

Commentary/Commentaire

Making Good Regulations

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Dans cet article, j'examine la façon dont les diverses réglementations sont ou pourraient être conçues en décrivant de façon précise les processus qui mènent à leur création, et j'explique le rôle que les économistes devraient y jouer. J'avance que les processus utilisés traditionnellement ne fonctionnent plus, et que la qualité des réglementations décroîtra si on ne les adapte pas à un environnement qui, lui, a changé. En plus de leur rôle traditionnel, qui est de comparer les instruments réglementaires et de calculer leurs avantages et leurs coûts, les économistes peuvent aussi être très utiles en tant que stratèges dont l'objectif est de faire en sorte que l'intérêt public sorte gagnant du jeu stratégique qu'est devenue la conception des réglementations.

Mots clés : réglementation, politiques gouvernementales

This paper looks at the changing nature of regulation making with a special emphasis on the role that economists should play. It focuses specifically on the processes used to develop regulations. It argues that the traditional process for regulation making is breaking down and that the quality of regulation will decline if processes do not adapt to the changing environment. In addition to their traditional work of comparing regulatory instruments and calculating their benefits and costs, economists can play an important role by serving as strategists to help the public interest win in the strategic game of regulation making.

Keywords: regulation, government policy

INTRODUCTION

It is fashionable these days in some circles to talk about regulation as a blight on society. Dreamed up by time-serving bureaucrats, regulations are the evil work of idle minds looking to destroy personal freedoms and grind the economy to a halt. But stop for a minute to think about a world without regulation. No more food safety regulations for meat packers or grocery stores. No more product safety regulations for aircraft or autos. No more control of toxic substances

like mercury or lead. No more investor protection against financial fraud or insider trading. It would be a pretty risky and frightening world.

However, even if our world is a safer place as a result of regulation, this does not mean that all regulations are beneficial or designed as efficiently as possible. Reactions against poorly designed or administered regulations have probably contributed a lot to giving regulations a bad name with politicians and the public.

It does not help matters that there is a lot of confusion about what regulations are and are not. For example, a recent *Globe and Mail* article entitled “Who’s Regulating the Regulators?” featured a full-page interview with Dan Kelly of the Canadian Federation of Independent Business (CFIB), who complained of the impact of “excessive rules and regulations on Canada’s productivity” (Calleja 2013). Later in the article, we are told of CFIB members’ ranking of the five most burdensome federal regulations: 1) the Goods and Services Tax (GST) and Harmonized Sales Tax (HST); 2) payroll taxes, like Employment Insurance (EI) and the Canada Pension Plan (CPP); 3) income taxes; 4) records of employment; and 5) Statistics Canada surveys. Interestingly, not a single one of these top five regulatory irritants is actually a regulation! What CFIB members *really* dislike is the paperwork needed to pay taxes for themselves or their employees. Who can blame them?

In this paper, I look at the changing nature of regulation making, with a special emphasis on the role that economists should play in making good regulations. I particularly focus on the processes we use to develop regulations. It is my contention that the traditional process for regulation making is breaking down and that the quality of regulation will decline if we do not adapt to the changing environment. Economists can play an important role, not only by doing their traditional work of comparing regulatory instruments and calculating the benefits and costs of regulations, but also by serving as strategists to help the public interest win in the strategic game that regulation making has become.

The paper is organized as follows. I start by discussing the ambivalence that politicians, voters, and even economists feel towards regulation. Next, I explore the characteristics of good regulations. Then I turn to what I call the traditional and evolving approaches to regulation making and the roles that economists play. I end with some conclusions and recommendations aimed at making good regulations.

THE POLICY INSTRUMENT WE LOVE TO HATE

Given the views of people like Dan Kelly and the small business owners he represents, it is perhaps not surprising that politicians have a love-hate relationship with regulations. Whether they are ministers or backbenchers, members of the government or opposition, politicians love to decry the burden of regulation. However, when pressed, few are ready to leave food or product safety or protection of the environment to totally unregulated markets. Nevertheless, their concerns regarding the burden of regulation lead to measures like the “One-for-One” Rule recently put in place by the federal government.

The “One-for-One” Rule says that the adoption of each new regulation must be balanced by the removal of an existing one. Unfortunately, the rule carries with it some unintended consequences. Let us look at an example from environmental regulation. The “One-for-One” Rule makes intuitive sense. If you want to control the overall regulatory burden, control the number of regulations. However, in the case of the environment, we have a few sweeping, prohibitive regulations nuanced by a large number of enabling regulations that permit the activity in specific circumstances that are deemed safe. In a one-for-one world, new enabling regulations go to the bottom of the pile because they must be “paid for” by eliminating prohibitive regulations that provide a measure of protection to the environment. In this case, the unintended consequence of the “One-for-One” Rule is to prevent the passage of enabling regulations that actually serve to reduce the regulatory burden.

What about the “love” side of the love-hate relationship that politicians have with regulations? That is a little more difficult to understand until you compare regulations with their alternatives. Often the alternative is to use an economic instrument to achieve a desired policy goal. Such an instrument could be a tax or a subsidy, depending on the behaviour the policy is trying to incent. A carbon

tax would be an example currently being publicly discussed.

These days, most politicians find the tax burden even more irksome than the regulatory burden, and few want to be labelled by their opponents as a “tax raiser.” Likewise, deficit-cutting politicians would rather pass a regulation (free to the treasury, at least initially) than worsen the deficit as a result of another subsidy program. Thus, because their effects on the treasury¹ are relatively small, many politicians harbour a secret preference for regulations over their economic instrument alternatives.

Where do economists stand in the debate on regulation? It is probably fair to say that, like politicians, economists also have a love-hate relationship with regulation as a policy instrument. Economists recognize the existence of market failures and externalities that underpin the need for many regulations. Moreover, the economic effects of regulations are relatively simple to analyze using the microeconomic models we studied as undergraduates. However, given the choice, most economists would prefer that an economic instrument (tax or subsidy) be deployed to offset an externality, or that a market structure be created to overcome a market failure. This preference is deeply engrained in our neo-classical tradition.

In addition, economists are wary of regulatory capture, e.g., George Stigler’s “regulation for the benefit of the regulated” (Peltzman 1993). This wariness has been handed down from Stigler and Friedland (1962) who, based on some very early empirical work, found little effect of utility regulation beyond the guarantee of rates of return and protection from competition that is part and parcel of such regulation.

Not all economists are down on regulations. For example, Harvard economist Michael Porter (Porter and van der Linde 1995) developed the so-called “Porter hypothesis.” The idea here is that regulation

can be a spur to innovation by firms and may lead to a competitive advantage for first movers sufficient to overcome the cost of regulation.

During my time as a regulator, both in telecommunications and the environment, I did see lots of effort expended by regulatees to ensure that regulation worked for their benefit. Sometimes they were successful and sometimes not. In general, their success was inversely proportional to the transparency of the regulatory process. Lacking transparent processes, I think economists are right to be wary of regulation. Regulators need to be vigilant to ensure they are advancing the public interest and not just the interests of regulatees with loud voices or political influence.

Less easy to understand, however, is economists’ uncritical preference for using economic instruments or creating new market structures rather than using regulations. As an economist and former regulator, I attribute this to the lack of practical experience many (especially academic) economists have with the design and implementation of economic instruments. They forget that choosing between second-best alternatives is almost always a decision that must be made based on empirical evidence.

An example will serve to illustrate this point. Consider a standard externality problem related to water pollution. Suppose a municipality discharges waste into a river as it flows by, creating a pollution problem for those living downstream. The simple solution, we tell undergraduates (and I am guilty of this particular sin myself), is to locate the municipal water discharge upstream from the water intake. The externality will be internalized and the municipality will take the necessary steps to make sure the river is not polluted.

Of course, there are many practical reasons why this solution may not be implemented. Municipal voters are not homogeneous and do not live forever. They may not have full information or may

be struggling with limited budgets and other, more pressing public health problems. Some polluters may live out of town or the appropriate technology may not exist or be affordable. We know lots of instances where cities do not deal with pollution issues that affect only themselves—so why should we expect that our simple theoretical solution to the externality would be the best practical policy as well?

My point is not that regulations are always better than economic instruments. Rather, it is to admit the *possibility* that in some practical instances they are. Regulations are here to stay, and as economists, we should recognize this and turn our minds to making them as good as they can be.

WHAT MAKES GOOD REGULATIONS?

It would be easy to say that smart, public-spirited regulators and like-minded political masters are all you need to have good regulations—perhaps throwing in some altruistic regulatees to complete the circle. However, like most good things, good regulations do not happen automatically or simply by correctly aligning incentives. You need to know what good regulations look like and then have a good process to achieve them.

If regulations are more than simply doing the paperwork to pay your taxes or your employees' source deductions, what are they? The federal Privy Council Office (PCO) gives us a concise definition:

Regulations are a form of law, often referred to as delegated or subordinate legislation. Like Acts, they have binding legal effect and usually state rules that apply generally, rather than to specific persons or situations. However, regulations are not made by Parliament. Rather, they are made by persons or bodies to whom Parliament has delegated the authority to make them, such as the Governor in Council [federal cabinet], a Minis-

ter or an administrative agency. ([Privy Council Office 2001](#))

Not being made by Parliament means that regulations do not undergo the public scrutiny and discussion that comes when parliamentarians debate and vote on laws. However, regulators do have rules of their own to follow. In general they are governed at the federal level by the Statutory Instruments Act and (of course) the Statutory Instrument Regulations. In addition, the enabling legislation that gives regulators the power to make regulations may impose conditions on the regulations themselves and on their development.

What makes regulations good? It is useful to divide the answer to this question into two parts, the first part focusing on their purpose and the second part focusing on their nature or characteristics. To address the first part, we turn to the federal government's Cabinet Directive on the Management of Regulation:

The Government of Canada is committed to protecting and advancing the public interest by working with Canadians and other governments to ensure that its regulatory activities result in the greatest overall benefit to current and future generations of Canadians. ([Treasury Board Secretariat of Canada 2012](#))

It is worthwhile to spend a moment to unpack this statement of purpose. Key in the first half of the statement is that regulations are to be made in the public interest, not to serve the private interests of individuals or firms. Key in the second half is the notion of greatest overall benefit, i.e., ensuring that regulations are both effective and efficient, in the sense of minimizing the burden of regulation consistent with achieving a given regulatory goal.

What about the second part of the answer, related to the characteristics of good regulations? To address this, I will draw on my own experience as

a regulator. One of our signature initiatives while I was at Environment Canada (EC) was what we called the World-Class Regulator (WCR) project. The minister of the day, Jim Prentice, told me that being a WCR should be an aspiration of the department. I saw the project as a way to unite a very disparate group of public servants with a shared commitment to the environment behind a project that would cross their disciplinary boundaries (biologists talking to economists talking to lawyers). We engaged the department broadly—trying to give anyone who was interested a voice—and the result was even better than I had hoped.

After a lot of discussion and research, Environment Canada came up with the following five characteristics of world-class regulation:

1. Evidence-based decision-making: Decisions are supported by science and precaution is used where evidence is incomplete.
2. Effectiveness: Clear environmental objectives are defined and the regulatory instrument achieves the desired environmental outcome.
3. Efficiency: Regulatory instruments achieve the desired environmental objectives at the lowest possible cost.
4. Transparency: Affected parties are engaged throughout the process to give stakeholders a voice, enable market certainty, reinforce credibility, and engender public trust.
5. Adaptability: Processes are reviewed and performance is measured to determine whether regulatory instruments are achieving the intended policy objectives.

This may all sound a bit like motherhood, but in fact, it provided a framework to analyze almost all the regulatory work we did. Some regulations looked pretty good. Others did not. More importantly, it

gave us a basis to look at every decision in the regulatory process and ask a fundamental question: Is this what a world-class regulator would do?

How does this framework fit with the traditional and evolving approaches to regulation making and what does it mean for the role of economists? In my view, the framework is such that a number of disciplines, including economics, can see their role. In addition, the framework provides some useful guidance as we move from the traditional approach to its evolving counterpart.

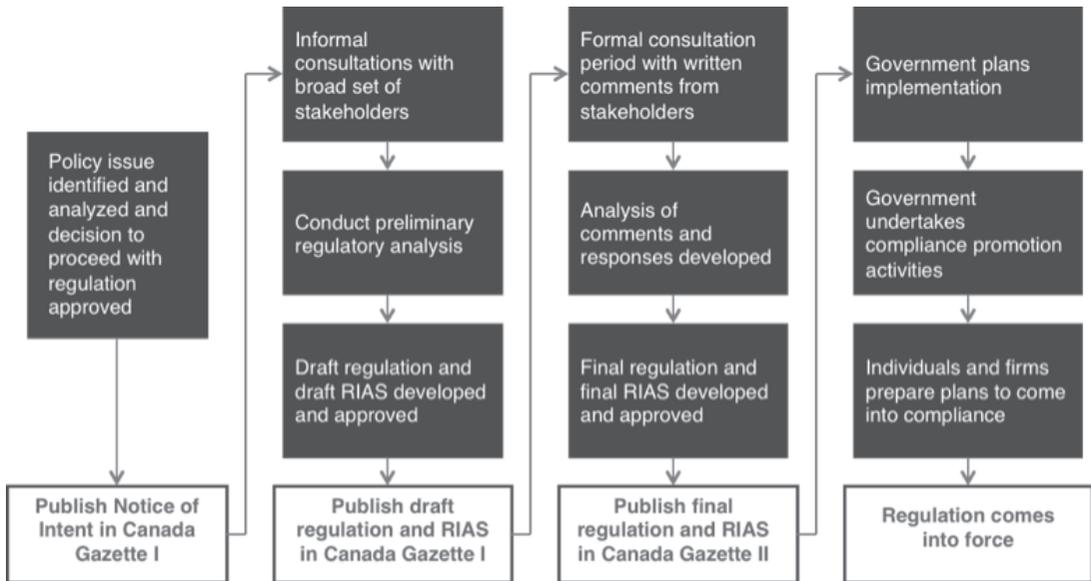
THE TRADITIONAL APPROACH TO REGULATION MAKING

No two regulatory processes are exactly the same. Every one will have some peculiarities that arise from the specifics of the activity or substance to be regulated. However, there are a lot of similarities across regulatory processes. The key to understanding the traditional approach is to understand the role of the actors—in the traditional (or stylized) approach, actors take the regulatory process as exogenous. There is a process to follow and everyone agrees, at least implicitly, to work within it.

Figure 1 gives a chronological depiction of a regulatory process. The process begins with the identification of a policy issue or problem and the political approval to proceed with the development of a regulatory response. For major regulatory initiatives, the public is made aware of the government's decision to develop a regulation by way of a Notice of Intent (NOI) published in *Canada Gazette, Part I* (CGI).

The regulator next begins a set of informal consultations with a broad set of stakeholders to understand their interests and gain knowledge of the implications of alternative regulations. Based on those consultations, the regulator conducts a preliminary regulatory analysis and produces a draft

FIGURE 1
Traditional Approach Timeline



Notes: RIAS=Regulatory Impact Analysis Statement.

Source: Author design.

regulation using the appropriate legal language. An associated Regulatory Impact Analysis Statement (RIAS) is also developed. The draft regulation and RIAS are published in CGI.

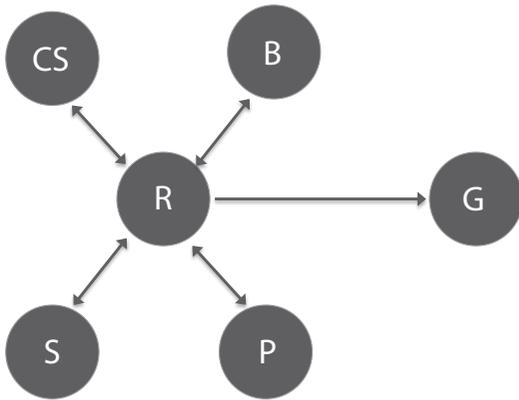
The publication of the draft regulation and RIAS triggers the formal public consultation where written comments from stakeholders are solicited. At the end of the formal consultation period, the regulator considers and develops responses to the comments and then modifies the draft regulation and RIAS as required. Political approval is secured and the final regulation and associated RIAS are published in *Canada Gazette, Part II* (CGII) with the regulations to come into force at some specified time in the future.

The final phase in the process is implementation. The regulator executes the implementation plan and undertakes compliance promotion activities to help individuals and firms prepare to come into compliance. After an appropriate period, the regulation comes into force and the regulator monitors compliance and undertakes enforcement activities as required.

An alternate way to describe the traditional regulatory approach is depicted in Figure 2. Six groups of actors are involved. They are the regulator (R), business (B), provinces (P) representing other orders of government in areas of shared jurisdiction, science (S) representing technical expertise and academics, civil society (CS) representing other

stakeholders, and government (G) representing political decision-makers with legislative authority to make regulations. Arrows show the direction of information flow. In the traditional approach, the regulator is the mediator of discussions with the stakeholders and the aggregator of information for political decision-makers.

FIGURE 2
Traditional Approach



Notes: CS=civil society (other stakeholders), B=business. R=the regulator. G=government. S=science (technical expertise and academics). P=provinces (representing other areas of government).

Source: Author design.

A recent example employing the traditional approach is the regulation of greenhouse gas (GHG) emissions of light-duty vehicles (LDVs). The essence of the regulation is to reduce tailpipe emissions in cars and light-duty trucks in line with regulations being formulated in the United States. The regulation has the dual benefit for society of reducing GHG emissions and for producers of eliminating costly regulatory differences between Canada and the United States. In addition to the GHG reduction, the regulation provides a net benefit

to consumers since the fuel saved over the life of the vehicle will exceed the cost of the technology upgrades required to meet the new standards.

What did the process look like? There had been talk of LDV regulations since the middle of the last decade and, of course, interested parties were watching what was happening in the United States. In January 2008, Transport Canada issued a discussion document that laid out some of the issues and alerted stakeholders that the government was getting serious about moving in this direction.

The formal process began in April 2009 with the publication of a Notice of Intent in CGI. This was followed by a series of informal consultations, including the Canadian Environmental Protection Act Advisory Committee, provinces, industry groups, and environmental non-governmental organizations (NGOs). Consultations proceeded to the point where the government felt it could release a consultation draft to focus the discussion in December 2009. The draft regulation was followed by more meetings with stakeholders and an invitation to submit written comments.

In April 2010, the government published a full regulatory package in CGI. This included the RAIS and triggered a formal sixty-day consultation period where written comments were solicited. Final decisions regarding the regulation were made internal to government, the RAIS was re-drafted, and responses were prepared to the written comments. The whole package was published in CGII in October 2010, about eighteen months after the publication of the NOI.

The regulation was well received by industry and environmental NGOs, although some argued that the government could have been more aggressive. The development of the regulation was relatively fast, probably driven by parallel developments in the United States and large degree of consensus among stakeholders. However, I would argue that

it was also speeded along (and maintained its ability to meet its stated goals) by the existence of a clearly defined, well-understood process. That process put regulators in the driver's seat when it came to formulating the final regulation in light of the various arguments that had been made through the consultations.

The role of economists in the process was also well defined: to consider and recommend among various regulatory instruments, and to analyze the impacts of the proposed regulation and its alternatives. Their partners in this activity included engineers and lawyers.

I also think that the process that was followed fit well with the first four characteristics of world-class regulator: evidence-based, efficient, effective, and transparent. It also looks to be on track with the final characteristic, adaptability, given that—as I write—the government is looking to update the regulation with more ambitious targets, again in alignment with developments in the United States.

THE EVOLVING APPROACH TO REGULATION MAKING

A useful way to think about the evolving approach to regulation making is to treat the regulatory process itself as endogenous. Regulators have influence, but do not control the rules of the game. The first thing to observe is that when the process itself is in play, the optimal strategies of regulators and stakeholders become a lot more complicated. More variables are in play, and actions by some players are not visible to others.

Regulatory outcomes may be better or worse, depending on how each party formulates and implements its strategy. Factors like political influence become much more important. This is not to say that political influence had no role in the traditional approach, but rather that it was constrained, in part, by the actions of regulators and the transparency of the process.

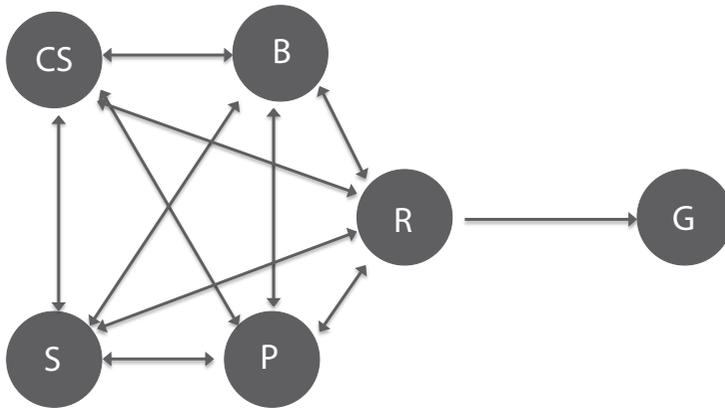
Figure 3 presents a graphical depiction of one variant of the evolving approach to regulatory process. The regulator is no longer at the centre of the process, mediating conversations between the various stakeholders. Stakeholders are all talking to one another as well as to the regulator. Direct conversations between stakeholders may have the benefits of improved understanding of seemingly opposing views and the development of consensus positions. The regulator is still the one who collates the various views, and provides information and recommendations to political decision-makers.

An example of a complex regulatory game that, in my view, is being particularly well managed is the process around the Air Quality Management System (AQMS) that is in its implementation stage. After a false start in 2007, the government launched a new initiative regarding air quality in 2008. Federal officials began meeting with a steering committee comprised of two provinces, six major industry associations, and six environmental NGOs.

The meetings with the two provinces were no surprise, given that constitutionally, the environment is an area of shared jurisdiction in Canada. However, to have a formal structure that included business and NGOs at the same table was a departure from the norm. The result was a process of discovery to explore one another's interests and knowledge of issues. From these discussions came a shared commitment to work together in order to take a more comprehensive approach to air quality management.

Subcommittees were used to drill down into the specifics of different sectors' industrial emissions. Environment Canada provided information regarding best practices from other jurisdictions and wrote reports outlining areas of consensus and disagreement for each subcommittee. The idea was that regulators would likely adopt consensus plans, but would move ahead on their own if no consensus emerged. This coalition-building strategy created a strong incentive for subcommittees to find solutions rather than agree to disagree.

FIGURE 3
Evolving Approach—Type A



Notes: For abbreviations, please see Figure 2.

Source: Author design.

Environment Canada also encountered reticence on the part of some provinces as the decision to proceed approached. Recall that this was occurring in the aftermath of a nasty recession when no one wanted to be held responsible for a lost job if they could avoid it. To bolster support, EC was able to get industry and NGO stakeholders to take the unusual step of publicly releasing a joint letter to ministers indicating that they were ready to take action to improve air quality. The letter helped give ministers the confidence needed to press ahead with the process.

In early 2012, deputy ministers met to decide whether to recommend final approval from ministers to begin regulating. Again, some provinces balked at regulating specific (generally the most uncompetitive) industries in their regions. EC officials quickly changed the process so that regulation could proceed for the vast majority of industries where consensus had been reached and work could continue on the remaining few. This strategy prevented a blocking coalition from forming.

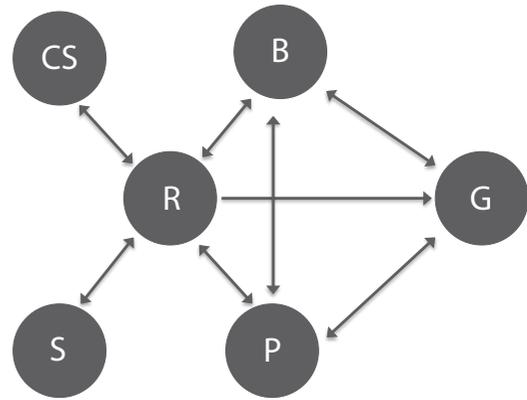
How does this regulatory case study stack up using the five WCR characteristics? Reasonably well, I think—especially when the alternative is no national regulation of air quality. In my view, no national regulation of air quality is the realistic counterfactual case, since it is extremely unlikely that the federal government would override a blocking provincial coalition in an area of shared jurisdiction. Although we are just entering the implementation phase, it is certainly evidence-based and transparent (subcommittees ensured that) and will likely be efficient and effective relative to any realistic alternative. As for its adaptability, only time will tell.

What about the role of economists? In addition to using their analytical skills to assist in instrument choice and impact analysis, economists were called upon to use their game theoretic frameworks to develop strategies to form coalitions supporting good regulatory processes and divide coalitions opposing them. Although economists are not the only ones

called upon to navigate these complex policy negotiations (the daily bread of good deputy ministers), they are the only ones who have the training and theoretical frameworks to analyze such situations in a rigorous and consistent way.

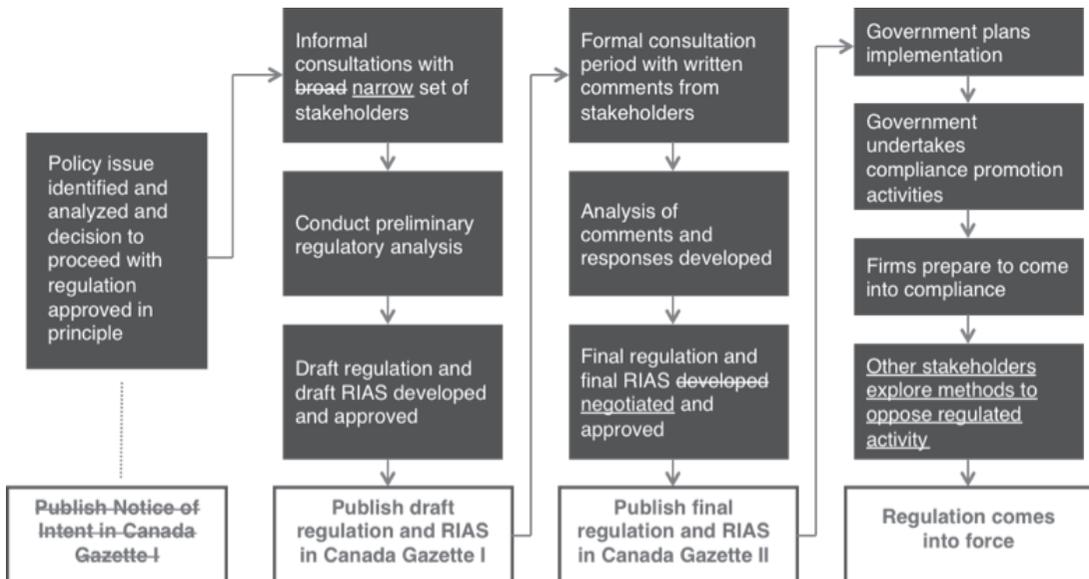
While this regulatory example seems headed for a positive outcome, it does not follow that all regulations resulting from endogenous regulatory processes will end well. Figures 4 and 5 depict a variant of the evolving approach that is less likely to result in a positive outcome. Stakeholders continue to interact with the regulator, but business and provinces deal directly with each other and with political decision-makers. They ignore civil society and the scientific community, who in turn have no direct link to political decision-makers.

FIGURE 4
Evolving Approach—Type B



Notes: For abbreviations, please see Figure 2.
Source: Author design.

FIGURE 5
Evolving Approach—Type B Timeline



Notes: RIAS=Regulatory Impact Analysis Statement. Deletions (crossed out) and additions (underlined) indicate changes to the traditional approach.
Source: Author design.

With no agreed process in place, governments will be tempted to reduce transparency, consulting with their allies and ignoring the views of their opponents. Stakeholders may find it more advantageous to pursue regulatory outcomes through political influence than by participating in good faith in consensus-building processes. Evidence that is politically inconvenient may be suppressed. The result may be the regulatory capture that Stigler and other economists warned against and a less efficient and effective regulatory regime.

Indeed, we are already seeing some evidence of reduced transparency and shortcuts in regulatory processes. We learned recently that individuals and groups must now fill out a ten-page application before they can write a letter to the National Energy Board (NEB). Presumably this is to demonstrate that they have an interest in a proceeding. Surely where environmental matters are concerned, all Canadians can claim a legitimate interest and should have the opportunity to express their views in writing to the NEB.

In reality, a regulatory process that is not well defined and transparent may not even be in the interest of firms affected by the regulation in question. Of course there is the question of what happens if the government of the day is not well aligned with business interests. More important, in my view, is what excluded parties do when frustrated by regulatory processes that deny them meaningful participation.

Their options include legal challenge, attacking a firm's brand in the market place, or even civil disobedience in the case of development projects. All these options have the potential to be extremely costly and time-consuming to businesses and represent a second-best approach to maximizing the public interest.

CONCLUSIONS AND RECOMMENDATIONS

What does this mean for the economics profession? First of all, as I said at the outset, regulation is here

to stay—so do not count on a wholesale replacement of regulation with economic instruments like taxes and subsidies any time soon. A dogmatic adherence to economic instruments will leave our profession sitting on the sidelines.

Second, we need more training of students and young economists in regulatory work. Understanding industries, choosing regulatory instruments, and analyzing regulatory impacts are the work that economics training is uniquely suited for. It is interesting and important work and applied microeconomics at its best.

Third, we need applied research to understand the world of strategic regulatory processes. The days of the regulator as benevolent final arbiter are gone (if they ever existed). Strategic regulatory processes can be designed to produce good outcomes. However, they can also result in a free-for-all where the public interest gets sacrificed for the interests of the politically influential.

Finally, even strategic regulatory processes need some clearly defined ground rules, if only around transparency. In the long-run it is in no one's interest, even the currently politically influential, to have weak processes for formulating regulations. We need to enlist all stakeholders, including business and civil society, to build broad support for regulatory processes that have integrity and share most, if not all, of the five characteristics of good regulations.

Failure to do so would be costly in the long run—in terms of time, in terms of money, and in terms of the credibility of our regulatory system—a failure that Canada cannot afford.

NOTES

Canadian Public Policy Annual Lecture delivered at the 2013 Canadian Economics Association Meetings, Montreal, Quebec. I am grateful to Environment Canada colleagues and an anonymous reviewer for comments on an earlier draft and to Brook Coatsworth for research assistance. None

of the opinions expressed in this paper should be attributed to any other individual or organization.

¹ Notice that I refer here to the “treasury” rather than to the “economy.”

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