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*The Market Failure Justification  
for the Regulation of  
Professional Service Markets  
and the Characteristics of Consumers*

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## The Market Failure Justification for the Regulation of Professional Service Markets and the Characteristics of Consumers

*Frank H Stephen*\*

### I. Introduction

The views of economists on the regulation of professional services (and indeed on regulation more generally) tend to divide between those based on a *public interest* perspective and those based on a *private interest* perspective. The public interest perspective is grounded on the concept of market failure whilst the private interest theory is grounded on the concept of regulatory capture. The market failure approach is, at least, implicit in much public policy towards professional regulation. This paper evaluates the market failure justification for regulation of professional markets on its own terms and also considers the empirical evidence on the effects of particular instruments used by regulatory bodies.

Although the term *market* failure features prominently in academic and policy discussions of professional regulation, the discussion usually quickly turns to the evaluation of particular instruments by which professional (self-) regulation is commonly exercised, with the focus very much on the profession<sup>1</sup>. There is usually no detailed discussion of actual markets or attention paid to the segmented nature of professional markets. The present paper adopts a different approach by emphasising that in any economy there are a number of markets in which members of a profession are the suppliers. One of the differentiating features of these markets is the nature of the 'consumer'. In many instances the consumer is not at the informational disadvantage implied by public interest perspective and consequently the case for regulation is reduced.

The next section outlines, briefly, the potential sources of market failure identified by economists in markets for professional services. This is followed by a brief review of the evidence on the impact of restrictions on competition in professional markets drawing on the empirical literature. The third section provides a discussion of the characteristics of consumers in such markets and the importance of these characteristics for determining whether there is market failure. The paper then concludes on the implications of the foregoing for the approach to the regulation of competition in professional service markets.

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<sup>1</sup> This is possibly explained, as Olsen (2002) implies, by the normative nature of the market failure approach and the positive nature of the capture theory. The empirical evidence is usually marshalled by those looking for evidence that regulation acts to the benefit of the profession and not the consumer.

## II. Market failure in professional service markets<sup>2</sup>

Economists who support the market failure justification generally begin from the premise that any economic activity should be free from regulation (or at least regulated only by the market) unless it can be shown that it is subject to *market failure*: left unregulated it will not generate socially efficient levels of output. The socially efficient level of output is usually taken to be that which maximises the sum of the net benefits of the activity to producers and consumers. Market failure arises when the sum of these net benefits is below the maximum attainable with the existing level of resources in the economy.

Market failure can arise from a number of sources which can be brought together under two main headings:

- (i) Structural Factors;
- (ii) Missing or Incomplete Markets.

The main structural factors leading to market failure are the existence of *market power* and *incomplete information*. ‘Missing’ and ‘incomplete markets’ are due to *externalities* or *public goods*. The types of market failure most often associated with professional service markets come under the heading of structural factors. However, it can be argued that there may be externalities from the provision of some professional services because they are of social value beyond that accruing to the professional and client. Due to an incomplete market the additional value is not taken into account by those directly involved in the market for the professional service.

The competitive process which generates efficiency requires that no single producer of a good or service (or group of co-ordinated producers) controls a sufficiently large share of that market that it can determine, by its own decision, the equilibrium combination of price and output for the market. The market power exerted by such a dominant producer (or group of producers) results in prices being higher and output lower than in a truly competitive market. A major function of competition policy in modern market economies is that of forestalling the creation of a market structure which generates market power (through mergers or collusion/restrictive practices) or where the potential already exists due to historic or technological reasons (e.g. economies of scale) restraining its exercise.

The second source of market failure for structural reasons is incomplete information. The competitive process will only generate an efficient outcome for a market if all actors in that market have full information as to market possibilities and alternatives. Producers require access to the same technology (and hence costs) while consumers need to have well ordered preferences over the alternatives. In particular, consumers must know what is available from different producers in the market and be in a position to make judgements about the nature of the goods or services provided including the price/quality trade-off. For some types of goods and services the latter condition is difficult to meet. Potential consumers do not have the technical or expert knowledge to make judgements about the quality of what is being offered to them or in some cases whether what they are being offered will satisfy their requirements. Indeed, in the extreme, a situation can exist where even after the service has been provided the consumer is unable to judge whether what was supplied was appropriate.

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<sup>2</sup> This section draws heavily on Stephen and Love (2002) and the literature cited therein.

The term *credence good* has been used to describe this situation<sup>3</sup>. Professional services are usually thought to fall into this category.

The consumer of a professional service needs the professional precisely because she/he does not have the specialist knowledge possessed by the professional. There is an information asymmetry between professional and client. This asymmetry can have two consequences: adverse selection and moral hazard.

Adverse selection affects the client's choice of professional. If clients are unable to distinguish between high quality and low quality providers before engaging one, the price they are willing to pay for the services will be lower than that which they would be willing to pay to a high quality provider if they could identify one. If the cost of providing the high quality service is greater than for low quality service, the price consumers will be willing to pay may be insufficient to keep high quality providers in the market. Consequently, high quality providers will exit the market reducing the average quality of suppliers in the market. This will lead to consumers revising downwards the price they are willing to pay, possibly generating a race to the bottom or a 'lemons market'<sup>4</sup>. The typical solution to this problem in professional markets has been, historically, to regulate entry to professional markets by some form of certification or licensing. In most European and North American jurisdictions this has taken the form of giving monopoly rights over some professional services to those who are members of a professional body requiring an educational qualification and a period of professional training<sup>5</sup>. The professional body reduces the adverse selection problem by setting and policing a minimum quality standard. However, the professional body may set the minimum quality standard above the socially desirable level<sup>6</sup>.

Moral hazard arises after a client has selected a supplier. As discussed above, the client is not in a position to judge whether the service being provided by the professional is necessary or adequate. Indeed, most professional services involve two separate functions<sup>7</sup>. First, there is the diagnosis of the problem and the identification of the services necessary to deal with it. Secondly, there is the supply of these services. In some fields these are separate activities e.g. architects are employed to design buildings to satisfy a client's specified needs but they do not provide construction services. On the other hand, when a party to a dispute consults a lawyer, the latter will usually diagnose the legal problem, suggest a remedy and implement it. In such circumstances, a lawyer motivated solely in terms of financial gain may be tempted to suggest an expensive remedy in the knowledge that he/she will receive a higher fee for providing that remedy. By definition the client is not in a position to judge whether that remedy is the only one possible or even if it is likely to be successful. In the economic literature on the professions this is often described as giving rise to 'supplier-induced demand'.

In these circumstances a market for professional services is likely to generate a level of professional services which is above the optimal (or efficient) level and thus there will be market failure. This suggests that such markets for professional services

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<sup>3</sup> This term is due to Darby and Karni (1973). Credence goods may be contrasted with *search goods* and *experience goods* (Nelson, 1970). Search goods are such that their quality can be ascertained prior to consumption, whereas experience goods need to be consumed before their quality can be ascertained.

<sup>4</sup> Akerlof (1970).

<sup>5</sup> It should be noted, however, that in Finland there are no restrictions on who can provide legal advice and representation in the courts.

<sup>6</sup> Leland (1979).

<sup>7</sup> The discussion which follows is based on Quinn(1982).

require regulation to ensure that suppliers do not exploit their informational advantage. However, it can be argued that this is too sweeping a conclusion. Not all clients of professionals are necessarily at an informational disadvantage. This issue is discussed further in the next section but one.

### III. Restrictions on competition in professional service markets<sup>8</sup>

Commentators have identified a number of instruments typically used by self-regulators of the professions that may work against the public interest:

- (i) restrictions on entry;
- (ii) restrictions on advertising and other means of promoting a competitive process within the profession;
- (iii) restrictions on fee competition; and
- (iv) restrictions on organisational form.

A detailed discussion of regulatory restrictions for a number of professions in EU member states is provided by Paterson, Fink and Ogus (2003).

Restrictions on entry to professional markets usually have two components: the granting of monopoly rights in a particular market to a 'profession' and the regulation of entry to that 'profession' according to educational, training or numerical criteria. Economists' empirical studies of the effects of mobility restrictions for the legal profession are largely restricted to the U.S.A. They find, for example, that lack of reciprocity between state bar associations leads to lower numbers of practising lawyers and higher lawyer incomes. However, Lueck, Olsen and Ransom (1995) in a thorough empirical study find little support for the view that licensing restrictions affect the price of legal services. Their evidence suggests that it is what they describe as 'market forces' which are most important. Olsen (2002) in a review of the empirical literature on licensure in medical professions<sup>9</sup> concludes that the evidence is mixed and varies across both time and the professions covered. Button and Fleming (1992) studied the licensing of architects in the UK but found no conclusive evidence of an impact on incomes.

Love and Stephen (1996) review an extensive empirical literature which has developed on the restriction of advertising of professional services and what happens to fee levels when such restrictions are relaxed. The general thrust of the evidence from this literature is that restrictions on advertising increase the fees charged for the profession's services and that the more advertising there is the lower are fees. There are, however, a number of limitations to these studies.

The early empirical studies of advertising by members of the legal profession found that law firms which advertise, on the whole, charge lower fees than those that do not advertise. More recent studies find the stronger result that the more advertising by lawyers there is in a locality the lower are the fees charge by *all* lawyers in the locality (at least for certain transactions)<sup>10</sup>. However, UK studies<sup>11</sup> have found that this result is only valid for some forms of lawyer advertising. Most studies do not distinguish between different forms of advertising.

<sup>8</sup> This section draws on part 7 of Stephen and Love (2002)

<sup>9</sup> Focussing on the USA.

<sup>10</sup> For example Schroeter, Smith and Cox (1987)

<sup>11</sup> Love *et al.* (1992) for England & Wales and Stephen (1994) for Scotland.

Critics of professional advertising frequently assert that advertising will drive down the quality of services provided. Economists have examined the relationship between advertising and quality. It has been shown formally that even if price can communicate no information directly about quality, it can do so indirectly because price serves as a positive signal of quality *when price advertising is allowed*. Price advertising is therefore welfare enhancing because it improves consumer choice. A problem arises, however, if price advertising is undertaken exclusively, or at least principally, by low-price/low-quality suppliers. In these circumstances price advertising becomes an adverse signal on quality. This is a general argument, and does not depend on price being a clear signal on quality. It is reasoned that consumers who are unable to assess quality *ex ante* (and possibly even *ex post*) and who observe a low price for a non-standardised service may assume that more knowledgeable purchasers have assessed the service as being of low quality. Professionals are keen to avoid such adverse signals on quality, and so it is concluded that price advertising will be uncommon in most professions<sup>12</sup>. Thus not only may advertising have an effect on quality, perceptions of quality may have an effect on the form of advertising chosen by professionals. Evidence from the USA and UK on low rates of price advertising supports this view.

The third weapon in the armoury of the self-regulating profession is the regulation of fees. Traditionally fees have been subject to control by the profession itself, by the courts or by the state through mandatory fee schedules. In some jurisdictions these mandatory scales have been transformed into recommendations. Some self-regulatory bodies, however, have retained powers to punish those who charge 'excessively' low fees for bringing the profession into disrepute. Observers of professional self-regulation are highly critical of scale fees even when they are recommended rather than mandatory.<sup>13</sup> It is argued that this is tantamount to cartel-like price fixing. However, economists are generally sceptical about the ability of cartels to avoid their members selling output at prices below those agreed by the cartel. One of the few studies of the impact of recommended scale fees<sup>14</sup> provides evidence from two jurisdictions of professionals not seeing recommended fees as being mandatory. Whilst the data rejects a 'national cartel' in both jurisdictions it is consistent in one jurisdiction with, at least, two other explanations: (1) local market competition; (2) local cartels. The study was unable to differentiate between these explanations.

Restrictions on organisational form and in particular Multi-disciplinary practice remain for a number of professions. However, there is little empirical evidence in the economics literature of their impact.

The study by Paterson, Fink and Ogus (2002) has not only extended our knowledge of the details of entry and conduct restrictions in EU professional service markets but has offered a tentative cross-country analysis. This suggests, subject to the limitations of the data, that performance is negatively correlated with the extent of regulation across professions and countries.

Overall close scrutiny of the empirical evidence in the economics literature, however, does not always support the strong rhetoric of the private interest theorists. The question to be answered is whether the typical instruments of regulation used by the professions are likely to be appropriate in dealing with the asymmetry of information between infrequent consumers of professional services and the professionals.

<sup>12</sup> This argument is due to Rizzo and Zeckhauser (1992).

<sup>13</sup> MMC (1970), LECG (2001), 63 – 65.

<sup>14</sup> This is reported in Shinnick and Stephen (2000).

#### IV. Professionals' clients and information asymmetry

Clients who are repeat purchasers of a particular professional service will gain experience of a professional's diagnostic efficiency. Such repeat purchasers may also be able to use different professionals at different times and compare their relative efficiency leading to the choice of the most efficient supplier over time<sup>15</sup>. Alternatively, the frequent purchaser may be in a position to generate competition between purchasers resulting in a more efficient specification of service and price. If frequency of demand by the purchaser is sufficiently high, direct employment of a professional may also be an option. Such repeat purchasers are likely to be large commercial organisations or public bodies. This suggests that there may be less need to regulate the supply of legal services to such organisations. The market can be relied on to generate the efficient level of service and cost.

On the other hand, individuals and households require some professional services less frequently. For them purchasing a house, writing a will, disputing a contract commissioning an architect or engaging an accountant are relatively infrequent occurrences. Individual expertise and experience cannot be built up. These are the clients who suffer from an informational disadvantage with respect to the professional. Thus there is a *prima facie* case for regulation of the market for such professional services. However, the fact that individual clients lack expertise and information on quality does not mean that the market will inevitably fail. What if such information can be transferred between clients? If such experience can be easily transferred between purchasers, reputation will play a role in disciplining suppliers. In particular, if repeat purchasers can easily transfer their experience to inexperienced clients (by acting on their behalf in the selection of the professional or via a list of approved professionals) information asymmetry may be overcome<sup>16</sup>.

The foregoing suggests that there is the potential for oversupply in the professional service markets for those categories of service sought by infrequent purchasers (usually individuals) where the mechanism of reputation or the use of experienced agents do not operate. In such cases an unregulated market cannot be relied upon to generate efficient levels of output and prices.

At least two questions remain, however. Does the need for regulation of markets with infrequent purchasers justify regulation being extended to markets where purchasers are experienced? Does the justification for regulation in these areas extend to the regulatory instruments actually used by self-regulating professions?

Answering the first question requires focussing attention on the nature of the market rather than the profession. Is it reasonable to talk of market failure in the *market for legal services*, for example, given the range of different legal services that exist? Should concern not be with whether or not there is market failure in the market for a particular legal service? When someone purchases a croft<sup>17</sup> in the Western Isles of Scotland is he in the same market for legal services as, say, the Royal Bank of Scotland<sup>18</sup> seeking to sue its supplier of computers for breach of contract? The purchaser of the croft is likely to be an infrequent user of conveyance services and uses a 'high street' firm of solicitors whilst Royal Bank of Scotland is an international

<sup>15</sup> In such circumstances the professional service may be thought of as an *experience good* rather than a *credence good*.

<sup>16</sup> This is done through legal and health expenses insurers and through organisations such as trades unions.

<sup>17</sup> A small piece of arable land together with dwelling house.

<sup>18</sup> The Royal Bank of Scotland has a capital value of £41bn.

financial institution which is a frequent user of multifarious legal services. The solicitors competing for these two types of business will never be competing against each other in the same market. The two clients are unlikely to be competing for the services of the same law firms. In other words the 'market for legal services' is likely to be segmented into a series of different markets with different potential consumers and suppliers. Market failure due to information asymmetry is only likely to arise in those markets where consumers are infrequent purchasers.

It appears that this issue is infrequently addressed in studies of professional regulation<sup>19</sup>. Consequently it is difficult to judge how significant a problem it is. The report by LECG for the UK's Office of Fair Trading (OFT, 2001) discusses the issue but does not appear to take account of it in discussing individual professions – yet it indicates that the single largest source of income for solicitors is business and commercial work (para. 130). In fact the Law Society (2002) reports that in a sample of 585 solicitors firms 37% of gross fee income in 2001 was from private individuals and 42% from private sector and public sector organisation. Indeed for the solicitors firms in the largest size category (by number of partners) these figures were 21% and 57% respectively. On the other hand, 72% of the business of sole practitioner firms was for private clients. Private clients accounted for 81% of the business of firms with 2 to 5 partners.

The study carried out by INDECON for the Competition Authority in Ireland (INDECON, 2003) goes further than most such studies in looking at the importance of business versus personal clients. It also investigates the frequency of use of the professions by the different types of clients. It is reported that the mean percentage of fee income from business clients for solicitors is 33%, although it is not reported whether this is a weighted or arithmetic mean. The published data does not show the data for different sizes of solicitors' firms. In the case of barristers just under half of the fee income is derived from business clients, for professional engineers the figure is 79% (with median of 90%) and for architects it is 66.7% with a median of 75%.

The INDECON report also has information on frequency of use of professional services. For personal clients this is based on a random sample of members of the public. Business clients are represented through a survey of insurance companies. In the case of solicitors 51% of the personal sample had not used one in the previous five years<sup>20</sup> and a further 33% not more than 5 times over that period, whereas for insurance companies the corresponding figures were 7.7% and zero. 69.2% of insurance companies had used solicitors more than twenty times in the previous year. In the case of barristers 98% of the personal sample had used a barrister less than five times in the previous five years, whilst 54% of the insurance companies had used a barrister more than 20 times per year.

Other professional services such as the medical professions are likely to be dominated by personal consumers. For them the information asymmetry problem remains. Nevertheless, the figures for Ireland indicate that the consumers of some types of professional services are predominately businesses or other organisations which are repeat purchasers and are unlikely to suffer from an informational disadvantage vis-à-vis producers. This suggests that public policy towards markets for professional services should become more differentiated than in the past, differentiated by profession and by consumer type within each market.

<sup>19</sup> It does not appear to be addressed, even from a theoretical perspective, in Paterson, Fink and Ogus (2003)

<sup>20</sup> This contrast with a Law Society survey of the public in England & Wales published in 1989 which reported that only 32% of the adult population had consulted a solicitor in the previous 3 years.

A more differentiated policy based on specific characteristics of markets is not without precedent. Both in public policy and academic discourse there has been a shift over the last twenty or so years in the attitude to public utility industries. Prior to that there had been a tendency to see such industries as natural monopolies prone to market failure. Consequently, the industry was regulated or in many cases taken into public ownership. What has changed in the last twenty years (particularly in the UK) is a clearer focus on the sectors of these industries that are the natural monopolies: the network component. The potential market failure in the electricity industry due to natural monopoly is not in electricity generation, nor is it in the supply to the final consumer but it is the transmission and distribution systems. It is the pricing of access to this system for generators and suppliers that needs to be regulated not electricity generation or supply to final consumers. A more differentiated system of regulation has developed as a consequence. In this section of the present paper it has been argued that an analogous differentiated approach needs to be taken with respect to professional services.

## V. Conclusions

In markets where consumers are infrequent purchasers the focus should be on improving the information available to consumers to permit them as informed a choice as possible. The least cost way of doing this is likely to be informative advertising on the part of suppliers. Whilst this should not preclude price advertising, research evidence suggests that in many cases the incidence of price advertising will be low. A role can also be played by third parties with wider knowledge and experience of the professional service concerned in providing information that would be of assistance to infrequent consumers<sup>21</sup>. There is no case on consumer interest grounds for banning or restricting truthful advertising by professionals. Similarly there are no general grounds for restricting price competition within professional markets. Restrictions on price competition reduce the incentive for market entry or innovation in the provision of services which are likely to be of benefit to the consumer. These arguments point to a minimalist approach to conduct regulation which might be best enforced by requiring the professional body to justify other conduct regulation in the context of a *particular* market and on the basis of compensating for asymmetric information in the least harmful way.

Entry regulation is a somewhat more complex matter. In many professional service markets there is a case for certification based on education and some degree of practical training resulting in an identifiable level of competence, particularly where the market failure is the result of an externality e.g. certain medical professions, auditing, representation in court. This process should be protected from any control on numbers entering the profession designed to protect the economic interests of existing members.

The foregoing discussion suggests the professions should be subject to general competition law, rather than exempt from it. This would place the onus on professional bodies to justify any restrictions on competition in a particular professional service market.

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<sup>21</sup> For example, solicitors in the UK who receive public funding through legal aid bodies are subject to competency and review procedures which go beyond the professional body's requirements. Failure to meet these requirements results in the removal from the list of solicitors competent to receive such public funds. Such information may be of benefit to clients who pay for such services themselves. Similar benefits may arise from the production of approved solicitors by mortgage lenders etc.

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