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HOW RED TAPE STOPS BUSINESS AND JOB CREATION

CUT RED TAPE FOR AUSTRALIA'S JOBS

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Introduction

In response to the COVID-19 pandemic, federal and state governments in Australia implemented social distancing rules and lockdown measures which forced many businesses to close with the effect of putting Australians out of work. The best available evidence shows that 8% of small businesses (those with 20 employees or fewer) stopped trading within one week of the imposition of the social distancing regulations. Additionally, some 1.6 million businesses experienced a decline to revenue in June of this year compared with the same time last year, with approximately 220,000 of those businesses experiencing a decline of at least 75%.

The result has been widespread unemployment. According to the Australian Bureau of Statistics, by mid-June, three months after the lockdowns started, 815,000 jobs were lost entirely or reduced to zero hours of work.[1] The official unemployment rate is currently 7.4%, but this counts as unemployed only those who are out of work but are actively seeking and available to work. This measure ignores those who have lost their job and have left the labour force entirely, meaning they have given up even looking for a job. When these Australians, plus those who are still technically employed but are working zero hours, are added to the official estimate, the unemployment rate rises to 11.7%.

Unemployment is more than an economic or financial problem; it is a profound social and humanitarian issue. Work is the epicenter of a good and flourishing life. Those who work are more likely to be able to afford to purchase their own home, participate in their local community, have better physiological and mental health outcomes, are less likely to become addicted to drugs and alcohol, and are less likely to commit crime and become incarcerated. Work, in a word, brings dignity.

In response to the economic downturn caused by the lockdowns, both the federal and state governments have introduced unprecedented levels of spending. Throughout April, May and June, just over half of the Australian labour force was either directly employed by Commonwealth and state governments or local councils, or in receipt of the JobSeeker unemployment payment or the JobKeeper wage subsidy.[2]

As a result of these extraordinary levels of spending, gross federal debt is expected to increase to $1 trillion within three years.[3]

Public policy must focus on getting Australians back into work and businesses operating again as soon as possible. Part of this will be achieved as the lockdown measures are ended. But there are also deeper, structural problems which predate the crisis and have undermined job and business creation in recent years.

1 Australian Bureau of Statistics, "Labour Force, Australia," cat. no. 6202.

2 Kurt Wallace and Cian Hussey, "Coronavirus Economic Update", Institute of Public Affairs, available from https://ipa.org.au/.

3 John Roskam, "$1 Trillion Worth of Debt Within Three Years," Institute of Public Affairs, 1 April 2020, https://ipa.org.au/publications-ipa/1-trillion-worth-of-debt-within-three-years.

Foremost among these problems is government regulation and red tape. Institute of Public Affairs research estimated that red tape costs the Australian economy $176 billion each year in terms of lost economic output, which is equivalent to 9.2% of GDP.[4] This makes red tape Australia's biggest industry.

The purpose of this paper is to analyse the extent to which regulation has undermined business creation in Australia. To do this, this paper develops the novel methodology of combining the business entry statistics provided by the Australian Bureau of Statistics with the count of federal regulations provided by the RegData Australia dataset. RegData provides a count of regulation by tallying the number of 'restrictiveness clauses' found in a body of legislation and its associated regulation. Restrictiveness clauses indicate a legal obligation through the use of the words "shall", "must", "may not", "prohibited", and "required". Counting those restrictions provides a proxy for the overall level of regulation.[5] This paper uses a count of regulatory restrictions contained in legislation and delegated (or subsidiary) legislation at the federal level. A more comprehensive overview of RegData can be found in Appendix A.

Based on this methodology, this paper estimates that the growth of regulation since the 2004-05 financial year is responsible for up to 398,000 businesses never being created. In other words, if regulation had been held constant – not even reduced – at 2004-05 levels an additional 398,000 businesses, in gross terms, could have been created between 2004-05 and 2018-19.

This paper also estimates that as a result of these 398,000 businesses never being created, approximately 894,400 jobs were never created between 2004-05 and 2018-19. This calculation is a conservative estimate, which assumes that all missing businesses would have been small businesses that employed on average 2.25 people each between 2004-05 and 2018-19. The assumption that all missing businesses were small businesses is based on the fact that between 2004-05 and 2018-19 small businesses made up between 97.4% and 99.7% of all business entries.[6] And the assumption of 2.25 employees per small business is based on an analysis of data from the Australian Bureau of Statistics.[7]

Between 2004-05 and 2018-19, average net employment growth was 18,450 jobs per month, meaning that these missing jobs were equivalent to just over four years' worth of job creation. These missing jobs came at a cost of $26.3 billion of wages that were never paid, based on the average annual wage per employee per small business of $29,420 between 2004-05 and 2018-19.

4 Dr Mikayla Novak, "Red Tape: The $176 Billion Tax on Our Prosperity," Institute of Public Affairs, 2016, https://ipa.org.au/wp-content/uploads/2016/12/The-176-Billion-Tax-On-Our-Prosperity.pdf.

5 See Patrick A. McLaughlin, Jason Potts and Oliver Sherouse, "RegData: Australia," *Mercatus Working Paper*, Mercatus Center at George Mason University, Arlington, VA, June 2019.

6 Australian Bureau of Statistics, "Counts of Australian Businesses, including Entries and Exits," cat. no. 8165.

7 Australian Bureau of Statistics, "Australian Industry," cat. no. 8155 and Australian Bureau of Statistics, "Counts of Australian Businesses, including Entries and Exits," cat. no. 8165.

This paper also provides two other measures which demonstrate declining rates of business creation in Australia: business density, which is measured as the number of businesses operating at a given point in time per 1,000 Australians, and the business creation rate, which is measured as the number of businesses created in a given year per 1,000 Australians.

In 2018-19 the business density rate dropped to 91.8 businesses per 1,000 Australians, from 95.9 in 2003-04 (the earliest year for business entry data). The business density rate measures the number of businesses that exist in a given year, controlled for population. A declining business density rate means there are fewer businesses per Australian, which in turn suggests the Australian economy is becoming more consolidated around a declining number of businesses, leaving Australian workers with less diverse employment opportunities and less competition for their labour, which can result in lower wages.

Similarly, in 2018-19 the business creation rate dropped to 13.7 businesses per 1,000 Australians, from 16.4 per 1,000 Australians in 2003-04. The business creation rate measures how many new businesses have been created in a given year, controlled for population. A declining business creation rate means there are fewer businesses being created per Australian, suggesting a decline in economic dynamism which is an important component of the creative destruction process that drives innovation and productivity growth.

Business creation will be essential to revitalising the economy and getting Australians back into work. There will be a natural increase to business and job creation as governments ease social distancing regulations. But this alone will not be sufficient to return economic performance, such as in relation to business investment and unemployment rates, to pre-COVID levels, much less to improve upon that performance.

This report provides five public policy recommendations to improve Australia's rate of business creation:

1. Cut red tape by implementing a one-in-two-out requirement where two rules are removed for every new rule that is introduced.
2. Reduce the corporate tax rate from 30%, which is the equal third highest in the OECD, to below 20%.
3. Carve small businesses out of the *Fair Work Act 2009* to make it easier for them to hire new staff.
4. Permanently increase the Instant Asset Write-Off from $150,000 to $1 million, and allow all businesses to access the scheme.
5. Abolish all government fees and charges incurred in establishing a business.

Regulation Prevents Business Creation

Red tape imposes significant economic and social costs. Research from the Institute of Public Affairs published in 2016 estimated that red tape costs the Australian economy $176 billion in foregone economic output each year.[8] This estimate captures all of the businesses that are never started, the jobs that are never created, and wage rises that are never given due to red tape.

Measuring red tape and regulation in a consistent and accurate manner has traditionally been a challenging task. However, in recent years the development of the RegData methodology has allowed for significant improvements in the field of regulatory research. RegData provides a count of regulation by tallying the number of 'restrictiveness clauses' found in a body of legislation and its associated regulation. Restrictiveness clauses indicate a legal obligation through the use of the words "shall", "must", "may not", "prohibited", and "required". Counting those restrictions provides a proxy for the overall level of regulation.[9] This paper uses a count of regulatory restrictions contained in legislation and delegated (or subsidiary) legislation at the federal level. A more comprehensive overview of RegData can be found in Appendix A.

By combining the RegData Australia dataset with datasets from the Australian Bureau of Statistics (ABS), this paper shows that higher levels of regulation are associated with lower levels of business creation. Business creation statistics come from *Counts of Australian businesses, including Entries and Exits*, which is published by the ABS each year and provides a count of existing businesses at the beginning and end of each financial year, along with the number of businesses that were created and destroyed over the financial year. *Australian Demographic Statistics*, published by the ABS each quarter, are used to adjust the number of existing and newly created businesses for population to analyse changing business density.

For the purposes of this paper, the business entry rate is defined as the number of businesses that were created in a given year, divided by the number of businesses that existed at the beginning of that year. This is not to be confused with the business creation rate, used later in this paper, which is calculated by dividing the number of business creations in a year by the population to give a count of new businesses per 1,000 Australians.

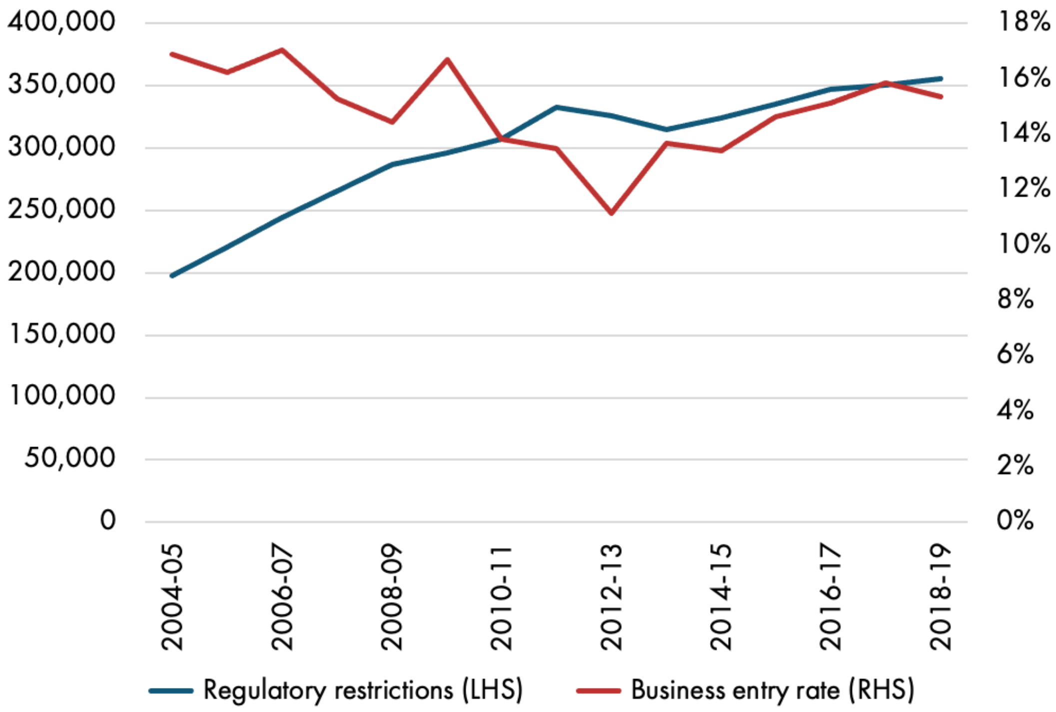
As shown in Graph 1 below, there is a correlation between changes to the volume of regulation and changes to the business entry rate. From 2004-05 (the earliest available data for subsidiary legislation in RegData) until 2011-12, regulation grew by 68.4%, from 197,658 to 332,861 restrictions. Over that period the business entry rate declined from 16.9% to 13.5% and hit a record low of 11.2% in 2012-13. Following a brief decline to regulation from 2011-12 to 2013-14, regulation began to grow again

8 Dr Mikayla Novak, "Red Tape: The $176 Billion Tax on Our Prosperity," *Institute of Public Affairs*, 2016, https://ipa.org.au/wp-content/uploads/2016/12/The-176-Billion-Tax-On-Our-Prosperity.pdf.

9 See Patrick A. McLaughlin, Jason Potts and Oliver Sherouse, "RegData: Australia," *Mercatus Working Paper*, Mercatus Center at George Mason University, Arlington, VA, June 2019.

but at a much more modest pace. Specifically, from 2013-14 to 2018-19, regulation increased by 13%, from 315,363 to 356,198 restrictions. Over this period there was a gradual improvement in the business entry rate, which increased to 15.4% in 2018-19.

Graph 1: Business entries and regulatory growth since 2004-05



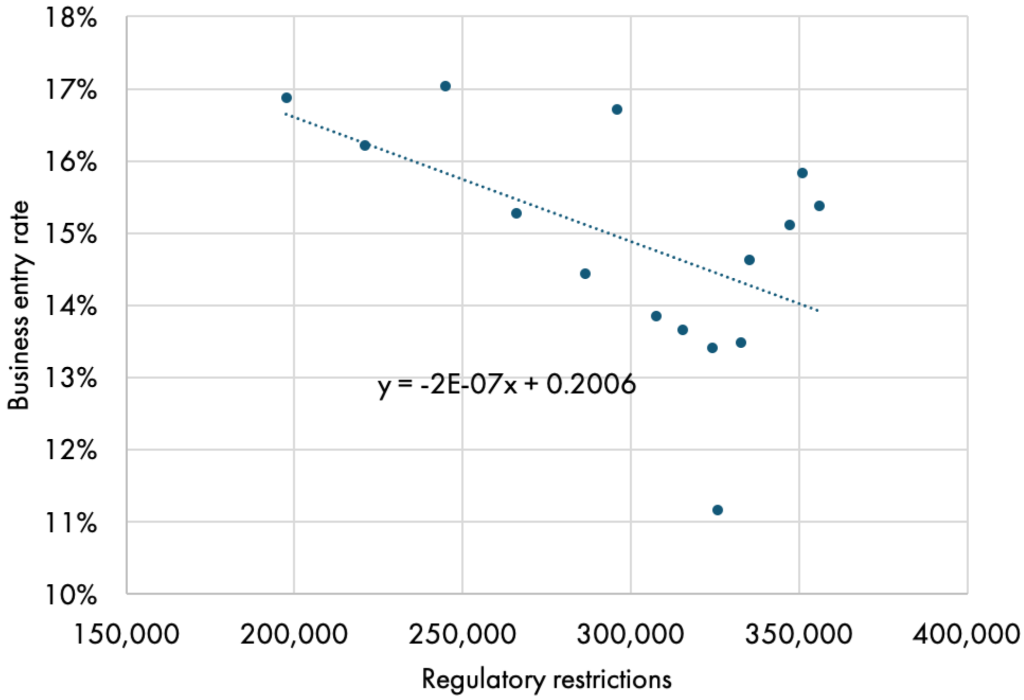
Source: Australian Bureau of Statistics cat. no. 8165, 3101; RegData Australia; IPA.

This paper uses a linear regression to model the relationship between regulation and the business entry rate. The regression, shown in Graph 2 below, estimates that if regulation remained at 2004-05 levels (197,658 regulations), the average annual business entry rate would have been 16.1%,[10] above the actual average annual rate of 14.7%.

To determine the effect of this lower rate of business creation, the absolute number of foregone business creations is calculated. The number of businesses existing at the beginning of each year is multiplied by the 'potential business entry rate' of 16.1%, calculated above. This provides a potential number of new business entries – that is, the number of businesses that could have been created in the absence of regulatory growth. The actual number of business entries is then subtracted from the number of potential business entries in each year, which provides the number of missing business entries in each year. The number of missing business entries each year are then added together, which provides a total of 397,827 missing business entries between 2004-05 and 2018-19.

10 The equation from the linear regression is: *y = -2E-07x+ 0.2006*, where y is the business entry rate and x is the number of regulations. The entry rate of 16.11% is calculated by solving for y when x is the 2004-05 regulation count of 197,658: *y = -2E-07(197,658) + 0.2006 = 0.16107.*

Graph 2: **Business entry and regulation**



Source: Australian Bureau of Statistics cat. no. 8178; RegData Australia; IPA.

Why Business Creation is Important

As mentioned above, business creation is vital to job creation. Almost all business creations are small businesses,[11] and assuming that all of the 397,827 missing businesses were small allows for a conservative estimate of the effect this has had on employment. An analysis of the ABS's *Australian Industry* and *Counts of Australian Businesses, including Entries and Exits* datasets provide the average number of employees per small business over the years 2004-05 to 2018-19, which was 2.25 employees.[12]

As a result of the missing 397,827 businesses, 894,444 jobs were never created.[13] Between 2004-05 and 2018-19, a net average of 18,450 jobs have been created each month meaning that the missing jobs are equivalent to just over four years' worth of job creation.[14] Each of these missing jobs represents $29,420 of missing wages, based on the average annual wage per employee per small business over the period 2004-05 to 2018-19. This is a total of $26.3 billion of wages that were never paid.[15]

These jobs that were never created and wages never paid pose a broader issue to the Australian economy. Fewer business creations results in less competition for workers, as indicated above, which in turn has the effect of depressing wages. Reviving business creation is an important part of reviving wage growth for Australian workers.

Entrepreneurship plays a vital role in fostering innovation. New businesses have stronger jobs growth, higher sales, higher productivity and profit, and are more innovative and collaborative than their longer-existing rivals.[16] Innovation in particular is an important contributing factor to economic growth. One study undertaken by the OECD, for example, estimated that innovation accounts for around 50% of total GDP growth.[17]

11 Between 2004-05 and 2018-19 the portion of business creations that were small businesses ranged from 97.4% to 99.7%. See Australian Bureau of Statistics, "Counts of Australian Businesses, including Entries and Exits," cat. no. 8165.

12 Australian Bureau of Statistics, "Australian Industry," cat. no. 8155 and Australian Bureau of Statistics, "Counts of Australian Businesses, including Entries and Exits," cat. no. 8165.

13 Ibid; This estimate is made by calculating the average number of employees per small business in each year and multiplying that number by the number of missing businesses. These 'missing employees' are added together to give the total number of jobs not created in the period 2004-05 to 2018-19.

14 Australian Bureau of Statistics, "Labour Force," cat. no. 6202.

15 Calculation based on Australian Bureau of Statistics, "Australian Industry," cat. no. 8155.

16 Office of the Chief Economist, "Australian Innovation System Report 2015," Department of Industry, Innovation and Science, 2015, https://industry.gov.au/Office-of-the-Chief-Economist/Publications/Documents/Australian-Innovation-System/Australian-Innovation-SystemReport-2015.pdf.

17 Meeting of the OECD Council at Ministerial Level, "OECD Innovation Strategy 2015: An Agenda for Policy Action," Organisation for Economic Co-operation and Development, 2015, https://www.oecd.org/sti/OECD-Innovation-Strategy-2015-CMIN2015-7.pdf, p. 4.

According to a 2015 paper by the Department of Industry and Science, young businesses, particularly young small and medium-sized businesses, contribute disproportionately to job growth, with the authors finding that from 2006 to 2011, 40% of job creation came from young SMEs.[18] The authors concluded that business creation is "critical for employment growth in Australia."[19]

While business creation has a number of practical benefits, such as providing new jobs and keeping prices down through competition, it is also an important social force. Entrepreneurship provides Australians with a means to create their own prosperity and a stake in their community. Business creation is central to Australia's egalitarian spirit in that, as explained by Joel Kotkin, Presidential Fellow in Urban Futures at Chapman University in Orange, California, "You do not need a Ph.D. to operate a donut shop, a gym, or a hair salon."[20] Starting a business provides an opportunity for upward mobility without any prerequisites for wealth or education. According to the 2016 Australian Census, for example, the business ownership rate among high school dropouts is higher than among those with a postgraduate degree.[21]

18 Luke Hendrickson, Stan Bucifal, Antonio Balaguer, and David Hansell, "The employment dynamics of Australian entrepreneurship," Department of Industry and Science, 2015, https://www.industry.gov.au/sites/default/files/June%202018/document/pdf/the_employment_dynamics_of_australian_entrepreneurship.pdf?acsf_files_redirect, p. 8.

19 Ibid, p. 19.

20 Joel Kotkin, "The Rebellion of America's New Underclass," *American Mind*, 8 June 2020, https://americanmind.org/essays/the-rebellion-of-americas-new-underclass/.

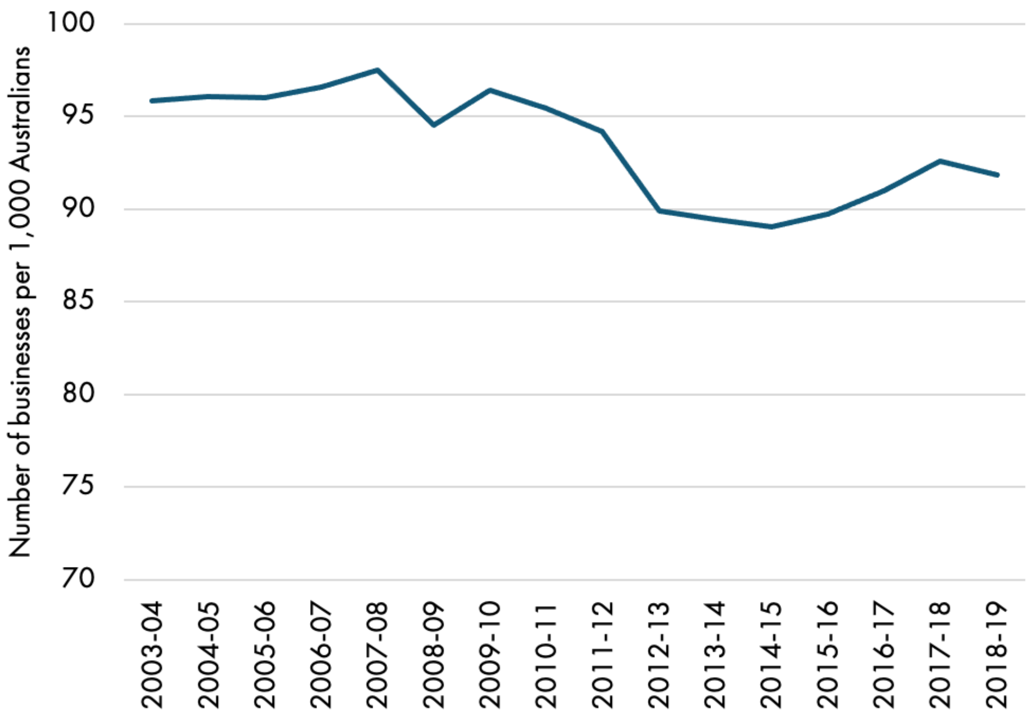
21 Australian Bureau of Statistics, "Employment, Income and Education," 2016 Census, TableBuilder.

The Decline of Business Creation

Data from the Australian Bureau of Statistics (ABS) indicates that there was a crisis of business creation before COVID-19 arrived in Australia.

Graphs 3 and 4 below show the trends of existing and newly created businesses adjusted for population. The business density rate measures the number of businesses that exist in a given year, controlled for population. ABS data shows that the business density rate declined from 95.9 businesses per 1,000 people in 2003-04 to 91.8 businesses per 1,000 people in 2018-19. A declining business density rate means there are fewer businesses per Australian, which in turn suggests the Australian economy is becoming more consolidated around a declining number of businesses, leaving Australian workers with less diverse employment opportunities and less competition for their labour, which can result in lower wages.

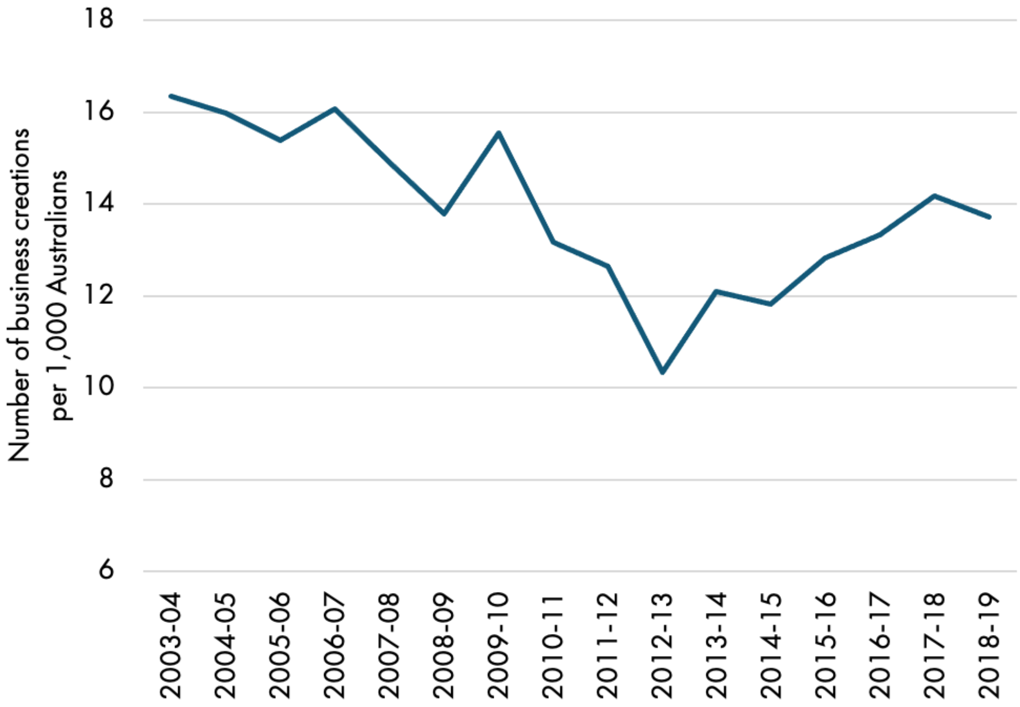
Graph 3: Business density



Source: Australian Bureau of Statistics cat. no. 8165, 3101; IPA.

In addition to having fewer businesses per capita, Australia also has fewer business creations per capita than it did in 2003-04. As shown in Graph 4 below, in 2003-04 there were 16.4 business created per 1,000 people, which dropped to 13.7 in 2018-19. A declining business creation rate means there are fewer businesses being created per person, suggesting a decline in economic dynamism which is an important component of the creative destruction process that drives innovation and productivity growth.

Graph 4: Business creation per 1,000 people



Source: Australian Bureau of Statistics cat. no. 8165, 3101; IPA.

Conclusion and Recommendations

Before COVID-19 arrived in Australia, the economy was underperforming. According to the Australian Bureau of Statistics, new private sector business investment was just 10.9% of GDP, a low not seen since the wake of the previous recession in the early 1990s. Private sector wages were stagnating. And per capita economic growth was weak reflecting Australia's dependence on population rather than productivity growth to underpin headline GDP growth.

The social distancing measures introduced to manage the spread of COVID-19 have caused many businesses to close and some 815,000 Australians to lose their job. Many of the businesses that closed during the lockdown will never be reopened, and many jobs will simply not exist for workers to go back to.

This means that business creation will be central to the economic recovery. Creating a business involves taking significant risk and most small businesses in Australia are created by the owner taking on debts that they are personally liable for. In the post-COVID-19 economy, the risk of creating a business will be even greater due to the prospect of a return to the social isolation laws in the event of a re-emergence of the virus.

There are five key policies the government should implement to foster business creation in the post-lockdown economy.

1. Cut red tape.

Red tape acts as a handbrake on economic activity, costing $176 billion in foregone output each year. Red tape disproportionately impacts small and new businesses, forcing their owners to divert time and money towards unnecessary compliance. Reducing the red tape burden will allow Australians to get back to work, start new businesses and expand existing ones. One highly successful approach undertaken in the United States is to introduce a one-in-two-out approach where two regulations are removed for every new regulation introduced.[22]

2. Reduce the company tax rate.

Australia has the equal-third highest top corporate tax rate in the OECD at 30%, far higher than the average of 23.1%.[23] The federal government should reduce this rate to an internationally competitive rate below 20%, which will incentivise entrepreneurial Australians to create their own businesses and attract higher levels of business investment which is key to job creation.

22 Daniel Wild and Cian Hussey, "The Trump Administration's Red Tape Reduction Agenda," Institute of Public Affairs, 2019, https://ipa.org.au/wp-content/uploads/2019/11/IPA-Report-The-Trump-Administration%E2%80%99s-Red-Tape-Reduction-Agenda-.pdf.

23 Organisation for Economic Co-operation and Development, "Country delegates to Working Party No.2 (Tax Policy and Tax Statistics) of the OECD Committee on Fiscal Affairs," April 2020.

3. Carve small businesses out of the *Fair Work Act 2009*.

The *Fair Work Act 2009* reduces labour market flexibility, imposes economic barriers to employment, and results in structural disincentives to hire.[24] The *Fair Work Act 2009* imposes disproportionate costs on smaller businesses by exposing them to unfair dismissal claims and locking them into high default awards. Prior to the *Fair Work Act 2009*, small businesses were exempt from unfair dismissal claims. And while their larger competitors can negotiate enterprise bargaining agreements to reduce the high labour costs imposed by default awards, smaller business to not have the resources to negotiate such agreements. Together, these factors provide a disincentive for small businesses to hire workers, and make those workers relatively more expensive compared to those at larger firms.

4. Permanently expand and increase the Instant Asset Write-Off.

The Instant Asset Write-off (IAWO) increases investment by reducing the cost of capital. Until 31 December 2020, the IAWO is available for investments valued at up to $150,000 made by businesses with $500 million or less in turnover. From 1 January 2021, the IAWO is set to be available for investments worth only up to $1,000 made by businesses with up to $10 million in turnover. The federal government should permanently increase the IAWO to $1 million and allow all businesses to access the scheme to encourage productivity-boosting investment. Evidence from overseas shows that permanently increasing asset write-off policies increases investment, employment and wages in the long run.[25]

5. Abolish all fees and charges incurred in establishing a business.

Every dollar spent on registration fees and charges could have been spent on paying wages, expanding a marketing campaign, or other essential costs of establishing and running a business. In 2018-19, it cost $488 to register a new company with the Australian Securities and Investments Commission (ASIC) and a total of 223,661 new companies were registered.[26] This implies that ASIC extracted just over $109 million from the private economy through business registration fees alone. All government-imposed fees and charges should be abolished. At a minimum, fees and charges should be payable from profits, lowering the opportunity cost of creating a business and increasing the likelihood that entrepreneurs can successfully create jobs.

24 Gideon Rozner, "Fair Work and the Right to Work," Institute of Public Affairs, 2017, https://ipa.org.au/wp-content/uploads/2017/06/IPA_Report_Fair_Work_And_The_Right_To_Work26062017.pdf.

25 See Yongzeheng Liu and Jie Mao, "How Do Tax Incentives Affect Investment and Productivity? Firm-Level Evidence from China," *American Economic Journal: Economic Policy*, vol. 11, no. 3, 2019, doi: 10.1257/pol.20170478; Giorgia Maffini, Jing Xing and Michael P. Devereux, "The impact of investment incentives: Evidence from UK corporation tax returns," Oxford University Centre for Business Taxation, January 2016, http://eureka.sbs.ox.ac.uk/6145/1/WP1601.pdf; Eric Ohrn, "The Effect of Tax Incentives on U.S. Manufacturing: Evidence from State Accelerated Depreciation Policies," *Journal of Public Economics*, vol. 180, 2019, doi: 10.1016/j.jpubeco.2019.104084.

26 Australian Securities and Investments Commission, "Annual Report 2018-19," October 2019, https://download.asic.gov.au/media/5314396/asic-annual-report-2018-19-full.pdf.

Appendix A - Introduction to RegData Australia

RegData is a database that quantifies regulations by analysing the text of legislation and subsidiary legislation (otherwise known as delegated legislation, or regulation). After first being developed for the United States and then Canada, RegData was extended to Australia and a database was created for each state and at the federal level.

By counting the number of regulatory restrictions in a given corpus of legislation and subsidiary legislation, RegData provides a clear and consistent method of measuring regulation. Regulatory restrictions are words that imply a legal obligation, in the case of RegData Australia these words are "shall", "must", "may not", "prohibited", and "required". Counting regulatory restrictions provides a more sophisticated count of regulations, compared to methods such as page counts and file size measurements.

According to its creators, "RegData's design allows users to easily combine regulatory data with many other datasets measuring possible causes and consequences of regulation."[27] As RegData is open for anyone to access, researchers around the world can explore the effects of regulation by combining it with other datasets, such as employment or productivity figures.

RegData has been used in countless academic articles published in respected journals, such as The Quarterly Journal of Economics (the oldest professional journal of economics in the English language, edited by Harvard University's Department of Economics), Review of Economic Dynamics and Public Choice.

Additionally, RegData has been referenced by a number of respected publications such as The Economist, The New York Times, The Wall Street Journal, The Australian, Forbes, Politico, The Hill, and Financial Post. It has also been referenced by The Executive Office of the President of the United States, The State of Ohio, and The State of Illinois. A number of jurisdictions across North America have used RegData to measure their regulatory reform efforts, including Idaho, Missouri, Kentucky, and Iowa.

All code used and data collected in the RegData methodology is subject to quality review.

RegData is recognised as an important and effective tool that has furthered the field of regulatory economics. It is open source, meaning that anyone can access the data free of charge. This is the basis of open and free academic inquiry and leads to a higher quality public debate.

27 Patrick McLaughlin and Omar Ahmad Al-Ubaydli, "RegData: A Numerical Database on Industry-specific Regulations for All U.S. Industries and Federal Regulations, 1997-2012," *Regulation & Governance*, vol 11, no. 1, 2017, pp. 109-123, doi: 10.1111/rego.12107.

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About the author

Cian Hussey is a Research Fellow at the Institute of Public Affairs.

He is interested in the impacts of red tape on small business, employment, and investment. His work at the IPA focuses on using RegData Australia to quantify regulation and its impacts on the economy.

Cian holds a Bachelor of Arts from The University of Notre Dame Australia, with a major in Politics and International Relations.

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