Why Small Business is Not Hiring:
Regulatory Impediments to Small Business Growth

Jason Soon and Helen Hughes

CIS Issue Analysis No. 6

10 February 1999

Contents

Executive Summary

Small business makes an important contribution to the Australian economy, accounting for 42 per cent of employment in 1997-98. Many small firms are labour intensive, employing more workers per dollar of value added than large firms. The concerns voiced by small business about barriers to employing workers therefore need to be addressed.

The financial risks imposed on small firms by unfair dismissal legislation are high because of strict procedural requirements and the amount of discretion given to tribunals and courts. Their findings have condoned excessive absenteeism and use of sick leave, shirking, incompetence and even theft, on the grounds that the letter of the law was not implemented in dismissals. Though there is a cap on the amount of compensation and penalties that can be ordered against employers in breach of these laws, most cases are settled out of court to avoid even higher litigation costs.

Unfair dismissal and anti-discrimination legislation must be reconsidered because it discourages employment. Small firms see the prospect of litigation arising from dismissal laws as a major risk and opt not to employ extra staff. Proposed Federal legislation to exempt business with 15 or fewer employees from unfair dismissal laws is a step in the right direction. A Senate inquiry into unfair dismissal laws will produce a report by mid-February.

The compliance costs of administering wage and on-costs have been growing with the complexity of superannuation, taxation and other arrangements that employers are expected to carry out on behalf of government.

Compliance costs are similar for all workers. Thus they are proportionately higher for young workers who are relatively less skilled and experienced than for adult workers on the same wage. This reduces young job-seekers' employment prospects.

Lower youth wages reflecting lack of skills and experience are essential to encourage employers to hire young job-seekers. To boost youth employment, workers under 21 should also be exempted from on-costs such as provisions for superannuation and long service leave. Further simplification of the award system would be a more certain path to employment creation.

Introduction

The drop in unemployment to around 8 per cent highlights the importance of overall policy reform in reducing unemployment. No one policy will increase employment, but unless the remaining sources of inefficiency are overcome, unemployment will not continue to fall.

The Australian Bureau of Statistics defines small business as non-manufacturing industries with fewer than 20 employees and manufacturing industries with fewer than 100 employees.

With the rising importance of service industries among small business, many small enterprises are labour intensive, employing more workers per unit of value added than large firms, and can therefore be an important source of employment growth. In May 1998, small business – excluding self-employed – accounted for 42.05 per cent of employment (Australian Bureau of Statistics 1998).

Recent figures indicate sluggish job creation by small business. The small business share of employment, including those self-employed, was rising until 1993-94. It then began to fall (Graph 1). From 1993-94 to 1996-97, annual growth in small business employment was 3.6 per cent compared with 7 per cent for other business. The onerous dismissal regulations introduced since 1993 are at least partly responsible for this change.

A breakdown of the above statistics reveals a decline in the growth of people working in their own business, as well as a weaker growth rate in small business employment compared with larger business since 1993. Not only are entrepreneurs not hiring, potential entrepreneurs are not going into business.

Compliance costs are one of the main factors having an adverse effect on employment by small business.

Employment compliance costs include the cost of administering wages and on-costs such as leave, superannuation, workers' compensation and acting as tax collectors for the PAYE system and other taxes. Unfair dismissal and equal opportunity legislation has introduced additional compliance costs and new risks. To avoid inadvertent non-compliance, firms must undertake time-consuming and complex procedures in hiring, daily management and dismissal practices. Failure to comply with the letter of the law can incur high legal costs and fines. Legal interpretations of dismissal laws make outcomes extremely uncertain.

Unfair Dismissal Laws

The Federal Government's move late last year to introduce regulations which excluded business with 15 or fewer employees from the unfair dismissal regime was a step in the right direction. The Senate has twice rejected the proposed legislation, but in January held an inquiry into the unfair dismissal laws. Its report is due in the middle of February.

The Australian Financial Review (January 21 1999, p.8) reported that, in submissions to the inquiry, Australia's largest employer groups backed the proposed legislation. Australian Business Ltd (ABL) told the inquiry that compliance and transaction costs 'impact quite unfairly and disproportionately on smaller businesses' and its research 'indicates that business, and small business in particular, perceive the current statute as a barrier to recruiting additional staff'. An ABL survey from December 1998 showed 84 per cent of small business employers were concerned about the potential for an unfair dismissal action when hiring new staff (*The Australian Financial Review*, January 21 1999, p.8).

Unfair dismissal laws have created a considerable barrier to employment growth, discouraging employers from hiring workers – especially the young and unskilled. Laws at federal and state level, as well as common law interpretations of employment contract and award provisions, have made termination of employment extremely complex, and extremely expensive for employers if they get things wrong.

Dismissing employees according to the legislation presumes detailed documentation, record-keeping and extensive counselling. Large firms can afford to hire human resources personnel to handle problems with employees and ensure the proper procedure is followed. But for small firms, which deal with workplace issues as they arise, the laws can prove costly. Arbitrators may interpret the unfair dismissal provisions so that the slightest deviation from procedure, even in cases involving employee incompetence or misconduct, may result in dismissals being overturned.

The NSW Employers Federation advises members in its *Employers' Handbook* that termination of employment should only be a last resort for unsatisfactory performance after the following procedures have been complied with: 1)counselling and verbal warnings to bring to the attention of the employee the undesired behaviour; 2) a counselling session and written warning; 3) a counselling session and final written warning.

Because the unfair dismissal laws are so prescriptive, employers who want to dismiss incompetent or insubordinate employees have to expend considerable resources to minimise the risk of a lawsuit. The Industrial Relations Commission can order up to six months' remuneration for unfair dismissal, with a $10,000 maximum additional penalty for termination for a prohibited reason such as temporary absence or union membership. But most employers pay considerable settlements out of court to avoid the even higher costs of litigation.

There is little reason to assume that most employers treat their employees unfairly. Such bad management practices, by undermining workplace morale, are against an employer's interests. Yet federal unfair dismissal laws, starting with those contained in the *Industrial Relations Reform Act* 1993, seem to work on this assumption in laying down procedures which must be followed when terminating employment. The *Workplace Relations Act* 1996 does little to counter this assumption, though it does remove the onus of proof previously placed on employers.

The *Act* prohibits sackings that are 'harsh, unjust or unreasonable' or on prohibited grounds. In determining whether a dismissal was 'harsh, unjust or unreasonable', the Industrial Relations Commission must look at whether there was a valid reason related to the capacity or conduct of an employee or operational requirements, and whether the employee was properly notified before dismissal.

The NSW Department of Industrial Relations reported that unfair dismissal cases fell from a monthly average of 384 in 1997 to 340 a month in 1998. This trend is encouraging but still means more than 4000 cases a year in NSW.

The average time of settlement – 90 days – imposes a heavy burden on small business, with a lot of time taken out of managing the business to attend legal proceedings. For the 2400 cases that went to arbitration, average processing time was 180 days. It is understandable that, regardless of the merits of their cases,

employers are prepared to pay substantial sums to avoid the high costs, in terms of both time and money, of arbitration.

In 1996-97, the median amount of time it took for a case to be finalised by a hearing in the Court after being filed with the Commission varied from 130 days in South Australia to 234 days in Tasmania, with a national median of 185 days.

There were 2694 cases filed before the federal Industrial Relations Court in 1996-97, compared with 9080 in 1995-96 (see Table 1). This decrease is due to changes in filing procedure and the introduction of the *Workplace Relations Act*, which has reduced recourse to the court system. The number of cases filed with the Industrial Relations Commission better indicates the volume of legal proceedings involving dismissals (see Table 1).

Table 1: Number of cases filed with the Industrial Relations Court
(Australian Industrial Relations Commission and Australian Industrial Registry *Annual Report 1997-98*)

State/Territory	1996-97	1995-96	1994-95
ACT	104	258	334
NSW	718	3045	2625
NT	78	185	184
QLD	110	312	338
SA	131	591	399
TAS	60	199	262
VIC	1186	3469	4435
WA	307	1021	1251
Total	2964	9080	9828

Box 1: The Industrial Relations Court and the Industrial Relations Commission

As judicial power can only be exercised by a court of law, the role of the Industrial Relations Court is to interpret and enforce industrial awards and agreements, hear claims for unlawful dismissals and punish breaches of industrial law. The Industrial Relations Commission is an administrative tribunal that determines questions of future rights in the workplace and settles industrial disputes by conciliation.

The *Workplace Relations Act* 1996 and changes in filing procedure have reduced recourse to the Industrial Relations Court. Unlawful dismissal claims could be filed directly with the Court until January 1996, after which claims had to be filed with the Commission instead of the Court. Now the Commission can conciliate and arbitrate almost all claims without having to refer them to a court. Cases are referred to the Court only when conciliation fails.

Since June 1997, the Court's jurisdiction has been transferred mostly to the Federal Court; its staff and resources are now part of the Federal Court. The Industrial Relations Court continues to exist at law until the last of its judges resigns or retires. There are currently 11 judges appointed to the Court, who delegate most unfair dismissal cases to Judicial Registrars. As of December 1998, the Court had one part-time and four full-time Judicial Registrars.

A survey in 1995 of users of the Industrial Relations Court, including barristers, union officials and employers, revealed some dissatisfaction with Judicial Registrars determining the majority of unfair dismissal cases. Judicial Registrars were not provided with training in industrial relations or required to have a minimum number of years' experience in the area, unlike an Industrial Relations Commissioner. (*Industrial Relations and Management* March 1995).

From January 1996, over 300 new cases per month were referred from the Commission to the Court. There were 1200 claims a month filed with the Court or, following the change of procedure, to the Court and the Commission, from octover 1995 to December 1996 (Industrial Relations Court of Australia *Annual Report 1996-97*). Streamlining under the *Workplace Relations Act* has reduced the number of dismissal cases filed with the Commission. In the first six months of 1998, the total of State and Federal applications regarding dismissals was 8310, 18 per cent less than for the same period in 1996 and 2 per cent less than in 1997.

However, if the courst continue to expand their reach to catch practices which amount to 'constructive dismissals', such as hiring some employees for shorter hours or assigning simpler and lower paying tasks to them, this will add to the disincentives to employ new workers. It would discourage employers from making necessary workplace adjustments in case they were liable for unfair dismissal (Epstein 1995:

161-162). The inability to swiftly implement workplace changes could lead to the company's failure, and therefore higher unemployment.

In the long term, the climate of legal uncertainty created by the unfair dismissal laws will mean that instead of responding to increased demand by hiring workers, employers will increase their capital intensity, replace workers with machines and use more careful and begrudging selection procedures. This will further marginalise young job-seekers.

Anti-discrimination Law

Federal anti-discrimination laws include the *Racial Discrimination Act*, the *Sex Discrimination Act*, *Disability Discrimination Act*, the *Human Rights and Equal Opportunity Act* and the *Workplace Relations Act*. They aim to ensure that everyone – regardless of gender, race, sexuality or disability – is treated equally in the workplace. Each State also has its own anti-discrimination law regimes. Anything from the wording of application forms, interviews, or medical examinations may be potential grounds of liability for the employer. Employers must also take all 'reasonable' steps to ensure that discriminatory conduct by employees does not occur.

Discriminatory treatment may be direct or indirect, such as imposing conditions that disproportionately exclude or favour groups of employees. 'Disproportionate treatment' tests introduce considerable uncertainties. Judges' discretion in discovering such treatment and evaluating reasonableness is a real source of uncertainty for employers, and is a factor they are likely to take into account when weighing up the litigation risks involved in employment.

Where discrimination is alleged, an investigation is launched. The employer and employee attend a conciliation meeting, with a hearing held if conciliation fails. The maximum penalty for discrimination in NSW is $40,000. Each party has to pay legal costs regardless of outcome. The NSW Anti-Discrimination Board in 1995 estimated that the average cost of a sexual harassment complaint was a minimum of $36,000, excluding compensation and time spent attending proceedings (*Industrial Relations and Management* April 1995: 4). In 1995, the Human Rights and Equal Opportunity Commission found more than 135 hours of an employer's internal managing time was needed to attend a sexual harassment complaint up to the end of the conciliation process (*Industrial Relations and Management* April 1995: 4).

The volume of litigation means there is a real possibility that a business will be involved in an anti-discrimination case. In 1996-97, of the 940 claims under the *Sex Discrimination Act* lodged with the Human Rights and Equal Opportunity Commission, 785 were employment related. In NSW in 1997-98, there were 731 employment-related complaints to the Anti-Discrimination Board.

There is some mitigation for very small employers. Under NSW law, employers who employ five or fewer employees are exempt from discrimination relating to gender, marital status, homosexuality and transgenderism.

The obligations of anti-discrimination and unfair dismissal laws are in potential conflict. For example, if a firm employs a worker who has persistently exhibited discriminatory conduct, it may attract an anti-discrimination suit from other workers for failing to maintain a non-discriminatory workplace. If the firm fires the offending employee, it may conflict with the requirements of the unfair dismissal laws. Box 3 lists some examples of anti-discrimination cases which impinge on the management prerogatives of employers.

Box 2: Anti-discrimination Cases

Some cases highlighting the worrying tendency of anti-discrimination tribunals to micromanage the employment practices of business can be found in the Human Rights and Equal Opportunity Commission *Annual Report 1996-97*, including these:

The complainant sought employment from an optometrist and was invited to do a day's trial work. He claimed that he was offered the position but the offer was withdrawn after he disclosed that he was suffering from Hepatitis C. The employer denied making a firm offer but nonetheless settled the case for an amount of $13,500.

The complainant had a degenerative disability and claimed her boss did not accommodate her condition by reducing her sales targets. The employer claimed the worker did not request any special consideration and had indicated that her disability did not impact on her capacity to work. The employer claimed the worker was dismissed for regularly failing to meet targets. The case was settled for $15,000 in compensation, with disability discrimination training ordered for management.

On-costs

On-costs are the compliance costs most likely to affect a firm's decision on whether or not to hire more staff (Cabalu, Doss and Dawkins 1996). On-costs include payroll taxes, contributions to long service leave, annual leave, sick leave and parental (maternity, paternity and adoptive) leave and superannuation. They also include workers' compensation and other occupational health and safety costs.

The expense of complying with on-cost regulations is substantial. For instance, different types of leave must be identified, recorded and paid separately, and they apply to contractors as well as to award employees and to workers who are paid partly or wholly by commission.

A recent study (Cabalu, Doss and Dawkins 1996) confirmed that compliance with employee related regulations required considerably more hours than non-employee related regulations. Complying with superannuation was the most time-consuming (Cabalu, Doss and Dawkins, 1996: 11) and particularly costly. Employers must keep records of employees, payroll contributions on behalf of all employees, tax deductions and contributions to funds.

On top of obligations to contribute under awards, the Federal *Superannuation Guarantee Administration Act* requires employers to provide a minimum level of superannuation support for employees, whether they are covered by an award or not. New legislation passed but not implemented will oblige employers to offer a choice of superannuation funds. Employers must offer employees a choice of at least five superannuation funds or Retirement Savings Accounts, including at least one Retirement Savings Account and one public offer fund for new employees.

Employer Tax Compliance Costs

Employers must keep records and deduct payments for taxes levied on their employees, including income tax deductions from payroll of salary and wages and fringe benefits tax. Employers are responsible for collecting taxes under the Prescribed Payments System when they hire subcontractors in selected industries. Business are also expected to collect taxes that are clearly not their responsibility, such as Higher Education Contribution Scheme repayments.

According to Cabalu, Doss and Dawkins' 1996 study, tax compliance placed the most stress on employers, probably because of the heavy penalties that may follow errors.

Pay As You Earn (PAYE) regulations were the most time consuming, while the most difficult regulation to comply with was the Fringe Benefits Tax. Employers receive some cash flow offsets to tax compliance costs because many make quarterly payments to the taxation office.

The Disproportionate Impact of Regulatory Requirements on Small Business

Compliance costs have a disproportionate impact on small business. As a percentage of value added or wages, compliance costs are higher for small business. Mean compliance costs as a percentage of turnover of the smallest category of firms was more than six times that of the largest firms and more than twice that of the medium sized firms (Cabalu, Doss and Dawkins 1996).

A 1997 study of taxation compliance costs found that the burden was 7.5 per cent of turnover for smaller players and only 0.06 per cent for larger business. Although small and medium enterprises account for only 30 per cent of turnover, the study implied that they carried 90 per cent of federal tax compliance burdens (Lattimore et al. 1998: 184). Small business spent more of their time complying with PAYE tax regulations than any other regulations.

Regulations impose significant fixed costs for things such as learning about regulatory requirements (Lattimore et al. 1998: 184) and establishing an appropriate system to deal with these requirements. As small firms are less likely to be able to afford specialised staff to handle regulatory matters (Lattimore et al. 1998: 177), small business owners frequently have to deal with these compliance activities themselves.

Surveys by the Australian Chamber of Commerce and Industry and the NSW Chamber of Manufacturers focused on the attitudes of small business owners to compliance issues. They found that two-thirds of respondents thought the frequency and complexity of changes to tax rates and taxation compliance were the greatest cause of concern, followed by unfair dismissal legislation and the Fringe Benefits Tax (Lattimore et al. 1998: 188-190).

Given the choice between incurring compliance costs associated with hiring full time workers and incurring some of the inconveniences associated with casual employment, many employers are opting for more casual employment. Many workers also prefer higher cash wages to long term entitlements.

Disproportionate Impacts on Young Workers

Young and inexperienced job-seekers, who have the most to gain from obtaining employment, are the ones most disadvantaged by the impact of these regulations. Because compliance costs are usually the same for each worker regardless of their wage, qualifications or experience, employers are more likely to hire skilled or experienced workers. Taking into account the substantial risk and uncertainty involved in litigation, firms avoid workers who are less qualified or experienced in case they later have to be dismissed for lacking the necessary skills or application.

The Federal Government has proposed a new law creating permanent protection for the present system of junior pay rates up to the age of 21. Considering the disproportionate impact of compliance costs on younger workers it is particularly important that youth wages are preserved as a means of easing entry of younger workers into the labour market. A staff paper by the Productivity Commission found a significant negative relationship between youth employment and youth wages with best estimates suggesting that a one per cent rise in youth wages would lead to a 2 to 5 per cent fall in youth employment (Daly et al. 1998).

Conclusion

The risk and uncertainty introduced by unfair dismissal and anti-discrimination law, particularly for small firms, discourages them from hiring workers, particularly young ones. Tribunals interpreting unfair dismissal laws have made legal proceedings highly risky for business. High levels of absenteeism, misuse of sick leave and theft have been condoned on the grounds that dismissals have not followed the letter of the law. Unfair dismissal and anti-discrimination laws should be reconsidered in light of their employment disincentive effects.

As a proportion of labour costs, compliance costs are higher for small than for large firms. Compliance costs are also proportionately higher for young workers who are relatively less skilled than for adult workers on the same wage. The procedural requirements of unfair dismissal and anti-discrimination laws further add to compliance costs.

Lower youth wages reflecting lack of skills and experience and essential to encourage employers to hire young job-seekers. To boost youth employment, workers under 21 should also be exempt from on-costs such as superannuation and long service leave. Further simplification of the award system would be a surer – if more politically difficult – path to employment creation.

References

Anti-Discrimination Board of NSW, *Annual Report 1997-98*.

Australian Bureau of Statistics 1997, *Small Business*, 1321.0.

Australian Bureau of Statistics, 1998, *Wage and Salary Earners*, June Quarter, 6248.0.

Australian Industrial Relations Commission and Australian Industrial Registry, *Annual Report 1997-98*.

Birmingham, Amanda 1997, 'A Guide to the Workplace Relations Act 1996', *Australian Bulletin of Labour* 23(1): 33-47.

Brosnan, P. and P. Walsh 1996, 'Non-standard Employment in Australia and New Zealand: Results from a Workplace Survey', in J. Teicher, *Non-standard Employment in Australia and New Zealand*, Monograph No. 9, National Key Centre in Industrial Relations.

Cabalu, Helen, Noelle Doss and Peter Dawkins 1996, 'Employers' Compliance Costs', Discussion Paper, The Centre for Labour Market Research.

Daly, Anne, et al.1998, *Youth Wages and Employment*, Productivity Commission Staff Research Paper, Canberra.

Epstein, Richard, 1995, *Simple Rules for a Complex World*, Harvard University Press, Cambridge, Mass.

Human Rights and Equal Opportunity Commission *Annual Report 1996-97*.

Industrial Relations and Management (newsletter) March 1995, April 1995, May 1996.

Industrial Relations Court of Australia, *Annual Report 1996-97*.

Lattimore, Ralph, et al. 1998, *Design Principles for Small Business Programs and Regulations*, Productivity Commission Staff Research Paper, Canberra.

Murphy, Katharine 1999, Employers urge Senate to back exemption bid, *The Australian Financial Review*, January 21, p.8

NSW Department of Industrial Relations 1998, *Industrial Relations in NSW*, June 1998 Report.

Organisation for Economic Cooperation and Development 1994, *Employment Outlook*, Paris.