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# Antitrust Immunity and the Economics of Occupational Licensing

## Abstract

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## Keywords

licensing schemes, professionalism, current economic theory

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## Comments

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# ANTITRUST IMMUNITY AND THE ECONOMICS OF OCCUPATIONAL LICENSING

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## INTRODUCTION

The proposition that the common law tends to evolve in the direction of economic efficiency has been advanced by Posner and others.<sup>1</sup> This proposition implies that, over time, legal precedent which promotes efficiency of exchange in the market, and thus maximizes the wealth of market agents, will displace precedent that is incompatible with this objective.<sup>2</sup> In evaluating market impact, however, it is important to note that legal precedent which is perceived to be compatible with efficient exchange when viewed from the perspective of outmoded economic theory may not be as compatible as it appears.

This article examines the extent to which legal precedent in the area of occupational licensing is compatible with efficient exchange in the market (hereafter referred to as the “efficiency” of the case law). Recently there have been rapid advances in the economic theory of occupational licensing. These advances are now relatively well accepted by experts in the field<sup>3</sup> and, consequently, such a

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<sup>1</sup> For a review of the evidence in support of this proposition see R. Posner, *Economic Analysis of the Law* (2d ed. 1977); Goodman, *An Economic Theory of the Evolution of Common Law*, 7 J. Legal Stud. 393 (1978); Jordan & Rubin, *An Economic Analysis of the Law of False Advertising*, 8 J. Legal Stud. 527 (1979); Shavell, *An Analysis of Causation and the Scope of Liability in the Law of Torts*, 9 J. Legal Stud. 463 (1980); Muris, *Opportunistic Behavior and the Law of Contracts*, 65 Minn. L. Rev. 801 (1981); Rubin, *Unenforceable Contracts: Penalty Clauses and Specific Performance*, 10 J. Legal Stud. 237 (1981). Criticisms of this proposition have come from a number of sources including Leff, *Economic Analysis of the Law: Some Realism About Nominalism*, 60 Va. L. Rev. 451 (1974) and Michelman, *A Comment on Some Uses and Abuses of Economics in Law*, 46 U. Chi. L. Rev. 307 (1979). Posner has responded to these criticisms in *The Value of Wealth: A Comment on Dworkin and Kronman*, 9 J. Legal Stud. 243 (1980) and *A Reply to Some Recent Criticisms of the Efficiency Theory of the Common Law*, 9 Hofstra L. Rev. 775 (1981).

<sup>2</sup> Even the most obscure types of judicial decisions can exert a significant impact on the efficiency of exchange (i.e., the price-quality equilibrium) in the market. For example, a decision as to whether a book, movie, or magazine is “obscene” and can thus be banned by a state government exercising its police power, or whether it has “redeeming social value” and is thus protected under the first amendment, can exert a significant impact on the market. While such a decision is apparently concerned with artistic, not economic issues, it can be evaluated in terms of its impact on the efficiency of exchange in the market. It is the extent to which a decision increases or decreases the efficiency of exchange in the market that determines the “efficiency” of the legal precedent it creates. We will develop this concept more fully later in the article.

<sup>3</sup> Fisher, *Diagnosing Monopoly*, 19 Q. REV. ECON. BUS. 7 (1979); and Demsetz, *Barriers to Entry*, 72 AM. ECON. REV. 47 (1982); have argued that the traditional economic view of activities like occupational licensing is too narrow in its consideration of relevant costs, focusing too heavily upon the costs of producing physical output. As discussed *infra*, an alternative view has been offered by Leland, *Quacks, Lemons, and Licensing: A Theory of Minimum Quality Standards*, 87 J. POL. ECON. 1328, 1329 (1979):

reexamination offers an opportunity to determine whether the perceived efficiency of the case law in this area corresponds to its actual efficiency. Further, such an analysis offers an opportunity to determine how any existing inefficiency in the case law might be alleviated.

In line with this dual objective, we first review the history and current status of the "professionalism" defense. This defense specifies when occupational licensing is immune from the Sherman Act.<sup>4</sup> Next, we examine differences between the traditional and current economic theory of occupational licensing. Finally, we analyze the compatibility of this doctrine with the current economic theory of occupational licensing to determine the extent to which its perceived efficiency corresponds to its actual efficiency. We also provide suggestions to alleviate inefficiencies in the current version of the doctrine.

### **HISTORY AND CURRENT STATUS OF THE PROFESSIONALISM DEFENSE**

It is important to distinguish mandatory licensing schemes (hereafter referred to as "occupational licensing") from voluntary licensing schemes (hereafter referred to as "occupational certification"). In the former, the occupational group itself imposes certain minimum entry and/or retention requirements on all individuals who wish to sell a particular type of service in the market (e.g., requiring the passage of a bar examination and evidence of good moral character in order to practice law). By contrast, occupational certification does not restrict individuals from selling a particular type of service in the market. Its function is to provide members of an occupation with the opportunity to voluntarily obtain certification of their competency in order to improve the marketability of their services (e.g., a practicing attorney who earns an LL.M. degree in taxation in order to attract new clients to the law practice). Although occupational certification may be prohibited when tantamount to fraud, there generally are no legal obstacles to the implementation of such schemes. Occupational licensing, because of its potentially anticompetitive side effects, may be subject to legal constraints under the antitrust laws. Therefore, the primary legal issues in this area concern occupational licensing, not occupational certification.

The professionalism defense has evolved through a series of United States Supreme Court decisions over the past sixty years. This evolutionary process can be viewed as a sequence of four basic phases that have gradually narrowed the scope and applicability of the doctrine.

The earliest suggestion of such a doctrine may be found in the Court's 1922 decision in *Federal Baseball Club v. National League*<sup>5</sup> This case involved a suit by a baseball club that had joined with seven

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It is not clear that traditional economic tools are adequate for investigating the licensing problem in its full complexity. Markets which have minimum quality standards tend to be characterized by informational asymmetry in which the seller knows the quality of his service or product, but the buyer does not. Thus, uncertainty and differences in information seem to characterize markets with licensing and other forms of minimum quality standards, and, until recently, these aspects of markets have been outside the purview of economic theory.

<sup>4</sup> 15 U.S.C. § 1 et. seq. (1976). The term "professionalism defense" has been suggested by Kissam, *Antitrust Law, the First Amendment, and Professional Self-Regulation of Technical Quality*, in *REGULATING THE PROFESSIONS*, at 143 (Blair and Rubin eds., 1980), to refer to the body of legal precedent dealing with the "claim that professional self-regulation deserves to be 'treated differently' because of its special characteristics."

<sup>5</sup> 259 U.S. 200 (1922)

other clubs in a new league in order to challenge the monopoly over professional major league baseball enjoyed by the two existing baseball leagues. In dicta, the Court noted that the "defendants were not within [the jurisdiction of] the Sherman Act" because baseball exhibitions are not "trade or commerce in the commonly accepted use of these terms."<sup>6</sup> The Court further noted that the mere transportation of members of a profession across state lines does not, in itself, make the activity interstate commerce.

Federal Baseball Club is illustrative of the Court's initial tendency to dismiss antitrust challenges to professional self-regulation schemes on jurisdictional grounds.<sup>7</sup> This first phase in the evolution of the professionalism defense was characterized by a tendency to evade the substantive issues involved and thereby permit a relatively broad set of activities to be legitimately regulated by members of a professional group.

The emergence of the second phase in the evolution of the professionalism defense may be traced to the Court's 1943 decision in *American Medical Association v. United States*.<sup>8</sup> This case involved an indictment against the AMA and the Medical Society of the District of Columbia "for conspiring to violate section 3 of the Sherman Act by impeding a nonprofit organization of government employees which had set up a group health plan and employed its own physicians in an attempt to share the risk of medical expenses."<sup>9</sup> In dismissing the defendant's jurisdictional arguments that medicine constitutes neither "interstate commerce" nor "trade or commerce," the Court held that "the calling or occupation of the individual physicians charged as defendants is immaterial if the purpose and effect of their conspiracy was [the] obstruction and restraint of [price competition in the market for] group health [insurance]."<sup>10</sup>

Another important case during this second phase was *United States v. National Association of Real Estate Boards*.<sup>11</sup> This case involved an indictment against the Real Estate Board of the District of Columbia for conspiring to violate section 3 of the Sherman Act<sup>12</sup> by restricting membership to those who adopted and adhered to a set of standard commission rates. After dismissing jurisdictional arguments by the defendants, the Court held that any such self-regulation scheme which involves price-fixing is illegal per se under that section of the Sherman Act.

*American Medical Association* and *National Association of Real Estate Boards* are illustrative of the Court's tendency to begin to deny jurisdictional defenses when the professional self-regulation scheme involved price fixing. Also, this second phase in the evolution of the professionalism defense was characterized by a tendency on the part of the courts to begin to scrutinize the effect of the scheme upon price competition.

The third phase may be traced to the Court's 1952 decision in *United States v. Oregon* the definitional requirement of 'trade or commerce' [or] the failure to satisfy the 'interstate commerce' requirement."

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<sup>6</sup> *Id.* at 208-209

<sup>7</sup> Bauer, *Professional Activities and the Antitrust Laws*, 50 *Notre Dame Law* 570, 573 (1975), notes that most early cases were dismissed because of either "the failure to satisfy" the definitional requirement of "trade or commerce" [or] the failure to satisfy the "interstate commerce requirement."

<sup>8</sup> 318 U.S. 519 (1943).

<sup>9</sup> Bauer, *supra* note 7, at 575. Substantively, section 3 of the Sherman Act is the same as section 1; the difference is that section 3 applies to activities in the Territories and the District of Columbia.

<sup>10</sup> *American Med. Ass'n v. United States*, 318 U.S. 519, 528 (1943). Technically, since the indictment was brought under § 3 of the Sherman Act, which applies specifically to actions brought in the District of Columbia, no showing of "interstate commerce" or "trade or commerce" is necessary to establish jurisdiction.

<sup>11</sup> 339 U.S. 485 (1950).

<sup>12</sup> 15 U.S.C. 5 3 (1976).

Medical Society.<sup>13</sup> This case involved an indictment under section 1 of the Sherman Act<sup>14</sup> against a group of physicians that had organized a Blue Shield health insurance plan in order to provide an alternative to commercial health insurance. In dicta, the Court suggested that the relationship between members of a “profession” and those purchasing their services is special (i.e., not purely commercial) and, therefore, “forms of competition usual in the business world may be demoralizing to the ethical standards of a profession.”<sup>15</sup> Consequently, certain types of self-regulation by members of a “profession” may be immune from the application of the Sherman Act because they are legitimate uses of a state’s power to protect the public health, safety, and other valid interests of its citizens.

Oregon Medical Society is illustrative of the tendency of the Court to begin to distinguish “professions” from “other occupations” and restrict immunity from the Sherman Act to the former. This phase was characterized by a tendency on the part of the Court to grant antitrust immunity only to occupational self-regulation schemes involving members of a “learned profession,” and only if the scheme involved no price fixing.

The emergence of the current (fourth) phase in the evolution of the professionalism defense may be traced to the Court’s 1975 and 1978 decisions in *Goldfarb v. Virginia State Bar*<sup>16</sup> and *National Society of Professional Engineers v. United States*,<sup>17</sup> respectively. *Goldfarb* involved an indictment under section 1 of the Sherman Act against the members of the Fairfax County Bar Association for publishing a recommended fee schedule that had been adopted and adhered to by virtually all members of the organization. *Engineers* involved an indictment under section 1 of the Sherman Act against the National Society of Professional Engineers for prohibiting the use of competitive bidding practices by its members as part of the organization’s code of ethics. Although both cases involved activities which come very close to price fixing, which is illegal per se, because of the professional setting the Court indicated that the governing standard should be the “Rule of Reason” originally articulated for antitrust cases in *Standard Oil Co. v. United States*.<sup>18</sup>

On the basis of the Court’s decisions in *Goldfarb* and *Engineers*, it now appears that in order for an occupational self-regulation scheme to fall within the professionalism defense it must:

- (1) Apply to an occupation which qualifies as a “profession”;
- (2) Be a “quality regulation,” rather than a “price regulation,” scheme; and
- (3) Be justifiable under the “Rule of Reason.”

#### *The Legal Distinction Between “Professions” and “Other Occupations”*

Although no precise definition of “profession” has yet been provided by the Court, relevant holdings have emphasized three properties:

- (1) The employment of intellectual and technical knowledge and skills that have been obtained by a substantial investment in education and training;
- (2) The special (i.e., not purely commercial) nature of the relationship between buyers and sellers of such services; and

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<sup>13</sup> 343 U.S. 326 (1952).

<sup>14</sup> 15 U.S.C. S 1 (1976).

<sup>15</sup> *United States v. Oregon Med. Soc’y*, 343 U.S. 326, 336 (1952).

<sup>16</sup> 421 U.S. 773 (1975).

<sup>17</sup> 435 U.S. 679 (1978).

<sup>18</sup> 221 U.S. 1, 55-58 (1911).

- (3) The possibility of irreparable harm to the public if low quality services are provided.<sup>19</sup>

Occupations referred to as "learned professions" by the Court include physicians,<sup>20</sup> lawyers,<sup>21</sup> pharmacists,<sup>22</sup> and engineers.<sup>23</sup>

#### *The Legal Distinction Between "Price Regulation" and "Quality Regulation"*

Goldfarb held that schemes which regulate the terms of sale of professional services, as opposed to the technical quality of services, are not exempt from the Sherman Act. Specifically, Goldfarb held that schemes of the former type focus on the "business or commercial aspects" of providing professional services and are not intended to be protected by the professionalism defense. Arrangements held to constitute price regulation, rather than quality regulation, include the establishment of uniform fee schedules for members<sup>24</sup> and the imposition of ethical canons against competitive bidding by members.<sup>25</sup>

#### *The Court's Method of Applying the "Rule of Reason"*

The Court has suggested that for a regulation scheme to fall within the professionalism defense its "procompetitive effects" must outweigh its "anticompetitive effects."<sup>26</sup> Although the Court offers no precise guidance as to how the "Rule of Reason" is to be applied in assessing the "net competitive effect" of an occupational licensing scheme, decisions apparently turn on whether some positive impact on the quality received by or the prices paid by consumers can be demonstrated—with the burden of proof falling on the party defending the legality of the scheme. Therefore, it seems reasonable to infer that "a successful antitrust defense of any professional self-regulation that has substantial anti-competitive effects will have to include some fairly specific showing that the regulation helps protect consumers from purchasing inferior services and thereby 'promotes' competition on balance."<sup>27</sup>

#### *Historical Patterns in the Evolution of the Professionalism Defense*

Analysis of the history of the professionalism defense reveals that over the past forty years the courts have systematically narrowed and clarified the applicability of this doctrine. The presumption that professions are capable of objectively and competently regulating their own affairs, without the need for outside monitoring by the courts, has given way to a belief that the burden of demonstrating the net procompetitive effects of self-regulation ought to fall on its proponents.

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<sup>19</sup> Kissam, *supra* note 4.

<sup>20</sup> " *United States v. Oregon Med. Soc'y*, 343 U.S. 326 (1952).

<sup>21</sup> *Goldfarb v. Virginia State Bar*, 421 U.S. 773 (1975).

<sup>22</sup> *Virginia State Board of Pharmacy v. Virginia Citizens Consumer Council, Inc.*, 425 U.S. 748 (1976).

<sup>23</sup> *National Soc'y of Prof. Eng'rs v. United States*, 435 U.S. 679 (1978).

<sup>24</sup> *Goldfarb v. Virginia State Bar*, 421 U.S. 773 (1975).

<sup>25</sup> *National Soc'y of Prof. Eng'rs v. United States*, 435 U.S. 679 (1978).

<sup>26</sup> This requirement implies that the proponents of a self-regulation scheme must demonstrate that its "procompetitive effects" outweigh its "anticompetitive effects" on the prices and quality of services exchanged in the market.

<sup>27</sup> Kissam, *supra* note 4, at 152.

In the process of narrowing and clarifying the applicability of the doctrine, the Court has tended to distinguish between self-regulation schemes that focus solely on issues of technical quality and those that involve issues not directly related to technical quality such as the commercial terms under which services may be sold. While schemes of the former type have generally been upheld by the Court,<sup>28</sup> the latter have generally been rejected.<sup>29</sup>

A final discernible pattern involves the Court's increasing emphasis on the market effects of self-regulation schemes. Schemes that can be shown to increase the efficiency of exchange in the markets for professional services have generally been upheld by the Court,<sup>30</sup> while schemes that cannot be shown to exert such an effect have generally been rejected.<sup>31</sup>

## **TRADITIONAL AND CURRENT ECONOMIC THEORY OF OCCUPATIONAL LICENSING**

Rapid advances in the economic theory of occupational licensing have occurred over the past few years. In order to clarify the nature of these advances and their implications, we contrast here traditional and current economic theories.

### *Traditional Economic Theory*

Traditional economic theory of occupational licensing is based on the premise that protection from unlicensed competitors may be justified in order to allow a profession to upgrade the quality of the services offered for sale in the market.<sup>32</sup> This upgrading of quality may result from the imposition of higher educational and other standards on potential practitioners who wish to offer their services for sale. According to this theory, occupational licensing is often the most effective way of protecting the public from low quality professional services and may, therefore, be a legitimate form of market intervention.<sup>33</sup>

An important corollary to this traditional economic theory of occupational licensing suggests that the real intent of such self-regulation schemes is to restrict the supply of services available in the market in order to drive up prices.<sup>34</sup> According to this "barrier-to-entry" corollary, in many cases any increase in the overall quality of professional services brought about by occupational licensing is more

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<sup>28</sup> See, e.g., *Majorie Webster Junior College v. Middle States Ass'n of Colleges & Secondary Schools*, 432 F.2d 650 (D.C. Cir.), cert denied, 400 U.S. 965 (1970).

<sup>29</sup> See, e.g., *National Soc'y of Prof. Eng'rs v. United States*, 435 U.S. 679 (1978); *Goldfarb v. Virginia State Bar*, 421 U.S. 773 (1976); *American Med. Ass'n v. United States*, 317 U.S. 519 (1943).

<sup>30</sup> See, e.g., *United States v. Oregon Med. Soc'y*, 343 U.S. 326 (1952).

<sup>31</sup> See, e.g., *National Soc'y of Prof. Eng'rs v. United States*, 435 U.S. 679 (1978); *United States v. National Ass'n of Real Estate Boards*, 339 U.S. 485 (1950).

<sup>32</sup> For a more complete discussion of traditional economic theory, see Horowitz, *The Economic Foundations of Self-Regulation in Professions*, in *REGULATING THE PROFESSIONS 3* (Blair & Rubin eds. 1980)

<sup>33</sup> This theory is conceptually similar to the theory offered in support of protective tariffs on the importation of goods that conflict with those of domestic producers

<sup>34</sup> A study by Carroll & Gaston, *State Occupational Licensing Provisions and Quality of Service: The Real Estate Business*, 1 *RESEARCH IN L. & ECON.* 1 (Zerbe ed. 1979) indicates the pass rates on state real estate license exams are inversely related, holding other factors constant, to brokers' incomes. Another study, Holen, *Effects of Professional Licensing Arrangements on Interstate Mobility and Resource Allocation*, 73 *J. POL. ECON.* 492 (1965), suggests that licensing may significantly reduce geographic mobility in some occupations.

than offset by its anticompetitive side-effects. In such cases, the net effect of occupational licensing is the extraction of "monopoly rents" from the market by licensed practitioners.<sup>35</sup>

Overall, traditional economic theory focuses on the question of whether the potentially anticompetitive side-effects of occupational licensing are justified by the need to protect the public from incompetent practitioners. Under this traditional economic perspective, occupational licensing may be justified only where: (1) there is a serious threat of harm to the public posed by incompetent practitioners; and (2) the protection provided by means of such a scheme is adequate to compensate for the potentially anticompetitive consequences of restricting the supply of services available in the market.

### *Current Economic Theory*

Over the past decade economic theory has begun to evaluate occupational licensing in terms of its ability to provide information about the quality of professional services to potential purchasers. The emergence of this informational perspective on the proper economic role of occupational licensing can be traced to a seminal paper by Akerlof.<sup>36</sup> Akerlof suggests that occupational licensing may improve the efficiency of exchange in markets where buyers are unable to effectively differentiate the various services offered for sale on the basis of quality. In such markets, sellers possess information about quality, but may refuse to voluntarily disclose it to potential buyers. According to Akerlof, if this informational disparity or asymmetry between buyers and sellers is not corrected, a type of "market failure" referred to as "adverse selection" may result.<sup>37</sup>

In order to demonstrate this adverse selection phenomenon, Akerlof posits that the used car market is characterized by an asymmetry of information between buyers and sellers so that potential buyers cannot differentiate "lemons" from "good cars" (i.e., "nonlemons"). In such markets, sellers of lemons will not reveal the quality of their merchandise and will, therefore, demand a price consistent with the productive capabilities of a nonlemon. Since buyers cannot differentiate lemons from nonlemons, the market equilibrium price will be based on what buyers perceive to be the average quality of all cars in the market, not on the actual quality of any particular car.

The consequences of this unwillingness of buyers to pay a higher price than they perceive the average quality car to be worth is demonstrated by means of Figure 1. Quality distribution A represents the density function that corresponds to the actual quality of all possible used cars offered for sale in the market. Since buyers are unable to differentiate lemons from nonlemons, the resulting market price is  $P_j$ , the price for an average quality car. As a result, sellers of lemons are more than willing to sell their cars for  $P_j$ , but sellers of nonlemons will withhold their cars from the market. At this point, only lemons are offered for sale in the market and the quality distribution shrinks from distribution A to distribution B. Since buyers are unable to differentiate the above-average quality lemons in distribution B, the market price shifts from  $P_j$  to  $P_2$ , the price for the average quality lemon. At this point, only below-

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<sup>35</sup> See, e.g., Moore, *The Purpose of Licensing*, 4 J.L. & ECON. 93 (1961).

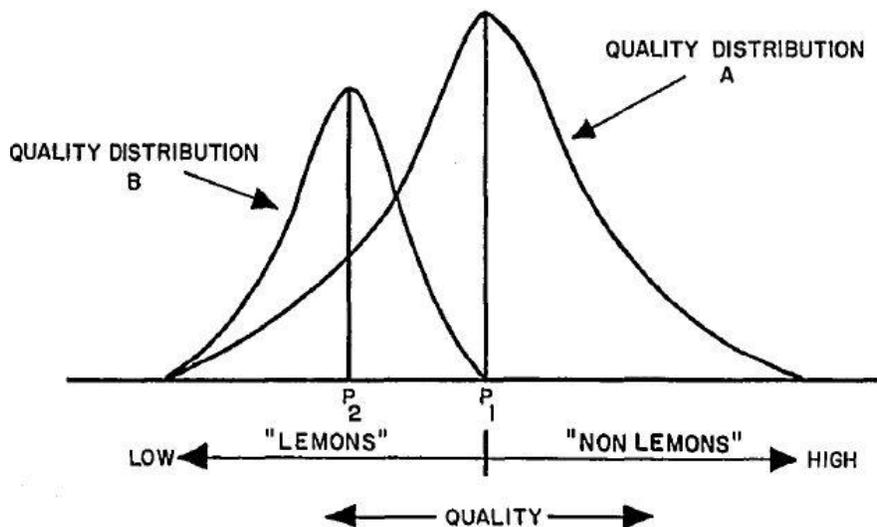
<sup>36</sup> Akerlof, *The Market for 'Lemons': Quality Uncertainty and the Market Mechanism*, 84 Q.J. Econ. 488 (1970).

<sup>37</sup> Akerlof, *id.* at 488, explains this "adverse selection" problem as follows:

There are many markets in which buyers use some market statistic to judge • the quality of prospective purchases, e.g., average quality. In this case, there is incentive for sellers to market poor quality merchandise since the return for good quality accrues mainly to the entire group whose statistic is affected rather than to the individual seller. As a result, there tends to be a reduction in the average quality of goods and also in the size of the market. It should also be perceived that in these markets, social and private returns differ and, therefore, in some cases, governmental intervention may increase the welfare of all parties.

average lemons are offered for sale in the market and the quality distribution again shrinks and the market price shifts further to the left. It is this iterative process which leads to the type of market failure which Akerlof refers to as adverse selection.

**Figure 1.**  
**Price-Quality Relationship in a Market with Informational Asymmetry**



The same sort of informational asymmetry that characterizes the used car market may be present in markets for professional services. While the quality of professional services varies, differences in quality are not observable by potential buyers. If buyers of medical services, for example, are unable to differentiate the quality of the services offered by physicians in the market, then high quality physicians may be unable to obtain an adequate price for their services and overall quality may deteriorate as higher quality service is priced out of the market. By imposing a lower limit on quality, occupational licensing may be one means of averting adverse selection in the markets for professional services.

Two corollaries to Akerlof's theory have been offered in support of the notion that informational asymmetries between buyers and sellers are often corrected by the market itself without the need for regulatory intervention. One corollary, attributable to Spence,<sup>38</sup> suggests that, in markets characterized by extreme informational asymmetries, sellers of high quality services have an incentive to voluntarily disseminate or "signal" their qualifications to potential buyers. By disseminating this information to buyers, sellers can differentiate their services from lower quality services and obtain a higher than average price.<sup>39</sup>

According to Spence, however, two conditions must be present in order for voluntary dissemination or signaling to occur in such markets: (1) there must be an endemic signaling mechanism available (i.e., a method by which sellers can have their assertions of quality certified to give them credibility); and (2) there must be an expectation by sellers that the benefits to be obtained by such signaling will exceed its costs. In the used car market analyzed by Akerlof, there is no endemic signaling

<sup>38</sup> Spence, Job Market Signaling, 87 Q.J. ECON. 355 (1973).

<sup>39</sup> This incentive is similar conceptually to that which motivates producers to advertise their goods in order to establish a "brand-name" advantage in the market.

mechanism and hence no signaling occurs.<sup>40</sup> In markets where such a mechanism does exist, however, signaling may automatically alleviate informational asymmetries between buyers and sellers.

In line with this signaling corollary, Moore<sup>41</sup> asserts that occupational certification can provide the same benefits as does occupational licensing, but without its potentially anticompetitive side-effects. This assertion suggests that occupational certification can facilitate signaling in markets for professional services by providing a mechanism by which sellers voluntarily signal (i.e., certify) their competency to potential buyers.

A second corollary to Akerlof's theory, attributable to Stigler,<sup>42</sup> suggests that buyers often have an incentive to search out and acquire information that will enable them to make more informed purchasing decisions. Therefore, the problem of informational asymmetries may be self-correcting in markets where information is not extremely asymmetric and costly. By acquiring information about the quality of the various services available in such markets, buyers can avoid the purchase of overpriced services and obtain a better value for their money.<sup>43</sup>

According to Stigler, however, two conditions must be present in order for buyer search to occur in such markets: (1) there must be an intermediary channel (i.e., a source such as a consumer information agency or information broker) through which buyers can acquire the information they desire; and (2) there must be an expectation by buyers that the benefits to be obtained from such information search will exceed its costs. Stigler posits that there are many markets where both these conditions exist and buyer search may automatically alleviate informational asymmetries between buyers and sellers.<sup>44</sup>

In extending this corollary, Schwartz and Wilde<sup>45</sup> suggest that the imposition of occupational licensing may actually hamper the emergence (or continued existence) of the intermediary channels needed for buyer search. This suggestion implies that occupational licensing may unduly interfere with the natural self-correcting tendencies of the market.

In addition to occupational licensing, occupational certification, and buyer search, other possible remedies to the problem of adverse selection include the imposition of two-part tariffs, and the adoption of random licensing rather than licensing based on quality.<sup>46</sup> Although economists often differ as to which remedy is most appropriate, current economic theory tends to focus on the question of how

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<sup>40</sup> SPENCE, MARKET SIGNALING 93-94 (1974), notes: "Verbal declarations [by sellers of used cars] are costless and therefore useless...Reliability reports from the owner's mechanic are untrustworthy... Guarantees do not work. The seller may move to Cleveland, leaving no forwarding address."

<sup>41</sup> Moore, *supra* note 35.

<sup>42</sup> Stigler, *The Economics of Information*, 69 J. POL. ECON. 213 (1961).

<sup>43</sup> Stigler's original concern was with price information search, not quality information search. See also, Wilde & Schwartz, *Equilibrium Comparison Shopping*, 46 REV. ECON. STUD. 543 (1979); Vailan, *A Model of Sales*, 70 AM. ECON. REV. 651 (1980). Only recently have models been proposed which encompass the fact that sellers choose both price and quality, and that information on these properties may be costly for consumers to obtain. See, e.g., Leland, *supra* note 3; Farrel, *A Model of Price and Quality Choice with Informed and Uninformed Buyers* (1980) (unpublished manuscript, Department of Economics, M.I.T.); and Chan & Leland, *Prices and Qualities in Markets with Costly Information* (1980) (unpublished manuscript, University of California, Berkeley).

<sup>44</sup> Stigler, *supra* note 42, at 220, explains: "As the market grows ... there will [often] appear a set of firms that specialize in collecting and selling information. They may take the form of trade journals or specialized brokers."

<sup>45</sup> Schwartz & Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 Penn. L. Rev. 630,631 (1979).

<sup>46</sup> For a discussion of these alternatives, see Leland, *supra* note 3.

informational asymmetries in markets for professional services can and should be alleviated. Under current economic theory, occupational licensing may be socially preferable only when the market itself is unable to avert adverse selection by means of seller signaling, buyer information search, or some similar nonregulatory remedy.<sup>47</sup>

### *Differences Between Traditional and Current Economic Theory*

Current economic theory differs from traditional theory in three important respects:

- (1) current theory focuses on how occupational licensing affects the price-quality equilibrium for professional services exchanged in the market, not solely on how it affects particular buyers or sellers;
- (2) current theory recognizes that the possibility of adverse selection is implicit in any market for professional services; and
- (3) current theory recognizes that occupational licensing is only one of several possible approaches to improving the flow of information to potential buyers in order to prevent adverse selection.

It is these differences which explain why traditional economic theory is incapable of providing an appropriate assessment of the actual efficiency of occupational licensing.<sup>48</sup>

### **THE PROFESSIONALISM DEFENSE: COMPATIBILITY WITH CURRENT ECONOMIC THEORY**

As discussed, occupational licensing schemes generally are immune from the Sherman Act only when they fall within the professionalism defense. Further, the professionalism defense applies only to schemes which: (1) regulate an occupation which qualifies as a "profession;" (2) regulate the "quality," not the "price," of services offered for sale; and (3) satisfy the "Rule of Reason, ". As these criteria are currently formulated and applied, however, they may be incompatible with current economic theory.

To determine the actual efficiency of these criteria it is hypothesized that the professionalism defense, as it is currently formulated and applied by the courts, is incompatible with current economic theory. To the extent that this hypothesis holds, it is possible to infer that the doctrine is not as economically efficient as it was once perceived to be. The validity of this hypothesis is evaluated on a criterion-by-criterion basis.

### *Compatibility of the "Profession" Criterion*

The professionalism defense is applicable only to schemes that regulate occupations which qualify as "professions." The courts have suggested that professions may be dealt with somewhat differently under the Sherman Act because of the unique nature of their services.<sup>49</sup> In distinguishing professions from other occupations, the courts emphasize three properties of the former:

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<sup>47</sup> 47 As suggested by Schwartz & Wilde, *supra* note 45, at 630: "A decision to intervene [in the market]... cannot be sustained by showing that an appreciable number of customers are informed; rather the normative question should be whether the existence of imperfect information has produced noncompetitive prices and terms."

<sup>48</sup> See Leland, *supra* note 3, at 1329.

<sup>49</sup> *Goldfarb v. Virginia State Bar*, 421 U.S. at 786-787, for example, states: "It would be unrealistic to view the practice of professions as interchangeable with other business activities, and automatically apply to the professions antitrust concepts which originated in other areas. The public interest aspect, and other features of

- (1) the employment of intellectual and technical knowledge and skills that have been obtained by a substantial investment in education and training;<sup>50</sup>
- (2) the special (i.e., not purely commercial) nature of the relationship between buyers and sellers of such services;<sup>51</sup> and
- (3) the threat to the public posed by incompetent practitioners.<sup>52</sup>

This formulation and application of the "profession" criterion appears to be incompatible with current economic theory in at least two respects: (1) it focuses on such factors as the level of education and training of practitioners, not on the ability of potential purchasers to distinguish quality differences between sellers; and (2) it appears to assume that potential purchasers are incapable of simply avoiding the purchase of services from incompetent practitioners even when they are adequately informed as to differences in the quality of the various services offered for sale. As a result, this criterion appears to be far less efficient when viewed from the perspective of current economic theory.

### *Compatibility of the "Quality Regulation" Criterion*

The professionalism defense is applicable only to schemes that regulate the quality, not the price, of services offered for sale. The courts have adopted the conclusive presumption that price regulation inevitably exerts a net anticompetitive effect on markets for professional services, and should, therefore, not be granted immunity from the Sherman Act.<sup>53</sup> In distinguishing price regulation from quality regulation schemes, the courts emphasize that any restraint on the purely commercial aspects of offering professional services for sale (e.g., the establishment of fee schedules) cannot be justified under the "Rule of Reason" and is therefore illegal.

This formulation and application of the "quality regulation" criterion appears to be compatible with current economic theory for at least two reasons: (1) regulating price, rather than quality, cannot be justified as a means of preventing adverse selection in markets for professional services; and (2) price regulation may actually contribute to the problem of adverse selection by helping to price high quality services out of the market. As a result, this criterion appears to be efficient even when viewed from the perspective of current economic theory.

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the professions may require that a particular practice, which could properly be viewed as a violation of the Sherman Act in another context, be treated differently."

<sup>50</sup> See, e.g., *American Med. Ass'n v. United States*, 317 U.S. 519 (1948).

<sup>51</sup> See, e.g., *United States v. Oregon Med. Soc'y*, 343 U.S. 326 (1952).

<sup>52</sup> See, e.g., *Sender v. Oregon State Bd. of Dental Examiners*, 294 U.S. 608 (1934).

<sup>53</sup> *National Soc'y of Prof. Eng'rs v. United States*, 435 U.S. at 691-92, for example, states: "The true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition." There are, thus, two complementary categories of antitrust analysis. In the first category are agreements whose nature and necessary effect are so plainly anticompetitive that no elaborate study of the industry is needed to establish their illegality—they are "illegal per se." In the second category are agreements whose competitive effect can only be evaluated by analyzing the facts peculiar to the business, the history of the restraint, and the reasons why it was imposed. In either event, the purpose of the analysis is to form a judgment about the competitive significance of the restraint; it is not to decide whether a policy favoring competition is in the public interest, or in the interests of the members of the industry. Subject to exceptions defined by statute, that policy decision has been made by Congress. Price is the "central nervous system of the economy," and an agreement that "interferes with the setting of price by free market forces" is illegal on its face.

### *Compatibility of the “Rule of Reason” Criterion*

Finally, the professionalism defense is applicable only to schemes which satisfy the “Rule of Reason. According to this criterion, only when an occupational licensing scheme exerts a net procompetitive effect on the price and quality of professional services offered for sale should it be granted immunity from the Sherman Act.<sup>54</sup> Although the Court provides no real guidance as to how this competitive effect is to be evaluated, it does emphasize that alternative institutional arrangements need not be considered in applying this criterion.

This formulation and application of the “Rule of Reason” criterion appears to be incompatible with current economic theory in at least two respects: (1) since it does not require this net competitive effect to be assessed in terms of its price-quality equilibrium effect on the market for professional services, there is a possibility that net competitiveness will be assessed only in terms of its impact on particular buyers and sellers; and (2) the appropriateness of occupational licensing is determined by evaluating the net competitive effect of only the scheme in question, without considering its relative merits vis-a-vis other available institutional alternatives.<sup>55</sup> As a result, this criterion appears to be far less efficient when viewed from the perspective of current economic theory.

### **How THE PROFESSIONALISM DEFENSE MIGHT BE MADE MORE COMPATIBLE WITH CURRENT ECONOMIC THEORY**

As discussed in the preceding section, the “profession” and “Rule of Reason” criteria appear to be incompatible with current economic theory and, therefore, their actual efficiency is far lower than their perceived efficiency. In this section we suggest how these criteria might be made more compatible with current economic theory.

### *Suggested Changes in the “Profession” Criterion*

The Court’s current approach to determining whether a particular occupation qualifies as a “profession” emphasizes the substantial investment in education and training required for practitioners, the special (i.e., not purely commercial) nature of the relationship between practitioners and those who purchase their services, and the threat posed to the public by incompetent practitioners. These properties, however, may not provide an appropriate basis for distinguishing services markets where occupational licensing is warranted and from those where it clearly is not. Since the objective of the Sherman Act is to prohibit restraints that impede the competitive exchange of goods and services in the

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<sup>54</sup> *National Soc’y of Prof. Eng’rs v. United States*, 435 U.S. at 688, for example, states: Congress, however, did not intend the text of the Sherman Act to delineate the full meaning of the statute or its application in concrete situations. The legislative history makes it perfectly clear that it expected the courts to give shape to the statute’s broad mandate by drawing on common law tradition. The Rule of Reason, with its origins in common law precedents long antedating the Sherman Act, has served that purpose. It has been used to give the Act both flexibility and definition, and its central principle of antitrust analysis has remained constant. Contrary to its name, the Rule does not open the field of antitrust inquiry to any argument in favor of a challenged restraint that may fall within the realm of reason. Instead, it focuses directly on the challenged restraint’s impact on competitive conditions.

<sup>55</sup> This need for comparative analysis in resolving questions of this nature has been suggested by Demsetz, *Information and Efficiency: Another Viewpoint*, 12 *J.L. & Econ.* 1 (1969).

market, occupational licensing may warrant immunity only in services markets where it provides an appropriate means of remedying some preexisting obstacle to competitive exchange.

In general, competitiveness (i.e., efficiency) in the exchange of services in the market is defined as the extent to which the marginal product (MP) of the services sold, an indicator of quality, corresponds to their sale price (P).<sup>56</sup> Consequently, the market price-quality equilibrium for a service can assume one of three states:

- (1)  $MP = P$ , "efficient exchange";
- (2)  $P > MP$ , a type of inefficiency referred to as "seller-dominated exchange"; or
- (3)  $MP > P$ , a type of inefficiency referred to as "exchange characterized by adverse selection."

Thus, the efficiency of occupational licensing (and, in turn, the professionalism defense) is a function of whether it causes P and MP to converge or diverge.<sup>57</sup>

Specifically, the efficiency of exchange in a services market is determined by the competitiveness of the contracts entered into between sellers and those who wish to purchase their services. In markets where the output or productivity of a seller, which are indicators of MP, can be readily assessed by the buyer (e.g., by counting the number of widgets produced), the most efficient way of compensating the seller is to pay a pre-established fee for each level of output (e.g., by paying a certain amount for each widget produced).<sup>58</sup> In markets where the seller's output or productivity cannot

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<sup>56</sup> The usual definition of efficiency of exchange in the services markets focuses on the marginal value of each additional employee's services to the firm. Under this definition, in a perfectly competitive labor market an employee (i.e., seller of services) would be paid an amount which is equal to the marginal value of his services to the firm. For many types of jobs, such as the assembly of widgets, the quality of the employee's services (i.e., the MP of his or her services to the firm) can be correlated to the price or wage to be paid by paying a certain amount per widget produced. In such a case, it can readily be seen that MP is an indicator of the quality of the services provided. While the assessment of the quality (i.e., MP) of a seller's services is more difficult in the provision of sophisticated services, such as brain surgery, this basic relationship between MP and P still holds. For further discussion see Becker, Investment in Human Capital: A Theoretical Analysis, 70 J. POL. ECON. 9 (1962).

<sup>57</sup> In "efficient exchange," the seller receives an amount for his services which is equal to a competitive market equivalent return on his investment (in human or other capital) plus the variable costs of providing the services. In "seller-dominated exchange," however, the seller receives an amount for his services which is greater than a competitive market equivalent return on investment plus the variable costs of providing the services. In such a case, the seller is able to extract "monopoly rents" from the market. In "exchange characterized by adverse selection," the seller of high quality services is unable to receive an amount sufficient to cover a competitive market equivalent return on his or her investment plus the variable costs of providing the services. In such a case, the seller must either accept less than the high quality services are worth, lower the quality of the services, or withdraw the services from the market. Consequently, the efficiency of occupational licensing (and, in turn, the professionalism defense) is a function of whether it moves P and MP closer to or further away from MP when the preexisting services markets are characterized by either "seller-dominated exchange" or "adverse selection." Similarly, if the preexisting services markets are characterized by "efficient exchange," the efficiency of occupational licensing (and, in turn, the professionalism defense) is a function of whether it disrupts this efficiency by causing P to diverge from MP.

<sup>58</sup> Since sellers of services (e.g., employees) seek to maximize their compensation while minimizing their effort, it is necessary to have some means of monitoring or observing the quality of performance in order to determine what the seller's services are worth (i.e., to assess the quality of the services provided). When quality can be assessed by simply monitoring output, such as on an assembly line, the most efficient type of compensation contract may be to pay the seller of services on a piecework or similar basis. For a general discussion of this important relationship

be directly assessed by the buyer, but the buyer can indirectly assess output or productivity by assessing the quality of the seller's effort (e.g., by observing the number of hours worked in situations where hours worked is a good surrogate for output or productivity), the most efficient way of compensating the seller is in terms of the quality of effort (e.g., by paying a certain amount per hour). In either of these types of markets it is "informationally possible" for buyers and sellers to negotiate competitive exchange contracts without the need for third party monitoring of the seller's performance. Therefore, occupational licensing can serve no legitimate purpose in such markets.

There is a third type of services market, such as the market for the services of a surgeon, where those contracting to purchase the services of the seller have no effective means of assessing the seller's output or productivity directly, or indirectly by assessing effort. In such markets it is infeasible to base the seller's fee or wage on either output or effort, therefore buyers must rely on some other means of monitoring performance. Occupational licensing is one possible means, although not necessarily the most appropriate, of fulfilling this need for monitoring. As a result, the "profession" criterion might be made more compatible with current economic theory by defining a profession as an occupation for which there may be a need for third party monitoring of practitioners' performance because it is "informationally impossible" for buyers and sellers to negotiate competitive exchange contracts on their own.

Application of this new "profession" criterion might require an empirical assessment of the degree to which the performance of members of a particular occupation can be effectively monitored by purchasers without third party monitoring. The degree to which such buyer assessment or observability of performance is possible is a function of both the nature of the services performed and the state of existing monitoring technology. Therefore, the ability of buyers and sellers to negotiate competitive exchange contracts without the need for third party monitoring of performance might be assessed on a case-by-case basis and change with technology.

### *Suggested Changes in the "Rule of Reason" Criterion*

The Court's current approach to determining whether an occupational licensing scheme satisfies the "Rule of Reason" focuses on whether a net procompetitive or anticompetitive effect is exerted on the market for professional services. This test may not, however, provide an adequate basis for justifying legality under the Sherman Act. Assessment of the net procompetitive or anticompetitive effect of only the particular scheme under scrutiny is tantamount to the sort of "nirvana" analysis criticized by Demsetz.<sup>59</sup> Demsetz argues that a "comparative institution," not a nirvana, approach ought to be employed in assessing the appropriateness of an institutional alternative, such as occupational

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between the ability to monitor or observe the seller's output (i.e., quality of services) and the most efficient compensation contract to use, see Harris and Raviv, Optimal Incentive Contracts with Imperfect Information, 20 J. ECON. THEORY 231 (1979); and Mirrlees, The Optimal Structure of Incentives and Authority Within an Organization, 7 BELL J. ECON. 105 (1976).

<sup>59</sup> Demsetz, *supra* note 55, at 1-2, explains this distinction as follows:

This nirvana approach differs considerably from a comparative institution approach in which the relevant choice is between alternative real institutional arrangements. In practice, those who adopt the nirvana viewpoint seek to discover discrepancies between the ideal and the real and if discrepancies are found, they deduce that the real is inefficient. Users of the comparative institution approach attempt to assess which alternative real institutional arrangement seems best able to cope with the economic problem; practitioners of this approach may use an ideal norm to provide standards from which divergencies are assessed for all practical alternatives of interest and select as efficient that alternative which seems most likely to minimize the divergence.

licensing, because it reduces the likelihood that the decision maker will commit one of several possible logical fallacies in arriving at a conclusion.<sup>60</sup>

Under a comparative institution version of the "Rule of Reason" criterion, occupational licensing would be legal under the Sherman Act only if: (1) it can be demonstrated that the market is unable to adequately alleviate informational asymmetries between buyers and sellers without outside intervention (e.g., by means of endemic seller signaling or buyer search processes); and (2) it can be demonstrated that occupational licensing is the most appropriate means of alleviating these informational asymmetries and restoring the competitiveness of the price-quality equilibrium in the market. Such a version of the "Rule of Reason" criterion could lead to more efficient judicial decision making because the net competitive effect of other types of market intervention (e.g., tax subsidies to encourage seller signaling or buyer search) would, by necessity, also be considered. -

Application of this new "Rule of Reason" criterion would require an analytical or empirical assessment of both the occupational licensing scheme at issue and its leading alternatives. In operationalizing such an approach, however, it is important to avoid: (1) comparison of the occupational licensing scheme with alternatives that have been introduced into the analysis only to be rejected (i.e., "strawmen"); and (2) adoption of an assessment criterion that predetermines the selection of the occupational licensing scheme.<sup>61</sup>

## CONCLUSION

This paper has examined the professionalism defense in terms of its compatibility with the current economic theory of occupational licensing. The analysis revealed that, when viewed from the perspective of current economic theory, the professionalism defense is not as efficient as it was once perceived to be. Therefore, as this doctrine is currently applied by the courts, it is possible that efficient occupational licensing schemes may be prohibited by the Sherman Act and inefficient schemes may be permitted.

We offered suggestions about how the professionalism defense might be made more compatible with current economic theory. We suggested versions of the "profession" and "Rule of Reason" criteria which could help insure that only schemes which are actually efficient would be permitted under the Sherman Act because: (1) courts would focus on how a particular scheme affects

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<sup>60</sup> The three logical fallacies which Demsetz warns against are; (1) "the grass is always greener" fallacy; (2) the "free lunch" fallacy; and (3) "the people could be different" fallacy. The first fallacy is committed when a seemingly attractive institutional alternative is proposed (e.g., government intervention) without a careful analysis of the consequences of introducing that alternative. The fallacy of the free lunch is committed when it is assumed that regulatory intervention or other nonmarket arrangements are costless to implement. According to Demsetz, the desirability of a particular institutional alternative is a function of its relative costs and benefits and the assumption that government regulation is costless tends to distort the analysis. Finally, the people-could-be-different fallacy is committed by assuming that people will not continue to act in their own self-interests if a perfectly equitable institutional environment can be derived. According to Demsetz, in the design of institutional arrangements it is necessary to begin by assuming that people will act in their own self-interests and, therefore, an effective institutional environment must provide incentives that make individuals' self-interests compatible with those of society.

<sup>61</sup> There are, of course, other manipulative practices that should also be avoided. For example, it is also necessary to prevent manipulation of the order in which each alternative is assessed so as not to bias the outcome. See Levine & Plott, *Agenda Influence and Its Implications*, 68 VA.L.REV.661 (1977); Levine & Plott, *A Model of Agenda Influence on Committee Decisions*, 68 AM. ECON. REV. 146 (1978)

the price-quality equilibrium in the market as a whole, not on how it affects particular buyers and sellers: and (2) the occupational licensing scheme under consideration would be viewed as only one of several possible means of alleviating informational barriers to the efficient exchange of professional services in the market.