Does Regulation Promote Small Business Performance? A Critical Realist Informed Approach

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ABSTRACT

Objectives: The purpose of the paper is to explore whether and how Government regulation influences small business performance.

Prior Work: Previous studies often suffer from inadequate conceptualisation of regulation and methodological shortcomings and/or fail to investigate the full range of tendencies through which regulation contributes to business performance outcomes. Much previous research focuses on a narrow subset of regulatory influences, those centring on the costs and constraints associated with regulation on business owners' actions, but neglects the wider range of regulatory tendencies that shape business performance.

Approach: The study explicitly adopts an approach informed by critical realism, a philosophical perspective that conceptualises social reality as stratified and social causality in terms of the operation of causal mechanisms, among them human agents, in particular social contexts. A new approach to studying the impact of regulation on small business performance is developed. Data was collected through face-to-face interviews with 124 small and medium-sized business owners, employing up to 250 employees.

Results: Several major findings are presented. First, regulation generates enabling and motivating tendencies that contribute to small business performance *as well as* constraining tendencies that impede it. Second, from the perspective of an individual business owner, such tendencies operate directly, through requiring adaptation by owner-managers, and indirectly, through changing the behaviour of other stakeholders whose actions causally affect small business owners (competitors, customers, suppliers, infrastructure providers and regulatory authorities). Third, as a consequence, regulation does not have determinate effects on small business performance; the precise impacts for particular businesses depend on the broader contexts within which they operate. Specifically, how business owners choose to adapt to regulation has a crucial influence upon performance outcomes.

Implications: Those wishing to understand how regulation contributes to small business performance outcomes must take into account the range of possible routes through which regulation produces its effects. Simplistic arguments that regulation *necessarily* impedes performance or, alternatively, that deregulation *necessarily* enhances performance must be rejected.

Value: By broadening our understanding of precisely how regulation generates small business performance effects, the paper contributes knowledge that will be of use to business owners, researchers and policy makers. The findings will be of particular value to those responsible for using the Small Firms Impact Test to consider the impact of proposed regulation.

Key Words: regulation, small business performance, critical realism, causal mechanism

INTRODUCTION

The influence of Government regulation on businesses is a major topic of public debate; indeed, creating 'better regulation' is a key policy objective of the UK Government (Cabinet Office 1999; HM Treasury 2005; BERR 2008a). Small businesses are argued to suffer disproportionately from regulation because of higher fixed compliance costs and their lower resilience to external shocks due to limited resources (e.g. Chittenden et al. 2002). One recent estimate, derived from the Government's own impact assessments, suggests that implementing new legislation has cost UK businesses approximately £66bn since 1998 (BCC 2008). Other sources, in contrast, note the 'business friendliness' of the UK regulatory regime; the World Bank (2007) ranks the UK sixth out of 178 countries in terms of the ease of doing business. Critics of regulation ignore the fact that in spite of the regulatory framework – or is it because of – almost 4.7 million businesses operate in the UK (BERR 2008b), a number that has continued to rise in recent years despite claims of increasing regulation.

We adopt a new approach to exploring the influence of regulation on small business performance at the micro level, one explicitly informed by a critical realist perspective. Specifically, we consider the question: does regulation promote small business performance? Previous studies, by and large, argue that regulation necessarily constrains business performance. While we do not reject such views out of hand, we argue that these approaches are limited and do not capture the full range of regulatory tendencies that influence small business performance.

To begin, we define regulation, review the evidence base on the impact of regulation on small business performance, introduce critical realism and our analytical approach, and provide details of the methodology before presenting the study findings. We begin with the task of definition.

REGULATION DEFINED

The research literature tends to define 'regulation' narrowly either in terms of the particular obligations placed on business owners to act (or not act) in particular ways, for example, to provide information to Government; alternatively, studies do not define regulation, allowing business owners to draw on their own meanings (IFF 2008). Both of these approaches are limited because they do not permit identification of the full range of regulatory influences on small business performance. In the context of this study, we define 'regulation' 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.

The purpose of this definition is twofold: to include activities by regulatory bodies within and without the nation-state; and to include the activities of agents in addition to small business owners, whose actions influence small business performance. Government regulatory authorities include the 63 national regulators, 203 trading standards offices and 408 environmental health offices in 486 UK local authorities covered by Hampton (2005) as well as the European Union and World Trade Organisation which regulate trade between member states. Regulation takes many forms, including: Acts of Parliament; statutory instruments; rules, orders and schemes made under statutory powers by Ministers or agencies; licenses and permits issued under the central Government authority; codes of practice with statutory force; guidance with statutory force, codes of practice/guidance/self-regulation/industry agreements with government backing; bye-laws made by central Government; and EU regulations and Directives (NAO 2007).

RESEARCH CONTEXT

Much of the evidence regarding the impact of regulation on small business performance adopts a one-sided view of regulation and is constrained by various methodological limitations (Kitching 2006). Most studies identify regulation solely or primarily as a cost to, or constraint upon, business owners; few studies explicitly examine whether, and how, regulation might promote business performance. Surveys typically ask business owners whether they perceive regulation as a 'burden' (or other synonym) on business performance (or similar indicator) (e.g. Cosh and Wood 1998; IFF 2008). Such surveys tell us what business owners *think* about regulation but not what they do about it. Other surveys using statistical methods examine the impact of regulation on, for example, business start-up, with mixed results as to whether it is a deterrent (Djankov et al. 2002; Ho and Wong 2007) or not (van Stel et al., 2007). Nor do such studies allow for respondents to *mis*perceive the impact of regulation. Prospective and actual business owners often over-estimate the extent to which regulation constitutes a real burden (Allinson et al. 2005, 2006); a finding at least partly explicable in terms of the pervasiveness of 'anti-regulation' discourses in the wider society. Such discourses, to the extent they deter business start-up, investment and innovation, exert a genuine constraining influence on business performance.

Compliance cost studies adopt more sophisticated methods but, on the whole, assume regulation to be a cost or constraint (e.g. Chittenden, 2002; Lancaster et al. 2003). The benefits of regulation and its dynamic influence on small business owners' activities and performance are often neglected. Qualitative studies highlight small business owners' variable awareness of regulation (e.g. Yapp and Fairman, 2005), distinct attitudes to compliance (e.g. Petts et al., 1999; Vickers et al., 2005), the benefits of regulation (e.g. IpsosMORI, 2007) and provide deeper insights into the dynamic effects of regulation on business decision-making and competitiveness (e.g. Arrowsmith et al., 2003; Grimshaw and Carroll, 2006). The impact of regulation on business performance is a dynamic process occurring over time not a one-off impact at a single point in time.

Our approach goes beyond studies focusing on small firm owners' perceptions of regulation as a 'burden on business' and compliance cost studies that present a static picture of regulation as a cost or constraint. Instead, we propose a model explaining the dynamic impact of regulation on small business performance. The model specifically allows for variation in business owners' adaptations to regulation due to differences in their capacities and motivations, and to differences in outcomes due to the influence of other stakeholders whose actions influence the activities and performance of small businesses. Small enterprises operating in the same regulatory context achieve very different performance outcomes; some perform well and grow, others struggle.

CRITICAL REALISM AND SOCIAL SCIENCE

All social scientific research, necessarily, rests upon underlying assumptions about the nature of human-made world (ontology) and how it can be known (epistemology) (Bhaskar 1979; Sayer 1992). Ontology is non-optional (Fleetwood 2004). This is the case even where researchers do not reflect explicitly upon these assumptions; rather, they are implicit and taken for granted. These assumptions shape our definition of the objects studied, their interrelations, and the choice of methods to study them. Researchers often remain unaware of these implicit assumptions and of their influence on research practice – with adverse consequences for research quality.

Critical realism is a particular philosophical approach, taking a particular position in relation to ontology and epistemology. It licenses multiple substantive theories of the impact of regulation on business performance, as long as they are consistent with its ontological and epistemological presuppositions. Critical realists argue that the social world must be constituted in a particular way in order for the practice of science to be intelligible, that research methods should be adopted that recognise this constitution, and that explanations of social phenomena must be consistent with these assumptions (Bhaskar 1979; Sayer 1992; Archer 1995).

Critical realists argue that the social world is stratified, with a threefold ontological distinction between events, people's experiences of those events, and the causal mechanisms that generate those events respectively (Bhaskar 1978).[1] Causal mechanisms, including regulation,

[1] Bhaskar (1978) elaborates these ontological distinctions using the example of scientific experimentation. If event regularities occurred naturally, there would be no need for scientific experiment because they could be observed in nature. Rather, scientists work to *produce*

necessarily possess particular causal powers by virtue of being what they are; these powers, when exercised, interact with other mechanisms, including those embodied in human agents, to generate events. Such mechanisms are usually unobservable directly and only identifiable through their effects on events. Because nature and society are open systems, causal mechanisms are out of phase with patterns of events; that is, mechanisms may or may not be exercised and, if exercised, they may or may not produce particular events, because of the operation of other countervailing mechanisms. In the social sciences, causal mechanisms are only exercised through human agency, through the practical activity of human beings. Figure 1 schematises the process by which generative mechanisms contribute to the production of events.

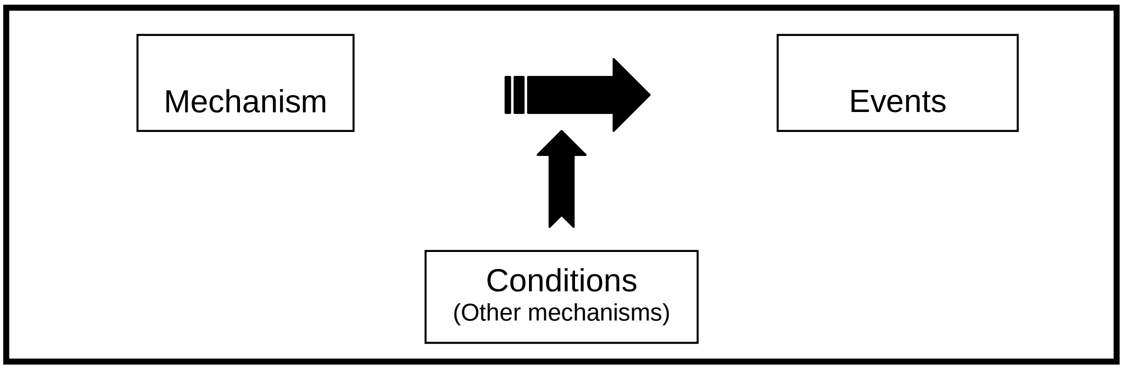

Figure 1: A Critical Realist View of Causation (adapted from Sayer 2000: 15)

Critical realism can be contrasted with positivism which presupposes social reality is constituted by event regularities of the 'whenever X, then Y' type and our observations of them. Under such a view, scientific laws are grounded by event regularities. Quantitative approaches, in seeking correlations between variables, tacitly assume such an ontology. Statistical modelling techniques that 'explain' social phenomena, probabilistically, in terms of the co-variance of variables, necessarily *presuppose* that event regularities exist and are there to be found. Yet quantitative approaches have discovered no 'strong' regularities in the social sciences, that is, 100 per cent correlations, at anything beyond the most trivial level. In the absence of established event regularities, one must, therefore, conclude either that that social science has made no discoveries, that events in the social world are ungoverned by scientific laws or, alternatively, that event regularities are neither sufficient nor necessary to ground causal laws.

For critical realists, it is the generative mechanisms whose operation causes the events we observe that are the subject of scientific laws. Event regularities are neither sufficient nor necessary to ground causal laws; the absence of regularities is no impediment to the discovery of scientific laws. Instead of defining causal laws in terms of constant conjunctions of events, critical realists ground causal laws in natural necessity, the necessary ways of acting of social objects. Critical realists attempt to provide a causal explanation of social phenomena by retroduction: by working backwards from events to hypothesising the causal mechanism that would have generated the phenomenon in question; in short, by offering an explanation as to *how* events happen. In contrast, positivist approaches lack explanatory power because they do not identify the causal mechanisms that generate the social phenomena under scrutiny.

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regularities by closing the natural systems they investigate, in order to isolate the mechanisms they believe are causally responsible for generating particular events. 'Naturally-occurring' regularities over large stretches of time-space are equally rare in society, indicating that both the natural and social worlds are open systems where causally efficacious objects, including human agents, interact to produce the events we observe. Hence there is an ontological distinction between the causal mechanisms that generate events and the events themselves.

THEORISING THE IMPACT OF REGULATION ON BUSINESS PERFORMANCE

Critical realists place great emphasis on conceptualising the objects they study, in this case regulation, elaborating their causal powers and tendencies. Regulation is a social structure governing the activities of certain types of agents but, as with all social structures, only produces its effects through the exercise of human agency. If human beings do not adapt their behaviour as a consequence of regulation, its effect is nil. By mandating and prohibiting action on the part of small business owners and other stakeholders whose actions affect them – for instance, actual and prospective competitors, customers, suppliers, infrastructure providers and regulatory authorities (henceforth 'stakeholders') - regulation shapes small business activities and performance outcomes. This is the case whether or not business owners (and other stakeholders) recognise regulation as an influence on theirs' or others' behaviour. Understanding the properties of regulation, and business owners' and other stakeholders' adaptations to it, are essential to providing a causal explanation of the impact of regulation on small business performance.

Regulation influences business performance by enabling, motivating and/or constraining the projects of business owners and other stakeholders. Regulation *enables* agents to achieve their aims by making certain actions possible; it *motivates* by incentivising agents to act in particular ways rather than others; and it *constrains* agents by limiting their scope for action. Regulation triggers multiple tendencies *simultaneously*. For instance, the National Minimum Wage (NMW) constrains business owners by requiring them to pay the minimum rate to employees. But by restricting their capacity to keep labour costs low, it also motivates them to implement product and process innovations, and/or to raise prices, in order to cut costs and/or increase trading revenue. The NMW is also enabling in so far as it forces competitors to adapt their pay rates and possibly prices, and thereby make their products less attractive to consumers; it might also increase labour supply by encouraging job-seekers to look for work. What is a constraint for one business owner is another's enablement because firms are in competition for resources and markets. If competitors adapt better or more quickly to regulation, then the focal business may experience a decline in performance.

From the point of view of a specific business owner, direct and indirect regulatory influences can be distinguished, although in practice, they operate together, causally contributing to business performance outcomes. Figure 2 presents these regulatory influences graphically. The ellipse represents the entire regulatory framework within which businesses and other actors operate. The black arrows indicate direct regulatory influences on small business owners and other stakeholders (enabling, motivating and constraining); the white arrows indicate indirect influences on a focal small business owner operating via market and non-market relations with other stakeholders.

Direct influences relate to small business owners' adaptations to regulation that mandates or prohibits action by *them*, either by constraining them to comply, or by enabling and motivating them to adapt business practices and products in order to maintain or improve business performance. Most small business research has focused on the direct influences of regulation, particularly constraining ones.

Indirect influences refer to changes in small business activity and performance arising from adaptations to regulation by *other* stakeholders, either through market relations (competitors, customers, suppliers and some infrastructure providers), or non-market relations (some infrastructure providers and regulatory authorities). For example, where suppliers increase employee pay rates and product prices as a result of the NMW, then this generates pressure on suppliers' customers to adapt *their* business practices and products, although whether they, in fact, do so, depends on them exercising *their* agency. Indirect influences will be experienced most commonly by small business owners as changes in the cost or availability of resources, or in product sales. Given the inter-dependent nature of firms' relations with other stakeholders, indirect regulatory influences on small business performance are potentially very complex and far-reaching, whether business owners are aware of them or not.

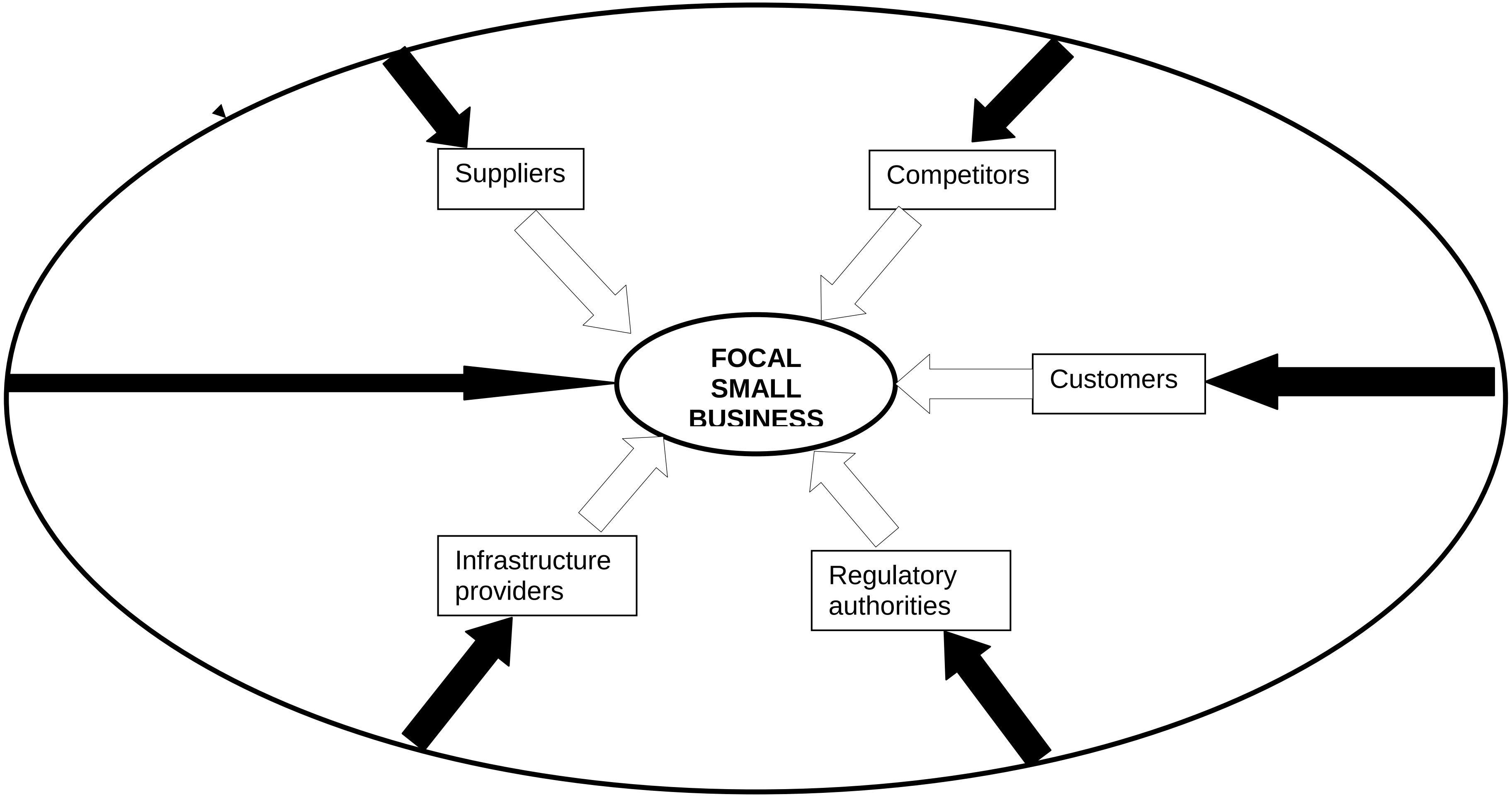

Figure 2: Direct and Indirect Regulatory Influences on Business Performance

It is not possible *a priori* to predict whether enabling, motivating and constraining tendencies will be the most powerful for any particular business with regard to any particular regulation. Business owners, and other stakeholders, vary in their capacities to discover, interpret and adapt to regulation, in their motivations to adapt, and in their methods of adaptation. Because of differences in resources, motivations and modes of adaptation, regulation does not, therefore, generate uniform effects on small business performance. There is no 'typical' regulatory influence on small business performance; outcomes always depend on context.

METHODOLOGY

Data were obtained from face-to-face interviews using a semi-structured interview topic guide with 124 small and medium-sized business owners (or managers) in a range of business settings.[2] Sample businesses were identified using a commercial database and satisfied the following criteria:

- Independence – not part of, or owned by, large companies;
- Employment – employed 1-249 people;
- Sector – businesses operated in a range of sectors;
- Location – mainly located in London, the South East, South West, Leicester and Leeds.

A sample was constructed to incorporate businesses with a range of size and sector characteristics (Table 1). The purpose of the study was not to achieve a 'representative sample' in order to generalise empirical relationships to the broader UK small business population. Rather, our aim was to explain how regulation contributes to particular performance outcomes in particular contexts. By selecting businesses with a range of features, we hoped to uncover a wide range of regulatory influences on business performance. Sample size is not of central importance in this type of research methodology. The regulatory influences we identify shape, though do not determine, the performance of *all* businesses, their precise impact in particular business cases varying with the internal and external conditions within which these influences operate.

Table 1
Interview Sample

	Number of Businesses	*% of Sample*
Micro (< 10 employees)	53	42.7
Small (10-49 employees)	55	44.3
Medium (50+ employees)	16	13.0
Manufacturing	23	18.5
Construction	12	9.7
Retail/wholesale	13	10.5
Hospitality	20	16.1
Transport/communications	11	8.9
Finance/business services	36	29.0
Health and social care	5	4.0
Other	4	3.3
ALL	**124**	**100.0**

Several features of our methodological approach are worthy of mention. First, business owners were approached on the premise of investigating the determinants of performance - not to assess the impact of regulation. We did not assume regulation was a principal influence on

[2] The study incorporated a telephone survey of 1205 SMEs. The survey findings are reported elsewhere (SBRC 2008; Hart et al. 2008) and are not discussed here.

performance nor wish to encourage respondents to perceive it as such. Second, the topic guide was constructed to identify the influences on, and barriers to, business performance in an open-ended way before raising the thorny issue of regulation. Third, the topic guide was used flexibly, with interviewers exercising discretion in question sequencing where respondents raised regulatory issues prior to their position in the guide.

Fourth, the method of data collection permitted deeper probing into business owners' actions and motives beyond that usually possible using more structured research instruments such as postal or telephone survey formats. Small business owners, like other people, are more likely to report direct, rather than indirect, regulatory influences because they are more knowledgeable about their own behaviour and motivations than they are of others, but this does not mean that indirect influences are less important. Again, like other people, small business owners might be expected to be more likely to report constraining influences than enabling and motivating ones because in undertaking action agents are more cognisant of the barriers that prevent them attaining their goals than of the conditions that enable them to act and to achieve their objectives. Face-to-face interviews provide space to probe deeper into respondents' accounts and to press on issues that respondents touch on in passing but which appear relevant to research objectives.

Fifth, analytically, owner-managers' accounts provide the starting point for understanding how regulation influences business performance but they do not, and cannot, constitute the whole regulation/performance story. Many studies treat respondent reports as causal explanations in their own right rather than as data that contribute to an explanation. Regulation shapes business owners' activities without necessarily explicitly entering their motivations or reasoning; indeed, over time, particular regulations are likely to become absorbed into business routines such that they become a taken-for-granted, barely visible, condition of conducting business. Few business owners, for instance, report property or contract rights as important regulatory influences on their behaviour, yet these are necessary for trading.[3] Business owners' lack of awareness of particular regulations does not mean they exert no influence on firms' activities and performance.

GOVERNMENT REGULATION AND THE MARKET MECHANISM

Government regulation plays a fundamental and necessary role in enabling advanced market economies to function. Without regulation, market relations of the scale and complexity prevalent today would be impossible. Although regulation is often perceived as a Government response to market failure, arguments counterposing the market to the state ignore the fact that markets are constituted, in part, by a comprehensive regulatory framework. Regulation does not interfere with previously-existing market signals; rather, regulation is a necessary institutional precondition of the adequate functioning of an advanced market economy. Regulation performs a fundamental enabling role for those involved in the production, exchange and consumption of goods and services.

Regulation provides a legal framework governing business activities and relations, and supports Government action to create a civil society infrastructure and other public goods that enable market trading.[4] Private property, contract and money, for instance, are essential for an advanced market economy to function; all presuppose an active Government role as regulator (Sayer, 1995). The World Bank (2007), for example, identified investor protection as a key indicator of the ease of doing business; the higher the level of regulatory protection, the easier it is to do business. A reduction in investor protection, it is feared, might cause a decline in the supply of finance to businesses with adverse consequences for business investment, innovation and performance.

Regulation permits the development of a financial system that enables the supply of credit to business investors; a welfare system that enables the supply of healthy, educated and

[3] Property and contract rights also constrain business owners, of course, by prohibiting the unauthorised use of *others'* property and by binding contractors to the agreements they make.
[4] To describe certain Government activities as public goods does not mean all are able to benefit equally from them.

motivated individuals to form businesses and to work in them; a science base to create knowledge; a defence and national security system that enables trading free from external threats; and energy, transport and communications infrastructures that enable businesses to operate. Even where the private sector supplies infrastructure and public goods, the Government's role in enabling them to do so is necessary and could be provided by no other institution. Moreover, by creating specific expectations of behaviour, regulation stabilises trading conditions which, in turn, facilitate market exchange and long-term investment. Without these institutional supports, buyers and suppliers separated by time and distance who will never meet would have neither the will nor the means to engage in market exchange.

Regulation, defined in this way, is a necessary condition of sustaining an advanced market economy like that of the UK, though it does not determine the precise form regulation will take nor guarantee that policy objectives will be achieved. A reduction in regulation might not lead to a 'pure' market, but rather provoke a crisis of the market system because buyers and sellers lack the confidence and the capacity to engage in trade. An advanced market economy without comprehensive Government regulation is an impossibility.

In the next three sections, we examine the diverse tendencies regulation generates and provide examples to illustrate these tendencies. We spend less time discussing some types of constraining tendency if only because these are well understood, not because they are less important. Previous research has focused primarily on the direct constraining tendencies of regulation, but these are just one subset of all regulatory tendencies (Kitching 2007). The examples illustrate the manifold paths through which regulation influences small business owners' activities and performance and also demonstrate the necessary role of human agency in connecting regulation to business performance outcomes. For simplicity, we separate the discussion of enabling and motivating, and constraining, tendencies while recognising that, in practice, these tendencies always operate together, generating multiple, and often contradictory, pressures on small business owners. Because regulation is so all-encompassing of business activity, managing multiple and contradictory regulatory influences is the normal condition of doing business.

ENABLING AND MOTIVATING REGULATORY TENDENCIES

Government regulation enables higher levels of business performance in various ways, for instance, by making it easier for firms to access and deploy resources, and by creating market opportunities. Property and contract rights enable firms to acquire and deploy assets with the aim of achieving business sales. Employment laws grant employers a general right to issue commands to employees. Consumer rights give customers the confidence to buy goods and services, thereby encouraging sales. 'Fair trading' laws enable firms to enter markets and to compete by prohibiting anti-competitive behaviour.[5]

Two points are worth emphasis here. First, the creation of opportunities is enabling and motivating for actual and prospective business owners but this does not guarantee the opportunities enabled are commercially exploited by any particular business. Business owners must act on the basis of these enablements if these tendencies are to be actualised; regulation only makes such action possible. Market opportunities may go unrealised because no-one attempts to exploit them. Second, business owners themselves might not perceive regulation as enabling or motivating in the manner described; examples have often been reconstructed from owner-manager accounts by the research team. Here we identify a number of important regulatory tendencies that enable and/or motivate action that generates higher levels of business performance and illustrate them with examples. Regulation might, for instance, enable higher levels of business performance through:

- licensing, registration, and prior approval
- deterring competitor entry/motivating competitor exit
- mandating, or motivating, customer purchases
- motivating product and process innovations

[5] None of these rights, of course, are absolute; all are circumscribed.

Regulatory authorities sanction agents as ‘business owners’ through the allocation of tax statuses (as self-employed traders or incorporated bodies), company registration and, where relevant, licensing or registration to undertake particular trading activities. These prior approval practices regulate market entry and the supply of particular goods and services – for instance, professional services such as medicine, law and architecture as well as food production and distribution, entertainment and leisure, health and care services, and transport all require licensing. These regulatory influences operate directly on small business owners – by permitting them to trade lawfully or not – and indirectly, by permitting or prohibiting others to do the same. Everything business owners do subsequently – and the business performance outcomes achieved - is shaped, though not determined, by these fundamental regulatory enablements. Competitive pressures operate to influence performance outcomes with some businesses out-performing others.

Regulation, by raising the actual or perceived costs of operating, may deter market entry and/or encourage exit by existing providers. For businesses that continue to operate, such regulatory influences are indirectly enabling by reducing the number of competitors. A retail travel insurance provider, with 25 employees, provides a good example. Despite being regulated by the Financial Services Authority (FSA) since January 2005, sales had grown rapidly. The company turned over £3.5m in the financial year prior to interview, with a profit of £900k, and projected sales of £4.5m for the following year. Ironically, falling within the orbit of the FSA – a matter of considerable irritation for the respondent - was one of the reasons why he had been recruited to the position of company director a few months previously. FSA regulation had not, however, prevented the business from achieving a high sales and profit performance.

Regulation often requires consumers to purchase particular goods and services if they wish to undertake a particular activity and by creating, or raising, demand for those goods and services generates market opportunities for actual and would-be suppliers; these regulations are, therefore, indirectly enabling for such businesses. This example could be multiplied many times from the sample. Regulation requiring business owners to submit annual accounts, for example, provides market opportunities for accountants and financial advisers and is, therefore, enabling for suppliers of such services. Regulation requiring boat-users to purchase safety clothing and equipment, and regulation requiring schools to purchase IT equipment to meet their educational obligations, stimulates sales for these goods providers.

Regulation can also be indirectly enabling for small business owners, for example, where it encourages, but does not compel, consumers to purchase certain goods and services. A good example of this would be food regulations that assure customers of the quality of food products; frequent food scares might reduce consumer confidence in foodstuffs. An interesting example from the sample relates to the indirect impact of the US Sarbanes-Oxley Act. The Act’s purpose is to restore investor confidence in large corporations’ financial practices post-Enron, and imposes harsh penalties for failure to present truthful financial accounts. A recruitment agency owner, employing 13 people, reported an unintended consequence of the Act in terms of demand for his firm’s services: the Act encourages companies to hire staff in order to ensure compliance and thereby creates market opportunities for employment agencies and businesses supplying staff to clients.

Business owners frequently adapt business practices and products in response to perceived external pressures – for example, falling competitor prices, increased input prices - in order to maintain or enhance competitiveness. Regulation is a major, if often unacknowledged, source of such pressure. The costs of handling regulation can stimulate the search for alternative sources of supply, and the development of new working practices and products. Such changes causally influence business performance outcomes by generating reductions in costs and/or improving product quality. Process and product innovations, though costly to introduce in the short-term, constitute a long-term investment for the business and, potentially, lead to performance improvements. Whether business owners perceive regulation as a causal influence on decisions to adapt business practices and products is an empirical question - its impact on business activities and performance might go unrecognised.

A steel supplier, employing 160 staff, adapted to health and safety legislation by implementing a wide range of improvements in working practices that led to a marked reduction in insurance costs and working days lost through accidents. A health and safety officer was hired to tackle the large insurance bill of £200k per annum. This increased internal management capacity to deal with regulation facilitated change in working practices, for example, the wearing of hard hats and providing training for fork-lift truck drivers. As a consequence, the number of accidents dropped dramatically with a corresponding drop in the insurance premium to £85k.

There are a number of cases within the sample where business owners have developed new products and services in order to meet a need created or stimulated by regulatory change. Building and environmental regulations create opportunities for those able to supply such services. New regulations dealing with the treatment of water systems in new buildings led one construction firm owner to develop a particular water treatment service in order to generate sales. Regulation was perceived explicitly as a benefit to the company.

In summary, such examples illustrate that regulation can both enable and motivate action that promotes higher levels of business performance. Such tendencies, to be actualised, necessarily rely on the agency of small business owners and other stakeholders; there is no necessary connection between regulation and higher levels of business performance. It is those businesses with the resources and the motivation to adapt to regulation quickly and effectively that are in the best position to realise the benefits of regulatory change.

CONSTRAINING REGULATORY TENDENCIES

As previous studies have found, business owners often focus, initially at least, on the direct costs or constraints associated with regulation. Regulatory change is argued to raise the substantive, administrative and psychological costs to businesses, and to lead business owners to divert resources from profit-generating to 'unproductive' activities, and, consequently, to undermine business performance. Such costs might deter start-up, investment and innovation. As the direct constraining tendencies of regulation have been the primary focus of most previous studies, and are well understood, here we focus on examples of indirect constraining tendencies. Such influences are potentially very diverse and complex as they arise through the influence of regulation on *other* stakeholders whose actions subsequently impact upon the focal small business; again, these are necessarily dependent upon human agency.

One particularly interesting example of the indirect influence of regulation came from a small electrical contractor, employing 10 people, where a specific regulation impacted on small business performance indirectly through its influence on employee behaviour. Part P regulations stipulate that residential electrical installations must be tested by 'competent persons'. This regulation encouraged the owner-manager to train employees in order to become qualified installers and testers under Part P. Once qualified, five employees quit the firm on the same day in order to start their own businesses, causing major labour shortage problems for the employer. To service existing contracts, the employer personally had to go 'back on the tools' and also use labour subcontractors, a practice previously avoided on quality grounds. Moreover, the employer's focus on servicing existing contracts restricted time spent on winning new business; consequently, there had been a decline in new contracts obtained. Had the employer taken action to pre-empt the mass quit, or had suitably qualified workers been easily accessible in the labour market, some of these problems could have been mitigated. This example highlights the diversity and unpredictability of regulatory effects, particularly indirect ones that depend on the actions of important stakeholders – in this case, employees.

Regulation might motivate, but not mandate, changes in working practices that lead to changes in business activity and performance. A number of business owners reported the recruitment (or redeployment) of staff specifically to deal with regulatory issues. Respondents were concerned with the cost of an annual salary on a post devoted to what were commonly perceived as 'unproductive' activities. Yet, it might be argued that even regulation that constrains business owners to implement such actions as creating a dedicated regulation-handling post, although constraining in the short-term, might also be enabling in the longer term, where they develop superior regulation-handling skills or encourage a proactive orientation towards adapting to regulatory change. Similar arguments have been made in relation to auditing requirements and the development of superior financial management skills (Tabone and Baldacchino 2003).

In summary, regulation generates tendencies that constrain small business owners to act in particular ways, many of which they would not choose to undertake if the regulation did not exist. These constraints may arise directly as with the obligations regulations place on small business owners, but they might also arise indirectly as the consequence of other stakeholders' adaptations to regulatory change. But, even constraining tendencies may generate longer-term enablements such as enhanced management or regulation-handling capabilities that subsequently benefit the business.

REGULATION GENERATES MULTIPLE TENDENCIES SIMULTANEOUSLY

Business owners are always *simultaneously* enabled, motivated and constrained by regulation. Regulation generates multiple, and often contradictory, tendencies simultaneously that produce a combined and dynamic impact on small businesses. Regulation impacts on business performance in an almost infinite variety of ways: by encouraging adaptations in the practices of small businesses *and* other stakeholders whose actions causally influence their performance. The influence of regulation on business performance is a process occurring over time, contingent upon the activities of agents internal and external to the focal small business. Once a regulation has generated an adaptation by an actor within the focal small business' network of stakeholders, this will place pressures on the focal small business to adapt practices and/or products.

To illustrate how business owners manage these multiple and conflicting regulatory influences, data are presented from two businesses. The first is a highly successful storage service company that had expanded from 2-160 people since the early-1990s, operating in 11 UK cities, with sales of £6m. The owner-manager did not report regulation as an influence when asked about the influences on business performance but was highly critical of regulation once the issue was raised. Subsequent probing revealed a more nuanced, even contradictory, picture in which regulation was acknowledged as enabling market opportunities as well as constraining action in certain respects. High business rates limited the finance available for business development; the compliance cost of time, though unmeasured, was described as a 'pain in the arse' (tempered by the knowledge that other companies have to deal with the same regulations); and employment law made it difficult to dismiss employees. Pressed on these issues, the owner reported that impacts were difficult to measure and were perhaps more of an irritant than a major impediment to performance. Any additional costs arising from regulation are passed onto consumers wherever possible. Crucially, although initially unacknowledged, the owner agreed that regulation had created market opportunities by placing a statutory obligation on certain kinds of businesses to maintain records, for example, health and law firms. Such regulation was enabling for the storage firm, by encouraging client businesses to outsource document storage in order to free up space in their expensive high street locations. Without probing respondents' initial responses, the study would have remained blind to the enabling tendencies of regulation.

London's 20,000 taxi firm operators are required to abide by Public Carriage Office regulations. Licensing, documentation and inspection all entail costs for operators and in that sense exert a constraining influence on performance. But, such regulation is also enabling for taxi businesses where it encourages: drivers to enter the sector, thereby reducing labour supply constraints; customers to use taxis because they consider them safer to travel; and where it deters entry or motivates exit by operators unable or unwilling to comply with the new regulatory regime. One owner-manager, with five employees and 35 self-employed drivers reported that the intention to regulate the sector formed part of his motivation to set up a mini-cab business; professionalising the business was perceived as facilitating increased margins. Moreover, drivers were reported to be attracted to 'more professional' operators prepared to embrace regulation and to make it easier for drivers to become legitimate. Sales turnover had increased from £90k at start-up to £150k at the time of interview (with 20 per cent profit on turnover).

In summary, managing multiple contradictory regulatory pressures is the normal condition of running a small business. Regulation enables, motivates and constrains business activity and the performance that flows from those activities. Business owners may be more likely to be aware of the constraining tendencies of regulation as this impedes their actions, but this does not mean that other tendencies of which they are unaware are less important influences on performance. The enabling and motivating tendencies arising out of property and contract rules are perhaps the most obvious examples but there are many more that shape investors' decisions' to invest, customers' decisions to buy, job-seekers' decisions to seek paid employment, competitors' decisions to exit, suppliers' decisions to supply, or infrastructure providers' decisions to supply goods and services – all of which enable the performance of particular small enterprises.

CONCLUSION

A new approach to studying the impact of regulation on small business performance, one informed by critical realism, has been presented. The model attempts to capture the complexity of the influence of regulation on performance. Regulation is conceptualised as a social structure governing the activities of particular kinds of agents. Different regulations place different obligations on different agents, although those subject to regulation always have some discretion about whether and how to adapt. Like all social structures, regulation is enabling and motivating for agents as well as constraining. One advantage of the methodology adopted was the ability to explore beneath the surface of owners' general perceptions of regulation to discover in depth how owner-managers had adapted their behaviour as a result of regulation and how this had influenced business performance. Had we terminated our inquiry with owner-managers' initial responses, we might have concluded, as have others, that regulation is a major impediment to small business performance. With careful probing, we were able to discover that although business owners often complain about regulation, the actual impact is frequently quite limited and/or enabling of business performance.

At a macro level, regulation promotes business performance by enabling an advanced market economy to function; without regulation, it is impossible to imagine how a complex economy like that of the UK could function. Regulation generates multiple tendencies simultaneously – enabling, motivating and constraining - that influence small business activities and performance outcomes, whether or not owner-managers (or other stakeholders) are explicitly aware of them. Regulation promotes small business performance at the micro level by enabling and motivating small businesses to acquire and deploy resources, and to engage in trade, in order to generate sales. Because regulation is so all-encompassing of business activity, managing multiple and contradictory regulatory influences is the normal condition of doing business.

Explaining the influence of regulation is not simply about the properties of regulation, for example, the ease with which obligations can be interpreted, or the scope of rights and obligations created, important though these are, but crucially depends on how business owners, and other stakeholders (actual and prospective competitors, customers, suppliers, infrastructure providers and regulatory authorities), adapt to regulation. Agents adapt to regulation in different ways and these diverse adaptations feed through into performance outcomes for the focal small firm. Business owners' adaptations to regulation are dependent on their resources and motivations as well as those of the stakeholders whose actions affect them. If competitors adapt better or more quickly to regulatory change, adaptation by the focal small business might not suffice to improve performance. There is no single 'small business effect'; outcomes always depend on context.

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