CONTRACTING for CHAOS

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Commonwealth legal aid cuts and agency theory.

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Economic rationalism: rhetoric or reality?

If there is an easy target in current policy debates it is that well known villain, the economic rationalist. When decisions are made such as that by the Commonwealth Government in 1996 to cut legal aid funding to the States by up to $100 million over three years, it is easy to describe this as yet another example of economic rationalism hitting the poorest, most vulnerable sections of society.

But is the decision one which follows an economically rational model? Would an 'economic rationalist' approve of the way agency theory is being implemented by the Commonwealth? In answering this question the article does not intend to address the economic impact of possible outcomes, the cost to society of these cuts and their flow on effects. Rather, the question is whether the funding cut itself is consistent with the 'rational' model it is seeking to implement?

There is a need first to explain in some detail what is meant by 'agency theory', a theory which has been drawn from an economic policy model and frequently applied in the public sector in recent years. The article does not take any view either way on the validity of agency theory, but rather seeks to examine what the theory has to say about the legal aid funding cuts as implemented.

Agency theory

Agency theory is a variant of the contractual model by which a government as purchaser contracts out service delivery to a separate agency as provider. In the contractual model the government funder is the 'principal'; relationships such as 'partnership' are irrelevant because the agencies that government contracts with to provide services are seen in the same way as any commercial supplier of services. Their role as 'agent' is to deliver to the principal the goods or services at the lowest unit cost consistent with the aims of the contract, unless the principal agrees otherwise.

Agency theory is primarily a response to two situations arising in the contractual model:

- where the goals of the principal and agent conflict, and it is difficult or expensive for the principal to verify what the agent is doing ; or
- where the principal and agent have different attitudes to risk.[1]

The response to these situations is for the principal to define either the *outcomes* or the *behaviour* of the agent in a formal contract document. Making the agent responsible for the outcomes shifts the risk of the contract to the agent, and can only be effective if the outcome is within the agent's control; behaviour-based contracts rely on the principal investing in information systems to monitor how the agent is acting.[2]

Agency theory and its variations have been widely used overseas and in some Australian States.[3] While some argue it simply shifts costs previously internalised onto the wider community,[4] even its supporters generally concede that the way in which it is used must be contingent

on the nature of the policy and organisational environment in which it is used.[5] Agency theory may be effective or inappropriate, depending on how it is introduced and the organisational environment into which it is introduced.

To examine the application of agency theory to legal aid, the circumstances of the current cuts need to be put in context.

Legal aid funding: a broken partnership

Since the 1970s the provision of legal aid in Australia has involved a largely unbroken partnership between the Commonwealth and the States.[6] While there is a complex history of development in Federal/State relations between 1973-1985,[7] the funding partnership has been formalised since 1987 by agreements under which the Commonwealth provides 55% of the agreed core funding for the provision of legal aid in each State. These agreements have been indexed so as to increase total levels of funding in accordance with changes in the Consumer Price Index and average weekly earnings.[8]

Although the States have contributed 45% of core funding, this is not merely State government funding. It also includes income from solicitors' trust account interest funds. As an example, the Commonwealth provided $37.7 million compared to $18.9 million from the NSW Government to the NSW Legal Aid Commission in 1992-93, with a further $13 million from solicitors' trust account interest funds.[9] With the decline in income available from Solicitor's Trust Funds (due to banking changes and lower interest rates) State governments would have to increase their contribution in coming years just to maintain the existing 45% State contribution to core funding.

Under existing agreements the Commonwealth estimates it will contribute $150 million to legal aid in Australia in 1996/97.[10] From 1 July 1997 the Commonwealth will terminate its existing legal aid agreements with the States and reduce funding by at least $33 million a year for each of the following three years.[11] The effect of this is an immediate 20% cut in the funding to legal aid commissions, organisations which have limited flexibility to respond to funding fluctuations. The result has been a unified outcry from all States, the legal profession, the judiciary and other service providers.

The head of the NSW Legal Aid Commission estimates the cuts could result in 30,000 fewer people being assisted in NSW each year.[12] The States will be forced to devote most of their remaining budget to criminal matters, as trials in serious matters may have to be aborted if no representation is available. Even so, more expensive trials will have to be extensively delayed, and legal aid for committal hearings will be scrapped in most States.

The biggest impact will be in the other areas of legal aid which are under State law. In NSW, for instance, the cutbacks will result in some or all of the following:

- reduced funding of domestic violence services,
- reduction of legal aid to children,
- cutting back on 1800 phone service to rural areas,
- reduced tenancy advice services to retirement village residents and nursing homes,
- reduced assistance in consumer credit and debt problems, and
- cutting legal aid in anti-discrimination cases.

The Commonwealth has announced it only wishes to have its legal aid funding used in Commonwealth matters, that is, matters under its laws such as family law and the *Trade Practices Act*. It will no longer fund criminal matters under State law, which make up two thirds of matters funded by State commissions.[13]

This change is said to ensure greater accountability in how the Commonwealth's funding is spent and 'better value' for the Commonwealth legal aid dollar.[14] This rationale for the funding cut has created additional problems which would not be present in a simple funding cut. While the Attorney-General has not used the jargon of economic policy, this type of 'value for the dollar' approach is typical of the arguments used in the application of agency theory. Agency theory has been the theoretical basis for many of the reforms in Victoria under the Kennett Government[15] and increasingly in most other States. It has been widely used in the health sector at a Commonwealth level but its appearance in the legal policy environment is relatively new.

Agency theory applied to legal aid cuts

Conflicting goals between the principal and the agent is said to be one of the situations in which agency theory can be considered as a useful tool. There has clearly been a sudden goal divergence between the Commonwealth and the States with regard to legal aid. In 1973, when the Commonwealth first began significant legal aid funding, Attorney-General Lionel Murphy expressed its commitment as being twofold:

> to provide legal advice and assistance on all matters of Federal Law [and]...on matters of both Federal and State law, to persons for whom the Australian government has a special responsibility, for example pensioners, aborigines, ex servicemen and newcomers to Australia.[16]

This partnership with the States in ensuring equality of legal access for disadvantaged Australians has remained a relatively stable goal over the last 23 years, through both Labor and Coalition governments. Now the Commonwealth has stated that this represents an 'unjustified subsidy to State...governments.[17] Its response to the shift in goals has been to see itself as a principal contracting the State legal aid commissions to deliver legal aid services for matters under its law only. The Government has shifted its perception of its role in legal aid from a partnership to that of a principal contracting services in return for its funding.

A theory poorly applied

The strength of agency theory is said to be its ability to define respective obligations that were previously unclear.[18] It is therefore essential that the principal can identify the services it is contracting the agent to deliver — this may either be by defining the outcomes or the way the agent is to behave in delivering the services. During the continuing debate on the cuts, however, the Commonwealth has never suggested a clear definition of Commonwealth matters for the States to use.

Several months after the initial announcement, the head of the Attorney-General's Department was quoted as telling heads of legal aid commissions 'there isn't a document, there isn't a definition'.[19] The Commonwealth in October 1996 submitted a general definition of 'Commonwealth matters' which was little more than a series of examples of what would and would not be funded. While this clarified Commonwealth priorities, the definition of what is a 'Commonwealth matter' is still the subject of much debate and needs further clarification.

In this case the principal is trying to contract with the agent without adequately specifying the services it wishes the agent to provide under the contract. The result is the agent has little guidance on how to comply with the intended contract.

In many cases such a Federal/State division is either an administrative impossibility or an encouragement to use

Federal Courts for matters previously best dealt with in State jurisdictions. Many (presumably) unintended consequences are already apparent. For instance, family law matters are a Federal matter but domestic violence, which may be associated with a marriage breakdown, is a State matter. Rather than resolve the domestic violence issue through a Local Court, for which legal aid may now not be available, solicitors would need to advise impoverished clients to attach this to an action in the Family Court.

Similarly in discrimination matters, lawyers in some States will have to advise needy clients to proceed in the Human Rights and Equal Opportunity Commission (soon to be in the Federal Court) under Federal legislation, even though the matter may have been more suited to proceeding under State anti-discrimination legislation in, say, the NSW Equal Opportunity Tribunal for which legal aid is now not available. In some States contractual and consumer credit matters previously litigated under State legislation will now have to be stretched to fit under Federal trade practices legislation to find legal aid support. It is difficult to see the efficiency gains from such redirection of litigation.

The impact of the cuts would be less serious if the State legal aid commissions could await the outcome of negotiations on the final form of the Commonwealth model before acting. However the nature of legal aid funding is such that commitments are made now which have their full impact in two to three years because of the nature of trial times and delays.[20] The sudden shift from 23 years of goal consensus means the legal aid commissions have to make cuts now to avoid a financial crisis later. The lack of flexibility of the agent in this case leads to a very harsh and immediate impact, before the final definition of services contracted by the principal has been clarified.

In addition to uncertainty in its definition of contracted services, the Commonwealth is trying to use agency theory when it has poor access to reliable information with which to monitor the State's performance.[21] Although the Commonwealth has made substantial efforts to improve information systems, logistical problems have made it very difficult to compare States' use of funds. The Commonwealth has relied on State legal aid commissions for raw data on use of funds, but most commisssions use different measures not easily comparable to each other. Despite a commitment by the Commonwealth to invest in the information systems necessary to monitor compliance, this is a long way from being a reality. The principal therefore has little ability to monitor compliance by the agent due to inadequate information systems.

A further organisational response by the commissions may make any ultimate cost savings for the Commonwealth negligible. The State governments have considerable ability to 'retaliate', and thereby gain the revenue they need to meet the funding shortfalls.[22] The Commonwealth is a major user of State courts for importation cases and corporate law cases: the States may choose to levy greatly increased court charges on the Commonwealth.

A recent threat along these lines[23] is that the State legal aid commissions could refuse to administer legal aid for any Commonwealth matters, forcing the Commonwealth to establish its own administrative infrastructure to deliver legal aid in family law and other matters. This would see the agent refusing the terms of the principal. While perhaps only part of the negotiation process, it nevertheless illustrates how agency theory used in the wrong situations may simply bring out previously internalised costs with efficiency losses rather than gains overall.[24]

Conclusion

The main conclusion which can be drawn is that this is an inappropriate application of agency theory; alternatively the Commonwealth Government purports to be using agency theory to justify what is simply a funding cut affecting the most disadvantaged sections of society.

Legal aid in Australia is very narrowly targeted to the most disadvantaged sections of the community;[25] any cuts to its funding directly impact on the poor. The recently announced cuts have been accompanied by a sudden shift from a partnership based on agreed goals which has lasted more than 20 years, to an application of agency theory which has seen the Commonwealth greatly limit its responsibility.

The approach taken has worsened the impact of an already significant cut because of the Commonwealth's failure to adequately define its change in goals, and the lack of flexibility of response open to legal aid commissions. The impact will see all legal aid recipients suffer, but particularly women, children and the aged. The outcome is likely to be at best administrative chaos or, at worst, an overall increase in public expenditure on legal aid in a less effective way.

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