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## Regulatory Reform 101: A Guide for the States

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All states have administrative procedures in place for the purpose of ensuring that regulations achieve goals, are informed by factual evidence, and are not overly burdensome. Unfortunately, these procedures sometimes break down and need reforming. Broken regulatory procedures result in rules that address nonexistent problems, that impose costs out of proportion to the benefits produced, or that overlook simpler, lower-cost solutions that would achieve similar outcomes. Poor procedures also create incentives for the regulatory code to grow without limit, which can impede innovation and slow economic growth.

Policymakers who are concerned about slow economic growth in their state, who worry about the tendency for policies and programs to consume more and more resources and become ever more complex over time, or who believe that regulations too often waste scarce taxpayer resources without solving pressing societal problems should consider the potential benefits of reforming regulatory procedures in their states. Regulatory reforms may be relatively easy to achieve politically as well, making them low-hanging fruit compared with tax or spending changes that can require making difficult budgetary choices or facing angry constituent groups. This essay outlines some reform options for state policymakers. Future research from the Mercatus Center will expand on this essay by going into more detail about state-specific regulatory procedures and opportunities to reform those procedures.

Regulatory process reforms come in two basic forms, depending on whether the intent of reformers is to design better regulations before rules are implemented, or whether their intent is to assess the success

of regulations after they are finalized. Reforms related to reviewing regulations already in place are known as *regulatory look-back reforms*, and they encourage regulators to periodically review and update existing regulations. The goal is to identify and modify or repeal rules that are obsolete, inefficient, or otherwise ineffective, and to identify, learn from, and improve upon successful rules.

Changes to the process of creating regulations are known as *ex ante regulatory process reforms*. Here, the aim is to make policy more evidence-based and efficient, as well as to encourage regulators to be more responsive to the public. This essay will avoid any discussion of the legislative process that initially authorizes regulation, but it is important to remember that the process by which authorizing statutes (which delegate law-making powers to regulators) are written and enforced also shapes the administrative rulemaking process in important ways.

## REGULATORY LOOK-BACK

Periodic reviews of the regulatory code address two kinds of problems: *nonfunctional rules* and *regulatory accumulation*. Nonfunctional rules are regulations that do not work as intended because they are obsolete, inefficient, or otherwise ineffective.<sup>1</sup> Regulatory accumulation refers to problems arising from a growing regulatory code. A growing code is problematic when rules interact with one another in unexpected and harmful ways. A large code can also become too complex, and regulatory complexity can overwhelm the public,<sup>2</sup> creating confusion and uncertainty for citizens, discouraging desirable economic activity like new business start-ups,<sup>3</sup> and ultimately slowing economic growth.<sup>4</sup>

Periodic review of the regulatory code is simply a matter of good housekeeping. Review may or may not be accompanied by a commitment to reduce the size of the overall body of law. The key with any look-back effort is to properly align the incentives of the actors involved in the review process so that information about the effectiveness of rules is gathered, problematic rules are identified, and policymakers respond to this information in a timely manner.

### A. Red Tape Reduction

When the regulatory code grows too large, policymakers might decide to reduce the level of regulation by a

certain amount. These efforts target “red tape,” which refers to “rules, policies, and poor government services that do little or nothing to serve the public interest while creating financial cost or frustration to producers and consumers alike.”<sup>5</sup>

Red tape reduction efforts have been successful in reducing regulatory burdens in many countries.<sup>6</sup> In 2001, the province of British Columbia, Canada, committed to reducing regulatory requirements by one-third,<sup>7</sup> while the Netherlands set a goal of reducing the cost of regulatory burdens on businesses by 25 percent within four years of an effort that also began in the early 2000s.<sup>8</sup> These efforts show how red tape reduction can come in the form of a cut in the number of individual requirements in the code or instead as a cut in the total compliance burden. Such efforts also often coincide with other reforms, such as regulatory pay-go schemes (discussed in the next section). British Columbia accompanied its red tape reduction effort with a one-in-one-out rule, for example.

Perhaps the greatest challenge with efforts to reduce red tape is deciding what the appropriate level of regulation should be. Benefit-cost analysis helps analysts determine the efficiency of individual rules or programs in isolation, but this analytic tool has difficulty determining the efficient level of regulation for the system as a whole. As a result, the appropriate level of regulation is largely a political decision made by representatives of the public. Common sense can also be useful here. When the regulatory code becomes so large and complex that even experts in regulation have difficulty reading and comprehending the code’s effects, it is probably time to start cutting.

### B. Regulatory Pay-Go and One-In-One-Out

Sometimes legislatures want to place a hard cap on the number of requirements or burdens imposed by regulations. Such caps are called “regulatory budgets,” and they will be discussed in more detail below. One simple form of regulatory budget is a regulatory pay-go system. Under such a scheme, costs imposed by new regulations are offset by eliminating equivalent burdens from rules already on the books. This is similar to when new government spending is offset by reducing spending on existing programs, as a means to keep the overall burden of spending from growing. An even simpler form of regulatory budget is a one-in-one-out rule, where regulators eliminate an old rule for every new rule introduced. A one-in-two-out rule has also been

**TABLE 1. REGULATORY REFORM OPTIONS FOR STATES**

Regulatory look-back reforms	
Red tape reduction	A commitment to reduce the size of the regulatory code by a predetermined amount. The chosen level of reduction is usually a political decision, made by representatives of the public, as opposed to being determined with efficiency analysis.
Regulatory pay-go and one-in-one-out	A one-in-one-out (or one-in-two-out) rule eliminates one (or two) old rule(s) for every new one introduced, while regulatory pay-go systems offset new compliance burdens with reductions in compliance burdens from existing rules. Such regulatory budgets can stimulate thoughtful reviews of old rules each time new rules are introduced.
Agency-driven retrospective review and analysis	Regulatory agencies review and analyze their own rules in order to streamline the regulatory code and learn from past experience.
Independent commission to review rules and programs	An independent committee of experts is set up to evaluate rules. A model is the federal Base Realignment and Closure (BRAC) system for military bases. Alternatively, the commission could play an oversight role to ensure deadlines and targets are met under agency-driven review.
Sunset provision	An automatic expiration provision is built into regulations. Sunset commissions can help evaluate rules and programs when the time comes to consider reauthorization.
Ex ante regulatory process reforms	
Regulatory budget	(Both an ex ante and a look-back reform.) Regulatory budgets place a limit on the amount of regulatory “spending” by agencies. Regulatory spending might be capped, such as under a pay-go system, or it could be allowed to grow over time as state income rises.
Economic analysis requirement	Policymakers must conduct regulatory impact analysis, which evaluates the problem, various policy alternatives, and costs and benefits of alternative policy options. Judicial review of analysis can ensure that analysis is of high quality and is used in the process of designing regulations.
Early notification requirement	The public is notified before an agency proposes a regulation. The agency may also be required to perform a preliminary analysis of the problem being addressed and various alternative solutions and seek public input before moving forward with a proposal.
Regulatory review and oversight	Third parties within the government—but outside the regulatory agency—review new rules before they go into effect. Either an office in the executive branch or a legislative committee usually conducts the review. Review may focus on technical or legal factors, and it may come in “hard” or “soft” form depending on the ability of the reviewing body to demand changes before rules go into effect.

used when the goal was to gradually reduce the number of rules over time.

These types of caps stimulate review of old rules each time new rules are introduced, which helps incentivize a culture of retrospection at agencies. Caps are also fairly simple reforms, making it easy to track whether the effort is working as intended and whether agencies are complying. However, without analytic requirements alongside regulatory caps, regulators may unintentionally eliminate some rules that are socially beneficial, or they may fail to implement efficient regulations that could otherwise improve social welfare. Legislative approval is likely needed to eliminate rules mandated by previous legislation, which can complicate the review process and raise constitutional issues. Finally, eliminating rules usually requires initiating a new rulemaking, which can be a lengthy process.

Caps on the regulatory code are simplest when they are based on the number of regulations, requirements, or restrictions rather than on compliance burdens. Computer programs can help identify the number of regulatory restrictions, and how this number changes over time,<sup>9</sup> making it easy to track whether a reform is achieving its intended goals. Theoretically, caps based on administrative or social cost burdens are also appealing, but these reforms will be more difficult to implement and track the success of given the inherent difficulties in measuring these costs. Tools are available to measure such costs, including the Standard Cost Model used in the Netherlands or the Australian Regulatory Burden Measure,<sup>10</sup> but it will take considerable time and resources to get state agencies to use these tools effectively.

### C. Who Conducts the Review?

#### *Agency-Driven Retrospective Review and Analysis*

Since aligning incentives is crucial, both the review process and the individuals selected to conduct the reviews will be important. Regulatory agencies themselves might be tasked with reviewing their existing regulations. A benefit of an agency-driven review is that the agencies often know which rules and programs are working and which are not. A major drawback, however, is that regulators face poor incentives when it comes to identifying problematic rules. They may feel a sense of personal attachment to certain rules after having spent years writing, implementing, and enforcing them.<sup>11</sup>

Additionally, admitting rules have problems can attract unwanted attention and be perceived as failure. Just as students can't be trusted to grade their own homework, agencies may not be honest evaluators of the effectiveness of their own rules and programs.

### *An Independent Commission to Review Rules and Programs*

Since agencies face poor incentives when reviewing their own rules, an independent commission might be set up to conduct reviews instead. At the federal level, the Base Realignment and Closure (BRAC) system provides a model for such an approach.<sup>12</sup> Understandably, legislators are reluctant to close military bases in their districts because of lost jobs or reduced federal funding flowing to constituents. Similarly, regulators are reluctant to eliminate their own rules and programs, as this results in lost agency funding, power, and prestige. The BRAC model serves as an example of an institutional change that overcomes these political barriers to better policy.

A major benefit of an independent commission is its objectivity relative to the agencies that write rules. A commission may also thwart special interests that try to sway the review process (avoiding the “regulatory capture” problem that commonly arises in regulatory agencies).<sup>13</sup> The challenges to setting up an independent commission include deciding who should serve on the commission in order to provide balance and deciding on the process to follow in reviewing the code. More specifically, the goal of any review process should be to analyze the actual consequences of regulations, not just to remove code. Achieving this goal requires, in the first place, identifying the regulations and programs that merit the most careful scrutiny and analysis.

If resources are scarce, the commission might play more of an oversight role. For example, regulatory agencies might be tasked with identifying rules for review and the commission would simply track whether agencies are meeting deadlines and targets. This is why combining a regulatory cap, such as a one-in-one-out rule, with a BRAC-style commission can be an effective reform. The cap will change the agency's incentives. Those in the agency become rule-managers, and not just rule-writers. The cap may also get some buy-in from the agencies since they will be involved in the look-back effort. The commission will then have an oversight role to ensure agencies are not shirking their new responsibilities.

### D. Sunset Provision

Sunset provisions are automatic expirations that are built into regulations. These provisions often empower legislatures since they must act to renew rules that are set to expire,<sup>14</sup> although sometimes regulatory agencies have the authority to renew regulations themselves. In either case, sunsets should incentivize careful reflection by the government, as agencies are forced to demonstrate the effectiveness of their programs and explain why rules and programs are still needed, if at all.

Sunset advisory commissions might be set up to make recommendations about whether reauthorization makes sense.<sup>15</sup> Such a commission is especially useful when state employees work part time and don't have the time or resources to devote to a systematic review and analysis of expiring rules. A sunset commission is similar in many respects to the independent commission described above, and either type of commission could be set up on an as-needed basis or as a permanent fixture in the regulatory process.

At the time of a 2010 review of state regulatory procedures by researchers at New York University, six states had in place sunset provisions for their rules.<sup>16</sup> However, researchers have debated the effectiveness of sunset provisions. Some research has found that legislatures avoid the difficult process of reviewing rules by renewing many expiring rules together in an omnibus bill.<sup>17</sup> If this happens because part-time state legislators do not have the time to dedicate to review, a sunset commission might help to overcome the difficulty. Other research has found that—compared to other regulatory reforms—sunset provisions are effective at lowering the overall level of regulation.<sup>18</sup> Lowering the level of regulation can address the problem of regulatory accumulation, but for sunsets to be truly effective, they should do more than just lower the level of regulation. They should stimulate careful consideration of the costs and benefits of rules and programs by gathering critical information and organizing it in a way that is useful to legislators as they set goals, priorities, and budgets.

### EX ANTE REGULATORY PROCESS REFORMS

Most states have adopted an administrative procedure act (APA) or legal equivalent that governs the process by which regulatory agencies prepare rules and put them into effect. In order to achieve transparency, accountability in rulemaking, and democratic

input from the public, APAs generally require regulators to notify the public and gather feedback before finalizing regulations. APAs also impose an oversight role for the courts. However, these core procedures are not always sufficient to ensure regulations are well designed or informed by the latest technical evidence. In other words, APA requirements alone are not enough to ensure regulations achieve objectives. State legislators should consider further procedural requirements in addition to the core administrative procedures found in most APAs.

### A. Regulatory Budget

Legislators may decide to place a limit on regulatory “spending” by agencies, which is called a regulatory budget. One way to do this is to cap the costs that agencies are allowed to impose on the public through regulation in a given year. These costs, which are akin to a form of spending that takes place off the government’s books, include items such as private expenditures incurred by those who must comply with regulations. Some costs are harder to quantify, such as the time individuals must spend reading and understanding regulations before it is even possible for them to comply, or the time and effort people spend finding ways to avoid having to comply with regulations. These social costs may also be included as part of the budget.

Regulatory budgets help ensure that regulators do not impose unlimited costs on society, and they can also bring important sources of cost onto governments’ books that would otherwise remain invisible. Any cap must be binding, however, in order to influence agency behavior. Setting a cap too high won’t change agency behavior, and setting a cap too low could mean that efficient regulations either are not put in place or are removed. Striking the right balance is critical.

As mentioned earlier, two simple forms of regulatory budget are a one-in-one-out rule and a regulatory pay-go system. These kinds of budget place a hard cap on the quantity of regulation, meaning the level of regulation should not grow over time. But regulatory budgets can also be less restrictive and can allow cost burdens to rise each year. Given that national and state incomes tend to rise over time, it’s not unreasonable to think that regulatory costs might rise as well.

### B. Economic Analysis Requirement

Since the early 1980s, major federal regulations have been required to include economic analyses known as a regulatory impact analyses (RIAs). The purpose of these documents is to organize and present technical information in a coherent way for decision makers to use when deciding whether and how to proceed with a rulemaking. RIAs are intended to make rulemaking more evidence-based, organized, and rational. They help overcome problems related to poorly informed decision-making.

A thorough RIA presents more than just the costs and benefits of a policy intervention. It includes evidence that a real problem exists that requires a regulatory solution. It traces that problem back to its root cause. It identifies the outcomes that a regulation is supposed to achieve. It lists alternative ways to address the problem. And, finally, an RIA quantifies benefits and costs of alternative policy approaches, preferably in monetary terms, in order to identify the most efficient way forward. Analysis should also include information about who is expected to bear the costs and enjoy the benefits of the new rule, as well as information about any budgetary impact of the rule.

Some states already have analysis requirements along these lines. For example, the Commonwealth of Kentucky requires a very simple form of RIA.<sup>19</sup> But requirements alone do not ensure that the analysis will be of high quality or that it will be used to inform policy. Subjecting analysis requirements to judicial review by the courts can help ensure that agency compliance with analytic requirements is more than just a box-checking exercise. Judicial review can also ensure analysis is not only used to justify decisions, but also to inform them. Sometimes agency economists are told to craft an analysis that supports a decision that has already been made by the economists’ supervisors.<sup>20</sup> When this happens, analysis becomes a marketing tool rather than a tool that guides good decision-making. Courts can help prevent this outcome by ensuring that analysis meets certain legal standards of quality and that there is evidence in the factual record that the analysis was used in a way that helped to shape the regulation.

### C. Early Notification Requirement

When agencies decide what they want to do and then craft analysis or gather public input only

after the decision has been made, this is known as the “ready, fire, aim” problem in rulemaking.<sup>21</sup> It would be far more responsible if analysis and public input came before regulators made decisions, so that the information gathered could actually help shape policy.

A statute or executive order could require agencies to prepare a preliminary analysis of a problem and various alternative solutions before proposing a regulation. The agency could then seek comments from the public before moving forward with a proposed rule.<sup>22</sup> The idea is that regulators should seek public input and consider alternative forms of rulemaking before any decision is made about how to regulate. This means policymaking takes place in the right order (ready, aim, fire) and allows for more public participation in the rulemaking process. Early notification can also occur without producing an economic analysis or taking public comments. In such cases, the public will get advanced notice that an agency is preparing a proposed rule. This gives the public some extra time to prepare for a rulemaking, but doesn’t help to address the “ready, fire, aim” problem.

#### D. Regulatory Review and Oversight

Several states require that before new rules go into effect, they must be reviewed by third parties who are inside the government but outside the regulatory agency that has developed the rule.<sup>23</sup> The purpose of review varies depending on certain factors, including who does the reviewing. Sometimes review acts as a quality control measure, ensuring that regulations are informed by the most up-to-date scientific, economic, or other technical evidence. Other times review might focus on legal factors, such as whether a particular regulation falls within the bounds of its authorizing statute or the state constitution.

Under *executive review*, an office working for the governor is tasked with reviewing rules. For example, Virginia has an office in the executive branch that reviews rules for their economic impacts, among other things.<sup>24</sup> Executive review can also ensure that new rules are in line with the priorities of governors, who, because they are elected, are more accountable to voters than are the civil servants working in regulatory agencies.

With *legislative review*, one or more committees in the legislature review rules. This kind of review often focuses on constituent interests as well as on whether a

regulation passes legal muster. Legislative review comes in both a hard and a soft form. In the soft form, reviewing committees issue nonbinding recommendations to agencies. This is the case in Kentucky, where rules can be deemed “deficient” by reviewing subcommittees, but such a finding does not preclude a rule from going into effect. A harder form of review includes a *legislative veto*, whereby the legislature can actually override a proposed regulation.<sup>25</sup> A review system like this can be found in Idaho.

There are also oversight bodies that fall somewhere between the hard and the soft form of review. For example, Pennsylvania’s Independent Regulatory Review Commission and South Carolina’s Small Business Regulatory Review Committee both have some ability to require agencies to conduct economic analysis or to change regulations.<sup>26</sup> Oversight hearings and the budget appropriations process are two more ways that legislatures influence agencies during rulemaking.

## CONCLUSION

Regulation is too important to be designed in a cavalier manner. The danger in failing to address problems with regulatory procedures is that taxpayer resources are wasted or, worse, solvable problems go unaddressed or are exacerbated. Good incentives are necessary at every step of the process so that regulators and the regulated community work in concert to achieve societal goals.

A rulemaking system that is working will produce the intended results without creating too many additional harms. An *ex ante* rulemaking process that includes analysis requirements, early notification, and oversight by courts and executive or legislative committees can help guarantee that rules are well thought out and are likely to achieve their goals. Once rules are finalized, regular review and analysis of the consequences of rulemaking is vital to ensure that regulations continue to be effective and do not create undue burdens for society.

Each state must decide for itself what institutional arrangement is most likely to achieve these outcomes. This will depend on the unique characteristics of each state’s government and the particular needs of the state’s residents. When reform makes sense, there are powerful tools available to lawmakers that make rulemaking procedures more effective and more responsive to citizens.

## NOTES

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