



Literature Review for the SME Capability to Manage Regulation Project

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INTRODUCTION AND RESEARCH OBJECTIVES

The regulation of business activity has become an important policy concern in both developed and developing economies (European Commission 2010). Reducing the costs of compliance for business and delivering *better* regulation have become key policy objectives for governments in Europe, North America, Asia and Australasia (Weatherill 2007; Ambler et al. 2009; Nijsen et al. 2009). The World Bank (2009) ranks 183 countries in terms of the ease of doing business in terms of 10 broad indicator sets, all of which have regulatory implications.¹ Singapore is the highest-ranked economy in the World Bank rankings for the fourth year in a row, with New Zealand ranked second and Hong Kong, China third.

Proponents of government regulation argue that it is necessary to tackle market failures or to address social equity problems, although the costs of regulation should be kept as low as possible even where regulation is justified in principle (e.g. BRE 2009a, b). At a more fundamental level, it may be argued that regulation enables market exchange through, for example, the enhancement of property and contract rights, as the experience of some transition economies demonstrates. Market failures exist where the market under-supplies certain goods; regulation might be considered necessary to remedy the failure. Examples of market failure include the provision of public goods, externalities, imperfect information and concentrations of market power. Social equity issues are potentially very wide-ranging and include economic, social and environmental objectives. Examples include the protection of investors, employees, citizens, and consumers as well as business owners themselves. Critics, conversely, insist regulation imposes costs on individuals and firms that impede business 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. Boyfield 2009).

Small businesses, in particular, many argue, find it more difficult than large companies to manage government regulation, because of resource-based constraints and reduced scope

¹ These ten indicator sets are: starting a business; dealing with construction permits; employing workers; registering property; getting credit; protecting investors; paying taxes; trading across borders; enforcing contracts; and closing a business. There have been minor changes in these indicator sets over time.

for a managerial division of labour (Bannock and Peacock 1989; Chittenden et al, 2002) and, consequently, suffer disproportionately from it. The primary objectives of the review are to answer the following questions:

- Which types of SMEs find it difficult to deal with regulations and which find it manageable?
- How does this relate to the capability of SMEs in terms of their management, staff and systems, and when do SMEs move towards professional support or advice?
- How does this relate to other influences such as attitudes towards regulation, the size, location and age of the SME, and the influence of culture, ethnicity, gender, or the age of the entrepreneur?

In more detail, the review seeks to document:

- What is known about SME capability for dealing with regulations and identify the gaps in the knowledge.
- Research that has investigated reasons and influences that affect the ease and likelihood of compliance with regulations.
- The determinants of compliance capability.
- the positive aspects (e.g. increased motivation) and negative aspects (e.g. increased cost) of regulation including any links to business performance.
- The methodologies that have worked in the area of measuring SME capability.
- Previous studies that have similar objectives and have used similar methodology (i.e. qualitative research with large numbers of businesses with good and poor compliance to government regulation).

The review builds on, and develops, previous work by the authors (Kitching 2006, 2007; SBRC 2008) in two major ways. First, the focus of attention shifts towards the processes surrounding compliance and the management of regulation, including firms' broader adaptations to regulation, and away from the impact of regulation on business performance outcomes. Many previous studies treat the firm as a 'black box', neglecting the internal processes that contribute to performance, or, alternatively, do not take them as their central focus, so inferences have to be drawn from the performance data and analysis presented. The focus on compliance and adaptation directs attention to regulation that applies directly to businesses rather than that which applies to other stakeholders with

whom small firms interact but inevitably exerts an influence on small business activities and performance. Studies are reviewed for analysis and data relevant to small firms' resources, regulation-handling capabilities and motivations to comply and adapt. Second, the report updates earlier work by including material published since 2006, although key sources prior to this date are also included.

The review is structured as follows. First, regulation and its influence on small business compliance and adaptation to regulation are defined. Second, empirical studies are categorised, reviewed and critiqued in relation to the review objectives specified above. We conclude by summarising the findings and by highlighting the primary weakness and omissions in the existing evidence base.

DEFINING REGULATION AND ITS INFLUENCE ON SMALL BUSINESS COMPLIANCE AND REGULATION-HANDLING

Following SBRC (2008: 3), regulation can be defined as:

... the legal and administrative rules created, applied and enforced by Government regulatory authorities – at local, national and transnational level – that both mandate and prohibit actions by individuals and organisations, with infringements subject to criminal, civil and administrative penalties.

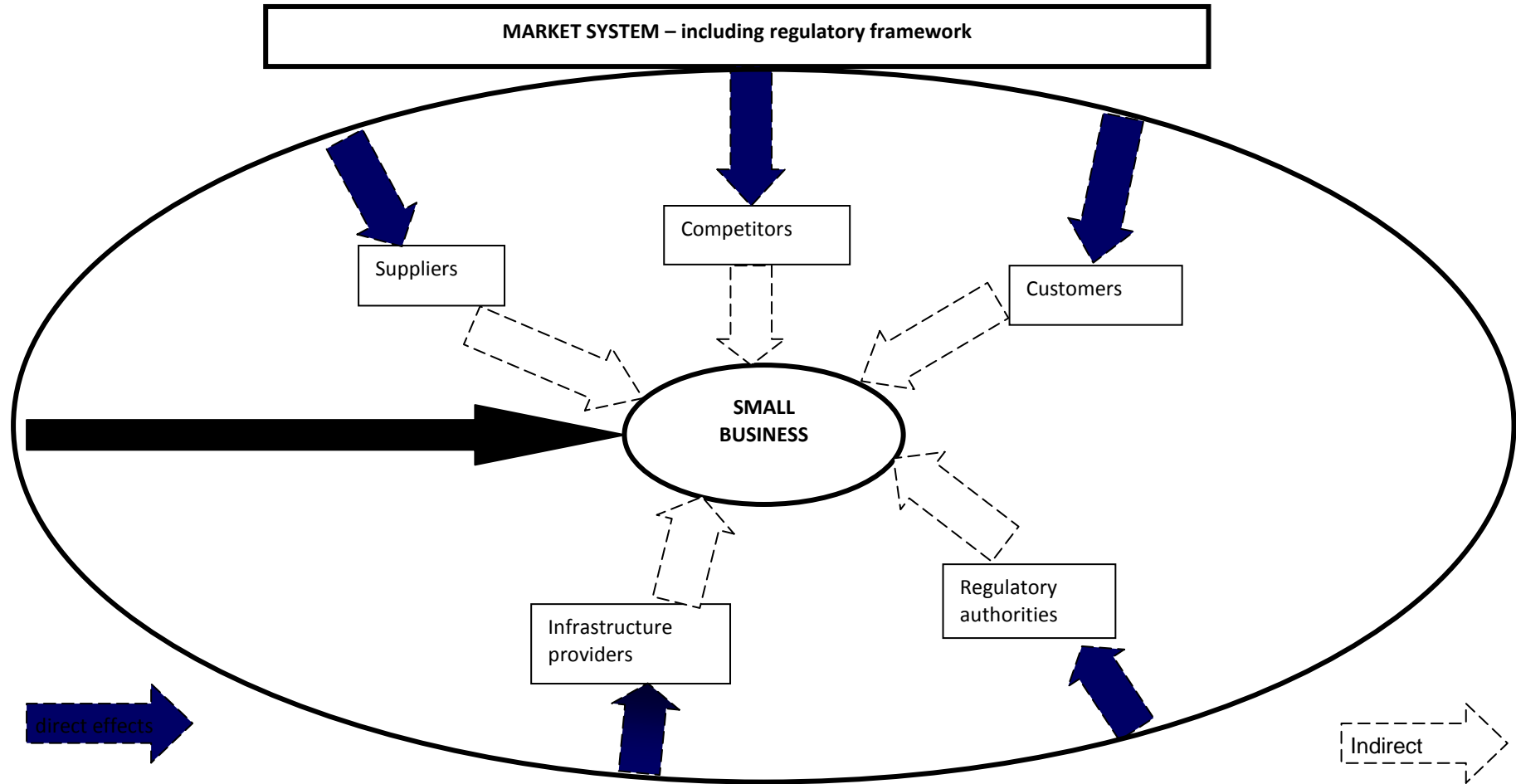
Three points are worth noting about this definition. First, regulation takes many forms, including the criminal and civil law codes and administrative rules that mandate or prohibit certain types of behaviour. What matters is that the state imposes sanctions for non-compliance; self-regulation and voluntary approaches are excluded unless ultimately founded on state power, or the threat of it. Second, regulation derives from authorities operating at various territorial scales, so businesses and other agents are governed by multiple sources of regulation. Third, taking a small business perspective, regulation influences behaviour *directly* by mandating or prohibiting behaviour by firms themselves but also *indirectly* by shaping the behaviour of other stakeholders with whom firms interact - including actual and prospective competitors, suppliers, employees, infrastructure providers and regulatory authorities. These processes operate simultaneously (see Figure 1). The

‘invisible hand of regulation’ connecting particular regulatory interventions to the actions of particular small businesses is, therefore, extremely complex.

One of the primary purposes of regulation, from the perspective of Government, is to maintain and enhance the conditions that enable an advanced market economy to function. The regulatory framework profoundly shapes all economic activity by influencing the behaviour of firms and other stakeholders. Regulation, therefore, is a *necessary* condition of sustaining an advanced market economy, although this does not indicate the precise form regulation should take nor guarantee success in meeting policy objectives.

Regulation produces effects only through the actions of human agents and has no effect at all unless small businesses, or other stakeholders, adapt their behaviour, whether intentionally or unconsciously, as a consequence. The existence of a regulation does not, of course, guarantee compliance nor does it determine how firms adapt. Adaptation refers to all activities undertaken by businesses and their agents in response to regulation – from minimal compliance, where agents do simply what is necessary to comply, through to highly innovative and far-reaching adjustments to practices and products. Business owners/managers always have some discretion regarding whether to comply and whether to adapt products and processes beyond minimal compliance. Adaptations vary in scale and scope according to internal resources, capabilities and key actors’ motivations, as well as the external context in terms of the product, labour and capital market conditions.

Figure 1: Direct and Indirect Regulatory Influences on Business Behaviour



Source: adapted from SBRC (2008)

Regulation enables small business owners to act in particular ways, as well as placing constraints upon them. Property and contract protection and enforcement are perhaps the most obvious regulatory enablements. By enabling small businesses to deploy assets in order to trade and granting them means of legal redress in case of default by trading partners, property and contract provide small businesses with the means and the confidence to create and operate enterprises. International studies of economies at differing stages of market development demonstrate, for example, that where property rights are more effective, firms reinvest their profits but do not otherwise (Johnson et al. 2002), that contract law can promote cooperation and dynamic efficiency (Arrighetti et al. 1997), consumer protection laws may stimulate business (Parker 2007) and, further, state-provided contract enforcement facilitates international trade (Ackerman, 2006; Leeson 2008).

Regulation is fundamental in market creation and shaping, for instance, capital markets, which by providing debt and equity capital to businesses to facilitate trade. Laws forbidding 'anti-competitive'² practices enable businesses to enter markets and operate on a 'level playing field', contributing to processes of competition.³ Consumer protection legislation is also enabling for businesses where, by overcoming problems of information asymmetry and providing confidence in product standards, it motivates customers to purchase goods and services. This is an area where, in some sectors at least, quality assurance initiatives by retailers may enhance the capability of SMEs to comply with health and safety and employment protection standards and manage regulation (Tipples and Watman, 2009). Moreover, by restricting certain courses of action or imposing costs on small business owners, regulation can motivate them to implement product and process innovations with the intention of cutting costs and/or increasing trading revenue, and thereby achieve an advantage over competitors who may be slower and/or more conservative in their response. In an investigation of the effect of minimum wage legislation on Asian clothing firms, Ram et al (2003) found that although the legislation was found to be burdensome by

² This includes the control of monopolies and restrictive trading practices.

³ Similar arguments have been made for various types of standard, including accounting standards (Meeks and Swann 2008).

many firms, it could also act as a 'positive shock' in terms of stimulating more efficient practices and a move into niche markets.

METHODOLOGY

A systematic search of data sources was undertaken to compile the evidence base with the emphasis on new material published since 2006. Sources were identified and obtained primarily from electronic databases available through Kingston University, supplemented using a Google internet search engine and by manual searches of library materials. Search terms such as 'small business', 'enterprise' and 'company' combined with 'regulation', 'legislation', and 'compliance costs' were used to locate material. Some studies were small business-specific; others included larger organisations. These sources were supplemented by material obtained from personal contacts in Australia and other material from New Zealand supplied by the client.

EMPIRICAL STUDIES OF SMALL BUSINESS COMPLIANCE AND ADAPTATION TO REGULATION

Studies are categorised into four types:

- 'business perception studies';
- 'cross-national surveys of regulation and business activity';
- 'compliance cost studies'; and
- 'qualitative studies of small business compliance and adaptation'.

Each type of study is described and examples given, before offering a critique of the approach and findings. Particular emphasis is given to qualitative studies as these, arguably, provide deeper insights into firms' compliance and adaptation practices – into business owners' awareness and understanding of regulatory rights and obligations, attitudes to compliance and adaptation, and linking business behaviour to the wider structural and cultural contexts of action.

Business Perception Surveys

Perception surveys typically present quantitative data on business owners' perceptions, or rankings, of regulation as 'burden' on business, or, alternatively, sources present data on business owners' responses to regulation. Examples of the approach include the UK Department for Business, Innovation and Skills (BIS) Annual Small Business Survey (Williams and Cowling 2009), the Open University Business School enterprise research team (e.g. OUBS 2009), the UK National Audit Office (NAO 2007, 2008, 2009) and the surveys conducted by the UK Federation of Small Business (Mason et al. 2006; Carter et al. 2009; Federation of Small Businesses, 2008).

Williams and Cowling (2009) found that 'regulations' were reported as the fourth biggest obstacle to business success by small employers, accounting for 12 per cent of the sample responses, behind 'the economy' (16 per cent), 'competition in the market' (14 per cent) and 'taxation, VAT, PAYE, national Insurance, business rates' (12 per cent). For regulations, this constitutes a decline from the survey of the previous year, when 14 per cent of the sample reported it as the major obstacle, second only to competition. Such data indicates that small businesses perceive regulation as a problem. Respondents reported regulations to be an obstacle to business success in three main ways: difficulty, time and effort in deciding how to comply with the regulation; administration and paperwork associated with complying; and the costs of complying. Health and safety regulations were the most frequently reported obstacle to business success, followed by employment regulations. Just over one in ten (11 per cent) reporting regulation as an obstacle, however, were unable or unwilling to identify a particular piece of legislation, perhaps reflecting a general resentment of regulation rather than any specific law.

OUBS (2009) provides longitudinal data on small business owners' perceptions of Government regulation as a problem. The survey provides responses from approximately 800 business owners on a quarterly basis. Since Q4, 2008, the survey reports on respondents' views of the three most important problems facing the business. The most recent survey, for Q4, 2009, found that 33 per cent of the sample reported as among the top three problems facing the business. This places regulation the third most frequently cited problem behind 'economic climate or demand' (reported by 57 per cent of the sample)

and 'cashflow, payments or debtors' (reported by 35 per cent). Other possible responses offered to respondents are all reported by fewer than 33 per cent of the sample – total tax burden, competition, interest rates or access to finance, inflation or cost of inputs, lack of time/capacity, lack of skilled employees/high pay, internal management/marketing etc.

NAO studies each report on a survey of approximately 2,000 businesses (NAO 2007, 2008, 2009). In the 2009 study, business owners were asked various questions about regulation and its influence on business behaviour (NAO 2009). Asked for the most challenging aspect of running a business, respondents ranked 'complying with regulation' second of six items after 'attracting and retaining customers'. A majority (62 per cent) of sample businesses reported compliance as an obstacle to success. Just one per cent of businesses reported that compliance had become less time consuming in the last year, and 3 per cent that it had become easier, while 37 per cent reported it taking longer and 30 per cent stated it become more difficult. Asked which aspects of regulation they found so burdensome, more than half of the sample agreed that each of the following were a burden – 'keeping up to date with new regulations', 'the length of time to comply', 'finding information about which regulations apply', 'finding guidance and advice explaining how to comply', 'preparing and reporting facts and figures for government', 'completing paperwork', 'having to submit the same information more than once', and 'updating policies when regulations change'. Only 'being ready for and complying with inspections' was agreed to be a burden by fewer than half of the sample (49 per cent agreed, 33 per cent disagreed and 12 per cent neither agreed not disagreed).

The Federation of Small Businesses frequently find 'increased regulation' as a barrier to firms achieving their business objectives (Federation of Small Businesses, 2008). Respondents were asked how their businesses had been affected by ten specific types of legislation, on a rating scale from 1 (very negatively) to 5 (very positively). None of the specified regulatory areas were given an average rating below 2, which means that no specific regulatory field was rated as very negative. These results suggest that it is not specific legislation that concerns small business owners, but regulation in general, which they perceive to be increasing over time. In the latest FSB survey, one third of respondents (33 per cent) reported regulation as an obstacle to achieving business objectives. The

economy/recession and cash flow were both reported more frequently (by 72 and 42 per cent of the sample respectively) (Federation of Small Businesses, 2010).

There is evidence to suggest that regulation can deter business start-up and business development. The UK Household Survey of Entrepreneurship, a survey of adults aged 16-64, found individuals' perceptions of business regulation restrict the business start-up decision (NOP Social & Political 2004; IFF Research 2007, 2008).⁴ In the 2007 study, 45 per cent of 'avoiders', those who were neither 'doers' (the self-employed and business owners) nor 'thinkers' (those who had recently thought about starting a business, buying into an existing business or becoming self-employed), reported complexity of regulations as a barrier to entrepreneurial activity. Women were slightly more likely than men to report complexity of regulations as a barrier to entrepreneurial activity (47 per cent, compared to 42 per cent).

These surveys do not, however, 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'. Focus group and telephone survey evidence 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 (Allinson et al. 2005). 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 society. Such discourses arguably exert a genuine constraining influence on business start-up in the UK where they discourage individuals from establishing businesses because they perceive themselves as lacking the capability to handle regulation.

Regulation also influences business development and growth. Chittenden et al. (2005a), for instance, found that 32 per cent of their sample reported that the cost of operating payroll activities deterred recruitment.

⁴ The three survey samples vary in size, from 10,002 adults in the 2003 survey (NOP Social & Political 2004), 15,696 in 2005 (IFF Research 2007) to 7,329 in the 2007 survey (IFF Research 2008).

There are several problems with business perception studies in relation to explaining small business compliance and adaptation to regulation. First, studies provide little data on respondents' awareness and understanding of regulatory obligations (Atkinson and Curtis 2004), or their attitudes to compliance, both of which mediate the influence of regulation on behaviour. Business owners' awareness and understanding of regulation is likely to vary across different regulations, because they differ in volume, complexity and novelty, as well as the cumulative volume of regulation they have to deal with (Vanilla Research 2008). Blackburn and Hart (2002) found that owner-managers' knowledge of different individual employment rights varied markedly, although owners' self-reported data on awareness of particular regulations might not provide an accurate picture (Atkinson and Curtis 2004). It might be preferable to check business owners' awareness, and perception, of regulation in detail first before accepting such self-reports.

Second, motives for compliance derive from judgements of self-interest or from adherence to social norms (ENTEC 2003; Amodu 2008); both may be influenced by conscious and unconscious beliefs. Business owners may be more likely to comply where regulation is perceived as 'common sense' or where guidance is perceived as readily available and easy to understand (Fresh Minds 2009). Compliance behaviour may, therefore, be affected by the perceived properties of regulation – the clarity of aims and language and its communication; ease of understanding/complexity; volume; rapidity of change; lack of clear guidance on compliance; effectiveness of inspection and enforcement institutions; nature and extent of sanctions for non-compliance. Mason et al. (2006) found low levels of satisfaction with any aspect of regulation. Distinct owner-manager attitudes to compliance have been identified - the 'unaware' (Harris 2002), the 'avoider' (Vickers et al. 2005), those in 'vulnerable compliance' (Petts et al. 1999), where business owners are uncertain whether they are in compliance, through to 'proactive learners' (Vickers et al. 2005) that treat regulatory interventions as opportunities for learning and improvement. Owner-managers' motivations to comply are, therefore, highly variable.

Third, business perception studies rarely explore precisely *how* perceptions shape compliance and adaptation to regulation. It is not known whether, and to what degree, firms do, in fact, comply with the regulations they perceive as burdens, or whether, instead,

they go beyond minimal compliance, adapting practices and products in response. Compliance may be affected by negative perceptions of regulation (BRE 2009). If negative perceptions undermine the legitimacy of regulation, business owners may choose not to comply, particularly where they feel able to evade them at low cost or risk. In other cases, negative perceptions of regulation might motivate owner-managers to comply *and* to adapt practices and/or products with the aim of overcoming the perceived costs and constraints of compliance. Adaptation clearly depends on firms possessing key resources (finance, labour, managerial expertise) although adaptation alone cannot guarantee firms benefit; this also is contingent upon the responses of other stakeholders.

Cross-National Surveys of Regulation and Business Activity

A number of studies have used multi-country samples to explore whether regulation restricts business entry. Typically, these studies identify the varied entry procedures, and associated costs, experienced by prospective business owners in different countries and correlate these with measures of start-up, or other forms of entrepreneurial activity. Many studies conclude that entry regulation, or administrative complexity, constrain start-up (Djankov et al. 2002; Grilo and Irigoyen 2006; van Stel and Stunnenberg 2006; Klapper et al. 2006; Ho and Wong 2007), although others offer contrary views (Capelleras et al. 2008). Van Stel and Thurik (2007) note that although entry regulations do not appear to deter entry, labour regulations do.

Such studies provide interesting cross-national comparisons but do so at the cost of removing the human beings at the centre of these decisions from the picture. Without qualitative data on owner-managers' motivations for entry or non-entry, there is little to substantiate entry regulations, or administrative complexity, as importance influences on entry. Moreover, as van Stel and Stunnenberg (2006) indicate in the title of their paper, it might be that it is would-be business owners' *perceptions* of entry regulation and its complexity that shape the start-up decision, rather than the number and complexity of the regulations themselves. This, again, draws attention to discourses concerning regulation existing in different societies which individuals can use to account for their actions. Many factors – economic, political/regulatory and cultural - conceivably influence the business entry decision. Establishing quantitative correlations between entry measures and

regulation are suggestive of a causal connection but, by neglecting the views of the agents deciding whether or not to start a business, they ignore the very important, and necessary, subjective element in the entry process. Second, does the existence of entry regulations mean they are actually followed in practice? Prospective business owners might be able to evade certain regulations or, alternatively, they might incur higher costs due to corruption or rent-seeking by regulatory officials. Both issues cast doubt on the measures of regulation and associated costs used in such studies.

Compliance Cost Studies

Compliance cost studies, using survey techniques, quantify the administrative costs – and occasionally, the benefits - of compliance for business owners. Business owners, it is argued, face an opportunity cost in diverting scarce resources away from productive, profit-generating activities in order to discover, interpret and comply with regulatory obligations. Methods of calculating compliance costs vary but usually involve imputing monetary costs to labour time estimates associated with administering regulations, plus some monetary estimate for advisors' fees, and additional capital and operating costs incurred. References to time spent finding out about which regulations apply, reading and understanding the regulations (and associated guidance), completing paperwork and undertaking administrative procedures are all relevant to compliance costs (e.g. Williams and Cowling 2009). Compliance has been found to vary spatially (Slyuzberg et al. 2009) and sectorally (Hansford et al. 2003).

Studies from the UK (e.g. Collard et al. 1998; Chittenden et al. 2002, 2003, 2005a, b; Lancaster et al. 2003; Kauser et al. 2005; Amodu 2008) and elsewhere (Crain 2005; Business New Zealand/KPMG 2005; National Research Unit 205) support the claim that compliance costs are regressive: that small businesses incur higher proportionate costs than larger companies, either in terms of time or as a proportion of turnover. A large element of compliance costs is fixed and small businesses are said to be unable to spread these costs across large-scale operations due to their lack of internal resources (time, money, specialist expertise) with which to handle regulations and, because of their lower asset base, are less resilient to regulatory shocks. Chittenden et al.'s (2002) review concludes that compliance costs are approximately 35 per cent greater in firms with fewer than 20 employees than in

businesses with 500 staff, while acknowledging that 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 – all of which render generalisation difficult. Some studies, for example, 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. 2003; Kauser et al. 2005; Chittenden et al. 2005b).

Some studies find that the inverse relationship between compliance costs and business size is not always linear. Higher costs are not always found among the very smallest businesses, for example, Lancaster et al.'s (2003) study of health and safety regulations, and Chittenden et al.'s (2005b) study of Income Tax Self-Assessment. Carter et al.'s (2009) survey of nearly 17,000 UK firms found small firms to be least affected by employment regulation. It is possible that this reflects lower regulatory awareness, understanding and compliance among owners of the very smallest businesses (Blackburn and Hart 2002) and in some instances legislative exemptions for the smallest firms. Costs might also vary with business owners' experience of regulation-handling. Some find costs are reduced (e.g. Australian Government Productivity Commission 2008), while others that satisfaction with regulation is lower (Carter et al. 2009).

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. 2005a; Blackburn et al. 2005). Although these studies avoid treating regulation purely as a cost or constraint, they stop short of demonstrating how small business owners actually exploit such benefits.

Quantifying costs and benefits is, however, extremely difficult, particularly where these are intangible and/or likely to accrue over a long period of time. Estimating the costs of increasing wage rates to comply with the National Minimum wage, as in the UK, for example, may be relatively easy; estimating the benefits of innovating to adapt to these increased labour costs is much more difficult, particularly when competitor businesses

might be attempting to do the same. Firms, for instance, might incur various types of opportunity costs such as sales and profit opportunities missed arising from products never launched or markets never entered (Europe Economics 2003). This raises important questions about the utility of estimating quantitative costs and, especially, benefits in explaining the impact of regulation on small business performance.

Compliance cost studies go beyond surveys of business owners' perceptions by highlighting the importance of time, opportunity and psychological costs associated with compliance. But, they also have deficiencies with respect to review objectives. First, compliance cost studies conceptualise regulation in terms of the administrative activities surrounding compliance, primarily in terms of costs rather than any benefits. Moreover, emphasis is placed on those costs that can be quantified easily or, alternatively, attempts are made to force qualitative phenomena such as psychological costs into a quantitative cost-benefit framework (Kauser et al. 2005; Chittenden et al. 2005b). Second, such studies treat compliance as a static cost rather than as a dynamic force, neglecting learning processes, and enabling and motivating businesses to adapt practices and products with the aim of enhancing or maintaining performance. Simply measuring compliance costs tells us very little about how or why regulation might cause small business owners to adapt to regulatory change in particular ways in particular settings, nor how these adaptations impact upon business performance. Claims that "regulation increases business costs by £76 billion" (BCC 2009) or "the cost of regulation to the UK economy is between ten and twelve per cent of GDP" (BRTF 2005) reinforce assumptions that regulation imposes only costs and constraints on businesses, but misrepresent complex social processes.

Qualitative Studies of Small Business Compliance and Adaptation

Qualitative studies examine how and why small business owners adapt to regulations and regulatory change, including compliance and, in some cases, with what consequences for performance. Such studies offer deeper insights into the mechanisms through which regulation generates changes in business behaviour by demonstrating how regulation enables, motivates and constrains business owners to modify practices, and links compliance and broader adjustments to regulation to the business, market and institutional contexts. Qualitative studies provide greater detail of these processes and are more

sensitive to the specific content of regulations, owner-managers' awareness and adjustments, and context. As a result, they typically offer more nuanced insights than those gleaned from quantitative studies alone.

In the UK, the introduction of the National Minimum Wage (NMW) in 1999, which provided pay minima for employees aged 18 or over, has generated a large research output. Initial concerns that the NMW would lead to an increase in unemployment or a switch to younger workers not covered by the legislation, were not borne out by experience (Metcalf 2008). 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 in a variety of ways: absorption of wage rate increases with no further adaptations to business practice; raising product prices; reduction in employment, workers' hours and work intensification; cuts in training and non-pay benefits; and by product and process innovation (e.g. Ram et al. 2001, 2003; Heyes and Gray 2001, 2004; Gilman et al. 2002; Arrowsmith et al. 2003; Druker et al. 2005; Morris et al. 2005). Non-compliance has been reported in small businesses in the highly competitive clothing manufacture and restaurant sectors (Ram et al. 2003; Jones et al 2006a) and specifically in relation to the employment of illegal immigrants (Jones et al. 2006b). Despite a focus on two specific market sectors, a diversity of responses by small business owners to the NMW was demonstrated. This draws attention to the dangers of making oversimplified generalisations based on firm size and sectoral characteristics.

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 firms have been 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 without serious problems. Where product market competition is intense and businesses are struggling to survive, however, regulatory change could aggravate an already precarious market position, forcing some businesses to the edge of legality or, in some cases, into closure (Ram et al. 2003). Few businesses were 'shocked'

into implementing product innovations because of the wider constraints on innovative behaviour in small businesses which include 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. Overall, the evidence from studies of the effects of the NMW in the UK demonstrates the role of employer agency. Even under conditions of severe constraint, employers have *some* discretion as to whether to comply with regulation and whether, and how, to adapt products and practices. Employer choice regarding compliance and adaptation is contingent upon resources and motivation to comply and adapt, whether based on economic calculation, moral judgement or ignorance (Amodu 2008).

SBRC (2008) investigated the impact of regulation on small business performance outcomes in England. This involved a two-stage research design. The first stage involved face-to-face interviews with 124 owners/managers of small and medium-sized enterprises in England (mainly London and the South East); the second reports on a telephone survey of 1,205 small businesses in England. Several key findings are presented. First, although regulation clearly does impose costs on businesses and affect performance, the outcomes experienced in practice are not simply a function of the regulation involved. Rather, performance outcomes depend on how business owners, and other stakeholders, adapt to specific regulations, as previously discussed. Second, regulation generates multiple influences, simultaneously, which can be enabling and motivating for business owners as well as constraining. These influences operate whether or not owner-managers (and other actors) are explicitly aware of them. Third, business owners vary in their capacity to discover, interpret and adapt to regulation. Those with greater resources – finance, management capability, workforce knowledge and skills – are better placed to deal positively with regulation. Where businesses lack the resources to develop new practices and products, their capacity to adapt to regulation is constrained. Fourth, business owners reporting being well-informed about regulations affecting their businesses tended to adapt to regulation in ways which achieved superior business performance. This suggests that knowledge of regulation, coupled with the internal capacity to respond positively enables

businesses to adapt practices and products to overcome some of the constraining influences of regulation. Fifth, owners of fast growth enterprises were significantly more likely to report that the introduction of new regulations had encouraged them to take action to ensure their businesses remained competitive and to claim that that they were able to adapt more quickly than competitors. The greater resources that were typically found in these businesses placed them in a relatively strong position to make this adaptation.

The UK Better Regulation Executive have identified a range of ways in which regulation might deliver benefits for economy and society: standard-setting; underpinning consumer confidence; banning cartels; environmental protection; harm prevention to people; investor protection and limited liability; anti-corruption measures; and a range of benefits related to social equity or socially valued goals (BRE 2009a, b). Benefits are not always visible, for example, where the benefits are long-term, preventative or difficult to attribute to regulation. Regulatory change often generates costs and benefits simultaneously for different agents, or even the same ones. Gurtoo and Antony's (2007) review of the literature on environmental regulation, for instance, notes how it might generate indirect or unintended effects for the environment, for global trade barriers, for emerging markets and industries, for market entry barriers and competition, and for new business structures. However, some writers have played down the economic effects of regulation costs related to environmental protection (Ackerman, 2006).

Regulation does not have uniform consequences for small businesses; much depends on how owners and other stakeholders whose actions affect them - competitors, suppliers, employees, infrastructure providers and regulatory authorities – adapt to regulatory change. The influence of employment regulation might, for instance, be contingent upon employees' awareness of their rights and willingness to press employers to provide them (Marlow 2003); indeed, employees may actively collude in employer non-compliance with regard to employment regulation due to lack of alternative employment (Ram et al. 2007). Intellectual property laws are argued to encourage business entry (Klapper et al. 2006). Regulations governing financial markets influence small firms' access to capital (Carpentier et al. 2008). In some sectors, major customers can be a source of awareness of legislative requirements and, in some cases, pressure to comply (Vickers et al, 2005). Given the many

direct and indirect routes through which regulation influences any particular firm-in-focus, the impact on that business is highly variable. Such an obvious point is lost in aggregate data on business owners' perceptions of regulation and estimates of compliance costs. The regulatory framework becomes part of the taken-for-granted world of business owners until such time as it requires them to adapt.

A study of health and safety practices and legislative compliance in small firms, based on a combination of a large telephone survey and interviews with business owners and employees, found occupational health and safety outcomes to be related to a complex interplay of various internal and external influences on the firm (Vickers et al, 2003). Internal influences comprised those business characteristics, which have implications for management processes. These typically focus on the degree of formality/informality in management approach, reflected in differences between firms in the incidence of management training; the extent of employee representation and involvement with respect to health and safety; as well as in the values and behavioural traits of managers and employees. The benefits of a dual methodology were demonstrated by the fact that it enabled a degree of triangulation with respect to some of the key indicators relating to healthy and safety management and improvement measures. For example, based on in-depth interviews with some of the respondents to the telephone survey, it was suggested that some may have exaggerated their commitment to health and safety in the survey, because they were reluctant to admit to poor practice on the telephone.

Variability in regulatory awareness suggests variable levels of compliance (Patton and Worthington 2003); indeed, because many owners lack a proper understanding of some regulations, they do not know whether they are meeting their obligations or not (Yapp and Fairman 2005; Colmar Brunton 2006), a condition Petts et al. (1999) describe as 'vulnerable compliance'. Detailed knowledge is not, however, a necessary condition for compliance. Commitments to standards of professional practice (Corneliussen 2005), market forces, concerns about reputation, and a paternalistic attitude towards employees (Vickers et al. 2005) often influence business owners to act in accordance with regulatory requirements without complete knowledge. Yet, business owners may consciously choose *not* to comply despite adequate knowledge. Business owners negotiate the meanings of particular

regulations - and compliance with them - through interaction with others, including managers, employees, business advisers and regulatory authorities (e.g. Fairman and Yapp 2005). These negotiated understandings provide norms for action until such time as new understandings are learned, possibly as a result of inspection or litigation.

CONCLUSION

The report has reviewed the research relevant to small business compliance and capability to manage regulation. An analytical framework representing the direct and indirect ways in which regulation influences business compliance and adaptation has been presented. Regulation is argued to be enabling as well as constraining, and to motivate compliance and adaptation. All businesses operate in a broader context of other stakeholders – competitors, customers, suppliers, infrastructure providers and regulatory authorities - that influences, but does not determine, compliance and adaptation. Regulations vary in their complexity and visibility and, cumulatively, in the demands they make of those subject to them. Small business owners vary in their awareness and understanding of regulations, the resources and the motivations needed to comply and adapt.

The methodologies adopted to investigate the influence of regulation on small business compliance; adaptation and performance profoundly influence data quality and the inferences that can be drawn from them. Four types of study have been distinguished – business perception studies, cross-national surveys of regulation and business activity, compliance cost studies and qualitative studies of business adaptation to regulation. Business perception studies do not address these mechanisms, instead remaining at the level of what small business owners think about regulation but not how they adapt to it. Cross-national surveys of regulation and business activity draw inferences based on correlations between measures of the number and cost of regulation and measures of start-up, but they presuppose regulation is solely a cost or constraint, and neglect owner-managers' perceptions of the influence of regulation on their behaviour. Compliance cost studies identify the time, monetary and psychological costs (and occasionally benefits) associated with implementing regulation but do not explore its dynamic effects. Qualitative studies of business compliance and adaptation take a processual focus, examining the

dynamic influences on businesses and offer the best clues to understanding their responses to regulation. By highlighting the interrelationship between regulatory change, business owners' awareness and understanding of regulation, motivations to comply and adapt, resources and capabilities, and the broader context, such studies are better placed to offer a more robust explanation of the influence of regulation on different types of business, incorporating a variety of internal and contextual influences.

Studies have identified a number of key issues relevant to small firms' capability to manage regulation. Regulation exerts a dynamic force on business behaviour, enabling and constraining particular forms of adaptation. But, regulatory pressures have to be interpreted and acted upon by business owners; all will not respond in the same way. The role of resources, including finance, skills and the influence of stakeholders, is crucial. Wider social discourses relating to regulation inform such interpretations and might be particularly influential in shaping the perceptions of prospective business owners, rather than those already in business with direct experience of owning and managing a small enterprise.

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