Submission

to

Senate Employment, Workplace Relations and Education Legislation Committee

Inquiry into the provisions of the Workplace Relations Amendment (Protecting Small Business Employment) Bill 2004

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Australian Government

TERMINATION, CHANGE AND REDUNDANCY

APPLICATION 784 OF 2004

COMMONWEALTH SUBMISSION MATERIALS

[13 OCTOBER 2004]

OVERVIEW

On behalf of the Commonwealth, the Minister for Employment and Workplace Relations sought and was granted leave to intervene in these proceedings pursuant to Sub Section 30(2) of the *Industrial Relations Act 1979* in relation to three claims made by the Trades and Labour Council of Western Australia (the TLC). These three claims are:

- That severance pay should apply to businesses with fewer than 15 employees (Subclause 4.4 of Schedule B to the TLC's application);

- That when businesses are transmitted, severance pay should be paid to employees who are employed by the transmittee under an Australian workplace agreement (AWA), a certified agreement (CA) or federal award (Subclause 4.7 of Schedule B to the TLC's application); and

- That the severance pay scale should provide 16 weeks' pay for retrenchees with 10 or more years' service, rather than step down from 16 weeks to 12 weeks' pay for these retrenchees (Subclause 4.4 of Schedule B to the TLC's application).

As detailed in previous submissions to this Commission, the Commonwealth sought to intervene in relation to these specific claims because they have the potential to impact significantly on the Commonwealth's interests. In relation to other claims sought by the TLC in this case, the Commonwealth takes no position on the merits of the claims and leaves them to the determination of the Commission.

The Commonwealth is opposed to each of the three TLC claims outlined above for the following reasons:

Small business cannot afford to pay severance pay

- A substantial body of research and evidence shows that small businesses have a relative lack of financial resilience. Small businesses experience relative difficulty in obtaining finance on reasonable terms, leading in turn to chronic undercapitalisation. As a consequence, many small businesses have less capacity to put funds aside for contingent liabilities, and are unable to withstand sudden financial shocks such as the need to fund significant severance payments.

- Industrial tribunals have repeatedly recognised that small businesses are less able than larger businesses to bear the costs of severance pay because of this relative lack of financial resilience.

- The direct cost of the claim to small businesses who retrench in a given year would be very significant. Even the average cost impact on small businesses that retrench employees in any year would be about 3.1 per cent of their total annual wages bill under recessionary conditions and about 2.0 per cent under current favourable economic conditions.

- Small businesses are less able to redeploy employees, to divest parts of the business or to cross-subsidise within the business. Small businesses are confined more tightly than larger businesses to their core activities and structures.

- The imposition of severance pay obligations on small businesses would affect the financial viability of firms and would deter risk taking, business expansion and innovation. It would also provide a significant disincentive to employ additional staff.

- In the limited circumstances where severance pay is affordable and feasible for small business, enterprise bargaining is available for employers and employees to negotiate severance pay. Allowing bargaining to test affordability in this way is far more preferable than removing the exemption and imposing an across the board obligation on small businesses that cannot afford severance pay.

The AIRC's test case decision to remove the small business exemption is wrong and should not be adopted

- The central flaw in the AIRC's decision is to confuse profitability with the capacity to make severance payments. Even if small businesses are generally profitable, it does not mean that they are able to cope with the imposition of severance pay on an ongoing basis.

- The reason why the small business exemption was originally established is because small businesses generally lack the financial resilience to cope with large unpredicted impositions such as severance pay. It was not because small businesses are generally unprofitable.

- The AIRC's decision seriously misinterprets the findings of key research including a survey commissioned by the Australian Industry Group (AiG).[1] The decision states that the survey found that more than 90 per cent of the small companies who responded to the survey made severance payments. In fact, the survey showed that over 90 per cent of the small businesses did not pay severance pay. This is a very

[1] Ibid, paragraph 227.

serious mistake. What the AIRC took to support its conclusion that small businesses could cope with severance payments in fact indicates the opposite.

- The final consideration given by the AIRC in support of its conclusion was the absence of evidence of problems where the exemption does not operate such as in South Australia. The fundamental premise of this consideration is flawed. Many factors combine to determine the relative performance of small businesses and neither the data nor the complex analysis required to disentangle the effects of each of these factors has been undertaken.

The incapacity to pay process is not an effective substitute for the small business exemption

- The AIRC's decision suggests that small businesses that are unable to meet their severance pay obligations can seek relief through the incapacity to pay provision, as amended by the AIRC's decision. However, the incapacity to pay process cannot be an effective substitute for the small business exemption.

- The small business exemption was not established because most small businesses would be able to formally demonstrate an incapacity to pay severance pay. It was because small businesses would find it more difficult than larger businesses to cope with severance pay, and the sector would therefore be seriously disadvantaged if severance pay was imposed on it.

- In 1984 the federal Commission rejected the proposition that the incapacity to pay provision could be substituted for the exemption and awarded the exemption in addition to the incapacity to pay provision, as have other tribunals since.

- The incapacity to pay process is ineffective – it has proven incapable of protecting larger businesses that have an incapacity to pay severance pay, and would be equally as ineffective at protecting small businesses that cannot afford severance pay.

Consistency between federal and State awards on significant issues is only desirable if the approach taken in both jurisdictions is otherwise justified

- The only approach that is capable of producing appropriate consistency between the two jurisdictions is the retention of the small business exemption.

- The Australian Government will resubmit the Workplace Relations Amendment (Protecting Small Business Employment) Bill 2004 to the Parliament. The Government obtained a mandate for legislative proposal at the election. If passed, serious inconsistency would be produced within the Western Australian jurisdiction itself if this Commission were to remove the small business exemption. The Bill would have the effect of exempting from severance pay small businesses in the Western Australian jurisdiction that are constitutional corporations, irrespective of whether State awards or other State laws imposed severance pay on small businesses.

- For this reason, the Commonwealth submits that the Commission should not make a decision on the small business exemption until the Federal Parliament has completed its consideration of the Bill.

The TLC's claim to require severance payments in some transmission of business situations is unjustified and inequitable

- The reason why severance pay should not apply to a typical transmission of business is that employees do not unavoidably suffer the losses for which severance pay is intended to compensate. In particular, employees in these circumstances do not lose non-transferable credits for personal leave and long service leave, and they do not experience the hardship associated with having to find another job.

- The federal Termination, Change and Redundancy (TCR) test case decisions in both 1984 and 2003 found that severance pay should not be paid in situations where businesses are transmitted. This principle and the reasoning underlying it has been widely adopted by State workplace relations jurisdictions. The TLC's claim is clearly inconsistent with established arbitral principles.

- The claim would produce inequities amongst employees and between employers. Employees who receive exactly the same remuneration and other entitlements would receive different severance pay entitlements, dependent only on whether they were employed under an AWA or other federal instrument or under a State award or collective agreement.

The TLC's claim for 16 weeks' severance pay after 10 or more years of service is unwarranted

- Retrenchees with more than 10 years' service who are covered by the Western Australian long service leave standard are entitled to be paid their accumulated long service leave credits on retrenchment.

- It would therefore be inequitable and unfair if retrenchees with more than 10 years' service were compensated for long service leave twice. This would happen if they were paid their accumulated long service leave entitlement and, in addition, received the component of severance pay that compensates for lost long service leave credits. It would be obvious double counting.

- This double counting can be readily corrected by removing the component that compensates for lost long service leave credits from the rate of severance pay applicable to retrenchees with more than 10 years' service. The AIRC followed this logic in its recent federal redundancy test case decision. The result was a severance pay scale that steps down from 16 weeks' pay for retrenchees with 9 years' service to 12 weeks' pay for those with 10 or more years' service.

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COMMONWEALTH POSITION

1. Why the small business exemption should be retained

Industrial tribunals have found that small businesses have less capacity to bear the costs of severance pay

1. When establishing and maintaining the small business exemption, industrial tribunals have repeatedly recognised the lesser ability of small businesses to cope with severance pay. The central reason why industrial tribunals have done so was succinctly summarised by the NSW Industrial Commission (NSWIC) in 1994. The NSWIC reaffirmed the exemption because of the "*relative lack of financial resilience of small business*".[2]

2. An outline of the arbitral history of the small business exemption forms **Attachment A**. An examination of the arbitral history demonstrates that the original rationale for the exemption remains valid today. The key points borne out of this analysis are:

- Businesses with fewer than 15 employees were excluded from the process prescribed under the NSW *Employment Protection Act 1982* with respect to notification of redundancies;

- The AIRC ultimately excluded small businesses from the requirement to make redundancy payments in the 1984 test case;[3]

- The exemption was continued by the NSWIC in 1987 in *Re Clerks (State) Award & Other Awards.*[4] It was again specifically reaffirmed in 1994 when the NSWIC rejected a claim by the unions to remove the small business exemption from the NSW standard. In rejecting the claim the NSWIC stated:

  > *We note that this level of exception [the 15 employees threshold] is contained in the Employment Protection Act and has been extensively followed elsewhere. In the circumstances, bearing in mind the relative lack of financial resilience of small business, we determine to maintain the barrier in the same terms.*[5]

- The Queensland Industrial Relations Commission (Queensland Commission) exempted small businesses from having to make severance payments in its 1987 test case. It reaffirmed this position in

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[2] Re Redundancy Awards – Decision, Fisher P, Glynn J, Peterson J, & Buckley CC, 24 June 1994, 53 IR 419 at 444.
[3] Termination, Change and Redundancy Test Case – Supplementary Decision, Print F7262, Moore J, Maddern J and Brown C, 14 December 1984, 9 IR 115.
[4] Re Clerks (State) Award & Other Awards – Decision, Fisher P, Bauer & Glynn JJ, 8 April 1987, 21 IR 29.
[5] Re Redundancy Awards – Decision, Fisher P, Glynn J, Paterson J, & Buckley CC, 24 June 1994, 53 IR 419 at 444.

2003 citing the continuing *"lack of financial resilience in small business"* and recognised that *"[m]any small businesses operate in marginal circumstances"* where an *"obligation to make severance payments has the very real potential to result in the insolvency of a number of small businesses".*[6]

- The Victorian and Western Australian industrial tribunals also exempted small business employers from their severance pay standard. The Tasmanian Industrial Commission (TIC) has not set a standard. Only the South Australian Industrial Commission required small businesses to adhere to the severance pay standard.

Small businesses have a relative lack of financial resilience that impairs their capacity to cope with severance pay

3. Small businesses show a relative lack of financial resilience because they are generally unable to access external finance on reasonable terms. As a consequence, small businesses are often chronically undercapitalised and generally do not have ready access either to sufficient internal reserves or to additional external capital if the need arises. As a result, they do not have the financial resilience to cope with large unpredicted impositions such as severance pay.

4. There is a substantial body of evidence and research that demonstrates the causes of the undercapitalisation and relative lack of financial resilience of small business. The difficulty small businesses face in obtaining finance has been widely recognised in the international economic literature for many years. Carpenter and Petersen highlight the critical problems for small business in their discussion of recent literature:

> *[a] central proposition of this literature is that imperfections in capital markets create a wedge between the cost of internal and external finance (debt and new share issues). Recent research argues that the principal source of the wedge may be due to asymmetric information between firms and potential suppliers of external finance. Information problems can lead to adverse selection and moral hazard problems in markets for external finance. Moreover, the extensive use of debt finance is not appropriate for many firms especially firms whose projects have little collateral value because of asset specificity. Asymmetric information problems are likely to be more pronounced for small firms.*[7]

5. Mallick and Chakraborty (2002) note that *"[a] growing body of empirical literature on small business lending suggests that credit*

[6] QCU v QCCI [2003] QIRComm 383 (18 August 2003); 173 QGIG 1417 at paragraph 100.
[7] Ibid, pp. 301-302.

constraint affects a significant proportion of small businesses." [8] Butters and Linter (1945), cited in Carpenter and Petersen (2001), provide some of the earliest research in their examination of the histories of several industries. They conclude that *"[m]any small companies – even companies with promising growth opportunities – find it extremely difficult or impossible to raise outside capital on reasonably favourable terms"*, noting that *"most small firms finance their growth almost exclusively through retained earnings*".[9]

6. Mallick and Chakraborty provide some further discussion:

> *…a significant credit gap is expected for small businesses due to acute information asymmetry between borrowers and lenders. Under information asymmetries, excess demand for credit is due to the fact that increases in rates of interest will attract borrowers with higher risk when a lender is unable to distinguish among various borrowers' creditworthiness. In equilibrium, lenders will resort to rationing credit to their borrowers rather than use the interest rate as a market-clearing device (i.e., charge the less creditworthy borrowers higher rates of interest to compensate for the credit risk). Hence, information asymmetry could cause credit markets not to clear, and some firms to be credit rationed.*[10]

And

> *Small businesses are generally characterised by opacity of their operations. Owners know more about their business prospects and often have no credible mechanisms to convey such private information to lenders.*[11] *The resulting information asymmetry is fundamental to understanding why small businesses are credit rationed.*[12]

7. In their analysis Mallick and Chakraborty quantify the magnitude of the credit gap:

> *Our findings indicate that credit-constrained small businesses face an average credit gap of 20 percent. The magnitude of credit gap varies considerably across industries, size of firm, and the nature of business organization. Manufacturing*

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[8] Mallick, R and Chakraborty, A. (2002) 'Credit Gap in Small Businesses: Some New Evidence' Finance 0209008, Economics Working Paper Archive at WUSTL, (http://econwpa.wustl.edu/eps/fin/papers/0209/0209008.pdf) accessed 9 July 2004.

[9] Carpenter, R and Petersen, B. (2002) 'Is the Growth of Small Firms Constrained by Internal Finance?' *The Review of Economics and Statistics*, Vol 84, Issue 2, pp. 298-309.

[10] Mallick, R and Chakraborty, A. (2002) 'Credit Gap in Small Businesses: Some New Evidence' Finance 0209008, Economics Working Paper Archive at WUSTL, (http://econwpa.wustl.edu/eps/fin/papers/0209/0209008.pdf) accessed 9 July 2004, p. 3.

[11] Mallick and Chakraborty here cite Leland, H and Pyle, D. (1977) 'Information Asymmetries, Financial Structure, and Financial Intermediation' *Journal of Finance*, 371-87.

[12] Mallick, R and Chakraborty, A. (2002) 'Credit Gap in Small Businesses: Some New Evidence' Finance 0209008, Economics Working Paper Archive at WUSTL, (http://econwpa.wustl.edu/eps/fin/papers/0209/0209008.pdf) accessed 9 July 2004, p. 4-6.

> *firms face an average credit gap of 46 percent, while the credit gap for services and wholesale firms is estimated at 23 percent and 27 percent, respectively.*[13]

8. The credit constraint faced by small business is further exacerbated during recessionary times or periods of tight monetary policy. KeyPoint Consulting[14] notes that *"[s]maller businesses rely more on bank lending as a source of credit than do larger firms. As a consequence, smaller businesses may be more adversely affected when tighter monetary policies or adverse conditions in banking reduce the overall supply of bank loans."*[15] In its paper KeyPoint Consulting identifies a number of studies that have *"…documented that lending to small businesses and the economic activity of small businesses were affected by financial sector disruptions, such as the widespread merging of banks of all sizes and the capital shortfalls occasioned by large loan losses"*.[16]

9. Evidence collected by the Senate Employment, Workplace Relations and Education References Committee for its report in 2003 on Small Business Employment confirmed the chronic undercapitalisation experienced by Australian small businesses and the difficulties they face in obtaining finance.[17] Further, Reserve Bank of Australia data on indicator lending rates show that small businesses traditionally pay a higher interest rate than large businesses as demonstrated in Figure 1.[18] The small business interest rate premium currently in March 2004 stood at 8.1 per cent (1.2 percentage points above the large business rate).

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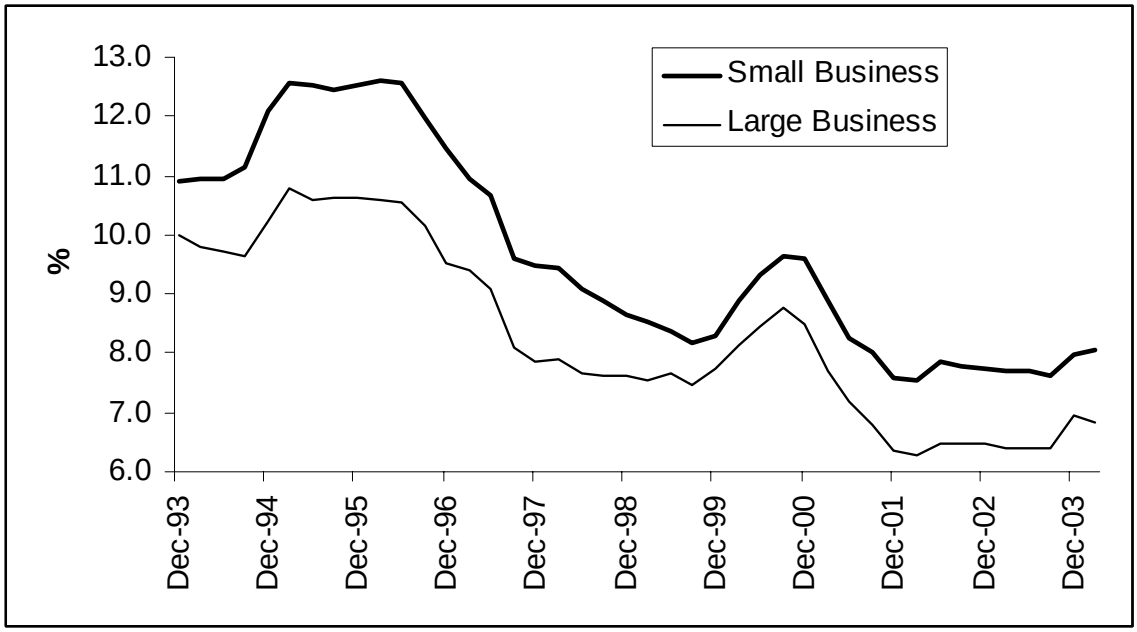
[13] Ibid, p. 21.
[14] KeyPoint Consulting was contracted by the United States Small Business Administration to investigate the impact of monetary policy and adverse economic conditions on small businesses in the United States.
[15] PM KeyPoint LLC (2003) 'Impact of Tight Money and/or Recession on Small Business' (http://www.sba.gov/advo/research/rs230tot.pdf) accessed 9 July 2004.
[16] Ibid.
[17] "Small Business Employment", a report of the Senate Employment, Workplace Relations and Education References Committee, February 2003 (http://www.aph.gov.au/Senate/committee/eet_ctte/smallbus_employ/report/report.pdf). See paragraphs 4.79 to 4.83.
[18] Reserve Bank of Australia Website www.rba.gov.au, Indicator Lending Rates, Table F5, 23 January 2003.

Figure 1: Small Business and Large Business Interest Rates(a).



Source: Reserve Bank of Australia Website www.rba.gov.au, Indicator Lending Rates, Table F5, March 2004.
(a) The weighted-average interest rate on credit outstanding is used as this incorporates risks margins.

10. In the Australian context, the Industry Commission's Staff Research Paper *Small Business Employment* found that:

> *Large businesses have advantages accessing finance — ultimately reflecting lower transactions costs. For example, large business:*
>
> *• can access equity through organised stock markets. The fixed costs of flotation, prospectuses, appropriate due diligence requirements and other components of the cost of issuing formal equity are typically beyond small businesses.*
>
> *• can obtain debt finance from the banks at lower interest rates and less onerous collateral requirements than small firms (BIE 1991) — reflecting the lower costs of monitoring and dealing with loan applications by larger enterprises. For example, the costs of assessing a loan for $5 million to a large company are much less than 100 times the costs of assessing a loan of $50 000 to a small business.*
>
> *Large firms engaged in many diverse activities are also able to spread risks more effectively than small enterprises involved in few activities. Theoretically, in the absence of frictions in the formal equity market, risk spreading could be achieved by shareholders holding diversified share portfolios in many small enterprises. However, the transactions costs of organising a formal sharemarket for very small firms favours some degree of risk spreading within larger enterprises.*[19]

11. Witness evidence that was heard in the AIRC's redundancy test case provided further confirmation that small businesses generally have

[19] Revesz, J. and Lattimore, R. (1997) Small Business Employment. Industry Commission Staff Research Paper.

less ability to bear the impact of severance pay than medium and large businesses because of undercapitalisation and lesser access to finance.

12. Of particular significance was the evidence of the Australian Council of Trade Union's (ACTU) expert witness on insolvency matters, Mr Michael Humphris. Mr Humphris has appeared as an expert witness in a number of litigation matters requiring financial analysis. He is a member of the Insolvency Practitioners Association of Australia, a Fellow of the Institute of Chartered Accountants in Australia, and an Affiliate of the Securities Institute of Australia.

13. Mr Humphris' evidence confirmed and explained that small businesses are characterised by a relative lack of financial resilience. He also confirmed that this lack of resilience could endanger small businesses if they had to pay severance pay to retrenched employees. Specifically, Mr Humphris pointed to the fact that small businesses have a special difficulty in raising additional capital to fund restructures and that approaches to financial institutions in these circumstances can result in closure of the business. He confirmed that this difficulty would also apply where small businesses had to retrench employees due to a significant reduction in demand for their products if they had to make severance payments. A relevant extract from the transcript of Mr Humphris' evidence is:

> *[Mr Stewart] Mr Humphris, I will be asking you a number of questions on behalf of the Commonwealth. First of all I would refer you to paragraph 13 of your original statement, and in paragraph 13 you refer to restructuring, and you state that it is often the case:*
>
> *... that a business cannot be restructured due to the lack of fixed assets acceptable to lenders for the purpose of advancing the necessary funds to restructure the enterprise.*
>
> *Could you just explain a bit more about that? In particular are you talking about just in the administration phase or in a business operating normally before it enters into administration?*
>
> *[Mr Humphris] I am talking pre-administration in that situation. The circumstance generally as we certainly have covered a fair bit of ground on this is that most small businesses don't have sufficient balance sheet assets to actually justify the credit risk that is bank is looking for, so accordingly the bank will look to collateral security in the form of a residence or some other investment. When they look to a restructuring position, restructuring normally requires additional capital, and restructuring can come across, as you would read from my paper, it may be restructuring associated with a growth phase or it may be coming back to core business which may mean the disposal of a division or some subset of the activities of the company that aren't making profits and therefore detrimentally affecting the overall total business. Getting rid of that debt arm, if you like, or getting rid of, you know, sort of - or accommodating a growth phase to facilitate a*

reconstruction will require capital. And in that sense, the bank will look at the balance sheet in a normal sense and say, well, the balance sheet isn't going to support any additional capital that we would consider worthy security, and we have already got your house for the current facility, so they are locked into a situation of saying we can't help you.

[Mr Stewart] And you go on to say in paragraph 13 that that is particularly the case for small business, and secondly, that it can - a situation arising like that, where there is a need for restructuring, can cause fixed asset financiers and charge holders to essentially seek the - putting the business into administration?

[Mr Humphris] That is correct.

(Transcript, 29 May 2003, PN 2808-11)

and

[Mr Humphris] In my experience it is often the case that a business cannot be restructured due to the lack of fixed assets acceptable to lenders for the purposes of advancing the necessary funds to restructure the enterprise. This is particularly the case with small businesses. Intensifying the problem of a lack of readily available fixed assets is the attitude of fixed asset financiers and charge holders when confronted with the problem of supporting the ongoing enterprise or making the necessary appointments to effect realisation of their security. Charge holders will often prefer to sever all ties with the client and recover sufficient funds from fixed assets to discharge the indebtedness.[20]

and

[Mr Stewart] Now I want you to consider a situation where a business is progressing well for a number of years, there are no retrenchments during those years so severance pay liabilities do not make it onto the balance sheet. And now I want you to consider a situation where there is a substantial drop in demand for that business's services for products, and it might be due, for example, to the effect of 9/11 in the tourism industry, it might be due to the drought or it might be due to the economic cycle, the widespread deterioration in the economic cycle. Now, in those circumstances, if a business has to, because of the drop in demand, reduce its workforce by, say, a third, well, then the severance pay entitlement obviously appears on the balance sheet in that case?

[Mr Humphris] That is correct.

[Mr Stewart] It could be a substantial one off payment that has to be made that hasn't had to be provided for before in the balance sheet of the company and it might be extremely difficult for the business to make that payment?

[Mr Humphris] It may well be and we see a number of illustrations of that. I guess Qantas is probably the classic example where they restructure every six months and another few thousand people go, but it is a fact, as soon as that happens, there is the liability that is crystallised, so it must be provided for. In small

[20] Witness statement of Mr Humphris, Paragraph 13, AIRC Exhibit ACTU 7, Tab 3.

business, however, it is not a normal situation that has to accommodate I guess the movement of a global industry. It will be something that they focus on very locally, but it certainly can still happen, but a successful business can only survive if in fact they do take radical steps to reduce their overhead and that overhead may certainly be attacked through employment costs. In those circumstances, it would form a liability onto the P and L account and impact on the profit and loss.

[Mr Stewart] And now looking specifically at the case of a small business that has to reduce its workforce by a third, if there are substantial severance pay costs, it might have to approach lenders and it would run into that problem that you refer to in paragraph 13, wouldn't it?

[Mr Humphris] It would.

(Transcript, 29 May 2003, PN 2815-17)

14. The difficulties that small businesses encounter in obtaining finance including those referred to by Mr Humphris are the cause of their relative lack of financial resilience. Small businesses generally do not have unencumbered assets that can be used to obtain the additional borrowings that would be needed to meet any large contingencies that arise. As a result, small businesses have less capacity than large businesses to cope with an unpredicted significant financial impost such as the need to fund severance pay. This difficulty in obtaining finance leads to the chronic undercapitalisation that characterises small business and frequently makes them reliant on the personal assets of the owner to provide collateral for loans, as also confirmed by Mr Humphris:

[Mr Stewart] How does small business generally raise capital for their operations?

[Mr Humphris] Well, the normal process is by bank finance. There is very little equity goes into small business, other than to say that the collateral security that is afforded to a bank by way of private residence or private investment could be described as quasi-capital, because without that support collateral security they would not normally get the finance based on the business asset.

[Mr Stewart] So the family home and mortgages are generally put up as part of that collateral, are they?

[Mr Humphris] That is normal.

(Transcript, 29 May 2003, PN 2792-93)

15. A number of individual employer witnesses in the AIRC's redundancy test case also confirmed that the general position outlined by Mr Humphris was consistent with their individual circumstances (all at AIRC Exhibit AIG 12):

The only way I could afford to pay redundancy would be to borrow the money from the bank or seek an extension of the existing overdraft. This would drive the business into more debt and extra interest repayments, assuming that the bank is prepared to give us the extra money. (Mr Trevor Butchard's witness statement, paragraph 19)

Nor can I borrow enough money to cover the cost. I have limited security for loans. My house and other possessions are already on the line. And cash flow is usually on a roller-coaster ride because I have to pay out money before I collect. (Mr Neville Jukes' witness statement, paragraph 13)

If the business was required to make redundancy payments, then I would need to borrow further from the bank or seek an extension of the overdraft. However, I seriously doubt whether the bank would allow us to do this, without charging higher interest rates. The bank is already aware of our difficult trading position and we have only limited collateral available as security for any further borrowings. (Mr John Wisby's witness statement, paragraph 11)

If the Company was required to provide for the liability of redundancy payments, then it would need to go back into debt. There are no shareholder funds or other accumulated capital set aside to meet these types of payments. We would need to borrow the money from the bank or utilise our overdraft. (Mr Stan Reynolds' witness statement, paragraph 17)

16. The significance of this relative lack of financial resilience of small business is that businesses need to be particularly financially resilient to cope with severance pay. It often must be paid when a business is already under severe financial stress. It is also paid out in conjunction with the payment of other significant entitlements such as accumulated annual leave and long service leave credits. In particular, if multiple retrenchments are involved, it can represent a very significant financial impost.

Impediments to small businesses building up financial reserves

17. Small businesses would also find it particularly difficult to build up the financial reserves that would be necessary to cover severance payments if retrenchments were necessary. The central reason for this again is the chronic undercapitalisation of small businesses that arises because of the limited access to borrowings.

18. The accumulation of sufficient reserves for severance pay would be particularly difficult for undercapitalised businesses because of the magnitude of the reserves that would be required. The Commonwealth estimates that in order to accumulate sufficient reserves to cover the severance pay entitlements for all its employees, the average Western Australian small business would have to put aside an amount equivalent to about 7.4 per cent of its wages bill. For all Western Australian small

businesses this equates to about $400.6 million. **Attachment B** sets out the basis of these costings.

19. Also set out in **Attachment B** are estimates of the direct cost of the claim to small businesses who retrench in a given year. Even the average cost impact on small businesses that retrench employees in any year would be about 3.1 per cent of their total annual wages bill under recessionary conditions and about 2.0 per cent under current favourable economic conditions. The combined labour cost impact of the removal of the small business exemption and of regular Safety Net Adjustment increases would be unsustainable for many small businesses.

20. Another significant impediment to the accumulation of reserves is that contingent liabilities for severance pay are not required to be included on a firm's balance sheet. Accounting requirements do not require a business to build up reserves to cover severance pay. Because the building of these reserves is discretionary, any small business that chooses to build up reserves will tend to be undercut by competitors that do not.

21. Furthermore, if a business attempts to build up such reserves off the balance sheet, the reserves will count as profit and will be subject to tax. In the AIRC case, the Australian Chamber of Commerce and Industry's (ACCI) witness Mr Lopez eluded to this in his statement:

> *Unlike other employee entitlements, such as wages, holiday and sick pay, redundancy can't really be planned and budgeted for. Like long service leave entitlements, redundancy entitlements are only a contingency that may never be used. Nevertheless, businesses will need to account for it as an accrued expense. A problem with accruals is the accrued expense is not deductible for tax purposes, That means, the business will be paying tax on a proportion of the profit it has not made. This only exacerbates the business's financial burden.*[21]

22. Finally, small businesses that rely primarily on the owner's assets for loan security will not be subject to supervision by banks that might otherwise encourage the business to build up a capacity to make severance payments. Evidence in the AIRC's case showed that banks that rely on the value of a business and its assets as loan security will generally ensure that the firm keeps sufficient in reserve to cover severance pay liabilities. This will ensure that the value of the security is sufficient to cover the loan if the firm fails.

23. As outlined above, the evidence of Mr Humphris in the federal redundancy test case confirmed that small businesses often do not have

[21] Witness statement of Mr Lopez, AIRC Exhibit B 4, Attachment J.

the unencumbered assets or financial reserves to restructure or make severance payments. Furthermore, the Queensland Industrial Relations Commission (the Queensland Commission) in its recent test case decision also acknowledged the difficulty that small businesses would have in accumulating reserves to meet severance pay requirements. The decision stated:

> *We accept the Queensland Government's submission that small business would generally have smaller cash reserves to meet severance pay requirements, and redundancies occurring would represent a greater proportion of the overall labour costs of the business. It is likely that small business facing a downturn or restructure sufficient to generate redundancies would not have sufficient cash reserves to launch a case in the Commission against an industrial organisation of employees (with perhaps greater access to financial resources) seeking an exemption from the application of severance pay provisions…* [22]

24. Insolvency practitioner, Mr Taylor, gave evidence in the AIRC's test case that most small businesses would not currently have the reserves or asset backing to cover severance pay liabilities if the exemption were removed. He indicated that the liability would exceed their current assets, making them insolvent in a technical sense (rather than in a legal sense):

> *If the small business exemption was removed and the quantum was increased it would effectively make most small businesses technically insolvent.*[23]

25. In summary, there are two key reasons why small businesses have significantly less capacity than large businesses to accumulate unencumbered assets and financial reserves to cover severance pay:

- First, small businesses tend to be chronically undercapitalised due to their lesser ability to obtain finance on reasonable terms.

- Second, small businesses are generally not subject to the supervision by lenders that tends to force larger businesses to provide for severance pay. This is because lenders generally do not rely on the assets of the small business and the health of the business to secure their loans. Instead, lenders generally require small business owners to provide their personal assets as collateral for borrowings, obviating the need to closely scrutinise the viability of the small business on an on-going basis.

[22] QCU v QCCI [2003] QIRComm 383 (18 August 2003), 173 QGIG 1417 at paragraph 100.
[23] AIRC Exhibit B 4, Mr Taylor's witness statement at paragraph 5, Attachment M.

26. In the context of this case there are two very important consequences of this limited ability of small businesses to accumulate reserves to cover severance pay:

- First, without such reserves small businesses will have difficulty in coping with severance pay if retrenchments are necessary. As Mr Humphris indicated, they are unlikely to be able to borrow the funds needed to make up the shortfall.

- Second, the AIRC's supplementary decision of June 2004[24] will not enable small businesses to cope with severance pay. As we discuss in greater detail below, the decision phases in the severance pay obligations over four years. However, small businesses that are unable to accumulate reserves will be in no better position to cope with severance pay in four years than if it were introduced in full immediately.

Other impediments to small businesses coping with severance pay

27. Other characteristics of small businesses also make it more difficult for them than larger businesses to cope with severance pay. In particular, small businesses generally have less capacity to avoid retrenchments. They generally have fewer options to redeploy employees, to divest parts of the business or to cross-subsidise within the business. Unlike large businesses, small firms have less capital to liquidate in times of financial difficulty. Instead, they are confined more tightly to their core activities and structures.[25]

28. This fundamental difference between small and large businesses was recognised by a Full Bench of the Queensland Commission when considering an application to remove the small business exemption from the *Building Products, Manufacture and Minor Maintenance Award – State* in 1997. The Full Bench noted that while some small businesses may be profitable and able to make severance payments, based on the material before it:

> *… we are not satisfied that larger employers do not generally have a greater capacity to re-arrange staff and workloads and provide for redundancy payments. It seems to us that in the case of many employers with only several employees the application of TCR provisions would impose a considerable burden and potentially discourage engagement of employees.*[26]

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[24] Federal Redundancy Test Case – Supplementary Decision, Print PR062004, Giudice J, Ross VP, Smith & Deegan CC, 8 June 2004.
[25] Michael, S. & Robbins, D., (1998) 'Retrenchment among small manufacturing firms during recession', *Journal of Small Business Management*, July.
[26] Re Building Products, Manufacture and Minor Maintenance Award – State (1997), 154 QGIG 458.

29. Furthermore, small businesses generally have less capacity to plan ahead to either avoid retrenchments or to prepare for them in advance. This is because they have less capacity to employ expert advice and because they are more likely to be entrepreneurial, operating in an unfamiliar environment and engaging in a process of experimentation and learning.

30. It is also important to recognise that the cost of retrenching a given number of employees is proportionately greater for a small business compared with a large business – "*redundancies occurring would represent a greater proportion of the overall labour costs of the business*".[27]

The detrimental impact of severance pay on small business

31. The removal of the small business exemption would impact severely on the small business sector. The detrimental impact on small businesses of a particular level of severance pay would be significantly higher than for larger businesses. The ability of small businesses to adapt to changing levels of demand, to the business cycle and to technological change would be impeded to a greater extent by a requirement to pay severance pay.

32. Due to their lack of financial resilience, small businesses would have a strong incentive to avoid retrenchments if the exemption was removed. It would be in their interests to minimise any actions that could increase the likelihood that retrenchments would become necessary, such as engaging extra staff. The removal of the small business exemption would therefore deter innovation, business expansion and other risk taking. Importantly, it would provide a significant disincentive to employ additional staff.

33. Small businesses could also attempt to avoid the need for retrenchments by expanding the use of casuals. The use of casuals would enable an employer to vary the quantity of work significantly without necessitating retrenchments. For this reason, the removal of the exemption could be expected to boost casualisation strongly in the small business sector.

34. Where retrenchments could not be avoided, many small businesses would be pushed into insolvency due to their relative lack of financial resilience. Businesses that were otherwise profitable and that

[27] QCU v QCCI [2003] QIRComm 383 (18 August 2003) 173 QGIG 1417 at paragraph 100.

were making a valuable contribution to the economy would be lost and their employees would lose their jobs.

Conclusion

35. For all these reasons, it follows that the fact that a small business might make a profit over a number of years does not mean that it is financially resilient. It does not mean that the business has sufficient reserves to cover severance pay. Nor does it mean that the business can obtain sufficient additional finance to cover severance pay. It therefore does not mean that the business can cope if an external shock causes it to have to retrench employees and pay significant amounts of severance pay. This is particularly the case if the shock is in the form of a sudden drop in demand or other financial stress.

36. When industrial tribunals established and confirmed the small business exemption, they were aware that many small businesses make a profit in any given year. This is not news. The central reason for the exemption is the relative lack of financial resilience of small businesses. It is not based on the level of profitability of a business.

2. The AIRC's test case decision to remove the small business exemption is wrong and should not be adopted

37. The AIRC concluded in its 2004 redundancy test case that "*the available evidence does not support the general proposition that small business has a relative lack of financial resilience and has less ability to bear the costs of severance pay than larger business*."[28]

38. The AIRC's decision went on to give three considerations in support of this conclusion:

> *The first is that small business is generally profitable. The second is that some small businesses make severance payment despite the absence of a legal liability to do so. A third consideration is the absence of evidence from those jurisdictions where the small business exemption does not exist, or in those industry sectors where it has been removed from the relevant federal award, that small business is less profitable or more likely to fail.*[29]

39. The Commonwealth considers that each of these considerations is mistaken and/or does not support the inference that the AIRC has drawn

[28] Federal Redundancy Test Case - Decision, Print PR 032004, Giudice J, Ross VP, Deegan & Smith CC, 26 March 2004, at paragraph 222.
[29] Ibid.

from it. This submission will now set out in detail the reasons for the Commonwealth's assessment of this part of the AIRC's decision.

Profitability does not imply ability to cope with severance pay

40. The central flaw in the AIRC's decision is to confuse profitability with the capacity to make severance payments. As this submission has demonstrated, even if small businesses were generally profitable, it would not mean that they were able to cope with the imposition of severance pay on an on-going basis.

41. When industrial tribunals established and confirmed the small business exemption, they were aware that many small businesses make a profit in any given year. This is not news. The central reason for the exemption is the relative lack of financial resilience of small businesses. It is not based on the level of profitability of a business.

42. If profitability did signify a capacity to make severance payments, industrial tribunals would not have repeatedly established and reaffirmed the exemption (as outlined in **Attachment A**). A significant proportion of small business has always made a profit in any given year – small businesses would not exist if this were not the case. This was the case in 1984 when the exemption was established by the federal Commission, it was the case in the following years when most State tribunals adopted the exemption, it was the case in 1994 when the NSW Commission reaffirmed the exemption, and it was the case in 2003 when the Queensland Commission refused to remove the exemption.

43. This submission has established that small businesses generally lack the financial resilience to cope with severance payments. In short, small businesses are generally unable to access finance on reasonable terms, are therefore chronically undercapitalised, and do not have the reserves or the capacity to raise the funds to meet large unpredicted impositions such as severance pay. This holds true whether or not a small business makes a profit in any particular year.

44. The fact that a small business might make a profit over a number of years does not mean that it is financially resilient. It does not mean that the business has sufficient reserves to cover severance pay. Nor does it mean that the business can obtain sufficient additional finance to cover severance pay. It therefore does not mean that the business can cope if an external shock causes it to have to retrench employees and pay significant amounts of severance pay. This is particularly the case if the shock is in the form of a sudden drop in demand or other financial stress.

45. The AIRC's 2004 decision does not contain any discussion of this critical distinction between profitability and financial resilience. The decision does not criticize or comment on the substantial body of evidence and argument that was put before it to show that profitability does not necessarily equate to capacity to make severance payments.

46. The AIRC's supplementary decision reflects some appreciation of the significance of the relative lack of financial resilience of small business. The supplementary decision effectively suspends the imposition of any severance pay obligations on small business for a full year, and suspends the full effect for four years. The decision states: *"In particular we accept that small business employers may not have the financial reserves necessary to meet a redundancy situation immediately, even though currently trading profitably."* [30]

47. However, the assumption underlying the decision to delay the implementation of severance pay is mistaken. The supplementary decision fails to recognise that when the full effect of severance pay is imposed on small businesses in four years' time, they will lack financial resilience to the same extent as they do now. They will be as incapable of coping with severance pay as they are now. Lack of financial resilience is not something that can be corrected merely by the passage of time. Small businesses lack financial resilience because they tend to be chronically undercapitalised (and have limited financial reserves) and because they have difficulties in accessing finance. In four years' time small businesses will continue to be undercapitalised, have limited financial reserves and difficulties in accessing finance, and will therefore continue to lack the capacity to cope with large unpredicted commitments such as severance pay.

48. For these reasons the approach taken by the AIRC in its supplementary decision will not enable small businesses to cope with severance pay and is not a viable substitute for the retention of the small business exemption.

Interpretation of Productivity Commission Staff Research Paper

49. In further support of its conclusion about the capacity of small businesses to make severance payments, the AIRC's decision refers to the Productivity Commission Staff Research Paper *Business Failure and Change: An Australian Perspective.* The decision highlights the paper's

[30] Federal Redundancy Test Case – Supplementary Decision, Print PR062004, Giudice J, Ross VP, Smith & Deegan CC, 8 June 2004, at paragraph 21.

findings that the single greatest reason for business exit is realising a profit. It also highlights data suggesting that many small business exits are anticipated years before they actually occur, and concludes that this allows for adjustment and a reduction of the costs of exiting[31].

50. The decision has seriously misinterpreted the findings of the paper. The research does not support the inferences that the AIRC seeks to draw from it. The mistake made by the AIRC is to apparently assume that business exits are situations in which employment is reduced, and where retrenchments occur. But this is not the case in the terminology used by the relevant research and data. The research counts situations in which a business is sold as a business exit. Business exits are not limited to situations in which a business closes and ceases to operate.

51. So the fact that the research finds that most business exits occur to realise a profit does not mean that most closures or cessations occur to realise a profit. In fact, the data shows only that the single greatest reason for sales of businesses is to realise a profit. This is entirely as would be expected – closing a business would not be expected to be a preferred way of realising a profit.

52. Moreover, the fact that the research finds that many business exits are planned years in advance does not mean that many failures or closures are planned years in advance. Small business operators are hardly going to plan the failure of their business years in advance. In fact, the data means only that many business sales are planned years in advance, as would be expected.

53. The research cited by the AIRC therefore does not support the view that many small businesses that are closing and retrenching their staff are profitable and are able to afford severance pay. Nor does it support the view that the much higher rate of closures of small businesses compared with larger businesses is planned, rather than due to factors such as the relative financial fragility of small business. The research does not contradict the significant body of evidence and argument that small business has far less capacity than large businesses to cope with severance pay.

54. However, it is possible to use the data considered by the Productivity Commission research to produce estimates that are far more relevant to the issue of the affordability of retrenchments. It is possible to estimate the extent to which business cessations occur to realise a profit,

[31] Federal Redundancy Test Case – Decision, Print PR032004, Giudice J, Ross VP, Smith & Deegan CC, 26 March 2004, at paragraph 226.

and the extent to which they occur because businesses are in financial difficulties. We have set out such an analysis in **Attachment C**. It shows:

- only about 15 per cent of business cessations in the study relied upon by the Report occurred to realise a profit;

- this fell far behind financial difficulties as the greatest reason for business cessation; and

- about 70 per cent of all business cessations are estimated to be due to financial difficulties.

All these findings are consistent with what would be expected.

55. These findings are diametrically opposed to the interpretations relied upon by the AIRC. The AIRC's decision is seriously mistaken about the import of the Productivity Commission research and other data that it refers to in this part of its decision. The AIRC took the data to give a green light to its conclusion that small business could generally afford severance pay. In fact the research and data, properly understood and interpreted, gives a clear red warning light.

No evidence that some small businesses already make severance payments

56. The second major consideration given by the decision in support of the removal of the small business exemption is that " [*t*]*he evidence establishes that some small businesses make severance payments, despite the absence of any legal requirement to do so*."[32]

57. This is a very important consideration because if a high proportion of small businesses are voluntarily making severance payments, it suggests that there is no general characteristic of small businesses that prevents them from doing so.

58. The main source of evidence relied on by the decision for this conclusion is a survey conducted by Professor Benson of members of AiG/Engineering Employers Association, South Australia. Apart from the Benson survey, the AIRC had very limited evidence of instances in which small businesses made severance payments (two were dealt with in witness evidence, and a small handful were referred to in a submission by Jobwatch).

[32] Ibid, paragraph 227.

59. According to the AIRC's decision, the Benson survey showed that "[m]*ore than 90 per cent of the small companies who responded to the survey made severance payments, and provided job search entitlements, in accordance with the TCR standard clause despite the absence, in many cases, of a legal requirement to do so."*[33]

60. In fact the survey showed that over 90 per cent of the small businesses did not pay severance pay. Over 90 per cent of the small business respondents to the survey indicated that they made severance payments *in accordance with the TCR standard clause*. The TCR standard clause *exempts* small businesses from severance pay. The survey questionnaire made it clear to survey respondents that making severance payments in accordance with the TCR standard clause equated to making nil payments (An extract of the relevant part of the questionnaire forms **Attachment D**[34]).

61. This is a serious error on the AIRC's part. Far from giving comfort to the view that severance payments could be imposed successfully on small businesses, the Benson survey should have been recognised as warning against doing so. A proper understanding of the survey should have prompted a much closer questioning of whether the fact that many small businesses are profitable in any given year means they have the financial resilience to cope with severance pay on an on-going basis. Again, what the AIRC took to be a green light for its conclusion was in fact a red warning light.

Absence of evidence of problems where the exemption does not operate

62. The final consideration given by the AIRC's decision in support of its conclusion is the absence of evidence of problems where the exemption does not operate. In particular, the decision noted that there is no significant difference between the bankruptcy experience or insolvency rates in South Australia compared with other States where the exemption currently applies.

63. The fundamental premise of this consideration is flawed. The consideration stands or falls on the premise that it would be immediately obvious if severance pay has had a serious impact on South Australian small businesses under the State jurisdiction. This is wrong. Many factors

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[33] Ibid.

[34] Question 3 in Section III in the document that is at Tab 12 of Volume 3 of the AiG submissions to the AIRC Redundancy case

combine to determine the relative performance of South Australian small businesses compared with those in other jurisdictions. Neither the data nor the complex analysis required to disentangle the effects of each of these factors has been undertaken. Until this substantial data collection and analysis is undertaken, it is not possible to empirically evaluate the effect of the imposition of redundancy pay.

64. Notably, the analysis of bankruptcy rates across the States undertaken by the National Institute of Economic and Industry Research (NIEIR) and submitted in the case by the ACTU does not control for other variables that could affect the relative performance of small businesses. For example, it does not control for the myriad of State government policies and programs implemented over this period that could have produced differential outcomes between States. The simplistic methodology used by NIEIR would not be expected to be able to disentangle the impact of a requirement that small businesses pay severance pay from the many other factors that would affect economic performance. The fact that the research might show nothing is not surprising and means nothing. A more detailed critique of the NIEIR's report is at **Attachment E**.

65. The need to control for all relevant variables in such an analysis and the difficulty in doing so was confirmed in the 2004 federal redundancy test case by the evidence of two expert economic witnesses. In particular, Professor Lewis made the following points in response to questions from the ACTU advocate Mr Watson (it is worth noting that Mr Watson's second question implies that the ACTU agrees with the need to control relevant variables):

> *[Mr Watson] Yes?*
>
> *[Professor Lewis] I would point out, if I may, that if you actually read the French literature on this they do go through that in quite detail and they - the - particularly Gautie is the French economist - he has pointed out that one of the problems in comparing those studies is that in countries like the United States, Japan and France and the Scandinavian countries, the government has put lots of policies in place to reduce the incidents of retrenchments etcetera. So it is very difficult when you compare a fairly interventionist government policy, which has ameliorated the effects, to judge whether in fact these other things have any effect or not.*
>
> *[Mr Watson] Yes, which is just another way of saying is it not, that when you do the multi varied analysis you have got to try and control for those factors?*
>
> *[Professor Lewis] Well, I would say it is almost impossible to control. For instance in France, the French they actually provide quite significant subsidies for firms to keep on workers who would have otherwise been retrenched and they also provide quite generous retirement schemes for older workers who have been retrenched, which I suppose backs up the thesis that if you reduce labour costs by*

subsidies then you increase employment and hence if you increase costs you will of course have loss of jobs.[35]

66. The ACTU's witness Professor Webber pointed to the difficulty in designing research that is able to isolate the impact of redundancy benefits, and suggests that if research is to do so, it has to be international, not research that considers only Australian data:

[Mr Barklamb] Yes. And would it be correct in saying that that would not be sensitive to levels of redundancy benefit?

[Professor Webber] I have no idea whether it would be sensitive to levels of redundancy benefit. That is not what is examined here. The evidence about the levels of - about the fact of levels of redundancy benefits and - and employee severance legislation on labour markets is, by definition - has, by definition, almost to be international because there isn't enough change within Australia and everything else is changing more rapidly than the legislation is changing so you have to compare internationally.[36]

And

[Vice President Ross] The point you make is that the variables are so many that it is just not possible to isolate.

[Mr Stewart] That is right?

[Professor Webber] In a sample of six states. That is the problem with Australia. It ought to have more states and then you can have more observations in order to do these kinds of statistics. But perhaps that isn't a sufficient - - - [37]

67. An examination of time series data that compares bankruptcy rates between States demonstrates that many factors other than severance pay are determining outcomes, and that it is impossible to disentangle the relative impact of these factors without a sophisticated analysis that controls the relevant variables. The Productivity Commission's Staff Research Paper on Business Failure and Change graphically shows that there have been very significant relative changes in bankruptcy rates between States and Territories during periods when there has been no relative change in severance pay requirements. [38]

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[35] Federal Redundancy Test Case - Transcript, 23 June 2003 at PN4032-4033.
[36] Federal Redundancy Test Case - Transcript, 27 May 2003 at PN867.
[37] Federal Redundancy Test Case - Transcript, 28 May 2003 at PN1407-08.
[38] Bickerdyke, I., Lattimore, R. and Madge A. (2000) *Business Failure and Change: An Australian Perspective* Productivity Commission Staff research Paper. Exhibit ACTU 3, Tab 2, Page 71.

68. The AIRC did not give the NIEIR analysis any significant recognition in its March 2004 decision.[39] On the contrary, the Full Bench appears to have concurred with Commonwealth submissions that many factors combine to determine the relative performance of South Australian small businesses compared with those in other jurisdictions. The Full Bench stated:

> *As a general proposition we accept that in order to quantify the effect of severance pay on the performance of small businesses, a range of other relevant variables would need to be controlled for.*[40]

69. However, the decision then goes on to speculate about some particular factors that might explain why any detrimental impact of severance pay has not shown up in South Australia e.g. a faster growing economy in South Australia, or a Government subsidy for small business. The decision then concludes that it is significant that none of the participants in the proceedings engaged in similar speculation, nor adduced any evidence about it.

70. This is a very strange turn for the AIRC decision to take. First it appears to accept that no inference can validly be drawn about the impact of severance pay in South Australia unless research that controls for all relevant variables is undertaken. But then it appears to go on to draw such an inference on the basis that the Commonwealth did not provide such research and did not speculate about factors that could have masked the impact of severance pay on small businesses in South Australia. The AIRC almost seems to have mistakenly reversed the onus of proof on this issue.

71. The complex research project that would be necessary to assess the impact on small business of severance pay in South Australia has not been undertaken. Until this research is undertaken, it is not possible to identify the factors that could explain the absence of any different outcome for small businesses in South Australia compared to the rest of Australia. The fact that evidence about these factors and about this research was not put before the AIRC in the test case signifies only that the research has not been undertaken. It does not justify a conclusion that the imposition of severance on small businesses in the South Australian jurisdiction did not have a highly detrimental impact.

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[39] Federal Redundancy Test Case – Decision, Print PR032004, Guidice J, Ross VP, Smith & Deegan CC, 26 March 2004, at paragraph 230

[40] Ibid, paragraph 234.

Conclusion

72. The central flaw in the AIRC's decision was to confuse profitability with ability to cope with severance pay. The AIRC's decision did not give sufficient regard to the substantial body of evidence and argument that shows that small businesses generally do not have the financial resilience to cope with severance pay, irrespective of whether or not they are making a profit. The decision also misinterpreted key evidence that it relied on to support its conclusion. Most seriously, the AIRC was under the misapprehension that over 90 per cent of a sample of small businesses were already making severance payments even though they had no legal obligation to do so. In fact the evidence showed precisely the opposite.

73. The AIRC's decision does not provide a sound basis for the removal of the small business exemption. In fact, the material considered by the AIRC when properly understood and interpreted, confirms and reinforces the desirability of retaining the small business exemption.

3. The incapacity to pay process is not an effective substitute for the small business exemption

74. The AIRC's 2004 decision suggests that small businesses that are unable to meet their severance pay obligations can seek relief through the incapacity to pay provisions, as amended by the AIRC's decision. However, as the following section will detail the incapacity to pay provision is not an adequate or appropriate substitute for the small business exemption.

75. There are two key reasons why the incapacity to pay process would be an ineffective substitute – first, it serves a different purpose to the small business exemption and second, it has proven to be ineffective.

76. We will examine the relevant arbitral history to show that the two measures were established for different purposes. We will also show that the incapacity to pay provision has not in practice been able to protect medium and larger sized businesses that are unable to afford severance pay and certainly will be incapable of protecting smaller enterprises. Furthermore, we will demonstrate that processes established by the AIRC to address deficiencies in the operation of other incapacity to pay provisions have similarly not been successful. Finally, the amendment

made to the provision by the AIRC in March 2004 will not overcome the shortfalls in the provision, as even the ACTU recognised[41].

Establishment of incapacity to pay provisions associated with redundancy

Federal TCR standard: 1984 – 2004

77. The AIRC included the incapacity to pay provision as an integral part of the TCR standard in its August 1984 test case decision. The provision enabled employers to seek relief from severance payments in particular redundancy cases where they did not have the capacity to meet those severance payments. In concluding that such relief was necessary, the Full Bench stated:

> *In coming to our decision in this case we have been conscious of the cost of the union's claim. … We have also paid regard to the fact that the impact of redundancy provisions will not apply equally to all businesses. … For many companies it will introduce a new charge directly impacting on industry resources which involves a considerable financial outlay which was not ascertainable beforehand and has not been funded. … [w]e have made provision, in our decision, for employers to argue in particular redundancy cases that they do not have capacity to pay.*[42]

78. The incapacity to pay provision was again addressed by the parties in proceedings leading to the AIRC's supplementary decision in December 1984. Employers were highly critical of the provision, including the practicality of relying on the procedure and the effect of the AIRC's decision on small enterprises. The AIRC noted the importance of the incapacity to pay provision as an exception to the standard of severance pay, and reaffirmed the need for an award provision that would ensure employers were aware of their right to argue incapacity to pay. The AIRC decided the following clause was appropriate:

> *An employer, in a particular redundancy case, may make application to the Commission to have the general severance pay prescription varied on the basis of the employer's incapacity to pay.*[43]

79. Significantly, the December 1984 decision established the small business exemption in addition to this incapacity to pay process.

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[41] Federal Redundancy Test Case – ACTU Outline of Contentions in Opposition, Volume 7, at paragraph O43.
[42] Termination, Change and Redundancy Test Case – Decision, Print F6230, Moore J, Maddern J and Brown C, 2 August 1984; 8 IR 34 at 61.
[43] Termination, Change and Redundancy Test Case – Supplementary Decision, Print F7262, Moore J, Maddern J and Brown C, 14 December 1984; 9 IR 115 at 134.

80. In the 2004 federal redundancy test case the ACCI sought to amend the incapacity to pay provision to enable groups of employers to apply for a variation of the redundancy pay prescription in circumstances where they allege they are incapable of meeting severance payments in part or in full. In agreeing to the ACCI's proposal the AIRC acknowledged the difficulties that businesses face in running a case under an incapacity to pay provision, stating:

> *We recognise that any incapacity to pay case may present the applicant or applicants with difficulties. Almost by definition, an employer's resources to conduct such a case are under serious strain.*[44]

81. The Full Bench further emphasised that the purpose of the variation was not to weaken the incapacity to pay principle but to improve access to it by employers. They also stressed that individual employers are still required to demonstrate an incapacity to make severance payments for relief to be granted.[45]

State jurisdictions

82. The majority of State jurisdictions similarly adopted the incapacity to pay provision to assist those medium and larger sized businesses which could not afford severance payments.

83. The provision was retained by the Queensland Commission in its August 2003 test case decision, in addition to the small business exemption. In reaching its decision, the Full bench specifically acknowledged the difficulties faced by small businesses and the inappropriateness of the incapacity to pay provision for small businesses, stating:

> *It is likely that small businesses facing a downturn or restructure sufficient to generate redundancies would not have sufficient cash reserves to launch a case in the Commission against an industrial organisation of employees (with perhaps greater access to financial resources) seeking an exemption from the application of severance pay provisions – see Building Products, Manufacture and Minor Maintenance Award – State (1997) 154 QGIG 458.*[46]

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[44] Federal Redundancy Test Case – Decision, Print PR032004, Giudice J, Ross VP, Smith & Deegan CC, 26 March 2004, at paragraph 354.
[45] Ibid at paragraph 355.
[46] QCU v QCCI [2003] QIRComm 383 (18 August 2003), 173 QGIG 1417 at paragraph 100.

Incapacity to pay is not why small businesses were exempted from severance pay

84. The arbitral history surrounding the incapacity to pay provision prior to the AIRC's 2004 decision clearly demonstrates that the exemption from severance pay for small businesses was not established because they were able to demonstrate incapacity to pay in the sense recognised by industrial tribunals. It was established because small businesses lack financial resilience and because they have a *"special difficulty in meeting the financial burden of redundancy pay"*[47]. Most small businesses will suffer from this special difficulty even though they might not be able to demonstrate an incapacity to pay in the sense recognised by industrial tribunals. Substituting an incapacity to pay provision for the small business exemption would be disastrous for small business. It would fail to protect most small businesses from the special difficulty they have in meeting the financial burden of severance pay.

85. The suggestion implicit in the AIRC's 2004 decision that small businesses which are unable to meet their severance pay obligations can seek relief through the incapacity to pay provision highlights a misunderstanding of the original rationales underpinning the two provisions.

86. The fact that incapacity to pay severance pay was not the reason behind the small business exemption was clarified and confirmed by the AIRC very early following the 1984 federal redundancy test case decisions. Just 18 months after the December 1984 decision, a Full Bench of the AIRC considered an application to vary the small business exemption in a case involving local government in Western Australia.[48] The Full Bench decision canvassed the basis on which the small business exemption was granted and its relationship to the incapacity to pay provision.

87. The decision of the Full Bench made it clear that incapacity to make severance payments was not the foundation on which the small business exemption was granted.[49] It follows that if a small business does have a capacity to pay, this is not sufficient grounds to overturn the exemption. Rather, the exemption was established because of the financial burden that severance pay would impose on small businesses. The majority decision stated:

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[47] Re Local Government Awards Western Australia – Decision, Print G1801, Coldham J, Issac DP and Coleman C, 24 January 1986.
[48] Ibid.
[49] Although this was a majority decision of the Full Bench, the minority agreed on this particular issue.

> *The two subclauses are interrelated in the sense that financial incapacity and profitability underlie both. The Test Case Bench was concerned that very small businesses might have a special difficulty in meeting the financial burden of redundancy pay and should therefore be exempt from such liability under the award; and further that it should be open for the larger employers to apply for partial or full exemption on the grounds of incapacity.*[50]

88. The fact that the small business exemption was not founded on an assumed incapacity to pay, was reaffirmed by Commissioner Oldmeadow in a 1993 decision concerning the clothing industry.[51] The specific matter under consideration was a claim by the Textile, Clothing and Footwear Union of Australia (the union) to have the small business exemption lifted in relation to a particular company which had made two employees redundant.

89. The union submitted a number of grounds in support of its case including that *"… the subclause must be considered within the context of a companies' capacity to pay".*[52] The union further argued that the majority decision referred to above showed that the clause exempting small businesses from severance pay is related to the incapacity issue and therefore the company involved in the matter must pay severance pay because it had not demonstrated incapacity. In dismissing this argument, Commissioner Oldmeadow stated:

> *...I do not accept that the comments of the majority decision lead to this conclusion. First there are two separate provisions in the standard TCR clause, an exemption subclause and an incapacity subclause. The incapacity subclause can be availed of by a company of any size. Had the TCR Full Bench required a company with less than 15 employees to demonstrate incapacity the TCR provisions would have reflected this requirement. The standard provisions however distinguishes companies with less than 15 employees. There is no requirement for a company falling within the exemption subclause to prove incapacity. Further, as the majority in the Full Bench decision observed the inclusion of the exemption clause by the TCR Full Bench was in recognition of the "special difficulty" for small businesses in meeting the "financial burden" of redundancy pay. A "special difficulty" does not necessarily mean incapacity to pay*[53]*. [our underlining]*

90. In her consideration of this matter, Commissioner Oldmeadow also critiqued two other cases relied upon by the union which had dealt with the relationship between the small business exemption and incapacity to pay. Commissioner Oldmeadow rejected the union's submissions with respect to both cases.

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[50] Ibid.
[51] Re Clothing Industry – Decision, Print K9342, Oldmeadow C, 12 October 1993.
[52] Ibid.
[53] Ibid.

91. The first case referred to by the union was a decision by Commissioner Oldmeadow involving the insertion of TCR provisions into two mining awards.[54] In this decision, Commissioner Oldmeadow decided against including the small business exemption provision in the awards because of difficulties the provision may pose where employees working side by side at the same mine may or may not be entitled to the TCR benefits depending on the size of the contract team. The Commissioner further noted that it was open to the employers at the time of redundancy to argue incapacity to pay.

92. In rejecting the relevance of the case to the assertion that small employers needed to also demonstrate an incapacity to pay, Commissioner Oldmeadow stated:

> *This decision related to the particular circumstances at these mines and in particular the division of contracts at the mines and the requirement that contractors pay award provisions. It is not support for the proposition that an employer subject to the exemption subclause must demonstrate incapacity.*[55]

93. The second case relied upon by the union was a decision by Commissioner Caesar in the clothing industry. In this matter Commissioner Caesar found that there were 15 employees at the time of the redundancy and thus the exemption subclause did not operate. Commissioner Caesar further observed that:

> *Should this construction be wrong, in any event, the company is not a company with incapacity to pay, nor is that being claimed. It is a company that should, in my view, be required to (pay redundancy)…*[56]

94. Commissioner Oldmeadow, however, rejected union submissions that the decision supported the proposition that the AIRC should also require companies using the small business exemption clause to demonstrate incapacity. Commissioner Oldmeadow stated:

> *I consider that this decision, was made in the light of the particular facts and circumstances of the matter before the Commission, and the findings of the Commissioner in that matter cannot easily be translated to an argument that an employer must demonstrate incapacity to pay in order to properly claim an exemption. The Commissioner was dealing with a situation where there was significant uncertainty as to employee numbers. An uncertainty which is reflected in the Commissioner's final decision. In my view, it was because of this uncertainty that the Commissioner made the observation concerning capacity to pay. I consider that Commissioner Caesar's decision does not create a precedent*

[54] Re Mining Industry – Decision, Print H9084, Oldmeadow C, 3 August 1989
[55] Ibid.
[56] Re Clothing Industry – Decision, Print H5975, Caesar C, 2 December 1988.

> *that requires that a company availing itself of the exemption subclause must, as a matter of course, also demonstrate incapacity to pay.*[57] *[our underlining]*

95. It follows that forcing small businesses to rely on the protection afforded by the incapacity to pay provision is clearly at odds with the established arbitral authority. It was firmly established in the early years following the 1984 federal TCR decisions that the small business exemption was not founded on the basis of whether a small business had capacity to pay severance pay or not. The small business exemption resulted from the fact that small businesses lack financial resilience. This is still the case.

96. Not only does the incapacity to pay provision serve a different purpose to the small business exemption, it would be incapable of serving its intended purpose. It would be ineffective at exempting small businesses that cannot afford severance pay. The provision has proved over time that it has not been capable of serving the more limited function for which it was designed. As we will discuss further in the next section, arbitral history and experience demonstrates that it has not been able to protect medium and larger size businesses with an incapacity to pay.

The incapacity to pay process fails in practice

Industrial tribunal decisions

97. The available evidence makes it obvious that the incapacity to pay provision will not be able to protect small businesses that cannot afford severance pay. The material before the AIRC on the effectiveness of the incapacity to pay provision clearly showed that the incapacity to pay provision has failed to protect medium and larger size businesses from severance pay obligations that they are incapable of meeting.

98. In order to examine the operation of the incapacity to pay provision the federal Department of Employment and Workplace Relations undertook a search to identify industrial tribunal decisions that involved applications by employers for exemptions from the severance pay provisions of relevant awards, orders or agreements.

99. The search material included an electronic version of the Australian Industrial Law Reports published by CCH Australia, the Australian Legal Information Institute (AustLII) database maintained by the University of Technology Sydney and University of NSW Faculties of Law, as well as the federal Wagenet database. The search identified only seven

[57] Re Clothing Industry – Decision, Print K9342, Oldmeadow C, 12 October 1993.

relevant industrial tribunal decisions – six federal decisions and one Tasmanian decision. In each decision the application was refused by the relevant industrial tribunal. None of the participants in the Queensland or AIRC redundancy test cases were able to add any additional cases to this list.

100. In the first federal decision dated 1 November 1989 concerning the clothing industry, the presiding Commissioner said:

> *Clearly the granting of an exemption in respect of those employees is marginal to the overall economic circumstances of the company and its directors. The debt to them is a debt like any other unless I am persuaded to vary the award to remove the company's obligation. I am not so persuaded. The award will apply except to the extent that the parties have agreed.*[58]

101. In another AIRC case in the clothing industry in 1990, Deputy President Riordan noted:

> *The circumstances of the present case appear to be that Klamar cannot meet all of its liabilities. Accrued entitlements of former employees represent one of those liabilities. These employee entitlements have a particular statutory ranking and the information supplied by the liquidator indicates that there are sufficient funds available to meet the entitlements of employees. Of course, if some relief from the award obligations were to be granted this would result in certain of the other unsatisfied creditors having an enhanced opportunity of receiving greater satisfaction than would otherwise be available. This, however, is not a good and sufficient reason to deny the payment of benefits intended to be paid to the employees. I am not persuaded that there should be any exemption granted or benefit reduced on this account.*[59]

102. A third AIRC decision dated 3 April 1992 concerned an application by an employer for an exemption from the severance pay provisions of the *Vehicle Industry – Repair, Service and Retail Award 1983*. Commissioner Frawley, while acknowledging the financial problems that faced the company, rejected the application stating:

> *I am not satisfied that the payment of the amounts in question would represent such an additional impost that the company would be forced to cease trading.*

and

> *This Commission has consistently held the view that it is a most extreme step to take away an award entitlement.*[60]

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[58] Re Clothing Industry – Decision, Print J0115, Lewin C, 1 November 1989.
[59] Re Clothing Industry – Decision, Print J6078, Riordan DP, 21 December 1990.
[60] Re Vehicle Industry – Decision, Print K2453, Frawley C, 3 April 1992.

103. In a fourth AIRC decision dated 24 November 1992 relating to the *Vehicle Industry – Repair, Service and Retail Award 1983,* Commissioner Frawley stated*:*

> *Finally, I am unable to accept Mr Bennett's arguments about incapacity to pay. The employees are entitled to benefits (including payment in redundancy situations) by virtue of their service with the employer. Very stringent tests have quite properly been set by the Commission in this regard as it is a very serious step indeed to take away entitlements which accumulate as a result of years of service and I have not been persuaded that this case is one where I should exercise my discretion.*[61]

104. In the fifth AIRC decision dated 18 October 2000 in relation to the *Clothing Trades Award 1999* Commissioner Whelan stated:

> *While it is accepted that in this case the company has taken steps to go into voluntary liquidation it has not, in my view, established that there are no assets or other sources from which the entitlements of these employees could be met in part or in full. Whether such sources exist may be revealed in due course by the liquidator.*
>
> *In my view, on the material before me, it would not be a proper exercise for the Commission to deny these employees access to any funds which may be available to meet entitlements which they had a right to expect to be honoured by the company. For these reasons I am not prepared to grant the order sought.*[62]

105. The sixth AIRC decision dated 19 December 2002 concerned a small business covered by the *Furnishing Industry National Award 1999.* The award does not contain the small business exemption. Commissioner O'Callagan rejected an application under the incapacity to pay provision, stating:

> *Accordingly, I am not satisfied, on the basis of the material before me that Tubemasters have demonstrated that the company is financially incompetent or unable to draw upon funds so as to make a payment to Ms Fazzine on the basis of the 0.4 of the severance payment to which she would ordinarily be entitled.*[63]

106. A decision of the TIC held that:

> *As to incapacity to pay I do not accept the submissions of the Chamber. At the hearing all parties accepted that responsibility for the financial commitments of Jireh House rested with the members of the Committee of Management. In evidence the Commission was told (in effect) that the annual income of Jireh House was close to $400 000. Factors like the overwhelming reliance on government monies and the social welfare nature of the work do not obviate Jireh*

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[61] Re Vehicle Industry – Decision, Print K5635, Frawley C, 24 November 1992.
[62] Re Clothing Industry – Decision, Print T2228, Whelan C, 18 October 2000.
[63] Re Furnishing Industry – Decision, Print PR926033, O'Callaghan SDP, 19 December 2002.

> *House's obligations as an employer. Jireh House is a business and having taken on the responsibilities of an employer must fulfil minimum requirements. In this case I accept the Union's submission as a minimum standard and I so decide.*[64]

107. The inference that can be drawn from the results of this search is that applications for exemption from the payment of severance pay provisions are relatively uncommon and, where applications are made, they are not successful. It is clear that industrial tribunals view the granting of such applications as 'a most extreme step' and that they rarely, if ever, exercise their discretion to exempt an employer from redundancy pay obligations, either in situations where they are facing financial difficulties or even after they have become insolvent.

108. The existence of the incapacity to pay provision does not appear to have assisted even one of the thousands of businesses with 15 or more employees that have become insolvent since the provision was first introduced in 1984.

109. The reasons why incapacity to pay provisions are ineffective are widely recognised. The following reasons were discussed in the Commonwealth's submission to the AIRC's redundancy test case, and were not seriously contested by any participants in the case:

- history has shown that the AIRC is very loath to grant an application – the likelihood of success is minimal;

- businesses are reluctant to initiate an application on the basis of incapacity to pay because it can cause lenders and suppliers to discontinue credit and force the business to close;

- the time and cost of making and pursuing an application are considerable, and cannot be significantly reduced by streamlining the processes. This is because the main components of the time and costs associated with pursuing applications result from factors that are irreducible and cannot be waived. Foremost amongst these are the evidentiary requirements and the rules of natural justice. For example, employees and their representatives must be given an opportunity to consider the material presented by the applicant employer, and to test that material by cross examination if they wish; and

- the requirement of businesses to open their financial records to the union even where a business employs no union members, and subject

[64] Tasmanian Industrial Commission – Decision, 6 July 1995, Case No. T5500 of 1995.

themselves to cross examination during hearings and site visits by the union.

110. Any proposal that purports to overcome the comprehensive failure of incapacity to pay processes must be able to demonstrate how it overcomes each of these impediments. As we show below, it is not possible to overcome these impediments, and incapacity to pay processes cannot provide an adequate alternative to the small business exemption because they will fail to protect small businesses that cannot cope with severance pay.

AIRC's 2004 decision to enable a group of employers to make application under the incapacity to pay provision

111. As we noted earlier in the submission, in agreeing to an application by the ACCI to vary the provision to enable a group of employers as well as individuals to make application under the provision, the AIRC acknowledged the very real difficulties that small employers may face in using the incapacity to pay provision. However, the amendment will not overcome the significant limitations on the operation of the provision. The AIRC's decision makes it clear that each employer will still have to separately demonstrate that it has an incapacity to pay. The Full Bench states:

> *On the basis that ACCI has submitted that its proposal is not designed to weaken the incapacity to pay principle but to simply improve access to it, we will make the alteration sought. It must be clearly understood, however, that for relief to be granted, the concept of averaging cannot be used and incapacity must be shown in the case of each employer.*[65]

112. The ACTU agreed in submissions to the AIRC in April 2004 that enabling groups of employers to make application under the incapacity to pay provision would not make any difference to the operation of the provision. In response to the ACCI's proposal, the ACTU stated:

> *The ACCI application regarding a change in the current incapacity to pay principle is unnecessary. In appropriate circumstances application can currently be made by groups of employers under this principle.*[66]

113. The Commonwealth also agrees. The particular change made by the AIRC will not improve the effectiveness of the provision. An incapacity to pay process that requires the examination of the circumstances of many

[65] Federal Redundancy Test Case – Decision, Print PR032004, Giudice J, Ross VP, Smith & Deegan CC, 26 March 2004, at paragraph 355.
[66] Federal Redundancy Test Case – ACTU Outline of Contentions in Opposition, Volume 7, at paragraph O43.

thousands of small businesses on a case-by-case basis would be extremely demanding of the resources of industrial tribunals including the AIRC. It would not be an efficient and practical way of protecting the many small businesses that would find it difficult to cope with severance pay.

114. A significant proportion of Australia's 538,500 small businesses could be expected to be detrimentally affected by a requirement to pay severance pay. The AIRC's decision noted ABS statistics that show almost 30 per cent of small businesses (161,500) are not profitable. This data was collected when the small business exemption from severance pay was in force, so does not include businesses that were profitable only in the absence of severance pay. Given that severance pay obligations can be very substantial where there are multiple retrenchments, the imposition of severance pay could be expected to significantly increase the numbers of small businesses that are not profitable.

115. Furthermore, as this submission has demonstrated, the fact that a small business is profitable does not mean that it can cope effectively with the imposition of severance pay. Many small businesses that are profitable are nonetheless chronically undercapitalised and lack the financial resilience to cope with severance pay. The data that would enable the numbers of these small businesses to be estimated is not available. However, it is clear that when these businesses are added to those that are not profitable (including those that are currently profitable but will not be if they have to pay severance pay), potentially hundreds of thousands of small businesses would need to make applications under incapacity to pay provisions if they were to serve as a real alternative to the small business exemption.

116. The incapacity to pay provision, as amended by the AIRC in 2004, fails to overcome the impediment identified by the Queensland Commission in its August 2003 decision. That is, that *"[i]t is likely that small businesses facing a downturn or restructure sufficient to generate redundancies would not have sufficient cash reserves to launch a case in the Commission against an industrial organisation of employees (with perhaps greater access to financial resources) seeking an exemption from the application of severance pay provisions".*[67]

117. The Queensland Full Bench referred to a case in the building industry to support and substantiate this point. The decision assists to clarify the reasoning underpinning the Queensland Commission's decision. The building industry case highlights the inappropriateness of the

[67] QCU V QCCI [2003] QIRComm 383 (18 August 2003), 173 QGIG 1417 at paragraph 100.

incapacity to provision as a general protection mechanism for small businesses. The Full Bench in that case stated:

> *It was also submitted that if the "15 employee" exemption was removed, as sought by the application, then any individual employer could still make an application for relief based on clause 13 "Incapacity to Pay" as already contained in the Declaration of Policy. Bearing in mind that the application involves a Common Rule Award which covers many small employers, it is our view that if such an employer is experiencing financial difficulties then to require the making of an application for relief would be likely to impose a substantial burden in time and cost on employer.*

And later

> *It was also submitted that many employers employing less than 15 employees conduct profitable businesses and have equal or greater capacity to make redundancy payments than many employers with 15 or more employees. Such submission may be correct in some cases, however, upon the only material before us, we are not satisfied that larger employers do not generally have a greater capacity to re-arrange staff and workloads and provide for redundancy payments. It seems to us that in the case of many employers with only several employees the application of TCR provisions would impose a considerable burden and potentially discourage engagement of employees.*[68]

118. The AIRC's amendment to the federal standard provision covering incapacity to pay situations does nothing to alleviate concerns expressed by both the AIRC and the Queensland Commission going to the financial capacity of small businesses to launch and conduct a case based on an incapacity to pay severance pay. As we have shown each individual employer must still prove to the AIRC that is incapable of paying severance pay. It is still just as likely that small businesses will lack the cash reserves to be able to launch such a case.

119. Nor would the AIRC's approach overcome other key reasons why incapacity to pay provisions fail to achieve their objective. It will not make the Commission any less loath to grant an application – the likelihood of success will still be minimal. It will not stop lenders and suppliers from discontinuing credit and forcing the closure of the business when they hear that a business has made an incapacity to pay application. And it will not prevent businesses from having to open their financial records to the union even where the business employs no union members, and subject themselves to cross examination during hearings and site visits by the union.

[68] Re: Building Products, Manufacture and Minor Maintenance Award – State (1997) 154 QGIG 458 at 460.

Exceptional circumstances and the 2003 Safety Net Review

120. While the AIRC's 2004 decision recognised the very significant difficulties that employers face in pursuing a case based on incapacity to pay, it also considered that the Commission could take additional action to alleviate the hardship involved. The Full Bench stated:

> *We recognise that any incapacity to pay case may present the applicant or applicants with difficulties. Almost by definition, an employer's resources to conduct such a case are under serious strain. However, the Commission is experienced in these matters and has sat out of hours, on-site, and has assisted both employers and employees who may not be represented. An example of an approach adopted by the Commission is provided by a recent matter involving the Pastoral Industry Award 1998.*[69]

121. However, the processes implemented by the AIRC under the federal Pastoral Industry Award have not alleviated the difficulties facing employers who launch an incapacity to pay case.

122. Following the 2003 Safety Net Review (SNR), the National Farmers Federation (NFF) applied for automatic recognition of incapacity to pay by farmers bound by the Pastoral Industry Award 1998 who were also receiving drought assistance under the Government's Exceptional Circumstances program. The AIRC did not agree to automatic recognition but instead provided a 'streamlined process' derived from principle 12 of the AIRC's Wage Fixing Principles.[70]

123. Principle 12 of the AIRC's Wage Fixing Principles requires employers seeking to delay SNR increases to apply to the President under s.107 who is then to decide whether or not to refer the application to a Full Bench. Each application requires proof of 'very serious or extreme economic adversity' to be established. Principle 12 also applies to employers seeking relief from redundancy provisions due to incapacity to pay.

124. In this case, Vice President Ross decided that where an employer was in an Exceptional Circumstances declared area and in receipt of Exceptional Circumstances Relief Payment benefits they would be *prima facie* entitled to relief on the grounds of economic incapacity.[71] In its submission the ACTU accepted *"that there are still instances of real, real hardship … [a]nd we accept that they have to be dealt with"*. Further, *"we*

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[69] Federal Redundancy Test Case – Decision, Print PR032004, Giudice J, Ross VP, Smith & Deegan CC, 26 March 2004, at paragraph 354.
[70] Re Agricultural Industry – Decision, Print PR940769, Ross VP, 19 November 2003.
[71] Ibid at paragraph 105.

accept that where businesses have accessed the Commonwealth funding that is referred to in the materials that NFF have, we accept that they have met a strict criteria about hardship and we accept that in the ordinary course that would be a compelling case for economic incapacity".[72]

125. Despite the fact that both the AIRC and the ACTU appear to have accepted that these farmers should be given relief, the 'streamlined' incapacity to pay process instituted by the AIRC has proven to be a failure. Not one farmer has been granted relief. Two applications were made under the arrangements established by Vice President Ross – both have subsequently been withdrawn.

126. The reasons for the failure of this incapacity to pay process were outlined by the NFF in its submission in reply in the SNR 2004 case. The NFF noted that this was due to the requirement for applicant employers to provide three years of financial records and to have them considered by the union even where none of the employees are union members, and the capacity for farmers to be cross-examined by the union.[73]

127. The NFF submission noted that:

> *[E]ligible farmers are not willing to go through the angst and difficulties of accessing a delay in the increases in wages. The cost in both time and potential stress is greater than the savings in accessing a delay in wage increases even though it may have resulted in a cost saving for the business in extreme financial difficulty and/or enabled the ongoing employment of an employee or the reemployment of labour.*[74]

128. The example given by the AIRC in its redundancy test case decision of how it can facilitate the operation of incapacity to pay processes in fact confirms that these processes cannot protect small businesses who are unable to cope with severance pay. The 'streamlined' incapacity to pay process in the pastoral industry failed to overcome the key impediments that generally cause these processes to fail. As the NFF pointed out, an applicant still has to open their financial records to the union, and accept cross examination by the union. Furthermore, a 'streamlined' process will not stop lenders and suppliers from discontinuing credit and forcing the closure of the business when they hear that a business has made an incapacity to pay application.

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[72] Ibid at paragraph 8.
[73] National Farmers' Federation Submission in Reply to the Safety Net Review 2004 Case at paragraphs 34 to 37.
[74] Ibid at paragraph 37.

TLC's fall back position on small business exemption

129. The TLC has put forward a fall back position in the event that the Commission refuses to remove the small business exemption in whole or in part. The TLC proposes that the small business exemption provision be amended so that it explicitly allows unions to argue, on a case-by-case basis that, in a particular redundancy situation, a small business employer has the capacity to pay severance payments and thus the exemption should be lifted.

130. The Commonwealth strongly opposes this fall back position. The proposal is inconsistent with the rationale underpinning the small business exemption and illustrates that the TLC misunderstands why the exemption was originally established.

131. As we have shown earlier in this submission, the reason small businesses were exempted from the requirement to pay severance pay was not because they were able to demonstrate incapacity to pay in the sense recognised by industrial tribunals. The key reason small businesses were exempted from severance pay was because they lack financial resilience.

132. As we have indicated, the lack of financial resilience experienced by small businesses manifests itself in a variety of ways. Small businesses find it relatively harder to obtain finance on reasonable terms and therefore tend to be chronically undercapitalised. They have particular difficulty in raising additional capital to fund restructures, including those restructures where retrenchments are involved. Small businesses therefore have less capacity than large businesses to cope with an unpredicted significant financial impost such as the need to fund severance pay.

133. We have already established that the removal of the small business exemption would severely disadvantage the small business sector. The detrimental impact on small businesses of a particular level of severance pay would be significantly higher than for larger businesses. Small businesses would be hindered in their ability to adapt to changing levels of demand and the business cycle. Restructuring by small businesses would be impeded, particularly where this is in response to a reduction in demand for their product. This is turn would be a deterrent to innovation, business expansion and other risk taking essential for the growth of small business.

134. It is clear from the arbitral history we have examined earlier that the small business exemption was not established because of a belief that

small businesses generally had an incapacity to pay in the formal sense. This was clarified by the AIRC in the early years following the 1984 federal redundancy test case decisions. It is worth quoting again from the key decision of Commissioner Oldmeadow which reviewed this arbitral history:

> *Further, as the majority in the Full Bench decision observed the inclusion of the exemption clause by the TCR Full Bench was in recognition of the "special difficulty" for small businesses in meeting the "financial burden" of redundancy pay. A "special difficulty" does not necessarily mean incapacity to pay*[75]*. [our underlining]*

135. The fall back position put forward by the TLC in the event that the Commission refuses to remove the small business exemption in whole or in part is clearly at odds with the established arbitral authority. The TLC position lacks merit and should be rejected by the Commission.

Appropriate consistency across jurisdictions does not support the removal of the exemption

136. As we have noted, the TLC has submitted that the removal of the small business exemption would have the advantage of producing consistency between State and federal awards in Western Australia.

137. While the Commonwealth agrees that consistency between State and federal awards on significant issues is generally desirable, this is only where the provisions in both jurisdictions are appropriate, both industrially and economically. Where a provision in one jurisdiction is inappropriate, it is clearly not desirable or sensible to replicate that provision in another jurisdiction simply in the name of consistency. This will only act to compound the inappropriateness of the original provision and any adverse impacts that it produces.

138. The removal of the small business exemption clearly falls into the latter category. That is, it is neither desirable nor appropriate to impose severance pay on small businesses operating in the Western Australian jurisdiction just because small businesses covered by federal awards may now be subject to severance pay.

139. It is essential that small businesses in Western Australia continue to be protected from the detrimental impact that the imposition of severance pay will have. Small businesses make a very significant contribution to the Western Australian economy and provide employment for over 120,000 employees. It is vital that the employment of these and

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[75] Ibid.

future employees is protected and every encouragement is given to small business to continue to expand its employment base.

140. Desirable and appropriate consistency between federal awards and Western Australian awards can only be achieved if this Commission rejects the TLC's claim and refuses to remove the small business exemption. Retaining the small business exemption will lead to desirable and appropriate consistency in two ways.

141. First, appropriate and desirable consistency will be achieved if the Federal Parliament passes the Workplace Relations Amendment (Protecting Small Business Employment) Bill 2004. The second reading speech by the then Minister for Employment and Workplace Relations, the Hon Kevin Andrews MP, outlined the purpose and effect of the Bill. A copy of the speech is provided at **Attachment F**. In summary, the Bill will:

- remove redundancy pay for small businesses with fewer than 15 employees from the jurisdiction of the federal Commission;
- not affect any redundancy pay provisions that were in awards prior to the federal Commission's decision;
- cancel the effect of any variations to awards that were made by the federal Commission from the time of the decision until the legislation commences;
- not affect any actual entitlement to redundancy pay that arises in respect of retrenched employees before the legislation commences; and
- prevent the flow-on of the federal Commission's decision to small businesses that are constitutional corporations and that are covered by State awards.

142. Appropriate consistency will be achieved if the Bill is passed by the Federal Parliament and this Commission retains the small business exemption because both small businesses under the federal jurisdiction and small businesses under the Western Australian jurisdiction will be exempted from having to pay severance pay.

143. However, appropriate and desirable consistency is also achievable in the event that the Bill is not passed by the Federal Parliament. If a number of State jurisdictions decide to retain the small business exemption, the AIRC might be able to be persuaded to re-open the federal redundancy case. Appropriate consistency would be achieved across jurisdictions on

this issue if such a review of the 2004 federal decision led the AIRC to reverse its decision and reinstate the small business exemption.

144. However, if this Commission were to impose severance pay on small businesses, and if the Bill were passed, serious inconsistency would be produced in the treatment of small businesses in the federal jurisdiction and the Western Australian jurisdiction. If the Bill is passed small businesses in the Western Australian jurisdiction that are constitutional corporations would be exempt from the obligation to pay severance pay. However, if this Commission were to remove the exemption, small businesses in the Western Australian jurisdiction that are not constitutional corporations would be required to pay retrenched employees severance pay. This would produce inconsistency between small businesses in the Western Australian jurisdiction and federal jurisdiction; and also between small businesses within the Western Australian jurisdiction.

145. Because of this potential inconsistency and the adverse situation it would create, the Commonwealth submits that the Western Australian Commission should not make a decision on the small business exemption until the Federal Parliament has completed its consideration of the Bill.

146. In direct contrast to the exemption from severance pay for small businesses, however, appropriate consistency between jurisdictions can be easily achieved in relation to the TLC's claim to require employers to consult over retrenchments.

147. In its 2004 decision, the AIRC made specific reference to submissions by the AiG which argued that small businesses should continue to be exempt from consultation requirements on the basis that:

- *small businesses do not typically employ specialist human resources personnel to ensure compliance with detailed procedural requirements in circumstances of redundancy;*

- *the Act recognises in ss. 170CG(3)(da) and (db) that small businesses are not generally able to implement termination of employment procedures which are as sophisticated as larger businesses;*

- *the consultation requirements set out in s. 170GA of the Act do not apply to situations where less than 15 employees are to be made redundant; and*

- *exempting small businesses from specific consultation requirements when redundancies are to occur is consistent with clause 5 of Article 2 of the*

> *Convention Concerning termination of Employment at the Initiative of the Employer (set out in Schedule 10 of the Act.)*[76]

148. The AIRC decision retained the long standing exemption of small businesses from consultation requirements, with the Full Bench stating:

> *We are satisfied that it is appropriate to exempt small business from the agreed clause. A feature of the clause is the requirement to discuss alternatives to redundancy (such as redeployment options) and to consult with employees generally. We accept that if the clause applied it would have the potential to cause a number of problems within small businesses including disruption to the workplace, lost productivity and administrative difficulties. Some of these problems were highlighted by the Benson survey.*[77]

149. The Full Bench also noted that evidence from individual employer witnesses supported this conclusion, indicating that a requirement to consider and discuss alternatives to redundancy, such as redeployment and the creation of part-time roles, would be of little practical value in a small business where redeployment is not a realistic option.[78]

150. It follows that to achieve appropriate consistency across jurisdictions this Commission should similarly retain the exemption for small businesses from the requirement to consult over retrenchments.

Conclusion – the small business exemption should not be removed

151. The Commonwealth submits that the TLC's claim to remove the small business exemption should be rejected because:

- Removal of the exemption would be against authoritative arbitral precedent that has recognised that small businesses are generally unable to cope with severance pay.

- Removal of the small business exemption would have a devastating impact on the sector and on employment in the sector because of the relative lack of financial resilience of small businesses.

- Small businesses would be unable to set aside the large amount of funds needed to cover severance pay if it were imposed.

- The AIRC's decision to remove the exemption is founded on mistakes, misunderstandings and misinterpretations.

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[76] Federal Redundancy Test Case – Decision, Print PR032004, Giudice J, Ross VP, Smith & Deegan CC, 26 March 2004 at paragraph 279.
[77] Ibid at paragraph 280.
[78] Ibid at paragraph 281.

- The material put before the AIRC did not justify the removal of the exemption.

- In fact, when the material considered by the AIRC is properly understood and interpreted, it strongly supports the retention of the small business exemption.

- Incapacity to pay provisions are not an appropriate substitute for the small business exemption.

- Removal of the exemption would not produce appropriate consistency between State and federal awards. The proposed Bill, if passed, would produce inconsistencies within the Western Australian jurisdiction.

- Severance pay for small business employees is more appropriately dealt with through workplace bargaining. This is far more preferable than removing the exemption and imposing an across the board obligation on small businesses that cannot cope with severance pay.

4. The TLC's claim to require severance payments in some transmission of business situations is unjustified and inequitable

152. Subclause 4.7 of the TLC's claim deals with transmission of business arrangements. Paragraph 4.7.1 outlines the circumstances in which the redundancy provisions provided in clause 4, including severance pay, would not apply where a business is transmitted from one employer to another employer. These circumstances include:

- where the employee accepts employment with the new employer (the transmittee) which recognises his/her period of continuous employment with the previous employer (the transmittor); and

- where the employee rejects an offer of employment with the transmittee in which the terms and conditions of employment are substantially similar and no less favourable than those applicable at the time of ceasing employment with the transmittor; and which recognise the period of continuous service with the transmittor.

153. The subclause then goes on in paragraph 4.7.2 to provide exceptions to the above circumstances. Where the exceptions apply, severance pay would be required to be paid. These are:

- where the acceptance of employment with the transmittee is conditional on the employee being employed under an Australian workplace agreement (AWA); or

- where an employee was employed under a collective agreement with the transmittor, but acceptance of employment with the transmittee is conditional on employment being under a statutory individual agreement under the *Industrial Relations Act 1979*; or

- unless the employee is offered employment by the transmittee under an award, order or collective agreement under the *Industrial Relations Act 1979*.

154. Paragraph 4.7.2 will operate to severely discourage the use of federal industrial instruments in circumstances where there is a transmission of business. This is because the provision dictates that an employee who accepts employment with a transmittee and whose terms and conditions of employment with the transmittee are to be regulated by either an AWA, a CA or federal award, will be entitled to receive severance pay from the transmittor. Severance pay will be required even though the employee may be employed by the transmittee on exactly the same terms and conditions as with the transmittor, and even though all previous service with the transmittor is recognised by the transmittee.

155. The provision therefore presents to the transmittor an additional cost which would not have to be borne if the employee was not covered by one of these federal industrial instruments. It could be expected that the potential for this impost will act to discourage the use of federal industrial instruments to regulate employment.

156. It is important to note here that the *Workplace Relations Act 1996* (the WR Act) includes provisions to ensure that employees who are covered by an AWA or CA are not disadvantaged in relation to their terms and conditions of employment. Section 170XA of the WR Act sets out the requirements of the ‘no disadvantage test’. In general, the test prevents an AWA or CA from reducing the overall terms and conditions to which employees covered by the agreement are entitled under any relevant award/s and laws. It follows that it is not open to the TLC to argue that employees who secure employment with a transmittee under an AWA or

CA are disadvantaged in any way compared to other employees whose terms and conditions are regulated by say, a State or federal award.

157. The Commonwealth is strongly opposed to this element of the TLC's claim. The following section details why paragraph 4.7.2 is inappropriate for inclusion in the proposed redundancy clause and the reasons underpinning the Commonwealth's opposition.

Arbitral history confirms that severance pay should not be paid in situations where businesses are transmitted from one employer to another employer

158. The Full Bench in the 1984 federal TCR test case decision clearly articulated that severance pay should not be paid in situations where businesses are transmitted, stating *"[h]owever, we would make it clear that we do not envisage severance payments being made in cases of succession, assignment or transmission of a business"*[79]. This principle and its underpinning reasoning has been widely adopted by State workplace relations jurisdictions, including this Commission.

159. The reason that severance pay should not apply to typical transmissions of businesses is that employees do not suffer the losses for which severance pay is intended to compensate. The central rationale underpinning severance pay in the federal jurisdiction was established in the August 1984 TCR test case decision. Severance pay was intended to compensate employees for hardship incurred due to the loss of their job through no fault of their own. Specifically, the Full Bench stated *"… severance pay is justifiable as compensation for non-transferable credits and the inconvenience and hardship imposed on employees".*[80]

160. In its 2004 federal redundancy test case decision, the AIRC reaffirmed the reasons for the establishment of severance pay, stating *"[w]e have not been persuaded that the rationale of the 1984 decision is incorrect…".*[81]

161. In a major case in 1986 in the Western Australian jurisdiction dealing with the Metal Trades (General) Award, the Commission in Court Session, by majority decision, accepted the reasoning of the AIRC, stating:

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[79] Termination, Change and Redundancy Test Case – Decision, Print F6230, Moore J, Maddern J and Brown C, 2 August 1984,; 8 IR 34 at 75
[80] Ibid, at 73
[81] Federal Redundancy Test Case – Decision, Print PR032004, Giudice J, Ross VP, Smith & Deegan CC, 26 March 2004, at paragraph 152

> *… Turning now to the redundancy provisions we respectively endorse the finding of the Australian Commission that … severance pay … is justified as compensation for the inconvenience and hardship imposed on employees and for loss of certain non-transferable credits.*[82]

162. The principle that severance pay should not apply to a typical transmission of business was again accepted by the ACTU, peak employer bodies and the AIRC in the 2004 federal redundancy test case. In that case the parties reached agreement to vary the transmission provisions to explicitly provide that severance pay is not payable to employees accepting employment with a transmittee who recognises previous service with the transmittor, or to employees who reject such an offer of ongoing employment on terms and conditions that are substantially similar and no less favourable when considered on an overall basis.

163. The ACTU indicated in its submissions in the 2004 case that the new transmission of business provisions reflect the principles underlying the 1984 federal decision. The transcript from 22 April 2004 records oral submissions made by the ACTU as follows:

> *[Ms Bissett] R7 is a new variation or a new transmission of business clause that the parties reached agreement about during the conciliation process. The purpose of this clause is to give certainty to the principles that we believe were enunciated in the 1984 decision, TCR decision, and that is that where transmission occurs and employment continues there is no redundancy situation. What it does do in addition - so it in our view properly reflects the intent of the '84 decision, we believe that that was the intent, but it does contain a capacity for the Commission to vary what is in the clause in circumstances where the clause would operate unfairly.*
>
> *It places the obligation squarely on the unions respondent to the awards if they see that clause operating unfairly to bring matters to the Commission and to argue them and to have them arbitrated. The capacity to bring the matters and to have them arbitrated operate similarly to the way the superannuation offset clause used to operate, so subject to further order and that is the intent of that particular provision.*[83]

The TLC's claim is inconsistent with established arbitral principles for severance pay

164. While the provisions of paragraph 4.7.1 are consistent with the established arbitral principles and the agreed position reached by the parties and accepted by the AIRC in the 2004 federal redundancy test case, the provisions sought in paragraph 4.7.2 are clearly not. In fact,

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[82] AMWSU (W.A.) v. Anchorage Butchers Pty. Ltd. &Ors; Industrial Relations Commission is Court Session (Collier C.C., Halliwell S.C., Martin, Fielding and Salmon CC.) (No. 394 of 1985) 19 February 1986.
[83] Federal Redundancy Test Case 2004, transcript from 22 April 2004, PN 8284-8285.

there is no arbitral precedent for the TLC's claim in any workplace relations jurisdiction in Australia.

165. To require employers to pay severance pay in circumstances where the employee does not experience or suffer the losses for which severance pay is intended would be nonsensical. Employees who gain employment with a transmittee, and have their previous service with the transmittor recognised, do not lose their non-transferable credits for personal leave or long service leave. Nor do they experience the hardships associated with job loss. They do not suffer these losses irrespective of what type of industrial instrument regulates their new employment situation.

166. An analogy which illustrates the absurdity of the TLC's claim is to compare it to a claim that seeks the payment of overtime to employees who have not experienced the circumstances for which overtime is intended to compensate – i.e. who have not worked any overtime. The TLC's claim has that little merit or logic. It seeks to require employers to pay an employee severance pay in circumstances where the employee has not suffered any of the losses for which severance pay was established to compensate. It requires severance pay to be paid to an employee who has not lost any non-transferable credits and has not suffered any hardship associated with losing a job. The severance payment under these circumstances becomes nothing more than a gratuitous payment. It is no longer purporting to compensate employees for any losses incurred.

167. The TLC's claim would result in inequities among employees and between employers. Employees who receive exactly the same remuneration and other entitlements would receive different severance pay entitlements, dependant only on whether they were employed under an AWA or other federal industrial instrument or under a State award or collective agreement.

168. The claim also potentially creates inequities between employees who secure employment with a transmittee and those who are retrenched. Employees who secure employment with a transmittee and who have their prior service with the transmittor recognised retain all their employment entitlements as if they were still employed by the transmittor. However, employees who are not successful in securing employment with the transmittee will be retrenched with the resultant loss of non-transferable credits such as personal leave and long service leave credits. They will also need to search for another job. If the transmittee regulates its new employees' terms and conditions of employment by an AWA or other federal industrial instrument, then pursuant to paragraph 4.7.2, those

employees will receive severance pay. That is, employees will receive severance pay irrespective of whether they are being retrenched, or whether they secure employment with the transmittee and retain their employment entitlements.

169. In short, there is no justification for the claim being pursued by the TLC. It is directly opposed to established arbitral principle accepted by most industrial tribunals, it will produce inequities among employees and between employers and lacks merit. The claim should accordingly be rejected by the Commission.

5. The TLC's claim for 16 weeks' severance pay after 10 or more years' service is unwarranted

170. The final part of the Commonwealth's submission deals with the TLC's claim for a severance pay scale that provides 16 weeks severance pay for retrenchees with 10 or more years' service. We have already indicated the Commonwealth's opposition to this element of the TLC's claim. The Commonwealth's reasons are dealt with in more depth in the following submission.

171. We have detailed earlier in the submission the overriding principle underpinning the establishment of severance pay in the federal jurisdiction by the AIRC in 1984. The key reason why severance pay was established was to compensate employees for losses they would incur when retrenched. These losses included principally the loss of non-transferable credits and the hardship associated with job loss.

172. Importantly, the majority of State jurisdictions agreed with the AIRC's conclusions regarding the establishment of severance pay. As we have already noted, the AIRC similarly reaffirmed the 1984 rationale for severance pay in the 2004 federal redundancy test case.

173. A very substantial component of non-transferable credits that are lost to employees on retrenchment is their long service leave entitlement. The minimum severance pay standard includes an amount to compensate employees for these lost long service leave credits. In its 2004 federal redundancy test case decision, the AIRC confirmed the significant part that long service leave entitlements had in the determination of the severance pay scale. In setting the new severance pay scale the Full Bench stated:

> *[154] Our decision to increase severance payments for employees whose employment is terminated by reason of redundancy after five or more years of*

> *service is based, to a significant extent, on the loss of non-transferable credits. The largest non-transferable credit is long service leave which accrues at the rate of 13 weeks' leave for 15 years of service.*[84]

174. However, retrenchees with more than 10 years' service who are covered by the Western Australian *Long Service Leave Act 1958* (LSL Act) do not lose any accumulated long service if they are retrenched. Subsection 8(3) of the LSL Act reads:

> *(3) Subject to subsection (5), where an employee has completed at least 10 years of such continuous employment since the commencement thereof, but less than 15 years, and the employment is terminated –*
>
> *(a) by his death; or*
>
> *(b) for any reason other than serious misconduct,*
>
> *the amount of leave to which the employee is entitled shall be a proportionate amount on the basis of 13 weeks for 15 years of such continuous service.*

175. This means that employees who are retrenched and have 10 or more years' continuous service with their employer will be paid their pro rata long service leave credits on retrenchment.

176. It follows that inequities will arise if retrenchees with 10 or more years' service are compensated for long service leave through both a payment of pro rata long service leave in accordance with the LSL Act, and through a severance payment which includes a component for loss of long service leave credits. The result is obvious double counting of long service leave entitlements.

177. This double counting can be corrected by adjusting the severance pay scale for those retrenchees with 10 or more years' service. To do this the long service leave component in the severance pay scale needs to be removed from the rate of payment applicable once an employee has reached 10 years service and thereafter.

178. In its 2004 federal redundancy test case decision, the AIRC recognised and accepted that double counting of long service credits was inappropriate in the establishment of the new federal severance pay scale. The Full Bench decided on a severance pay scale which steps down from 16 weeks severance pay for retrenchees with nine years' service to 12 weeks' severance pay for retrenchees with 10 or more years' service. In handing down this scale the Full Bench stated:

> *[154] … The amount of 12 weeks severance pay for 10 or more years of service, while still greater than the current maximum, has been fixed having regard to the*

[84] Federal Redundancy Test Case – Decision, Print PR032004, Giudice J, Ross VP, Deegan & Smith CC, 26 March 2004, at paragraph 154.

> *fact that under the standard long service leave provision in federal awards employees with 10 or more years service whose employment is terminated on account of redundancy are entitled to pro rata payment of long service leave. It would be double counting not to make an allowance for that fact in fixing the amount of severance pay to apply after 10 years of service.*[85]

179. Exactly the same logic and argument applies in this case. Double counting of long service in the manner encompassed in the TLC's claim is inappropriate and inequitable. This aspect of the TLC's claim should be rejected.

[85] Ibid.

Attachment A

ARBITRAL HISTORY OF THE SMALL BUSINESS EXEMPTION

1. This attachment provides information on the establishment and development of the exemption from severance pay for small business. An examination of the arbitral history of the small business exemption demonstrates that the original rationale for the exemption remains valid today. The key points borne out of the following analysis are:

- Businesses with fewer than 15 employees were excluded from the process prescribed under the NSW *Employment Protection Act 1982* with respect to notification of redundancies;

- The AIRC ultimately excluded small businesses from the requirement to make severance payments in the 1984 test case;[1]

- The exemption was continued by the NSW Industrial Commission (NSWIC) in 1987 in *Re Clerks (State) Award & Other Awards.*[2] It was again specifically reaffirmed in 1994 when the NSWIC rejected a claim by the unions to remove the small business exemption from the NSW standard. In rejecting the claim the NSWIC stated:

  > *We note that this level of exception [the 15 employees threshold] is contained in the Employment Protection Act and has been extensively followed elsewhere. In the circumstances, bearing in mind the relative lack of financial resilience of small business, we determine to maintain the barrier in the same terms.*[3]

- The Queensland Industrial Relations Commission (QIRC) exempted small businesses from having to make severance payments in its 1987 test case. It reaffirmed this position in 2003 citing the continuing *"lack of financial resilience in small business"* and recognised that *"[m]any small businesses operate in marginal circumstances"* where an *"obligation to make severance payments has the very real potential to result in the insolvency of a number of small businesses"*.[4]

- The Victorian and Western Australian industrial tribunals also exempted small business employers from their severance pay standard. The Tasmanian Industrial Commission (TIC) has not set a standard. Only the South Australian Industrial Commission requires small businesses to adhere to the severance pay standard.

2. The following analysis details the chronological history of the small business exemption in the federal and State jurisdictions.

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[1] Termination, Change and Redundancy Test Case – Supplementary Decision, Print F7262, Moore J, Maddern J and Brown C, 14 December 1984, 9 IR 115.
[2] Re Clerks (State) Award & Other Awards – Decision, Fisher P, Bauer & Glynn JJ, 8 April 1987, 21 IR 29.
[3] Re Redundancy Awards – Decision, Fisher P, Glynn J, Peterson J, & Buckley CC, 24 June 1994, 53 IR 419, 444.
[4] QCU v QCCI [2003] QIRComm 383 (18 August 2003); 173 QGIG 1417 at paragraph 100.

NSW Employment Protection Act 1982

3. The development of standard redundancy provisions and benefits in the NSW jurisdiction preceded the federal 1984 termination, change and redundancy (TCR) test case with the enactment of the NSW *Employment Protection Act 1982* (the NSW Act). From its commencement on 8 December 1982, the NSW Act did not apply to those employers with fewer than 15 employees.

4. The NSW Act established machinery to ensure that, on the intended termination of employment of an employee, the Industrial Registrar received notice so that it could review the circumstances and make an appropriate order. There were several exemptions under the NSW Act from the notice provisions including where the employer immediately before the termination or proposed termination employed fewer than 15 employees.

5. The intention and proposed operation of the NSW Act is summarised in the second reading speech delivered by Minister Hills, the then NSW Minister for Industrial Relations and Technology:

> *I emphasise … that the proposed measure in no way attempts to legislate for redundancy payments or entitlements. … The purpose of the legislation is to enable the New South Wales Industrial Commission, where necessary, to investigate and determine the reasonableness or otherwise of particular conditions of termination or redundancy. To achieve this, the Act will require employers of fifteen or more employees to notify the Industrial Registrar of their intention to terminate the employment of one or more employees at least seven days before the employer gives the employee or employees notice of termination of employment.*
>
> *… Upon receipt of the notice, the registrar must notify both the President of the Industrial Commission and the registered unions involved … The Industrial Registrar is empowered to report to the President of the Industrial Commission*
>
> *… The President may allocate any Industrial Registrar's report to any member of the Industrial Commission or any Conciliation Commissioner to consider and inquire into the matter …*
>
> *… the Tribunal may make orders in relation to the termination and these orders may include … severance payments … Before making such an order, however, the Industrial Commission will be required to have regard to the financial and other resources of the employer involved, and the probable effect the order, if made, will have in relation to the employer.*[5]

Federal TCR test case – 1984

6. The initial redundancy standard in the federal jurisdiction was established by the AIRC in 1984 through two Full Bench decisions – the first in August 1984 and the second in December 1984.

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[5] Second Reading Speech, Employment Protection Act 1982, Minister Hills, Minister for Industrial Relations and Technology, 1 December 1982.

7. In the August 1984 decision the AIRC excluded employers who employ fewer than 15 employees from the notification and consultation provisions only,[6] not from the requirement to make severance payments. However, a provision was included which enabled employers to argue incapacity to pay in a particular redundancy case.

8. The decision resulted in a multitude of complaints from employers, largely concerned with the cost implications of the decision and seeking a revision of several aspects of the decision, including the position with respect to exemptions. Employers claimed the decision did not make due recognition of the devastating impact the severance pay obligation would have on small businesses and presented further evidence detailing the vulnerability of small businesses. The new evidence was extensive, establishing that:

- an imposition of severance pay would severely hit at business viability by the creation of a large and unfunded contingent liability;
- the implementation of severance pay could cause businesses to fail because of the inability to attract finance;
- many businesses cannot get further finance and proprietors risk their own personal assets to enable their businesses to remain viable;
- to fund redundancies, proprietors may need to make payments out of their capital because there are no profits in the business for them to pay the liabilities, and there is an inability to borrow further from financial institutions;
- severance pay will impose a disincentive with respect to the desirability of employing employees permanently;
- there is a real fear of approaching the AIRC in terms of the incapacity to pay provisions as the AIRC's judgement may result in immediate insolvency because creditors learn about that fact and seek to protect their own interests by calling in debts; and
- there is a real fear that businesses will not take risks because of the contingent liability they may have to face in the event that their business venture fails.

9. This evidence persuaded the AIRC to introduce a new provision in its December 1984 decision which exempted employers with fewer than 15 employees from the impost of severance payments. This exemption was in addition to the provision dealing with an employer's incapacity to pay redundancy:

> *We would not be prepared to award an exemption from severance payments to employers who employ less than 100 employees from our decision, although we are aware that some such enterprises may not have the capacity to pay. However, in the interests of uniformity with New South Wales, and in the light of the material presented about the effect of taking into account previous service, we are prepared to grant an exemption for employers of less than 15 employees. This exemption will be subject to further order of the Commission.*[7]

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[6] Termination, Change and Redundancy Test Case – Decision, Print 6230, Moore J, Maddern J and Brown C, 2 August 1984, 8 IR 34 at 64.

[7] Termination, Change and Redundancy Test Case – Supplementary Decision, Print F7262, Moore J, Maddern J and Brown C, 14 December 1984, 9 IR 115 at 136-137.

Current NSW position – 1987 and 1994 test case decisions

10. In 1987, in *Re Clerks (State) Award & Other Awards*[8], the NSWIC adopted the federal redundancy provisions with some modifications for clerks, electricians and plant operators. Although the NSWIC granted provisions that were generally consistent with the federal provisions, including consistency with regard to the small business exemption, it maintained its different rationale for redundancy pay.

11. Removing the small business exemption was a major issue to be decided in a further test case determined in 1994 by the NSWIC. In that case the unions criticised the exemption as unrealistic and inappropriate.[9] Employers conversely argued that to remove the exemption would place a great burden on small employers and presented statistical material on the numbers of employees in retail establishments and the farm sector to support their argument.[10] The NSWIC decided to retain the exemption, pointing in particular to the "*relative lack of financial resilience in small business*".

> *We note that this level of exception [the 15 employees threshold] is contained in the Employment Protection Act and has been extensively followed elsewhere. In the circumstances, bearing in mind the relative lack of financial resilience of small business, we determine to maintain the barrier in the same terms.*[11]

12. Where the relevant award or agreement does not contain a clause dealing with employment protection, the NSW Act continues to apply.

Current Queensland position – 1987 and 2003 test case decisions

13. In 1987, the QIRC adopted the federal redundancy standard that exempted small businesses from an obligation to make severance payments. In 2002 the QIRC considered a further test case on redundancy standards to apply in the Queensland jurisdiction. A key claim considered in the case was the removal of the small business exemption.

14. The QIRC handed down its decision in the test case in August 2003, deciding to retain the small business exemption. Paragraph 100 of the Full Bench's decision[12] sets out in some detail the reasoning underpinning the QIRC's decision to retain the small business exemption, including:

- many small businesses operate in marginal circumstances;
- an obligation to make redundancy payments has the very real potential to result in the insolvency of a number of small businesses;
- the lack of financial resilience in small business previously referred to has not changed since 1994 when the NSWIC last reaffirmed the small business exemption;

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[8] Re Clerks (State) Award & Other Awards – Decision, Fisher P, Bauer & Glynn JJ, 8 April 1987, 21 IR 29 at 29.
[9] Re Redundancy Awards – Decision, Fisher P, Glynn J, Peterson J, & Buckley CC, 24 June 1994, 53 IR 419 at 424.
[10] Ibid at 428.
[11] Ibid at 444.
[12] QCU v QCCI [2003] QIRComm 383 (18 August 2003); 173 QGIG 1417.

- small business would generally have smaller cash reserves to meet redundancy pay requirements, and redundancies occurring would represent a greater proportion of the overall labour costs of the business;

- it is likely that small business facing a downturn or restructure sufficient to generate redundancies would not have sufficient cash reserves to launch a case in the Commission against an industrial organisation of employees (with perhaps greater access to financial resources) seeking an exemption from the application of severance pay provisions – see *Building Product, Manufacture and Minor Maintenance Award – State* (1997) 154 QGIG 458.

Cases which flowed the 1984 redundancy standard to other State jurisdictions

15. Following the 1984 federal TCR decision test cases were heard in the various State jurisdictions to flow-on the decision.

16. In October 1985, the then **Victorian Commission**, when adopting the other main elements of the federal redundancy standard also adopted the federal exemption for small businesses from severance pay until at least 31 December 1986. During this time leave was reserved for the Victorian Trades Hall Council to apply if significant cause for concern arose during that time. It did not do so.

17. Two cases were heard in **Western Australian** which sought to flow the federal standard to State awards. The first case in May 1985 was rejected by the Western Australian Commission on the basis that the union argument based on uniformity with federal conditions and standards was inadequate. The Commission preferred a case-by-case approach. In the second case in June 1986 the Western Australian Commission adopted the federal standard, including the small business exemption. However, the Commission felt that consistency with the relevant federal award demanded that it reject the unions claim not to include the small business exemption, even though it was convinced that the figure 15 was arbitrary, originated from the NSW *Employment Protection Act 1982*, and was more related to administrative problems than merit.

18. The **Tasmanian Commission** declined to adopt a redundancy pay standard in September 1985, instead agreeing to facilitate access to the Commission on a case-by-case basis by those suffering disabilities as a result of retrenchment. The Tasmanian Trades and Labour Council was to monitor the approach over a period of 12 months with a view to re-applying to the Commission after that time. It did not do so, and has not done so since.

19. The **South Australian Commission** declined to adopt the small business exemption in June 1987 when it adopted the other main elements of the federal TCR standard. While it agreed there were benefits in uniformity of approach between tribunals, it considered it unjust to grant an automatic exemption simply because the employer employs less than 15 employees. It did not agree that small employers could not necessarily not afford redundancy pay and the considered the number 15 as arbitrary.

Current Federal TCR standard – 2004 test case decision

20. In late 2002 the Australian Council of Trade Unions (ACTU) launched a test case in the federal jurisdiction to review the standard redundancy provisions established in 1984. A key element of the ACTU's claim was the removal of the small business exemption.

21. The Full Bench of the AIRC handed down its initial decision in the case on 26 March 2004. The decision removed the exemption for small businesses from having to make redundancy payments and applied the redundancy pay scale established for larger businesses in 1984 to small business redundancies (a maximum of 8 weeks' pay after four years' service).

22. In its decision, the AIRC noted that:

> *[a]s a general proposition the employees of small businesses are entitled to some level of severance pay. The evidence establishes that the nature and extent of losses suffered by small business employees upon being made redundant is broadly the same as suffered by persons employed by medium and larger businesses. It is also clear that the level of the exemption is to some extent arbitrary and can give rise to inequities in circumstances where a business reduces employment levels over time.*[13]

23. The AIRC also noted that *"[w]hile some small businesses lack financial resilience and have less ability to bear the costs of severance pay than larger businesses, the available evidence does not support the general proposition that small business does not have the capacity to pay severance pay"*. Further, *"[i]n the period 1997–98, the most recent period for which data are available, some 70 per cent of small businesses which reduced the number of persons they employed made a profit"*. [14]

24. Although the Full Bench acknowledged that most State jurisdictions' retention of small business exemption was *"a factor which supports the retention of the exemption in federal awards"* the Bench noted that *"it is not a determinative consideration and must be balanced against those considerations which favour the removal of the exemption."* [15]

25. The AIRC handed down a supplementary decision on 8 June 2004 dealing with outstanding issues that had arisen in the settlement of orders to vary the awards that were used in the test case. The AIRC decided that the redundancy pay scale for small business would take into account only the future service of employees, with previous service not counting in determining the entitlement of employees to redundancy pay. The Full Bench accepted that *"small business employers may not have the financial reserves necessary to meet a redundancy situation immediately, even though currently trading profitably"*.[16]

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[13] Federal Redundancy Test Case – Statement, Giudice J, Ross VP, Smith & Deegan CC, 26 March 2004, paragraph 11.
[14] Federal Redundancy Test Case – Decision, Print PR032004, Giudice J, Ross, VP, Smith & Deegan CC, 26 March 2004, at paragraph 273
[15] Ibid at paragraph 274.
[16] Federal Redundancy Test Case – Supplementary Decision, Print PR062004, Giudice J, Ross, VP, Smith & Deegan CC, 8 June 2004, at paragraph 21.

ATTACHMENT B

THE COST IMPACT OF IMPOSING SEVERANCE PAY ON SMALL BUSINESS IN WESTERN AUSTRALIA

Set out below is an outline of how the Commonwealth's estimates of the cost impact of imposing severance pay on small businesses in Western Australia were made. Note that the costing is for all small business employees in Western Australia, as data on the proportion of WA small business employees that are covered by the State jurisdiction is not available.

Cost per retrenching firm

1. The average weekly ordinary time wage of small business retrenchees (other than casuals) in WA was calculated as $669.60 (Sources: Data on the composition of employees who are retrenched was obtained from ABS Retrenchment and Redundancy, Cat. No. 6266.0, July 2001- unpublished data; data on the average weekly wages of the various categories of employees was obtained from ABS Employee Earnings and Hours, Cat. No. 6306.0, May 2002- unpublished data).

2. This average wage and the scale of severance payments granted by the AIRC was used together with data about the duration of employment for retrenchees (other than casuals) to compute an average cost per small business retrenchment of $3,513 in May 2002 dollars. This is equivalent to $3,367 on average over 2000-01 (Source: ABS Retrenchment and Redundancy, Cat. No. 6266.0, July 2001- unpublished data).

3. The average cost of retrenchment was multiplied by the total number of small business retrenchments (other than casuals) in WA to provide an estimate of $13.9 million as the total cost of retrenchments for small business employees in Western Australia over 2000-01, if the AIRC scale applied (The estimate of the number of employees retrenched by WA small businesses was computed from data from ABS Retrenchment and Redundancy, Cat. No. 6266.0, July 2001- unpublished data).

4. Over the same period, aggregate gross wages costs of all small business employees (including casuals) in WA totalled $5,442.5 million (Source: ABS Wage and Salary Earners, Cat. No. 6248.0, 2000-01 quarters; multiplied by 0.75 to get businesses with 1-14 employees). Assuming that 13 per cent of small businesses retrenched during 2000-01[1], the average cost per retrenching firm would have added around 2.0 per cent to their wages bill.

Recessionary conditions

The level of retrenchments over the year to July 2001 reflected relatively benign economic conditions. The retrenchment rate in the early 1990s was substantially higher than the rate in 2001. If a similar recession had occurred in 2000-01:

- the total cost of retrenchments for small business would have been $22.3 million; and

[1] Based on AWIRS estimate for 1995, page 363.

- the average cost per retrenching firm would have been equivalent to 3.1 per cent of their wages bill.

Contingent liability

The contingent liability would be equivalent to the cost of retrenching all relevant employees. The Commonwealth's estimate of the contingent liability created by the granting of severance pay at the level established by the AIRC was calculated as follows:

1. The average total number of employees (excluding casuals) in small businesses employing 1-14 people in WA over 2000-01 was 123,000 (Source: ABS Wage and Salary Earners, Cat. No. 6248.0, 2000-01 quarters).
2. The average weekly wage of all small business employees (excluding casuals) was calculated as $621.20. This is lower than the average weekly wage of small business retrenchees ($669.60) because of the relatively small proportion of part time small business employees that were retrenched (Source: ABS Employee Earnings and Hours, Cat. No. 6306.0, May 2002- unpublished data).
3. The average weekly wage was used together with data about the duration of employment of retrenchees (excluding casuals) and the AIRC's small business scale of severance pay to compute a total contingent liability for retrenchments for small businesses of $400.6 million.
4. This represents 7.4 per cent of aggregate gross wages costs of small business employers.

Attachment C

DO BUSINESSES CEASE OPERATION TO REALISE A PROFIT, OR ARE THEY MORE LIKELY TO CEASE DUE TO FINANCIAL DIFFICULTIES?

1. The Productivity Commission Staff Research Paper *Business Failure and Change: An Australian Perspective*[1] suggests that the single greatest reason for business exit is realising a profit. The paper based this finding entirely on evidence obtained from research conducted by Watson and Everett outlined in a paper *Do small businesses have high failure rates?: Evidence from Australian Retailers*[2].

2. As outlined in the submission, the finding was misinterpreted by the AIRC. The AIRC appears to have interpreted the finding as relating to cases in which businesses cease to operate and therefore retrench employees. The AIRC then appears to have drawn the inference that many such businesses could afford to pay severance pay because they were realising a profit. However, the Productivity Commission finding (based on Watson and Everett data) is not relevant to this issue because it in fact deals with business exits both in the sense of business cessation and changes in ownership.

3. Nevertheless, it is possible to use the Watson and Everett data to produce estimates that are far more relevant to the issue of the affordability of retrenchments – it is possible to estimate the extent to which business cessations covered by the study occurred to realise a profit, and the extent to which they occurred because businesses were in financial difficulties. We have undertaken such an analysis and it demonstrates what would be expected – the majority of business exits that were initiated to realise a profit involved the sale of the business. They did not involve the closure of the business and consequent retrenchments. More significantly, the analysis also shows that only about 15 per cent of the business cessations covered by the study occurred to realise a profit. In contrast, over 50 per cent of cessations occurred for the reasons: "to prevent further losses", "didn't make a go of it" and "bankruptcy".

4. We have also undertaken a similar analysis to adjust the finding of the Productivity Commission Report that only about 2.5 percentage points of business

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[1] Bickerdyke, I., Lattimore, R. & Madge, A. (2000) 'Business Failure and Change: An Australian Perspective', Productivity Commission Staff Research Paper, December in AIRC Exhibit ACTU 3, Tag 2, p. 20.
[2] Watson, J & Everett, J (1996) 'Do small businesses have high failure rates?: Evidence from Australian Retailers' *Journal of Small Business Management*, October, AIRC Exhibit C/W 4, Appendix 8.

exits are because of financial difficulty. When this is done, as shown below, it is found that 70 per cent of business cessations are due to financial difficulties.

Analysis of Watson and Everett data

5. As shown in Figure 1, the data provided by Watson and Everett show that, if the business exit rate is defined to mean only business cessations, the proportion due to realising a profit falls significantly from 3.4 per cent (or 36 per cent of business exits) to 0.6 per cent (or 15 per cent of business exits). As the Productivity Commission Paper explains in Section 2.7 (Summary) "Business exits should be distinguished from business failure. There are many reasons for businesses to exit, not least of which is taking advantage of an option of realising a profit from the sale of the business." (our underlining)

Figure 1: Business Exit Rates for various reasons for sale or closure.

Reason for sale or closure	**Discont. of ownership[(a)]**		**Discont. of business**	
Bankruptcy	179	0.7%	114	0.4%
To prevent further losses	415	1.5%	270	1.0%
Did not make a "go of it"	267	1.0%	162	0.6%
Retirement or ill health	126	0.5%	37	0.1%
To realise a profit	916	3.4%	152	0.6%
Unknown	329	1.2%	166	0.6%
Other – Not failed	277	1.0%	78	0.3%
Other – Failed	34	0.1%	23	0.1%
Total Exits	**2543**	**9.4%**	**1002**	**3.7%**
Total Businesses	**27067**	**100%**	**27067**	**100%**

Source: Watson & Everett – see footnote 2
(a) Discontinuance of Ownership includes those businesses exits that cease to exist and those that change ownership.

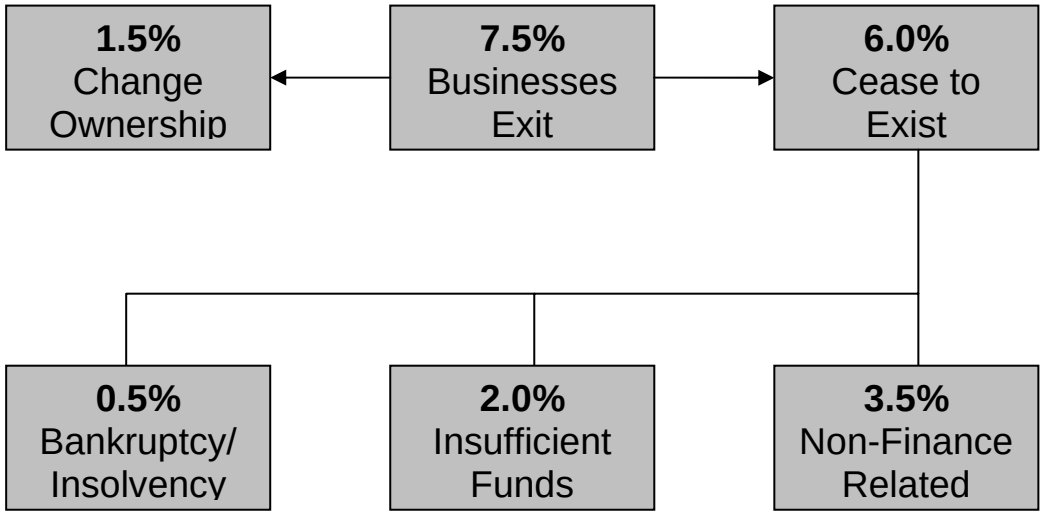
Business exit rates

6. The AIRC's decision also refers to other data from the Productivity Commission paper, stating that "of the 7.5 per cent of businesses which exit in any year, only 0.5 per cent do so for reasons of bankruptcy or insolvency."[3] The

[3] Federal Redundancy Test Case – Decision, Print PR032004, Giudice J, Ross VP, Smith & Deegan CC, 26 March 2004, at paragraph 226.

decision does not refer to the fact that the Productivity Commission research also shows that one third, or 2.5 percentage points of businesses which exit, are either insolvent or have insufficient funds. Contrary to the implication of the AIRC's decision, the Productivity Commission research shows that a significant proportion of exits are due to financial difficulties. The evidence is summarised in Figure 2 below.

Figure 2: Breakdown of business exits by reason for exit



Source: Bickerdale et al – see footnote 1.

7. However, on closer analysis it seems that the Productivity Commission Report itself substantially underestimates the role of financial difficulty in business exits. The key points of concern are set out below.

Applicability

8. The data are derived by the Productivity Commission using both ABS and academic research. The approach used by the Commission to derive the data is set out in Section 3.1 of the paper. There are a number of methodological issues to note.

9. The first problem is that the Watson and Everett study used by the Productivity Commission to determine the proportion of exits due to insufficient funds is limited to retail small businesses in major shopping centres and therefore

may not be representative of the broader population of small businesses.[4] Due to the narrow scope of this study the results should be applied cautiously to general business exit data, a point conceded by the authors themselves.

10. One notable difference between the general ABS data and the results from Watson and Everett is that it seems that retail businesses in managed shopping centres are more likely to change ownership rather than discontinue the business. For example, Watson and Everett show that 60 per cent of business exits are due to a change in ownership, compared to only 20 per cent suggested by the ABS.

11. One possible explanation for this difference is that shopping centre managers carefully screen, monitor and support tenant businesses in a number of ways thus reducing their failure rate.

12. For this reason, there is a question on the applicability of the Watson and Everett study to the ABS data used by the Productivity Commission. This said however, the Commonwealth accepts that there is a limited pool of data available on the number and reason of business exits in Australia and therefore Watson and Everett may be a useful information source.

Reason for Exit

13. Even if we accept the applicability of the Watson and Everett study to the ABS data, however, there are still several issues to be considered regarding the use of the data by the Productivity Commission.

14. The Productivity Commission derives a figure from Watson and Everett that suggests that 28 per cent of businesses exit due to solvent failure (as distinct from bankruptcy). In its calculations, however, the Productivity Commission fails to include the 166 business exits that are classed by Watson and Everett as unknown and as solvent failures.[5] As can be seen in Figure 3, with the inclusion of these the proportion jumps to 35 per cent.

15. Furthermore, the data used to determine these figures cover both cessations and changes in ownership. The proportion of solvent failures increases substantially to 62 per cent by using data just for those businesses which cease to exist. That is more than double the rate used by the Productivity Commission and suggests that in fact about 3.7 percentage points of the six percentage point

[4] Watson, J & Everett, J (1996) 'Do small businesses have high failure rates?: Evidence from Australian Retailers' *Journal of Small Business Management*, October, AIRC Exhibit C/W 4, Appendix 8.

[5] 166 of the unknown business exits are classified by Watson and Everett as failed. They justify this by stating: "…it seems reasonable to classify as failed (failed to make a go of it) those businesses where the reason for discontinuance is unknown and the business is liquidated."

component of cessations is due to solvent failure, much more than the two percentage point figure used by the Productivity Commission.

Figure 3: Business failure rates for various reasons for sale or closure

Reason for sale or closure	Discont. of ownership[(a)]		Discont. of business	
Bankruptcy	179	7%	114	11%
To prevent further losses	415	16%	270	27%
Did not make a "go of it"	267	11%	162	16%
Retirement or ill health	126	5%	37	4%
To realise a profit	916	36%	152	15%
Unknown	329	13%	166	17%
Other – Not failed	277	11%	78	8%
Other – Failed	34	1%	23	2%
Bankruptcy	**179**	**7%**	**114**	**11%**
Solvent Failure[(b)]	**882**	**35%**	**621**	**62%**
Non Finance Related[(c)]	**1482**	**58%**	**267**	**27%**
Total	**2543**	**100%**	**1002**	**100%**

Source: Watson & Everett – see footnote 10.(a) Discontinuance of Ownership includes those businesses exits that cease to exist and those that change ownership.
(b) Solvent failure includes the reasons "to prevent further losses", "Did not make a go of it", "Other – failed" and 166 of the Unknown category (as explained in footnote x).
(c) Non-Finance Related includes the reasons "Retirement or ill health", "To realise a profit", "Other – not failed" and the remaining 163 businesses in the Unknown category.

16. If a further 0.5 percentage points representing cessations due to insolvencies is added, the proportion of total cessations due to poor financial performance rises to 4.2 percentage points. In other words, almost 56 per cent of all business exits including change in ownership (and 70 per cent of all business cessations), may be due to financial losses or failure, rather than those exits due to non-financial reasons such as to realise a profit or retirement. This therefore indicates that the Productivity Commission's figure of 33 per cent significantly underestimates the role of financial difficulties in business exits.

Business cycles

17. The Watson and Everett study was conducted using data over a 30 year period (from 1961 to 1990) which was then added to give the figures in Figure 1. This is useful to get an average rate of business exits over the period but fails to show differences due to varying economic conditions. Usefully, Watson and Everett acknowledge this and provide a breakdown of the figures for the various reasons of business exits.

18. These results show that in difficult economic periods, such as the recession in 1982 and the aftermath of the stock market crash in 1987, the level of business exits increase, especially solvent failures. For example, during the 1982 recession, the level of bankruptcies more than doubled, from 0.4 percentage points in 1981 to 1.0 percentage points in 1982. In terms of the stock market crash in 1987, Watson and Everett state:

> *The failure rate under each of the definitions peaked in 1989, a little over a year after the stock market crash of October 1987.*

ATTACHMENT D

EXTRACT FROM PROFESSOR BENSON'S SURVEY OF AiG/ENGINEERING EMPLOYERS ASSOCIATION MEMBERS

Section III – Termination of employment due to redundancy

Severance Pay

3. For those federal award employees made redundant was severance pay made in accordance with the standard federal award provision? *(See Table 1 below)*

Yes……1

No…….2

Table 1: Standard federal award provision for severance pay

Severance Pay		
Length of service	Companies with less than 15 employees	Companies with 15 or more employees
Less than 1 year	nil	Nil
1 to 2 years	nil	4 weeks
2 to 3 years	nil	6 weeks
3 to 4 years	nil	7 weeks
over 4 years	nil	8 weeks

Note: a small number of federal awards do not provide an exemption for companies with less than 15 employees

Attachment E

DEFICIENCIES IN THE NATIONAL INSTITUTE OF ECONOMIC AND INDUSTRY RESEARCH (NIEIR) REPORT

1. The TLC presents a report prepared by the National Institute of Economic and Industry Research (NIEIR), which was originally prepared by NIEIR for the ACTU in relation to the federal redundancy test case.[1]

2. The report does not estimate the cost impact of the TLC's claim on Western Australian small businesses.

3. However, the report does develop estimates of the impact of the ACTU's claim in the federal case, including the impact if the claim flowed to all State jurisdictions. The NIEIR estimates that the ACTU claim would add 0.12 to total wage costs.

4. This is a very misleading assessment of the cost of the ACTU claim. The NIEIR costings seriously underestimate the true economic impact of the claim. In the federal redundancy test case the AIRC rejected any suggestion that the cost impact of the ACTU claim would be negligible. Although the AIRC made some criticisms of the Commonwealth's alternative costings the AIRC found:

> *There is no doubt, however, that for most of the employers actually affected the cost of the claim would be very significant.*[2]

5. It would be equally misleading and unjustified for the TLC to argue in this case that the cost impact of its claim would also be negligible because it would have a lower cost impact than the ACTU's claim.

6. The main deficiency in NIEIR's approach is that it expresses the cost impact as a proportion of the total wages bill across the entire economy. This approach produces a very misleading impression of the economic impact of the claim. The immediate and direct impact of the claim is not spread across all employers in the economy. To the contrary, the direct costs arising from the claim fall only on those employers who actually retrench and who are subject to the claim. Contrary to the impression created by the ACTU's costings, the claim does not represent a small cost increase born by all employers. Rather, it would impose a much more significant and potentially damaging increase on a much smaller subset of employers – those who actually retrench employees in any given year. In its recent TCR test case the Queensland Commission acknowledged that treating the cost impact as if it is spread across all employers is inappropriate, finding that *"[w]e do not consider it that helpful to estimate a cost spread across a whole community when many businesses would never have an occasion to make an employee redundant."* [3]

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[1] Exhibit ACTU 8, Tag 5.
[2] Paragraph 124.
[3] Queensland TCR test case decision, 171 QGIG 1417 at paragraph 72.

7. Because of the obvious deficiencies in NIEIR approach, the Commonwealth has computed more accurate and meaningful estimates of the cost impact on Western Australian small businesses of the severance pay scale imposed on small businesses by the AIRC decision. The basis of these estimates is set out in **Attachment B** to this submission. In contrast to the NIEIR report, the Commonwealth approach estimates the direct cost impact of the claim on those small businesses that actually bear the cost of the claim – the small businesses that actually retrench employees in a given year. These more meaningful estimates paint a quite different picture to the misleading NIEIR estimates. The estimates show that even the average cost impact on small businesses that retrench employees in any year would be about 3.1 per cent of their total annual wages bill under recessionary conditions and about 2.0 per cent under current favourable economic conditions. The combined labour cost impact of the removal of the small business exemption and of regular Safety Net Adjustment increases would be unsustainable for many small businesses.

8. The NIEIR report also attempts to analyse the performance of NSW in bankruptcy experience and employment growth compared to other States following the significant increase in severance pay entitlements in NSW in 1994.

9. Tables 16, 17 and 18 of the NIEIR report provide Gross State Product (GSP) per full-time equivalent person employed, GSP per capita, employment to population ratios and the ratio of the number of bankruptcies to the number of private sector businesses for each of the States. The measures of productivity growth, GSP per capita and employment/population are provided for the period 1992-93 to 2001-02, while the data on bankruptcies is provided for years 1994-95 to 2000-01.

10. The impact of the changed redundancy arrangements can be analysed in two ways – one is to present evidence of the performance of the NSW economy before and after the 1994 changes taking care to account for <u>all of the other factors</u> likely to affect the economic performance of NSW over this period. The other is to compare the growth rates of NSW with other States again taking account of <u>all of the other factors</u> affecting the economic performances of the respective States. The NIEIR's analysis does neither – it is inadequate in revealing the impact of the 1994 changes in redundancy arrangements.

11. The results as presented cannot be used to reveal the impact of the 1994 changes in NSW. The growth rates of productivity, per capita GDP, employment/population and bankruptcies will be affected by a host of factors which will confound any simple conclusion regarding the impact of the changed termination and redundancy arrangements in NSW. The general point made by Professor Lewis below holds for inter-State comparisons as well as international comparisons:

> *[Mr Watson] Yes, which is just another way of saying is it not, that when you do the multi varied analysis you have got to try and control for those factors?---*
>
> *[Professor Lewis] Well, I would say it is almost impossible to control. For instance in France, the French they actually provide quite significant subsidies for firms to keep on workers who would have otherwise been retrenched and they also provide quite generous retirement schemes for older workers who have been retrenched, which I suppose backs up the thesis that if you reduce labour costs by subsidies then you increase employment and hence if you increase costs you will of course have loss of jobs.*

[Mr Watson] Well - yes. Are you saying then that - that in this field there is simply no point in the international comparisons which the OECD undertook in its June '99 Outlook?---

[Professor Lewis] I am simply saying that when interpreting these results be very careful in the same way that people regard my results as somewhat less than convincing and I am sure that there are people who find those results less than convincing.

(Transcript, 23 June 2003, PN4033-4034)

12. The NIEIR's report points out that growth in NSW is lower over the period compared to other States, but doesn't attribute this difference to the change in 1994 to the NSW TCR standard. If the NIEIR truly believed in the validity of its approach, it would attribute any relative underperformance by NSW as caused by the higher TCR standard. It is no surprise that it does not. Instead of attributing the inferior growth per capita in NSW over the period to higher severance pay, the ACTU argues that this is due to what it calls the "convergence law" of economics.

13. Convergence law refers to a theory of relative regional/national economic performance whereby initially high productivity countries or regions grow more slowly than lower productivity countries or regions – productivity thereby converges over time. That is, the NIEIR expected NSW growth per capita to be lower than the rest of Australia because productivity was initially higher in NSW. However, convergence of economic performance is most certainly not a law as indicated by the NIEIR which applies indisputably in all situations or at all times. The theoretical and empirical discussions concerning economic convergence yield no easily generalisable conclusions and are not without severely conflicting evidence.

14. For example, Sachs (1995) concludes recent research has emphasised not the notion of convergence but rather divergence of economic growth rates as the initial advantages that particular regions enjoy are exploited and further developed.[4] Highlighting the limitations of the convergence theory is a study by Williamson (1995) which reveals that the appearance of convergence in the economic growth data appears to depend largely upon the particular time period analysed.[5] Williamson identifies a certain period within the twentieth century, 1914 to 1950, during which the gap between rich and poor countries widened rather than contracted. Even where economic convergence occurs it is not as easily identified as suggested by the NIEIR. Convergence processes when they occur take place over the very long term – that is, two or three decades and not a single decade as indicated by the NIEIR.

15. In short, it is not possible to have predicted the growth per capita of NSW compared to the other States based on the theory of 'economic convergence'. Accordingly, it is not possible to arrive at a view of what the economic performance of NSW would have been if the 1994 redundancy changes had not occurred.

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[4] Sachs, J. and Warner, A. 'Economic Convergence and Economic Policies', Brookings Papers on Economic Activity, ed. W. Brainard and G Perry, 1:1995, 1-95, 108-118.

[5] Williamson, J. 'Globalization, Convergence and History', Journal of Economic History, vol 56, no 2 (June 1996): 1-30.

16. The analysis of the effect of the performance on NSW in generating jobs compared to the other States post-1994 is also unconvincing. Again, it is not possible to arrive at a counterfactual regarding the employment experience in NSW in the absence of the 1994 changes.

17. Use of the ratio of number of business bankruptcies to number of private sector businesses in any one year employed by the NIEIR to demonstrate the lack of an impact of the changes in NSW redundancy arrangements is also not meaningful (Table 18). Business bankruptcy can result from many different circumstances other than simply from the impact of the redundancy provisions. Some of the intervening factors do not even relate to the business but, rather, to the business owner, as revealed by the following advice in the glossary of the ABS publication used by the NIEIR:

> *Bankruptcies Bankruptcy is a legal state relating to an individual, permitting the orderly repayment and release of their debts. It may be initiated either voluntarily by the debtor or by a creditor against the debtor's will, and even in the debtor's absence. The legislation generally provides for the assets of a bankrupt to be sold and the proceeds to be distributed to creditors*
>
> *Business bankruptcies When bankruptcy proceedings are taking place and it is found that the individual has been involved in any business activity in the five years preceding bankruptcy, then the bankruptcy is referred to as a 'business bankruptcy'.*
>
> *(ABS 1321.0 Small Business in Australia 2001)*

18. Hence, a business bankruptcy can occur due to the circumstances of an individual completely unrelated to the operations of the business. Further, it is clear that even where the bankruptcy was directly related to the business operations, the eventual bankruptcy 'event' will often relate to events that occurred in previous years. This, coupled with the time taken to conclude bankruptcy proceedings, will have a serious lag impact in the data which is not accounted for in the NIEIR's analysis. Finally, it is also important to note that when a business is experiencing extreme financial difficulty, bankruptcy is merely one of several options available to a business owner to resolve the situation.

19. For these reasons, the NIEIR methodology is incapable of identifying the impact of the higher NSW severance pay standard. It certainly does not show that the higher standard can be implemented without having a serious impact on business. To proceed as if it does would be unsafe.

Attachment F

SECOND READING SPEECH – WORKPLACE RELATIONS AMENDMENT (PROTECTING SMALL BUSINESS EMPLOYMENT) BILL 2004
EXTRACT FROM HANSARD

Wednesday, 26 May 2004 HOUSE OF REPRESENTATIVES 29095

CHAMBER

Second Reading

Mr ANDREWS (Menzies—Minister for Employment and Workplace Relations and Minister Assisting the Prime Minister for the Public Service) (9.40 a.m.)—I move:

That this bill be now read a second time.

This bill proposes to amend the Workplace Relations Act 1996 to maintain the exemption for small business from redundancy pay by overturning a recent decision of the Australian Industrial Relations Commission (AIRC) to impose redundancy pay obligations on small businesses.

This legislation is necessary because it is the only option available to rectify a flawed decision of the AIRC. Under the current industrial relations system there is no review or appeal process to reconsider the merits of test case decisions made by the full bench of the AIRC. The government strongly believes that it is parliament's responsibility to use its legislative power and authority to shield small businesses from the AIRC decision.

If this bill is not passed, the vast majority of small businesses covered by federal awards will eventually be subject to redundancy payments for their employees in accordance with the AIRC's decision. If this bill is not passed, small businesses that are constitutional corporations and that are covered by state awards will become subject to redundancy payments if the AIRC decision flows to state jurisdictions.

The bill has three effects. First, it will remove redundancy pay for small businesses with fewer than 15 employees from the jurisdiction of the AIRC.

Second, it will cancel the effect of any variations that were made by the AIRC to awards from the time of the decision until the legislation commences. It will not, how-ever, affect any redundancy pay provisions that were in awards prior to the AIRC's decision. It will also not affect any actual entitlement that arises before the legislation commences. The government's objective is not to take away something that employees already have.

And third, the bill will prevent flow-on of the AIRC's decision to small businesses that are constitutional corporations and that are covered by state awards.

The government will also work to protect small businesses that are not constitutional corporations and that are covered by state awards from any flow-on of the AIRC's decision. The

government will seek to intervene in any relevant proceedings before state workplace relations tribunals to oppose any flow-on, and will call on state governments to legislate to maintain the exemption of small businesses from redundancy pay.

It is vital that opportunities for continued growth and job creation for the 1.1 million non-agricultural small businesses in Australia be maximised. It is even more essential for the 3.3 million people employed by these businesses. This is nearly half of private sec-tor non-agricultural employment in Australia.

Small businesses are central to employment and economic prosperity in Australia. The small business sector has made a significantly larger contribution to employment growth over the last eight years than big business.

The small business sector is performing very well – it is very much the engine room of the continued growth and strength that our economy is enjoying. And without doubt many small businesses are profitable.

But we can't afford to confuse this profit-ability with an ability to make redundancy payments. Small businesses tend to be chronically undercapitalised and in general do not have the financial resources to cope with large, unpredicted commitments such as redundancy payments. Small businesses are twice as likely as larger businesses to go out of business in the earlier years of operation. Even after 15 years of operation they are still 1.7 times more likely to cease than larger businesses.

In the government's view, the AIRC's decision seriously underestimates the impact that redundancy pay would have on small businesses. For instance, a typical retail small business with seven employees, each with six years continuous employment, would now face a contingent liability for redundancy pay of nearly $30,000.

An obligation on small businesses to make redundancy payments will result in a cost impost that is unaffordable for many small businesses. The end result will of course be a significant decline in job growth in the small business sector and likely small business insolvencies. Clearly, employees of small businesses will not gain anything from the AIRC decision if they no longer have a job to go to.

The undesirability of removing the small business exemption is widely recognised. None of the four state governments that participated in the Australian Industrial Relations Commission test case supported the removal of the exemption. Indeed, the Queensland and Western Australian Labor governments opposed the removal, while the New South Wales and Victorian governments neither supported nor opposed it.

The Queensland Industrial Relations Commission recently agreed that small businesses are in a more financially constrained and precarious position compared to larger business. The Queensland commission unanimously decided that the exemption for small business from redundancy pay obligations under the Queensland workplace relations system ought to remain in place. The Queensland commission concluded that many small businesses operate in marginal circumstances and their lack of financial resilience had not changed since 1994 when the New South Wales Industrial Commission also reaffirmed the need for the small business exemption.

The Queensland commission also accepted that small businesses would generally have smaller cash reserves to meet redundancy pay requirements and that redundancies occurring would represent a greater pro-portion of the overall labour costs of the business.

In short, the Queensland commission found that to impose redundancy pay obligations on small businesses had 'the very real potential to result in the insolvency of a number of small usinesses'.

This government agrees with the conclusions of the Queensland commission. We think it is imperative that the small business sector continue to be supported and encouraged to further grow and create new jobs for our economy and for all Australians. This legislation will lift the additional cost burden imposed by the AIRC's decision from small businesses.

Of course, we are not saying that by introducing this legislation small businesses cannot reach agreement with their employees to make redundancy payments where they can afford it and where it is a priority for employees.

The government has a strong history of encouraging employers and employees to reach agreements on a wide range of issues at the workplace. In our view, this is preferable to imposing an 'across the board' obligation on small businesses which cannot afford redundancy pay.

In introducing this bill the government is demonstrating its ongoing commitment to the small business sector and its recognition of the vital and essential role it plays in ensuring Australia has a strong, thriving economy capable of employing all those who want jobs.

I commend the bill to the House and I pre-sent the explanatory memorandum to the bill.

Debate (on motion by **Mr Rud**d) ad-journed.