HOW TO REGULATE

Markets sometimes fail. But so do regulatory efforts to correct market failures. Sometimes regulations reach too far, condemning good activities as well as bad. Sometimes they do not reach far enough, allowing bad behavior to persist. In this highly instructive book, Thomas Lambert explains the pitfalls of both extremes and offers readers a manual of effective regulation, showing how the best regulation maximizes social welfare and minimizes social costs. Working like a physician, Lambert demonstrates how regulators should diagnose the underlying disease and identify its symptoms, potential remedies for it, and their side effects before selecting the regulation that offers the greatest net benefit. This book should be read by policymakers, students, and anyone else interested in understanding how the best regulations are crafted and why they work.

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How to Regulate

A GUIDE FOR POLICYMAKERS

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For Bob and Footy Lambert, who taught me to optimize.

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Preface

It seems a bad marketing strategy to give one's book a title that suggests a limited audience. For that reason, I have some trepidation about this book's subtitle: *A Guide for Policymakers*. Isn't that a pretty small group? Sure, it includes legislators, regulators, advisers to government officials, analysts at think tanks – maybe even lobbyists. But who else?

As it turns out, the class of people who are policymakers is enormous. Many people are policymakers and don't even know it. As used in this book's subtitle, the term "policymaker" refers to anyone who helps shape government "policy" – that is, the principles that guide government action. The people mentioned above are certainly policymakers, but so are plenty of other folks.

If you work for any branch of any level of government, you have occasional opportunities to influence your employer's position on various matters. When you take them, you are shaping policy. You are a policymaker.

If you are a lawyer or law student, you will likely at some point seek to persuade a court or government agency to make some decision or take some action as the government. When you do that, you are shaping policy.

If you are a teacher of any course that ever examines the propriety of government action, you are in a position to influence your students' thinking on what government should and should not do. When you shape the views of students who, in the future, will exercise government authority or seek to influence government action, you are a policymaker. The same goes for students who are taking courses in which the appropriateness of some government position or conduct is a topic of discussion. When your comments influence the views of classmates who will affect future government stances, you are shaping policy.

If you're out of school but continue to discuss and debate the merits of government decisions with your friends and family, you affect what others

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think about how government should and should not act. Some of those people will likely, at some point, make choices that influence government action. When you say things that shape their thinking, and thus their decisions, you are helping to make policy.

If you are an utter loner who has no job and never speaks to anyone, *but you vote*, you help to select the people whose views will determine the course of government conduct. Your voting shapes policy.

So, the class of people for whom this guide on how to regulate is written – policymakers – doesn't consist merely of legislators, regulators, government advisers, lobbyists, and think-tank wonks. If you're one of those folks *or* if you're a government employee, a lawyer or law student, a teacher or student of any course examining government action, a person who likes to discuss government decisions, or a voter, then this book is for you. Its goal is to help you think more clearly about one particular set of government decisions: those involving regulation (which we'll soon define). I hope, and I believe, that the book will enable you to make persuasive arguments in favor of better regulatory decisions that produce greater human welfare.

Before we begin, allow me a brief word on the motivation for the book, its structure, and the nature of the contribution it makes. For the past fourteen years, I have taught law at a major state university. Over the years, I've been surprised at the number of my students who have become legislators or who have very quickly risen to high-level positions in regulatory agencies. When I run into a former student who tells me he or she now holds one of these positions of power, my first thought (unspoken, of course) is, "Did we teach you how to make the decisions you now have to make?" I am not confident about the answer to that question. One motivation for this book, then, is that there are lots of people who really need to know how to regulate and probably aren't getting that training in their formal education.

Another thing that has surprised me as a law teacher is the large number of my students who want to know more about regulatory theory. I begin each of my courses with an extended consideration of whatever problem the body of law we're studying is seeking to address. In antitrust, we examine market power. In business organizations, agency costs. In environmental law, externalities. Soon after we've finished that discussion, I usually get a few emails or after-class questions asking "What should I read to learn more about that?" I've always recommended excellent books and articles – there are many – on each of the distinct subject areas. But I've never been able to suggest a single source that, in a readable fashion, covers all the major bases for regulating (at least, for purposes of enhancing social welfare) and locates everything within a unified theory of regulation. That is what this book aims to provide.

As you will see, the bulk of this nine-chapter book – Chapters 4 through 9 – addresses the classic market failures (externalities, public goods, market power, and information asymmetry), a problem that is closely related to a couple of those market failures (agency costs), and a prominent non-market failure-based justification for regulation (the cognitive and volitional limitations observed by behavioral economists). Before getting into all that, three short chapters define regulation (at least, for purposes of the book) and set forth a general model for how to regulate. Those first three chapters should probably be read in order and at the outset, but one could easily pick and choose among Chapters 4 through 9, each of which follows a common format and generally stands on its own. Although the book is not intended to be a reference book, readers could use it as such.

The major contribution this book makes is to bring together insights of legal theorists and economists of various stripes – neoclassical, Austrian, public choice, behavioral – and systematize their ideas into a unified, practical approach to regulating. While the ideas are put together in a novel and, I believe, useful fashion, I break little new ground in legal theory or economics. At times during the drafting, I have wondered whether this book is "original" enough. And in those times, I have taken comfort in the words of C.S. Lewis, whose *Mere Christianity* systematized the ideas of scores of philosophers and theologians, spoke plainly, and became a classic. On the closing page of that book, Lewis writes,

> Even in literature and art, no man who bothers about originality will ever be original: whereas if you simply try to tell the truth (without caring twopence how often it has been told before) you will, nine times out of ten, become original without ever having noticed it.[1]

That is what I have endeavored to do here.

Many people contributed to this book, either by helping to hone the ideas presented, providing feedback on drafts, or assisting with research. As a teacher myself, I must at the outset thank two outstanding professors who started me down the path that led to this book. At Wheaton College, P.J. Hill altered the course of my life by introducing me to "the economic way of thinking." Cass Sunstein, then at the University of Chicago Law School, taught me how to think about law and inspired in me a love for regulation (the study of it, at least).

Joshua Wright and Geoffrey Manne contributed far more than they likely know. Collaborating with Josh and Geoff through the years has helped me

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[1]   C.S. Lewis, *Mere Christianity* (New York: Macmillan Publishing Co., 1960), 190.

grasp the power of this book's organizing principle – i.e., that regulation of "mixed bag" behavior should minimize the sum of error and decision costs.

Numerous other friends and colleagues provided helpful feedback on the project. Among them are Jonathan Adler, Martha Dragich, Virginia Harper Ho, Todd Henderson, John Howe, Peter Kingma, Paul Litton, Uma Outka, Ajit Pai, Jordan Pandolfo, Michael Sykuta, and Stephen Ware. Alex Thrasher provided excellent research assistance, and Chuck and Nancy Wall have consistently offered support and encouragement. I am most grateful.