

Remarks on

PRIVATE REGULATION OF TRADE

by

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Thank you.

It is a great pleasure for me to join you today at this symposium on trade association law and practice. Probably everyone here is already knowledgeable about trade associations. Some of you may be employed by a trade association, many of you represent trade associations, and most of you, at the very least, belong to a trade association. Indeed, this event is sponsored by a local trade association to which many of us belong.

By the end of the day, at least one of the speakers from the morning or afternoon session surely will have discussed every major issue in trade association law and practice and the total amount of trade association expertise in the room will no doubt be at an all-time high. Fortunately, this relieves me of any need to attempt to teach this knowledgeable and distinguished crowd anything about trade association law.

What I would like to do instead is to explore for a few minutes some general concerns about regulation of trade -- not regulation by the government but self-regulation by private groups. As you no doubt expect, I will give my own perspective on this and I do not -- indeed cannot -- speak for the Commission or either of the other two sitting commissioners.

My thinking on private regulation of trade really began with the Adam Smith necktie. You all know who Adam Smith is. Unless you have been practicing family law in some place far outside the beltway for the last five years, you also undoubtedly know that the Adam Smith necktie has become a badge of membership in a guild of free market enthusiasts, some might even say zealots, many of whom occupy high positions in government today. Indeed, use of the Adam Smith tie has become so widespread among government officials that members of the private bar have been heard to grumble that they long for the days when you could walk into a government office and see a tie with plain old stripes instead of the profile of an eighteenth century Scottish economist.

I have been giving some serious thought to Adam Smith recently. Over the last few months, several people have approached me to suggest that because I am a member of an agency that promotes the free market, I too should wear an Adam Smith tie or, at least, an "appropriate" variation thereof. But so far, I have refused to decorate my wardrobe with the visage or the profile of Adam Smith. This is not because the tie is just not my style, although it is not. Nor is it because I am not terribly mindful of membership paraphernalia, although I am not. Nor is it because I disavow the work of Adam Smith. I do not.

The reason I have decided not to wear the tie is that I think it would be presumptuous to do so without first having read Smith's seminal work, The Wealth of Nations. It would be rather like Monday morning quarterbacking without watching Sunday's game. In addition, for all the people who revere Adam Smith, at least as many revile him. So I have also been reluctant to wear the tie, because I don't want to leave myself open to vicious attacks from anti-Smithites without having the requisite knowledge to defend myself. I decided not to adopt this trendy fashion. But I did decide to become better acquainted with the economic thought of Adam Smith.

I don't know how many of you have read The Wealth of Nations, but I've done an informal survey and have found that for someone whose image is so prominently displayed around the necks of official Washington, Adam Smith is surprisingly little read. If you haven't read The Wealth of Nations, I can tell you that it is 900 pages long, exclusive of an appendix and two indices. The good news is that it is highly readable.

It is interesting that despite the fact that Smith is read infrequently, his work nevertheless elicits strong and varied opinions. Many people vilify Adam Smith, because, as one scholar noted, Smith elevated the longings of the mercantile and industrial classes to the dignity of natural law. With Adam Smith, the practical maxims of business enterprise achieved the status of a theology. 1/ Or, as another scholar put it, Adam Smith gave a new sanctification to predatory impulses and a new dignity to greed. 2/

The Wealth of Nations, however, reveals that Smith had a genuine concern for the common man. Let me read a brief passage from Max Lerner's introduction to the 1937 Modern Library Edition of The Wealth of Nations:

His [Adam Smith's] own personal sympathies were not entirely with the capitalist. * * * [T]here runs through The Wealth of Nations a strain of partisanship for apprentices and laborers, for farmers, for the lowly and oppressed everywhere, and a hostility to the business corporations, the big-businessmen of the day, the ecclesiasts and the aristocrats. 3/

1/ H. Laski, Rise in Liberalism.

2/ Smith, The Wealth of Nations, Introduction by Max Lerner, p. viii (New York, Modern Library 1937).

3/ Id.

Although his books may not be best sellers, Smith's basic principles are well known. First, Smith assumes that the prime psychological drive in man as an economic being is self-interest. Next, he assumes the existence of a natural order in the universe -- the often cited invisible hand -- that makes all the individual strivings for self-interest add up to the social good. Finally, from these postulates, he concludes that the best program is for the government to leave the economic process severely alone.

Since Adam Smith published The Wealth of Nations in 1776, the attitude of society toward government intervention in the market has varied. For a time, an emphasis was placed on the need for government remedies for what economists call "market failures" -- circumstances in which Smith's invisible hand apparently does not work or, as the economists say, does not maximize social welfare.

In recent years, the pendulum has swung back toward the views of Adam Smith. Economists today are less likely to assume that government regulation is an improvement upon the unregulated marketplace. Experience has shown that government regulators -- unfortunately -- are not always the omniscient philosopher kings that we might want them to be. There is no guarantee that they will solve market problems better than private individuals and firms responding to marketplace incentives.

As the limitations of government regulation become better known, our appreciation for the performance of the marketplace is simultaneously rising. We now have a better understanding of just how powerful Adam Smith's invisible hand is. Entrepreneurs can be remarkably creative in devising solutions to problems of the marketplace. Indeed, market failures do not appear to be as common as they were once thought to be.

In a modern economy, individual participants in a market acting independently will be incapable of resolving numerous market deficiencies or problems. Often collective action by market participants, even some form of cooperative self-regulation, may be the only feasible means to satisfy certain needs or to solve certain problems. Now -- you may well ask -- why would someone involved in enforcing the antitrust laws make a statement like that? I will spend the remainder of my time attempting to explain and to qualify that remark.

Why should private self-regulation ever be preferred to government regulation? Former FTC Chairman Miller has pointed out several reasons. 4/ One reason is that the private sector

4/ Miller, "The FTC and Voluntary Standards: Maximizing the Net Benefits of Self-Regulation," 4 Cato Journal 897 (1985).

frequently has greater expertise than government agencies have or can develop. This is true, for example, in the case of self-regulation by the professions and in the establishment of product standards.

Another reason is that private regulators have a greater incentive to produce efficient regulations. Unlike government regulations, private regulations are subject to the test of the marketplace. If several firms band together and establish an inefficient standard for a particular product, they would likely face competition from other firms who would refuse to adhere to the standard and would perhaps establish a standard of their own. It is in the firms' own interest to choose efficient standards and to replace or discard them as they become obsolete. Regulations imposed by the government face no such test, and an inefficient government regulation is likely to remain in effect longer than an inefficient private one.

Private regulations can sometimes result in a higher degree of voluntary compliance than those imposed by the government. Standards or ethical codes developed and administered by one's professional peers based upon years of experience may simply command greater respect. Finally, one of the desirable aspects of private regulation is that the cost of the regulation is borne by the industry, rather than by the taxpayers at large. In these days of Gramm-Rudman-Hollings, this is no mean consideration.

I do not intend, of course, to suggest in any way that the only reason private individuals and firms might engage in collective action is to promote efficiency. Even Adam Smith did not hold such a sanguine view of enlightened self-interest. A famous passage from The Wealth of Nations highlights his view of the danger when people of the same trade associate with one another:

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. ^{5/}

The tendency for competitors to attempt to restrict output and raise prices is as real today as it was in Adam Smith's time. The need for government to detect and prosecute members of the private sector who attempt to regulate trade with the purpose or effect of stifling competition is as great as ever.

^{5/} Smith, The Wealth of Nations (New York: Modern Library, 1937) p. 128.

Trade associations perform a number of functions useful to their members and to society generally. The government encourages or has no quarrel with many of these functions, but not all. I would like to talk for a moment about three general categories of trade association activity: first, general information-providing activities; second, the regulation of advertising and other promotional activities by their members; and, third, standard-setting and certification.

Most of the general informational activities of trade associations pose little risk to competition. The importance of information in making markets work effectively is elementary. The economists' model of "perfect competition" assumes that consumers have access to all relevant information about the products and services they purchase. Among the useful informational functions associations perform is providing information to the public through advertising -- such as dental associations' advertising campaigns to promote toothbrushing and regular checkups -- and through other informational services such as the local bar's lawyer referral service.

Associations also provide information by arranging educational functions, such as this gathering today, and publishing newsletters, periodicals and various statistics about particular markets. You are all familiar, of course, with the legal pitfalls associated with the exchange of certain types of information, and I will not delve into that area this afternoon.

Associations can and often do play an important role in the formulation of legislation, regulations or other government policy by providing information to government decision-makers. The Commission has two related interests in this kind of association activity, interests that are of course tempered with a healthy respect for the First Amendment. ^{6/} First, because government regulation may result in anticompetitive restraints, such as limitations on entry, the Commission has taken an active role in analyzing the competitive effects of proposed government actions and submitting comments to federal, state and local legislative and regulatory bodies. In addition, the Commission scrutinizes conduct that may constitute abuse of the legal process by private interests for anticompetitive ends.

^{6/} In 1984, the Commission sponsored a conference on the role of private interests in the regulatory process. R. Rogowsky and B. Yandle, eds., The Political Economy of Regulation: Private Interests in the Regulatory Process (forthcoming).

Although a few of these various information providing activities involve potential risks to competition, they are not regulatory activities. The second general category of trade association activity I would like to mention is regulatory -- the regulation of advertising and other self-promotional efforts. Some associations regulate the nature and content of advertising by association members. In this area, we see both the potential for beneficial results and some serious hazards for competition.

To be successful, advertisers must be believed by consumers. Not surprisingly, firms have developed various forms of self-regulation designed to increase public confidence in advertising. One of the most successful industry self-regulation programs is the advertising review program of the National Advertising Division.

The National Advertising Division of the Council of Better Business Bureaus, commonly known as the NAD, monitors national television, radio and print advertising on a routine basis. When an ad is suspected of being deceptive or untrue or when a complaint about an ad is received from consumers or competitors, the NAD works with the advertiser to determine the facts and, where necessary, to secure modifications or permanent discontinuance of the advertising. The National Advertising Review Board serves as the court of appeals when the NAD and an advertiser cannot agree or when an advertiser will not accept an NAD decision. When this occurs, a five-member NARB panel will adjudicate the case. Each month, NAD releases a report describing the advertising it has investigated and the resolution of those investigations.

The NAD and state and local better business bureaus review an enormous volume of advertising each year. These voluntary mechanisms can accomplish quick and efficient correction of questionable ads without the complicated and time consuming legal maneuvering that may often accompany government intervention. While the role of the NAD and the BBB in monitoring advertising is laudable, other forms of self-regulation of advertising can have anticompetitive consequences. For example, efforts by some groups of professionals to restrict truthful advertising by their members can raise serious legal questions.

The Commission has been actively involved in promoting the availability of truthful information about professional services. Studies of the markets for professional services have shown a positive relationship between advertising and lower

prices. ^{7/} These studies have found no relationship between quality of care and the presence or absence of restrictions on truthful advertising. To the extent that truthful advertising is associated with lower prices and no adverse effects on quality, restrictions on truthful advertising by professionals are very difficult to justify.

A third general category of trade association activity is standard-setting and certification both for products and for people offering services. Product standards are specifications governing material, production, design, installation, safety or performance characteristics. Product certification involves testing and reporting whether a product meets the criteria of a given standard. Standards are also set for professional services usually in the form of licensing and certification requirements. Again, collective activity in each of these areas provides examples of the benefits as well as the possible pitfalls of self-regulation.

Private standard-setting provides tremendous benefits for our economy. Because of this, you may wonder why it is that antitrust enforcement officials seem preoccupied with possible adverse effects on competition attributable to setting standards. Indeed, collective activity among competitors can result in standards that inhibit innovation, unreasonably restrict entry and mislead consumers.

On the other hand, when you consider that we have in this country some 700 private standards-setting organizations that have promulgated about 32,000 standards, ^{8/} the relative paucity of antitrust problems in this area is impressive. Standards exist for products as simple as school paste and paints and for those as complex as computers and X-ray equipment. There are standards for light bulbs, automatic looms and viscometers -- and the list goes on.

^{7/} See, e.g., Bureaus of Consumer Protection and Economics, Federal Trade Commission, A Comparative Analysis of Cosmetic Contact Lens Fitting by Ophthalmologists, Optometrists, and Opticians (1983); Bureau of Economics and Cleveland Regional Office, Federal Trade Commission, Improving Consumer Access to Legal Services: The Case For Removing Restrictions on Truthful Advertising (1984); Muris & McChesney, Advertising and the Price and Quality of Legal Services: The Case for Legal Clinics, 1979 Am. B. Found. Research J. 179; Benham & Benham, Regulating through the Professions: A Perspective on Information Control, 18 J. Law & Econ. 421 (1975); Benham, The Effect of Advertising on the Price of Eyeglasses, J. Law & Econ. 337 (1972).

^{8/} R. Toth, Standards Activities of Organizations in the U.S., National Bureau of Standards (August 1984).

The benefits of private standards are significant. Our health and safety are protected by standards for such products as power tools, playground equipment and electric blankets. Standards and certification organizations can facilitate the introduction of new products and technologies, such as microwave ovens, because consumers are more inclined to buy a product that has been approved by a certification organization they trust.

Standards provide a shorthand means of communicating complicated product information from the manufacturer to the consumer. This has the virtue of reducing what economists call "search costs" and "transaction costs." Try to describe the exact dimensions and electrical output of an AA battery to a store clerk, and you will see what I mean.

Similarly, product certification is an easy way to describe product quality. This was true even in Adam Smith's day. Smith thought that certification was a better guarantee of quality than a minimum apprenticeship would be. He wrote, "[t]he sterling mark upon plate, and the stamps upon linen and woollen cloth, give the purchaser much greater security than any statute of apprenticeship." 9/

Finally, standardization lowers costs and maximizes consumer choice by making it possible for products made by different manufacturers to be used together. This allows us to "mix and match" different brands of stereo components, for example, to accommodate our personal tastes and budgets. The use of standards simplifies millions of transactions each day, at great savings to the economy. Although this kind of self-regulation imposes a risk in terms of anticompetitive potential, it is a risk that a strong antitrust enforcement presence can minimize.

Another example of private standard-setting regulation is the credentialing activities of professional groups. Self-regulation by the professions has existed for some time. Licensing, for example, began to develop seriously about 100 years ago and grew rapidly during the first half of this century. A wide range of professional associations have defined acceptable standards of conduct, education and scope of practice for their professions.

Responsible self-regulation helps protect consumers, other professionals, and third parties from dishonest, dangerous, or otherwise unacceptable conduct. Licensure and certification systems provide information about the quality of professionals. Licensure ensures that only those who possess a certain minimum level of education or experience are allowed to practice, and certification differentiates between those professionals who meet certain voluntary standards and those who do not.

9/ Smith at 136.

This information about quality is particularly important in the area of professional services because, as with certain highly technical products, consumers may be unable to judge for themselves either the quality of the provider or the need for the service. If high quality providers are unable to distinguish themselves from inferior providers and are unable to get compensation for their costlier higher quality, they may leave the market entirely. Economists refer to such a situation as a "lemons' market," because only the lowest quality products or services remain in the market. 10/ This, of course, has disadvantages for consumers.

Licensing and certification assist in resolving these market problems. Occupational licensing is mandated and sets a minimum standard that must be met to practice the designated profession. Licensing boards combine features of self-regulation and government control. They are generally composed primarily of members of the profession, but their enforcement powers are derived from state laws. Today dozens of occupations are licensed under hundreds of state statutes. In addition to the usual examples of medicine and law, many states also require barbers, beauticians, plumbers, electricians, exterminators, embalmers, real estate agents, bee keepers and dry cleaners -- among others -- to obtain a license to practice.

Certification, on the other hand, is voluntary. A private organization, sometimes a professional trade association, grants a certificate after ascertaining whether an individual has met certain qualifications and that enables the individual to label him or herself as certified. As with an uncertified product, an uncertified individual may still sell his or her professional services. The National Association of Securities Dealers, the Institute of Chartered Financial Analysts, the Ryder Mechanics Certification Program, and the National Architectural Registration Board are all certifying agencies. 11/

Some professions use both a licensing and a certification system. Physicians, for example, must obtain a license in order to practice medicine. They may also, after several years of practice and further examination, become "board certified" in a particular specialty. While any licensed physician may practice a branch of medicine, certification enables that physician to represent him or herself as an expert in a particular specialty.

10/ See George A. Akerlof, "The Market for 'Lemons': Qualitative Uncertainty and the Market Mechanism," 84 Quarterly Journal of Economics 488-500 (August 1970).

11/ Occupational Licensing: Practices and Policies, by Benjamin Shimberg, Barbara Esser, and Daniel Kruger (Washington, D.C.: Public Affairs Press, 1973) provides a description of the licensing of many different professions.

The mandatory-voluntary distinction between licensing and certification leads to different effects. Licensing, because it is mandatory, can be used to limit entry or to proscribe the activities of professionals beyond what is justified to maintain a quality standard. The Commission recognizes that quality judgments are best left to the professions but questions anticompetitive regulations of business practices that have no overriding quality justification. Not surprisingly, Adam Smith also had something to say about the potential benefits to a profession of self-erected entry barriers:

"By combining not to take apprentices they [the trades] can not only engross the employment, but reduce the whole manufacture into a sort of slavery to themselves, and raise the price of their labour much above what is due to the nature of their work." 12/

For example, many licensing boards of non-physician medical professionals are controlled by physicians. It may not be surprising, therefore, that certain non-physician health care professionals are licensed to perform only a limited range of functions or to practice only under the direct supervision of physicians. The use of licensing systems to foreclose competitive entry is a matter of concern to the Commission, which has studied the effects of restrictions placed on such professions as optometrists, certified nurse-midwives, and nurse anesthetists.

Certification, since it is voluntary, preserves free entry into any profession. Consumers may choose whether to use a certified landscape architect or simply a person who plants trees and shrubs, whereas a licensing scheme forecloses the latter, presumably cheaper, option. Although such freedom is generally beneficial to individual consumers, in some, reasonably rare, situations, it may not be beneficial to society as a whole. For example, if an individual with a contagious disease is treated by an incompetent medical professional, others may suffer. The purchase of low quality plumbing repairs may affect one's neighbors adversely.

In some cases -- doctors and lawyers immediately come to mind -- society has decided that the danger of harm resulting from low quality services is such that mandatory licensing, even though it may lead to the non-availability of some services, is preferable.

I do not mean to suggest that anyone benefits from the freedom to choose a complete quack. But the trouble with setting a minimum standard of quality is that it excludes all levels of

12/ Smith at 126.

quality below that standard, some of which may be valuable in various settings. For example, if I come down with what seems to be a simple cold or virus, I may not think it worth \$50 to visit my physician to confirm that, but I might feel differently about going to see a \$20 alternative provider. ^{13/} Similarly, I may not want to hire a costly licensed electrician for a simple wiring job -- such as installing a dimmer switch -- which would be time-consuming and difficult for me, but I might be willing to pay someone else a lesser fee to install the switch.

Neither the licensing nor the certification system is perfect. To the extent that consumption of incompetent services is costly, either to an individual or to society, licensing can lower such costs. Unfortunately, this benefit also comes at a cost to consumers -- the loss of flexibility to choose the quality level they may prefer. Licensing, since it is enforced by public regulation, is not directly subject to the market test of efficiency.

Because it is voluntary, certification, on the other hand, may be insufficient either to safeguard the public, where consumption of low quality services may affect others, or to provide sufficiently credible information to solve the lemons' problem.

Licensing and certification share some common problems. Both provide the consumer with dichotomous classifications of quality -- that is, completely qualified or completely unqualified. In fact, however, quality probably varies along a continuum. Certification, at least, permits several dichotomous measures of quality to exist simultaneously so that consumers can consider several aspects of quality. Of course, to the extent that different measures of quality produce conflicting results, this may be confusing to consumers.

Licensing and certification criteria measure training and experience and force consumers to assume that such criteria correctly predict the quality of professional service. Such an assumption is not always correct. As Adam Smith noted: "The institution of long apprenticeships can give no security that insufficient workmanship shall not frequently be exposed to public sale." ^{14/} Direct measurement of quality, however, may not be practical.

^{13/} Health Maintenance Organizations have been at the forefront in using allied health practitioners to substitute for physicians for many routine types of health care.

^{14/} Smith at 122.

After patiently listening to this discussion of the pros and cons of both licensing and certification, you probably would appreciate some definitive conclusion as to the absolute superiority of one or the other. For example, I could suggest that licensure of physicians is on balance harmful to society and should be replaced by voluntary certification. But I am not prepared to go that far today. The professions themselves are still experimenting with various licensing and certification systems. One thing does seem clear. Until someone comes up with a better way to obtain and disseminate information about the quality of professional services, the efforts of professional groups to provide this information will continue to be essential.

This completes my 1986 recap of some of the principles that Adam Smith first asserted over 200 years ago. Our complex modern economy, of course, did not exist in Smith's time. But I suspect that, were he alive today, he would tend to share my view that to the extent we need regulation in our economy, it is better to look to the private sector to take on the task, at least in the first instance. This thought is tempered by the caveat that a strong antitrust enforcement presence is necessary to insure that the incentives attributable to "dignified greed" do not yield to those of ordinary greed, thereby resulting in agreements among competitors to restrict the dissemination of useful information to consumers, to restrict entry into their businesses or professions or otherwise to restrain competition.

Thank you.