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Murray L. Weidenbaum
Washington University in St Louis

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Government Regulation and Medium-Sized Business

Murray Weidenbaum

The rapid growth of government regulation of business in the United States has generated widespread concern over its costs and impacts. However, virtually all the attention has focused on either very large enterprises or very small businesses. A substantial database is readily available to the researcher in the case of the larger companies. As a result, most of the professional writing on regulation examines the subject from the viewpoint of the large enterprise. Simultaneously, a combination of political pressures and equity concerns has resulted in numerous legislative provisions that exempt small firms from regulatory requirements or reduce their burden of compliance.

As a result of these two developments, a substantial middle sector of American business is neglected in professional as well as public policy discussions of regulatory matters. This report examines government regulation from the viewpoint of the entire array of American companies, but with special attention to what is the "overlooked middle" sector. Medium-sized firms benefit relatively little from the economies of scale generated by larger units or from the legislative protections provided to smaller enterprises.

Murray Weidenbaum is chairman of the Center for the Study of American Business at Washington University in St. Louis. This paper was presented at the FINOVA Policy Conference on Mid-Sized Business in Phoenix, Arizona, on March 1, 1996.

An Overview of Government Regulation

No regulatory agency has a mission to depress the economy or to raise the unemployment rate. However, many of their actions have those undesirable effects. The barriers to economic growth imposed by regulatory agencies are numerous and growing. Regulatory costs are a hidden tax reducing the competitiveness of American business and the availability of employment in the United States.

The popular view of regulation is wrong. It is not a contest between the "good guys" (government and the consumer) and the "bad guys" (business). The reality is that the consumer is at the receiving end of the benefits as well as the costs generated by government regulation. Business is the middleman (or woman).

The nature of regulation becomes apparent when seen from the viewpoint of the average company. For each box on its organizational chart, there are one or more government agencies that are counterparts to that box: Environmental Protection Agency (EPA) and construction of new facilities, Occupational Safety and Health Administration (OSHA) and the workplace, Equal Employment Opportunity Commission (EEOC) and human resource policies, etc. The rules these alphabet soup agencies enforce figure heavily in the company's internal decision making.

The impact of governmental rule makers is in one predictable direction: to increase the firm's overhead and operating costs, and to reduce the resources available to perform its major task of producing goods and services for the consumer. Government regulation results in the higher prices that consumers pay to cover the cost of compliance. But that characteristic makes regulation especially attractive to

government officials. The costs do not show up in the government's budget (and thus do not have to be paid for by taxation). But citizens-consumers *do* pay those costs in the form of higher prices.

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The EPA says that the cost of complying with environmental regulations came to $130 billion in 1994. That is not a static figure. Recently enacted legislation will add new costs in terms of billions of dollars a year. When researchers add in the costs of meeting the rules promulgated by several dozen other regulatory agencies ranging from the Food and Drug Administration (FDA) to the National Highway Traffic Safety Administration, they come up with an aggregate hidden tax of regulatory costs of $500 billion a year or more. If Congress had to appropriate another $500 billion a year to cover those costs, it would not approve so much regulation.

Going beyond the dollar signs, more subtle and far more serious burdens result from the tremendous amounts of regulations that are promulgated. Central among these are the adverse effects on research and development, productivity, and capital formation. According to professor Dale Jorgenson of Harvard University, by the time that the Clean Air Act is fully implemented in the year 2005, its impact (combined with that of previous environmental regulations) will reduce the nation's capital stock by 4.3 percent, increase the cost of capital by 5.5 percent, and reduce real gross domestic product by more than 3 percent annually.[1]

Regulation also reduces the flow of innovation and the production of new and better products because so many government regulatory agencies have the power, which they frequently exercise, to decide whether or not a new product will go on the market at all. The major obstacles to the development of a new biotechnology industry are not financial or technological. They are regulatory.

The Regulatory Burden on Middle-Sized Companies

As noted at the outset of this report, a great deal of regulatory legislation is so written as to lighten the burden on very small firms. However well motivated, such actions inevitably shift the focus of regulatory enforcement to other companies. This situation creates special difficulty for the medium-sized enterprises that cannot afford to maintain specialized staffs to deal with environmental, safety, workplace, and other complex regulatory requirements.

One modest-sized company printing T-shirts recently bemoaned the fact that the OSHA levied $2,250 in fines for such "serious" violations as using two-pronged plugs rather than three-pronged ones. The owner noted that if he had limited his payroll to ten people — his total labor force came to 14 — he would have been spared this random inspection aimed at the giants of the printing industry.

This adverse experience with government regulation is hardly unique. A recent survey by the accounting firm of Arthur Andersen reported that, by far, the biggest challenge facing mid-sized firms was government regulation. Over half of the companies listed regulations as the primary hurdle compared to only 18 percent which thought that "turning a profit" was the main problem (see Table 1 above).

Table 1

Mid-Sized Companies' Biggest Challenges

Category	Percent
Government regulation	52
Health insurance	20
Turning a profit	18
Taxes	18
Capital needs	14
Controlling expenses	9
Poor economy	5

Source: Arthur Andersen and Co.

The presence of economies of scale in complying with government regulation is clear. The *Fortune* 500 fill out pretty much the same forms and meet the same requirements as smaller firms. The result is that the cost of complying with regulation is a higher percent of sales for the medium-size company than for larger enterprises. A survey of the cost of compliance with OSHA rules for different sizes of U.S. manufacturers showed very large variations. Companies with 2,000 to 5,000 employees reported an average cost of $237 per worker, while companies with 500 to 1,000 employees had to pay almost twice as much — an average cost of compliance of $467 per worker.

An earlier study of the legal costs to employers for a National Labor Relations Board election reported that companies with 100 to 149 employees spent $19 per employee eligible to vote, more than double the amount ($8) paid by companies with 1,000 or more eligible workers.

Professor Thomas Hopkins of the Rochester Institute of Technology has prepared estimates of the burdens of complying with federal regulation for different sizes of business (see Table 2). For companies with 20-499 employees, the regulatory burden per employee averages \$5,195 — 78 percent higher than for companies with more than 500 employees. Very small companies (those with fewer than 20 workers) have the highest unit compliance costs — 4 percent more than mid-sized companies. However, this small percentage difference is well within the likely margin of error in these estimates.

A 1994 survey of mid-sized manufacturers in the United States reported that environmental regulations are the most burdensome regulations that they face. In answer to the question, "Which one area of government regulation would you describe as most burdensome?" 37 percent responded "environmental." In comparison, only 16 percent identified tax regulations, 15 percent work-place health and safety, and 4 percent product liability.

Unfortunately, Congress has responded to the issue of uneven distribution of regulatory burdens in the predictable manner. It has not reduced the burden of regulation by streamlining the process. Rather, it has exempted different sizes of companies, based arbitrarily on the different regulatory statutes it was writing.

There is a host of regulatory exemptions for very small businesses. A facility with nine or fewer full-time employees is not required to follow the procedures for Toxic Chemical Release Reporting Under the Emergency Planning and Community Right-to-Know Act. A company with a federal contract (or subcontract) of \$25,000 or less does not have to comply with the Drug-Free Workplace Act. A contractor (or sub-contractor) receiving a federal contract of less than \$10,000 does not have to meet the requirements of the Rehabilitation Act.

For all companies — even those not receiving a dime from the government — there is a bewildering array of size cutoffs, exempting some from one regulatory requirement or another. Companies with 14 or fewer employees are exempt from the Americans With Disabilities Act and from Title VII of the Civil Rights Act of 1964. Employers with 19 or fewer workers are exempt from the Age Discrimination in Employment Act and from the requirements of the Consolidated Omnibus Budget Reconciliation Act of 1985; the latter requires employers to provide certain health insurance benefits.

Table 2

Federal Regulatory Costs by Size of Firm

Type of Regulation	Average Costs per Employee for Firms With		
	1-19 Employees	20-499 Employees	500+ Employees
Environmental	\$1,246	\$1,194	\$671
Other social	658	630	354
Economic efficiency	574	550	309
Economic transfer	1,050	890	501
Process	2,017	1,931	1,086
All federal regulation	\$5,545	\$5,195	\$2,921

Source: Thomas D. Hopkins, *Profiles of Regulatory Costs*, A Report to the U.S. Small Business Administration, November 1995.

Firms with 99 or fewer employees are not covered by the Worker Adjustment and Retraining Notification Act. Companies with 99 or fewer participants in its employee benefit plan to not have to file a report each year with IRS by an independent qualified accountant.

There is a cluster of federal regulations that take effect when the company hires its 50th employee. These include the affirmative action program for companies working on government contracts, subcontracts, and grants and the Family and Medical Leave Act. The primary result usually escapes public attention because it is less dramatic than the issue of cost but far more fundamental: some small firms are reluctant to expand employment.

For example, WorldClass Process Inc., a new and growing Pittsburgh processor of flat-rolled steel coils, has increased its work force to 49. According to the company's chief financial officer, "We're going to keep at 49 as long as we can," to avoid crossing the 50-employee threshold for the Family Leave Act.[2]

Similarly, the Schonstedt Instrument Company of Reston, Virginia, a profitable, high-tech firm, deliberately keeps its work force below 50 employees. It does so to avoid having to file Form EEO-1 every year. The company's president makes the point effectively, although not in scholarly fashion:

> . . . a friend went over 50 employees on a government contract. He gave me his EEO file. . . it weighs more than 8 pounds. . . I have kept my employment under 50.[3]

U.S. firms do not entirely escape this problem when they establish overseas operations. In Germany, companies with 10 or more employees must set up works councils, while in

Belgium the cutoff is 50 and in France it is 100.

The most satisfying answer to this situation is not to raise the exemption ceiling now contained in many regulatory statutes. Rather, public policy should reduce the proliferation and burden of regulation on all companies — and thus obviate the need for special exemptions to a lucky few. This important objective does not require dismantling the regulatory apparatus. It does mean developing more sensible and effective ways of responding to the public's genuine concern for a cleaner environment, a safer work place, and other social concerns.

Alternative Approaches to Regulatory Reform

What can be done to reform government regulation? At the outset, the reader should be aware of the fact that command-and-control directives by governments have an ancient pedigree. In the Old Testament, the Book of Deuteronomy commands, "Thou shall not lend upon usury to thy brother." The ancient Babylonian Code of Hammurabi established uniform weights and measures and limited the rate of interest.

In contrast, most modern economists would rely primarily on competition in the marketplace to protect the consumer. Deregulation of interstate trucking, for example, has resulted in thousands of new businesses entering the market. The heightened degree of competition has forced sizable reductions in the cost of trucking which ultimately shows up in lower prices of all the items that move by truck.

When government does regulate (as in the case of environmental pollution), economists prefer that government policymakers make the maximum use of economic incentives. Thus, to an economist the environmental pollution problem is not the negative task of punishing wrongdoers. Rather, the challenge is a very positive one: to change people's incentives. After all, people do not pollute because they enjoy messing up the environment. They pollute because it often is cheaper or easier than not polluting.

The basic economic approach is that the price of a product should reflect its burden on the environment. If prices of goods and services were increased to reflect the costs imposed on the environment (perhaps as measured by cleanup costs), consumers would buy less of those environmentally damaging products. The idea is to get polluters to change their ways as high-polluting products become less attractive to consumers than low-polluting products.

Public policy should reduce the proliferation and burden of regulation on all companies — and thus obviate the need for special exemptions to a lucky few.

A study of the Delaware estuary showed that effluent fees, set at a high enough level to achieve the desired level of water purity, would cost only one-half as much as a conventional regulatory program to achieve the same environmental cleanup.

What about the existing array of command-and-control regulation? Here, economists offer the notion of benefit-cost analysis to make sure that any given regulation does more good than harm. Benefit-cost analysis has been used for decades in examining government spending programs. It is neither a revolutionary, new idea nor an invention of the far right. In fact, such analyses have been attacked by both ends of the political spectrum. The far left does not like using economic analysis because not every proposal for government intervention passes a benefit-cost test. The far right does not like it either, because benefit-cost analysis can be used to justify government intervention.

Benefit-cost tests compensate for the fact that government decision makers do not face economic constraints. If the costs to society of a governmental regulation exceed the benefits, that situation does not have an adverse impact on the agency. The administrators may not even know about it.

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Under the traditional approach they can crow about the benefits and ignore the costs — because the costs are transmitted to the consumer, not by the government but by business. In fact, regulatory activists can enjoy needling business about price increases, even when they result from the costs of complying with the very regulations that the activists had urged be adopted. To an economist, "overregulation" is not an emotional term. It is merely shorthand for governmental rules for which the costs to the public are greater than the benefits.

In cases where dollars are an inappropriate measure of government regulation's impact, there still may be opportunity for analysis in the decision-making process. For example, the drug that cures Rocky Mountain spotted fever also causes fatal anemia in one out of every 10,000 people who use it. A simple-minded approach would prohibit the use of this "dangerous" drug. Yet, the fever itself kills about eight out of every 10 people who contract the disease. Thus, the benefits of the drug greatly outweighs the costs — measured, not in dollar terms, but in human lives.

Critics who are offended by the notion of subjecting regulation to a benefit-cost test unwittingly expose the weakness of their position. They must fear that their pet rules would flunk the test. After all, showing that a regulatory activity generates an excess of benefits is a strong justification for continuing it. The painful knowledge that resources available to safeguard human lives are limited concerns economists when they see wasteful use of those resources because of regulation.

Conclusion

Now is an especially propitious time for Congress to embark upon significant reform and reduction of regulation. Such action would both respond to the widespread citizen dissatisfaction with government and improve the lot of the overlooked middle-sized company.

Government decision makers neglect an important fact when they adopt new or expanded regulatory requirements: government intervention often does more harm than good. Policymakers should not ignore the tremendous ability of individuals and private organizations to deal with the shortcomings that inevitably arise in a modern economy.

Notes

1. "Costs, Benefits of U.S. Environmental Regulation," *Capital Formation*, September-October 1991, pp. 1-2.

2. Brent Bowers, "Regulation Play," *Wall Street Journal*, October 15, 1993, p. R16.

3. E.O. Schonstedt, "'Robber Reg' Has Backfired," Letter to the Editor, *Washington Times*, February 16, 1992, p. B5.