Regulation and small business

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Summary

This article has three aims. First, it surveys the literature examining the claim that small businesses experience regulation more keenly than larger businesses. The survey indicates that, relative to their size, the burden of regulation is higher on smaller businesses where regulations impose the same requirements regardless of firm size. Second it demonstrates how a tiered regulatory approach can increase the net societal benefit of regulation. However, it also shows how tiering can have the unintended consequence of providing disincentives for small firms to grow due to more favourable treatment for remaining under tiering thresholds. The article concludes that reducing the burden of regulation and making compliance easier will typically increase the net benefits of small businesses regulation. This improvement results from increasing compliance rates and reduced compliance costs.

1. Small business experience of regulation

Concerns about the impact of regulation on small business are not new. For example, in 1978, similar concerns led to the commissioning of a special survey by the Australian Bureau of Statistics (ABS) to estimate the cost incurred by small business in meeting the administrative, regulatory and information requirements of the Commonwealth, State and local governments (Australian Bureau of Statistics 1979). Since then, several other processes have been directed at examining and reducing the regulatory compliance burden faced by small business. This included the establishment of the Small Business Deregulation Task Force in 1996 (Small Business Deregulation Task Force 1996), work by the Board of Taxation to scope small business tax compliance costs in 2007 (Board of Taxation 2007), and the Productivity Commission study into *Regulator Engagement with Small Business* (Productivity Commission 2013a).[1]

Responding to these sorts of concerns, and in order to inform policy making, the Australian Chamber of Commerce and Industry (ACCI) started surveying businesses (mainly small and medium businesses) about regulatory burden in 2012. Respondents continue to indicate that the burden of regulation is hampering businesses from growing (ACCI 2015).

To address concerns regarding the burden of regulation, the Australian Government created a deregulation agenda in 2013. Under this agenda, annual compliance costs for businesses, individuals and community organisations have been reduced by $5.8 billion (to 31 December 2016). In 2015, the Australian Government announced that it would expand this agenda into a regulatory reform agenda, with a focus on reforms that facilitate innovation, competitiveness and productivity growth (Hendy 2015). Small business has been a particular focus. In 2016 the Australian Small Business and Family Enterprise Ombudsman (ASBFEO) was created, with one of its functions being to research and inquire into laws, policies and practices that impact on small businesses (ASBFEO 2016).

Overseas studies demonstrate that the relationship between compliance costs and business size is neither unique to Australia nor confined to tax regulation. In a report on the complexity of tax systems for small to medium enterprises (SME), the Organisation for Economic Co-operation and Development observed that a range of studies on business compliance costs from 1992 to 2002 'systematically conclude that while total business tax compliance costs tend to be higher for large companies, as a percentage of sales they are significantly higher for SMEs.' Furthermore, the nature of their compliance costs differ: large firms spend a higher proportion of their compliance costs on tax planning — non-compulsory analysis designed to reduce effective tax rates — which could exacerbate their competitive advantages and proportionately lower their overall cost structures (OECD 2009, pp 118-19).

A European Commission study has estimated that on a per employee basis, small businesses (defined in Europe as those with less than ten employees) face regulatory compliance costs that are, on average, ten times higher than those of large businesses (defined as those with more than 500 employees) (European Commission 2007, p 17).

A broad range of factors influence what regulation any given business is subject to and what they must do to comply. The Productivity Commission has examined these factors on a number of occasions and found that, in general, small businesses incur proportionately higher compliance costs

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1   Douglas (2014) summarises the history of reports into the impact of regulatory costs on the economy and attempts to reduce this burden. Many of these included a particular focus on the impact of regulation on small business.

than larger businesses, even where both are engaged in the same activities. Further, smaller businesses are more likely to face greater challenges in understanding and fulfilling their compliance obligations (PC 2013a, p 68).

Fixed compliance costs

If a regulation imposes fixed costs, then a larger business will experience a lower proportional cost as it is able to spread the fixed cost across a larger number of units or sales turnover. This is illustrated in Figure 1. A similar relationship between compliance costs per unit of output and business size exists even if compliance costs are not entirely fixed. For example, a compliance cost might increase with business size, but do so at a decreasing rate. An example of this might be a café operator that wishes to open a second store in a neighbouring local council area. Although the café operator would need to understand and comply with two sets of food safety regulations, it is likely that there would be similarities between the requirements of the two councils so that the total compliance cost would be less than double that associated with operating a single store.

**Figure 1: Compliance costs of regulation and business size (stylised)**
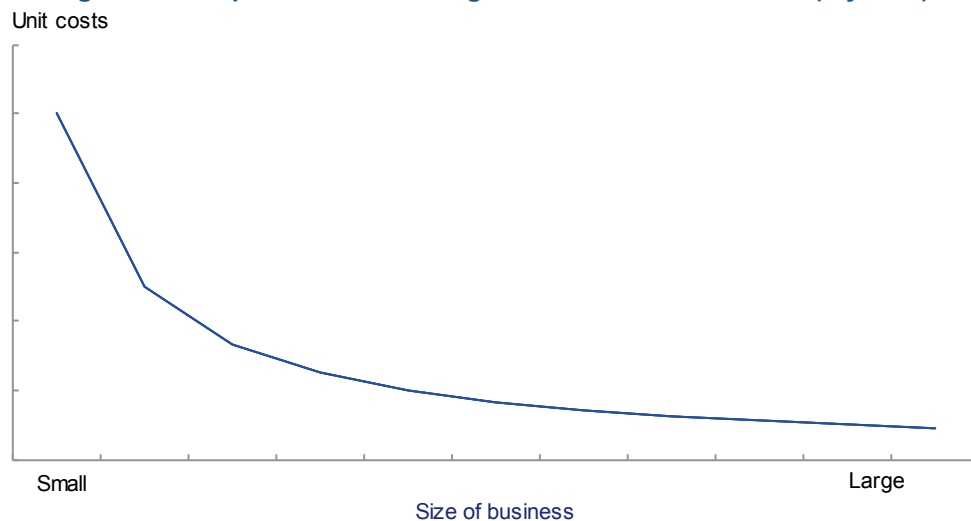
A quantitative study into tax-related compliance costs faced by businesses in Australia found that compliance costs were proportionately higher, the smaller the business size (Lignier, Evans and Tran-Nam 2014).

A question that arises is why the option to outsource compliance does not assist small businesses manage this burden. A likely explanation is that some regulation is designed so that outsourcing compliance can only remove some of the burden. For example, a feature of most value added taxes including Australia's goods and services tax (GST) is that businesses must collect evidence of transactions in order to outsource completion of a BAS statement (Lignier, Evans and Tran-Nam 2014, pp. 11-12). A business that has more sales can spread the cost of doing so over a larger turnover, reducing the cost per dollar of turnover. Note that Australia's GST threshold is turnover of $75,000 (although businesses under that threshold may opt in) — an example of tiering of regulatory requirements discussed in part 2.

Chart 1 shows estimates of tax-related compliance costs faced by businesses in Australia of various sizes, relative to their revenue. Lignier, Evans and Tran-Nam (2014, p 242) found that micro-businesses incur annual tax compliance costs of around $90 per $1,000 of turnover and small businesses around $12 per $1,000 of turnover. By comparison, the figure for large businesses was

around $0.40 per $1,000 of turnover (Evans, Tran-Nam and Lignier 2014, p 6). The authors attribute this difference to two main factors — 'the economies of scale enjoyed by larger enterprises; and the 'learning curve effect' whereby smaller businesses need to invest relatively greater resources in learning about and coping with tax complexity and tax change than is the case for larger businesses' (Evans, Lignier and Tran-Nam 2014, p 6).

Chart 1: Estimates of tax related compliance costs faced by businesses in Australia of various sizes, relative to their revenue
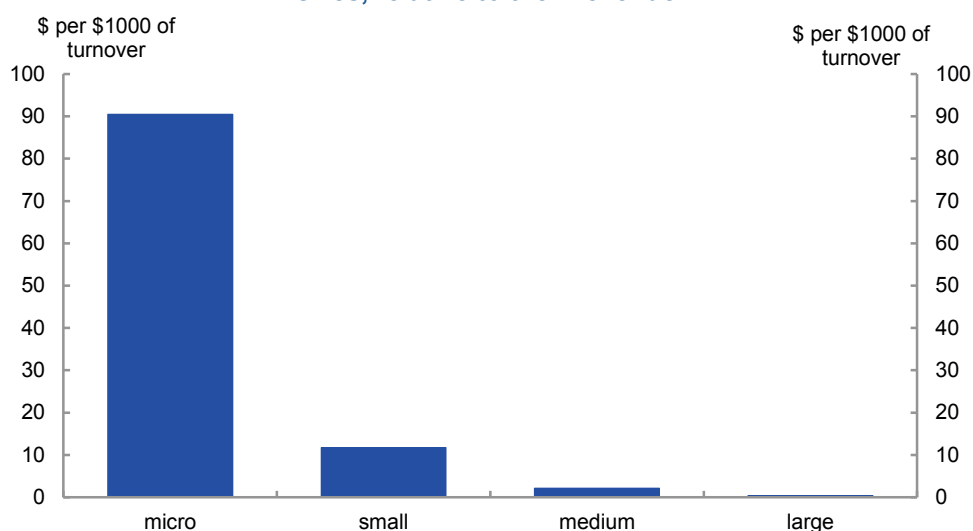
Sources: Lignier, Evans and Tran-Nam 2014; Evans, Tran-Nam and Lignier 2014.

Similarly, administration costs for regulating small businesses, including education, monitoring and enforcement, will often be proportionally higher because many costs of regulation are also fixed (Gunningham and Grabosky, 1998). Small business owners typically have less time to spend on finding out and understanding regulatory requirements than compliance departments of large organisations. Therefore, regulators are likely to need to invest proportionately greater resources into informing small businesses about the obligations imposed by a regulation and helping them to understand how they can comply. A regulator will need to monitor a much larger number of small businesses to verify compliance for a certain proportion of an industry's sales than if it only monitors large businesses (PC 2013a, p 77).

Gains from specialisation

Another source of relative compliance cost disadvantage faced by small businesses is that they have less scope to specialise in regulatory compliance. A large firm can hire expert staff who specialise in understanding regulatory requirements and considering the most cost effective way for the business to comply. In some instances, large businesses may even have a compliance department to maximise the scale efficiencies associated with regulatory compliance. Staff in such areas can benefit from the learning curve effect and reduce the per-unit cost of compliance.

Small businesses typically rely on the owner/operator to manage not only the business, but also compliance with regulations. A 2010 survey found that the person mainly responsible for the preparation of a business' quarterly Business Activity Statement was the small business owner (60 per cent), with 16 per cent responding that it was external accountants, 10 per cent other family members and 7 per cent a bookkeeper/finance manager employed by the business (American Express 2010). Another survey, in early 2013, found that, for 75 per cent of small and micro businesses, owners

and unpaid helpers were undertaking tax compliance work, while for medium sized entities, employees performed the compliance work (Lignier, Evans and Tran-Nam 2014, pp 21-23).

2. A tiered regulatory approach can increase net benefits

If the total societal costs imposed by a regulation are greater than the societal benefits, then the regulation will detract from overall societal well-being, even if the regulation is effective in reducing the harm (or risk of harm) that it is directed at mitigating. In other words, the medicine can be worse than the disease.

One of the ten principles for Australian Government policy makers is that 'regulation should be imposed only when it can be shown to offer an overall net benefit' (Department of the Prime Minister and Cabinet 2014, p 2). The net benefit of a regulation is a measure of its contribution to overall societal wellbeing, defined as the total benefit to society from a regulation minus its total costs. The benefits of a regulation typically relate to a reduction in the risk or severity of harm, or organising markets. The costs of a regulation include compliance costs on businesses and individuals, administration costs, monitoring and enforcement costs and indirect costs (such as competition and innovation costs).

In the same way that the costs of regulation can outweigh the benefits at an aggregate level, it is also important that costs and benefits are considered on an individual firm basis. Even if the benefits of a regulation outweigh the costs when considered on a whole of economy basis, the net benefit from applying the regulation to particular firms (or individuals) can be negative where the *marginal* costs of capturing those entities are greater than the *marginal* benefits.

Of course, it is difficult in practice to estimate marginal benefits on the basis of particular firms or individuals, and sometimes the 'deterrence effect' (on the behaviour of other actors) of focusing on particular firms or individuals may make the proposed regulation appear justified. However, when evaluating the net benefit it is important to ensure that both costs and benefits are compared on the same basis. Otherwise, it is possible to fall into the trap of comparing economy wide benefits with per business costs or vice versa. For example, when considering a regulation that would apply to an industry with a large number of small businesses, a policy maker could conclude that a regulation is justified on the basis that the overall benefit to society from the regulation is large but the cost to individual businesses is small. However, if the costs and benefits are both compared on a consistent basis, a different conclusion might be reached.

When considering a problem, the *Australian Government Guide to Regulation* requires policy makers to identify a range of policy options, including regulatory and non-regulatory approaches. The option (or mix of options) with the highest net benefit should be recommended (Department of the Prime Minister and Cabinet 2014, pp 25–29, 48). An option that fails to exclude sub-populations where the marginal societal costs of including that sub-population exceed the marginal societal benefits is not the option with the highest net benefit.

As discussed in Part 1, small businesses generally face higher compliance costs per unit of activity (turnover, production, number of employees and so on) as a result of not having economies of scale in learning about and complying with regulations. Therefore, other things being equal, even if the marginal benefit of applying a regulation to a particular small business is the same as the benefit of applying the regulation to a large business, the *net* societal benefit will be lower (and potentially negative) because the marginal costs are higher relative to the benefit.

Figure 2 illustrates this by comparing the marginal benefit and the marginal cost of applying a regulation to firms of various sizes. In the figure, both marginal benefit and marginal cost are expressed per unit of economic activity. The marginal social cost curve is labelled MSC and reflects the shape of the stylised compliance cost curve presented in Figure 1.

Figure 2: Marginal social benefit and social cost from a regulation v Business size
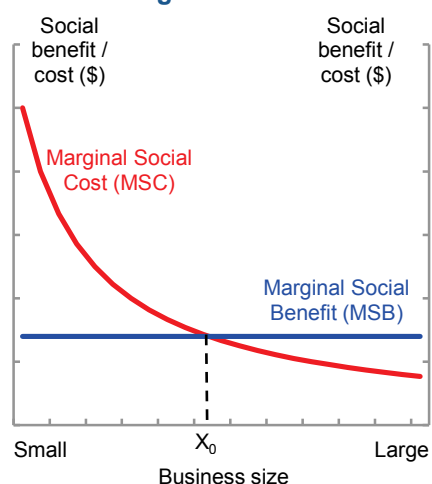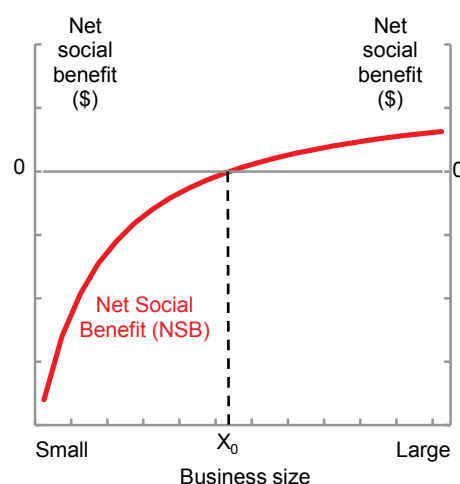
Figure 3: Net social benefit from regulation v Business size

By considering marginal benefit and marginal cost on a per unit of economic activity basis, we are able to assume that, in general, the marginal social benefit from a regulation will be constant and can be represented using the horizontal line denoted MSB. This assumption reflects that, generally, the amount of risk that an activity creates, and that a regulation seeks to mitigate, will depend on how much of that activity is affected. To illustrate this point, consider a regulation requiring builders to ensure that the houses they build have adequate foundations so that the houses do not collapse if it rains. The aggregate benefit from applying this regulation to a large construction company will generally be greater than for a small construction company because it is likely that the large company builds more houses. However, for each individual home owner, the marginal benefit of the regulation should be independent of whether their particular house was built by the large or small firm.[2]

The net benefit to society from imposing a regulation on a business of a particular size is the difference between marginal social benefit and the marginal social cost. This is represented in Figure 3 by the line denoted NSB. From the figure, it can be seen that imposing a regulation on the smallest businesses leads to marginal social costs that outweigh the marginal social benefit. In contrast, for the largest businesses, the social benefit outweighs the marginal social cost. Between the two extremes of very big and very small businesses, there is a 'breakeven' business size, where the

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2   The marginal social benefit of regulation may slope upwards as firm size increases. This would increase the slope of the net social benefit curve shown in Figure 3 (possibly increasing the breakeven business size) and does not materially alter the analysis in this paper. One situation where the marginal social benefit is likely to be upwards sloping is if small businesses are less likely to comply with a regulation. This could occur if the regulation is poorly communicated, such that some small businesses are unaware of the regulation, or if the regulation is too complex for small businesses to understand. It could also occur if the regulator has limited resources and targets its compliance and monitoring efforts at larger businesses so as to deploy its resources most efficiently. The marginal social cost curve could begin to slope upwards again for large firms, due to the investment made in complying with existing regulation, if existing regulation changes and that investment then needs to be increased to meet the additional compliance burden. One implication is that simplification and reduction of regulatory burdens would mean more firms would remain on the downwards slope of the MSC curve in figure 2.

social benefit and the social cost from requiring businesses of this size to comply with a regulation are equal, so that the net social benefit is zero. This size is denoted X_0 in Figure 3.

Sometimes the breakeven size will be smaller than any of the businesses that are engaged in, or that would in the future engage in, the activity being regulated. If this is the case, then there is a social benefit from applying the regulation to all businesses, regardless of their size. However, if a regulation is being applied to businesses that are smaller than X_0, then doing so will be imposing costs that outweigh the benefits and reducing overall societal well-being. In such cases, it is appropriate that policy makers consider providing an exemption for businesses that are smaller than the breakeven size, as doing so will improve the total well-being of society. An example is the GST turnover threshold of $75,000.

Of course, such exemptions would need to take into consideration the effects of behavioural change, as well as other risks and consequential effects (see part 3 of this paper on the effects of complexity). In the example provided above (of regulations on builders to ensure that the houses that they build have adequate foundations) lighter or zero regulation could encourage a shift to house building by small entities and (separately) to poorer building practice, thereby reducing overall societal well-being. One consequence of this could be higher information costs for consumers in establishing the extent of the greater risk of faulty foundations associated with engaging a small builder. Another might be unintended reputational issues and risks to volume and revenue for small builders as consumers learn about higher risks.

Other things being equal, providing an exemption for small businesses from a regulation is the simplest form of tiering. In some instances, a small business exemption will be the best policy option. However, as can be seen above, one potential weakness of this approach is that it does nothing to address risks created by the businesses covered by the exemption. If these risks are significant or the consequence serious if the risk eventuates, a better approach may be to apply a lighter touch version of the regulation to small businesses.

Figure 4 shows the net societal benefits of applying two possible regulatory approaches — 'full' and 'light touch' regulation — relative to the size of the business. The 'full' or detailed regulation imposes significant fixed costs on affected businesses, and provides relatively strong protections to society that increase with the size of the business (NSB_{Full}). A 'light touch' version of the regulation imposes lower costs, but delivers less societal protection, particularly when applied to larger businesses (NSB_{LT}).

Figure 4: relationship between size of business and social benefit of regulation
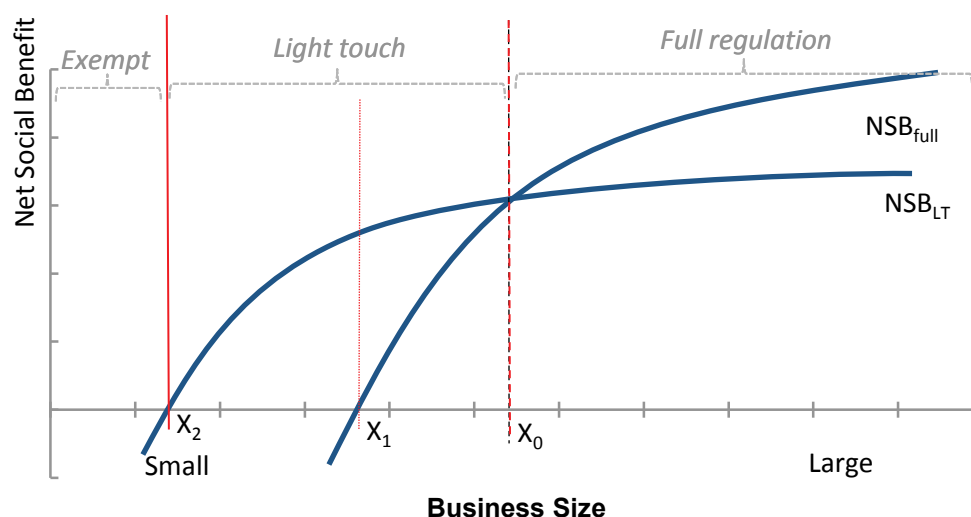
In this example, other things being equal, applying the full regulation to a business smaller than X_1 has a negative net societal benefit, and would reduce the overall net benefits of the policy if it were applied to businesses smaller than X_1. In contrast, the light touch regulation can provide a positive social benefit from being applied to businesses larger than X_2. Therefore, rather than simply exempting all businesses that are smaller than X_1, a better alternative is to consider using a combination of the full regulation and the light touch regulation. From Figure 4, it can be seen that even the light touch regulation gives a negative net social benefit for businesses that are smaller than X_2 and so exempting these businesses still maximises overall social welfare. However, for businesses that are between X_2 and X_0 in size, the light touch regulation delivers the greatest net social benefit. In contrast to the full regulation, the light touch regulation will deliver a positive net benefit to society if applied to businesses with sizes between X_2 and X_1. In addition, it will deliver a larger net social benefit for businesses between X_1 and X_0. For businesses larger than X_0, the full regulation should apply. The theoretical and mathematical basis underpinning the diagrammatical analysis presented above is provided in the Technical Appendix to this paper.

3. Balancing possible incentive effects and system complexity

Figure 4 demonstrates the theory behind how tiered regulation can lead to socially superior outcomes where small businesses face proportionally higher compliance costs, or where the benefits from regulating small business are proportionally lower than from regulating large business.

However, the potential gains from tiered regulation may need to be balanced against the additional complexity it can create, which in itself is a major source of regulatory compliance costs for small business. In particular, multiple different thresholds create uncertainty and increase the costs for small businesses to find out whether they qualify for various exemptions or light touch regulatory approaches. Introducing thresholds into the law can potentially create disincentives for businesses to grow beyond a given threshold, lest they lose access to certain concessions or become subject to more detailed and onerous regulation.

In Australia, it has been suggested that payroll tax thresholds provide a disincentive for small businesses to grow to optimal size or to export (Crowe 1996, 1999). In other cases, payroll tax thresholds may have contributed to businesses adopting complex corporate structures, thereby reducing transparency both for investors and management. For example, Kruger (2008) notes that,

prior to the demise of ABC Learning in 2008, the company claimed to employ more than 16,000 staff in 1100 childcare centres but paid no payroll tax because the centres were run through a network of regional companies, each of which fell just under the payroll tax threshold.

A quantitative study from France supported those observations. In France many labour laws start to bind on firms with exactly 50 or more employees. Many firms will choose to remain small to avoid labour regulation, resulting in a distorted size distribution with proportionally 'too many' firms just below 50 employees and 'too few' firms just above it (Garicano, LeLarge and Van Reenen 2013, p 27).

Tiering and exemptions also create the need for integrity rules, which can be difficult to comply with and enforce. For example, Australia has rules accompanying its small business tax concessions which require small businesses to aggregate turnover from certain entities connected or affiliated with them. If the aggregated turnover then exceeds the small business turnover threshold, those concessions are no longer available to any of the businesses (see subdivision 328-C of the *Income Tax Assessment Act 1997*). The aggregation rules were intended to simplify the tests for accessing the small business concessions (Pope 2008, p. 25), however they create another layer of regulation to deal with a problem created by a first layer of regulation (tiering).

Policy makers should take into account these possible incentive and other effects in designing tiered approaches and minimise the complexity of the overall regulatory system.

Complexity increases costs *and* economies of scale

Complex laws and regulations generally increase the costs of compliance for all parties. Nevertheless, small businesses face a higher burden from complex and unclear regulation and greater challenges in understanding and fulfilling their compliance obligations than larger businesses (PC 2013a).

Complexity typically increases economies of scale because it increases fixed compliance costs. More complex laws will increase the costs of understanding whether regulations apply to the business, and if so how to comply — regardless of whether the owners/managers do this in-house or obtain professional advice.

More complex laws will also increase the benefits from hiring specialists with the expertise to understand the complex regulation and determine the least cost way to comply. When the law reaches a certain level of complexity, it is likely that *only* a specialist, or team of specialists, will be able to fully understand the regulatory requirements a business faces. Whilst larger businesses may be able to justify hiring specialists where the cost is relatively small compared with overall turnover — particularly where improved understanding and compliance provides commercial advantages — small businesses may instead seek to comply on a 'best endeavours' basis, based on a common sense evaluation of what the law *probably* requires. This may result in small businesses doing more than is required in order to avoid the risk of being found non-compliant, or not claiming available concessions, thereby increasing costs.

The complexity of the law contributes to the disproportionate impact of compliance costs on small business because it increases fixed compliance costs and increases the need to use experts who specialise in understanding regulation, which many small business cannot afford. It follows that reducing the complexity of the law will benefit small business.

While volume of law does not necessarily indicate that law is complex, volume of law is proportionately harder for small businesses to cope with than large businesses, because of the time it would take to understand whether regulation was relevant. The volume of law at the

Commonwealth, State and Territory level has increased very substantially over the decades, from around 80 Acts totalling 281 pages in 1950 to 372 Acts totalling 4383 pages in 2000. In 2001, the Commonwealth stopped consecutively numbering of the pages of its seven volumes of statutes (Pearce and Geddes 2011, p 2). In 2014, the stock of Commonwealth regulations numbered approximately 85,000, including subordinate legislation (Australian Government 2014, p 24).

The complexity of the law has also increased. In 2011 the then Chief Justice of the Federal Court Justice Patrick Keane stated that 'many Federal Court judges were finding it difficult to come to grips with statutes and were struggling to determine how legislation was meant to change laws' (Eyers 2011, p 1). This highlights the difficulty that ordinary citizens and small businesses would have in dealing with the complexity of Australian federal law, let alone the interactions between Commonwealth laws, and state laws and local by-laws.

One reason for this increased complexity is the interaction of multiple regulatory regimes, both at the Commonwealth level and between Commonwealth and state law. Businesses need to understand not only the separate regulatory regimes, but also how they potentially interact. This can be particularly difficult when different regulatory regimes substantially overlap, but use different definitions for essentially the same concept (such as the definition of 'employee'), different thresholds (such as alternative definitions of 'small business'), or have different and potentially conflicting obligations for the same activity.

The number of potential interactions grows rapidly as the number of regulatory regimes increases (Oliver and Bartley 2005). For a given number of regulatory regimes (N), the number of potential interactions between those regimes is shown in Figure 5. If each of the 372 Commonwealth Acts that existed in 2000 contained one regulatory obligation, the maximum number of possible interactions would have been 69,006. However, as most Acts impose multiple obligations (including through subordinate instruments) and interactions can arise between obligations imposed by different levels of government, the true potential for interactions could have been much greater.

Figure 5: number of potential interactions between regulatory regimes
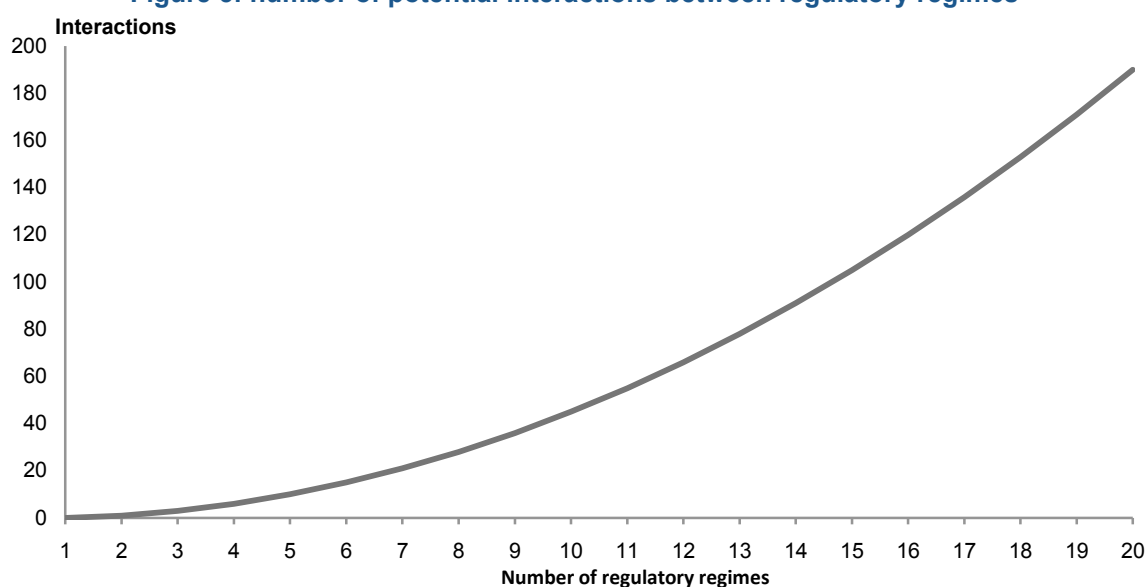
The costs of compliance will not necessarily increase in line with the number of potential interactions between laws. Firstly, not all regulatory regimes will potentially interact with other regimes, nor will all regulation be relevant for all businesses. Provided that this is readily ascertainable, businesses can focus their efforts on understanding and complying with the laws that are definitely (or at least

potentially) relevant and ignore potential interactions between clearly unrelated laws. For example, a small hairdresser business may be able to confidently ignore laws that regulate agricultural production, civil aviation, and mining and offshore petroleum, to name a few.

Secondly, a business may be able to hire or employ specialists to understand the web of regulatory regimes that apply to it. These specialists can benefit from learning curve effects and gains from specialisation, which will help to counteract the cost of increasing complexity. However, as noted in Part 2, larger businesses are more likely to be able to maintain in-house experts or afford professional advice to understand the cumulative regulation and determine how best to comply. It is worth noting that marginal costs will increase after a certain point for large businesses. As stated above, this could occur when regulations change in a costly and unanticipated way, demanding that the in-house or outsourced investment increase beyond a profitable level to cope with the newly imposed learning curve. The focus of this paper is on a reduction of regulatory burden, which would benefit small businesses.

Reducing the volume and complexity of regulation

One way in which the volume of law can be reduced is by regular review of laws and repeal of redundant law. The Australian Government held dedicated parliamentary sittings for this purpose throughout 2014 and 2015. In the 2016-17 Budget, the Australian Government also announced that it would introduce dedicated Regulatory Reform Bills into the Parliament with the aim of enhancing productivity.

In 2013, the Government also established a target of reducing the regulatory burden by at least $1 billion each year and created incentive mechanisms for Ministers and the public service to reduce compliance costs. Combined with measures to address the flow of new regulation, these policies are designed to reduce regulation (including quasi-regulation) over time and improve Australia's productivity and competitiveness.

Regulation reform programs should be 'needs driven', informed by business and community priorities. This will ensure that agencies are responsive and allocating resources efficiently and deliver the greatest gains (Douglas 2014).

Furthermore, business stakeholders have access to myriad firm-level data and first-hand accounts of the practical impacts of policy, which, when usefully deployed, can add significant value to the policy development process. For industry to meaningfully contribute to the policy development process, Governments need to enhance their transparency and communication with stakeholders, as envisaged in the updated *Australian Government Guide to Regulation*.

Principles-based law

Another way to reduce the volume and complexity of regulation is by writing and structuring law differently. The coherent principles approach aims to be more certain, less complex and more flexible than black-letter law (Pinder 2005). The Tax Law Improvement Project drafting style aims to use a clearer numbering system, shorter paragraphs, and boxed guides and examples within the law to assist readers to understand what each division of law is about in plain English. However, given that principles are intended to cover a range of scenarios rather than list them all, less sophisticated businesses may lack the confidence and the resources to defend a view of whether their circumstances are covered by a broad principle. This can lead to requests for clear-cut, 'yes or no' positions to be included in the law, focusing on current problems rather than future-proofing the law.

Preparing principles-based law is difficult where the subject of regulation is complex, but it can add value in expressing both simple and complex requirements. Part of success is consulting widely to ensure that the field of regulation is understood. A key objective of *coherent* principles-based laws is that 'they correctly identify the field in which they are intended to operate, and capture the essence of the intended outcomes in that field in a way that helps the reader make sense and order out of the law; and is intuitive or obvious to someone who understands the law's context' (Pinder 2005). Properly designed principles will minimise the need for additional explanatory materials, generally confined to uncommon circumstances that are only relevant for a subset of the regulated population.

There are examples of principles-based laws which anyone can understand. For example, rather than attempt to describe every possible form of unsafe driving, the New South Wales *Road Transport Act 2013 No 18*, section 117 states that 'A person must not drive a motor vehicle on a road … in a manner dangerous to the public.' This example also illustrates another feature of effective principles-based law in that the harm that the regulation is seeking to prevent (in this case, danger to the public) is either clearly stated or self-evident.

Improving accessibility

Another aspect of reducing complexity is improving the accessibility of regulation, in order to make it easier for people to understand and comply. Increasing education and assisted compliance can help small businesses with the burden of regulation. Rather than fines, a more facilitative and educative approach can increase compliance while reducing compliance costs (Australian Small Business Commissioner 2014). Having said that, compliance can also be seen as a question of whether the benefits of non-compliance exceed the product of the likelihood of being caught and the severity of the punishment (Becker 1968) so fines play a deterrent role as long as businesses believe their non-compliance will be detected and that the regulator requires them to comply. Facilitation and education should not be mistaken for endorsement of non-compliance.

Policy makers and regulators also need to consider the differing compliance costs imposed under different implementation models. For example, they may decide to devote more resources to building a higher quality website so that people can access information about their obligations more easily. Building the capability of businesses to comply can increase compliance rates more than enforcement activity that would impose higher compliance and administration costs.

Proportionate regulation

As noted in Part 2, regulation should only be imposed when the societal benefits exceed the costs. Where regulation is justified, it should be proportionate to the risk of harm, taking into account the consequences should that risk eventuate. Where small businesses present a lower risk of an adverse event, or the consequences from that risk are low, tiering regulation by providing an exemption or light touch approach for small businesses can ensure that regulation is proportionate.

Encouraging and empowering regulators to take a risk-based approach and use alternative compliance models where appropriate can also reduce complexity and compliance costs. In consultation with affected entities, regulators can determine where they target resources in order to mitigate harm.

Consistent with the potential benefits of tiering discussed in Part 2, regulation policy should therefore support flexible and simplified compliance arrangements that will help reduce complexity and eliminate unnecessary regulatory burdens. For this to be successful there needs to be better communication between policy makers and regulators so that regulators understand the policy intent

and can administer and enforce a regulation efficiently. Improved regulatory impact analysis and quantitative analysis of costs and benefits in the policy development process will assist.

Regulator discretion in compliance monitoring and enforcement need to be accompanied by appropriate guidance and transparency and accountability measures. The Australian Government has established the Regulator Performance Framework to monitor the administration of regulation and ensure regulators' actions are not excessively burdensome. Under this Framework, regulators are required to complete and publish annual self-assessments against six key performance indicators.

Regulators can draw on resources such as the Small Business Engagement Principles (Australian Government 2014c) and a Small Business Guidance Note (Australian Government 2015) which have been developed to assist agencies to better deal with small businesses. The office of the ASBFEO was launched on 11 March 2016, to address difficulties small businesses and family enterprises face with dispute resolution (commercial and government) and to provide a dedicated place for small business concerns and ideas to be heard (ASBFEO 2016). The ASBFEO can refer small businesses to the most suitable dispute resolution option. Often, a low-cost dispute resolution option exists, but navigating to find it is a hurdle in itself; therefore, the ASBFEO helps small businesses reduce the costs of disputes by being taking on the role of navigator.

Approaches to achieving societal improvements

This section briefly touches on differences between regulatory and non-regulatory approaches to achieving societal improvements, and how those approaches could complement each other. There is evidence that strict rules with strong punishments will get businesses to comply with regulations (Bardach and Kagan 1982, p. 93-94). Yet there is other evidence that the attitudes of individual staff members like administrators or supervisors can impact greatly on quality of services, such as nursing home care (Bardach and Kagan 1982, p. 99). This variation in experience will exist due to the attitudes of individuals and regulators. The issue for regulation is how to regulate so that inspectors focus on substantive and dangerous risks to safety (for example in factory inspections) or quality of life for elderly people (such as in nursing home inspections) rather than ticking off detailed lists while missing serious issues that would be noticed by, for example, talking with residents/workers (Bardach and Kagan 1982, p. 102-7). Consider a policy of unannounced inspections. They require a business to 'drop everything'. The business may think of itself as having made great efforts to operate a compliant workplace. The unannounced inspection approach is underpinned by wanting to 'catch someone out' in non-compliance. This stance will immediately set the relationship up as antagonistic rather than helpful (Bardach and Kagan 1982, p. 106-7). Therefore, regulators should be empowered to provide compliance pathways suitable to the level of sophistication of a business to allow the goals of regulation to be met.

This is illustrated by empirical research was done into small business compliance with food safety regulations. It was found that small to medium enterprises (SME) find it easiest to comply with rules where it is easy to understand what the rule is, how to comply with it, what harm the rule seeks to prevent and how to demonstrate that the rule has been complied with. Further, compliance is easier if regulations require a business to do things which it may do anyway to improve customer perception of the business. The example given was comparing a rule which required a SME such as a restaurant to re-paint a room with requiring a SME to document a 'hazard-analysis' of their business, the former being a rule which was easy to comply with on all those criteria and the latter being a rule which was not (Fairman and Yapp 2005, p. 503-12). This suggests that regulation should be designed to suit the level of complexity of the field, and the severity of harm sought to be avoided.

The design of tax compared to food safety regulation may be very different in order to maximise social benefits of each kind of regulation. But principles of simplification and ease of compliance would be relevant to both fields to maximise the social benefit of regulation.

4. Conclusions

Small businesses experience the burden of regulation more keenly than larger businesses because small businesses have fewer resources and are unable to take advantage of 'economies of scale' in order to understand, comply with and benefit from regulation.

A tiered approach to regulatory policy — in addition to risk-based administration of that policy — can help eliminate excessive regulation and increase the net benefits from regulation. Reducing the burden of regulation and making it easier to comply with will typically increase the net societal benefits of small business regulation by increasing compliance rates while reducing the costs of compliance. In designing tiered approaches, policy makers should take into account possible incentive effects of different thresholds and minimise the complexity of the overall regulatory system by selecting simpler options for dealing with policy problems, regardless of which size business is affected, and regularly reviewing the burden of regulation as a whole. Eliminating excessive regulation and reducing complexity will disproportionately benefit small business, even where regulatory reforms are not 'tiered' or targeted at small business, and would also benefit large businesses.

Technical Appendix

This attachment presents the mathematics underpinning Figures 2, 3 and 4 in parts 2 and 3 of this paper. In that discussion, it was assumed that the social benefit from requiring any particular business to comply with a regulation increases linearly with the amount of the regulated activity it does. This implies that the marginal social benefit from the regulation as the business gets larger is constant. This will often be the case. For example, the number of people protected by a regulation requiring a bicycle courier company to ensure that its employees wear helmets when riding, will primarily depend on the number of delivery riders employed by the company. If so, the social benefit can be expressed as:

$$SB = MB \times X,$$

where   MB = marginal benefit (e.g. protection to each delivery rider)
X = measure of economic activity/business size (e.g. number of delivery riders)

Similarly, the social cost can include both fixed and variable components. As discussed in part 2, the fixed component of costs can be significant, particularly if a substantial effort is required to learn about, understand and demonstrate compliance with a regulation.

$$SC = FC + (MC \times X)$$

where   FC = fixed cost; MC = marginal cost (e.g. the cost of purchasing bike helmets)

In this case, the net social benefit (NSB) is given by:

$$\begin{aligned} NSB &= SB - SC \\ &= [MB \times X] - [FC + (MC \times X)] \\ &= (MB - MC) \times X - FC \end{aligned}$$

The average net social benefit per unit of activity from imposing a regulation on a firm of size X can then be derived by dividing both sides by X and representing the difference between the marginal social benefit and marginal social cost as the marginal net social benefit, denoted MNSB.

$$\begin{aligned} \frac{NSB}{X} &= (MB - MC) - \frac{FC}{X} \\ &= MNSB - \frac{FC}{X} \end{aligned}$$

As this result is of the form y = a − β/X, it implies a hyperbolic relationship between the net social benefit from applying a regulation to a business and the size of the business. This is why the net benefit curves shown in Figures 3 and 4 have been drawn as hyperbolic curves. The vertical asymptote corresponds to a business size of zero for both full regulation and the light touch alternative. The horizontal asymptote is derived as X increases and is given by:

$$\lim_{X \to \infty} NSB = (MB - MC)$$

In other words, for the largest businesses, the fixed costs associated with regulation become less relevant. For the example of the full regulation and light touch regulation presented in Figure 4, it is assumed that the marginal net social benefit from the full regulation option is greater than the marginal net social benefit of the light touch regulation. If this were not the case, then light touch regulation would be superior for all businesses.

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