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Regulation Exemptions for Small Businesses Are Unwarranted and Inefficient

The Colorado State Senate proposes Bill SB17-186, "Reduce Regulatory Burden Rules on Businesses". The Bill would require State Agencies to prepare a regulatory flexibility analysis before adopting any new rules. The regulatory flexibility analysis stipulates that Agencies must consider methods of reducing the impact of proposed rules on small business and determine the necessity of proposed rules. The Bill would require State Agencies to file the regulatory flexibility analysis with the Secretary of State concurrently with their filing of proposed rules.

The Bill stipulates that an Agency's regulatory flexibility analysis must consider the following methods for reducing the impact of a proposed rule on small business: establishing more flexible compliance or reporting requirements, and more flexible deadlines for said requirements; establishing performance standards for small businesses; and exempting small businesses from any or all requirements included in a proposed regulation.

The first question this Bill raises is whether government intervention is warranted at all. Regulation would only merit government intervention if it causes a market failure. Here, the case for market failure relies on the idea that regulatory costs are relatively higher for small firms than large firms. Moreover, that the costs of government regulation exhibit economies of scale, disadvantaging small firms.

However, small firms face higher transaction costs in general. This is because transaction costs don't scale proportionately with the size of the transaction. An analogous argument is then that if the government doesn't subsidize privately-sourced resources for small businesses, then it shouldn't loosen their regulatory requirements.

The remainder of this analysis assumes that government intervention is warranted; however, it still finds that small business ought to be regulated to the extent that regulation benefits society as a whole.

The primary purpose government regulation is to force firms to bear some of the societal costs caused by their actions. Consider an unregulated manufacturing firm that produces air pollution, negatively affecting the health of people in the surrounding area. The equilibrium cost of production is then inefficiently low because it does not account for the external health costs caused by pollution. Government regulation can help bring markets to a more efficient equilibrium by forcing firms to internalize the societal costs caused by their behavior, i.e. the cost of negative externalities. Moreover, the benefit of government regulation is that it protects people from unregulated enterprise activity.

This Bill would potentially exempt small businesses from regulatory requirements that protect society from harmful firm behavior. If large businesses are regulated so as to not harm society, then it is unclear why small business should not be held to the same standards. This Bill seems to rely on the idea that "small businesses are more severely affected by red tape than large companies because small firms are less proficient in dealing with the complexities of regulation and are unable to spread the costs of compliance across large-scale operations"[1]. However, there appears to be no systematic evidence that supports this idea.

For instance, it is unclear as to how much of the burden of the regulation firms actually bear. Compliance costs can manifest as lost profits, but they can also be passed onto customers via higher prices. The capacity to which a business can increase its prices to compensate for regulation costs depends on the degree to which consumer demand is affected by a price increase. Moreover, without knowing specific market elasticities it is impossible to determine what portion of regulatory costs are actually borne by a regulated business versus unregulated third parties.

To the extent that businesses are paying the costs of regulation, the only economically justifiable reason to exempt small businesses from regulation is if the marginal cost of complying to government regulations exceeds the marginal benefit. Moreover, if the net benefit of regulating a firm is negative, then it is more efficient not to regulate them. This implies that there exists a threshold at which a firm is small enough that the cost of regulation exceeds the benefit.

Implicitly, this Bill initially defines the threshold for small business as one having either 500 or fewer employees or less than six million dollars in gross annual revenue. However, the Bill would require a regulatory flexibility analysis only be performed for small business consisting of 100 or fewer employees.

[1] http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.630.1697&rep=rep1&type=pdf

Unfortunately, number of employees is not a particularly efficient measure of firm size. The relevant dimension of size varies among different types of regulation and business sectors. A report in The Journal of Small & Emerging Business Law contends that "in the case of minimum wage law, the appropriate measure of size is undoubtedly total employee work hours... In the case of securities registration requirements, the appropriate dimension is the dollar amount of the offering... In the case of the regulation of pollution, the appropriate dimension is the amount of pollutants discharged"[2].

Although the relevant dimension of size is variable, empirical evidence suggests that the regulatory burden imposed on businesses with 20 or fewer employees is greater than it is for businesses with more employees. For instance, a 2010 report by the U.S. Small Business Administration (SBA) found that regulations cost firms with 20 or fewer employees at least 36 percent more per employee than firms with more employees[3]. In fact, the majority of empirical evidence indicating that the regulatory burden is significantly higher for small firms define small as having 20 or fewer employees (Crain and Crain, 2010; Hopkins, 1995; Inland Revenue, 1998; Pierre and Scarpetta, 2004).

As it is currently written, the Bill's definition of small firm actually applies to the vast majority of firms in Colorado; since 76% of private-sector firms in Colorado have 50 or fewer employees. Therefore, the definition of small business appears

[2] http://heinonline.org/HOL/Page?handle=hein.journals/jsebl8&div=6&g_sent=1&collection=journals
[3] http://www.noexcusessafetytraining.com/001_NOV_GS/Site_info/The%20Impact%20of%20Regulatory%20Costs%20on%20Firms%20(Full).pdf

distortionary if the motivation behind the Bill is that small firms suffer more from regulation. Further, it appears that the current definition encompasses too many firms that would have a net benefit from regulation. As such, it would be more appropriate to define small business as one having 20 employees.

Tangentially, the SBA has a variable definition for small firm based on industry. As such, it would be best to define small firm on an industry basis rather than a fixed basis.

This analysis does not find it justifiable to provide small businesses protection from government regulations as regulation often leads to a positive net benefit for society. The benefit of regulation comes from the protection regulation offers society from the negative externalities appearing in unregulated markets. Small businesses should only be exempt from government regulation if the net benefit of regulating them is negative. As such, this Bill not be passed until it provides a more efficient way of identifying the businesses for which regulation causes a net loss.

Citations

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