter	Airline Transport
(iv)	Local/commuter	BPA, Masling (a)	Cessna 402	Commercial/Senior Commercial
General Aviation (GA)				
(i)	Charter	(Note b)	Cessna 402 Piper Navaho	Commercial/Senior Commercial
(ii)	Aerial Work	(Note c)	Cessna 185 Bell 206	
(iii)	Private	(Note d)	Piper 28	Private

(a) BTE, 1981, Table 2.A, indicates 31 general aviation operators spent at least 60 per cent of their total hours flown in commuter operations in 1978-79.

(b) BTE, 1981, Table 2.A, reports 186 general aviation operators spent more than 60 per cent of their total hours flown in charter operations in 1978-79.

(c) Aerial work (flying training, aerial agriculture, other aerial work, short term hire, business, community welfare) accounted for 60 per cent of total hours flown of 2729 general aviation operators in 1978-79 (BTE, 1981, Table 2.A.) This category also includes 'mixed' operators who did not perform at least 60 per cent of their flying hours in a single type of activity.

(d) Private use (60 per cent of total time) operators numbered 1269 in 1978-79 (BTE, 1981, Table 2.A), giving a total of 4213 general aviation operators.

Pilot licensing

All members of the flight crew of an Australian aircraft are required to hold the appropriate licence issued under the Regulations and Orders (ANOs) accompanying the Commonwealth's Air Navigation Act. There are a number of licence categories and the higher categories require greater flying skills and experience as well as aeronautical knowledge. Types of licences available are listed in Table 2, where some of the prerequisites and privileges of each are shown. At all levels, endorsements of ratings can be added to the licence. There are aircraft type (or group) endorsements which indicate the types (or groups of types) the pilot may fly. For larger aircraft, there are two classes of type endorsement and the lower class permits the holder to act only as co-pilot. Another endorsement relates to proficiency in the use of instruments. Skills are tested in practical flight tests and written exams administered by the Department of Transport. All licences beyond 'Student' have recent experience conditions (for example, three take-offs and landings in the previous ninety days). Licences are issued for limited periods (six months for the higher licences), and will not generally be renewed unless the applicant passes a flight proficiency test.

Typical licences required in different types of operation are listed in Table 1. A pilot must have a Commercial licence to undertake aerial or charter work. The highest category of licence normally held by general aviation pilots is Senior Commercial, required for some commuter operations. Recently, licences required for different types of aircraft have been amended and this change is discussed in detail below. Trunk, regional and international pilots hold Airline Transport pilot licences. In 1980, there were 20,302 Student, 23,417 Private, 4,275 Commercial, 1,297 Senior Commercial and 2,201 Airline Transport Licence holders.[3]

Pilot market

The main Australian pilots' union is the Australian Federation of Air Pilots (AFAP). Brooks reports that at 30 June 1980 there were 2,791 members of AFAP of which only 709 were holders of Commercial or Senior Commercial licences.[4] Effectively 100 per cent of airline transport pilot licence holders are AFAP members. AFAP has generally negotiated contracts directly with the airline employers of these licence holders[5] and these agreements are then ratified by the Flight

TABLE 2: Types of Pilot Licence

Licence/Rating	Pre-requisite (a)	Privileges and Limitations
Student	None	Flight training within certain areas. Restrictions on solo and night flights.
Private	Student Licence; pass theoretical and practical flight experience.	Flights restricted to certain areas (b); private purposes only.
Commercial	Private Licence (c); pass theoretical and practical flight syllabus; minimum 175 hours flight experience.	Private aerial work and domestic charters; aircraft generally less than 5700 kg all-up weight; special provision for pilots aged over 60.
Senior Commercial	Commercial Licence; pass substantial theoretical	Private, aerial work and all charters. Aircraft can be
Transport	and practical knowledge syllabus; minimum 1000 hr. flight experience. Fourth class instrument rating.	heavier than 5700 kg; special provisions for pilots aged over 60.
Second Class	Commercial or Senior Commercial licence; second	As for Senior Commercial and may act as co-pilot of
Airline Transport	class instrument rating; flight radiotelephone operator licence (Morse code ⅋ 10 wpm). Pass practical syllabus.	aeroplanes normally operated with two or more pilots.
First Class	Commercial or Senior Commercial licence; first	All privileges of any category and may act as pilot in
Airline Transport	class instrument rating; flight radiotelephone operator licence (Morse code ⅋ 10 wpm); minimum 2000 hours flight experience (d). Pass theoretical and practical syllabus.	any capacity in regular public transport
Instrument Rating	Appropriate pilot licence; pass theory syllabus and/or flight proficiency test.	Depending on rating - permits day and night flight under visual and/or instrument flight rules (e).

(a) All pilot licences are issued only after a satisfactory medical examination.
(b) Area restriction can be removed on completion of a further flight training syllabus.
(c) Possession of Private Pilot Licence is not necessary if undertaking full-time course through a flying school with an Integrated Commercial School Rating.
(d) Experience must include not less than 500 hours on Australian regular public transport aeroplanes, 100 at night, 100 hours instrument time (of which at least 50 hours instrument flight time) and 430 hours pilot-in-command (500 hours for international operations). Similar divisions apply to total hours of experience in other licences.
(e) Rating is endorsed for particular radio navigational aids for which the pilot has qualified. Agricultural pilot and flight instructor ratings are not included.

Source: BTE (1980), DOT, *Air Navigation Orders*, Part 40.

Crew Officers Tribunal (discussed below). In summary, AFAP has unionised the international, trunk and regional markets. This power can be explained by the small number of pilots involved and the small number of firms, both of which lower negotiating costs within the union.

Before examining AFAP membership in the GA sector, it is interesting to note two recent events. The first is that AFAP has applied to be registered under the Conciliation and Arbitration Act. Previously the union had preferred to negotiate directly with each employer, outside the arbitration system. The government forced AFAP partly back to the system in 1967 through legislation creating the Flight Crew Officers Tribunal but AFAP did not have the privilege of being the sole representative of pilots under this legislation. Subsequently a rival union was formed, but was deregistered (not having sufficient members) in 1979. To avoid membership raids in the future (for example, an attempt by the Transport Workers Union to represent pilots), AFAP has changed its policy on methods of negotiation.[5]

The second event of interest is that Qantas pilots in May 1981 decided to withdraw from AFAP to form their own union, the Australian International Pilots Association. Contributing to this split appear to be AFAP policy on routes to be flown by Qantas and the domestic operators, claims of 'scabbing' by Qantas pilots during the dispute over cabin staffing in a new Qantas Boeing 747SP and the size of the union fee (of 1 per cent salary), a larger absolute amount for Qantas pilots.

AFAP has negotiated an award for GA pilots - the Pilots (General Aviation) Award, 1979 - through the Tribunal. AFAP membership in the GA sector has been low. At 30 June 1979 there were 5,135 holders of commercial and senior commercial licences. Not all these are active; BTE data indicate 2,280 pilots employed in GA.[7] Assuming those employed held Commercial or Senior Commercial licences, only about 44 per cent of licence holders were active and about 31 per cent of those active were members of AFAP.

There is an interesting comment on the GA sector in the AFAP President's 1979 report. The report indicates that wages paid in GA were less than the award. The President said he could not see GA pilots ever uniting and striking 'for decent conditions',[8] for two main reasons: first, there were so many non-AFAP members and so many owner-operators;[9] second, GA is, he said, 'essentially a deregulated environment and a lot of operators could not pay'. The options open to AFAP according to the President included getting the

industry regulated so there was strict control over route licences; then operators could pass on higher costs to passengers without fear of being undercut by entrants. The AFAP President said he was prepared to lobby 'at Canberra' for more regulations but that the lobby was 'not likely to be quickly successful, at least in the short term'.

More recently the tone of presidential statements about the GA sector has changed. Rising GA membership is claimed; Federation officers suggest there are now about 1,000 Commercial or Senior Commercial members (compared to 709 at June 1980). An explanation offered by AFAP is the 'achievements' of the union, following introduction of the 1979 award. But even at 1,000 members in GA, the AFAP share would still be less than 50 per cent of active licence holders. The proportion of members in some firms, such as Bush Pilots, would be much larger.

Summary

Product markets can be broadly divided into two sectors, one regulated (international, trunk and regional services), the other unregulated (the remainder; some qualification may need to be made for some commuter services). Regulation here refers to control of entry, capacity and fares (the last on domestic routes). The regulated sector is characterised by a small number of operators. Corresponding to the extent of regulation in the product market is the degree of unionisation of pilots. Pilots are represented by an effective union (AFAP) in the regulated sector but, despite the existence of an award, AFAP has not yet been effective in the other (GA) sectors. In the next section the implications of these characteristics for pilot salaries and the licensing system are explored.

III. PILOTS' SALARIES AND THE LICENSING SYSTEM

Rents in the unionised sectors

The first implication of the features of product and labour markets is that pilots in the unionised sectors will earn rents. The extent of rents in the unionised sector is estimated and reported in an unpublished article by Findlay,[18] the results of which are summarised here. The method used is to divide actual earnings of pilots into normal wages and rents. The technique is either to estimate an

earnings function with international data then convert that average relationship to a frontier by adjusting its intercept, or to estimate the frontier directly. Wages along the frontier are interpreted as those which would be earned if labour markets were competitive. These frontier wages are then compared to actual earnings to estimate rents. The results are estimated annual rent in 1978 of at least $A17,500 for Qantas pilots and of $17,000 for pilots in the domestic trunk network (the latter is an upper bound). These figures refer to money income only and there are other sources of utility to pilots in these companies, not the least of which may be the firms' protected positions, which lessens the risk of pilot redundancy. The presence of these other sources of utility means the figures quoted will tend to understate the true value of the rents,[11] ignoring other measurement problems.

Rent seeking in the non-unionised sector

It is evident from Table 1 that to get a job in the unionised sector a pilot needs an airline transport pilot licence. It is evident from Table 2 that to get one the private pilot must increase his flying experience, improve his instrument (and aircraft) ratings and pass written exams. When there are rents in the unionised sector, pilots with lesser licences will pursue them by trying to obtain higher licences.

Resources could be absorbed in a number of ways in this rent seeking activity. Lesser qualified pilots might hire aeroplanes to build up their hours and attend courses in aeronautical knowledge and instrument training. Instead of hiring aircraft to build up experience another strategy is to work for a GA operator (including commuters) and thereby increase hours 'in command' which the licence requires. Because of the possibility of future rents, the pilots in these sectors may be willing to work for lower wages than would compensate them for the costs of their training so far and of their time. A number of factors will influence the degree to which these pilots will offer themselves at a wage below what might otherwise be the competitive level. First, there is the speed with which the hours required are accumulated. The faster this occurs the lower the wage required (since the sooner rents will be earned to compensate the loss of current income). A second variable is the probability of getting a job in the unionised sector. The higher this probability (perhaps the higher the rate of recruitment and the smaller the size of the group queueing in the GA sectors) the lower the wage that the rent seekers will accept.

What is the maximum amount the rent seekers will pay? The answer is the expected value of the rents in the unionised sector (presuming them to be risk neutral). Thus it is possible that the whole of the aggregate value of the rents in the unionised sector will be passed back to flying schools, aircraft hire firms and GA operators. These rents could be redistributed even further, to consumers of the services of the firms who pay lower prices for pilots' services or to other factor owners, who receive higher incomes. The final resting place of the rents would be hard to predict but these rent seeking activities will contribute to the expansion of the sectors in which the rent seeking occurs as the other (regulated) sectors contract. In other words, while the rent seeking activity to some extent is redistributive, it can add to the welfare cost of the intervention in the regulated sectors.

There is anecdotal evidence of rent seeking behaviour in the AFAP President's Report of 1979 which quotes a letter from a GA member of AFAP:

> The only reason for General Aviation's existence seems to be to provide a never ending supply of recruits for the airlines at no training cost. The situation still exists after twenty years of young hopefuls clambering over each other to work for well below the Award, just to build up their total Senior Commercial hours. This law of the jungle is tolerated by all and paternally condoned by the airlines and the Department of Transport. These low cost juniors are costing jobs to seniors who need the Award.

The President comments that 'those of us who know General Aviation know how true a picture that letter paints'.

More evidence on the presence of rent seeking can be obtained as follows. Using a model of the decision to undertake general training, it is possible to predict the wage under competitive conditions. Some data are available on wages earned by applicants for positions in a domestic trunk carrier and these earnings can be compared to the competitive wage. The expectation is that actual earnings will be less than predicted.

The cost of training includes not only wages foregone, but other costs as well. For example, the cost of obtaining a commercial licence with a class one instrument rating (the highest rating) and twin engine type endorsement has been estimated to be $20-30,000.[12] The higher figure appears to

include accommodation costs for 42 weeks, 75 hours flying single engine aeroplanes, 100 hours on twin engines and 15 simulator hours. (These hours of experience would satisfy the licensing conditions.) The total cost of obtaining a commercial licence can then be estimated by subtracting from the upper figure an estimate of the cost of accommodation and keep (42 weeks at $50 per week or a total of $2,100) and adding the cost of wages foregone (42 weeks at $247.60 per week[13] before tax, a total of $10,400, or approximately $6,916 after tax[14]) to give a total cost of approximately $35,000. Assuming a 10 per cent interest rate, the trainee would need to be paid approximately an extra $3,500 each year (in 1979-80 dollars) after tax to recoup his initial outlay, equivalent to $5,300 before tax. In that case, predicted gross income for a pilot with a commercial licence and minimum experience (now 175 hours) is $18,200.[15] This figure is just above the 1979-80 award range of $17,118 to 18,167 for pilots of multi-engined commuter aircraft up to 5,700 kg with one to five years experience. It exceeds the award range for smaller multi-engined non-commuter aircraft of $12,912 to $14,318. These figures suggest the award contains no rents for GA pilots.

Actual earnings of GA pilots need not equal the award rate. There are data available on the salaries earned by applicants for positions as pilots in the domestic trunks. The average annual salary of 27 applicants[16] to one of the trunks over the period March 1980 to November 1981 was $13,500. These applicants worked for businesses (such as mining companies), charter operators, flying schools or commuters. (One worked for the RAAF but was not included in the calculation.) Assuming all these people must have had five years experience to be eligible to apply, their average earnings are much less than the 1979-80 award (by between $1,000 and $5,000 per year). This result was a prediction of the rent seeking model.

It is possible to illustrate the type of implicit calculation pilots in these rent seeking sectors must be making. Assume the domestic trunks hire 70 pilots per year on average (and that Qantas hires none, consistent with its recruiting over the last decade). After initial training and about five years GA experience, the GA pilot may become eligible to apply to the trunks. The number of pilots employed in GA in 1978-79 was 2,280 (see above). Assume that all these pilots were holders of commercial or senior commercial licences, that they all were eligible for application to the trunks (an overstatement of the number actually eligible because it ignores older pilots

and those with insufficient experience), and that they were all equally qualified. The probability of any one of them getting a job in the trunks is about 3 per cent (70/2280). Assume an annual rent of about $18,000 or $180,000 in present value terms, then these pilots would be willing to spend (when risk neutral) $5,400 in present value terms to bid for a place in the unionised sector. This figure is close to the lower bound estimate obtained above of the total salary foregone by working in the GA sector.

These salary comparisons have been based on a commercial licence with minimum experience but those qualifications are not sufficient to enter the regulated sector. Ansett and TAA require applicants to have a senior commercial licence (or to have passed the theoretical exams for the licence) with a minimum of 500 hours flight experience, plus a radio operator's licence with the morse code rating. These are only the minimum standards of the airline and they exceed the minimum standards required under the regulations for a job in an airline (that is, the second class airline transport licence conditions - see Table 2). Consistent with the rent seeking model applicants typically have much more experience, ranging from 1,500 hours to in excess of 2,500 hours (the minimum experience for a first class airline transport licence is only 2,000 hours). The average age of these applicants is 24-25 years; given their hours they would be expected to have at least five years experience.

One implication of this information is that the licensing system is not rationing pilot entry to the regulated product market sectors. If it were, the licensing conditions would be such that the applicants' experience would just match the minimum standards, which if correctly set (in this model) would clear the market.

In summary, there are two results from this section. First, not only the anecdotal evidence but also the data on wages of pilots in GA support the prediction that these pilots work for less than the wage which will compensate them for the costs of their training. Second, it was noted that not only the minimum qualifications set by employers but also those set by regulation for obtaining a job in an airline are exceeded by applicants for positions in the regulated sectors of the product market. Thus the licensing system is not imposing a binding constraint on the number of people available for employment at that level of skill.

Changes in the licensing system

Pilots work their way through the licensing system to get a better spot in the queue for a job in the unionised sector. It might be expected the licensing system would respond to this activity. A public interest model of licensing which interprets licences simply as a source of information on the skills of the holder would predict no change in the standards while technology and the demands of skill from pilots did not change. This model assumes the regulators know the appropriate safety standards and are able to translate them into pilots' qualifications.

A private interest model of the licensing system would emphasise the incentives of various private interest groups. Relevant groups include pilots, regulators and employers. Pilots in positions in the unionised sector would care little about the standards for lower level licences.[17] But pilots in the queue for positions in that sector have an interest in limiting new entrants, who drive down wages while they build up their hours. Their incentives will be to try to raise standards required for the lowest licence (Private).

The regulators of the licensing system could be presumed to act as if they were bureau/budget maximisers. An implication is that not only will regulators set standards to maximise their budget but in doing so will bias standards toward those involving examination of pilots rather than simply flying experience. The budget maximising choice is not straightforward. An increase in the qualifications of a licence raises its cost and reduces demand. The regulators then have to trade-off the number of people seeking a higher licence and the qualification required.

The third group is the employers. Higher qualifications would always raise their costs and they would resist what they saw as unnecessary changes in the licensing system. Their views would have to weigh against those of the other groups, perhaps along the lines of the Peltzman model of regulation.[18] While relative lobbying strengths and market conditions are fixed, licensing standards would also be fixed. But a change (for example, increased demand for pilots licences) could lead to increased standards.

As the queue for positions in the regulated product market lengthens, the regulators have incentives to change the licensing system to 'clear the market'. Pilots already in the queue would always demand higher standards for lower licences. The length of the queue is indicated by the supply and demand for pilots in the GA sector, summarised in Table

3 by the number of aircraft used in aerial and charter work and by hours flown per commercial and senior commercial licence held since 1970-71. The data indicate that while the output of the GA sector (measuring output by total hours) has been increasing, the numbers of licence holders relative to that output has been approximately the same, even falling. Thus the prediction is regulators acting as bureau maximisers will have had little incentive to raise standards over this period.

TABLE 3: Supply and Demand for GA Pilots

Year (a)	Aircraft per Licence (b)	Hours flown per Licence (c)	Total hours flown (1000s)
1970-71	0.60	242	832
1971-72	0.54	222	836
1972-73	0.53	223	873
1973-74	0.52	241	991
1974-75	0.48	241	998
1975-76	0.48	245	1020
1976-77	0.49	268	1191
1977-78	0.52	277	1276
1978-79	0.49	265	1364

(a) June 30 of latter year for licence and aircraft data. Licence data from DOT, *Air Transport Statistics, Flight Crew Licences*.
(b) Aerial work and charter aircraft from Table 1.1, BTE, 1980, p. 7, that is, all GA aircraft except 'private'. At 30 June 1962 there were 0.61 aircraft per licence holder. This figure rose to a maximum of 0.75 in 1968.
(c) Hours flown in GA (including commuter flights but not including private use) from Table 4.2, BTE 1980, p. 84.

There is one qualification to the prediction that licensing standards will not have changed. Derivation of the prediction presumed that standards were already set at their market clearing level. The evidence of the previous section is that applicants to the trunks have more qualifications than strictly required by the licensing system or by the trunks themselves, and that there are more applicants for positions in the trunks than there are jobs available. In other words the queue is longer than the number hired each year. This could suggest the current system is a disequilibrium so that there would be pressure to raise standards, despite the data of Table 3. On the other hand, the applicants are not identical, and employers might look for skills other than flying experience. Where seniority alone does not determine the rankings of applicants, there may always be a pool of people offering themselves at the current standard. It is then difficult to say whether the outcome currently observed is really a

disequilibrium. If the current outcome is an equilibrium, the prediction that there will be no observed change in standards since the 1960s is not affected. Otherwise there may be upward pressure on licensing standards.

A comparison of the Air Navigation Orders on pilot licensing in the late 1950s and early 1960s and the current orders indicated three major changes over the period. (The effects of changing technology are noted below.) First, the hours of experience required was changed in some cases. An extra ten hours is now required to obtain a commercial licence. Some basic instrument flight training is required to obtain a private licence while fewer hours in command (as part of the 1,000 hour minimum) are now required to obtain a senior commercial licence. Second, recent experience conditions have been added to the commercial and senior commercial licences when the pilot is to command an aeroplane carrying passengers.[19] The third and major change is that from September 1982 private and commercial licence holders must pass a flight test (called a flight review) every two years for the licence to be renewed. Previously, the only flight condition for renewal was some recent experience which is still the case for the senior commercial licence; airline transport licence holders have always had to pass a flight test.

The first two of these changes can most easily be interpreted in terms of the public interest model. (The extra ten hours for the commercial licence are to allow more instrument flight training.) The third change is consistent with the private interests of the budget maximising bureau, although a justification on safety grounds could also be offered. One qualification to the private interest argument is that (currently) the tests do not have to be provided by Departmental examiners, but can be made by flight instructors - for example, at flying schools or even within the firm employing the pilot.

Recently further changes to the Orders have been made. From July 1982, the minimum crew numbers in commuter aircraft will be changed; two pilots will be required, among other categories, for aircraft certified to carry ten or more passengers. Previously the limit was fifteen passengers. Commuter operators have estimated the costs of services affected could rise by 20 per cent. This estimate is supported by BTE data which suggest pilot costs account for 46 per cent of GA labour staff costs.[20] The BTE also quotes an elasticity of total cost with respect to labour and staff costs of 0.44.[21] Thus a 100 per cent rise in pilot costs (due to

doubling crews) would raise labour costs by 46 per cent and total costs by 20 per cent. The policy change therefore implies a significant increase in the cost of some types of commuter service. The justification offered by the Department of Transport was that:

> Commuter services should be regarded as an extension of the airline network and therefore a safety record comparable with the airline industry should be the prime objective. Although somewhat arbitrary in nature, the figure of 10 passenger seats was selected as having a bearing on the margin of safety at which such aircraft should be operated. A higher degree of complexity and performance capability is becoming evident in the design and equipment standards of these aircraft with a consequent impact on cockpit workload, indicating a need for two pilots when engaged in scheduled services.[22]

In its report 'Proposals Arising from the Review of Commuter Air Service Standards', the Department has also said that the two pilot rule is necessary to provide continuous monitoring of equipment and is identical to standards prescribed by many overseas authorities (US and Europe).[23] No data have yet been seen to be used to justify this safety argument,[24] although presumably there is advantage in another pair of eyes, especially at congested airports. On the other hand it is easy to imagine that the two pilot rule will increase demand for pilots (even if fares rose by 20 per cent the elasticity of demand would have to be -2.5 for traffic to halve), and further as shown below, it will increase demand for a particular group of pilots.

The Department has also recently proposed to alter the privileges of Commercial and Senior Commercial licence holders.[25] Briefly the proposal is to require commuter pilots to have more experience (at least 700 hours to command single pilot aircraft) and for the pilot in command of two pilot aircraft to have a senior commercial licence plus 1,200 hours total experience as a pilot. The Department describes these standards as 'more appropriate' for commuter operations but it is also interesting to note the change will increase demand for experienced pilots in this sector. In other words, people with a career in GA will be protected to some extent from the rent seeking activities of younger pilots.

In summary, the major changes to the licensing system since the early 1960s have been the introduction of biennial flight reviews for some licence holders, and the change in standards for commuter operators. While these changes are consistent with private interests of regulators and pilots they could also be justified on safety grounds. The difficulty with the latter public interest argument is the absence of data on the gains, via reduction in risk, while the changes, especially the commuter changes, are expected to substantially increase costs.

IV. POLICY OPTIONS

Previous sections have identified the presence of salary rents for Australian pilots and the rent seeking activity these rents generate. The question asked in this section is 'what should be done?' The starting point is to examine the welfare costs of rent seeking behaviour by pilots in GA.

It might be thought rent seeking is simply redistributive, for example, transfers from pilots in GA to their employers. But to the extent that the GA sector is competitive, these rents will be passed on to GA consumers so the GA sector will be larger than otherwise. The rent seeking behaviour therefore generates a subsidy for GA and like all subsidies involves a welfare cost, since the extra output consumed is valued by consumers at less than its social cost. It is as if a tax were imposed in the regulated sector, thereby imposing a welfare cost, and the revenue transferred to the GA sector, via the intermediation of the pilots, creating another welfare cost. Similarly, there may be a welfare cost due to the acquisition of higher qualifications in the GA sector. As a result of rent seeking, the average level of qualification in the GA sector will be higher. These standards no doubt lower the risk involved in flying in GA aircraft but they are acquired at a cost, for example, the attraction of more resources into flying schools or the hire of aircraft to build up hours. It may be that, at the GA level, society would not value the risk reduction as much as the resources foregone. In summary, the rent seeking activity will generate welfare costs so there would be a social gain from its removal.

The source of the rents to pilots was argued to be the characteristics of airline markets, including the high degree of economic regulation with limited entry. Economic regulation has been argued[26] to impose substantial welfare costs and there is a strong case for deregulation.

Deregulation would have the side effect of removing much of the bargaining power of the pilots' union. For example, any attempt to raise wages to Qantas pilots would raise Qantas costs and fares and attract entry of foreign competitors. The same effect could be observed on domestic routes. Deregulation of product markets would remove pilot rents thereby eliminating the incentive for the wasteful rent seeking behaviour.

Another option which would remove the rent seeking incentives would be for the government to auction airline transport pilot licences, or equivalently, place a tax on them to extract the value of the rents. The government did attempt to raise fees, as part of its 'cost recovery' policy, on pilot licences in 1980 but the proposed fees were small relative to the estimated value of rents. (The total revenue over all licences expected from original proposal was only $1.3m.) The original scale of fees was substantially reduced after AFAP members banned Canberra flights.[27] Now airline transport pilots pay $40-50 outright (no renewal fee) for their licences.

Product market deregulation is not a policy embraced in the aviation press. One policy that has been proposed is a subsidy for initial training of pilots.[28] A variety of arguments have been used to support this policy. One claim is a positive externality from having available a pool of pilots who 'agree to be called up by the RAAF immediately war breaks out'.[29] The validity of this case depends on the type of conflict expected, the notice given, the availability of pilots overseas and the skills required. Another argument is that subsidies for other forms of tertiary training but not pilots creates both inefficiencies and inequities. This argument is in effect saying that the externalities claimed for university training are not valid and that intervention in the pilot market is an appropriate redistributive device. The first point may be defensible; if so, the best solution would be to remove the other subsidies. Economists would deny the second point. Another argument for subsidy has been that there will be a 'shortage' of pilots in the near future.[30] The claim is labour markets for pilots do not operate to give the appropriate signals to recruits. Observers of GA markets might be misled by the observed relatively low wages into thinking a 'shortage' is imminent but as argued in this paper, GA pilots are compensated by the chance of a position in the unionised sector.

In summary, a variety of arguments for training subsidies have been made but the only valid ones rest on grounds of

externalities, in particular, defence benefits and the case there has not yet been adequately presented. If a subsidy were paid, it would be redistributed throughout the GA sector, in the same fashion as potential pilot rents are now transferred, further expanding the size of an already enlarged GA sector.

V. SUMMARY

Aviation product markets in Australia are characterised by varying degrees of economic regulation. Entry barriers and price (or capacity) control are most effective in the airline markets (that is, international, domestic trunk and regional markets). In these markets, the pilots union is most effective. The combination of product market regulation and the high degree of unionisation creates the opportunity to earn rents. These rents are observed in salaries of airline pilots, and their presence creates rent seeking incentives among other pilots. Lesser qualified pilots work through the licensing system to obtain the qualifications of an airline pilot licence. The opportunity to gain the experience required in the general aviation sectors and the possibility of future rents means GA pilots are willing to work for a wage less than that which would compensate them for the costs of their training. The lower wages predicted are observed in the GA sector. The presence of this rent seeking activity creates incentives for administrators of the licensing system and pilots in the queue for positions in the unionised sector to change the standards. Recent changes can be interpreted as consistent with the administrators' and pilots' interests, but also with a public interest safety explanation. Rent seeking behaviour does incur some welfare costs and the policy of deregulation of product markets will not only remove the costs of intervention in those markets but have the side effect of eliminating the rent seeking incentives.

*This paper has benefited from extensive comments by an anonymous referee. Remaining errors are the author's.

Notes

1. Department of Transport (DOT), *Domestic Air Transport Policy Review*, vol. 1, para. 3.2.9., Canberra: AGPS, 1979.
2. For a detailed discussion of legal aspects of regulation of international civil aviation, see: T.A. Pyman, 'Australia and International Law', in D.P. O'Connell (ed.), *International Law in Australia*, Sydney: Australian Institute of International Affairs, 1965; and P.M. Singh, 'The Legal Framework of Australia's International Civil Aviation Policy', a paper presented to the Bureau of Transport Economics Workshop on International Passenger Transport - Australia, Canberra, February 1981. For an economic perspective of the same issue, see C.C. Findlay, 'International Civil Aviation Policy Options', in *Australian Journal of Management*, 6, December 1981, pp. 27-42.
   For a discussion of the legal basis of the two airline policy, see: DOT, 1979; M.G. Kirby, 'The Legislative Framework for the Economic Regulation of Australia's Domestic Civil Aviation', mimeo, ANU, 1980; T.A. Pyman, 'The Air Navigation Act - a 60th Anniversary Review', in *Aircraft*, 60, February, pp. 30-35. For an economic perspective of this same issue, see M.G. Kirby, *Domestic Airline Regulation: the Australian Debate*, Sydney: Centre for Independent Studies, 1981.
3. DOT, Air Transport Statistics, Flight Crew Licenses.
4. R. Brooks, 'Rival Unions and Registration: the Australian Federation of Air Pilots and the Air Pilots Guild of Australia, 1969 to 1979', *Journal of Industrial Relations*, 23, December 1981, pp. 447-465.
5. Namely Qantas, TAA, AAA (and its regional subsidiaries), East-West and Connair (later Northern but now dissolved). AFAP also has contracts with IPEC and Bush Pilots.
6. For a more detailed history of AFAP, see: D. Yerbury, 'Some Aspects of Collective Agreements in Australia', unpublished Ph.D. thesis, University of Melbourne, 1973; J. Burgess, *An Examination of Some of the Factors Behind the Creation of Special Arbitration Tribunals for Flight Crew Officers and Coal Miners*, Working Paper 8,

Department of Industrial Relations, University of New South Wales, 1977; N. Blain, 'Collective Bargaining within the Context of Compulsory Arbitration: the Unique Experience of Australian Airline Pilots', mimeo, University of Western Australia, 1980. For an account of the rival union and its deregistration, see R. Brooks, 1981.

7. Bureau of Transport Economics (BTE), *Basic Characteristics of General Aviation in Australia*, Occasional Paper 33, Canberra: AGPS, 1980, Table 4.11, p. 103.
8. *Australian Air Pilot*, Spring 1979, p. 17.
9. There are also a large number of firms in the GA sector; 711 employers are named in the schedule of respondents to the Pilots (General Aviation) Award, 1979.
10. C.C. Findlay, 'A Wage Frontier for Airline Pilots; do Australian Pilots Earn Rents', mimeo, ANU, 1982.
11. Another possibility is that high wages compensate for other undesirable aspects of the employment contract but a comparison of working conditions and other aspects suggests this is unlikely.
12. The first figure was reported in *Aircraft*, November 1980, 60(2), p. 30 and the second in *Aircraft*, September 1980, 59(12), p. 44.
13. Average weekly earnings for a male unit in 1979-80 (from RBA, Statistical Bulletin, January 1981, p. 410).
14. Assumes a marginal tax rate of 33.5 per cent (the 1978-79 figures).
15. Assumes an annual income at the average weekly wage of $12,900.
16. 'Hundreds' of applications might be received by the airline over this period so only a small proportion of applicants was selected for use in this paper by airline executives and those included were not necessarily selected at random.
17. In the absence of a strong pilots' union, these pilots would have incentive to use the licensing system like a quota, to limit pilot supply to the regulated sectors of the product market.
18. S. Peltzman, 'Toward a more General Theory of Regulation', *Journal of Law and Economics*, 19, August 1976, pp. 211-240.
19. The pilot cannot do so unless he has had three take-offs and landings (by day or night whichever is relevant) in the previous ninety days.
20. BTE, 1980, Tables 4.11 and 5.5.
21. BTE, 1980, p. 128.

22. Quoted in *Aircraft*, May 1981, p. 16.
23. Previously cabin attendants were required in aircraft that could carry fifteen or more passengers but now with the extra crew member this limit has been relaxed to twenty. Another justification for the extra crew member has been passenger duties.
24. The BTE (*Economic and Financial Issues Associated with General Aviation in Australia*, Occasional Paper 34, Canberra: AGPS, 1981) reports that commuter aviation had the lowest accident rate in GA (5.77 accidents per 100,000 hours flown) over the period 1969-78 (which does not include the recent King Air fatal accident at Mascot) and suffered zero fatalities (the domestic trunks had no accidents over the same period).
25. See the Commuter Proposals report, and *Aircraft*, May 1981, pp.16-18.
26. See Kirby, 1981, and Findlay, 1982.
27. *Australian Financial Review*, 15 July 1980, p. 3.
28. See *Aircraft*, September 1980, p. 43 and November 1980, p. 30; and the AFAP magazine, *Australian Air Pilot*, Summer, 1980-81, p. 13. Captain Terrill, Qantas Director of Flight Operations says in the second reference; 'Student pilots currently rank with cosmeticians and the clergy as a vocational group not receiving government support'.
29. *Aircraft*, September 1980, p. 44.
30. This case has been made by Qantas (*Aircraft*, November 1980, p. 30). It is not supported by Ansett and TAA (*Aircraft*, September 1980, p. 44) nor by the BTE (1981, p. 276).

9

REGULATING TAXI OPERATORS: SOME HISTORICAL INSIGHTS

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REGULATING TAXI OPERATORS: SOME HISTORICAL INSIGHTS

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I. INTRODUCTION

This paper is designed to provide a perspective for the formulation of policy decisions for an important section of the transport industry - the taxicab. It is situation specific to the taxicab industry in Melbourne, Australia,[1] but the insights contained in it have their counterparts in most western cities.

II. THE BEGINNING OF REGULATION

From the available evidence, taxicabs were first introduced into Melbourne somewhere between 1835 and 1848. The former date corresponds with the proclamation, as a settlement district, of what is now known as Melbourne. In the latter year, the first attempts were made to regulate the taxicab industry.

In January 1848, the Melbourne City Council (MCC) petitioned successfully for the Legislative Committee of the MCC to frame a by-law to regulate hackney coaches[2] and other vehicles available for hire in the town of Melbourne.[3] By-law 26 was intended to manoeuvre around problems that arose where consumers lacked information on service quality and price. The regulations set standards on such things as the quality and road worthiness of the cab, insurance requirements, driver qualifications and behaviour, the site of taxi ranks, and maximum fares to be charged.[4] We were unable to find any evidence that efficiency was ever considered. It is interesting to note that the regulations closely followed those that existed in England, apparently transported without considering the change in context or indeed their original purpose.

In line with the laissez-faire attitude of the day, the regulations did not attempt to limit entry or specify minimum

fares, but rather appeared to be aimed at reducing the costs of uninformed bilateral bargaining and protecting consumers in weak bargaining positions against the proclivity of some operators to abuse them. However, this interpretation might be too generous to the regulators because we were not able to find any evidence of customer abuse. Similarly a lack of data prevents us from knowing whether the maximum fares were in fact treated as minimum fares by operators colluding. In any case it is also possible that maximum prices had undesirable efficiency consequences by preventing market clearing prices above the regulated maximum when supply was low and demand was high: for example, in the peak hours and on rainy days.

The MCC passed By-law 33 in February 1855 which represented the first full and detailed schedule of rates and fares.[5] Maximum rates and fares were prescribed for both carriages and cabs, specified on a time, distance, and detention basis. The maximum fare for one hour's travel was eight shillings in the case of a carriage and five shillings in the case of a cab. Prior to 1910, changes in similar regulations were limited to fees paid for licences, the fare structure and the number of taxi stands. Their primary emphasis seemed to be to provide more detail on vehicle road worthiness and driver qualifications and behaviour, and to prevent disagreements between buyers and sellers. By-law 44 changed the position of stands from the side to the middle of streets (presumably to alleviate the problem of congestion), restrained drivers from vocally advertising for business (to alleviate noise)[6] and established more taxi ranks.

III. INTRODUCTION OF MOTORISED CABS

Motorised taxicabs were introduced to Melbourne sometime during the period 1902 to 1906, when people who owned automobiles were approached by nearby residents for rides to specific destinations at a negotiated price. A number of these private hire cars were in operation before the first recorded example of a motorised taxicab in 1905,[7] and their existence almost certainly curtailed the numbers of licensed motorised taxicabs until 1911. Until then, the MCC was precluded by the original 1830 legislation from regulating 'carriages . . . previously ordered . . . at the . . . residences of their owners, and which shall never be permitted to ply for hire in any street'.[8] The exclusion of hire cars from legislation might have been justified on the grounds that they

increased consumer choice and gave consumers an incentive to collect information on service quality. We will return to these points below.

Despite the small number of licensed motorised taxicabs in operation (as confirmed in press reports and council minutes of the day),[9] horse cab owners feared the competition motorised cabs presented. It was no doubt in part an effort to placate these interests that led the MCC to attempt to regulate motorised taxicabs.

The question of what the council was doing to regulate 'the new public vehicles called taxicabs' was first raised in Council in February 1909. In May of that year, however, the motorised cab owners successfully petitioned for a deferment of any regulation until the Victorian Parliament had passed a Motor Car Bill.[10] After numerous postponements by council, and protests by the proprietors of taxicabs and hire cars and by the Drivers Protective and Benefits Union, the proposed By-Law was eventually passed by the MCC in December 1910.[11] Notwithstanding this debate, the MCC began regulating motor cabs in 1911, by which time By-law 125 was passed. This by-law, which dealt with fare charges, driver qualifications and vehicle safety, indicates that the regulation was introduced for similar reasons as previously; namely, in anticipation of problems that might arise where consumers lacked information on service quality and price. Because By-law 125 did not seek to impose direct entry regulation or minimum fares on motorised taxicabs, it is not clear what horse-drawn cab owners hoped to achieve by lobbying for its introduction. Perhaps it was felt that forcing motorised cabs to charge the same fares as horse-drawn cabs would squeeze the profits of the former and thereby limit their supply. Pressure for regulation may have also come from a concern to ensure that motorised cabs were prevented from competing except on equal terms. Whether this limitation of competition between types of cabs was in the public interest is doubtful, as we will see later.

In the period following the passing of By-law 125 to the end of the MCC's control over the regulatory function in 1952, the MCC initiated legislation on a number of issues. One of these concerned the fitting of meters to cabs. Taximeters were being used in Australia at least as early as 1907,[12] but it was not until September 1925 that the Council made it mandatory for cabs to be fitted with meters.

From as early as 1905, there had been public pressure to enact legislation to force both horse and motor taxicabs to fit meters. The pressure came from sections of the taxicab

industry who sought to circumvent an industry challenge to the MCC's right to license metered cabs.[13] It is also possible that the industry may have seen the capital cost of meters as an additional barrier to entry and the costs of changing the metered rate as a method of discouraging fare competition and haggling. It is not known whether the public had also placed pressure on the Council because of dissatisfaction with the unpredictable fares and disputes over distance travelled associated with unmetered cabs.[14]

IV. ADVENT OF THE TAXI COMPANY/CO-OPERATIVE

Just prior to the MCC making taximeters mandatory (October 1924), the structure of the industry underwent another important change: the beginning of taxicab companies and co-operatives. Three Melbourne entrepreneurs introduced Melbourne to the now highly successful Yellow Cabs from Chicago. The first Yellow Cab entered Melbourne streets in October 1924, and were an immediate success with the public.[15] A variety of reasons were cited for Yellow Cabs' success. Some said it was the absence of haggling with their drivers;[16] others that it was their price-cutting, as they abolished return charges for the cabs, extra charges for extra passengers, and introduced concessions for Sunday morning trade and round trips; others said it was their bright colour that attracted clientele. Such was their success that by the end of their first year of operation, Yellow Cabs had carried approximately two million passengers in its 177 Melbourne and 175 Sydney taxicabs.

Taxicab companies had an important influence both on the industry and as a lobbying group on the MCC. An example of the former was the change in driver wage policy initiated by Red Cabs and Checker Cabs and subsequently supported by Yellow Cabs. To counter their decreasing competitiveness with individual owner/drivers, the cab companies changed from paying a set weekly wage to hiring their cabs to drivers and paying them on a commission basis. In retrospect, this was an important development which saved taxicab companies from ruin during the Depression. The lack of entry and minimum price controls meant that the industry attracted many unemployed workers who owned automobiles. Real wages fell and the taxicab companies, paying fixed wages, found it difficult to compete. It was also very important because it discouraged unionisation, gave drivers an incentive to find more business, and later meant that the

influence of bodies such as the Arbitration Commission was minimal.

The taxicab industry would appear to qualify for inclusion in the lagging productivity sector of a Baumol type two sector growth model.[17] On that basis we would expect that drivers' wages would increase at approximately the same rate as wages in other industries, but that these wage increases would cause the price of taxi service to be relatively higher than prices in more technologically progressive industries, because the taxi industry would find it difficult to offset wage increases with productivity increases. Unless there was an inelastic demand for taxi service, the industry would likely diminish and perhaps ultimately vanish as a result of the increasing real price of its product.

As Williams and Scorgie have shown,[18] the industry has in fact prospered, and there is some evidence to suggest that demand has not diminished. Williams argues that this has occurred because the industry has been able to keep real costs down by adjusting labour quality. This is evidenced by an increasing wage differential between taxi drivers and other workers subject to wages tribunals, and an increasing industry reliance on part-time, student and migrant drivers. The introduction of leasing, which legally made drivers self-employed, effectively prevented the drivers union from ever again becoming a force in urban transportation, and allowed a widening wage differential between driver wages and the wages of other workers.[19]

In regard to the effect of cab companies acting as a lobby on the MCC, a number of issues may be cited. One of these issues concerned the number of cab licences issued. Prior to the efforts of Yellow Cabs, the MCC issued licences to operate a taxicab 'as of right' to anyone wealthy enough to own an automobile and keep it in good repair. Under this policy more than 1100 cabs were plying for hire in Melbourne by 1927. With the support of both Red and Checker Cabs as well as pressure from the drivers' union, Yellow Cabs successfully petitioned the Licensing Committee of the MCC to limit entry to the industry.[20] It is of some irony that Yellow Cabs was able to enter the market because of no limitation on entry, but once operating, was successful in preventing further entry.

V. REGULATING PRICE AND ENTRY

In 1931 Yellow Cabs submitted to Council that there should be a specific limit of 770 cab licences set.[21] Despite council's willingness, it was at that time powerless to limit numbers.[22] Pressure was brought to bear on Parliament and the Premiers from both the single owner/operators and the large companies, both groups reacting against an over-abundance in the supply of labour at a time when business had fallen off.[23] With no direct barriers to entry, the taxicab industry was an ideal occupation to try to earn some money for the unemployed who owned automobiles. Subsequently the Victorian Parliament passed the Carriages Act 1932, granting the necessary legislative power to the MCC. As a result, the Licensed Vehicle Committee specified a limit of 630 cabs, achieved mainly by retiring existing, but unused, company taxi licences. This number remained unchanged until 1936.

A third issue on which larger cab companies acted as a lobby on the MCC concerned the controversy over fare charges. During the Depression, the various taxi companies and unattached owner drivers engaged in vigorous price-cutting assisted by MCC by-laws that specified only maximum fares allowable. This ability to cut prices, together with the physical ease of entry to the industry by unemployed automobile owners, and a reduction in the number of licensed cabs allowed[24] increased the incentive for unlicensed taxicabs. It was in reaction to this problem that Yellow Cabs, the union and other licensed owners submitted that the MCC specified fare should be both a maximum and a minimum for a particular distance.[25] This fare structure was intended not only to hinder competition by unlicensed cabs by making them easier to detect, but also to constrain legal taxi companies like Blue Line and Classic Taxi Services who were trying to increase their market share by price-cutting.[26] It was argued that price-cutting was against the public interest because it placed the existence of a stable reliable taxi service at risk. Legislation to enact these proposals was passed by the MCC toward the end of 1937.

The increasing interest in innovative taxicab operations in the 1970s has brought the introduction of these mid-1930s regulations under new scrutiny. Elsewhere Williams has argued that the capital requirements of the industry renders destructive price cutting arguments questionable.[27] A more curious justification for price and entry regulations comes from Shreiber and other contemporary literature.[28] This

literature argues for price and entry regulation because, despite the existence of the technical conditions for competition, the taxi owner does not face a perfectly elastic demand curve for his product. The consumer who refuses a passing cab will on average double his waiting time. Furthermore, the gaining of a cheaper cab does not provide a purchaser with useful information for future purchases.

The consequence of this is that the price elasticity of demand is likely to be very small. Unlike other businesses that can reasonably expect to increase turnover by decreasing price, the sole taxi owner acting alone cannot hope to increase his number of passengers by decreasing price. Unless there is a price reduction by a large fleet owner or by an agreement between a large number of single owners, price reductions are unlikely. Any one operator who cuts his own fare can only succeed in decreasing his revenue because potential customers, even if they knew that a certain operator had a lower priced cab on the road, would be unlikely to turn down a more expensive cab when the probability of the cheaper cab passing within a reasonable time would be practically zero.

A cab owner who raises his price above the going rate is unlikely to lose many passengers and can therefore expect to increase his revenue. This upward tendency of prices is self-perpetuating over the relevant price range since, as other owners increase prices, a potential customer's expectation of the likely wait to the next cheaper vacant cab will increase. Each increase in price by existing operators will induce an influx of additional taxicabs into the market. This positive response of taxi availability to price increases, mirrors the inverse relationship between price movements and the number of trips per time period that each operator requires to break even. It is likely that the existence of these conditions will mean that in an unregulated taxi industry, taxi fares will be too high, the number of cabs too large, and the time between cabs too small.

In the ensuing debate between Williams and Shreiber, Williams argues that the information deficiencies of customers and suppliers, so necessary for a Shreiber type scenario, are no problem in practice. Taxicab meters, government appointed cab stands, two-way radio and computer plotting devices, all provide for a more heterogeneous taxi market and ensure that taxi operators face a more elastic demand curve for their services.

VI. REGULATORY PROBLEMS OCCASIONED BY PRICE AND ENTRY REGULATIONS

Along with concern over the maximum/minimum fare structure, the MCC was also, at this time, facing increased pressure particularly from the public to increase the limit on the number of taxicabs.[29] While on the one hand existing licensed cab owners complained of illegal cab activity, on the other, the MCC was receiving a large number of complaints from people unable to find a cab. In December of 1937 in a report to the Council on taxicabs, the Council's taxicab inspector recommended that the limit on numbers of taxicabs be removed.[30] The Licensed Vehicle Committee compromised this report and recommended that the limit on the number of taxicabs be increased from 550 to 650.[31]

The necessity, however, for a council decision was removed by the commencement of World War II. The Directorate of Emergency Road Transport (DERT) would not allow any increases in the number of licences and in addition raised fares by 50 per cent in an attempt to conserve fuel and rubber. Why the cab passenger was given such harsh treatment relative to owners, when uniform taxes on petrol could have achieved the desired result, is not known. Limitations on the number of cabs and increases in fares encouraged the expansion of hire car activity (privately owned vehicles being booked by phone from a home base). While unlicensed cabs could at least be partially controlled by law enforcement, the same was not true of hire car operators who escaped MCC control because they did not ply for hire in the streets. The number of hire cars had flourished since the introduction of limitations to taxicab numbers, and this had fostered a resentment by licensed taxi owners. In addition, pressure for their regulation came about because hire car operators had generally been charging 6 pence per mile while taxicabs were required to charge 9 pence per mile.[32]

In 1939 the Victorian Parliament granted complete control of hire cars to the Council. Resulting regulation limited their numbers to 450 and their fares were raised to the same level as that of taxicabs.[33] Regulation leads to more regulation! By the end of the war, the MCC had amassed a large waiting list for licences and there was mounting pressure on the Council to issue more licences.[34] However, restrictions from the war had not yet been lifted, and the government[35] and DERT[36] were concerned that no new licences be issued. Faced with these opponents, the MCC held back its proposal to increase the number of

taxicabs by 100 and the number of hire cars by 75 until as DERT rescinded its taxi order.[37] When this order was rescinded, the additional licences were distributed by ballot. This distribution technique was adopted under pressure from the Returned Serviceman's League (RSL) who wanted their members rather than the taxi companies to be granted the licences.

Despite the increase in available licences which boosted taxicab numbers to 650 and hire cars to 525, pressure remained for more licences to be authorised. The RSL, which now had a substantial number of new members, wanted more licences made available to its members.[38] Situations occurring elsewhere (such as in Brisbane where there were more cabs but only one-third of Melbourne's population) did much to support the pressure for more licences. Again the MCC faced a dilemma; the RSL, union and the public wanted more taxicabs, while existing owners (in particular owner-drivers) saw more licences as an encroachment of their business interests.

In September 1951, the MCC decided to issue another 150 taxicab licences and 100 hire car licences.[39] This was to be its final act in regulating taxicabs. After 102 years, control was passed to the Transport Regulation Board (TRB), a State government agency, by the Transport Regulation Act of 1951.

VII. A CHANGE IN THE INSTITUTIONAL FRAMEWORK

Two reasons stand out in explaining why the MCC was superseded by the TRB. The first centres around a general feeling of dissatisfaction with the MCC. In attempting to balance the demands of conflicting groups, the MCC had alienated almost all parties involved. By the late 1940s, these groups had successfully combined themselves into a lobby to divest the MCC of its control.[40] A second reason centres around what seemed to be a general concern of the government in the late 1940s and early 1950s that all forms of transport should be co-ordinated and correspondingly controlled by one body.[41]

The TRB's most immediate concern in its new office was the adequacy of the taxicab service in the outer metropolitan area.[42] Taxicabs were plying for hire within a radius of eight miles from Melbourne, generally leaving hire cars to service the suburbs beyond this radius. Many of these private hire car services operated with only one vehicle from suburban addresses. The consequences of this was that the traveller in

these outer areas not only found it more difficult than his city counterpart to hail a taxicab in the street, but when telephoning for a hire car he often faced a long wait.

The TRB proposal to increase the efficiency of the outer area service was twofold.[43] First, the suburban area was divided into a number of geographical zones. Existing hire car owners were then given 'composite' rights to act as taxicabs within their respective zones, thus allowing them to ply for hire in the streets and to sit at taxi ranks. Second, individual owner/drivers were combined together into depots so that demand by phone could be more efficiently met.[44] This merging of hire car and taxicab work meant that the hire car operator no longer had to return to his depot after each job. It did create a problem of how phone work was to be conveyed to the hire cars on the road. However, this was solved by the two-way radio which had been first introduced in 1949.

Despite the severe restrictions on taxicab numbers in Melbourne since the early 1930s, the problem of lack of outer area service was never seen to be a simple problem of supply. It is often commented by industry representatives today that in those days all cabs would congregate where the most work was, and something had to be done about providing a more geographically even service. However if more taxi licences had been issued, the marginal returns to each cab operator would have been diminished in the built-up areas, and the more marginal suburban areas would have looked that much more attractive to operators. Though not for the above reason, in June 1954 the TRB began a study which subsequently found a case for issuing 200 more taxicab licences and 70 more hire car licences.[45] This exercise was repeated in 1963, but the number of taxicabs has remained constant to this day.[46]

There were two other regulations introduced by the TRB. The first involves the testing and subsequent licensing of taxicab drivers. While special age and character requirements are still retained, the requirements for an advanced police department driving test and a knowledge test of streets and locations without the assistance of street directories were both abolished in the 1970s. Williams shows that these driver quality changes were not supported by the union.[47] The introduction of testing changes can be better understood in view of the widening wage differential between taxi drivers and other workers, but specifically by the lobbying dominance of taxi owners and the lack of power of the drivers.

The second regulatory change introduced was the implementation of differential peak and off-peak fares. The decision for peak-load pricing, like all TRB taxi pricing decisions, was made without recourse to public opinion. The TRB justified higher off-peak fares to encourage more cabs and drivers onto the road.[48] Taxi owners also added the argument that the off-peak surcharge could be seen as analogous to overtime payments to drivers.[49] Williams shows that the off-peak periods generally have the most satisfactory level of satisfied demand, that this implies sufficient cabs and drivers.[50] The adequate supply of drivers does not indicate they were in need of additional compensation.

Apart from changes to suburban operation, driver licensing and peak-load pricing, the TRB has carried forward the MCC regulations and presumably the underlying philosophy embodied in them. We are not aware of any attempt by the TRB to reassess the critical price and entry restrictions that constrain the industry. We have argued strongly elsewhere that the TRB should do this.[51]

VIII. CONCLUSION

The purpose of this paper has been to place the regulation of the taxicab industry into an historical perspective. Apart from a concern for information differences between taxi owners and taxi customers, early regulation was characterised by attempts to limit competition between various types of taxi service. Later regulation appeared to be aimed at improving conditions for regulated operators in the relative comfort of a closed shop. None of the regulations introduced during either of these periods were well-justified and the evidence we have presented here and elsewhere suggests that most were not in the public interest.

Authors' Note:
We gratefully acknowledge the assistance received from Peter Swan in revising this paper and especially for guiding us away from random antiquarianism.

Notes

1. In Melbourne, taxicabs travel more revenue kilometres than all other public transport combined, have a larger passenger revenue than other modes, provide more employment than trams and buses, and based upon 1977 passenger figures will soon carry more passengers than trams and buses. (D.J. Williams, 'Regulation of Taxicabs: The Victorian Case', unpublished M.Ec. thesis, La Trobe University, December 1978.)
2. The term 'hackney' was an expansion of the word 'hack' and means a horse let out for hire. The word was used as a catch-all to encompass the huge variety of horse-drawn vehicles that Europe had been experiencing since the early part of the 17th century and which were now present in Melbourne: the coach, car, cabriolet, hansom, Clarence, growler, etc.
3. *Melbourne Argus*, 11 January 1848.
4. 14 Vic. No. 3. The regulation of taxicabs and their drivers in Australia had already been undertaken in New South Wales. In this respect the Victorian legislation was not new and can be seen to have been influenced by 6 Wm. 4 No. 2, 11 Vic. No. 21 and 13 Vic. No. 5.
5. Fares were prescribed in By-law 26 but only as a function of distance travelled.
6. See D.J. Williams, 'Labour Costs and Taxi Supply in Melbourne', *Journal of Transport Economics and Policy*, vol. 14, no. 1, January 1980.
7. Keith McManus, 'The Uncommon Carrier', written for Yellow Cabs Australia, unpublished 1976.; also *Melbourne Argus*, 4 April 1911.
8. 14 Vic. No. 3, part 5.
9. *Melbourne Age*, 3 August 1907, and 22 July 1909. MCC, Hackney Carriage Committee Minutes, 27 May 1909 unpublished. In London, horse cab drivers picketed the garages of motor taxi companies to attempt to stop the industry, see *London Daily Mail*, 9 February 1907. In Melbourne the cab operators opposition to motorised transit was not new. A meeting of more than 100 cab operators in March 1902 called on the MCC to stop issuing motor car registrations. MCC, op.cit. 17 March 1902.
10. MCC, op.cit. 10 May 1909.
11. MCC, By-Law 125 'A by-law to provide for licensing and

regulating motor cars used as Hackney Carriages, and the owners and drivers thereof, plying for hire within the City of Melbourne, and within the distance of eight miles from the corporate limits of the said city'; see also 9 Ed. 7 No. 2237 '*The Motor Car Act*, 1909.

12. See *Melbourne Argus*, 11 February 1907; also *The Australian Motorist*, 20 September 1909.
13. 'Pressure groups fearful of competition had persuaded bureaucracy to adhere rigidly to the lack of provision for licensing metered cabs. P.W. Tewksbury made direct appeal to the impetuous Jack Lang, the Premier of NSW, and it was suddenly possible to have the needed regulations gazetted overnight.' See McManus, *Uncommon Carrier*. Tewksbury was one of the founders of the Yellow Cab Company. The logic of this fear of competition from metered cabs is not clear. Perhaps it was thought that metered cabs would be able to attract customers at above the maximum rate or perhaps not complying with the quality constraints of the regulations would have given metered cab owners a significant cost advantage.
14. Indeed the inventory of the first taximeter in 1891 was thrown into the river by angry cabmen, because it reduced their 'opportunities for overcharging'. See G.N. Georgano, 'Historical Survey of the Taxicab', *The Taxi Project: Realistic Solutions for Today*, ed. E. Ambasz, New York: The Museum of Modern Art, 1976, p. 110.
15. Subsequent companies to enter the market were Red Cabs and Checker Cabs.
16. Yellow Cab drivers were not permitted to haggle because the cabs they operated were imported complete with American taximeters. In addition, Yellow Cabs' price-cutting made it unnecessary for its drivers to haggle - haggling being common only because patrons were anxious to secure a ride for less than the MCC specified maximum fare.
17. W.J. Baumol, 'Macro Economics of Unbalanced Growth: The Anatomy of Urban Crisis', *American Economic Review*, vol. LVII, June 1967, pp. 415-426.
18. D.J. Williams and M.E. Scorgie, 'Taxicabs: the Other Side of Transportation', *Australian Road Research*, vol. 11, no. 1, March 1981, pp. 17-24.
19. D.J. Williams, 'Labour Costs and Taxi Supply in Melbourne', *Journal of Transport Economics and Policy*, vol 15., no. 2, May 1981.

20. MCC, Licensed Vehicle Committee Minutes, 30 January 1930, 12 February 1930, 12 March 1930, 37 March 1930, 9 April 1930.
21. MCC, op.cit. 3 June 1931.
22. MCC, op.cit. 1 July 1931.
23. D.J. Williams, 'Information and Price Determination in Taxi Markets', *Quarterly Review of Economics and Business*, vol. 20, no. 4, Winter 1980, pp. 36–43.
24. The number was reduced to 550 from 630. The request for a reduction had originally been suggested but postponed in May 1935, MCC, op.cit. 1 May 1935.
25. MCC, op.cit. 19 February 1937, 25 August 1937.
26. MCC, op.cit. 15 May 1938, 8 June 1938.
27. Williams, *Regulation of Taxicabs*, p. 134.
28. Chanoch Shreiber, 'The Economic Reasons for Price and Entry Regulations of Taxicabs', *Journal of Transport Economics and Policy*, vol. 15, no. 1, January 1981.
29. MCC, op.cit., 24 November 1937.
30. MCC, op.cit., 8 December 1937.
31. MCC, op.cit., 16 March 1938.
32. *Melbourne Herald*, 6 July 1939, p. 13; *Melbourne Argus*, 4 July 1939, p. 3 and 5 July 1939, p. 11.
33. The total licences were not at first taken up, and it is not clear whether the council purposely overprovided or whether the dispersed hire car owners wished to defy the MCC and only took up the licenses to obtain the benefits of petrol rationing which were soon introduced. To the former view, see Transport Regulation Board, 'Inquiry into the Need for More Taxi Cabs in the Metropolitan Area', unpublished 1954, p. 576. As to defiance, see *Melbourne Argus*, 6 July 1939, p. 3. Many hire car operators threatened to defy the new law and continued to charge less than taxicab fares.
34. The Yellow Cab Company anticipated that the Council would bow to this pressure and requested that Council make part of any new issue to Yellow Cabs. The company argued this case because in 1936 it had surrendered 132 of its licenses so that the council could impose the 550 taxi limit. MCC, *Licensed Vehicle Committee Minutes* 13 March 1946.
35. MCC, op.cit. 31 January 1946.
36. MCC, op.cit. 27 March 1946.
37. MCC, op.cit. 1 June 1946.
38. *Melbourne Age*, 26 October 1951.
39. Many existing owners were furious, while the RSL and

the press alleged that not all applicants were of good character and that there were side payments to councillors. The RSL was publicly demanding a Royal Commission, *Melbourne Age*, 23-28 October 1951. See also the allegations of a racket in the allocation of licences in MCC, *Licensed Vehicle Committee Minutes* 31 October, 1951

40. See the explanations given for this in TRB, op.cit., pp. 666, 1037, 1057.
41. Victorian Year Book 1932-33, p. 326.
42. TRB, *Circular Memorandum*, 4 May 1953.
43. To be fair, the MCC also recognised the poor availability of cabs in the outer areas, and in the closing years of its control it issued licences conditional upon them being operated from specific suburban addresses or locations. The efficiency problems of dispersed, one car depots however, was not addressed. See for example, TRB, *Annual Report 1952-53*, Melbourne: Government Printer, p. 13.
44. TRB, Annual Report, also TRB, *Circular Memorandum*, 6 July 1953, and private correspondence from TRB, 4 June 1975.
45. Victoria, *Government Gazette*, Melbourne: Government Printer, 7 March 1954. TRB, *Circular Memorandum*, 16 March 1965, 18 June 1954. Half of the proposed increase was brought about by a transfer of existing metropolitan hire car licences. Between 1959 and 1963, the TRB received 1,329 applications for taxi owners licences and 2,101 applications for hire car owners licences.
46. D.J. Williams, 'Changes in Real Incomes and the Demand for Taxicabs', *Transportation*, 10, 1981, p. 56.
47. Williams, 'Labour Costs and Taxi Supply in Melbourne'.
48. Private correspondence from TRB.
49. *Melbourne Age*, 23 April 1974.
50. D.J. Williams, 'Peak-Load Pricing: an Urban Transport Case Study', *Australian Road Research*, vol. 11, no. 3, September 1981, pp. 19-27.
51. Williams, 'Information and Price Determination'.

10

ARTHRITIC ACADEMIA: THE PROBLEMS OF GOVERNMENT UNIVERSITIES

Frank Milne

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ARTHRITIC ACADEMIA: THE PROBLEMS OF GOVERNMENT UNIVERSITIES

Frank Milne

I. INTRODUCTION

In most western countries, universities (and colleges) are funded and indirectly controlled by governments.[1] In fact these universities show many of the characteristics of government bureaucracies, sharing the same rigid salary scales, promotion structures and tenure provisions. During the rapid expansion in university education in the post-war era, a number of inefficiencies inherent in this situation were obscured by the general fervour for education.

By the late 1970s the expansion had come to an end, and the inflexibility of the bureaucratic university system was only too apparent. At the present time, governments are imposing cuts in university funding and investigating (or in the process of implementing) the dismantling of some of the structure they were so quick to erect. The problem is that the modification or contraction of a complicated bureaucratic structure cannot be undertaken lightly. It is only too easy to introduce what appears to be an economy, to find that the new measure has created a perverse incentive resulting in greater waste. In short, it is important to understand the incentive structure of universities before modifications are recommended; otherwise a large, inefficient system may become a somewhat smaller and even more inefficient system.

II. THE KEY: UNIVERSITY FUNDING PROCEDURES

The key to understanding the government university system, and the incentives facing academics, is the method of government funding. It is this method of funding and the incentive system that it creates, which explains many of the inefficiencies and rigidities of the government university

system. This link between funding and incentives was appreciated by Adam Smith, who provided a very clear statement of the problem in his celebrated book *An Inquiry into the Nature and Causes of the Wealth of Nations*.[2] Smith's insights have been modified and extended in various ways by more recent writers,[3] but his fundamental thesis remains:

> In some universities the salary makes but a part, and frequently but a small part, of the emoluments of the teacher, of which the greater part arises from the honoraries or fees of his pupils. The necessity of application, though always more or less diminished, is not in this case entirely taken away.
>
> In other universities the teacher is prohibited from receiving any honorary or fee from his pupils, and his salary constitutes the whole of the revenue which he derives from his office. His interest is, in this case, set as directly in opposition to his duty as it is possible to set it.
>
> If the authority to which he is subject resides in the body corporate, the college or university, of which he himself is a member, and in which the greater part of the other members are, like himself, persons who either are, or ought to be teachers; they are likely to make a common cause, to be all very indulgent to one another, and every man to consent that his neighbour may neglect his duty, provided he himself is allowed to neglect his own. In the University of Oxford, the greater part of the publick-professors have, for these many years, given up altogether even the pretence of teaching.[4]

Smith emphasises the role of teaching, whereas in modern universities, research plays a much bigger role in the duties of an academic. Nevertheless the same principle applies: the performance of academics is very much determined by the incentive system they face. In the following pages, I have tried to provide a brief description of that incentive system.

Aggregate university funding

During the period 1950-75 the university sector expanded rapidly. Although some of this growth can be explained by simple demographic factors and an increase in demand for more technical education, most economists would agree that

massive government subsidies and low (or zero) fees for students created an artificially large university system.[5] In turn this enlarged university sector produced an artificially large derived demand for academics to teach the subsidised students. Naturally, academics realised the implications of this subsidised expansion in terms of increased salaries, accelerated promotions and other rewards, and actively lobbied for further increases in the subsidy. Inevitably, the rapid growth could not continue; even without fees and the lowering of entry standards, student numbers have stagnated, or in some cases declined. With the current subsidised system, the best predictions forecast very little growth for the 1980s.[6]

The composition of university funding

Given the total level of government expenditure on universities, there are serious problems in deciding how the money should be divided between universities, and within the departments of a university. In Australia, the Tertiary Education Commission (TEC) is in charge of overall funding of tertiary education. It gathers information from the universities on projected student enrolments, costs and so on, and divides the total expenditure between the universities and colleges. Allowances are made for new institutions and research projects.

Given its total allocation and the guidelines laid down by the TEC, the university divides funds between its various faculties and departments. Again various estimates of costs, student numbers etc. are used to justify the allocation.

Taken as a whole, the process is complex and unwieldy. By its very nature, the market demand coming from the consumer (the student) is muted; and the demand from various pressure groups within academia and the government are greatly exaggerated.

For example, in the 1960s and 1970s the opening or expansion of universities and colleges replaced dam-building as an enticement to marginal electorates. The consequences were equally disastrous in wasting the tax-payer's money. Certain of these institutions should never have been opened, because even with the heavily subsidised education system they attract relatively small numbers of students.

Another example concerns the allocation of funds within universities. Funds are distributed to the faculties and departments via complicated formulae, supplemented by funds for special projects and contingencies. Often these

formulae have biases introduced to reflect the academic power structure of the university, so that teaching and research fund allocations are not an accurate reflection of teaching and research demands.

In effect the university system in Australia is a command economy with some decentralisation. It replaces the price system and the flexible incentive structures of the market with bureaucratic rules and formulae. The result is a cumbersome bureaucratic process with all the inevitable inefficiencies that we have come to expect of command economies.

III. INCENTIVES

Academic incentives: teaching

At the very bottom of the bureaucratic pyramid is the academic teacher, who, so far as students are concerned, is the person who delivers the goods. Because the reward system is only indirectly related to the lecturer's performance in the classroom, the incentive to teach well is greatly reduced. Although in principle a department head can lobby the administration for accelerated promotion as a reward for good teaching, academic administrators are wary of such claims. Removed from the student consumers and with limited data, they are only too aware that it is in the interests of the department head to promote and expand his department, and therefore extend his influence and prestige within the university, and in society in general. Thus the link between student demands and teacher rewards is very indirect and inefficient, and it is hardly surprising that students complain of poor teaching.[7]

Academic incentives: research

Academic research is produced for two basic markets: the first is for academic journals, and the second is in response to specific grants from government or private organisations. Of course it is quite common for research that has been undertaken under specific grants to be published in academic journals. Where research is undertaken under a specific grant, the incentives are clear cut in that inadequate performance will be penalised by a loss of future grants. Superior performance is rewarded by more lucrative grants and greater choice in potential topics, as the providers of

grants compete for the services of superior talent. The incentives facing researchers in funded research are very much like those of any other private business.[8]

Researchers who produce solely for academic journals face more complex incentives. There is the pleasure of doing something that the researcher thinks is worthwhile and the journal article is merely a way of disseminating that information. But there are other rewards. The publication of an article in a refereed journal is a signal of the competence of the author in a particular body of knowledge. The more prestigious the journal (that is, the quality of the refereeing) the more reliable is the signal of competence and originality. Therefore the publication of articles is a way in which administrators, who may not be familiar with a particular body of knowledge, can judge the intellectual competence of a teacher or researcher.

There is a danger that with indirect funding from government (or from private sources for that matter) research can become an end in itself. Whole areas of research may develop into elaborate intellectual games of marginal worth to society. Given poorly-directed funding, literatures and journals can grow up filled with fierce debates and frantic activity. Although the academics concerned may be quite honest in their enthusiasm for their 'field', it may be of little interest to anyone else in society now, or ever.

Although extremes of this sort are fairly easily detected, one can never hope to eliminate debates over trivia or the pursuit of deadends, because trivia and deadends are often discovered only after considerable honest effort. Even the best researchers fall flat on their faces with embarrassing frequency. Because of this fuzziness and uncertainty surrounding the development of new ideas or physical processes, it is not an easy task to construct an incentive system that minimises game playing and maximises creative activity.[9]

But one thing is certain, if governments give research money with minimal controls, they should not be surprised when academics spend it on things that **they** regard as important. Academic freedom in research funding can mean the freedom to develop new and powerful truths, but it can also be the freedom to squander tax-payers' money on useless projects.

IV. RIGIDITIES IN THE SYSTEM

Tenure

Academic tenure is a political issue in Australia and in Britain.[10] Unfortunately there appear to be some misunderstandings about its role, and the implications of its abolition.

Job tenure is a reward that is conferred after some probationary period. The first point to understand is that all employees have tenure; it is the length of tenure and the implied salary under that tenure that is the key issue. Australian academics earn tenure until retirement,[11] and have an indexed salary system similar to government employees.

The second point is that life tenure confers a benefit on the holder, and its abolition is a reduction in the attractiveness of the job for many applicants. Therefore abolition is seen by many as a cut in salary, and competent academics with options outside the university system may find that cut just sufficient to induce them to leave. (A similar argument can be made for cuts in study leave provisions.)

The third point is that if salary flexibility is admitted, then a departmental head can induce an incompetent or lazy tenured academic to leave by not increasing his nominal salary. Inflation will quickly reduce his real wage to a pittance. This weapon is available to administrators in private US universities and it appears to work fairly efficiently. Tenure is not an issue in those universities.

Finally, if tenure is abolished and the government wants to prune the system it will have to be careful in its choice of lambs to be slaughtered. What are the incentives of those making the decision? It is not at all clear that if the decision is left to the universities, that the least competent will go. As a general rule those with the most to lose would fight the hardest, and those with the least to lose would fight least. It is quite possible that in some departments the most competent academics will leave to avoid the bitter infighting, while the least competent and least mobile remain. Therefore, a purported 'fair', proportional cut across all departments may well lower the average quality of the university faculty.

Inflexible salaries

A critical constraint in the Australian universities is the inflexible salary scale. Because the whole structure is geared

to the basic wage decision, the system is largely inflation proof. (In recent years wage indexing was not complete.) The rigidity occurs in a number of ways: the first is that promotion within the Lecturer and Senior Lecturer salary ranges is automatic; so a Senior Lecturer, say, who gives up hope of being promoted to Reader, achieves a free ride to the top of the Senior Lecturer range, no matter how hard or how little he works.

Second, a Professor, no matter how distinguished, cannot be paid more than a small increment over the least competent Professor. Thus there is a tendency for distinguished academics with international reputations to be bid away by US universities. In certain disciplines, Australia is having increasing difficulty in holding top people, given the growing disparity between Australian and US salaries.

Third, the salary scale is the same for all disciplines. (Medicine has been treated as an exception in allowing a disproportionate number of Professorial appointments, so that, in effect, its salaries are higher.) The results of this are disastrous for departments with outside salaries higher than the prescribed scale. Examples of this are the accounting, finance and economics departments where good staff can earn significantly greater salaries (in some cases double their salaries) in either outside practice or in US or European universities.

But in other departments the reverse is true: the salary is well above the market wage for that discipline, with the result that any position which is advertised receives a flood of applications. Those who are able to obtain such a post have every incentive to stay unto death. Furthermore to obtain such positions, graduate students will undertake socially wasteful further studies as the requirements are raised to ration these subsidised positions. Good examples here are some of the humanities subjects such as English literature and history.

The result of such a salary scale is as perverse as one can imagine: the most highly prized academic faces the greatest tax, and the least valued (as measured by his market wage) receives the greatest subsidy.

In the US there is much greater variation in salaries between and within disciplines than in Australia. These salaries are geared to market factors and reward academic productivity. But in Australia, the rigid salary system and tenure provisions are very inefficient in a reduced or no growth university system. It is little wonder that the intellectual brain drain that was stemmed in the 1960s and

early 1970s has now reappeared: the most talented are beginning to leave, frustrated with the system; and young Australian graduate students who trained overseas are not returning.

Departmental structure

Because of the command economy structure of universities, academics have an incentive to promote each other and inflate their salaries. To prevent this, governments enforce hierarchical structures limiting the number of Professors, Readers, etc. in any department. The promotion pyramid with its rigid pay scales is tied to student numbers. The problem with this system is that it prevents the formation of a sustainable, high-quality department. If a department has a number of good young academics, inevitably some will leave given the few places with high salaries. Because the salary scales and hierarchical structures are virtually identical in every university in Australia, there is an inefficient levelling and scattering of good academics around the country. (The government apparently recognises the problem and has responded by creating a few 'Centres of Excellence'. Unfortunately these centres are funded on a relatively short-term basis and are grafted onto the old levelling system. Whether they will have a lasting or significant impact remains to be seen.)

One further problem is that the higher an academic progresses up the promotion ladder, the more time is spent in administrative tasks and sitting on committees. This is true especially for Professors. Often senior academics are expected to be proficient in administration, research and teaching. Surely it is very inefficient to promote the most promising academics who have progressed because of their ability in teaching and research, and turn them, against their will, into administrators. A more efficient system is to promote academics, particularly at senior levels, to more specialized tasks. So long as these senior appointments are given rigorous, periodic reviews, the incumbent can concentrate on mastering one or a few duties, rather than becoming a mediocre jack-of-all-trades.

V. A POSSIBLE SOLUTION

In previous sections I argued that the current problems in universities were the result of the method of government

funding and the incentives it generated. Therefore, if the system is to work more efficiently and responsively, the funding system will have to change.

I argue that a much more market orientated system will be superior to the arthritic structure we have at the moment. The argument is a natural extension of the views expressed by Adam Smith. If the buyers and sellers of services (academic or otherwise) confront one another directly, then they are going to be more satisfied than if a huge bureaucracy is interposed between them. If students pay the full cost of their tuition, they are going to demand value for money; so that if the teacher performs badly, students have an effective weapon in refusing to buy his services. Good teachers, on the other hand, will receive rewards which increase with their performance. Therefore if a lecturer is a member of a department which does not reward him commensurately with the revenue he generates, then it won't take long before he will be attracting bids from other departments elsewhere. The very fact of his threatening to leave will tend to bring his department into line, otherwise they will lose him and the revenue he generates.

The power of the student purse is a potent force also for directing teaching resources into the most valued subjects, and away from subjects for which there is declining interest. If there is an unanticipated surge in demand for a particular subject, there will be a jump in the salaries of those who teach it. At once this provides an incentive for potential teachers in related subjects, or elsewhere, to enter that market. Conversely, a fall in interest in a subject will lead to a decline in its teachers' salaries and an exodus of teachers.

It is important to understand that markets are really very subtle mechanisms that reward ingenuity, innovation and an ability to plan ahead. For example, consider how a private system would have reacted to the post-war baby boom. Because administrators in private universities realise that the financial health of their institution depends upon accurate forecasting of student demand, they will start to bid up the salaries of available teachers as the boom approaches. Potential teachers seeing the rise in salaries will be induced to train for that profession. Unanticipated shocks aside, salaries will adjust fairly gradually reflecting the anticipated demand and supply for teaching services.[12]

There is no reason to expect private universities to be myopic or poor planners - the incentives are quite the opposite. If private university administrators plan poorly or are slow to cut costs and introduce teaching innovations,

competition from other institutions will penalise them through a fall in net revenue. Therefore if the administrator's financial rewards and his reputation are tied to the financial health of his institution, he has a direct incentive to be an innovative and efficient manager.[13]

Although in this section I have concentrated upon private **teaching** institutions, similar comments apply to research organisations. I am not implying that research will necessarily take place in a separate organisation from a teaching institution. The beauty of the market system is that teaching and research will be combined or not, depending upon the financial rewards; and those are related directly to the efficiency of the organisation.

Before closing this section let me make one last point. I have here referred to rewards in (apparently) financial terms. If this appears to be a rather restrictive and materialistic reward system, I should point out that economists have a disconcerting habit of using the concept of wealth in a broad sense, which covers not only direct financial wealth, but also nonfinancial advantages and rewards. Given this interpretation, then there is no reason why academics in a private university would not be rewarded through a flexible system of salary, leisure and other benefits, depending upon their taste. Indeed, academics who find great pleasure in the noble pursuit of knowledge should be allowed to work for nothing!

VI. A MODIFIED PRIVATE SYSTEM

In the previous section I have given a brief outline of the incentives in a private university system. I am well aware that the discussion is incomplete, because any detailed analysis would soon exceed the modest limits of this paper. Nevertheless, let me consider two possible problems with a wholly private university system.

The first problem concerns the appropriability of rents from research ideas. Some types of research produce basic ideas that are used extensively, and ultimately implicitly, in a subject. It would be absurd, for example, for the Albert Einstein family trust to charge ten cents every time someone used Einstein's theory of relativity; the costs of collection would outweigh the revenue. Some economists have argued that an efficient way of obtaining such ideas is to subsidise basic research activity. This argument has been presented quite cogently by Arrow.[14] But as he admits, there are significant problems in devising the right incentives to

produce research.[15] This is a non-trivial problem, for which there is no simple solution.

The second problem concerns the possible market failure in students having difficulty in borrowing against future increased income. The problem here has to do with questions of adverse selection and moral hazard. That is, lenders are alleged to have difficulty in screening potentially good from bad students; and they have difficulty in enforcing the loan repayment. Investigations of these general problems are current in the economics literature, and it is not clear how significant they are in the student loan market.

Nevertheless, even if we grant the importance of these difficulties, they do not necessarily invalidate a basically private system supplemented by carefully designed subsidies.[16] Too often, critics of the private system use apparent market failures as an excuse to introduce a non-market system which, *in toto*, may be far more inefficient than the flawed private system it replaces.

VII. WHAT CAN BE DONE?

I think that it is clear that any attempt to introduce a private university system (that is, withdrawal of government regulation) would arouse a storm of protest. The vested interests who benefit from the current system would fight any such proposal. In particular, students who are heavily subsidised under the present regime would fight any withdrawal of that subsidy. The majority of academics would also be against such a move, although some would benefit from the removal of government intervention.

Others who would oppose the move would be those who have the uneasy feeling that a private system is untried - a theoretical, not a practical alternative. This fear can be partly allayed, because a form of private system operates in the United States. Because of various government measures of tax advantages, research funding, and the competition from government-funded universities, the performance of private universities is distorted from that of a purely private system. Even so, a close examination of the US private universities is very instructive in showing how a more flexible, market-orientated structure operates.

As a matter of practical politics, given the power of vested interests, I suspect that any changes that do occur will be in the nature of reforms to the present system. If this is the case, then the general thrust of this paper is still

relevant. Any changes, if they are to be really effective in improving incentives, should be seen in the context of the whole incentive system. Let me give a simple example. If the government wishes to continue with a system of subsidising students, there is an issue of how these subsidies are to be administered.[17] The current system subsidises students indirectly through direct financing to university administrations. But, for example, the subsidy could be given through a system of scholarships where the scholarship is a gift of money which must be spent on fees at any university department. With the second system, students have the power of the purse, and if they are dissatisfied with one department, they can threaten to spend their scholarship at a competing institution. Furthermore, because the departments receive the scholarships directly, it will strengthen the autonomy of academic departments vis-a-vis the central administration and other departments desiring to be subsidised.

If the scholarship system were altered to a straight gift of money which did not have to be spent on education (a substantial sum amounting to several thousands of dollars)[18] then it would be interesting to see how many students chose to spend the money on items other than university education. Indeed I suspect it would be embarrassing to the universities to see how little many students valued the education produced under the current system.

Given these simple examples, it should be obvious that the performance of the academic system will be affected significantly by the method of subsidy.

VIII. CONCLUSION

In this paper I have been discussing the problems of government universities. But universities are not much different from other government organisations (such as state-run railways or Telecom) and the arguments about creating market-orientated incentives apply with equal force to them as well. If academics feel embattled, they might take some comfort from the thought that the inefficiencies of academia are in a long and honourable tradition of government enterprises.

The important issue is that the performance of universities is very much related to their incentive structure. If this structure is arthritic, then massaging it with increasing expenditure will be a very inefficient way of increasing performance.

Equally, without careful reform of the incentive structure, expenditure cuts can be counter-productive; by reducing government grants, the universities could well respond by greatly reducing their output of intellectual services. As we observed above, the cost-cutting may simply drive out the most talented academics leaving the mediocre or worse. It would be ironic if government cost-cutting, motivated by a desire for greater economic efficiency, created an even more inefficient and costly university system where, on balance, the direct cost savings were outweighed by a fall in the intellectual benefits. Unfortunately, there is a strong possibility that the Australian government will react in a way that will bring about this result. Already there is evidence[19] that cuts in British university expenditure have had repercussions rather along the lines predicted in this paper. It would be folly to repeat these errors in Australia.

Notes

1. An exception occurs in the United States where many universities, including some of the most prestigious such as Harvard and Yale, are private institutions.
2. Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, ed. R.H. Campbell & A.S. Skinner, Oxford: Clarendon Press, 1976. The relevant section is contained in Book V, Chapter 1, 'Of the Expense of the Institutions for the Education of Youth'.
3. For a recent survey see R. Blandy, J. Hayles & A. Woodfield, 'Economics of Education', in F.H. Gruen (ed.), *Surveys of Australian Economics*, vol. 2, Sydney: Allen & Unwin, 1979. See also Milton Friedman, *Capitalism and Freedom*, Chicago: University of Chicago Press, 1962, chap. VI. In a fascinating contribution, E.G. West (*Education and the State*, London: Institute of Economic Affairs, 1970) has traced the rise of the government school system in nineteenth century Britain. He came to quite different conclusions from the flattering, official view that government intervention was a great success.
4. Smith, pp. 760-761.
5. See Blandy, Hayles and Woodfield. The experience in other countries is very similar.
6. See the papers in G.S. Harman et al, *Academia Becalmed: Australia Tertiary Education in the Aftermath of Expansion*, ANU Press, 1980.
7. An extreme situation occurred in France in 1968, where student frustration, arising from overcrowded lecture theatres, and arrogant and indifferent teachers led to student riots.
8. In the USA, private research organisations are common. Some are associated with universities and some are not.
9. The whole topic of research funding by private or government sources, and the construction of non-perverse incentives is a complicated problem which goes well beyond the confines of this paper.
10. In 1982 in Australia the Senate Standing Committee on Education and the Arts investigated academic tenure.
11. Until 1981, Federal public servants had a similar system. It is a myth that academic life tenure is unique.

12. This argument is a combination of two ideas familiar to economists. The first is that acquired skills are a form of human capital which requires costly investment. The second is that durable skills are an asset, and asset prices adjust to equal the present value of their net returns.
13. Because of space limitations, I have been vague about the possible organisational structure of private universities. I think it is reasonable to expect that there would be a variety of organisational forms depending upon market conditions. This is consistent with the variety of private universities and colleges in the USA. Similar observations can be made about research organisations which range from foundations and co-operatives to private corporations. Thus, various types of organisations simply reflect the different incentives across the spectrum of academic markets. Nevertheless, inefficient organisational forms tend to be competed away by more efficient, lower cost organisations.
14. K. Arrow, 'Economic Welfare and the Allocation of Resources for Invention', *The Rate and Direction of Inventive Activity: Economic Social Factors*, Princeton University Press, 1962.
15. J. Hirshleifer and J. Riley, 'The Analytics of Uncertainty and Information - an Expository Survey', *Journal of Economic Literature*, December, vol. XVII, no. 4, 1979.
16. For a discussion of these schemes see Blandy, Hayles and Woodfield.
17. Discussions of this problem are contained in A. Alchian, 'The Economic and Social Impact of Free Tuition', *New Individualist Review*, 3, no. 1, Winter 1968, pp. 42-52; and H.G. Brennan, 'Fee Abolition: an Appraisal', *The Australian University*, vol. 9, no. 2, July 1971, pp. 81-149.
18. See Blandy, Hayles and Woodfield.
19. See the recent article, 'Cutting Britain's Universities Down to Size', in *The Economist*, 2 October 1982, pp. 99-104.

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