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Regulator Engagement with Small Business
Productivity Commission
PO Box 1428
Canberra City ACT 2601

NSW Business Chamber
incorporates

- Sydney Business Chamber
- Australian Business Limited Apprenticeships
- Australian Business Lawyers and Advisors
- Australian Business Consulting and Solution

Dear Dr Mundy,

Thank you for the opportunity to contribute to the Productivity Commission's Inquiry into Regulator Engagement with Small Business.

ABOUT THE NSW BUSINESS CHAMBER

As you may be aware, the NSW Business Chamber ("the Chamber") is one of Australia's largest business support groups, with a direct membership of more than 11,500 businesses, providing services to over 30,000 businesses each year. Tracing its heritage back to the Sydney Chamber of Commerce established in 1825, the Chamber works with thousands of businesses ranging in size from owner operators to large corporations, and spanning all industries sectors from product-based manufacturers to service provider enterprises. The Chamber is a leading business solutions provider and advocacy group with strengths in workplace management, occupational health and safety, industrial relations, human resources, international trade and business performance consulting.

Operating throughout a network of offices in metropolitan and regional NSW, the Chamber represents the needs of business at a local, regional, State and Federal level, advocating on behalf of its members to create a better environment for industry.

STRUCTURE OF THIS SUBMISSION

The remainder of this submission is divided into three sections. The first section discusses the general rationale for treating small businesses differently. The second section explains how this rationale should be used as the basis for distinguishing small businesses in a regulatory context. The third section considers how regulators can improve their engagement with small businesses and businesses more generally.

RATIONALE FOR TREATING SMALL BUSINESSES DIFFERENTLY

The rationale for treating small business differently is that doing so can increase the net benefits of regulation.

Tailoring regulations to small businesses

Treating small businesses differently does not have to involve regulating small businesses less strictly than large businesses. The operations of small and large businesses are usually very different and tailoring regulations or regulatory behaviour to the circumstances of small businesses can often deliver superior regulatory outcomes at an equal or lower cost.

For example, large businesses have the scale to hire specialists and may benefit from lengthy technical regulatory guides. In many small businesses, the owner is often responsible for regulatory compliance. Small business owners will often be unable to decipher the practical implications of more detailed material and will usually prefer a simple overview of their obligations, an explanation of the regulations objectives, and a step-by-step guide to compliance.

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Similarly, unforeseeable changes in business and personal circumstances may make little difference to the compliance of large businesses with established systems, multiple layers of management and specialised personnel. However, in small businesses the owner is often responsible for doing the work, managing staff and meeting all the regulatory obligations. As a result, major personal events in the owner's life, events that lead to the sudden absence of an employee or sudden changes in work volume can have a major impact on a small businesses ability to comply with regulations on time. A sensible regulatory regime recognises that in such circumstances more can be gained through understanding and education than punitive measures.

Regulating small businesses less heavily

In some circumstances, there is a case for regulating small businesses less strictly than large businesses. This can involve lighter substantive regulatory requirements or less burdensome monitoring such as fewer inspections or reduced reporting requirements.

A number of factors need to be considered to determine whether regulatory tiering is appropriate. These factors are outlined below. The Chamber's overall view is that the rationale for regulatory tiering needs to be considered on a case by case basis.

Compliance costs: The first factor that must be considered to assess the appropriateness of regulatory tiering is how the unit costs of compliance vary with firm size. Bradford explains that regulatory compliance generally involves substantial fixed costs – including capital investments in monitoring equipment, the time required to understand the rules and rule changes and preparing and recording information – and specialisation can lead to economies of scale in even the variable costs of large firms.¹

Outsourcing compliance may provide a partial solution to some of the issues raised by Bradford. However, outsourcing also imposes its own costs in terms of search and monitoring costs for the small business and marketing and reporting costs for the service providers.

Bradford argues that the empirical evidence broadly supports the theory that the per-unit cost of compliance is higher for smaller firms and that this effect is not simply the result of short-run transition costs.² The research Bradford cites focuses on North America, but Lattimore et al cites similar results in Australia studies, though they are largely limited to the context of tax compliance.³

Compliance benefits: The second factor that needs to be considered is how the unit benefits of compliance vary with firm size. Common sense suggests that regulatory benefits usually fall at a constant rate in line with the activity being regulated. For example, the amount of tax revenue that can be lost through tax avoidance for a business with a turnover of \$200,000 is probably about 10 per cent of the tax revenue that can be lost through tax avoidance by a firm with a turnover of \$2 million.

Pierce appears to suggest that small businesses are less likely to comply with regulations than large businesses. This may occur since higher unit compliance costs for small business

¹ Bradford, C. (2004). Does Size Matter? An Economic Analysis of Small Business Exemptions from Regulation. *Journal of Small and Emerging Business Law*, 8(1), 1-37. pp.1-11.

² Bradford, 2004, pp.11-15.

³ Lattimore, R. G., Madge, A., Martin, B., & Mills, J. (1998). *Design principles for small business programs and regulations*. Productivity Commission Staff Research Paper. AusInfo. Canberra. August. pp.181-189.

provide greater benefits from non-compliance. Higher unit enforcement costs for regulators also reduces the risk of being caught and, regardless of their attentions, the general complexity of regulatory requirements may make it difficult for small businesses to comply.⁴

The feedback the Chamber receives from its members suggests that most businesses will do whatever they can to comply with the rules. Perhaps in some circumstances there are lower compliance rates among small business, but this actually strengthens the arguments for regulatory tiering because the benefits of imposing a regulatory requirement fall as businesses become less likely to comply. Lower compliance rates can be offset by devoting more resources to enforcement and imposing stricter monitoring requirements, but this drastically increases the cost of regulation.

Moreover, applying a regulatory regime where effective monitoring and enforcement is prohibitively expensive can lead to further problems because it means that firms that choose not to comply gain a competitive advantage over those that do and use this to increase their market share, leading to market distortions and even lower levels of compliance.

Changes in market structure: The third factor that needs to be considered is the effect of regulation on market structure. Sometimes this effect will be minimal because small businesses remain competitive – despite the regulatory driven increase in their relative costs – because they fill a unique product niche or have other cost advantages over large businesses.

However, sometimes the additional costs that a regulation creates will make small businesses uncompetitive in comparison to larger businesses and the result will be industry consolidation, with large firms increasing their market share and small firms leaving the industry. A similar effect can occur across industries, if the increased regulatory costs lead consumers to move their consumption away from goods and services produced predominantly by small businesses and into other sectors.

Restructuring, either within or between industries, involves various costs, including transitional costs that are incurred as the changes take place, the loss of whatever benefits that small businesses provided to consumers that made them competitive in the first place, and reductions in competitive pressure that may allow larger firms to exercise market power.

It is possible that the costs of restructuring are less than the loss of regulatory benefits associated with imposing lighter regulations on small business, even if the costs of small business actually complying with these regulations would have been higher. On the other hand, the costs of restructuring can easily outweigh the loss of regulatory benefits from tiered regulation, particularly when reductions in competitive pressure are taken into account.

The dynamic effects of imposing tiered regulation add further complications. If tiered regulation actually improves the competitiveness of small businesses (as opposed to just offsetting increases in the relative regulatory burden) then it could create an incentive for firms to remain small and lead to an increase in the number of small firms in a market, which would lead to further reductions in regulatory benefits that need to be taken into account, along with any transitional costs.

A related problem is that regulatory tiering can create problems with compliance and disincentives for firm growth, particularly if the jump in compliance burdens between tiers is

⁴ Pierce Jr, R. J. (1998). Small Is Not Beautiful: The Case Against Special Regulatory Treatment of Small Firms. *Admin. L. Rev.*, 50, 537.

large and sudden. This is unlikely to change the decisions of rapidly growing firms, but at the margin it may discourage a firm from taking on additional employees.

However, regulators can mitigate these problems by helping to manage firms through the transition between regulatory tiers and minimising the jump in obligations between regulatory tiers wherever possible.

Cultural status of small business: A further issue is the special place of small businesses in Australian culture. Many Australians aspire to one day be their own boss, there is widespread sympathy for the struggles of 'mum and dad' business owners and great respect for the contribution that small businesses make to their local communities. As such, a strong small businesses presence in the economy may have an existence value and the capacity to become a small business owner with relative ease may have an option value.

Transaction costs of tiered regulation: The final factor that must be considered is the additional complexity created by regulatory tiering. Even if regulatory tiering produces net benefits after taking into account the effect of regulation on market structure, the additional complexity that it creates for businesses and for regulators may lead to offsetting costs. Complexity may be a particular problem if different regulatory regimes use different thresholds to determine tiering.

DEFINITION OF SMALL BUSINESS

From a regulatory perspective, small businesses should be defined with reference to the rationale for treating smaller businesses differently. Specifically, businesses should be separated into size based categories to the extent that net benefits can be maximised by treating these categories differently.

Tailoring regulatory behaviour to meet the needs of small business may not require any formal definition of small business at all, though rules of thumb may be useful for targeting educational programs and other initiatives.

However, if regulatory tiering is appropriate then a formal definition of small business becomes unavoidable. In theory, there could be any number of different business size categories. In practice, the benefits of having too many categories could be outweighed by the complexity this creates and the difficulty in obtaining the information required to make such fine distinctions.

Whether there is a single set of business size categories across different regulatory areas should be determined on a pragmatic basis. A useful starting point is the scale of the activity that is subject to regulation as this determines the potential benefits of regulation and is the key determinant of unit compliance costs. There may also be some grounds for considering employment as a general indicator of a firm's level of sophistication.

Looking at the appropriate level of regulatory tiering category by category could lead to a very large number of different sets of business size categories. However, when consideration is given to the impact this has on overall regulatory complexity there appears to be a strong case for a more limited number of categories, particularly if there is insufficient data to draw precise boundaries or the coverage of the existing definitions already overlap substantially. For example, the definition of a small business as a business with less than 15 employees under the unfair dismissal laws seems very similar to the 20 employee definition of small business used by the Australian Bureau of Statistics (ABS). In such instances it is not clear that it is worthwhile having two definitions. Although the ABS definition of small business cannot be justified with reference to a particular regulatory rationale, it is not clear that the unfair dismissal definition has been developed using

rigorous reasoning either – it simply seems to rely on historical precedent. Therefore, abolishing the unfair dismissals definition and extending the use of the broader ABS definition appears sensible. However, the costs of making this transition may also exceed the benefits.

Other factors that should be considered in determining the appropriate set of definitions for small business include the information available to regulators and comparability with international definitions.

IMPROVING REGULATOR BEHAVIOUR

Improving regulator behaviour is not a peripheral concern. In 2012, around 50 per cent of businesses nationwide said that they had to comply with regulations that were at least somewhat poorly enforced, compared to around 45 per cent that said there were regulations that simply made no sense.⁵ Moreover, over 45 per cent of businesses felt that the most costly stage of compliance was either preparing reports or identifying and understanding the requirements.⁶

Most approaches to improving regulator engagement with small business are also important for improving regulator engagement with businesses generally – though as discussed previously, there are some instances where the particular circumstances of small businesses may warrant a unique approach.

As the Commission noted in its issues paper, a great deal has already been written about how regulators should engage with business. There appears to be little disagreement among regulators, governments and businesses about the general thrust of this literature. For example, few would argue against better communication, risk based regulation or improving the skills of front line staff.

However, there is more debate about whether regulators have taken the appropriate practical steps to achieve best practice regulatory behaviour. For example, the NSW Food Authority has taken steps towards a risk based approach to regulation, including separating businesses based on the type of food they prepare. While this is a positive step, the Chamber has noted in a submission to the Independent Pricing and Regulatory Tribunal Inquiry into Licence Design that there is much more to do given the Food Authority's system does not take into account a business's past compliance history.

There is also a tendency for existing guidance on best practice regulation to provide a laundry list of actions without a more systematic underlying framework. This can encourage regulators to see best practice regulation as a box ticking exercise, which discourages continuous improvement and creative attempts to adapt the overarching principles to suit the circumstances of particular regulators. It also means the communication of best practice typically relies on detailed guides that few people will ever read.

At a fundamental level, best practice regulatory behaviour is about achieving the specified regulatory outcomes with the minimum impact on business. One way of approaching this goal more systematically is to distinguish between best practice regulator behaviour – defined as the way that regulators actually interact with businesses – and best practice regulator organisational strategies – defined as the ways that regulators and policy makers ensure that regulators have the incentives and capacity to deliver best practice regulation.

⁵ Australian Chamber of Commerce and Industry. (2012). *ACCI National Red Tape Survey*. ACCI. Canberra. October. p.11.

⁶ Australian Chamber of Commerce and Industry, 2012, p.12.

Best practice regulator behaviour

The best way to systematically consider what constitutes best practice regulator behaviour is to start with the ways that regulations impose burdens on business and then consider what regulators can do to minimise these burdens within their regulatory mandate.

Behaviour to reduce to substantive compliance burdens: The most obvious source of regulatory burdens is the substantive compliance burden imposed by the regulations. The ability of regulators to minimise substantive compliance burdens is limited, but they can still collect feedback about the costs that regulations impose on business and pass this information on to policy makers.

Regulators have an important role to play in gathering evidence about the burdens of regulation on small businesses as small businesses usually lack the economic incentives to devote substantial resources required to engage in policy development and implementation a detailed way. Small businesses can pool their financial resources through organisations like chambers of commerce to ensure that there is always a voice supporting small business interests. However, it is much harder to spread the time related costs associated with identifying regulatory problems on the ground and participating in the back-and-forth conversation required to develop solutions. This is particularly true when the individual regulatory burdens are relatively small – which is what makes the cumulative burden of regulation so insidious. Sometimes larger businesses can do the heavy lifting, but the concerns of small and large businesses may not always be the same.

Small business participation in the regulatory process is further discouraged by the perception that when they do choose to engage, their views are ignored by policy makers and regulators. This may occur because small businesses see the costs of regulation, but the benefits are much harder to calculate. As such, they may raise concerns about the regulations that impose the biggest burdens, even if those particular regulations are there for good policy reasons or are unlikely to change because of political considerations. Meanwhile small regulatory imposts where there is a clear case for reform can be easily passed over.

Specific strategies for gathering information about regulatory burdens will need to be developed with reference to the specific activities and management structures of different regulators.

Behaviour to reduce to information costs: Another source of regulatory burdens is the need for businesses to identify and understand regulatory requirements – ensuring that businesses can understand what is required of them is also vital to actually achieving the regulatory objectives.

Complex regulations will take longer to understand regardless of a regulator's efforts, but it is important for regulators to do what they can to improve their communications. Around 55 per cent of businesses said that they either could not find information about regulatory requirements or had to spend a large amount of time searching for it.⁷ Research for HM Revenues and Customs in the UK found that 26 per cent of those regulated were either unaware of their obligations or needed help to comply.⁸

⁷ Australian Chamber of Commerce and Industry, 2012, p.15.

⁸ Quadrangle and PriceWaterhouse Coopers. (2009). *Individuals Prioritisation: An investigation into segmentation of the Individuals customer base*. Research Report for HM Revenue and Customs Service. Available online at <http://www.hmrc.gov.uk/research/individuals-prioritisation-publication.pdf>.

The key overarching principle to improving communication with business is for regulators to actually test the effectiveness of their communication strategies, by seeking feedback from businesses. For regulations that affect a large number of businesses, it may be even be worthwhile paying businesses to participate in market testing of communication strategies.

Another basic principle of effective communication is to tailor content to the needs of the audience and it is important for regulators to apply this principle. Usually, this will mean providing a simple summary and step-by-step guide to compliance for small businesses, and a more detailed technical document for those that wish to use it. In preparing material, regulators should bear in mind the Australian Bureau of Statistics ABS figures that suggest that 44 per cent of Australians aged 15 to 74 years old had literacy skills below the level that is required to read through dense and lengthy text and disregard irrelevant or inappropriate text content to answer accurately.⁹

Consistency in the design of content – including the structure of individual documents and the overall design of regulator websites – is also an important part of making it easier for businesses to understand what is required of them.

However, regulators should not assume that businesses will find information simply because it is located on their websites. Businesses prefer a proactive approach to the dissemination of information, with 80 per cent preferring to be informed about regulatory changes via email from either the regulator or their local business chamber.¹⁰

Regulators should also ensure that they have staff available that businesses can call to clarify requirements. However, for this sort of strategy to be effective, businesses must be confident that information they disclose in asking question about how to comply will not be used against them.

Behaviour to reduce the burden of regulatory processes: The process of seeking regulatory approvals or providing information to regulators is what many businesses think of when they hear the words ‘red tape’.

Every effort should be taken to minimise the burden of these processes on business. This means ensuring forms require the minimum possible information and making use of auto-filling and information sharing wherever possible. It also means dealing with approvals as quickly as possible, ensuring that there are clear timetables for approval, and allowing non-contentious applications to be fast tracked.

Behaviour to reduce the burden of monitoring and enforcement: The impact that monitoring and enforcement have on businesses varies between different regulatory areas. Often only a limited number of businesses are directly affected by monitoring activities and even fewer have to deal with the enforcement of regulatory rules.

Nonetheless, the effect of monitoring activities – such as audits – and enforcement activities – such as the impositions of penalties – often have a major effect on the businesses that do have to deal with them.

The importance of taking a risk based approach to monitoring activities is widely recognised, but it is essential for regulators to continue to develop their risk assessment frameworks. This will often mean subjecting small businesses to less rigorous monitoring than large businesses because the size of the risk relative to the cost of monitoring is lower. Regulators

⁹ Australian Bureau of Statistics. (2013). *Programme for the International Assessment of Adult Competencies, Australia, 2011-2012*. Cat. 4228.0.

¹⁰ Australian Chamber of Commerce and Industry, 2012, p.14.

should also ensure that they take into account compliance history when assessing the level of monitoring that is required.

Similarly, it is generally accepted that regulators should take a graduated approach to enforcement and only apply penalties where it is judged that this will result in a meaningful improvement in compliance. Singling out some businesses for large penalties to scare other small businesses into line is rarely effective as most small businesses will not even be aware of the actions that the regulator has taken.

Best practice regulator organisational strategies

Providing detailed guidance on regulatory best practice becomes unnecessary if regulators can establish organisational strategies that give them the incentives and capacity to reduce the regulatory burdens facing business.

Organisation strategies to create incentives for best practice: Organisational strategies to give regulators the incentive to pursue regulatory best practice need to start with politicians. There is certainly a general endorsement of red tape reduction at the political level, but this is unlikely to provide motivation for concerted action unless it is accompanied by concrete commitments. An option that has a number of advantages is the NSW model of assigning a formal dollar value to a red tape reduction target. Having a red tape reduction target allows the Premier to devolve the task of achieving the target to individual ministers, heads of department and regulators, who can choose to further devolve responsibility if they think doing so would be useful.

Another strategy for creating top down incentives to improve regulatory behaviour is to create systems for publicly measuring regulator performance. This may include peer assessments by other regulators or independent bodies such as the state and national audit offices. It is worth noting that the publication of results can sometimes make organisations less likely to provide damaging information or accept results that are critical, so it is sometimes also appropriate to facilitate internal reviews for regulators. One model that could be adopted in Australia is the Hampton Implementation Reviews that were conducted in the UK to assess how well regulators were complying with the Hampton principles of better regulation. For larger regulators, these reviews were conducted by teams that included representatives from peer regulators, the National Audit Office, the Better Regulation Executive and an external stakeholder.

Creating empathy and understanding for the circumstances of business and the challenges they face is also an important strategy to pursue, particularly among front-line staff. The NSW Government is implementing a plan to deliver a single service provider for all government transactional services. Part of the implementation has been work to develop a view of the 'customer voice' to ensure that the providers operations are informed by the needs and preferences of citizens and businesses. Such efforts should also be extended to all regulatory functions. However, a major challenge is determining how to promote business friendly attitudes among front-line staff without resorting to top-down rules. One possibility would be to host workshops where front-line regulatory staff play the role of regulated small businesses – the role of regulators could be played by regulatory officers from another organisation or by representatives of business groups.

Organisation strategies to create capability for best practice: It is important to ensure that regulators have the capacity to achieve best practice in addition to simply creating the right incentives.

At a fundamental level, this means regulators need to be adequately resourced. However, providing adequate resourcing does not necessarily mean spending extra money as there

may be significant efficiencies that can be achieved through the consolidation of small regulators. For example, the Chamber has been a strong advocate of council amalgamations in NSW to ensure that they have the capacity to properly fulfil their responsibilities, particularly in relation to regulation.

It is difficult for outsiders to give regulators specific guidance on how they should set up their operations to ensure they have the capacity to deliver best practice regulation.

Perhaps the best way to ensure that regulators have the capacity to deliver best practice is to establish more formal arrangements for regulators to collaborate and share views about what works in terms of organisation strategies and specific practices for minimising the regulatory burden faced by business.

One positive example is work by the NSW Attorney General to develop guidelines to help support frontline officers in their use of discretion. The Caution Guidelines assist officers in when deciding whether to issue a caution or penalty notice. The Internal Review Guidelines have also been developed to assist all NSW government agencies to conduct internal reviews of penalty notices fairly, impartially and consistently. Consideration might be given to developing a similar model guide that would support all federal regulatory agencies and their officers in using discretion appropriately when undertaking regulatory functions.

CLOSING REMARKS

Once again, thank you for the opportunity to provide input to this Inquiry.

Yours sincerely

Paul Orton

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