Five Questions Regulators Should Ask:
1. What’s the problem?
2. Do I have to solve this problem?
3. What are my options?
4. What are the consequences of each option?
5. How do I make a decision?

Congress relies on regulatory agencies to implement laws. Introducing new regulation is one way of fulfilling this role, but regulating well takes a lot of work—and regulating badly can cause a lot of harm. Agencies are often required to use a formal tool called a “regulatory impact analysis” (RIA) to help them determine whether to regulate and, if so, how to do it.

Even when agencies are not legally obligated to complete an RIA, they can and should use decision-making 101 principles to help them effectively carry out their role. These principles clarify what problem is, who is in the best position to solve it, and how to arrive at the most favorable solution.

The following are decision-making 101 principles for federal agencies:

- Don’t design solutions before you understand the problem.
- Don’t try to solve every problem. Identify who is best-situated to solve the problem.
- Before settling on a certain solution to the problem, explicitly state your goal and identify and assess a range of possible solutions.
- Use reliable empirical data and reproducible methods of analysis, and quantify costs and benefits whenever possible.
- Make your analysis available to the public, so that people can understand and constructively engage in the decision-making process.
• Make decisions about regulation only after an analysis is done—not before.
• When it’s time to choose a solution, select the option that will provide the greatest difference between benefits and costs. In other words, aim for the most “bang for the buck.”

**STEP 1: WHAT’S THE PROBLEM?**

The first step toward quality regulation is understanding the problem—and its root causes. Defining a problem means a great deal more than simply citing a statute or act of Congress. Anecdotes may call attention to the existence of a problem, but they don’t provide a thorough grasp of the issue. Federal regulation is more likely to be appropriate when dealing with a significant or systemic problem rather than a unique situation. If the problem is significant and systemic, formulate a theory about how it came to exist. The theory should be backed up by data and acknowledge any uncertainties about the existence, size, or cause of the problem. Doing so will allow other people to test the theory.

Problems of public policy generally fall into three categories.

1. **Market Failure.** Markets are generally very good at allocating resources to their best use. In certain situations, though, markets don’t work the way they should. For example, if I don’t have to pay for the resources I use, I will use more resources than I would if I had to pay for them. Similarly, if I can impose a cost on someone else without compensating that person, I will not take his or her cost into account when I make my own decisions. Other examples arise from natural monopolies, which allow firms to charge higher prices than they would if they had to deal with competitors, and inadequate information, which may prevent market participants from making good buying and selling decisions.

2. **Government Failure.** Even when the government could theoretically correct a market failure, the political nature of arriving at a solution often prevents it from doing so. The government tends to take measures to protect certain constituencies. It might do this, for example, by preventing foreign competitors from selling their products in the home market, by providing subsidies to a particular set of producers, or by granting a company monopoly status. In addition, government action can bring unintended consequences. Finally, a set of existing regulations that might have been effective and appropriate at one time may now be ineffective or even counterproductive, owing to advances in technology or other changing circumstances.

3. **Overriding Social Need.** Sometimes markets are working just the way they should and government has not failed, but legislators believe a particularly vulnerable group needs special protection or access to resources. In this case, quality regulatory analysis can help identify the most effective and least costly way to meet this social need.

**STEP 2: DO I HAVE TO SOLVE THIS PROBLEM?**

Once the problem and its root cause have been identified, it is important to determine whether to do anything about it. You may not be best-situated to solve this problem—and your agency has limited resources, so you need to choose your regulatory projects wisely. The end goal is not simply to adopt regulations but rather to solve the systemic problems that are not being solved by anyone else.

Proposing new regulation may not be the best response to a problem if the problem is:
• not widespread, in which case a broad solution is unnecessary.
• limited to a few bad actors, in which case agency enforcement actions or private litigation against those bad actors might be a better solution.
• limited in geographic scope, in which case state, local, or tribal regulation might be able to handle the problem, and will be better equipped to take local conditions into account.
• likely to be temporary because the market is in the process of developing solutions.
• within another regulatory agency’s purview.
• able to be addressed through existing frameworks such as antitrust law or workers’ compensation systems.
• the result of existing regulation, in which case amending or eliminating that regulation might be a better solution.

If some regulatory action is warranted, it is important to determine what measurable outcome or outcomes are expected by solving the problem. An “outcome” is a result that directly affects citizens’ quality of life. Fewer cancer deaths, fewer industrial injuries, and lower prices for consumers are all outcomes. Outcomes are not processes, activities, or outputs, which may affect outcomes but are not outcomes themselves. Examples of processes, activities, and outputs include the number of regulations written, enforcement actions, the information reported, and the pollution control technologies installed. These are means to an end, not ends in themselves.

**STEP 3: WHAT ARE MY OPTIONS?**

Experience teaches that some regulatory approaches work better than others. For example, you should try to avoid price controls and barriers to entry into a market. The approaches that work best tend to harness market forces and incorporate economic incentives. Simply setting performance
standards works better than prescribing a particular method for achieving the desired standard.

Because an analysis can help Congress make legislative decisions, a list of options might include reasonable solutions that fall outside your statutory authority. (The Office of Management and Budget explicitly tells agencies to analyze options outside their current legislative authority in order to inform Congress.) Remember that the goal of this exercise is to identify options that can achieve the desired outcome.

Here are some options to consider:

- Provide the public with more information so that people can make better decisions.
- Establish market mechanisms that use economic incentives (for example, tradable fishing quotas to prevent overfishing).
- Set a performance standard rather than a design standard. (For example, set a permissible pollution level, rather than specifying a particular pollution-reducing technology.)
- Require individuals to think about decisions that they might not otherwise think about. (For example, automatically enroll people in a retirement savings program, so that, if they don’t want to participate, they have to affirmatively opt out.)
- Set different degrees of stringency. (For example, requiring daily reporting by firms instead of real-time reporting might lower the costs of compliance without measurably decreasing the benefits.)
- Establish different compliance dates. (For example, allowing firms two years, instead of one, to come into compliance with a new requirement might lower costs considerably without greatly decreasing benefits.)
- Set different requirements based on the unique characteristics of different geographic regions.
- Make different requirements for firms of different sizes.
- Establish different enforcement and monitoring methods. (For example, requiring firms to self-report rather than subjecting all firms to periodic inspections.)

To assess the different options, use a tool called benefit-cost analysis. When conducting this analysis, you should use reliable data and models and identify the assumptions you have made—as well as any uncertainties.

Benefit-cost analysis starts with identifying a baseline: What would the world look like without a new regulation? You determine the baseline by considering not only what people are doing now, but also how their behavior—and other factors, such as other regulations—will change in the near future. This gives you a scenario for what the problem will look like if it is not addressed by a new regulation. You then measure the costs and benefits of your different regulatory options against this baseline.

You might not be able to quantify all the costs and benefits of the potential solutions, because you may not have figured out how to measure some of their possible outcomes, and some situations are inherently subjective. Even if you can’t quantify particular costs or benefits, you need to offer empirical evidence—from scientific studies, pilot programs, or the experiences of states and foreign countries—that the regulatory option will generate these costs or benefits. Correctly done, your benefit-cost analysis can identify which option produces the greatest net benefits or cost-effectiveness.

With respect to each option, here are some of the factors you should identify:

- expenditures, including private compliance expenditures and government expenditures to implement, administer, and enforce the regulation
- effects on the prices of goods and services
- costs resulting from changes in behavior by consumers and producers
- “risk/risk” tradeoffs (For example, enhanced airport security measures may cause more people to drive, which may result in more car accident deaths.)
- parts of the option for which the costs exceed the benefits
- who will bear the costs and enjoy the benefits (Sometimes one group benefits while another group bears the costs.)

Identifying the problem, figuring out whether your agency needs to act, distinguishing different options, and using benefit-cost analysis to determine which solution offers the biggest “bang for the buck” is a lot of work.

Now that you have assessed the benefits and costs of the different options against a common baseline, you are ready to take the final step.

**STEP 4: WHAT ARE THE CONSEQUENCES OF EACH OPTION?**

Once a range of options has been identified, compare them to see which one offers the greatest difference between benefits and costs. The alternative with the largest difference is the one that “maximizes net benefits.” This option may not be the least costly, but it will provide the greatest return (in the form of benefits) benefit for the costs imposed.
STEP 5: HOW DO I MAKE A DECISION?

The analysis you just did is not itself the decision, but the information you have gathered about the consequences of the different options should inform the decision. That is why the benefit-cost analysis should be as complete as possible before you decide which alternative to pick.

Of course, as the analysis reveals information about the benefits and costs of alternative solutions, you may also want to revise some of the alternatives in ways that increase their benefits or reduce their costs. So crafting regulations can be an interactive process.

If the goal is to produce the greatest possible benefit using scarce resources, you should probably select the solution that offers the largest difference between benefits and costs—the one that maximizes net benefits. This is a reliable rule of thumb when you believe that the analysis has taken the major benefits and costs into account reasonably accurately.

If you do not choose the alternative that maximizes net benefits, you should explain why:

• Perhaps there is empirical evidence that significant benefits or costs exist that have not been quantified.
• Perhaps the net benefits of two or more alternatives are close, and uncertainties about benefit or cost estimates mean that either might arguably maximize net benefits.
• Perhaps concerns about fairness or equity motivate a different decision. If this is the case, you have a responsibility to explain what you mean by “fairness” or “equity” and to demonstrate, using evidence, that the alternative you have chosen will actually be more fair or equitable than the alternative that maximizes net benefits.
• Or perhaps legislation prohibits you from considering costs or net benefits, or it explicitly directs some approach other than the alternative that maximizes net benefits.

In any of these cases, transparency requires that you explain the reasons for your decision and justify those reasons with evidence.

As you can see, applying decision-making 101 principles is not easy. All this work should pay off, though, in the form of better, more effective regulations. The transparency of the process you use will help others understand why you did what you did—and will make it easier for you and others to assess how well the regulations are working after some time has passed.

FURTHER READING


Mercatus Center Regulatory Report Cards (evaluations of the RIAs of the proposed economically significant rulemakings published by federal agencies), available at http://mercatus.org/reportcard.

Susan Dudley and Jerry Brito, Regulation: A Primer (Arlington, VA: Mercatus Center at George Mason University, forthcoming).

See also Circular A-4, an Office of Management and Budget guide to economic analysis, available online at http://www.whitehouse.gov/omb/circulars_a004_a-4/.

Hester Peirce is a senior research fellow at the Mercatus Center at George Mason University. Peirce’s primary research interests relate to the regulation of the financial markets.

Jerry Ellig is a senior research fellow at the Mercatus Center at George Mason University. His primary research interests include the federal regulatory process, economic regulation, and telecommunications regulation.

The Mercatus Center at George Mason University is a research, education, and outreach organization that works with scholars, policy experts, and government officials to connect academic learning and real-world practice.

The mission of Mercatus is to promote sound interdisciplinary research and application in the humane sciences that integrates theory and practice to produce solutions that advance in a sustainable way a free, prosperous, and civil society.