

An Economic Analysis of Business Exemptions from Public Policies - UPDATE

Donald Bruce, Ph.D.

**Associate Director, Boyd Center for Business and Economic Research
Douglas and Brenda Horne Professor of Business, Department of Economics
The University of Tennessee
Knoxville, TN
dbruce@utk.edu**

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EXECUTIVE SUMMARY

The free enterprise system requires a network of regulations to protect firms, consumers, and markets from the dangers of unbridled self-interest. It is no surprise that compliance with these regulations can be quite costly, especially for new and/or small businesses. In recognition of these costs and of the fundamental importance of small businesses to the American economy, virtually every regulation provides an exemption for businesses that are sufficiently small by some objective standard. Many of these exemptions are based on the number of employees in a particular business, while some are based on such things as total receipts.

To be sure, exempting certain businesses from costly regulations or requirements certainly makes sense. This is especially true in light of recent efforts to require businesses to pay their “Fair Share of Health Care” or pay costly flat-amount “Head Taxes.” The fact remains that some businesses, and especially those in highly competitive sectors, are not able to afford the high cost of compliance. But although exemptions are necessary, the variety of exemption rules currently on the books is arbitrary, inconsistent, and unfair. Given the stakes involved in such things as employer requirements to offer employee health insurance coverage, it continues to be important to step back and ask the fundamental questions of whether and how to most effectively determine business exemptions from major regulations.

In this report, I provide an updated look at my 2010 analysis of the economics of business exemptions from public policies (Bruce, 2010). I examine current exemption policies and briefly describe the *ad hoc* nature of many of them. I revisit the arguments in favor of exemptions, and then turn to an exploration of the implications of the exemptions for such things as regulatory compliance and distortions of business activity. I conclude by identifying what I view as a more efficient and equitable way to handle business exemptions from public policies.

Several themes emerge from an examination of several recent large-scale data sources:

- The bright-line nature of exemption thresholds fails to recognize variation in business models across industries. Some industries are characterized by a smaller number of extremely large firms, while others are made up of a larger number of smaller firms. Regulations that use employment thresholds for exemption policies will thus have uneven applicability across sectors.
- Distributions of businesses by employment size also differ considerably across states. As a result, exemption standards that are based on employment will therefore place a higher relative compliance burden on states that tend to have larger establishments.

- Employment size is not necessarily correlated with receipts size. In other words, an apparent lack of variation from the overall employment size distribution in certain industries masks what is often substantial variation in receipts.

It is important to recognize that exemptions based on the number of employees or total business receipts will necessarily exempt some highly-profitable firms in some industries while failing to exempt some larger but less-profitable firms in other sectors. A more modern and defensible exemption standard should therefore be driven by a consideration of each firm's ability to bear the burden of compliance.

Exemption standards should have the following major features:

- Exemptions should be based on data that are easily and fairly measured for each firm. Ideally, the data required to prove eligibility for an exemption should be drawn from sources that are regularly reported by businesses in a systematic and uniform fashion regardless of firm size, type, industry, or location.
- A better exemption system should minimize incentives to become or remain exempt, as these distortions to business activity can create significant economic losses.
- A modern system of business exemptions should also build in opportunities for discretion, as opposed to a network of inflexible rules.

Profits per FTE employee (henceforth, PPE) would be a superior measure of a firm's ability to bear the burden of regulatory compliance because it simultaneously captures ability to pay and size. It is also based on data elements (profits and employment) that are regularly reported by all types of firms on annual tax forms. A focus on PPE is motivated in part by a recognition that average employment and profits per employee appear to be inversely related. Some sectors are characterized by above-average profits per employee and below-average employment, while others have low PPE and high employment.

The selection of an appropriate exemption standard comes down to a tradeoff between the benefits from having more businesses comply with a particular regulation and the benefits from protecting certain businesses from the burden of compliance. The current labyrinth of exemption standards is arbitrary, inconsistent, and unfair. And the prominent use of employment size standards gives businesses strong incentives to remain small, and thus exempt from key regulations or requirements. Moving to a PPE-based exemption system could provide considerable benefits in terms of fairness, efficiency, consistency, and simplicity, yielding savings for businesses while preserving the intent of the regulatory system.

1. Introduction and Overview

The free enterprise system requires a network of regulations to protect firms, consumers, and markets from the dangers of unbridled self-interest. It is no surprise that compliance with these regulations can be quite costly, especially for new and/or small businesses. In recognition of these costs, and of the fundamental importance of small businesses to the American economy, virtually every regulation provides an exemption for businesses that are sufficiently small by some objective standard. Many of these exemptions are based on the number of employees in a particular business, while some are based on such things as total receipts.

Any system of regulatory exemptions runs the dual risk of (a) granting exemptions to some businesses that could easily comply with the regulation and (b) requiring some businesses to comply even when they are financially or otherwise unable to bear the regulatory burden. An additional concern is that exemption standards for particularly costly regulations could impact business decisions about expansion and growth, to the extent that they have an economic incentive to remain sufficiently small.

It seems obvious that exempting certain businesses from costly regulations or requirements makes good sense. Regulations or policies that lack exemption standards run the risk of causing some businesses to shut their doors. This is especially concerning in highly competitive sectors characterized by lower profit margins. But although exemptions are necessary, the variety of exemption rules currently on the books is arbitrary, inconsistent, and unfair. A new exemption standard is needed that provides clarity and uniformity to the business community. It is difficult to imagine that any chosen exemption standard could possibly be free of the various risks and concerns outlined above. That said, it is easy to imagine an equally clear standard that is more uniform than the current patchwork quilt of regulatory exemption policies—one that is also more efficient and equitable.

In this report, I provide an updated look at my 2010 analysis of the economics of business exemptions from public policies (Bruce, 2010). I examine current exemption policies and briefly describe the *ad hoc* and non-systematic nature of many of them. I revisit the various arguments in favor of business exemptions, and then turn to an exploration of the implications of the exemptions for such things as regulatory compliance and distortions of business activity. I conclude by identifying what I view as a more efficient and equitable way to handle business exemptions from public policies.

2. Business Exemptions in the Current Regulatory Environment

Business exemptions are typically based on the number of employees or total receipts at the firm or establishment level. I briefly list several prominent examples here to demonstrate the variety of exemption statutes in existence.

Minimum Wage and Overtime Pay. The Fair Labor Standards Act of 1938 established a national minimum wage which has been increased several times. The FLSA also guarantees time-and-a-half overtime pay for most jobs. Employers with over \$500,000 in annual sales or with employees working in interstate commerce must abide by these provisions. Interestingly, exemptions from these provisions are typically based on the sector or type of job rather than the size of the employer.¹

Family and Medical Leave. The Family and Medical Leave Act of 1993 requires most employers to grant eligible employees up to 12 weeks of unpaid leave during a 12-month period for a variety of family and medical reasons (most commonly childbirth).² Employers with fewer than 50 employees working at least 20 calendar weeks in the current or preceding calendar year are generally exempt from the FMLA requirement.

Title VII of the Civil Rights Act of 1964. This landmark provision prohibits discrimination by covered employers on the basis of race, color, religion, sex, or national origin.³ Interestingly, Title VII only applies to employers with 15 or more employees working 20 or more weeks in the current or preceding calendar year.

Payroll Taxes on the Self-Employed. While self-employed workers were not subject to payroll taxation under the original provisions enacted in 1935, the Self-Employment Contributions Act of 1954 officially brought the self-employed into the financing system for Social Security. However, an exemption that was part of that original legislation and continues today is that those with less than \$400 in combined self-employment income are exempt from having to pay SECA taxes.

Sarbanes-Oxley Act of 2002. Section 404b of this historic set of requirements that arose out of the Enron and Worldcom scandals requires an external audit of the management report on internal control that is mandated by Section 404a. However, firms with less than \$100 million in revenues have been exempted from Section 404b (broadened from \$75 million in early 2020).

Employer Health Insurance. Under Patient Protection and Affordable Care Act (PPACA), employers with 50 or more full-time-equivalent (FTE) employees working at least 30 hours per week face fines if they fail to offer suitable health insurance coverage to their workers.

These are just a few examples of the many and varied business exemption policies currently in effect. A more exhaustive survey of the current regulatory environment would surely yield an even more varied list of exemption rules, each one having been established seemingly independently of the others. The variety of exemption rules is interesting, but perhaps more important is the apparent lack of thorough justification for any one of the rules. Given the

¹ For more details, see https://www.dol.gov/sites/dolgov/files/WHD/legacy/files/overtime_complianceguide.pdf.

² For more details, see <https://www.dol.gov/sites/dolgov/files/WHD/legacy/files/whdfs28.pdf>.

³ For more details, see <http://www.eeoc.gov/laws/statutes/titlevii.cfm>.

stakes involved in such things as employer requirements to offer employee health insurance coverage, it continues to be important to step back and ask the fundamental questions of whether and how to most effectively determine business exemptions from major regulations.

Sometimes a business exemption standard can be so problematic that it prompts additional policy action to bring more businesses into compliance. Indeed, several recent policy actions have been undertaken by state and local governments without any sort of exemption policy, and in direct response to an exemption standard they deem as unfair. Examples include “Fair Share Health Care” legislation and fixed-amount taxes (i.e., “Head Taxes”) that are designed to ensure that all businesses contribute at least some minimum amount to certain public services, typically health insurance. Not only are many of these efforts intended to apply to a larger share of businesses (and in some cases, all businesses), they appear to be motivated at least in part by the presence of other exemption standards that allow seemingly-profitable businesses to avoid particularly costly regulations and requirements.

These politically-popular policies might seem reasonable on paper, but they are blind to the very real variation within and across industries and states in business profitability and ability to pay. Importantly, they place greater relative burden on the most competitive industries in which profit margins are lowest. With this in mind, it is worthwhile to revisit the economics behind business exemption policies in order to lay a foundation for potential improvements.

3. The Economics of Business Exemptions

The regulatory compliance burden on small businesses permeates nearly every policy discussion at some point. Indeed, the Regulatory Flexibility Act (RFA) of 1980 requires an analysis of the costs of new regulations on small businesses (generally as defined by the Small Business Administration) before Congress can implement them.⁴ But if the regulation in question provides an important benefit to the economy, one might ask the fundamental question of why *any* businesses should be exempted.

Several studies have concluded that the costs of compliance are higher for smaller businesses.⁵ Regulatory compliance is largely a fixed-cost burden, so costs per employee end up being much higher for firms with fewer employees. With this in mind, it is useful to consider how some businesses might respond to a regulation. Consider the Affordable Care Act’s employer health insurance mandate as an illustrative example. A business with fewer than 50 full-time employees need to incur the expense of offering health insurance, while larger businesses must offer insurance or pay a fine. How might businesses respond?

⁴ See Shive (2006) for a thorough discussion of the origin, goals, and continuing challenges of the RFA.

⁵ Crain and Crain (2014 and 2010) echo earlier results from Crain (2005), Hopkins (1995), and Crain and Hopkins (2001), finding that per-employee compliance costs vary significantly by employment size group and industrial sector. Specifically, they consistently estimate that average total compliance costs fall as the employment size of the business increases. Bradford (2004) concludes that the evidence suggests the presence of enduring economies of scale in the cost of compliance that are largely due to fixed rather than variable components.

First, a business that is required to offer health insurance might attempt to shift the regulatory burden forward to consumers through higher prices for what they sell, or backward to input suppliers through lower prices for the inputs they buy. These options create unfair advantages for exempt businesses that can maintain lower output prices, and generate additional unfair advantages for businesses in less-competitive industries that have more power over input and output prices. More competitive industries will obviously have less power over these prices and will have to turn to other options.

Some businesses might try to change their input mix away from the relatively more costly workers toward less costly capital inputs that do not require health insurance. One option would be to simply lay off workers in order to become exempt from the health insurance requirement.⁶ Other businesses might bear the compliance burden by eating into their profit margins, potentially reducing returns for owners and investors. As a last resort, some businesses might relocate away from the US toward areas without the health insurance requirement. Others might go out of business entirely.

Regardless of these very real economic incentives in the presence of some form of size-based regulatory exemption, these small firm protections are often inserted in order to guarantee passage of an otherwise controversial policy. The exemptions give political cover to those who favor the regulation, and effectively place more of a compliance burden on the larger firms that are obviously able to bear the cost of compliance. Rarely are they based on meaningful research, and rarely are they subjected to considerable scrutiny.

Bradford (2004) provides a useful discussion of the merits of a diverse system of exemptions that are individually tailored to each regulation in question. That said, while Bradford (2004) provides the framework for a diverse set exemption policies, the theoretically optimal system would almost certainly not align with the current patchwork quilt of independently-determined exemption policies.

Importantly, little to no evidence exists on the extent to which specific business exemption policies have led to desirable outcomes. Specifically, if an exemption policy is intended to protect smaller or newer business entities, one might be interested to know how many such firms were protected or how many jobs were saved by a particular exemption. On one hand, the benefits created by requiring a broader set of firms to comply with a particular regulation might be enough to offset the costs incurred if some firms choose to close their doors rather than comply. On the other hand, the benefits from exempting a larger group of firms might be enough to offset the potential costs that arise from firms changing their behavior in order to comply or become exempt.

⁶ Gao, Wu, and Zimmerman (2009) provide evidence that the small-firm exemption in the Sarbanes-Oxley Act of 2002 gave small firms clear incentives to stay small. Firms were able to remain below the exemption threshold by engaging in a wide array of legitimate activities.

Regardless of these tradeoffs, the bright-line nature of each exemption threshold fails to recognize variation in business models across industries. Some industries are characterized by a smaller number of extremely large firms, while others are made up of a larger number of smaller firms. I return to this issue in the next section.

4. A Closer Look at the Size Distribution of American Businesses

Even though prior studies have shown that regulatory compliance costs are inversely related to firm size, it does not necessarily follow that any particular regulatory exemption should be based on firm size. The imposed burden of a regulation need not be directly correlated with firm size. In this section, I provide an updated overview of the current size distribution of American businesses using several prominent publicly-available data sources. The purpose of this part of the analysis is to demonstrate the variety of size distributions across several common measures of size (including employment, receipts, and payroll), and also to document variations in these distributions across industrial sectors and states.

Table 1 below provides a wealth of data on the distribution of business activity by the employment size of the establishment.⁷ The data, which are drawn from the 2019 County Business Patterns data made available by the Census, include the number of establishments, employees, and amount of annual payroll within each employment size class. Data are based on employer establishments only and are shown for the US as a whole and by major industrial sector.⁸ Note that 94.4 percent of all establishments have fewer than 50 employees. That said, those establishments hire only 39.4 percent of all employees and pay only 32.1 percent of total annual payroll. Policies that exempt establishments with fewer than 50 employees will thus only cover about 5.6 percent of all establishments but will cover about 60.6 percent of all employees.

The data in Table 1 highlight the significant differences in establishment size distributions across sectors. Several sectors, including Utilities; Manufacturing; and Management of Companies and Enterprises; are characterized by larger establishments (at least as defined by the number of employees. Specifically, only about 79 to 86 percent of employer establishments in these sectors have fewer than 50 employees, and those establishments only contain about 12 to 25 percent of all employees. Other sectors are made up of smaller establishments, including Agricultural, Forestry, Fishing, and Hunting; Real Estate and Rental and Leasing; and Other Services (Excluding Public Administration). In these sectors, 98 to 99 percent of all employer establishments have fewer than 50 employees, and those establishments hire 62 to 73 percent of all employees. Regulations that use employment thresholds for exemption policies will thus have uneven applicability across sectors.

⁷ Note that business entities, commonly referred to as *firms*, are often collections of *establishments*. Data are provided in this report for both firm and establishment size categories.

⁸ While about three-quarters of all US firms are non-employer firms, they typically account for less than five percent of total business receipts and are thus tabulated separately by Census and other data sources. We return to this issue below.

Table 2 shows similar data by US state, revealing that employment-based exemption standards will also have uneven applicability in geographic terms. While the percentage of employer establishments with fewer than 50 employees varies only slightly across states, the employment and payroll shares of those establishments can vary significantly. For example, employer establishments with fewer than 50 employees in the District of Columbia only hire about a third of all employees in DC while those in Montana and Wyoming hire about 60 percent of all employees. Business exemptions that are based on establishment employment in isolation will therefore place a higher relative compliance burden on states that tend to have larger establishments.

Exemptions can also be based on firm-level (as opposed to establishment-level) employment. The Small Business Administration works with the Census to provide an array of firm-employment-size data through the Statistics of US Businesses (SUSB) program. Table 3 provides a similar set of data to that in Table 1, but for size categories that are based on firm rather than establishment employment.⁹ While the available size categories for the 2007 SUSB data at the industry level do not include 50, we can explore the percentages of activity among firms with fewer than 20 and fewer than 100 employees (among others outside this range). Interestingly, the themes that emerge from the data in Table 3 mirror those in Table 1. The same sectors tend to have larger or smaller firms (Table 3) as well as establishments (Table 1).

Of course, business exemptions are not always based on establishment or firm employment. Fortunately, one advantage of the SUSB is that data are available for another measure of firm size: total receipts. Table 4 provides data by receipts size class. Note that 73.4 percent of employer firms (containing 56.2 percent of establishments) have total receipts below \$1 million. Those firms only hire 11.3 percent of all employees and pay 6.0 percent of all payroll. They also bring in only 3.5 percent of all receipts.

On the surface, it appears that sectors that tend to have smaller firms in terms of receipts also tend to be smaller by employment standards, and sectors that tend to have larger firms in terms of receipts also tend to be larger by employment standards as well.¹⁰ A closer look reveals an important lesson from the comparison of Tables 3 and 4: employment size is not necessarily correlated with receipts size. In other words, an apparent lack of variation from the overall employment size distribution in certain industries masks what is often substantial variation in receipts.

As one example, looking across the major industry groups, Agriculture, Forestry, Fishing, and Hunting has the second-highest percentage of firms with fewer than 20 employees (at 93.6 percent and tenth-lowest percentage of firms with less than \$1 million in receipts (at 72.1 percent). Conversely, a few sectors (namely Educational Services, Arts, Entertainment, and Recreation, and Accommodation and Food Services) have similar percentages of firms with

⁹ The SUSB data, like the County Business Patterns data, exclude non-employer firms.

¹⁰ My earlier report revealed similar trends by annual payroll size classes, but similar updated data by payroll size were not available for the present analysis.

fewer than 20 employees and less than \$1 million in receipts. Additionally, the pairwise correlation coefficient between the percentage of firms with fewer than 20 employees and the percentage of firms with less than \$1 million in receipts is only about 0.85 across all industry groups. I return to this issue in greater detail below.

Recall that all of the tables discussed thus far exclude non-employer establishments or firms, which make up about three-quarters of all American businesses. Business exemption policies that are based on something besides employment might encompass some of the non-employers, however, so it is important to investigate more inclusive data sources to get a better sense of the overall distribution of businesses. Perhaps the best all-inclusive publicly-available aggregated data source on businesses is the Internal Revenue Service Statistics of Income Integrated Business Data (IBD), based on combined tax returns filed by a wide variety of types of businesses.¹¹ While the most recent IBD information is based on the 2015 tax year, those data have not been made available by the size of business (defined by receipts) since 2003.

Because the IBD represents the only source of a uniform set of information for employer and non-employer firms alike and is also the only source of reliable data on net business income (profits and losses), I briefly highlight the themes from the 2003 data here, as originally discussed in my earlier report. First, while large businesses (i.e., those with more than \$500,000 or \$1 million in total receipts) represent only a small percentage of total business, they report the vast majority of all gross and net income and payroll and pay the lion's share of total taxes. However, the concentration of profits among the largest businesses varies substantially across the major industrial sectors. While some sectors are characterized by heavily concentrated profits among the largest businesses, other sectors have decidedly broader distribution of total profits by business size. This highlights the basic idea that exemptions based on the number of employees or total business receipts will necessarily exempt some highly-profitable firms in some industries while failing to exempt some larger but less-profitable firms in other sectors.

5. Desirable Features of a More Efficient and Equitable Business Exemption System

With the preceding data analysis in hand, I now turn to a consideration of a framework for a more equitable and efficient system of granting business exemptions. The unfortunate reality is that the readily-available measures of firm size—Employment, receipts, and payroll—all have their shortcomings. Our focus is therefore on a concept of ability to pay, because any exemption standard should be driven by a consideration of each firm's ability to bear the burden of compliance.

¹¹ The IBD includes information for incorporated businesses taken from corporate income tax returns and for other business entities drawn from individual tax returns.

Exemption standards should be based on something easily and fairly measured for each firm. Ideally, the data required to prove eligibility for an exemption should be drawn from sources that are regularly reported by businesses in a systematic and uniform fashion regardless of firm size, type, industry, or location. Candidate data sources might, therefore include such things as financial statements or tax returns. A better exemption system should also minimize distortions to business activity, such that incentives to become or remain exempt create economic losses.

A modern system of business exemptions should also build in opportunities for discretion, as opposed to a network of inflexible rules. For example, exemptions based on profit or sales levels should recognize that businesses often experience ebbs and flows that might be driven by external macroeconomic forces rather than their own actions. Also, businesses that are not exempt should be given opportunities to apply for special-case or good-cause exemptions.

Despite the fact that businesses of varying legal form and size all face different data reporting requirements, they all have to file some kind of tax return that enumerates such things as their gross receipts, expenses, and net profits. And business taxes are always based on some concept of net profits. It seems obvious that the primary measure of ability to pay taxes might also be the best candidate for measuring a firm's ability to comply with costly regulations. That said, a firm's profit level is not a sufficient indicator of ability to pay. Two firms with the same profit level in dollars might have widely different abilities to pay depending on their size.

Profits per FTE employee (henceforth, PPE) would be a superior measure of a firm's ability to pay because it simultaneously captures ability to pay and size. It is also based on data elements (profits and employment) that are regularly reported by all types of firms on annual tax forms¹² Also, using a tax-based (rather than book-based) measure of profits ensures that the resulting value of PPE is calculated consistently for business entities of varying types and forms.

Ideally, exemptions would be granted on the basis of a multi-year history of PPE data rather than a single year, in recognition of the cyclicity of business profits and employment. Using a three-year or five-year average, for example, would reduce a firm's ability to change its operations in a single year in order to qualify for an exemption. It would also reduce the impact of unusually good or bad "outlier" years on the extent to which businesses are granted exemptions. New firms could also be granted exemptions until they build up sufficient historical PPE data. Policy makers might also consider opt-in provisions to smooth the transition from current exemption standards to a new PPE-based standard. It might also be worthwhile to follow other elements of the tax code by building in phase-ins and/or phase-outs to smooth out sharp cliffs in eligibility standards and minimize distortions to firm behavior.

¹² While total FTE employment is not reported on the tax return directly (only total wages and salaries are listed as an expense item), the IRS receives W-2 forms for each employee and thus already gathers information on total employment. To be sure, a mechanism would need to be established by which total employment and total compensation as reported in tax forms would be converted to a measure of FTE employment, perhaps by considering average annual compensation by industry.

6. Employment vs. Profits per Employee (PPE) as Foundations for Business Exemptions

Figure 1 shows average employment per business entity by major industrial sector as of 2015, where total employment is approximated by summing total employment in employer establishments with the number of non-employer establishments. This method essentially assumes that each non-employer establishment has only one employee.¹³ The average number of employees per business across all industries is 4.2 when calculated in this manner, with the highest averages being observed in such sectors as Management of Companies and Enterprises; Utilities; and Manufacturing.

To demonstrate the fact that total employment is a weak proxy for ability to pay, Figure 2 shows profits per employee by major industrial sector for the same year, 2015. In this figure, profits are drawn from IRS-SOI Integrated Business Data, while total employment is approximated exactly as in Figure 1 above. The average value of profits per employee is \$21,197 across all industries, but ranges from a low of \$1,248 in Educational Services (ignoring the negative values in Mining and Utilities) to a high of \$133,175 in Finance and Insurance.

It is important to observe the large number of sectors for which average employment (Figure 1) and profits per employee (Figure 2) appear to be inversely related. For example, note that the Real Estate and Rental and Leasing; and Agriculture, Forestry, Fishing, and Hunting sectors are all characterized by above-average profits per employee and average employment that is well below the overall average. Businesses in these sectors would tend to qualify for employment-based exemptions from various regulations, despite the fact that they tend to enjoy some of the highest profit levels per employee.

At the same time, businesses in several sectors including Utilities, Educational Services and Accommodation, Food Services, and Drinking Places are characterized by high average employment and very low profits per employee. Businesses in these sectors would not likely be exempt from employment-based exemptions but would obviously face significant difficulty in covering the compliance cost of new regulations due to very low profit margins. Interestingly, at least some of these industries appear to be highly-competitive sectors in which price power is not likely to be enjoyed by any one supplier. Conversely, it is feasible that those with higher profits per employee and lower average employment are characterized by relatively more price power and less competition. A complete analysis of this possibility is beyond the scope of this report but would be an interesting and worthwhile topic for future research.

7. Summary and Conclusions

Just as regulations are a necessary component of our free enterprise system, exemptions are a necessary component of some of the more costly regulations. The appropriate exemption standard comes down to a tradeoff between the benefits from having more businesses comply

¹³ The trends in Figure 1 are qualitatively identical when non-employer firms are ignored.

with a particular regulation and the benefits from protecting certain businesses from the burden of compliance. The current labyrinth of exemption standards is somewhat arbitrary, inconsistent, and unfair. And the prominent use of employment size standards gives businesses strong incentives to remain small, and thus exempt from key regulations or requirements. Additional distortions to business activity represent significant efficiency losses that could be minimized with a more modern approach to exemption policies.

A better exemption standard would be based not only on the size of the business, but also on that business' ability to bear the costs of compliance. Simply exempting businesses below a certain employment or receipts threshold ignores the variation in true ability to pay, and conveys unfair advantages to businesses in less competitive industries.

Given that our system of business taxes is based on net profits, it seems obvious that exemption standards should follow suit. Profits per employee takes this a significant step further by accounting for the size of the enterprise. Both profits and employment are reported by all business entities to the IRS each year. The data are readily, consistently, and accurately available for firms of all sizes and legal forms. Additional modernizations could include the use of a multi-year history of PPE, phase-ins or phase-outs to smooth out exemption "cliffs" that distort business activity, or an opt-in structure through which businesses apply for exemptions to certain regulations or requirements.

While transition policy would need to be designed in order to hold businesses relatively harmless, moving to a PPE-based exemption system could provide considerable benefits in terms of the fairness, efficiency, consistency, and simplicity. This would yield dividends for businesses while preserving the intent of the regulatory system.

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