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Administrative Costs of SMEs

Introduction

By administrative costs is meant costs of enterprises resulting from requirements imposed by law to draw up, compile, store and/or submit to public agencies or third parties. Today, European Union has concentrated firstly, on the quantification of these costs, and secondly, on the reduction of these costs in order to improve the competitiveness of EU and in order to guarantee economic growth. Several Member States, like Denmark, Great Britain, the Netherlands and Sweden, have taken this task seriously, too. Instead, for instance, Finland has still much to be done in this field of economic policy. So-called Standard Cost Model (SCM) – originally developed in the Netherlands – has been in a key position when the amount of administrative burden has been quantified.

One purpose of this paper is to show how important it is especially for SMEs that administrative costs and other regulatory costs imposed by legislation, and their reduction would be taken seriously into account both in legal and economic policy-making. Or more specifically, the smaller the enterprise, the more important this issue is. Another purpose is to analyse different kinds of loopholes and other drawbacks in the measurement of administrative costs. Moreover, an important approach is to analyse the means by which administrative burden may be diminished, and in particular the burden of smallest enterprises. Finally, this brief paper may show how closely related topics legal and economic policies are with each other: on the one hand, many issues in economy are regulated by law, and on the other hand, laws have impacts in economy.

Some Results about the Administrative Costs of Enterprises

The Netherlands has been a pioneer in measuring the administrative costs of enterprises. In recent years, Denmark and Sweden have also devoted resources into this task. Moreover, for instance Belgium and Great Britain are Member States of EU, which have measured the administrative burden of enterprises, at least with respect to certain fields of legislation. In spite of these examples, measurement of administrative burden is still in 'pilot stage', as European Commission (2005) has expressed it.

Administrative costs imposed by legislation to the enterprises are not small figures. For instance, in the Netherlands the amount of these costs has been estimated to be approximately 3,6 % in relation to GDP and in Sweden approximately 2,9 %.[2]

International studies have also shown that tax law, environmental law and labour law are the most important sources of administrative costs. Over one half the administrative costs are caused by these fields of legislation, and approximately so that the two first fields both have generated approximately 20 % of these costs and labour law about 10-15 % of these costs.[3] These figures are based on measurement or estimates made in Denmark, the Netherlands and Sweden.

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[2] NUTEK (2004a), 9.

[3] NUTEK (2004a), 8.

International studies – especially in some European countries – have concentrated on administrative costs of enterprises in total. In other words, there are only quite few studies which have estimated the administrative costs of SMEs. However, it is possible to refer to some results which show clearly that the relative administrative burden of small enterprises is much larger than that of bigger companies.

Already studies made during 1990s have shown that administrative costs of small enterprises were relatively large. For instance, according to German study, administrative burden per employee of micro enterprises was over 20 times larger than in large enterprises. Similar kind of study from the Netherlands showed that administrative burden per employee was six times larger in smaller enterprises than in bigger companies which had more than 100 employees.[4]

Administrative costs per employee in value-added taxation show very well – and drastically – by which way these costs are distributed among firms. A reference can be made to a Swedish study. On average, administrative costs were 555 crowns per employee and per firm. However, this figure shows only one side of the coin. Another side is, of course, the distribution of these costs. When it was question about a large enterprise – more than 250 employees – administrative costs per employee were 9 crowns, but when it was question about micro enterprise, these costs were 1.575 crowns. The gap is – by one word – huge.[5] On the other hand, these figures show that when the policy-making is approaching administrative burden of enterprises, SMEs – and especially smallest firms – have to be taken separately into account.

It is also possible to analyse the administrative burden more detailed taking into account which kinds of specific legal provisions generate administrative costs.

- For instance, the heterogeneity of tax legislation across different countries has made it more difficult to small enterprises to become important players in foreign trade. Thus, this factor is some kind of entry barrier and in particular to the smallest firms.[6]
- Over-regulation is a self-evident cause for high administrative costs.[7] The regulatory problem is – in principle – easy to solve, because under these circumstances fewer instruments are sufficient to regulate the social problem. Within this context, it has also been discussed about double regulation caused by non-coordination of national and EC legislation.[8]
- Inconsistent definitions in legislation are, of course, a factor generating unnecessary administrative costs. For instance, labour law has been criticised in Sweden because of this.[9] On the other hand, improving the consistency of legislation across legal rules, e.g. between tax law and other parts of legislation, is one way to reduce administrative burden.[10]
- Differentiated VAT rates have caused in practice large administrative costs.[11]

Certain features of legislation reveal also that the relative administrative burden is distributed unevenly among enterprises. First, *ex ante* regulation is often such that the costs generated by it are fixed in nature. In other words, for instance the costs of making a plan to promote equality in the undertaking are such they are the same irrespective of the size of the production or the number of employees. Moreover, against this background, the claim that these kinds of costs constitute a

[4] SOU 1998:78, 26.
[5] NUTEK (2004b), 12.
[6] See e.g. Cnossen (2002).
[7] NUTEK (2004a).
[8] See also Skr. 2005/06:49, 31.
[9] NUTEK (2004a), 25.
[10] See e.g. Skr. 2005/06:49, 15.
[11] See. e.g. SOU 2005:57, chapter 9, which concerns Swedish VAT system.

market barrier for new enterprises is justified.[12] What is worth noting too is the threat about 'regulation circle' due to this kind of entry barriers. This is as such leading to the reduction of competition in the markets which may worsen the welfare of consumers. This may lead to the tightening of the consumer protection law and perhaps other parts of legislation, too; which further harms competition since the entry barriers become higher; which may lead to stricter and administratively more burdensome legal rules; etc.[13]

Another side of the coin concerns mostly *ex post* regulation. Under these circumstances, big companies can make use of the 'law of big number', while SMEs usually are not well able to self-insure the risks, in particular, due to the large damages. Moreover, often third-party-market-insurance is not obtainable for small enterprises at reasonable cost.[14]

Specific legal treatment of small enterprises may be justified still by other arguments. From interest group point of view, larger enterprises are in a better position than smaller firms in order to affect the content of legislation. Several reasons explain this. The starting point is that large firms constitute organisations to which only few participators belong, but SMEs constitute organisations to which belong plenty of firms. Under these circumstances, organisations of large enterprises have smaller internal transaction costs. Preferences are also more likely to be similar in groups consisting of only few participants. In addition, in smaller groups rewards for each firm are bigger. Another side of the coin is that in the groups consisting of plenty of firms, they may have incentives to free ride.[15]

What is finally worth noting is to what extent administrative costs have been settled in the preparatory drafts of legislation. Following remarks concern Finnish legislation, particularly on the basis of government bills. An overview of these preparatory drafts has shown that administrative costs of enterprises in general and separately those costs of SMEs have been omitted. Instead administrative costs of public sector have been emphasised more. This is to some extent paradoxical, because public administrative costs are usually much less than private administrative costs. In addition, only very few remarks have been made at very general level about the relatively large administrative burden of small firms compared with bigger companies. In summary, the policy conclusion is clear-cut: when new legislation is introduced or existing legislation is amended, administrative (and regulatory) costs of private sector have to be studied better, and taking into account, too, the uneven distribution of these costs among firms.[16]

Pitfalls in the Measurement of Administrative Costs

Even though it sounds good to cut the administrative costs of enterprises, there are quite many pitfalls in this approach.[17] First, only such legal requirements are taken into account, which are *obligatory* to the enterprises. However, voluntary tasks may generate – and they sometimes generate *de facto* – quite large administrative burden to enterprises. For instance, small enterprises are exempted from auditing of the accounts in many countries. In practice, however, small enterprises have invested in audit even though they do not have any legal obligations to do this, but

[12] See e.g. Haupt (2003), 1163 with respect to the consumer protection law.
[13] Määttä (2006).
[14] See also Haupt (2003), 1163-1164.
[15] See also Olson (1965).
[16] See also Kanniainen – Määttä (2007, forthcoming).
[17] See also Kanniainen – Määttä (2007, forthcoming).

because they may otherwise lose e.g. their right to public grants. Moreover, audit is from administrative point of view an important field, since it has generated according to international studies approximately 10-15 % of the administrative burden of the enterprises. Another example is *self-regulation* understood here as "law" formulated by private agencies to govern professional and trading activities. Thus, administrative costs of self-regulation are not covered by the SCM, and again, the actual total administrative burden is larger than the burden measured by SCM.

Second problem is related to the objectives of reducing administrative costs. Taking into account the above-mentioned feature of SCM, it is possible to reach the goals without reducing the actual administrative burden of enterprises. This may occur e.g. by moving from traditional regulation to self-regulation, or by exempting small enterprises from legal obligations, which are not actual exemptions. Another kind of problem is created by the fact, if different goals are set *ex ante* to different fields of legislation (e.g. reducing administrative costs under tax law by 20 %, but under environmental law by 10 %). The threat is that the reduction of administrative costs does not occur cost-effectively under the circumstances in which sector-specific goals are applied.

Third problem is created by the fact that only administrative costs, but not other costs due to the legislation, are taken into account. By the term *regulatory costs*, we refer to the costs covering all the costs to the enterprises because of the legislation. For instance, it may be question about material costs resulting from requirements that necessitate investments in facilities or staff (in addition to administrative costs). Environmental law may show well, what kind of problems may emerge if we concentrate on administrative costs but omit regulatory costs in general. In principle, enterprises should be given choice as to how to meet the environmental goals, since that encourages innovations and it is also more costs-effective than alternative solution. However, the benefits of such less interventionist measures might be outweighed by the costs of administering them. On the other hand, if. e.g. a standard compels the enterprise to employ certain production methods or materials, administrative costs are low. However, this kind of standard induces technological rigidity, etc., generating major social welfare losses. In summary, concentrating only on the minimisation of the administrative costs may lead to the increase in other regulatory costs. And at worst, the regulatory costs in total may become larger than otherwise. This result is far away from the aim of the SCM: improving the competitiveness and economic growth. What is worth noting still is that research in the United States has concentrated more on the measurement of regulatory costs, not only on administrative costs.[18]

Fourth problem of many studies is that they have concentrated on administrative costs of business in general, not separately on small and/or medium-sized enterprises. This is very important, since the relative administrative costs of small firms seem to be much bigger than the relative administrative costs of large firms (e.g. in relation to the number of employees). What is worth noting still is that SCM facilitates that the administrative costs are measured separately, e.g. according to the size of the enterprises.

Fifthly, when international discussion has concentrated on administrative costs, transaction costs have been forgotten – at least – to some extent. Nevertheless, transaction costs work also like friction in business. Moreover, a realistic assumption here is that the relative burden of transaction costs of small firms is larger than this burden of big companies. In addition, it is not sufficient that the minimisation of transaction costs is emphasised under property and contract law, but that the issue would be analysed more specifically.[19]

[18] See e.g. Crain (2005).

[19] See also Cooter – Ulen (2004), 91-96.

One potential pitfall in the measurement of administrative costs is that the research takes into account only certain fields of legislation, such as tax law, environmental law and labour law. Under these circumstances, one problem is that administrative costs imposed by other parts of legislation may increase drastically, but they are outside of the SCM results. Moreover, sometimes certain legal provisions may be removed from the legal fields studied by the SCM, but they are replaced by other legal provisions in other fields of the legislation. An instance for this is tax subsidies which may be replaced by direct subsidies to enterprises. From this point of view, if the analysis of administrative costs is not comprehensive, there is threat that these costs may not decrease in total even though SCM may show something else.

Still one issue is worth noting, and it is best characterised by a brief question: how easy should it be to get business licence? If only administrative costs are taken into account, the procedure should be as simple as possible in order to minimise the administrative costs. But other costs have to be taken into account here, too. They are, in particular, expected error costs, i.e. those persons getting licence who have not at all qualifications for the business. Thus, the regulatory problem is not how to minimise the administrative costs but how to minimise the sum of the administrative and expected error costs.[20]

Simplification of Legislation or Legal Reliefs for SMEs?

International studies and proposals have concentrated on the simplification and streamlining of legislation in order to reduce administrative costs of enterprises. Even though this approach is difficult to criticise as such, it omits the specific position of SMEs, and the potential measures which may be used in order to minimise their administrative burden. What is worth noting here are so-called legal reliefs: SMEs may be exempted from certain legal obligations or at least their obligations may be relieved.[21]

But first, for instance, should we simplify legislation by removing certain provisions from legislation? To some extent, a 'warning' example has been Danish corporate law in this respect. This act was written shorter, but on the other hand, many relevant questions were left unanswered in the legislation. Thus, this kind of simplification would increase problems of interpretation and thereby administrative burden.[22] In addition, one self-evident remark is that administrative burden may not decrease – but at worst increase – if removed legal provisions are replaced by other legal provisions.

In any case, simplifying legislation may be a good means to reduce rent seeking. And this may reduce administrative costs for, at least, two reasons. First, law would not involve anymore so many exceptions, like exemptions, which are sources of interpretation problems. Secondly, there would not be anymore so many amendments in legislation, which further reduces the administrative burden and also legal uncertainty.

In practice, legal system involves already nowadays different kinds of legal reliefs.[23] On the other hand, what is worth noting is that they are not directed at SMEs in total but usually to smaller

[20] See, however, Skr. 2005/06:49, 16.

[21] On the other hand, tax subsidies may be enacted for SMEs but this option is omitted from this paper. However, in OEC countries this kind of alternative is in any case quite common.

[22] See also HE 109/2005 vp.

[23] In principle, outlining legal reliefs is similar task than to outline tax expenditures (or tax subsidies) from tax legislation.

enterprises. Differences are reflected by the fact that reliefs are e.g. linked to the number of employees in the firm, sometimes to the turnover of the enterprise, and sometimes to the start-up stage of the firm.[24] And still, for instance the critical number of employees may vary from one law to another. An instance of this is Finnish Act on Co-operation within Undertakings (725/1978) and on the other hand, Act on Equality between Women and Men (609/1986). The former act is applied to undertakings normally employing at least 20 persons, whereas the latter act is applied – concerning the obligation to make a plan to promote equality – to undertakings normally employing at least 30 persons.

Some further examples about legal reliefs for SMEs may be mentioned. Certain obligations of firms are continuous in nature. For instance, firms have to pay value-added tax every month in Finland. Under these circumstances, legal reliefs are easily implemented by lengthening the period of time in which small firms have to fulfil this obligation. In Sweden, enterprises have advocated this kind of regulatory option already during 1990s.[25] Sometimes the legal reliefs have been implemented so that the law covers only corporations and other legal persons but not natural persons. An instance of this is Finnish Environmental Damage Insurance Act (81/1998).

Even though legal reliefs for SMEs can be justified in order to reduce the administrative burden of SMEs, they are not, of course, without problems. Let's start by the exemption of small firms from value-added tax. In Finland, the exemption has covered only enterprises with turnover below 8.500 euros. It is easy to see immediately that this kind of legal relief concerns only hobbies rather than economic life. On the other hand, in Great Britain the level of turnover threshold is much higher and approximately two million firms fall there below the threshold.[26]

Another problem due to the legal reliefs may be called *threshold effect*. It has at least two 'faces'. First, bigger enterprises have an incentive to split their activities to smaller firms in order to take advantage of legal reliefs. However, this kind of impact should not be exaggerated. Legislator may require – and often does – that small enterprises should be independent from each other in order to get the right to legal relief. Another expression of threshold effect is that small firms do not have incentive to grow since they are confronted with new legal obligations. One way to mitigate the threshold effect here – as well as above – is that the threshold varies across legislation, as it does in practice for instance in Finland.

Third problem related to the legal reliefs concerns the interpretation of legal rules. In particular, it is inevitable that borderline problems emerge in determining whether the enterprise belongs to the scope of the relief or not. Problems of interpretation may be reduced by detailed – not flexible – legislation. On the other hand, detailed legal rules may have drawbacks, too. First, detailed rules do not take into account individual circumstances in which small firms have to act. Second, detailed rules become easily outdated requiring, thus, that they have to be amended. And amendments involve administrative costs as well as legal uncertainty. Moreover, detailed rules may provide – at least sometimes - incentives to inappropriate measures to circumvent the law. On the other hand, flexible legal rules may generate problems of their own. First, it takes time before the final decision has been made in court, especially if the decision has to be made in the Supreme Court. Moreover, costs of the legal process may be a threshold for small firms to go the court. In summary, this brief analysis shows that there is not at all such thing as perfect law and the selection has to occur between imperfect options.

[24] See further Kanniainen – Määttä (2007, forthcoming).
[25] SOU 1998:78, 38.
[26] See e.g. Kanniainen – Määttä (2007, forthcoming).

Fourth problem confronted with is the *under-* or *over-inclusiveness* of legal reliefs. Sometimes reliefs are provided to the firms, which do not need for them, and sometimes firms, which may need for reliefs fall outside of them. Targeting problems should be taken into account seriously since according to the studies made e.g. in the United States regulatory costs of industry are approximately and on average two times larger that similar costs of service sector.[27]

Targeting may become a problem in the longer run, too. In particular, turnover-related reliefs are problematic since their 'threshold value' decreases under inflationary circumstances. Thus, there may emerge a need for 'inflationary corrections' in order to keep the real value of the threshold value unchanged. Another solution would be to link turnover-related reliefs to some price index. However, latter mentioned policy option has not worked well e.g. under consumption taxation.[28]

Concluding Remarks

Even though Standard Cost Method has been useful in analysing the amount of the administrative costs of firms, it has still many pitfalls. For instance, it takes into account only such legal requirements to enterprises, which are formally obligatory to the enterprises, but on the other hand, it omits such requirements, which are not formally but actually obligatory to firms. From this point of view, the results of SCM are too small in relation to the actual administrative burden.

Moreover, administrative costs are not all the costs imposed by the legislation to enterprises. So-called regulatory costs have to be taken into account completely, if the purpose is to outline the actual burden imposed by legislation to enterprises. This is also compatible with the aims of SCM: to improve the competitiveness of EU and to guarantee economic growth.

Particularly in Europe studies have concentrated on administrative costs of enterprises in total. Even though this approach is needed also in the future, more resources should be devoted to the analysis of administrative burden of SMEs separately. The main reason is simple: administrative burden seems to be very unevenly distributed among firms.

In addition, if the position of smallest enterprises is attempted to be corrected, only simplifying and streamlining legislation is not sufficient. Political and research interest should be directed more at the legal reliefs for small firms.

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[27] See also Crain (2000).
[28] See e.g. OECD (1988).

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