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A Burden on Business?

Reviewing the Evidence Base on Regulation and

Small Business Performance

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Abstract: The evidence base regarding the impact of regulation on small business performance is reviewed. The substantive findings of various studies and their methodological approaches are critiqued. Many studies suffer from inadequate conceptualisation of 'regulation' and methodological shortcomings, and fail to investigate the causal mechanisms through which regulation contributes to business performance outcomes. In some cases, they positively encourage superficial and misleading results. More sophisticated approaches, using qualitative data, demonstrate that regulations generate a variety of consequences and should not be conceptualised solely in terms of costs and constraints. Rather, regulation can impact upon small businesses directly and indirectly, and both constrain <u>and</u> enable and motivate business owners to act. The impact of regulation is contingent upon business owners' adaptations to particular interventions within the broader social contexts within which they operate. The implications for policymakers are discussed.

Key Words: small business, regulation, compliance costs, business performance, small business policy.

Introduction

Regulation has become an important topic of public debate among politicians, media commentators, academics, lobby groups and practitioners. One estimate, derived from Government sources, suggests that implementing new legislation has cost UK businesses more than £50bn since 1998 (BCC 2006). Other sources, in contrast, note the 'business-friendliness' of the UK regulatory regime. The World Bank (2006) places the UK ninth out of 155 countries in terms of the ease of doing business[1] and the World Economic Forum (2005) ranks the UK's public institutions 12th out of 117 countries in their Growth Competitiveness Index.[2] Nevertheless, reducing the costs of regulatory compliance for business and delivering better regulation have become key policy objectives for the UK Government (Cabinet Office 2005). Important initiatives include: the use of Regulatory Impact Assessments (RIAs) to scrutinise regulatory proposals; the creation of the Better Regulation Task Force (now the Better Regulation Commission) to advise Government on regulatory issues; measuring and reducing administrative burdens on business; the simplification of the stock

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[1] Assessments are made in terms of ten 'indicator sets' all of which have regulatory implications: starting a business; dealing with licenses; hiring and firing workers; registering property; getting credit; protecting investors; paying taxes; trading across borders; enforcing contracts; and closing a business.

[2] Rankings are based on judgements relating to: the protection given by property rights; the independence of the judiciary; Government neutrality in awarding public contracts; the cost impact of organised crime and bribery on business and Government officials. Again, regulation is directly relevant to these issues.

of legislation and of the tax system; the Davidson review to examine the transfer of EU law into the UK; and the promotion of regulatory reform within the EU (HM Treasury 2006).

Critics of regulation insist it imposes costs on individuals and businesses that impede start-up, investment, innovation, employment, growth and, ultimately weakens national economic performance from which businesses, workers and consumers, it is argued, all suffer (e.g. Nicoletti and Scarpetta 2003). Proponents of regulation argue it is necessary to achieve a wide variety of economic, social and environmental objectives including creating the conditions to sustain a market economy, and the protection of investors, employees, citizens, consumers and the environment as well as business owners themselves (Cabinet Office 2005; WEF 2005; World Bank 2006; TUC 2006).[3]

Small businesses, many insist, suffer disproportionately from state regulation (Fletcher 2001; SBC 2001-4; Harris 2002; Baldwin 2004; Boys Smith 2004). Reflecting this concern, policymakers now require RIAs to include a Small Firms Impact Test to examine the likely effects of regulatory proposals on small businesses. The purpose here is to examine the evidence base on the impact of regulation on small business performance through an exposition and critique of existing studies. We begin by conceptualising 'regulation' and how it causally influences small

[3] Such an approach does not deny that powerful interest groups attempt, and are able, to influence regulators to act in a manner conducive to their interests (e.g. Stigler 1971), but it does not reduce regulators' motives to obtaining the support of specific social groups.

business owners' activities and performance before reviewing three types of study and concluding with implications for policymakers arising from the review.

Conceptualising Regulation

The regulatory framework created and enforced by state organisations profoundly shapes all economic activity. The activities of all sub-national, national and supra-national bodies possessing powers to design, implement and enforce regulation, including tax-raising and collecting powers, fall within the remit.[4] The primary purpose of regulation, from the perspective of Government, is to maintain and enhance the conditions that enable an advanced market economy to function. The framework incorporates the criminal and civil law codes that protect the person, private property and contract. Government also regulate by conferring duties upon designated bodies to provide a civil society infrastructure and other public goods that enable individuals to create businesses, acquire and deploy resources, and engage in trade. These include establishing: a financial system that enables the provision of credit to business investors; a welfare system that enables the supply of healthy, educated and 'disciplined' individuals to create and to staff businesses; and an energy, transport and communications infrastructure that enables businesses to operate. Even where these activities are carried out by private sector organisations, it is the state that authorises and enables

[4] This would include the 63 national regulators, 203 trading standards offices and 408 environmental health offices in 486 UK local authorities covered by the Hampton report (2005), as well as the European Union and World Trade Organisation which both set rules governing trade between member states.

their activity. Government mandates public and private providers of infrastructure and public goods to pursue specific objectives or to act in particular ways, for example, the economic regulators govern the activities of private sector utility providers. Moreover, by creating expectations of behaviour, regulation can contribute to the creation and maintenance of stable trading conditions which facilitate market exchange and long-term business investment.[5]

Regulation, as defined here, is a <u>necessary</u> condition of sustaining an advanced market economy, though this does not indicate the form regulation should nor guarantee success in meeting policy objectives. Without regulation advanced economies like the UK simply could not function effectively. Consider the difficult transition to a market economy in Russia since the early-1990s where the rule of law and private property rights were not deeply institutionalized (Safavian et al. 2001). Regulation can be defined as:

> the legal and administrative rules created, applied and enforced by state institutions – at local, national and supra-national level – that both mandate and prohibit actions by individuals and organisations, with infringements subject to criminal, civil and administrative penalties.

[5] To describe these as public goods does not mean all are able to benefit equally from them in practice.

Regulation mandates and/or prohibits action by small business owners and a range of other agents whose actions causally affect them - competitors, suppliers, employees, infrastructure providers and regulatory authorities – many of which are also small businesses. As far as any particular small business is concerned, regulation can affect them directly or indirectly. Direct influences are those which mandate or prohibit actions by small business owners themselves. Examples include making tax payments and observing the National Minimum Wage. Most research has focused on the individual small business owner in this way. Indirectly, small business owners might change their behaviour as a result of other agents - for example, competitors - adapting their behaviour to regulatory change. Whatever affects competitors necessarily causally influences, in however small a way, small business activity and performance. Such influences extend to prospective as well as actual competitors. The causal chains constituting the 'invisible hand of regulation', connecting particular regulatory interventions to the actions of particular small business owners could, therefore, be long and complex.

In popular discourse, regulation is represented as a cost or constraint on the actions of agents. But by changing agents' resources and reasoning (Pawson and Tilly 1997), regulation can enable or motivate them to adapt in particular ways, although this may happen without their conscious acknowledgement. Regulation does not have determinate effects; it is only through the active exercise of human agency that regulation impacts upon small business performance.[6] Regulation has no effect at all unless agents – small business owners, competitors, suppliers, employees, infrastructure providers and regulatory authorities - change their behaviour as a result of them. Business owners, intentionally and unintentionally, draw upon regulations - for instance, property and contract rights - to achieve their business objectives. Regulation grants rights to, as well as places obligations upon, small business owners, that are enforceable against significant others; one example is the right to charge interest on late payments by customers. The regulation of others' activities might also prove enabling for small business owners; for example, regulation forbidding 'anti-competitive' practices might enable small business owners to compete on a 'level playing field'. An Office of Fair Trading telephone survey found that 22% of SME owners, employing 10-250 staff, reported being a victim of anti-competitive behaviour (OFT 2005). Moreover, by restricting certain courses of action or imposing certain costs on small business owners, regulation can motivate them to implement product and process innovations in order to cut costs and/or increase trading revenue. In pursuit of their specific goals, business owners adapt their practices to the contexts they encounter. The regulatory framework constitutes part of this broader context which shapes, but does not determine, business owners' resources, goals and performance.

[6] The existence of a regulation does not, of course, guarantee that regulatees will comply in the manner desired by regulators, though non-compliance risks legal sanctions.

Methodology

A systematic search of data sources was undertaken to compile the evidence base. The primary methods used were manual searches of library sources and electronic academic databases; these were supplemented using a Google internet search engine and were particularly useful to locate Government and other non-academic sources. Search terms such as 'small business', 'enterprise' and 'company' combined with 'regulation', 'legislation', 'compliance costs' and the titles of particular regulations were used to locate material. Some studies were small business-specific; others included larger organisations. Most materials found were UK sources though the arguments presented here are intended to be of wider significance.

Interrogating the Evidence Base on Regulation and Small Business Performance

A large number of studies were identified, and can be categorised as one or more of the following types:

- business burden studies;
- compliance cost studies;
- business decision-making and competitiveness studies.

In the following sections, evidence is reviewed under these sub-heads. Some studies appear under more than one sub-head as they combine more than one of the types listed above. For each type of study, the implications for policymakers are discussed.

‘Business Burden’ Studies

Typically, these studies present quantitative survey data on business owners’ perceptions, or rankings, of regulation (or particular regulations) as a ‘burden/barrier/obstacle’ (or other synonym) in relation to business ‘success/performance/growth’; alternatively, inferences about the importance of regulation can be drawn from the policy changes sought by business owners (Bennett, forthcoming). Surveys either do not define regulation or define it inadequately. The Small Business Service (SBS) Annual Survey of Small Businesses, incorporating 7,505 businesses in a range of industries employing up to 250 employees in the 2004/5 survey, found that 31% of owners cited ‘regulation’ (undefined) as an obstacle to business success (13% cited it as the main obstacle). ‘Taxation’ was also cited as an obstacle to business success by 24% of the sample (8% main obstacle) (SBS 2006). The 2003 survey data were 39% for ‘regulation’ (15% main obstacle) and 38% (9% main obstacle) for ‘taxation’ (Atkinson and Hurstfield 2004). In both surveys, however, obstacles other than regulation and taxation were seen as more important. ‘The economy’ was cited more frequently as an obstacle to success in the 2003 survey and ‘competition’ and ‘the economy’ were cited more frequently as an obstacle to success in the 2004/5 survey. Both of these studies reflect, and reinforce, notions of regulation as a ‘burden’ or constraint but neither examines how regulation constitutes an obstacle to success: what does regulation cause business owners (or others) to do, or not do, that obstructs success? Neither study considers how regulation might enable business owners to attain their business objectives.

Several Cambridge University small business surveys have examined the impact of regulation on innovation (but not other business performance objectives) (Cosh et al. 1996; Cosh and Wood 1998; Cosh and Hughes 2003). Business owners were asked to rate the importance of various factors as barriers to innovation, on a 5- or 6-point scale (ranging from 'insignificant' to 'crucial'). In all three surveys, 'regulation' is covered by the rather wider concept of 'legislation, norms, regulations, standards and taxation'. Both norms and standards could refer to industrial, trade or commercial customs rather than legal rules. But, even allowing for this, the wider concept is not a major barrier to innovation. This factor was the tenth (out of 18) most important barrier to innovation in the 1996 report, tenth (out of 16) in the 1998 report, and joint seventh (out of 16) in the 2003 report. Again, this survey evidence provides little insight into precisely how 'legislation, norms, regulations, standards and taxation' act as barriers to innovation activities; nor is consideration given to the possibility that these influences may be drivers of, rather than barriers to, innovation.

The Federation of Small Business biennial membership surveys indicate substantial dissatisfaction with various aspects of regulation (Carter et al. 2002, 2004, 2006). The 2006 study of nearly 19,000 business owners found that large proportions of respondents were either 'dissatisfied' or 'very dissatisfied' with: the complexity of legislation (54%), the volume (53%), the rate of change (51%), the cost of compliance (51%), the interpretation of legislation (48%), the enforcement regimes (31%) and the inspection regime (29%). Only 2-4% of respondents reported being 'satisfied' with each of these six aspects of legislation (Carter 2006: Table 8.1). Interestingly, when asked about the effects on the business of specific employment laws – disability discrimination; flexible working; maternity, paternity and parental leave; and working time – more than six in ten respondents reported no effect at all; only 5-9% of respondents reported negative views, with 1-4% reporting positive views, and the remainder reporting 'not relevant' or giving no answer (Carter 2006: Table 5.9). Again, though, evidence is not presented as to why owners were dissatisfied, reported positive or negative views, or, more important, whether this caused business owners to adapt their behaviour in other ways which might have had consequences for business performance.

Many commentators assume the constraining impact of regulation to be inversely related to business size: the smaller the business, the greater the impact of regulation (e.g. SBS 2004). The survey data on this issue, however, suggest a more nuanced interpretation. The 2004/5 SBS Survey found that businesses without employees and micro firms (1-9 employees) were both less likely to report regulation as an obstacle to business success (29% and 37% respectively) than medium-sized businesses with 50-250 employees (39%) (SBS 2006). Other studies have produced similar findings (NatWest/SERT 2004; PACEC 2004; Carter et al. 2006). Blackburn and Hart (2002), in a telephone survey of 1071 small employers, attribute a similar association between business size and perceptions of the impact of individual employment rights to lower levels of awareness and engagement among owners of micro businesses. It is not clear, however, whether such a finding is explicable in terms of a lack of awareness of regulation, deliberate non-compliance, or some other cause.

Quantitative survey data on business owners' perceptions of regulation is perhaps the least satisfying in terms of enhancing understanding of the impact of regulation on small business performance. First, such studies offer little insight into the meaning of, and influences on, owners' perceptions and, therefore, provide little explanation of the variation in reported perceptions either within or across studies. Direct comparisons between surveys are rendered difficult by differences in the range of regulations covered, sampling, question wording, the number of response alternatives offered, and in data interpretation (e.g. Blackburn and Hart 2002, 2003; PACEC 2004; Fraser 2004; RSA 2005; Baldwin and Anderson 2005; Hart and Blackburn 2005; CBI 2005). Without further detail as to the meanings business owners attach to regulation, it is difficult to explain these divergent findings or to generalise from particular studies. Are business owners expressing opinions on the policy costs of regulation, the administrative costs of discovering, interpreting and implementing regulation, both policy and administrative costs, or some other experience?

Second, surveys are unable to provide robust data on respondents' awareness and understanding of their regulatory obligations or their attitudes to compliance, both of which mediate the influence of regulation on business behaviour and performance. Owner-manager awareness of specific regulations has been found to be limited and/or levels of compliance variable in relation to employment (Westrip 1986; Scott et al. 1989; Marlow 2002; Harris 2002; Woodland et al. 2003; Atkinson and Curtis 2004; Thomson 2004; Harris and Foster 2005; Pratten and Lovatt 2005), health and safety (Vickers et al. 2003, 2005), the environment (Petts et al. 1999; Gunningham 2002; Patton and Worthington 2004; NetRegs 2005), food hygiene (Yapp and Fairman 2005), late payment (SBS 2006), and more generally among hospitality (Price 1994) and biotechnology (Corneliussen 2005) business owners. Blackburn and Hart (2002) suggest that differences in awareness reflect a 'need to know' orientation to regulation, but this presupposes that business owners know what they don't know. KPMG (2006) suggest business owners spend considerable time finding out whether particular regulations do, in fact, apply to them. Business owners' self-reported data on awareness of particular regulations might not be a reliable means of establishing whether they have a detailed knowledge of their obligations (Atkinson and Curtis 2004). Such findings suggest scepticism towards survey reports of business owners' perceptions of specific regulations without checking their awareness of them first.

Variability in regulatory awareness suggests variable levels of compliance; indeed, because many owners lack a proper understanding of some regulations, they do not know whether they are meeting their obligations or not (Scott et al. 1989; Yapp and Fairman 2005), a condition Petts et al. (1999) describe as 'vulnerable compliance'. Having said this, detailed knowledge is not a necessary condition for compliance. Commitments to standards of professional practice (Corneliussen 2004), market forces, concerns about reputation, and a paternalistic attitude towards employees (Vickers et al. 2005) can influence business owners to act in accordance with regulatory requirements without complete knowledge. Yet, business owners may consciously choose <u>not</u> to comply despite adequate knowledge. Distinct attitudes to compliance have been identified, from the 'avoider' (Vickers et al. 2005) and the 'unaware' (Harris 2002) through 'vulnerable compliance' (Petts et al. 1999) to 'proactive learners' (Vickers et al. 2005) that actively seek to build upon regulatory compliance to achieve wider business benefits. Business owners negotiate the meanings of particular regulations - and compliance with them - through interaction with others, including managers, employees, business advisers and regulatory authorities. These negotiated understandings provide norms for action until such time as new understandings are learned, possibly as a result of inspection or litigation, leading to modifications in behaviour and, as a consequence, business performance.

Third, many surveys can be criticised for their one-sided conceptualisation of regulation as a cost or constraint. Partly, this derives from explicit definitions of regulation as 'red tape' or the use of leading questions and pejorative language. For example, the ICAEW survey of business advisers asked respondents to comment on the imbalance between the needs of regulation and the encouragement of enterprise; this presupposes that regulation and enterprise <u>are</u> imbalanced: the more you have of one, the less you have of the other (ICAEW 2005). The Forum of Private Business online survey, entitled 'Busting Red Tape', invites business owners to identify the 'red tape' they feel is 'burdensome' (http://surveys.fpb.org/redtape/). It is hardly surprising that such surveys find high proportions of dissatisfied or critical business owners. Partly, the problem arises from not defining regulation at all. Not providing a definition of regulation invariably encourages business owners to focus on regulations that place obligations upon them, such as making tax payments, rather than on any enablements afforded them. Business owners, like other people, are more likely to focus on what prevents them achieving their goals rather than on the conditions that enable them. Partly, the problem arises because few surveys inquire whether regulations confer benefits on business owners or enable them to achieve their goals; for an exception see Carter et al. (2006: Table 5.9). Failure to recognise both the constraining and enabling/motivating influence of regulatory change will lead policymakers to adopt a partial view of regulation.

Fourth, and most important, survey data of owners' perceptions provides little insight into the causal mechanisms through which regulations influence small business behaviour and performance. Simply reporting owners' perceptions gives no indication of whether, and how, business owners - and other agents who causally influence them - adapt to regulatory change. Survey data relies too strongly on superficial 'sound-bite' responses which provide good headlines but, at best, only tell us what business owners think about regulation rather than what they do about it. Furthermore, how should reported perceptions be interpreted? Do they reflect owners' direct experiences of regulatory impacts on their own enterprises, reports of regulatory impacts by known others, wider public discourses of 'regulatory burdens', owners' attitudes towards Government, or even owners' other experiences of running a business unrelated to regulation and policy? The 2003 and 2004/5 SBS Surveys found that sizeable minorities of those reporting regulations as an obstacle to business success could not cite <u>any</u> specific regulation as an obstacle to success: 23% in the 2003 survey (Atkinson and Hurstfield 2004) and 31% in the 2004/5 survey[7], plus a further 9% reported 'don't know' responses (SBS 2006: Table 5.5). Edwards et al. (2003: Table 2, and pp40-42) note business owners' general perceptions of employment legislation often differ from their concrete experiences of managing the impact of regulation on their own enterprises. Business owners may, in general, view employment rights as a burden on business and yet be able to claim positive effects on their own firms. Such apparent discrepancies might be explicable in terms of the power and prevalence of what might be termed 'anti-regulation' discourses in the wider society. In sum, reliance on owner-managers' reported perceptions provides little evidence of whether and how they adapt to regulatory change and does not, therefore, provide a sound foundation for policy-making.

Compliance Cost Studies

Using survey techniques, compliance cost studies attempt to quantify the administrative costs – and very occasionally, the benefits - for business

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[7] Strictly speaking, the 31% relates to those reporting 'no specific regulations/all regulations'. Even so, almost a third of the relevant business owners could not identify a <u>specific</u> troublesome regulation.

owners of regulatory compliance. For business owners, it is argued, there is an opportunity cost in diverting scarce resources away from more productive, profit-generating activities in order to discover, interpret and comply with regulatory obligations. In the SBS 2004/5 Survey, of those reporting that regulations acted as an obstacle to business, the most common obstacle cited was ‘paperwork/administrative procedures’ (reported by 39%). With regard to taxation, the main barrier identified was ‘difficult to understand the regime’ (44%) (SBS 2006: Figure 5.2). The NatWest/SERT study (2004) of 589 small firms found an inverse relationship between business size and time spent on government regulations and paperwork (including time spent by owners, their employees and professional advisers). Owners working alone reported spending 8.4 hours per person per month on regulations and paperwork; in businesses with 25 or more workers, owners spent 1.8 hours per person per month on regulations and paperwork.

Studies from the UK (Collard et al. 1998; Collard and Godwin 1999; Lancaster et al. 2001; Chittenden et al. 2002, 2003, 2005a, b; Baldwin 2004; Kauser et al. 2005; KPMG 2006) and elsewhere (Crain 2001; OECD 2001; European Commission 2004; Confederation of Swedish Enterprise 2004; Klun 2004; Business New Zealand/KPMG 2005) illustrate the regressive character of compliance costs: small businesses incur higher proportionate costs than larger companies, either in terms of time or as a proportion of turnover. Methods of calculating compliance costs vary but usually involve imputing monetary costs to labour time estimates administering regulations, plus some monetary estimate for advisors’ fees, capital and other operating costs. Much of this cost is fixed and small businesses are unable to spread these costs across large-scale operations; they lack the internal resources (time, money, specialist expertise) to handle regulations and, because of their lower asset base, are less resilient to regulatory shocks. There is no consensus on the size of these costs due to variations in how the 'small business' is defined, the specific regulations covered, sample sizes and composition, the methods of calculating costs and undertaking comparisons with large enterprises (Chittenden et al. 2002) – all of which render generalisation difficult.

The inverse relationship between compliance costs and business size is not always linear. Some studies find lower proportionate costs among the very smallest businesses, for example, Lancaster et al.'s (2003) study of health and safety regulations, and Chittenden et al.'s (2005a) study of Income Tax Self-Assessment. It is possible that this reflects lower regulatory awareness, understanding and compliance among owners of the very smallest businesses.

RIAs are intended to provide a cost-benefit analysis of proposed regulation as part of the policy-making process but, in practice, the costs and benefits are often either ignored completely or not quantified (Ambler et al. 2005, 2006). Quantifying costs and benefits is, however, extremely difficult, particularly where these are intangible and/or likely to accrue over a long period of time. For example, estimating the costs of increasing wage rates to comply with the National Minimum wage may be relatively easy;

estimating the benefits of innovating to adapt to these increased labour costs will be very difficult, particularly when competitor businesses might be attempting to do the same. This raises important questions about the utility of estimating quantitative costs and, especially, benefits in explaining the impact of regulation on small business performance. Headline figures of 'regulation increases business costs by £50m' variety inevitably simplify, and misrepresent, complex social processes.

Some studies identify benefits arising from regulatory compliance, for instance, cashflow benefits arising from the payment of taxes after liability for them has accrued (e.g. Tran-Nam et al. 2000; Chittenden et al. 2005b; Blackburn et al. 2005). Although these studies avoid treating regulation purely a cost or constraint, they stop short of demonstrating how small business owners exploit such benefits.

Compliance cost studies go beyond surveys of business owners' perceptions by highlighting the importance of time and the opportunity costs associated with meeting regulatory obligations, but adopt a narrow and static focus on costs, and hence a partial picture of the impact of regulation on small business performance. Regulation is conceptualised, implicitly, in terms of the administrative activities surrounding compliance rather than in terms of the broader dynamic influence of intervention. Business owners adapt to regulatory interventions in a variety of ways, often in combination: by raising consumer prices, by implementing product or process innovations, or by continuing to operate as before. Compliance costs, in time or money terms, might simply be absorbed by the business owner and stimulate no change in business practices. Simply measuring compliance costs tells us very little about how or why small business owners adapt to regulatory change in particular settings in the ways they do, nor how these adaptations impact upon business performance. Many, though not all, compliance cost studies, like business burden studies, do not consider the potential benefits of regulation to small business owners or explore how regulation can enable or motivate business owners to act with the aim of improving business performance. Again, this reinforces the assumption that regulation imposes only costs and constraints on business owners.

Compliance cost analysis tends to focus on those costs that can be quantified easily, or alternatively, attempts are made to force qualitative phenomena into a quantitative cost-benefit framework. For example, some studies find an association between the psychological costs associated with handling regulation - the stress and anxiety associated with discovering, interpreting and implementing regulation - and overall compliance costs (e.g. Hansford et al. 2004). These are no doubt important influences on owner-manager behaviour, both motivating and demotivating, but very difficult to quantify. Kauser et al. (2005) and Chittenden et al. (2005a) claim to measure psychological costs but the question asked requests business owners to state how much Government should compensate them for administering a particular tax. It is questionable whether this measure captures ‘psychological costs’ in the sense of felt anxiety, or is simply a reflection of time costs.

Business Decision-Making and Competitiveness Studies

These studies, both quantitative and qualitative, examine how and why small business owners adapt to regulatory change in the ways they do, and with what consequences for business competitiveness. Qualitative studies offer deeper insights into the causal mechanisms through which regulation generates changes in business behaviour and performance; they do this by demonstrating how regulation enables and motivates business owners to modify business practices, as well as constrains them, within the particular social contexts that support or hinder these adaptations. Conversely, quantitative surveys, though an improvement on business burden studies, tend to provide descriptive data on actions taken but by themselves provide limited insight into the causal processes underlying these actions.

The Household Survey of Entrepreneurship, a UK survey of 10,000 adults aged 16-64, found individuals' perceptions of business regulation to influence the business start-up decision (NOP Social & Political 2004). Large minorities of those who had recently thought about starting their own business, buying into an existing business, or becoming self-employed (36%), and of those not currently running a business/self-employed, nor having recently thought about becoming so (44%), cited the complexity of regulations as influencing them not to start a business, though for both groups other factors were cited as barriers more frequently. The study did not consider whether regulation might encourage business formation, for example, by creating market opportunities, providing guidance on running a business or in creating a 'level playing field' upon which small businesses are able to compete. Focus group and telephone survey evidence both from current owners and non-owners suggests that those thinking about going into business tend to over-estimate the extent to which tax and regulation issues constitute a real burden; those currently in business reported regulations to be less onerous than anticipated (SBS 2005). Again, these differences between prospective business owners' expectations of regulation and current owners' direct experience might be explicable in terms of the pervasiveness of 'anti-regulation' discourses in the wider society. If true, such discourses exert a genuine constraining influence on business start-up in the UK.

Regulation also influences business development and growth. Most quantitative surveys report that regulation has impeded expansion, to widely varying degrees, rather than assisted it. The SBS 2004/5 Survey found that taxation impacts negatively on business success primarily by reducing resources for investment (41%) (SBS 2006: Figure 5.3). The NatWest/SERT (2004) survey found that 36% of respondents had avoided employing more people and a further 18% reported reducing numbers employed as a result of the 'burden of regulation and paperwork'. Chittenden et al. (2005b) found that 32% of their sample reported that the cost of operating payroll activities deterred recruitment. Opinion Leader Research (2004) focus group data suggested employment protection laws discourage recruitment of protected categories of employee. Pierre and Scarpetta (2004), using survey data from 17,000 firms in 81 countries, report that small firms (less than 20 employees) were more likely to rely on temporary employment to circumvent the costs associated with strict labour regulations than medium-sized firms (with 21-100 employees). In contrast, the SBS 2003 Survey found only 7% of business owners without employees reported employment regulations as the reason for not employing other staff (Atkinson and Hurstfield 2004) and, in the 2004/5 survey, only 3% reported regulations had deterred growth (SBS 2006: Table 4.3a). Chittenden et al. (2000) interpret the spiky distribution of business turnover at levels just below the VAT threshold in terms of a 'distorted business behaviour zone' (cited in Chittenden et al. 2002), implying that business owners choose to operate at lower levels of activity to avoid regulatory obligations. How far proximity to the VAT threshold causes business owners to restrict turnover growth rather than there being a bunched distribution for other reasons is unclear. Data is suggestive of causal links through statistical correlation rather than through linking business owners' motivations and actions to the broader context, including the regulatory framework.

Regulation does not have uniform consequences for small business owners; everything depends on how owners, and others whose actions causally affect them - competitors, suppliers, employees, infrastructure providers and regulatory authorities – exercise their agency and adapt to regulatory change. The impact is, therefore, variable. These obvious points can be lost in aggregate data on business owners' perceptions of regulation and estimates of compliance costs. It is the interaction of the specific character of regulatory change, its insertion into pre-existing business practices, agents' adaptations, and the broader context of adjustment that researchers must address to assess the impact of regulation on small firm performance. Regulatory change always intervenes into pre-existing business relationships and practices. Adaptation necessarily changes these relations and practices though to different degrees, depending upon prior conditions; hence it is regulatory change that causes most concern for business owners (Edwards et al. 2004). The regulatory framework becomes part of the taken-for-granted world of business owners until such time as it requires them to adapt. Qualitative studies provide greater detail of these causal processes and are more sensitive to the specific content of regulations, owner-managers' awareness and adjustments, and the business context.

Initial worries regarding the adverse impact of the National Minimum Wage (NMW) on labour costs and employment have not been borne out by experience (Low Pay Commission 2005), but nor is there much evidence that employers have been motivated into implementing 'high road' competitive strategies associated with raising workforce skills and implementing product and process innovations. Small employers have adapted to the NMW and other employment regulations in a variety of ways with no single dominant type of employer response: absorption with no further adaptations to business practice; raising product prices; reducing employment, workers' hours and work intensification; cuts in training and non-pay benefits; product and process innovations; or by choosing not to comply (Bullock et al. 2000, 2001; Ram et al. 2001, 2003; Heyes and Gray 2001, 2004; Gilman et al. 2002; Lucas and Langlois 2003; Arrowsmith et al.

2003; Mason et al. 2004; Atkinson and Curtis 2004; Arrowsmith and Gilman 2005; Druker et al. 2005; Morris et al. 2005).

Edwards et al. (2003, 2004) conclude, on the basis of studies of the NMW and other employment regulations, that the law often exerts only a limited impact on small business owners' decision-making and business competitiveness. Most were able to adapt to regulatory change with limited disruption to existing practice either because the cost increases imposed by regulation were minimal, or because the firm's product market position and 'informal' workplace relationships enabled cost increases to be absorbed or passed on to customers as higher prices without serious problems. Where product market competition was intense and businesses were struggling, however, regulatory change could aggravate an already precarious market position, forcing some businesses to the edge of legality or, in some cases, into closure. Few businesses were 'shocked' into implementing product innovations owing to limited access to capital and/or skills. Grimshaw and Carroll (2006) suggest that small business employer norms regarding employee pay and an unwillingness to invest in external workforce training combined with restrictive product market conditions limit the capacity of individual firms to develop innovative business strategies.

Various studies argue for the potential benefits of regulation for small business owners' activities. Tabone and Baldacchino (2003) note how the requirement for a statutory audit generated benefits by imposing financial discipline upon business owners as well as protecting society from business malpractice. Employment regulation can benefit small employers by providing guidelines and clarification in setting employment conditions (Blackburn and Hart 2002) and by enabling the formalisation of procedures for dealing with matters such as discipline and dismissal (Edwards et al. 2003) - though others report increasing formalisation as a disadvantage for small employers because it undermines the flexibility of existing informal workplace relationships (Marlow 2002; Harris 2002; Walsh 2004). Environmental regulation can stimulate business owners to search for innovative product and process solutions (Noci and Verganti 1999; Vickers and Cordey-Hayes 1999). Even requirements for information provision can improve management systems in terms of record-keeping. Such evidence helps to counter the one-sided character of much of the discussion about regulation.

There is little evidence that regulation encourages small business owners to implement major product or process innovations. Such innovations do occur but are contingent upon a wide range of influences, including the severity of the regulatory shock and the capacity and willingness of owner-managers to adapt working routines and/or products. This suggests a dilemma. Where the regulatory shock is minor, business owners might prefer to continue 'business as usual' because they lack incentives to reform their business practices fundamentally (Arrowsmith et al. 2003). Where regulatory change is major, business owners often lack the resources and/or the willingness to adapt effectively - indeed, some business owners' aversion to change may lead them to become 'entrapped' in a situation where they remain committed to existing ways of operating, or incremental change, despite obvious difficulties (Drummond 2004). Consequently, some may struggle to survive and, in critical cases, cease trading.

Studies, understandably, tend to focus on agents' conscious adjustments to regulatory change. But regulatory change also constitutes an unacknowledged condition of action - enabling, motivating and constraining changes in business practice, with consequent performance effects, 'behind the backs' of small business owners in so far as it does not explicitly enter their motivations or reasoning. Property and contract rights giving business owners powers to take ownership of and deploy resources, and to realise product sales, are essential for business owners to conduct trade and achieve their objectives, irrespective as to whether these rights enter their reasoning explicitly. The World Bank (2006) highlights the importance of regulations providing protection for private property as an influence on its country rankings for ease of doing business. Regulations governing the financial, education, health and social security systems influence the supply of finance and labour to businesses. Regulations relevant to the energy, transport and communications sectors shape access to key infrastructure resources. Furthermore, changes in competitor, supplier and customer behaviour arising out of regulatory change may stimulate adjustments by small business owners in their own practices, with potential performance effects, but are unlikely to be attributed to regulation. Failure to acknowledge the 'invisible hand of regulation' does not mean its effects on small business performance are not real.

Conclusion and Policy Implications

This review of the evidence base on regulation and small business performance has identified several different types of study. The methodologies adopted profoundly influence data quality and the inferences and policy implications that can be drawn from them. Many studies focus solely on business owners themselves and conceptualise regulation, explicitly or implicitly, in narrow terms as a cost or constraint. Such a narrow focus does scant justice to the complex causal mechanisms through which regulation causes changes in small business practices and performance – direct and indirect; constraining, enabling and motivating.

Failure to understand how regulation affects business performance means that policy interventions are likely to produce unwanted consequences because they do not identify the full range of mechanisms shaping small business performance nor the conditions which support or hinder the exercise of these mechanisms and the generation of their tendential effects. Business burden studies do not address these mechanisms, instead remaining at the level of what small business owners think about regulation but not what they do to adapt to it. Compliance cost studies identify the time and monetary costs (and occasionally benefits) associated with implementing regulation but do not explore the dynamic effects of regulation. Competitiveness studies have identified some of the dynamic causal influences on business performance and offer the best clues to understanding and, therefore, to policymakers contemplating intervention. By highlighting the interrelationship between regulatory change, business owners' motives, capabilities and actions, and business context, such studies can explain the variability of impact of particular types of regulation on different types of business.

Policymakers can benefit from the more adequate conceptualisation of regulation and a deeper understanding of the mechanisms (direct/indirect; constraining/enabling/motivating) generating business performance effects presented here The regulatory framework shapes the resources and reasoning of small business owners, and those with whom they causally interact, thereby influencing their actions. Combined these mechanisms causally influence performance outcomes at the level of the individual small business. A broader conceptualisation of regulation enables policymakers to look beyond the administrative activities associated with compliance to consider the full range of state regulatory activities that might facilitate improvements in small business performance – including interventions to provide easier access to valuable resources and a stable framework of market competition that encourages business start-up and development. Seen in this broader context, reducing the administrative burden of regulatory compliance, though beneficial, might be much less important than other measures regulators might take to support small businesses.

Moreover, small business owners are only one constituency whose interests policymakers might wish to take into account when contemplating regulatory change. A more adequate understanding of how regulation contributes to, or constrains, small business performance might permit a clearer picture of the trade-offs involved between small business policy goals and other highly-valued policy objectives. How such trade-offs with regard to the 'burden of regulation' on small business owners should be resolved is, of course, a political decision.

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