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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TABLE OF CONTENTS

Introduction

1. The Workplace Relations Amendment (Protecting Small Business Employment) Bill 2004 (the Bill) was introduced into the House of Representatives on 26 May 2004. The Bill was debated and passed by the House of Representatives on 25 June 2004. The Bill was referred to the Senate Employment, Workplace Relations and Education Committee on 16 June 2004.

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

3. This submission is divided into three key areas. Part A provides detail on the specific amendments proposed by the Bill. Part B provides important background information for the Committee on the history of the exemption from redundancy pay for small business and the history of the operation of the incapacity to pay process. Finally, Part C of the submission outlines the Government's policy rationale supporting the need for the Bill.

Part A: Workplace Relations Amendment (Protecting Small Business Employment) Bill 2004

1. Summary of current provisions

4. The AIRC has responsibility, under the WR Act, to settle industrial disputes brought before it as far as possible by conciliation, and if conciliation is not effective, by arbitration. The AIRC's arbitral jurisdiction is limited to 20 allowable award matters listed in subsection 89A(2) of the WR Act, and to matters that are incidental to those matters and necessary for the effective operation of the award. These allowable matters include 'redundancy pay' [paragraph 89A(2)(m)].

5. Under current section 170FA of the WR Act, the AIRC has the power to make an order to give effect to the requirements of Article 12 (in so far as it relates to a severance allowance or other separation benefits) or 13 of the Termination of Employment Convention in relation to the termination of employment of employees.

6. The Bill would amend the WR Act to protect small business employers from redundancy payments that would otherwise adversely affect the capacity of small businesses to provide employment. The Bill would overturn the decision of the AIRC of 26 March 2004, which determined that the exemption of businesses with fewer than 15 employees from redundancy pay obligations should be removed.

To achieve this, the Bill would:

- amend paragraph 89A(2)(m) of the WR Act to limit the allowability of redundancy pay to employers of 15 or more employees; and

- provide that any variations to awards, made after the 26 March 2004 redundancy test case decision and imposing redundancy pay obligations on employers who employ fewer than 15 employees, have no effect; and

- exclude constitutional corporations which employ fewer than 15 employees from redundancy pay obligations which may be imposed by State laws or State awards. The Bill will not remove redundancy pay obligations that were imposed by a State law or State award before 26 March 2004; and

- amend section 170FA of the WR Act to prevent the AIRC from making redundancy pay orders in relation to employers of 15 or fewer employees.

2. Proposed amendments

Schedule 1

7. The Bill would replace the existing paragraph 89A(2)(m) with a new paragraph 89A(2)(m) which would make redundancy pay by an employer of 15 or more employees an allowable award matter. This means that redundancy pay by an employer of fewer than 15 employees would no longer be an allowable matter.

8. A new subsection 89A(7A) would be inserted that would prevent the AIRC from making an exceptional matters order in relation to redundancy pay by an employer of fewer than 15 employees.

9. A new subsection 89A(8A) would set out the time ('the relevant time') at which it is to be worked out whether a particular employer employs 15 employees or fewer than 15 employees for the purposes of paragraph 89A(2)(m) and subsection 89A(7A).

10. The 'relevant time' is either when notice of redundancy is given by the employer or by the employee who becomes redundant, or when the redundancy occurs, whichever happens first.

11. Proposed paragraph 89A(8A)(b) provides that a reference to employees in either proposed paragraph 89A(2)(m) or proposed subsection 89A(7A) includes a reference to the employee who becomes redundant and any other employee who becomes redundant at the relevant time. A reference to employees also includes any casual employee who, at the relevant time, has been engaged by the employer on a regular and systematic basis for at least 12 months. However, it does not include any other casual employee. There are a number of other provisions in the Bill which use the same formula.

12. The above amendments would apply where the AIRC is:

- dealing with industrial disputes by arbitration; and

- making an award or order about the prevention or settlement of industrial disputes; and

- varying an award or order that would involve maintaining the settlement of industrial disputes;

after the Schedule commences. The amendments will apply irrespective of whether the industrial dispute arose before or after the commencement of the Schedule.

13. The Bill would also insert a new section 153A after section 153. Subsection 153A(1) would provide that a constitutional corporation which employs fewer than 15 employees is not required to make redundancy payments to its employees where a State law or State award would otherwise require the constitutional corporation to make such payments. Proposed paragraph 153A(2)(a) sets out the time ('the relevant time') at which it is to be worked out whether a particular corporation employs fewer than 15 employees for the purposes of proposed subsection 153A(1).

14. New section 153A will apply to:

- a State law or State award made after the commencement of the Schedule that has the effect of imposing redundancy pay obligations on a constitutional corporation that employs fewer than 15 employees; and
- a State law or State award made before or after the commencement of the Schedule that is amended or varied after the commencement of the Schedule and has the effect of imposing redundancy pay obligations on a constitutional corporation that employs fewer than 15 employees.

15. The Bill would amend section 170FA to insert proposed subsections 170FA(3) and (4). Proposed subsection 170FA(3) provides that the AIRC must not make an order to give effect to Article 12 of the Termination of Employment Convention in relation to the matter of redundancy pay by an employer of fewer than 15 employees. Proposed paragraph 170FA(4)(a) sets out the time ('the relevant time') at which it is to be worked out whether an employer employs fewer than 15 employees for the purposes of subsection 170FA(3).

16. Item 8 of Schedule 1 provides that if:

- during the period from 26 March 2004 until the Schedule commences, the AIRC made an award or order that had the effect of requiring an employer of fewer than 15 employees to pay redundancy pay; or

- the AIRC varied an award or order that was made before or during that period to that effect,

then from the commencement of the Schedule such an award or order ceases to have that effect.

17. Item 8 also sets out the time ('the relevant time') at which it is to be worked out whether an employer employs fewer than 15 employees for the purpose of the transitional provisions.

18. Item 9 deals with a State law or award that is made, amended or varied during the period from 26 March 2004 until Schedule 1 commences and which has the effect of requiring a constitutional corporation employing 15 or fewer employees to pay redundancy pay. This item provides that such a law or award ceases to have effect from the commencement of the Schedule.

Relationship of the Bill to the Workplace Relations Amendment (Award Simplification) Act 2004 (the Award Simplification Act) proposed by Schedule 2

19. The Bill is presently before the Parliament. It would amend paragraph 89A(2)(m) of the WR Act to replace 'redundancy pay' as an allowable award matter with payments in relation to a termination that is:

(i) on the initiative of the employer; and

(ii) on the grounds of operational requirements.

20. The amendment would ensure that awards will only apply to genuine redundancy situations where the employment of employees is terminated at the initiative of the employer. The term 'redundancy' has been given a very liberal interpretation in certain awards. Provisions in some building and construction industry awards define redundancy as any situation where an employee ceases to work for an employer (other than for reasons of misconduct or if an employee refuses to work) as allowable. For example, an employee who resigns his/her employment is entitled to redundancy payments. In other words, termination of employment at the initiative of the employee is treated as if it were a redundancy.

21. The amendments proposed by Schedule 2 are similar to the amendments proposed by Schedule 1. They are premised on the Award

Simplification Bill commencing before this Bill commences. Schedule 2 would only operate if Schedule 1 does not commence and vice-versa. Schedules 1 and 2 will not operate concurrently.

Schedule 3

22. Schedule 3 would operate where this Act receives Royal Assent and then later Schedule 1 to the Award Simplification Act commences.

23. In this situation, amendments under Schedule 1 (as discussed above) would have already taken effect. Subsequently, Schedule 3 amendments would make only those changes necessary to take account of the amendments effected by the Award Simplification Act.

Protection of existing entitlements

24. Item 1 of Schedule 4 will ensure that the amendments made by the Act would not effect any entitlement to a redundancy or termination payment that had arisen before the commencement of those amendments.

25. This means that if a person had been made redundant or had been terminated at the employer's initiative and on the grounds of operational requirements and had become entitled to a payment before the relevant Schedule to the Act commenced, then the entitlement to that payment is not affected. This avoids any suggestion of retrospectivity as well as any constitutional issues concerning acquisition of property without just terms or compensation.

Part B: Background

26. This part of the submission provides background information on the establishment and development of the exemption from redundancy pay for small business. It also traces the history of the operation of the incapacity to pay process. This includes an examination of specific cases determined by the AIRC and recent developments designed to 'streamline' the process.

1. History of the exemption from redundancy pay for small business

27. An examination of the arbitral history of the exemption from redundancy pay for small business 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* in respect to notification of redundancies;

- The AIRC ultimately excluded small businesses from the requirement to make redundancy 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 redundancy 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

[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.

"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 redundancy 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 redundancy pay standard.

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

NSW Employment Protection Act 1982

29. 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.

30. 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.

31. 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.*

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

… 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

32. 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.

33. 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 redundancy payments. However, a provision was included which enabled employers to argue incapacity to pay in a particular redundancy case.

34. 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 redundancy 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 redundancy pay would severely hit at business viability by the creation of a large and unfunded contingent liability;
- the implementation of redundancy pay could cause businesses to fail because of the inability to attract finance;

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

[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.

- 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;
- redundancy pay will impose a disincentive in 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.

35. 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 redundancy 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]

36. There have been a number of occasions where the AIRC has been asked to exercise its powers under this provision and make a further order varying the exemption of small businesses from redundancy pay in particular cases. While the December 1984 decision did not explicitly state the types of circumstances envisaged by the AIRC that may warrant variation of the exemption clause in a particular redundancy case, these subsequent decisions of the AIRC have dealt with applications to vary the exemption and these provide sound guidance on the intent of the provision.

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[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.

37. Importantly, the decisions demonstrate that while the small business exemption and the incapacity to pay provision were interrelated they were not seen by the AIRC as interchangeable. They were two separate provisions designed for different purposes and established on different assumptions.

38. Some 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.[8] The Full Bench's decision canvassed the basis on which the small business exemption was granted, making it clear that incapacity to make redundancy payments was not the foundation on which the exemption was granted. It follows that if a small business does have a 'capacity to pay', this is not a sufficient reason to overturn the exemption. The Full Bench stated:

> *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 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.*[9]

39. In a 1993 decision concerning the clothing industry, Commissioner Oldmeadow similarly found that the small business exemption was not founded on an assumed incapacity to pay, and that capacity to pay was thus not a basis for removing the exemption in a particular case, stating:

> *...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*[10]*. [our underlining]*

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[8] Re Local Government Awards Western Australia – Decision, Print G1801, Coldham J, Isaac DP and Coleman C, 24 January 1986.
[9] Ibid
[10] Re Clothing Industry – Decision, Print K9342, Oldmeadow C, 12 October 1993.

40. Commissioner Oldmeadow, in 1995, in relation to a case concerning the metal industry, considered that variation of the small business exemption could only be done having regard to the particular circumstances of the case. In this matter, the Commissioner noted:

> *It is clear, on consideration of the relevant decisions, that an application to remove the fifteen employee exemption in respect of severance payments is a matter for discretion and is to be determined by consideration of the facts and circumstances in each particular case, and with due regard to the decision of the Full Bench in the Termination, Change and Redundancy Case and the related Supplementary decision (Prints F6230 and F7262).*[11]

41. In her consideration of this matter, Commissioner Oldmeadow specifically referred to a number of other AIRC decisions concerning applications by unions for removal of the exemption where the employer had fewer than 15 employees. These decisions covered a range of industries including clothing, footwear, timber, metal and shipbuilding. None of the decisions turned on the 'capacity to pay' of the business. In all cases, the key issue was whether or not the actual number of employees at the time of the redundancies, or the structure/restructuring of the businesses, meant that the business should not qualify for the existing small business exemption.[12,13]

Current NSW position – 1987 and 1994 test case decisions

42. In 1987, in *Re Clerks (State) Award & Other Awards*[14], 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.

43. The rationale established for redundancy pay by the NSWIC in 1983[15] is fundamentally different to the basis underpinning the current federal standard. Redundancy pay in NSW includes a component for income maintenance during periods of unemployment. However, the AIRC rejected this premise when establishing redundancy pay in the

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[11] Re Metal Industry – Decision, Print M7407, Oldmeadow C, 1 December 1995.
[12] For example: G7894, 16 June 1987; H5975, 2 December 1988; J5068, 19 October 1990; K2225, 23 March 1992
[13] For further discussion see Termination, Change and Redundancy Case 2002, Commonwealth's Outline of Contentions, Appendix 3, pp.182-186.
[14] Re Clerks (State) Award & Other Awards – Decision, Fisher P, Bauer & Glynn JJ, 8 April 1987, 21 IR 29 at 29.
[15] Re Shop, Distributive &Allied Employees' Assn (NSW) v Myer (NSW) Ltd – Decision, Fisher (President), 18 August 1983, 7 IR 300.

federal jurisdiction. Rather, the AIRC established redundancy pay to compensate employees for the loss of non-transferable credits and the inconvenience and hardship imposed on employees when retrenched.

44. 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.[16] 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.[17] 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.*[18]

45. 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

46. In 1987, the QIRC adopted the federal redundancy standard that exempted small businesses from an obligation to make redundancy 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.

47. 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[19] 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;

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[16] Re Redundancy Awards – Decision, Fisher P, Glynn J, Peterson J, & Buckley CC, 24 June 1994, 53 IR 419 at 424.
[17] Ibid at 428.
[18] Ibid at 444.
[19] QCU v QCCI [2003] QIRComm 383 (18 August 2003); 173 QGIG 1417

- 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;

- 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; and

- the majority of other States and the federal jurisdiction retain a small business exemption.

Current Federal TCR standard – 2004 test case decision

48. 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.

49. 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).

50. 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.[20]

51. 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".* [21]

52. 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."* [22]

53. 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".*[23]

2. History of the operation of the incapacity to pay process

Federal TCR standard – 1984

54. As noted above, in addition to exempting small businesses from an obligation to make redundancy payments, the AIRC included an incapacity to pay provision in the original redundancy test case standard established in 1984. The provision enabled employers with 15 or more

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

employees to argue in particular redundancy cases that they did not have the capacity to meet the required redundancy pay entitlements. In explaining its position on the issue of incapacity to pay in August 1984, the Full Bench said:

> *In coming to our decision in this case we have been conscious of the cost of the unions' 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…we have made provision, in our decision, for employers to argue in particular redundancy cases that they do not have the capacity to pay.*[24]

55. In its supplementary decision in December 1984 the AIRC reaffirmed the need for an award provision that would ensure employers were aware of their right to argue incapacity to pay, but accepted that such incapacity may only require a variation of redundancy pay rather than a total exemption from other TCR provisions.

State jurisdictions

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

57. In its 2003 test case decision the QIRC similarly retained both the small business exemption and incapacity to pay provisions, acknowledging the inappropriateness of the incapacity to pay provision for small businesses in the following way:

> *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.*[25]

Streamlining the incapacity to pay process - electronic lodgement

58. The AIRC has recognised that the process required to initiate incapacity to pay proceedings can be time consuming and costly for applicants. Since March 2003 the AIRC has accepted electronic

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[24] Termination, Change and Redundancy Test Case – Decision, Print 6230, Moore J, Maddern J and Brown C, 2 August 1984, 8 IR 34 at 61.
[25] QCU v QCCI [2003] QIRComm 383 (18 August 2003), 173 QGIG 1417 at paragraph 100.

lodgement of all documents. Applicants wishing to file an application seeking relief due to economic incapacity are currently able to do so electronically.

Current federal standard - 2004

59. In its 2004 test case decision the AIRC acknowledged the difficulties associated with running a case based on incapacity to pay, 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.*[26]

60. In recognition of these difficulties, the AIRC agreed to a proposal by the Australian Chamber of Commerce and Industry that the incapacity to pay provision be amended 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 redundancy payments in part or in full.

61. The intention of the variation is to improve access to the incapacity to pay provision. Individual employers are still required to demonstrate an incapacity to make redundancy payments.[27]

Incapacity to pay process – industrial tribunal decisions

62. To date, the incapacity to pay provision has seldom been used. In order to examine the operation of the incapacity to pay provision the Department performed a search to identify industrial tribunal decisions that involved applications by employers for exemptions from the redundancy pay provisions of relevant awards, orders or agreements.

63. 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 relevant industrial tribunal decisions – six federal decisions and one Tasmanian decision. In each decision the application was refused by the relevant industrial tribunal.

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[26] Federal Redundancy Test Case – Decision, Print PR032004, Giudice J, Ross, VP, Smith & Deegan CC, 26 March 2004, at paragraph 354.
[27] Ibid at paragraph 355.

64. In the first federal decision dated 1 November 1989 concerning the clothing industry, the AIRC 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.*[28]

65. In another AIRC case in the clothing industry in 1990, the Commissioner 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.*[29]

66. 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*. The Commissioner, 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.*[30]

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

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

> *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.*[31]

68. In the fifth AIRC decision dated 18 October 2000 in relation to the *Clothing Trades Award 1999* the Commissioner 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.*[32]

69. 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. The Commissioner 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.*[33]

70. A decision of the TIC stated:

> *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 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*

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

this case I accept the Union's submission as a minimum standard and I so decide.[34]

71. The inference that can be drawn from the results of this search is that applications for exemption from the payment of redundancy pay provisions are relatively uncommon and, where applications have been made, they are rarely, if ever, 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.

General Employee Entitlements and Redundancy Scheme

72. The Commonwealth plays a key role in the protection of employee entitlements arising from employer insolvency through the General Employee Entitlements and Redundancy Scheme (GEERS).[35] The GEERS is fully funded by the Australian Government.

73. Statistical analysis of GEERS data confirms that the incapacity to pay provision is not working effectively for medium and large firms. In the 2004 federal redundancy test case, the ACTU used GEERS data to estimate that about 130 such medium and large firms in the federal system failed last year without being able to meet all employees' redundancy entitlements. Assuming that about this number of medium or large firms fail each year in the federal system without capacity to pay entitlements, it can be extrapolated that over 2000 firms similarly failed without capacity to pay redundancy entitlements in the 18 years between 1985 and 2002. Yet only six firms appear to have sought relief from the AIRC under the standard incapacity to pay provisions – and not one was successful.

Exceptional Circumstances and the 2003 Safety Net Review

74. Following the 2003 Safety Net Review, 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

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

[35] GEERS provides for the payment by the Government to eligible claimants of all unpaid wages, annual leave, long service leave, payment in lieu of notice and up to 8 weeks redundancy pay, subject to a defined salary cap, for employees whose employment has been terminated as a result of their employer's insolvency; and recovery of funds from the realisation of assets or other proceedings.

Circumstances program. The Commission did not agree to automatic recognition but instead provided a "streamlined process" derived from principle 12 of the AIRC's Wage Fixing Principles.[36]

- Principle 12 of the AIRC's Wage Fixing Principles requires employers seeking to delay SNR increases to apply to the President under s.107 and the President then to decide whether or not to refer the application to a Full Bench. Each application requires onerous 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.

75. 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.[37] 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 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"*.[38]

76. Two applications were made under the arrangements established by Vice President Ross – both have subsequently been withdrawn.

77. In order to establish economic incapacity, farmers were required to submit three years of financial records to the AIRC. The financial records also had to be forwarded to and considered by the relevant union, even where no union members were employed. The NFF note that *"it is appropriate for the Commission to consider their records but not the union, therefore, while the decision of Vice President Ross made the process easier than usual Principle 12 applications, in practice it has not made Principle 12 applications more accessible"*.[39]

78. The NFF 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*

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[36] Re Agricultural Industry – Decision, Print PR940769, Ross VP, 19 November 2003.
[37] Ibid at paragraph 105.
[38] Ibid at paragraph 8.
[39] National Farmers' Federation Submission in Reply to the Safety Net Review 2004 Case at paragraph 35.

> *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.*[40]

79. In its submission in reply to the Safety Net Review 2004 Case the NFF notes that the withdrawal of the two applications that were made, and lack of further applications, was due to the requirement 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 there is capacity for the farmers to be cross-examined by the union at a hearing. Neither of the applicants in the above case had a union member working on their properties.

[40] Ibid at paragraph 37.

Part C: Policy rationale

80. This part sets out the Government's policy rationale for the proposed legislation.

1. Overview

81. The Bill proposes to amend the WR Act to maintain the exemption for small business from redundancy pay by overturning the recent decision of the AIRC to impose redundancy pay obligations on small businesses.

82. Under the current industrial relations system there is no review or appeal process to reconsider the merits of Test Case decisions made by a Full Bench of the AIRC. Legislative measures are the only option available to address these decisions.

83. Without this legislation, 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. Similarly, many small businesses that are covered by State awards will become subject to redundancy payments if the AIRC's decision flows to State jurisdictions.

84. The flow-on process has already commenced. UnionsWA, the peak union body in Western Australia, is the first union to initiate such proceedings. It lodged an application with the Western Australian Industrial Relations Commission on 15 June 2004.

85. In late July the Queensland Council of Unions (QCU) also formally requested the QIRC to relist the redundancy test case in that jurisdiction. The QCU has specifically indicated that it is seeking the removal of the small business exemption from redundancy pay obligations as determined by the AIRC's decision.

86. Except for the AIRC's decision, the imposition of redundancy pay on small businesses would not be a serious issue in State jurisdictions. The majority of State jurisdictions have long recognised the need to protect small businesses from redundancy pay. The QIRC reaffirmed the need for a small business exemption in 2003 and the NSWIC also did so in 1994.

87. To protect small business employment from the detrimental impact of redundancy pay it is necessary to prevent the AIRC's decision from flowing to State workplace relations systems. The Bill will prevent flow-on of the AIRC's decision to small businesses that are constitutional corporations. It will prevent any State redundancy pay requirements made after the decision from applying to small businesses that are constitutional corporations.

88. The Government will also seek to protect small businesses that are not constitutional corporations by seeking to intervene in any relevant proceedings before State workplace relations tribunals to oppose any flow-on.

89. The Government is concerned that the AIRC's decision to impose redundancy pay obligations on small business seriously underestimates the impact that such an obligation will have on small businesses.

90. Employment in Australian small businesses accounts for nearly half of private sector, non-agricultural employment. There are 1.1 million non-agricultural small businesses in Australia and 3.3 million people employed by these businesses.[41] The Government considers that the imposition of redundancy pay on small businesses will severely retard opportunities for both economic growth and further job creation.

91. While small businesses may be profitable, they also tend to be chronically undercapitalised and in general don't have the financial resources to cope with large, unpredicted commitments such as redundancy payments. The new liability created by redundancy pay is substantial. For instance, a typical retail small business with seven employees, each with four years continuous employment, would face a contingent liability for redundancy pay of nearly $30,000 under the AIRC's decision.[42]

92. 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.[43]

93. An obligation on small businesses to make redundancy payments will result in a cost impost that is unaffordable for many small businesses.

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[41] ABS 'Small Business in Australia' (Cat1321.0), 2001 at page 11.
[42] Workplace Relations Amendment (Protecting Small Business Employment) Bill 2004, Second Reading Speech, page 2.
[43] Ibid.

This will result in a significant decline in job growth in the small business sector and likely increase small business insolvencies.

94. The undesirability of removing the small business exemption is widely recognised. None of the four State Governments that participated in the AIRC test case supported the removal of the exemption. Queensland and Western Australia opposed the removal, while NSW and Victoria neither supported nor opposed it.

95. The QIRC agreed in its 2003 test case decision that small businesses are in a more financially constrained and precarious position compared to larger business. The QIRC unanimously decided that the exemption for small business from redundancy pay obligations under the Queensland workplace relations system ought to remain in place.

96. It concluded that many small businesses operate in marginal circumstances and that their lack of financial resilience had not changed since 1994 when the NSWIC also reaffirmed the need for the small business exemption.

97. The QIRC also accepted that small businesses would generally have smaller cash reserves to meet redundancy pay requirements and that redundancies occurring would represent a greater proportion of the overall labour costs of the business. In summary, the QIRC 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 businesses"*.[44]

98. Industrial tribunals have also generally rejected the notion that incapacity to pay provisions are sufficient to shield small businesses from the harmful impact of redundancy pay.

99. The QIRC's test case decision confirmed this, finding that:

> *It is likely that small businesses facing a downturn or restructure sufficient enough 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.*[45]

[44] QCU v QCCI [2003] QIRComm 383 (18 August 2003), 173 QGIG 1417 at paragraph 100.
[45] Ibid

100. Where redundancy pay is affordable for small business, workplace bargaining is available for employers and employees to negotiate redundancy pay. This is preferable to imposing an obligation on small businesses that cannot afford redundancy pay.

101. Importantly, the proposed legislation does not restrict or impede small businesses from reaching agreement with their employees to make redundancy payments where they can afford it and where it is a priority for employees.

102. This submission will now consider in greater detail three of the key elements of the policy rationale for the Bill. First, the submission examines the significant impact on small business of the imposition of redundancy pay. Second, it considers whether 'incapacity to pay' mechanisms would be effective in protecting small businesses from the impact of redundancy pay. Finally the submission evaluates the reasoning used by the AIRC to support its conclusion about the capacity of most small businesses to cope with redundancy pay.

2. Impact on small business of redundancy pay

103. Small businesses have a number of inherent characteristics which makes it more difficult for them to cope with redundancy payments. This part of the submission examines in detail the nature of these distinguishing characteristics of small businesses and the impact that the imposition of redundancy pay is likely to have on them.

The lack of financial resilience of small business

104. The central reason why industrial tribunals have exempted small businesses from redundancy pay was succinctly summarised by the NSW tribunal in 1994. The NSWIC reaffirmed the exemption in 1994 because of the "*relative lack of financial resilience of small business*".[46] Small businesses tend to lack financial resilience because they tend to be undercapitalised and do not have the same access to financial markets as large businesses. In particular, small businesses generally do not have ready access either to sufficient internal reserves or to additional external capital if the need arises. As a result, they often do not have the financial flexibility to fund large unpredicted commitments such as redundancy pay.

[46] Re Redundancy Awards – Decision, Fisher P, Glynn J, Peterson J, & Buckley CC, 24 June 1994, 53 IR 419 at 444.

Impediments to obtaining adequate finance

105. The difficulty small businesses face in obtaining finance has been widely recognised in the international economic literature for many years. Mallick and Chakraborty (2002) note that *"[a] growing body of empirical literature on small business lending suggests that credit constraint affects a significant proportion of small businesses."*[47] 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*".[48]

106. 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.*[49]

107. 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*

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[47] 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.

[48] 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.

[49] ibid, pp. 301-302.

asymmetry could cause credit markets not to clear, and some firms to be credit rationed.[50]

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.[51] *The resulting information asymmetry is fundamental to understanding why small businesses are credit rationed.*[52]

108. 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 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.[53]

109. The credit constraint faced by small business is further exacerbated during recessionary times or periods of tight money. KeyPoint Consulting[54] 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."*[55] 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"*.[56]

110. Evidence collected by this Committee for its recent report on Small Business Employment confirmed the chronic undercapitalisation

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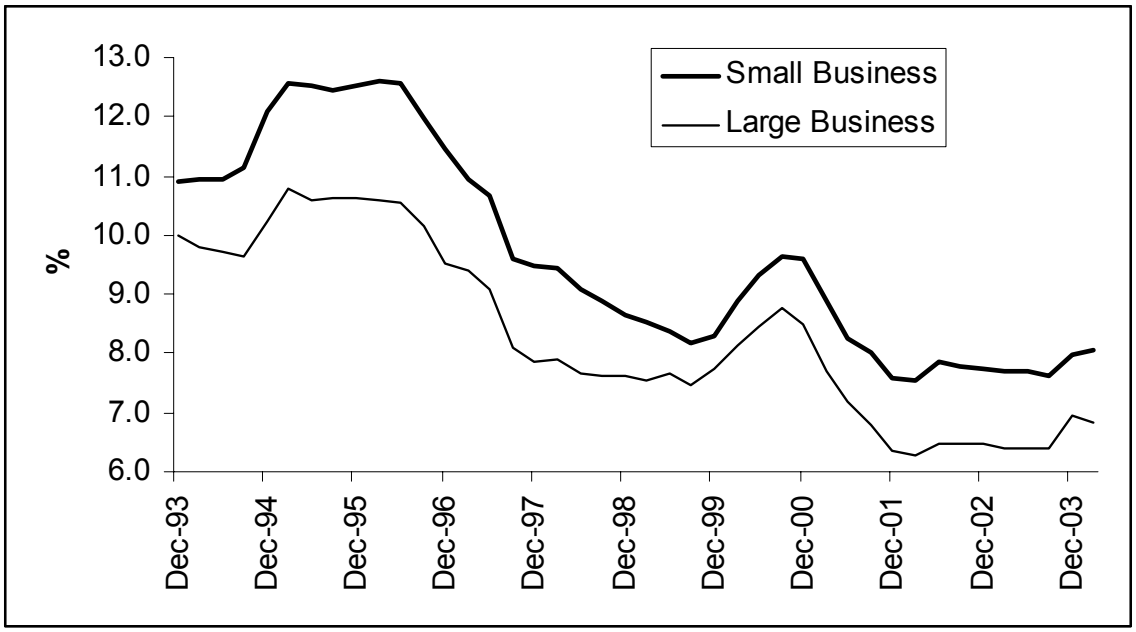
[50] Mallick, R and Chakraborty, A. (2002) 'Credit Gap in Small Businesses: Some New Evidence' Finance 0209008, Economics Working Paper Archive at WUSTL, (http://econwpa.wustl.edu/eps/fin/papers/0209/0209008.pdf) accessed 9 July 2004, p. 3.
[51] Mallick and Chakraborty here cite Leland, H and Pyle, D. (1977) 'Information Asymmetries, Financial Structure, and Financial Intermediation' *Journal of Finance*, 371-87.
[52] 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.
[53] Ibid at p. 21.
[54] 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.
[55] 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.
[56] Ibid.

experienced by small businesses and the difficulties they face in obtaining finance.[57] 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.[58] The small business interest rate premium currently stands at 8.1 per cent (1.2 percentage points above the large business rate).

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.

111. In its submission to the AIRC in the redundancy test case, the Commonwealth detailed additional evidence and argument which demonstrates that small businesses generally have less ability to bear the impact of redundancy pay than medium and large businesses. This material is contained in Appendices 2 and 9 of the Commonwealth's final written submission. These are copied as **Attachments A and B** of this submission respectively.

112. In particular, the Commonwealth's submission examined evidence provided to the AIRC by the ACTU's 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

[57] "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.
[58] Reserve Bank of Australia Website www.rba.gov.au, Indicator Lending Rates, Table F5, 23 January 2003.

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.

113. Mr Humphris' evidence confirmed that small businesses are characterised by a relative lack of financial resilience which could endanger small businesses if they had to pay redundancy pay to retrenched employees. 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 redundancy payments. The Commonwealth's detailed analysis of Mr Humphris' evidence is contained in **Attachment B**.[59]

114. The Commonwealth's submission identified the difficulties that small businesses encounter in obtaining finance as the central cause of their relative lack of financial resilience. The 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. 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 redundancy pay.[60]

115. Businesses need to be particularly financially resilient to cope with redundancy 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.

Impediments to building up financial reserves

116. Small businesses would also find it particularly difficult to build up the financial reserves that would be necessary to cover redundancy payments if retrenchments were necessary. The central reason for this

[59] Paragraphs 28-29 and 63-74.
[60] See Attachment A, in particular paragraphs 27-72.

again is the chronic undercapitalisation of small businesses that arises because of the limited access to borrowings.

117. Another important impediment to the accumulations of reserves is that contingent liabilities for redundancy 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 redundancy pay.

118. In fact, 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. 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.

119. 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 redundancy payments.

120. The evidence of Mr Humphris in the federal redundancy test case confirmed that small businesses often do not have the unencumbered assets or financial reserves to restructure or make redundancy payments. Furthermore, in its recent test case decision, the QIRC acknowledged the difficulty that small businesses would have in accumulating reserves to meet redundancy 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…* [61]

121. 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 redundancy pay:

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

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

- Second, small businesses are generally not subject to the supervision by lenders that tends to force larger businesses to provide for redundancy 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.

The AIRC's supplementary decision does not solve the problem

122. The fact that small businesses find it very difficult to build up reserves means that the AIRC's supplementary redundancy case decision will not protect small businesses in the longer term. As noted in part B of this submission, the AIRC issued a supplementary decision on 8 June 2004 (PR062004), determining that the redundancy pay scale to apply to small business would not take into account service rendered prior to the operative date of any order giving effect to the original decision.

123. In its decision the AIRC acknowledged the more precarious financial position of small businesses compared to larger businesses. The Full Bench stated: *"…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."*[62]

124. The effect of the decision is to defer any requirement for a small business to make redundancy payments for a year, and to defer full payments for up to four years. However, after four years the redundancy pay scale will apply in full and small businesses will be exposed to the full cost impact of redundancy pay.

125. The Department estimates that to accumulate reserves to cover the impact of redundancy pay the average small business would have to put aside an amount equivalent to 7.8 per cent of its wages bill. For all small businesses under federal awards this equates to about $2 billion. For all Australian small businesses it equates to about $5 billion. As indicated above, a typical small retail business with seven employees, each with four years continuous employment, would face a contingent liability for redundancy pay of about $30,000.

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

126. Small businesses would find it extremely difficult to accumulate the reserves needed to cover their full redundancy pay liabilities. They need this capital to operate their businesses and to employ people. As indicated above, even small businesses that are consistently profitable are often under-capitalised and unable to accumulate large amounts of reserves. As a consequence many small businesses would be just as unable to cope with redundancy pay in four years' time as they would be now.

Other impediments to small businesses coping with redundancy pay

127. The Commonwealth's submission to the AIRC redundancy test case also identified other characteristics of small businesses that make it more difficult for them than larger businesses to cope with redundancy pay. [63] 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.

128. 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.

129. The cost of retrenching a given number of employees is proportionately greater for a small business compared with a large business.

Profitability does not equate to capacity to cope with redundancy pay

130. The Commonwealth's submission also emphasised that although a small business might make a profit over a number of years, this does not mean that it is financially resilient. It does not mean that the business has sufficient reserves to cover redundancy pay. Nor does it mean that the business can obtain sufficient additional finance to cover redundancy 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

[63] See Appendix A, in particular paragraphs 46-50.

redundancy pay. This is particularly the case if the shock is in the form of a sudden drop in demand or other financial stress.[64]

131. As shown in part B of this submission, when industrial tribunals established and confirmed the small business exemption, they were aware that many small businesses make a profit. 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.

The detrimental impact of redundancy pay on small business

132. The Commonwealth's submission to the AIRC redundancy case concluded that 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 redundancy 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 given level of redundancy pay.

133. 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.

134. The Commonwealth's submission also pointed out that 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.

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

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[64] See Appendix A, in particular paragraph 51.

3. Would the 'incapacity to pay' mechanism adequately protect small business from redundancy pay?

136. The incapacity to pay provision in the TCR standard is not an effective substitute for the small business exemption. The reasons for this are detailed in the Commonwealth's submission to the AIRC's redundancy test case that is copied at **Attachment A.**[65]

137. The Commonwealth's submission notes that industrial tribunals in the majority of jurisdictions have generally rejected the notion that incapacity to pay provisions are sufficient to shield small businesses from the harmful impact of redundancy pay. In the 1984 test case, the AIRC 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. NSW took the same position in its 1994 test case, as has the QIRC in its 2003 test case.

138. The reason why the incapacity to pay provision is not an appropriate substitute for the small business exemption is clear from the arbitral case history outlined in part B of this submission. The small business exemption was established because small businesses have a *"special difficulty in meeting the financial burden of redundancy pay."*[66] 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 therefore 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 redundancy pay.

139. 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 redundancy pay. The provision has proved over time that it has not been capable of serving the more limited function for which it was designed. Arbitral history and experience demonstrates that it has not been able to protect medium and larger size businesses with an incapacity to pay.

140. As discussed in more detail in part B of this submission, a search of electronic databases by the Department revealed only seven decisions

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[65] Paragraphs 20-21 and 101-125.

[66] Print G1801, 24 January 1986. Also referred to in Print K9342, 12 October 1993.

(six federal, one Tasmanian) where an employer has sought relief under the incapacity to pay provisions of the TCR standard – and not one was successful. This is despite the fact that one of these businesses was in liquidation and another in receivership. The existence of the provision has not assisted the thousands of businesses with 15 or more employees that have become insolvent over the same period of time.

141. The streamlining of incapacity to pay provisions has failed to correct their ineffectiveness. As outlined in part B of this submission, the AIRC recently developed streamlined incapacity to pay provisions for farmers who were receiving drought assistance under the Government's Exceptional Circumstances program. Following the 2003 Safety Net case Vice President Ross determined that where an employer was in an Exceptional Circumstances declared area and in receipt of Exceptional Circumstances Relief Payments, they would be *prima facie* entitled to relief on the grounds of economic incapacity.[67] As indicated in part B, only two applications were made by farmers and both were subsequently withdrawn. The NFF suggested in its Submission in Reply to the Safety Net Review 2004 Case that this was due to the requirement 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.[68]

142. The streamlining of incapacity to pay provisions will not make them effective because it does not deal with the central reasons why the provisions have failed in the past. The widely recognised reasons for the failure of incapacity to pay provisions that are discussed in the Commonwealth's submission to the AIRC's redundancy test case include:

- history has shown that the Commission is very loath to grant an application – the likelihood of success is minimal (see the arbitral history outlined in part B of this submission);

- 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 cause them 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

[67] Re Agricultural Industry – Decision, Print PR940769, Ross VP, 19 November 2003, at paragraph 105.
[68] National Farmers' Federation Submission in Reply to the Safety Net Review 2004 Case at paragraphs 34 to 37.

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

143. Nor will these significant limitations on the operation of the incapacity to pay provision be remedied and overcome by the AIRC's decision to enable applications under the provision to be made by a group of employers as well as individuals.[69] Under the AIRC's decision each employer will still have to separately demonstrate that it has an incapacity to pay.

144. An incapacity to pay process that requires the examination of the circumstances of many thousands of small business 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 redundancy pay.

145. A significant proportion of Australia's 538,500 small businesses could be expected to be detrimentally affected by redundancy 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 redundancy pay was in force, so does not include businesses that were profitable only in the absence of redundancy pay. Given that redundancy pay obligations can be very substantial where there are multiple retrenchments, the imposition of redundancy pay could be expected to significantly increase the numbers of small businesses that are not profitable.

146. 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 redundancy pay. Many small businesses that are

[69] Federal Redundancy Test Case – Decision, Print PR032004, Giudice J, Ross VP, Smith & Deegan CC, 26 March 2004, at paragraphs 271 and 355.

profitable are nonetheless chronically undercapitalised and lack the financial resilience to cope with redundancy 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 redundancy pay), potentially hundreds of thousands of small businesses would need to make applications under incapacity to pay provisions.

4. Evaluation of the reasoning used by the AIRC to support its conclusion about the ability of small business to cope with redundancy pay.

147. The AIRC concluded in its 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*."[70]

148. 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.*[71]

149. The Government considers that each of these considerations is mistaken and/or does not support the inference that the AIRC has drawn from it. This submission will now set out in detail the reasons for the Government's assessment of this part of the AIRC's decision.

Profitability does not imply ability to cope with severance pay

150. The central flaw in the AIRC's decision is to confuse profitability with the capacity to make redundancy 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 redundancy pay on an on-going basis.

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[70] Ibid at paragraph 222.
[71] Ibid.

151. The reason why the exemption was established and maintained is because small businesses generally lack the financial resilience to cope with large unpredicted impositions such as redundancy pay, not because they do not make profits. If profitability did signify capacity to make redundancy payments, industrial tribunals would not have established and reaffirmed the exemption in the first place - a significant proportion of small business has always made a profit in any given year.

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

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

154. The AIRC's supplementary decision reflects a greater appreciation of the significance of the relative lack of financial resilience of small business. The supplementary decision effectively suspends the imposition of any redundancy 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 profitability."*[72]

155. This rationale is flawed. The supplementary decision does not recognise that when the full effect of redundancy 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 redundancy 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 year's time small businesses

[72] Federal Redundancy Test Case – Supplementary Decision, Print PR062004, Giudice J, Ross VP, Smith & Deegan CC, 8 June 2004, at paragraph 20.

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 redundancy pay.

Interpretation of Productivity Commission Staff Research Paper

156. In support of its conclusion about the capacity of small businesses to make redundancy 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 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.

157. 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.

158. 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.

159. 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.

160. The research therefore does not support the view that many small businesses that are closing and retrenching their staff are profitable and are able to afford redundancy 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 redundancy pay.

Some small businesses already make redundancy payments

161. 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*."[73]

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

163. 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 only a very small number of cases before it in which a small business made redundancy payments (two dealt with in witness evidence, and a small handful referred to in a submission by Jobwatch).

164. According to the AIRC's decision, the Benson survey showed that "*More 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."*

165. In fact the survey showed that over 90 per cent of the small businesses did <u>not</u> pay redundancy pay. Over 90 per cent of the small businesses respondents to the survey indicated that they made redundancy payments *in accordance with the TCR standard clause*. The TCR standard clause exempts small businesses from redundancy pay. The survey questionnaire made it clear to survey respondents that making redundancy payments in accordance with the TCR standard clause equated to making nil payments (A copy of the relevant part of the questionnaire [Question 3 in Section III in the document that is at Tab 12

[73] Federal Redundancy Test Case – Decision, Print PR032004, Giudice J, Ross VP, Smith & Deegan CC, 26 March 2004, at paragraph 227.

of Volume 3 of the AiG submissions to the AIRC Redundancy case] forms **Attachment C**).

166. This is a serious error on the AIRC's part. Far from giving comfort to the view that redundancy 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 redundancy pay on an on-going basis.

Absence of evidence

167. The final consideration given by the 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.

168. 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 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.

169. The decision seems to accept this. It states "[*a*]*s 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*."[74] 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. 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.

[74] Ibid at paragraph 234.

170. The complex research project that would be necessary to assess the impact on small business of redundancy 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 redundancy on small businesses in the South Australian jurisdiction did not have a highly detrimental impact.

Conclusion

171. The central flaw in the AIRC's decision was to confuse profitability with capacity to pay redundancy pay. The 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 redundancy 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 decision was under the misapprehension that over 90 per cent of a sample of small businesses were already making redundancy payments even though they had no legal obligation to do so. In fact the evidence showed precisely the opposite.