



S O U T H A F R I C A F O U N D A T I O N

A U G U S T 2 0 0 3

**DESIGNING A REGULATORY
IMPACT ASSESSMENT
FOR SOUTH AFRICA**

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1. Introduction

Regulation is a reality in the South African market. Regulation without the necessary checks and balances, however, can create as many problems as it provides solutions. In particular, it has been shown that small businesses often carry a disproportionate burden of regulatory costs.

A recent Small Business Project publication (Small Business Project, 2003) makes the case for regulatory assessment based on the experience and methodologies used in the UK, USA, Australia and New Zealand. This discussion document takes the debate one step further by evaluating the international models and the current South African regulatory regime. It identifies a number of principles for success and makes suggestions on how the process can be taken forward. The line of thinking presented here is based on the Regulatory Impact Assessments (RIAs) and Regulatory Impact Units (RIUs) discussed in the SBP document. These are not new concepts and similar models are followed in the UK, USA, Australia and New Zealand. This analysis considers how these models have been applied to inform the way ahead for Regulatory Impact Assessment in the South African environment.

Regulatory Impact Assessment benefits the market as a whole

Although the discussion will focus on the impact of regulation on SMEs, the institutional and policy design can and should be extended to the market as a whole. RIAs can ensure that regulation is well thought through and designed – taking into account both the intended and unintended impact.

2. The Case for Regulatory Assessment

2.1 Unintended Costs

Markets can react to regulation in unexpected ways

There are always unintended costs and spin-offs to regulation. Markets are dynamic, interactive systems that react to the incentives and disincentives provided by, amongst other things, regulation. In many cases policy makers are primarily concerned with the first order effects of regulation and do not consider spill-over and second-order effects. This mindset, which can be referred to as 'regulate first', tends to deal with unintended consequences after regulation has been imposed rather than trying to prevent it.

An example of unintended consequences is a change in market structure due to the differential impact on different institutions. This, in turn, often results in institutional arbitrage, entrenching suboptimal institutional forms. Such consequences are often difficult to undo even when the regulations are removed.

Particularly for SMEs, the direct compliance cost of regulation can be non-trivial. A 1996 survey¹ commissioned by the Australian Government's Small Business Deregulation Task Force found that the average Australian small business² spends 16 hours per week on financial accounts and compliance issues (Yellow pages, 1996). Of this, tax and other compliance issues accounted for four hours per week³, representing an average total annual cost of \$7,000 per business (compared to the average of \$11,215 spent on general accounts and bookkeeping). Of this amount it is estimated that \$3,000 goes to external consultants predominantly for dealing with compliance issues.

2.2 Unintended Cost Incidence

Aggravating the problem of unintended costs is the uneven incidence of these costs. Regulatory cost is seldom distributed in an equitable manner.

Small businesses carry a much larger relative cost

Even where there is no difference in the absolute regulatory cost for institutions of various sizes but on a per employee basis, small businesses carry a much larger relative burden. Small firms do not have the scale of operation to offset regulatory costs and often cannot afford to appoint dedicated staff to look after compliance issues.

¹ The "Working overtime" survey forms part of the Yellow Pages Small Business Index series of surveys designed to track confidence and behaviour in the small business sector.

² Employing up to 19 employees

³ Taxation matters took three hours and one was spent on other compliance activities.

Complexity of regulation may require the help of external consultants to understand and comply with it⁴. Research commissioned by the US Small Business Administration Office of Advocacy (2002) in 2001 found that businesses with fewer than 20 employees incurred average costs of roughly \$6,975 per employee from regulations, versus \$4,463 for firms with more than 500 employees – 56% larger cost for small firms.

A recent Grant Thornton Kessel Feinstein international survey (2003) conducted amongst independent, medium sized businesses found that 46% of South African respondents identified regulatory 'red tape' as a major constraint on business growth. This compares to a global average of 35%. The survey reports that, due to the 'red tape', *"business administration and paperwork have become onerous, distracting and time-consuming tasks which impede the productivity of owner-managed businesses"*. The respondents also indicated that the red tape burden increased and that *"business today is more complex than it was in the past"*.

**Regulatory barriers
can contribute to the
'missing middle'
problem**

It is important for long-term economic development that businesses are able to develop from small informal to larger formal businesses. Unintended regulatory costs and unequal incidence of these costs, however, present a significant financial hurdle to the formalisation of small businesses. This leads to the so-called 'missing middle' phenomenon - the gap that exists in the development continuum between small informal firms on the one hand and giant formal businesses on the other. In support of this an NBER paper on the regulation of entry (Djankov, La Porta, Lopez-de-Silanes & Shleifer, 2000) found that countries⁵ with heavier regulation of entry have higher levels of corruption and larger informal economies but not necessarily better quality of public or private goods. In addition, Erneste and Schneider (1998, as quoted in Small Business Project, 2002) point towards the potential cost of such barriers to formalisation showing a clear inverse relationship between economic development (as approximated by per capita GDP) and the size of the "shadow" economy.

⁴ Large businesses have the in-house capacity to deal with this.

⁵ The sample included nine African countries, nine East Asian countries including China and Vietnam, three South Asian countries (India, Pakistan and Sri Lanka), all Central and Eastern European countries except for Albania and some of the former Yugoslav republics, seven former Soviet Union republics, ten Latin American countries, five Middle Eastern countries (Egypt, Israel, Jordan, Lebanon, and Tunisia), and all major developed countries. Selection of countries was guided by the goal of spanning a wide range of income levels and political systems but was also dictated by the availability of reports on business registration procedures by consulting companies.

Rigidities in business entry and growth retard long-term economic development and can partly explain the dual economy phenomenon in South Africa and the difficulty in developing what is currently the informal market.

2.3 Costs can be Quantified

Much of the earlier reticence on the issue of impact assessment stemmed from the perception that most costs and benefits cannot be quantified. Elaborate work done by the regulators in particularly the UK, USA, New Zealand and Australia has shown that this is not the case. This is not to say that it is an easy exercise, but several techniques have been developed to provide accurate approximations of the cost and benefits of regulation⁶.

2.4 The Importance of Small Business to the Economy

The case for supporting small businesses is well established. The benefits include the labour intensity of small business operations, their contribution to gross domestic product and the potential rearing ground that small business provides to potential giants of the future. These arguments weigh especially heavy in the South African environment of high unemployment and modest economic growth.

The above sections describe the potential debilitating effect that regulation can have on economic potential. Regulatory Impact Assessments are one way of limiting the damage done. The following section looks at how RIAs have been applied in the UK, USA, New Zealand and Australia.

⁶ Some of these techniques are discussed in the SBP SME Alert (SBP, 2003).

3 Existing Regulatory Impact Assessment Models around the Globe

All the regulatory regimes described in this section use regulatory impact assessments to limit the unintended cost of complying with regulation. In most cases specific efforts are made to monitor and limit the effect on small businesses.

3.1 The US Model

US model the oldest and most aggressive in controlling the cost of regulation

The United States (at federal level) has the longest experience of RIAs and is also more aggressive than other countries in controlling regulation (SBP, 2003). In 1980 the Regulatory Flexibility Act was passed. This Act requires regulators to explicitly evaluate the effect of regulation on small businesses. A high political priority is also accorded to RIA for small businesses through the Small Business Administration Office of Advocacy, which reports directly to the President.

The federal regulatory regime is managed through the Office of Information and Regulatory Affairs (OIRA) under the Office of Management and Budget (OMB) (SBA Office of Advocacy, 2002). Executive Order 12866, issued in 1993 and managed by the OMB, forces all agencies to assess the costs and benefits of regulations under its management - particularly when small businesses are affected. Under the Regulatory Right-to-Know Act (Section 624 of the Treasury and General Government Appropriations Act, 2001), the Office of Management and Budget is also required to prepare annual costs-benefit analyses of federal regulations, including recommendations for regulatory reforms.

In addition a number of other acts support small businesses and seek to limit the cost of compliance. These include:

- Small Business Regulatory Enforcement Fairness Act (1996): Requires agencies to simplify language, provide more accessible information on reporting and compliance requirements and publish compliance guides for important new acts. It also provides the necessary 'teeth' by allowing small businesses to seek judicial review of compliance to the Regulatory Flexibility Act.
- Small Business Paperwork Relief Act (2001): Requires all proposed regulations to be analysed as to the paperwork that they require and that paperwork be reduced to a minimum. A regulation which creates new paperwork must be cleared by the Office of Management and Budget (OMB) (SBA Office of Advocacy, 2003).

Although the US has, in terms of law, the most aggressive RIA regime, this is not necessarily reflected on ground level as much of the implementation lies in the hands of the state governments. An assessment of state efforts to mitigate the regulatory burden of small businesses (SBA Office of Advocacy, 2002) reported somewhat mixed results, with not all the states implementing the federal model. The most successful states seemed to be the ones where high level political commitment was combined with explicit protection for small business through legislation similar to that on the Federal level.

3.2 The UK Model

RIA was only introduced in the UK in the mid 1990s. The main coordinating body is the Regulatory Impact Unit (RIU) in the Cabinet Office. In addition there are a number of departmental RIUs, an RIU Scrutiny Team and a Better Regulation Task Force (BRTF).

Ministers required to sign off on assessments

The system ensures high level political involvement by requiring Ministers to sign a declaration upon proposing any new policy that the relevant department has evaluated the proposed policy and that the benefits justify the costs. The main Regulatory Impact Unit (RIU) in the Cabinet Office provides support to ministers in this process. Unlike its counterpart in the US, the RIU does not have legal authority to take on agencies that do not implement their RIA responsibilities.

In addition to main RIU, each Government department has its own departmental RIU, which prepares RIAs on departmental level. They are assisted by an RIU Scrutiny Team, which includes secondees from the private sector. The Scrutiny Team ensures that robust assessments are prepared and that early and effective consultation is provided to those affected.

Five principles of good regulation

The Better Regulation Task Force (BRTF) was established in September 1997 as an independent body to advise Government on ensuring that regulation accords with the five principles of good regulation: Transparency, Accountability, Proportionality, Consistency and Targeting.

At the level of individual regulators, new legislation drafted for the Financial Services Authority (FSA)⁷ requires publicly available cost-benefit analyses of all new regulation and changes to existing regulation. In anticipation of this, the FSA has already made cost-benefit analysis an explicit part of its regulatory development process.

⁷ The FSA is the single regulator for financial services in the UK.

The analyses are done at departmental level. A dedicated Cost-Benefit Analysis Department supports the various internal departments in preparing cost benefit analysis.

3.3 Australian Model

In 1996, the Australian government established the Small Business Deregulation Task Force (SBDTF). The Task Force was given six months to advise the Federal Government on revenue-neutral ways to halve the paperwork and compliance burden on small business. The task force's final report, entitled "Time for Business" and published at the end of 1996, contained various recommendations to ease the regulatory burden on Small Businesses. Most of these recommendations were subsequently implemented.

Ongoing regulatory reform is managed through the Office of Regulation Review (ORR), a subdivision of the Productivity Commission, the principal Government advisory body on all aspects of microeconomic and regulatory reform. It has the responsibility of reviewing Regulation Impact Statements prepared by the various regulatory agencies and focuses particularly on the impact on SMEs. Its arms-length relationship with the government bureaucracy enables fresh and independent assessments.

**Arms-length
relationship with
government
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assessments**

Government policy now requires that a Regulation Impact Statement (RIS) be prepared for regulatory proposals which affect business or restrict competition. For any proposal that requires legislative change, the RIS must be tabled in Parliament, thereby making it available to the public. The Office of Regulation Review has a central role in promoting compliance with the regulation review requirements. The Assistant Treasurer has ministerial responsibility for promoting regulatory best practice. Departments and agencies are required to consult with the ORR at the earliest practicable stage in the policy development process. Adequacy criteria for RISs (as set out in the cabinet-endorsed "Guide to Regulation") includes:

- determining which groups are likely to experience the benefits and costs and the extent of these
- identifying the impact on small business
- comprehensive assessment of each option's expected impact

In addition, the Department of Industry, Tourism and Resources (Office of Small Business) is responsible for promoting and maintaining links across government departments and agencies responsible for issues which impact on the small business sector. This includes issues around regulation.

3.4 New Zealand Model

As part of its compliance cost programme, the government in October 2000 appointed a ministerial panel to identify and make recommendations to the government on ways to reduce compliance costs for business. The government also committed to establish industry test panels, where necessary, to audit the likely compliance costs and workability of any proposed new regulations.

Since 1 April 2001, all policy proposals submitted to cabinet or that have cost implications for business have to be accompanied by Regulatory Impact Statements (RIS) and Business Compliance Cost Statements (BCCS). The Business Compliance Cost Unit (BCCU) has been established under the Ministry of Economic Development to monitor and assess these statements. The BCCU also advises departments.

4 The South African Environment

For a developing country, South Africa has an advanced and comprehensive regulatory regime, especially in the area of financial regulation. In an environment characterised by resource limitations, it is important to prevent overregulation and to understand the costs and benefits that regulation imposes on various players. This will ensure that the regulation supports long-term development goals. There is, however, currently no overriding policy framework to align the efforts of the various regulators to national development goals. There is also no legislation compelling regulatory agencies to assess and account for regulation on a cost-benefit basis.

No legislation compelling regulatory agencies to assess and account for regulation on a cost-benefit basis

Some authorities, notably the Department of Trade and Industry (DTI) and the Financial Services Board (FSB), have pro-actively considered cost-benefits issues in regulation.

The DTI has numerous programmes for the development and support of small businesses. One component, the Consumer and Corporate Regulation Division (CCRD), specifically focuses on regulation and legislative issues. Two of the initiatives under this unit are:

- **Business Regulatory Compliance Advice:** Assists businesses (especially SMEs) in their compliance with legislation and regulations administered by the DTI (consumer and competition law, commercial law and regulated industries). Provides businesses with copies of the legislation or regulations, highlighting relevant provisions, as well as by providing written clarification of how the DTI would approach and interpret certain provisions of these laws.
- Businesses and consumers can make inputs into the development of regulations by submissions to the CCRD.

DTI to commission study to investigate the disproportionate impact of regulation on SMMEs

The DTI has also indicated that they intend to commission a study to investigate the regulations that impose disproportionately high costs on SMMEs (SBP, 2003).

5 Principles for Success

Following from the overview presented above, the following can be identified as principles for success. These should guide the design of a regulatory reform regime for South Africa.

Principle 1: Integration with independence

Whilst RIA must be integrated into government policy processes, there should also be some independence to ensure that the process is not captured by internal government issues or politics. This was, for example, achieved in Australia by placing the overseeing role within a statutorily independent institution (the ORR). Independence is a pre-requisite for objective evaluations. In the US case, the SBA Office of Advocacy reports directly to the president so that its independence of other government departments is secured.

Principle 2: Public private partnership

The process should not be a purely government initiative and the public must be involved at every level. This will ensure that the decisions taken actually benefit the public. In all of the above examples, public participation already began in the design phases where the private sector was well represented on the task forces or ministerial panels charged with evaluating the need for and designing the RIA system. The private sector is usually also involved in the assessment system itself - for example, in the UK the RIU Scrutiny Team includes private sector experts.

Principle 3: Appropriate authority

The various assessment institutions need to have the authority to affect the regulation they assess. This is not to say that all the departmental regulatory impact units should be given executive authority. The appropriate level of authority can be provided through the highest level coordinating and assessment body in the RIA system. The UK and US models differ in the level of authority provided to the high level body: US body has much wider legal authority to take on agencies that do not implement their RIA responsibilities. However, it is not clear that this provides a big advantage over the UK system. The decision on authority would have to be carefully considered within the South African legal and government framework.

Principle 4: Public accountability

It is essential that the whole system and design process is transparent, reporting to both the government and the broader public. In the US case, the OMB must report its assessment of federal regulations on an annual basis, including recommendations for reform.

Principle 5: High level political support

Political support and involvement is critical. In the UK, ministerial involvement is ensured by requiring the minister of the relevant department to sign off on regulatory impact assessment. The final responsibility for reform and limiting unintended compliance costs, therefore, resides with the respective ministers.

Principle 6: Reform should be embedded in legislation

This will give small businesses and advocacy groups the necessary leverage to keep institutions to its promises. In the US, the Small Business Regulatory Enforcement Fairness Act of 1996 allows small businesses to request a judicial review of compliance to the Regulatory Flexibility Act (which requires departments to evaluate and minimise the cost impact of regulations).

Principle 7: Clear guidelines

One of the main contributions of the task forces or ministerial panels is to formulate clear guidelines on regulation that provides a basis for evaluation and ensures consistency.

Principle 8: Coordination

It is advisable that there should be a central coordinating body that can align and monitor efforts at various levels. The necessary authority should be given to the bodies at the various levels to affect the regulation it assesses. The central body should also be independent of the regulator to ensure objectivity. In the UK, the RIU reports to the cabinet.

Principle 9: Appropriate cost

The cost of running the regulatory assessment system should be appropriate to the benefits it delivers. In the South African case, this would need careful consideration to ensure that RIA results in a net benefit for the public.

Principle 10: Sufficient information

The system implemented needs to ensure that sufficient information is available to guide and evaluate regulation.

6 Suggestions Going Forward

RIA has particular value for parties operating on fringe of market, such as SMEs and individuals

The literature leaves no doubt as to the value - both in financial and development terms - of RIA. This value is particularly beneficial for parties operating on the fringe of the market, such as SMEs and individuals.

The overriding goal of RIA is to ensure that regulation achieves its goals in the most efficient way - and in a way that facilitates long-term development. The RIA methodology can contribute significantly to the evaluation of policies in the early phases of development. RIA should, therefore, not be seen as static post-event damage assessment, but as a dynamic learning and facilitation process which will ensure continual best practice in policy development.

Proper regulatory assessment contributes to "an inclusive, innovative and prosperous economy"

Although RIA clearly benefits SMEs, the benefits are not limited to smaller entities and should not be seen as an isolated SME protection or development initiative. RIA will facilitate a competitive economy that allows a multitude of parties to compete whilst ensuring the protection of consumers. In the words of Paul Swain (Minister of Commerce in New Zealand), proper regulatory assessment contributes to "an inclusive, innovative and prosperous economy" (New Zealand Ministry of Economic Development, 2001).

The establishment of an RIA is not an academic or government exercise and should be done with maximum private sector and specifically also SME participation.

⇒ **Firstly**, it is suggested that a public-private task team or panel be appointed to do an initial evaluation of all regulation in South Africa and, building on the work already done by the some regulators, to prepare suggestions on evaluating and reducing compliance costs in general and also specifically for SMEs.

⇒ **Secondly**, the study should evaluate the regulatory reform regimes of relevant countries and propose recommendations on the appropriate institutional structure to ensure ongoing economy wide assessment with the necessary expertise as well as sufficient government buy-in and authority. It should also look at the legislative and regulatory changes required.

It should be noted that the examples discussed in this paper are all from developed countries with ample resources. In South Africa, resources are also needed in other areas. The proposed study should pay particular attention to proposing an appropriate and affordable solution.

Finally, government should be required to respond to the study within a reasonable period of time.

7 Reading List

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8 Glossary

- BCCS:** Business Compliance Cost Statement
- BCCU:** Business Compliance Cost Unit
- BRTF:** Better Regulation Task Force
- CBA:** Cost-benefit Analysis
- CCRD:** Consumer and Corporate Regulation Division
- DTI:** Department of Trade and Industry
- FSA:** Financial Services Authority
- FSB:** Financial Services Board
- MFRC:** Microfinance Regulatory Council
- NBER:** National Bureau for Economic Research
- OIRA:** Office of Information and Regulatory Affairs
- OMB:** Office of Management and Budget
- ORR:** Office of Regulatory Review
- RIA:** Regulatory Impact Assessments
- RIS:** Regulatory Impact Statement
- RIU:** Regulatory Impact Unit
- SARB:** South African Reserve Bank
- SBA Office of Advocacy:** Small Business Administration Office of Advocacy
- SBDTF:** Small Business Deregulation Task Force
- SME:** Small and Medium Enterprise
- SMME:** Small, Medium and Micro Enterprise

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