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A Public Choice Analysis of Occupational Licensing

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Abstract

Occupational licensing is increasingly widespread throughout American industry. Incumbent firms believe that licensing prevents competition by new entrants that would drive down prices. Public Interest or Market Failure Theory defended licensing as protecting the public against service providers who were incompetent or charlatans. That approach fails to explain why it is incumbents, not members of the public, who seek licensing rules most vigorously. Public Choice Theory, by contrast, maintains that incumbents support licensing to garner economic rents. This theory better explains why government officials generally, and often enthusiastically, support licensing requirements instead of certification programs. Knowing why legislatures impose occupational licensing requirements and how they adversely affect the public are the first steps toward undoing laws that injure the public.

Today, between one-quarter and one-third of all American jobs are subject to a licensing requirement of some kind.[1] How did we wind up in this situation? Has there been an explosion of subspecialties within already licensed fields, with each new niche requiring a new and separate license? Or have there been across-the-board torts or frauds committed against consumers that have resulted in numerous cases of large-scale financial loss, bankruptcy, serious bodily injury, or death? Why else would society have become so besotted with occupational licensing?

It turns out that the justification is far more prosaic, far more predictable, and far less salutary than the public might expect.

Key Points

- According to Public Interest or Market Failure Theory, the optimal way to reduce public uncertainty regarding a service provider's qualifications is for the government to prohibit its supply by anyone who has not shown the minimum qualifications necessary to offer it safely.
- Perhaps the principal weakness of Public Interest Theory is that it does not explain a curious fact: Private firms often urge governments to adopt licensing regimes, the exact opposite of what Public Interest Theory predicts.
- Public Choice Theory, by contrast, offers a view of market regulation that is materially different from the one that underlies Public Interest Theory.
- In particular, Public Choice Theory explains why regulated businesses, not consumers, seek out licensing requirements: Incumbents support licensing to garner economic rents.
- Knowing why legislatures impose occupational licensing requirements and how they affect the public are the first steps toward undoing laws that injure the public.

This paper, in its entirety, can be found at **http://report.heritage.org/lm205**

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The Problem: Market Failure

A pure laissez-faire economic system would not work in the United States. Structural imperfections such as natural monopolies, externalities, transaction costs, and collective action problems such as free-rider strategies keep the market from allocating goods and services efficiently. Consider telecommunications or transportation. If one land-based telephone or railroad system can meet the entire market demand at a lower cost than would be the case if two or more firms were to compete for business, the market is a natural monopoly. The optimal response is to allow that one firm to operate under price constraints so that it cannot take advantage of its monopoly position.[2] What that means, however, is that *some* forms of regulation of *some* business practices are necessary in *some* instances. If so, the question becomes: How far does that conclusion apply? How do we know *when* regulation is necessary?

Now turn to occupational licensing. A rationale akin to the foregoing one has served as the traditional justification for occupational licensing. The problem is what economists call an "information asymmetry." In many occupations, there are multiple service providers with different skills (e.g., Emergency Medical Technicians), and consumers lack the knowledge needed to distinguish among them or the time to do so (e.g., automobile accident victims cannot decide which EMTs will treat them). The question then becomes: How do we protect the public in those circumstances?

The Solution: Licensing in the Public Interest

The Public Interest or Market Failure Theory emerged to justify regulation in the public interest.[3] The optimal way to reduce public uncertainty regarding a service provider's qualifications, the argument goes, is for the government to prohibit its supply by anyone who has not proved that he possesses the minimum qualifications necessary to offer it safely. To do so, governments use an education, testing, and licensing process to filter out unqualified practitioners. That process sets a floor below which no one may offer a service that puts the public at risk. The public therefore can select from approved providers without needing to investigate their bona fides and relative qualifications. As Nobel laureate Kenneth Arrow has explained:

> When there is uncertainty, information or knowledge becomes a commodity. Like other commodities, it has a cost of production and a cost of transmission.... The general uncertainty about the prospects of medical treatment is socially handled by rigid entry requirements. These are designed to reduce the uncertainty in the mind of the consumer as to the quality of product insofar as this is possible.[4]

Of course, suppliers will still vary in their qualifications. A licensing process is designed not to eliminate suppliers with superior talents, only to eliminate those with substandard skills. In theory, however, no unlicensed provider may operate and no licensed provider will endanger the public by plying his trade.[5]

The Problem with the Solution: Licensing Is Generally Not in the Public Interest

Public Interest or Market Failure Theory was the orthodoxy as late as the 1970s.[6] Since then, however, it has lost favor in the economic community.[7] The reason is that the Public Interest Theory fails to acknowledge that governments are often as flawed as markets. There is no guarantee that elected or appointed officials are subject-matter experts or that they will select regulatory schemes that can correct market flaws rather than satisfy the demands of favored constituents. Moreover, statutes are no less difficult to repeal than they are to pass,[8] meaning that bootless laws (e.g., the Robinson–Patman Act of 1936[9]) can remain on the books far longer than a product that consumers reject (e.g., "New Coke") will remain on the shelves.

In addition, the theory mistakenly idealizes the motives of public officials by assuming that they always act in the nation's best interests even when the evidence is to the contrary.[10] As Professor Peter Schuck has noted, Public Interest Theory stands as a "vacuous and dangerously naive" account of public policymaking, both as to how public policy is adopted and as to how it is implemented.[11] "[R]ational self-interest (as the actor perceives it) unquestionably drives most political behavior most of the time."[12]

Finally, Public Interest Theory fails to explain why a licensing regime is superior to a certification program—that is, to a system in which the government issues a certificate to a service provider who has passed a competency test similar to being

board-certified in a medical specialty or to receiving the Underwriters Laboratories certification or Good Housekeeping Seal of Approval. That alternative protects members of the public without limiting their choices or raising the price of the service they want.

Perhaps the principal weakness of Public Interest Theory is that it does not explain a rather curious fact: Private firms often urge governments to adopt licensing regimes, conduct that is the exact opposite of what Public Interest Theory predicts. Historian Lawrence Friedman found that practice prevalent throughout American history, noting that "the licensing urge flowed from the needs of the licensed occupations. The state did not impose 'friendly' licensing; rather, this licensing was actively sought by the regulated."[13]

Economist and Nobel laureate George Stigler was the first to explain why that odd scenario is so widespread. He found a simple explanation for companies' otherwise irrational conduct: Incumbent businesses endorse licensing requirements because it protects them against competition.[14] Professor Walter Gellhorn summarized this phenomenon succinctly:

> The thrust of occupational licensing, like that of the guilds, is toward decreasing competition by restricting access to the profession; toward a definition of occupational prerogatives that will debar others from sharing in them; toward attaching legal consequences to essentially private determinations of what are ethically or economically permissible practices.[15]

In short, licensing requirements enable incumbents to receive what economists label "economic rents"—that is, supracompetitive profits made available by laws limiting rivalry. Any benefit that the public receives is largely fortuitous and almost invariably outweighed by its costs.

The New Solution to the Problem with the Original Solution: Public Choice Theory

Stigler was one of the first scholars to subject political behavior to economic analysis and offer a rational economic explanation for irrational political behavior.[16] But others followed. In fact, the process of applying microeconomics and game theory to politics gave rise to a new way of analyzing the operation of the two, one known today as Public Choice Theory.[17] Public Choice Theory offered a view of market regulation that was materially different from the one that underlies Public Interest Theory. In particular, Public Choice Theory explains why regulated businesses, not consumers, prefer and seek out licensing requirements:

> Public Choice Theory teaches that elected officials do not fundamentally change their character and abandon the rational, self-interested nature they display as individual participants in a free market when assuming public office. The person that is "an egoistic, rational, utility maximizer" in the market also has that nature in the halls of government. *Homo economicus* and *homo politicus* are one and the same. The difference is in the goods that private parties desire and government officials dispense—statutes, regulations, funding, licenses, and so forth, rather than consumer goods or widgets. Their motivation, however, is parallel in each setting. Producers, consumers, and voters seek to maximize their own welfare; politicians, to attain or remain in office; and bureaucrats, to expand their authority. The result is trade in a political market. Interest groups will trade political rents in the form of votes, campaign contributions, paid speaking engagements, book purchases, and get-out-the-vote efforts in return for the economic rents that cartel-creating or reinforcing regulations, such as occupational licensing, can provide. Government officials are aware of interest groups' motivations and use those groups to their own political advantage. Lobbyists and associations serve as the brokers.[18]

Public Choice Theory has become an accepted approach to the analysis of political behavior.[19]

Public Choice Strategies

Public Choice Theory recognizes that legislators have complementary strategies.

- *Rent creation* is the adoption of competitive restrictions, such as occupational licenses, for the benefit of a few incumbents. The licensing requirement generates economic rents for incumbents (supracompetitive profits) and political rents for politicians (campaign contributions, book sales, voter-turnout efforts, etc.).

- *Rent extraction* is the threat of new legislation by politicians that would reduce the rents incumbents receive from an existing scheme to obtain more political rents for themselves.[20] Proposed legislation would lower a firm's profits or increase its costs by eliminating a benefit that it currently enjoys (e.g., an occupational licensing requirement that keeps out would-be competitors) or by imposing new regulatory burdens (e.g., environmental regulations). However this is accomplished, politicians benefit.

Note that that a legislator need not see a bill enacted in order to gain political rents from rent extraction. He can merely threaten to introduce or promote a bill to warn interested parties that their rents are at stake. Known by names such as "cash cows," such bills or draft bills have the sole purpose of extracting political rents from interested parties.[21] Minatory statements by a legislator, especially a powerful one such as a committee chairman, make even the mere threat to introduce a bill quite effective.[22] Moreover, legislators can use rent extraction over and over again until they leave office.[23]

Public Choice Theory has its critics.[24] They say, for example, that it oversimplifies legislators' motivations. Claiming that elected officials act only for self-advancement, critics maintain, ignores the reality that over their terms in office, legislators take positions on issues for a host of reasons—individual beliefs, party loyalty, logrolling, the futility of opposition, and so forth—many of which are of no concern to individual voters. Because politicians will act for reasons that do not advance (or may even injure) their own careers, Public Choice Theory does not accurately reflect the reality that it purports to describe.

In response, Public Choice Theory's supporters would argue that legislators are not always the "villainous brigands that Thomas Hobbes envisions in the state of nature,"[25] nor need they pursue their self-interest at every turn for the theory to explain the motivations of legislators better than Public Interest Theory explains them.

> Moreover, certainty is too demanding a standard for any economic or political theory. Proof can be sought in mathematics, but not in the social sciences. The question here is whether a theory has more predictive power than alternatives, not whether it proves correct in every case. Public Choice Theory readily passes that test.[26]

Conclusion

Occupational licensing has become increasingly widespread throughout American industry. Incumbent firms favor licensing because it prevents competition by new entrants that would drive down prices. Licensing was defended originally on the ground that it protected the public against service providers who were incompetent or charlatans. That approach, the Public Interest or Market Failure Theory, fails to explain adequately why incumbents, not members of the public, are the one who most vigorously seek licensing rules.

The new explanation for the rise of occupational licensing, Public Choice Theory, maintains that incumbents support licensing to garner economic rents. Unlike the Public Interest or Market Failure Theory, Public Choice Theory better explains why government officials generally, and often enthusiastically, support licensing requirements instead of certification programs.

Knowing why legislatures impose occupational licensing requirements and how such requirements injure the public are the first steps toward undoing such laws.

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Endnotes

1. *See, e.g.*, The White House, Occupational Licensing: A Framework for Policymakers 17 (2015) (hereafter WH Framework); Paul J. Larkin, Jr., *Public Choice Theory and Occupational Licensing*, 39 Harv. J.L. & Pub. Pol'y 209, 211 (2016); Paul J. Larkin, Jr., *A Brief History of Occupational Licensing*, Heritage Found. Legal Memorandum No. 204 (May 23, 2017).
2. *See, e.g.*, Stephen G. Breyer, Regulation and Its Reform 15–28 (1982); Dennis W. Carlton & Jeffrey M. Perloff, Modern Industrial Organization 82–84 (4th ed. 2004).
3. *See, e.g.*, Gary S. Becker, *A Theory of Competition Among Pressure Groups for Political Influence*, 98 Q.J. Econ. 371, 383 (1983); James M. Buchanan, *Politics Without Romance: A Sketch of Positive Public Choice Theory and Its Normative Implications*, in The Theory of Public Choice—II, at 11 (James M. Buchanan & Robert D. Tollison eds., 1984).
4. Kenneth Arrow, *Uncertainty and the Welfare Economics of Medical Care*, 53 Am. Econ. Rev. 941, 946, 966 (1963) (citation omitted); *see also, e.g.*, Hayne E. Leland, *Quacks, Lemons, and Licensing: A Theory of Minimum Quality Standards*, 87 J. Pol. Econ. 1328, 1329–30, 1342 (1979).
5. *See, e.g.*, Carolyn Cox & Susan Foster, FTC, The Costs and Benefits of Occupational Regulation 5 (1990); Morris M. Kleiner, Licensing Occupations: Ensuring Quality or Restricting Competition? 1, 7–9 (2006); George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. Econ. 488 (1970); Carl Shapiro, *Investment, Moral Hazard, and Occupational Licensing*, 53 Rev. Econ. Stud. 843, 843 (1986).
6. *See, e.g.*, Thomas G. Moore, *The Purpose of Licensing*, 4 J.L. & Econ. 93, 113–14 (1961).
7. Perhaps "lost favor" is putting it mildly. *See, e.g.*, Douglas Ginsberg, *A New Economic Theory of Regulation: Rent Extraction Rather Than Rent Creation*, 97 Mich. L. Rev. 1771, 1771 (1997) ("Once upon a time, people believed that the government regulated various industries in 'the public interest.'").
8. In fact, statutes generally are *more* difficult to repeal than to pass. Once on the books, a law benefits one or more interest groups that can and will mobilize their efforts to defend whatever benefit to which they are now legally entitled. *See* Mancur Olson, The Logic of Collective Action (1965); James Q. Wilson, *The Rise of the Bureaucratic State*, 31 Nat'l Affairs 77, 93–94 (Fall 1975).
9. 15 U.S.C. § 13 (2012). The act was designed to protect small retail stores against competition from large chain stores by prohibiting the latter from offering discounts for bulk purchases. At one time, the Supreme Court believed that the best way to promote competition was to protect competitors. *See* Utah Pie Co. v. Continental Baking Co., 386 U.S. 685 (1967). Today, the Court believes that the best way to protect competition is to promote the competitive process rather than safeguard any particular class of firms from rivalry. *See* Brooke Grp. Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 223–24 (1993).
10. See James W. Ely, Jr., The Guardian of Every Other Right: A Constitutional History of Property Rights 124 (3d ed. 2008) ("[T]he Progressives proceeded on the questionable assumption that all social legislation benefitted the public. Reformers rarely acknowledged that much economic legislation, although couched in terms of general benefits, served selfish special interests.").
11. Peter H. Schuck, Why Government Fails So Often: And How it Can Do Better 132 (2014).
12. *Id.* at 133. He also argues that we should neither deny that obvious fact nor deem it a vice. "Only the cloistered idealist will regard this as altogether pernicious. Self-interest, after all, is among the most powerful motivators of human action and thus of the civic conduct and participation on which a vigorous democracy depend." *Id*.
13. Lawrence M. Friedman, *Freedom of Contract and Occupational Licensing 1890–1910: A Legal and Social Study*, 53 Calif. L. Rev. 487, 503 (1965).
14. *See* George J. Stigler, *The Theory of Economic Regulation*, 2 Bell J. Econ. & Mgmt. Sci. 3 (1971). Adam Smith criticized guilds' restrictions for limiting the supply of tradesmen and raising prices, but he did not draw the connection to politics that Stiglitz did. *See* Adam Smith, An Inquiry Into the Nature and Causes of the Wealth of Nations 118–29 (Edwin Cannan ed. 1937).
15. Walter Gellhorn, Individual Freedom and Economic Restraints 114 (1956).
16. For others, see, for example, Kenneth J. Arrow, Social Choice and Individual Values (1951); Duncan Black, The Theory of Committees and Elections (1958); Anthony Downs, An Economic Theory of Democracy (1957); William Riker, The Theory of Political Coalitions (1962).
17. *See, e.g.*, James M. Buchanan & Gordon Tullock, The Calculus of Consent: Logical Foundations of Constitutional Democracy (1962); Democracy and Public Choice (Charles K. Rowley ed., 1987); Gordon Tullock et al., Government Failure: A Primer on Public Choice 27 (2002).
18. Larkin, *Public Choice Theory and Occupational Licensing, supra* note 1, at 228–29 (footnotes omitted); *see also, e.g.*, Richard A. Posner, *Theories of Economic Regulation*, 5 Bell J. Econ. & Mgmt. Sci. 335, 337 (1974); Simon Rottenberg, *The Economics of Occupational Licensing*, *in* Nat'l Bureau of Econ. Res., Aspects of Labor Economics 18 (1962).
19. *See, e.g.*, Albert Breton, The Economic Theory of Representative Government (2007); Robert McCormick & Robert Tollison, Politicians, Legislation, and the Economy: An Inquiry into the Interest-Group Theory of Government (1981); Guido Pincione & Fernando R. Teson, Rational Choice and Democratic Deliberation: A Theory of Discourse Failure (2006); Anne O. Krueger, *The Political Economy of the Rent-Seeking Society*, 64 Am. Econ. Rev. 291 (1974); Paul J. Larkin, Jr., *Public Choice Theory and Overcriminalization*, 36 Harv. J.L. & Pub. Pol'y 715 (2013); Jonathan R. Macey, *Federal Deference to Local Regulators and the Economic Theory of Regulation: Toward a Public-Choice Explanation of Federalism*, 76 Va. L. Rev. 265 (1990); Jonathan R. Macey, *Public Choice: The Theory of the Firm and the Theory of Market Exchange*, 74 Cornell L. Rev. 43 (1988); John O. McGinnis, *The Original Constitution and Its Decline: A Public Choice Perspective*, 21 Harv. J.L. & Pub. Pol'y 195 (1997); W. Kip Viscusi & Ted Gayer, *Behavioral Public Choice: The Behavioral Paradox of Government Policy*, 39 Harv. J.L. & Pub. Pol'y 973 (2015).

20. *See, e.g.*, Fred McChesney, Money for Nothing: Politicians, Rent Extraction, and Political Extortion 155 (1997); Susan Rose-Ackerman, Corruption and Government: Causes, Consequences, and Reform 129 n.1 (1999); Peter Schweizer, Extortion: How Politicians Extract Your Money, Buy Votes, and Line Their Own Pockets (2013); Fred S. McChesney, *Purchasing Political Inaction: How Regulators Use the Threat of Legal "Reform" to Extort Payoffs*, 21 Harv. J.L. & Pub. Pol'y 211 (1997).
21. *See, e.g.*, McChesney, Money for Nothing, *supra* note 20, at 155.
22. *Id.* at 26–34; Larkin, *Public Choice Theory and Occupational Licensing*, *supra* note 1, at 230.
23. "Temporary tax credits, for instance, must be reauthorized or they will expire. Bills that threaten to take away a program, a benefit, or a perk may not carry over from one session of the legislature to another; if so, a legislator must reintroduce the bill for it to be considered in the next legislative term. Legislators therefore have the opportunity to introduce the same 'cash cow' each time that a new Congress is sworn in. Private parties would prefer a long-term deal to a shorter one because it allows them to engage in long-term investment strategies. But every representative must stand for reelection every two years, with every senator running for reelection at six-year intervals. Some also retire or lose their races. That turnover makes enforcement of long-term agreements politically impossible. Even if it were possible to work out such a deal with an important member—such as the chairman of the House Ways and Means Committee from a safe district—such agreements are not binding legally enforceable contracts. In other words, rent-extraction contracts are extralegal, outside the judicial system governing most other contracts. No statute and no deal lasts forever, and no ally and no opponent is ever permanent. For politicians, rent extraction is a gift that keeps on giving. A politician may be able to bestow a privilege on a favored group only once, but he can threaten to limit it or take it away over and over and over again." Larkin, *Public Choice Theory and Occupational Licensing*, *supra* note 1, at 230–31 (footnotes and internal punctuation omitted).
24. *See, e.g.*, Jeffrey Friedman, Introduction, The Rational Choice Controversy 1–2 (Jeffrey Friedman ed., 1996); Donald P. Green & Ian Shapiro, Pathologies of Rational Choice Theory: A Critique of Applications in Political Science, at ix–x (1994); Leif Lewin, Self Interest and Public Interest in Western Politics 22 (1991); Jerry L. Mashaw, Greed, Chaos, and Governance: Using Public Choice to Improve Public Law 44 (1997); Daniel A. Farber & Philip P. Frickey, *The Jurisprudence of Public Choice*, 65 Tex. L. Rev. 873, 878–79 (1987); Mark Kelman, *On Democracy Bashing: A Skeptical Look at the Theoretical and "Empirical" Practice of the Public Choice Movement*, 74 Va. L. Rev. 199, 204–06 (1988).
25. Jay Cost, A Republic No More: Big Government and the Rise of American Political Corruption 26 (2015).
26. Larkin, *Public Choice Theory and Occupational Licensing*, *supra* note 1, at 233–34.