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SME alert!

Understanding Regulatory Impact Assessments: Key issues from the international experience

This edition of *SME Alert* explores the mechanism of Regulatory Impact Assessments (RIAs) as a tool for assessing the likely impact of regulations. RIAs can be an instrument for decreasing the barriers to small and medium enterprise (SME) development. Essentially, an RIA is about measurement; about quantifying and calculating the transaction costs of doing business and testing the costs, benefits and risks of each potential course of action. Basic questions are asked, such as: 'Are government staff trained to implement the law? Is it enforceable? Is it good for business growth and the creation of more jobs? Does business agree with it and is the government capable of implementing it on due date?'¹

This is not to say that business interests should be the sole determinant of policy², but rather that policy should take full account of the practical realities for business, particularly SMEs. Why SMEs? Regulations impose disproportionate costs on SMEs because they lack the administrative capacity to absorb them easily. This is also the area where the greatest degree of non-compliance happens. Little wonder that in the UK, government departments are reminded to 'think small first' in assessing the costs of proposed new regulations.

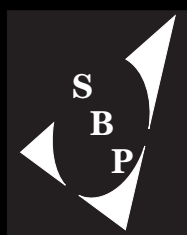
RIA is important for all regulation, not only regulations that affect business, or small business. The overall focus of RIAs is on appropriate or better regulation. In the case of business, the objective must be to enhance private sector growth, enable mar-

kets to function more effectively and facilitate investor certainty. RIAs are a key element in improving regulation.

South Africa's Department of Trade and Industry towards the end of 2002 announced the intention to commission a study to investigate regulations that impose disproportionately high costs on small, medium and micro-enterprises. This is a welcome development; but matters should not be left there. Political will and commitment to the broader concept of regulatory best practice, and specifically the use of RIAs as a standard element in the policy process, are critically important. In addition to being a clear sign of good policy making, the consistent use of RIAs would send a positive signal to investors that South Africa is 'a good place to do business'.

Thumbs up for RIAs: An international perspective

The US has the longest experience of RIAs. Its approach to controlling regulation is also more aggressive than in other countries. The Head of the Office of Advocacy of the Small Business Administration reports directly to the President of the USA. The Regulatory Flexibility Act (RFA) of 1980 for the first time required regulators to calculate the effect of their rules on small business. In 1996 a bill approved by the US Senate added 'teeth' to it by allowing small businesses to seek judicial review of an



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agency's compliance with the 1980 law. The 1996 Small Business Regulatory Enforcement Fairness Act requires agencies to simplify language, provide more accessible information on reporting and compliance requirements and, in a key section, to publish compliance guides for important new acts. Senator Dale Bumpers noted that requiring agencies such as the Internal Revenue Service to publish forms and rules in non-bureaucratic 'plain English' would go a long way to easing the animosity many people have toward government.³

Importantly, the US does not rely only on RIA procedures, it has other relevant acts, such as the Small Business Paperwork Relief Act of 2001. However, challenges remain. Senator Christopher S Bond said, 'Federal regulators continue to put the cart before the horse by favoring citations and litigation over practical guidance to help small businesses comply. The agencies are playing an elaborate game of "gotcha" that is projected to cost small firms

nearly \$7 000 per employee each year. This is a needless drain on small firms' potential to boost the economy.'⁹ Some agencies had to learn to comply with the RFA the hard way through litigation. (*See box: School of hard knocks: Regulators go back to the drawing board – 3 examples*)

By contrast, the UK experience is relatively new. In August 2000, Prime Minister Tony Blair said,

'Our aim for Britain is to create an environment where businesses thrive and enterprise is rewarded. Alongside this, we must ensure that minimum standards exist to ensure fairness at work, safe products and a clean environment. In August 1998, I announced that no proposal for regulation which has an impact on businesses, charities or voluntary bodies, should be considered by Ministers without an RIA being carried out.'¹⁰

Ministers responsible for the policy must sign a declaration stating that the relevant department is satisfied that the proposed benefits justify the costs. The Regulatory Impact Unit (RIU) supports Cabinet Office Ministers in overseeing this system.

The RIU works with other government departments, agencies, regulators and the regulated. Each government department has a Departmental Regulatory Impact Unit (DRIU) which acts as the first point of contact within departments on regulatory issues. The RIU Scrutiny Team – which includes a number of secondees from the private sector – works closely with DRIUs and departmental officials to ensure departments prepare robust RIAs which consider all available options – including 'doing nothing' – and non-regulatory alternatives.¹¹ The Unit's work also involves removing unnecessary, outmoded or over-burdensome legislation through the powers enacted in the Regulatory Reform Act of 2001. Unlike the US, the RIU does not have the broad legal authority to take on agencies that do not implement their RIA responsibilities.¹²

Similar procedures operate in Australia, where the Office of Regulation Review has oversight and responsibility for the review of Regulation Impact Statements prepared by the Australian Taxation Office. In New Zealand, Compliance Cost Impact Reports are prepared by the Inland Revenue Department for tax policy and administrative changes.¹³

The use of RIAs has yet to put down deep roots in many developing countries. In part, this might be

What is an RIA?⁴

An RIA is a mechanism to ensure that ministers and officials have a shared understanding of what they are doing, why they are doing it and what the consequences are likely to be.

RIAs should be simple, concise documents, using clear non-technical language and crafted in such a way that anyone reading the RIA can assess the proposed regulation, even those unfamiliar with the proposal. Positive and negative impacts of proposed regulation are presented in quantitative terms and outline the magnitude, timing and likelihood of impacts.⁵ Public consultation is conducted in parallel with the actual assessment. RIAs also provide recommendations and strategies for achieving the desired outcome⁶ and highlight areas where more work is needed. Ultimately they also provide a useful evaluation tool. Importantly, RIAs can be used as an 'integrating framework to identify and compare the linkages and impacts between economic, social and environmental regulatory changes'.⁷

Major policy proposals usually need a team of policy officials, lawyers, economists and other advisers. At times, there will be a need for a 'quick and dirty' RIA to establish the appropriate level of detail, cost and complexity.⁸ In some cases, an RIA is compiled by economists or numerate officials in relevant ministries, in others it is contracted out to an organisation capable of undertaking the assessment. The detail included within the RIA should be proportional to the scale and impact of the proposed regulation.

RIAs are a key element in improving regulation

due to the challenges that applying RIA entails. Says Kirkpatrick, 'At present, there is not even rudimentary data in many countries on the effects of regulation.'¹⁴ There are steps in the right direction. In Hungary the SME Act requires the use of regulatory impact procedures. This is also proposed in Lesotho's White Paper on Small Business Development. During 2002, the Deregulation Project in Uganda played an increasingly important role as a 'watchdog' ensuring that the impact of new laws and regulations was properly assessed. Its efforts meant that four key labour bills, that would have harmed economic growth and, in addition, been unenforceable, were halted and returned to the Ministry of Labour for more rigorous research and redrafting.¹⁵

Controlling inappropriate regulation is a difficult task. No country has really cracked it. An RIA can only take you so far. It is not a substitute for decision-making but rather a tool to enhance the quality of debate and understanding, and strengthen the evidence base of policy-making – a crucial condition for improving its quality.¹⁶ The real test is whether compliance burdens are reduced. RIAs are not enough but can be an important part of the effort.

And big business thought they had it bad¹⁷

Although they might dispute it, the world of public policy-makers and bureaucrats is often somewhat removed from that of entrepreneurs. Civil servants typically lack business experience. RIAs help bridge this gap.

A key part of the assessment process is the effects on small firms of the proposed regulation. SMEs occupy a unique position within the private sector. While regulations affect the private sector as a whole, they weigh most heavily on smaller firms. Complying with regulations can be expensive and difficult, assuming the businesses can figure out what constitutes compliance. A 2001 study by the US Office of Advocacy concluded that firms employing fewer than 20 workers face an annual regulatory bill of \$6 975 per employee. This burden is 60% higher than that faced by firms with more than 500 employees.¹⁸

School of hard knocks: Regulators go back to the drawing board – 3 examples

- Working in conjunction with general practitioner (GP) advisers, the UK's RIU suggested ways to ease the pressure on GPs in mid 2002. As many as 3.2 million appointments with family doctors could be saved if ministers were to strip away unnecessary work. The report noted that removing the burden of the repeat prescription system – along with sick note notification, social housing reports and disability benefit assessments – could free up to 360 appointments per year for every GP. It could also help government meet a target of all GPs being able to offer non-urgent appointments within 48 hours. Lord Macdonald, minister for the Cabinet Office, said 'This report will let GPs spend more time treating people who are ill rather than filling in forms.'¹⁹
- The US Bureau of Land Management had to revise its hard-rock-mining reclamation order after a court ordered it to consider the regulation's effect on small business.²⁰
- In January 2003 a regional representative for the US Office of Advocacy reported, 'A less burdensome way to rebuild groundfish stocks has been found by considering the concerns of small fishermen in the regulatory process' – a significant gain given that small business makes up approximately 99% of the fishing industry.²¹

Not all SMEs are affected in the same way by regulation. Sectoral considerations, the size of the firm, and how long it has been in operation are important factors. As Bannock notes, for example, 'the high costs of business registration may be of little concern to well-established firms (even though it might once have been) and, of course, surveys do not include firms which have not been established at all as a result of regulatory obstruction.'²² He adds, 'costs tend to fall over time through the learning effect as systems settle down. Frequent changes cause disruptions and push up costs in a way which could be avoided had there been sufficient consultation at the outset.'²³

Are regulatory costs susceptible to measurement?

Yes.²⁴ The basis for valuing costs and benefits is their 'opportunity cost' – the cost/price per item in its next best alternative use. For example, the opportunity cost of an employee's time spent visiting a government office to obtain a form to comply with a regulation would normally be the cost of wages for the time that is taken, that is the number of hours multiplied by the hourly wage.

Costs can typically be divided into policy and implementation costs.²⁵ Examples of the former – costs that are directly attributable to the policy goal of regulation – include:

- costs associated with loss of production and/or additional labour costs as a result of for example, enforced maximum working hours;
- loss of revenue associated with a ban on products;
- costs to business of purchasing a licence to operate a business.

Implementation costs of regulation, often referred to as 'red tape', are those costs that are not directly associated with the achievement of the aims of the regulation but are incurred when the regulation is implemented. They include:

- legal and other advisory costs of understanding the regulation, the costs of expertise purchased to assist with the completion of tax activities, for example;
- staff costs or time in training staff in the requirements of new regulations;
- staff costs in filling in forms;
- travelling to government offices;

It is important to assess who is likely to face the costs imposed by regulation, to quantify the direct cost as well as any indirect costs

- keeping records, compiling receipts, recording data;
- costs of buying new machinery/equipment – for example, computer software to comply with regulations; and
- costs of devoting additional time to satisfying officials.²⁷

In addition to 'hardcore' costs of lawyers and consultants there is little doubt that navigating 'red tape' requires not only time but patience and results in a variable degree of stress.

It is important to assess who is likely to face the costs imposed by regulation. The RIA should clarify the total number of businesses or jobs affected, quantify the direct costs as well as any indirect costs such as the downstream knock-on effects.²⁸

The tricky business of balancing costs and benefits

An RIA should not only identify the immediate costs and benefits of any direct intervention, but should also capture dynamic effects on the way in which product markets develop. If a regulation has a disproportionate impact on small firms or potential new entrants to a market, or introduces distortions between existing competitors, competition and consumer choice will be reduced; and the longer term competitiveness and productivity of the sector may well be harmed.²⁹

This is an important point. RIAs should avoid knee-jerk reactions to one off incidents or specific contexts, where it might be tempting to put in place restrictive regulations which might have detrimental long-term effects on the industry concerned and thus on overall national economic growth.³⁰

It must be remembered that regulations do not only incur costs. Analysing the benefits of regulating is essential, not only because it is for these reasons that the regulation is being proposed, but also because if this aspect is downplayed, an unbalanced assessment results.

Environmental and social costs

When proposing changes in regulation, the linkages between environmental, social and economic aspects must be factored in and the trade-offs examined. Concerns about social and environmental costs and benefits are just as important as the impact on business.

When should an RIA be done?

Timing is important. To be useful, an RIA should be started as soon as possible in the case of any proposal likely to have a direct or indirect impact (whether benefit or cost) on business. Used in advance of policy change to assess predicted impacts, RIAs can help policy-makers think through the consequences of proposals, improve the quality of advice to ministers and encourage informed public debate. After the policy has been implemented the RIA can be used to assess actual impacts.²⁶ RIAs are often thought to apply to new regulations. But it is equally important to apply RIA to existing systems. So, RIAs can be used to cut existing red tape as well as avoid new red tape.

Many South African business organisations complain about regulatory costs. Introducing RIAs into the process of governing would serve to test these claims and help government to better understand the concerns of business

RIAs can usefully inform political decisions. Are options likely to have a socially unacceptable effect or impose unfair costs on a specific or vulnerable group, such as the elderly, the disabled, the young, those on low incomes? Chosen policy options should not inadvertently create new groups of vulnerable people.³¹

While regulations are needed to protect people at work, consumers and the environment, it is 'important to strike a balance so that they do not impose unnecessary burdens on businesses or stifle growth'.³²

Securing compliance

Because there are not only technical but also political aspects to RIAs, public consultation is vital. While a degree of non-compliance is perhaps inevitable, widespread and enduring non-compliance can devalue regulatory instruments in general and diminish the credibility of government.³³ Bannock argues that 'whilst it may be difficult to satisfy all enterprises with a specific policy reform, most governments find policies easier to implement if firms can see that their concerns have been considered in their formation.'³⁴ He adds that 'it is a widespread experience that policies introduced without adequate consultation may engender

unforeseen consequences.'³⁶ This consultation should incorporate all stakeholders – consumer and civil society groups, local government officials, business and so on.

Written consultation is not always the best way to canvass views on a new policy or service. Other methods include: meetings with interested parties; 'listening' events; web forums, user and public surveys.³⁷

Ideally policy-makers should try to understand the characteristics of their target group – what motivates and hinders compliance – and use that understanding to inform regulatory design. What are real people in real businesses doing and how best can the law and regulations capture this? As the UK Cabinet Office reminds us, 'Robust enforcement is no substitute for voluntary compliance.'³⁸

A problem can arise in countries with a weak private sector as business representative bodies are also likely to be either weak or fragmented or both with small memberships and inadequate capacity for research. Few entrepreneurs have time to participate in representation as they are too busy running their businesses, while a wide variety of sectoral interests may lead to divisions of opinion between business organisations.³⁹

Many South African business organisations complain about regulatory costs. Introducing RIAs into the process of governing would serve to test these claims and help government to better understand the concerns of business.

Experience has demonstrated the limits of not spelling out costs, benefits and risks associated with policy choices in a systematic, objective fashion. RIAs serve to clarify conflicts of interest. Our context of limited resources demands sharp political footwork and a careful examination of the different options available for each policy choice and the likely impacts. RIAs also present important opportunities for business to present its case to government. But business must become a much smarter, more strategic player in public life, clarifying and promoting its interests better.

Once introduced, the task then becomes how to embed RIA in the process of governing. This suggests the need for a top-level body with authority in government, that reviews regulations, reports at the highest level and is empowered to work across all ministries.

Good regulation

The rule of law and appropriate regulation are central to good governance. New laws and regulations, if deemed absolutely necessary, should ideally be:

- transparent – open, simple, user-friendly;
- accountable – to ministers, parliament, users and the public;
- consistent – predictable, so that people know where they stand;
- targeted – focused on the problem, with minimal side effects;³⁵ and
- enforceable – a regulation that cannot be enforced will not achieve its policy objective.

Endnotes

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