Regulatory Flexibility: What It Is And Why It Matters

According to a 2001 study funded by the Office of Advocacy, *The Impact of Regulatory Costs on Small Firms*, by Drs. Mark Crain and Thomas Hopkins, small businesses spend $6,975 each year per employee just to comply with federal regulations and mandates. That is 60 percent more than large firms.

In September 1980, Congress enacted the Regulatory Flexibility Act (RFA), which mandated that agencies consider the impact of their regulatory proposals on small entities, analyze equally effective alternatives, and make their analyses available for public comment.

The law was not intended to create special treatment for small businesses. Congress intended that agencies consider impacts on small businesses to ensure that, in their efforts to fulfill their public responsibilities, their regulatory proposals did not have unintended anticompetitive impacts and that agencies explored less burdensome alternatives that were equally effective in resolving agency objectives.

In March 1996, Congress was finally persuaded by 16 years of uneven compliance with the RFA, and by the repeated urging of the small business community, to authorize the courts to review agency compliance with the RFA. This amendment to the RFA, in the form of the Small Business Regulatory Enforcement Fairness Act (SBREFA), became law and raised the stakes for regulatory agencies. Judicial review gave the RFA "teeth" and reinforced the RFA requirement that agencies reach out and consider the input of small businesses in the development of regulatory proposals.

One of the clearest examples of how benefits can be derived from efforts to ensure compliance with the RFA comes from the Office of Advocacy's work with the U.S. Department of Transportation (DOT). In 2002, DOT published a proposed rule to revise its Computer Reservations System (CRS) regulations. DOT issued its proposed rule to examine whether the existing rules governing these systems were necessary and if so, whether they should be modified. Through small business outreach, Advocacy determined that the proposed rule had several provisions that could harm small businesses such as travel agencies. In its March 2003 comment letter, Advocacy encouraged DOT to publish for comment a revised initial regulatory flexibility analysis that identified the affected small entities, analyzed the proposal's economic impact on the small entities, and addressed regulatory alternatives that would minimize the impact on small businesses.

On January 7, 2004, DOT announced that it would deregulate the CRS industry by discontinuing most of its regulations on January 31, 2004. To ensure a smooth transition, rules governing display bias and prohibiting CRSs from imposing certain unreasonably restrictive contract clauses remained in effect until July 31, 2004. The final rule allowed travel agencies to negotiate their own contracts and receive bonuses and other incentives from CRSs. The travel agent industry was very pleased with DOT's decision and estimated that removal of the CRS rules prevented travel agents from losing $438 million annually in revenue.

Enforcing the RFA is central to the success of tearing down regulatory barriers to entrepreneurial success. By working with federal agencies to implement the RFA, the Office of Advocacy in FY 2004 saved small businesses $17.1 billion in foregone federal regulatory costs—money that can now be invested by the businesses in other productive uses.

Regulatory Flexibility and the States

While there are federal measures in place to reduce regulatory burdens on small businesses, the need does not stop at the federal level. More than 92 percent of businesses in every state are small businesses, which bear a disproportionate share of regulatory costs and burdens. However, sometimes because of their size, the aggregate importance of small businesses to the economy is overlooked. Because of this, it is very easy to fail to notice the negative impact of regulatory activities on them.
Recognizing that in addition to the federal government, state and local governments can also be a

source of burdensome regulations on small business, Advocacy drafted model regulatory flexibility legislation for the states based on the federal RFA.

The intent of Advocacy's model legislation is to foster a climate for entrepreneurial success in the states so that small businesses will continue to create jobs, produce innovative new products and services, bring more Americans into the economic mainstream, and broaden the tax base. Excessive regulation can be reduced and the economy improved without sacrificing important regulatory goals such as higher environmental quality, greater travel safety, better workplace conditions, and increased family financial security.

"This bill recognizes the vital role that small business plays in growing jobs and opportunity within the state. We must work to create an environment that fosters small business growth."—Kentucky Governor Ernie Fletcher

Many states have some form of regulatory flexibility laws on the books. However, many of these laws do not contain all of the five critical elements addressed in Advocacy's model legislation. Recognizing that some laws are missing key components that give regulatory flexibility its effectiveness, legislators continue to introduce legislation to strengthen their current systems.

According to Advocacy's state model legislation, successful state-level regulatory flexibility laws should address the following: 1) a small business definition that is consistent with state practices and permitting authorities; 2) a requirement that state agencies perform an economic impact analysis on the effect of a rule on small businesses before they regulate; 3) a requirement that state agencies consider alternatives for small businesses that are less burdensome while meeting the agency's regulatory goals; 4) a provision that requires state governments to review existing regulations periodically; and 5) judicial review to give the law "teeth."

Since 2002, 14 state regulatory flexibility laws have been signed into law,[1] 33 state legislatures have considered regulatory flexibility legislation,[2] and four executive orders have been signed by governors implementing regulatory flexibility.[3]

"This bill is all about making life easier for our state's small businesses, which is a big step forward in stimulating job creation and economic growth in South Carolina. Ultimately, though, letting those businesses keep more of what they earn so they can reinvest in new people, new equipment and new technologies is going to have the biggest impact on our state's economy."—South Carolina Governor Mark Sanford

In 2005, 18 states introduced regulatory flexibility legislation (Alabama, Alaska, Hawaii, Indiana, Iowa, Mississippi, Missouri, Montana, New Jersey, New Mexico, North Carolina, Ohio, Oregon, Pennsylvania, Tennessee, Utah, Virginia, and Washington). Alaska Governor Frank Murkowski, Indiana Governor Mitch Daniels, Missouri Governor Matt Blunt, New Mexico Governor Bill Richardson, and Virginia Governor Mark Warner signed regulatory flexibility legislation into law and Arkansas Governor Mike Huckabee implemented regulatory flexibility through an executive order in 2005.

One of the most recent examples on the state level of how benefits can be derived from regulatory flexibility laws comes from the New York Department of Health. In October 2004, New York State adopted an emergency regulation to prevent

1 These states include: Alaska; Colorado; Connecticut; Indiana; Kentucky; Missouri; North Dakota; New Mexico; Rhode Island, South Carolina, South Dakota, Virginia, and Wisconsin.

2 These states include: Alabama, Alaska, California, Colorado, Connecticut, Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Mississippi, Missouri, Montana, Nebraska, New Jersey, New Mexico, North Carolina, North Dakota, Ohio, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Utah, Virginia, Washington, and Wisconsin.

3 These states include: Arkansas, Massachusetts, Missouri (whose executive order was later superseded by legislation), and West Virginia.

prescription fraud by requiring the use of an official state prescription form for all prescriptions issued in New York. These forms have a security feature used to curtail alterations and forgeries which often divert drugs to the black market and result in the sale to unsuspecting consumers. This type of fraud also costs New York's Medicaid program and private insurers tens of millions of dollars annually in fraudulent claims.

Under New York's Administrative Procedure Act and an Executive Order signed by Governor Pataki, the Department of Health was required to perform a regulatory flexibility analysis for small business. As a result of its analysis, the agency found that the proposed regulation would affect a variety of small businesses such as practitioners, pharmacists, retail pharmacies, hospitals, and nursing homes.

Therefore, in drafting the regulation, the Department of Health met with and considered comments from the affected small businesses. By consulting with small business throughout the rule writing process, the agency was able to craft a regulation that met its goals without unduly burdening small entities.

As a result of this collaborative effort, the Department of Health promulgated a rule that took into account the uniqueness of small businesses by establishing a grant administered by the agency to defray costs for software adjustments faced by small pharmacies; eliminating the official prescription fee for small practitioners and institutions; and allowing small practitioners, pharmacists, retail pharmacies, hospitals, and nursing homes 18 months to transition to the new prescription form system.

Under the Serialized Official New York State Prescription Form regulation, private insurers and the Medicaid program are expected to save millions of dollars by reducing fraudulent prescription claims while at the same time benefiting the state, its citizens, and private insurers.

A vibrant and growing small business sector is critical to creating jobs in a dynamic economy. Small businesses are 99.7 percent of all businesses, employ half of the work force, produce 52 percent of the private sector output, and provide significant ownership opportunities for women, minorities, and immigrants.

"Small business is the dynamo that powers our economy and every dollar a small business puts towards complying with cumbersome government regulations is a dollar that cannot be spent expanding the business, providing benefits, or hiring new employees. I sponsored HB 33 because I see smarter regulations as an economic development tool and strongly feel that we can add an awareness of the needs of small businesses to the regulatory process without compromising the health, safety, or welfare of the public."
—Alaska Representative Kevin Meyer

Advocacy welcomes the opportunity to work with state leaders on their regulatory issues. In addition to this report, the text of Advocacy's model legislation and frequently updated versions of the state regulatory flexibility legislative activity map can be found on Advocacy's website at **http://www.sba.gov/advo/laws/law_modeleg.html**.