ATTACHMENT A

Termination Change and Redundancy Case –

Commonwealth's Final Submission

Appendix 2: Why the small business exemption should not be removed

Note: Some documents referred to in the Commonwealth's submission are not contained in this extract. A guide to these documents can be found at **Attachment D**.

APPENDIX 2 WHY THE SMALL BUSINESS EXEMPTION SHOULD NOT BE REMOVED

Introduction

The ACTU's claim

1. The ACTU seeks the removal of the existing TCR standard provision that exempts employers who employ less than 15 employees – that is, small businesses – from the requirement to make severance payments.

2. This standard provision reads:

> *Subject to an order of the Commission, in a particular redundancy case, this clause shall not apply to employers who employ less than fifteen employees.*

3. The ACTU argues that employees of small businesses should be entitled to severance payments as a matter of fairness and equity since they face the same losses when retrenched as do employees of larger businesses.

4. The ACTU argues that small businesses are just as likely as large businesses to be profitable or breaking even, and that there is no evidence that the imposition of a requirement on small businesses to make severance payments will have adverse employment effects. It also argues that claims about the jobs generating role of small businesses do not constitute a cogent basis for selective assistance to small business in the form of regulatory exemption.

5. The ACTU also seeks that small businesses be subject to the otherwise agreed redundancy dispute settling procedures.

The Commonwealth's position

6. The Commonwealth strongly opposes the removal of the small business exemption. The key reasons for retaining this provision are:

Ability to bear cost impact

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

8. The relative lack of resilience of small businesses is due in large part to their relative difficulty in obtaining finance on reasonable terms, leading in turn to chronic undercapitalisation. As a consequence, many small businesses are unable to withstand sudden financial shocks such as the need to fund significant severance payments.

9. The ACTU has failed to show that industrial tribunals have got it wrong in the past when they have exempted small businesses from severance pay.

10. If small businesses were to put funds aside to cover the contingent liability that would be imposed by this claim for severance pay obligations, the cost would be prohibitive.

11. The ACTU has substantially underestimated the overall economic impact of the claim. The corrected ACTU estimates show that the direct cost of the claim to small businesses who retrench in a given year and who are covered by federal awards would be 7.7 per cent of their total annual wages bill (assuming recessionary rates of retrenchment). Even under the current favourable economic conditions, the direct cost would be about 4.6 per cent.

12. This is a very large impact and represents double the wage increase that applied at the C10 level due to this year's Safety Net Adjustment case. The combined labour cost impact of the removal of the small business exemption and of regular Safety Net Adjustment increases would be economically unsustainable for many small businesses.

13. The contingent liability that would be imposed by the claim on all small businesses (not just those who retrench in any year) would represent about 14 per cent of their wages bill.

14. The relative lack of financial resilience of small businesses means that they are less able than larger businesses to bear the cost of a given level of severance pay. This is because they have less capacity to put

funds aside to provide for the contingent liability, have less access to external finance, are chronically under capitalised, generally operate in a highly competitive environment and have less capacity to avoid retrenchments by redeployment.

15. For these reasons, imposing severance pay obligations on small businesses would affect the financial viability of firms and would deter risk taking, business expansion and innovation.

Arbitral precedent

16. As we have indicated, the unique characteristics and the less robust financial position of small businesses have been specifically recognised by Australian industrial tribunals – for instance, the NSW Commission, when deciding to retain the exemption in 1994, pointed to the *"relative lack of financial resilience of small business"* [1] while the Queensland Commission noted in its 2003 test case decision that an "*obligation to make severance payments has the very real potential to result in the insolvency of a number of small businesses*".[2]

17. While the ACTU's claim has taken the general approach of imitating the NSW TCR provisions resulting from the 1994 decision, it conveniently ignores the fact that NSW has taken exactly the same approach to small business as the federal Commission and most other jurisdictions across the nation.

18. The ACTU has failed to provide material that would show that the small business environment is more favourable today than it was 19 years ago when the exemption was granted.

19. Where awards have been varied to remove the small business exemption, it has been done on the basis of characteristics specific to coverage under that award.

Incapacity to pay

20. The standard incapacity to pay provision is not an effective substitute for the small business exemption. In 1984 the federal Commission rejected the proposition that the incapacity to pay provision

[1] 53 IR 419 at 444.
[2] Queensland TCR test case decision, 171 QGIG 1417 at paragraph 100.

could be substituted for the exemption and awarded the exemption in addition to the incapacity to pay provision.

21. History and experience demonstrate that the incapacity to pay provision has not been able to protect larger businesses with an incapacity to pay. Few employers have sought relief under the incapacity to pay provisions of the TCR standard since 1984. The existence of the provision has not assisted the many businesses with 15 or more employees that have become insolvent over the same period of time.

Inconsistency between jurisdictions

22. Removal of the exemption in the federal jurisdiction would clash with State awards in most States.

Australia's international obligations

23. Australia's existing legislation is already in line with the relevant ILO instruments – the *Termination of Employment Convention 1982* and the *Termination of Employment Recommendation 1982*. Both instruments permit the exemption of small businesses from certain termination of employment obligations.

Bargaining tests affordability

24. Where severance pay is affordable for small business, enterprise bargaining is available for employers and employees to negotiate severance pay.

Redundancy disputes clause

25. For similar reasons to those that justify exemption from severance pay, small businesses should also be exempted from the proposed redundancy dispute resolution procedure.

Issues

26. In this section the Commonwealth substantiates each of the above points in detail.

Small Business has less ability to bear the impact of severance pay

27. The small business exemption was established by the federal Commission in 1984 and adopted by most State tribunals in recognition of the serious financial impact of a requirement to pay severance payments. Industrial tribunals have repeatedly recognised that small businesses have less ability than larger businesses to bear the costs of severance pay.

28. The ACTU has failed to show that industrial tribunals have got it wrong in the past.

29. In fact, the ACTU's submissions show that it does not understand the reasons why industrial tribunals have concluded that small businesses are less able to pay severance pay. The ACTU does not understand what it is about the operation of small businesses that makes it relatively more difficult for them to cope with severance pay. The ACTU is wrong when it suggests that the reason for the exemption is because small businesses are less profitable than larger business or because the exemption is designed to promote jobs growth by taking advantage of the job generating capacity of small business. These were never the key reasons for the exemption and the ACTU's attack on them proves nothing. It misses the point entirely.

30. The central reason for the exemption was succinctly summarised by the NSW Commission in 1994. In that test case the NSW Commission reaffirmed the exemption because of the "*relative lack of financial resilience of small business"*.[3] Significantly, the ACTU's submission fails to address this key characteristic of small business at all. The ACTU's submission does not show any understanding of the central role of financial resilience in necessitating the current exemption.

31. In the most recent consideration of the small business exemption by an industrial tribunal in a test case, a Full Bench of the Queensland Commission reaffirmed the centrality of financial resilience to the exemption:

> *Many small businesses operate in marginal circumstances. An obligation to make severance payments has the very real potential to result in the insolvency*

[3] 53 IR 419 at 444.

of a number of small businesses. The lack of financial resilience in small business previously referred to has not changed since 1994.[4]

32. The fact that small businesses are characterised by a relative lack of financial resilience was confirmed and explained in this case by ACTU expert witness Mr Humphris. He also confirmed that this lack of resilience could endanger small businesses if they had to pay severance pay to retrenched employees. As Mr Humphris pointed out, small businesses have a special difficulty in raising additional capital to fund restructures and approaches to financial institutions in these circumstances can result in closure of the business. He confirmed that if small businesses had to provide severance payments, this impediment to restructuring would also apply where small businesses had to retrench employees due to a significant reduction in demand for their products. A relevant exchange from the transcript is:

[Mr Stewart] Mr Humphris, I will be asking you a number of questions on behalf of the Commonwealth. First of all I would refer you to paragraph 13 of your original statement, and in paragraph 13 you refer to restructuring, and you state that it is often the case:

... that a business cannot be restructured due to the lack of fixed assets acceptable to lenders for the purpose of advancing the necessary funds to restructure the enterprise.

Could you just explain a bit more about that? In particular are you talking about just in the administration phase or in a business operating normally before it enters into administration?

[Mr Humphris] I am talking pre-administration in that situation. The circumstance generally as we certainly have covered a fair bit of ground on this is that most small businesses don't have sufficient balance sheet assets to actually justify the credit risk that is bank is looking for, so accordingly the bank will look to collateral security in the form of a residence or some other investment. When they look to a restructuring position, restructuring normally requires additional capital, and restructuring can come across, as you would read from my paper, it may be restructuring associated with a growth phase or it may be coming back to core business which may mean the disposal of a division or some subset of the activities of the company that aren't making profits and therefore detrimentally affecting the overall total business. Getting rid of that debt arm, if you like, or getting rid of, you know, sort of - or accommodating a growth phase to facilitate a reconstruction will require capital. And in that sense, the bank will look at the balance sheet in a normal sense and say, well, the balance sheet isn't going to support any additional capital that we would consider worthy security, and we

[4] Queensland TCR test case decision, 171 QGIG 1417 at paragraph 100.

have already got your house for the current facility, so they are locked into a situation of saying we can't help you.

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

[Mr Humphris] That is correct.

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

and

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

[Mr Humphris] That is correct.

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

[Mr Humphris] It may well be and we see a number of illustrations of that. I guess Qantas is probably the classic example where they restructure ever six months and another few thousand people go, but it is a fact, as soon as that happens, there is the liability that is crystallised, so it must be provided for. In small business, however, it is not a normal situation that has to accommodate I guess the movement of a global industry. It will be something that they focus on very locally, but it certainly can still happen, but a successful business can only survive if in fact they do take radical steps to reduce their overhead and that overhead may certainly be attacked through employment costs. In those circumstances, it would form a liability onto the P and L account and impact on the profit and loss.

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

[Mr Humphris] It would.

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

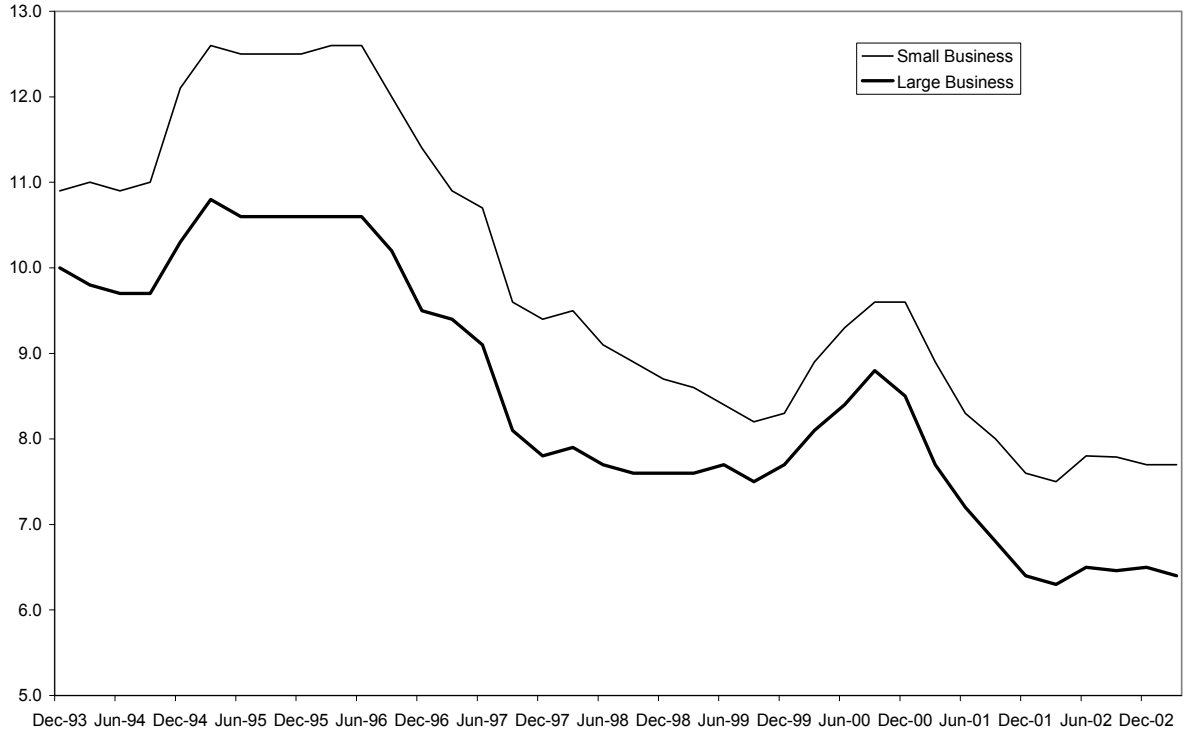
33. The central cause of this relative lack of financial resilience of small business is their relative difficulty in obtaining finance on reasonable terms. The reasons for this difficulty are outlined in the Industry Commission's Staff Research Paper *Small Business Employment*.[5] As we demonstrate in detail in **Appendix 9**, this impediment is widely recognised. For example, Carpenter and Petersen (2002) state:

> *Many small companies – even companies with promising growth opportunities – find it extremely difficult or impossible to raise outside capital on reasonably favourable terms.*[6]

34. RBA data on indicator lending rates show that small businesses traditionally pay a higher interest rate than large businesses as demonstrated in Figure 2.1.[7] The small business interest rate premium seems to have worsened significantly since the end of 1999. The premium rose from 7.8 per cent in December 1999 to 20.3 per cent in March 2003.

[5] Revesz, J & Lattimore, R. (1997) 'Small Business Employment' *Industry Commission Staff Research Paper* See Appendix I, page 184 (Tab 3 in Exhibit ACTU 3).
[6] Carpenter, R & Petersen, B (2002) "Is the growth of small firms constrained by internal finance', *The Review of Economics and Statistics*, Vol 84 No 2, pp. 298-309.
[7] Reserve Bank of Australia Website www.rba.gov.au , Indicator Lending Rates, Table F5, 23 January 2003.

Figure 2.1: Small Business and Large Business Interest Rates(a).



Source: Reserve Bank of Australia Website www.rba.gov.au , Indicator Lending Rates, Table F5, 23 January 2003.
(a) The weighted-average interest rate on credit outstanding is used as this incorporates risks margins.

35. This fundamental difficulty in obtaining finance produces the notorious chronic undercapitalisation that characterises small businesses,[8] and frequently makes them reliant on the personal assets of the owner to provide collateral for loans, as confirmed by Mr Humphris:

> *[Mr Stewart] How does small business generally raise capital for their operations?*
>
> *[Mr Humphris] Well, the normal process is by bank finance. There is very little equity goes into small business, other than to say that the collateral security that is afforded to a bank by way of private residence or private investment could be described as quasi-capital, because without that support collateral security they would not normally get the finance based on the business asset.*
>
> *[Mr Stewart] So the family home and mortgages are generally put up as part of that collateral, are they?*
>
> *[Mr Humphris] That is normal.*

[8] For graphic illustrations of this chronic undercapitalisation, see for example paragraphs 4.79 to 4.83 inclusive of "Small Business Employment", a report of the Senate Employment, Workplace Relations and Education References Committee, February 2003, Exhibit AIG 13, Tab 5.

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

36. As confirmed by Mr Humphris, this in turn means that 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. The result is the relative lack of financial resilience of small business. Small business has less capacity than large business to cope with an unpredicted significant financial impost such as the need to fund severance pay. Credit may be withdrawn if they approach lenders to obtain finance to fund the requirement, as Mr Humphris confirms in his original witness statement:

> *In my experience it is often the case that a business cannot be restructured due to the lack of fixed assets acceptable to lenders for the purposes of advancing the necessary funds to restructure the enterprise. This is particularly the case with small businesses. Intensifying the problem of a lack of readily available fixed assets is the attitude of fixed asset financiers and charge holders when confronted with the problem of supporting the ongoing enterprise or making the necessary appointments to effect realisation of their security. Charge holders will often prefer to sever all ties with the client and recover sufficient funds from fixed assets to discharge the indebtedness.*[9]

37. As indicated above, Mr Humphris confirmed under cross-examination that this scenario would apply equally to small businesses if they had to pay severance pay to retrenched employees.[10]

38. A number of individual employer witnesses confirmed that the general position outlined by Mr Humphris was consistent with their individual circumstances (all at Exhibit AIG 12):

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

> *Nor can I borrow enough money to cover the cost. I have limited security for loans. My house and other possessions are already on the line. And cash flow is*

[9] Witness statement Mr Humphris, Paragraph 13, Exhibit ACTU 7, Tab 3.
[10] Transcript, 29 May 2003 at PN2817.

usually on a roller-coaster ride because I have to pay out money before I collect. (Mr Neville Jukes' witness statement, paragraph 13)

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

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

39. Businesses need to be particularly financially resilient to cope with severance pay. It often must be paid when a business is already under severe financial stress. It is also paid out in conjunction with the payment of other significant entitlements such as notice, accumulated annual leave and long service leave credits.

40. The evidence of Mr Humphris is that small businesses generally do not have the unencumbered assets or financial reserves to restructure or pay severance pay. It is clear that small businesses would find it particularly difficult to build up reserves that would enable them to cope with severance pay if the need arose. A key impediment to their doing so is their chronic undercapitalisation. Another important impediment is that contingent liabilities for severance pay are not required to be included on a firm's balance sheet. Accounting requirements therefore do not require a business to build up reserves to cover severance pay. In contrast to provision for annual leave and long service leave, accounting rules cannot be relied upon to drive the accumulation of reserves for severance pay.

41. 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, as confirmed by the statement of the ACCI's witness Mr Lopez.[11] Because the building up of these reserves is discretionary, any small business that chooses to build up reserves will tend to be undercut by competitors that do not. Finally, small businesses that rely primarily on

[11] Exhibit B 4, witness statement of Mr Lopez, attached article "Redundancy Pay Increases to Affect SME's", Attachment J.

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 pay severance pay.

42. In summary, there are two key reasons why small businesses have significantly less capacity than large businesses to accumulate unencumbered assets and financial reserves to cover severance pay. First, small businesses tend to be chronically undercapitalised due to their lesser ability to obtain finance on reasonable terms. Second, small businesses are generally not subject to the supervision by lenders that tends to force larger businesses to provide for severance pay. This is because lenders generally do not rely on the assets of the small business and the health of the business to secure their loans. Instead, lenders generally require small business owners to provide their personal assets as collateral for borrowings, obviating the need to closely scrutinise the viability of the small business on an on-going basis.

43. In its recent test case decision, the Queensland Commission also recognised the difficulty that small businesses would have in accumulating reserves to meet severance pay requirements:

> *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…* [12]

44. The evidence of insolvency practitioner Mr Taylor is that most small businesses would not currently have the reserves or asset backing to cover severance pay liabilities if the exemption were removed. He indicated that the liability would exceed their current assets, making them insolvent in a technical sense (rather than in a legal sense):

> *If the small business exemption was removed and the quantum was increased it would effectively make most small businesses technically insolvent.*[13]

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[12] Queensland TCR test case decision, 171 QGIG 1417 at paragraph 100.
[13] Exhibit B 4, Mr Taylor's witness statement at paragraph 5, Attachment M.

45. As we show in the next section of our submission, if small businesses were to attempt to put funds aside to cover the contingent liability that would be imposed by this claim for severance pay obligations, the cost impact on small business would be prohibitive. The ACTU's assessment of the cost impact of its claim assumes that businesses do not put any money aside to cover the contingent liability that would be imposed by this claim for severance pay obligations. To the extent that this would be true for small businesses, it counts heavily against the ACTU's claim to remove the small business exemption. Without such reserves, their relative lack of financial resilience would prevent them from coping with severance pay obligations when they arise.

46. Other characteristics of small business also make it more difficult for them to cope with severance pay than larger businesses. 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.

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

> *… we are not satisfied that larger employers do not generally have a greater capacity to re-arrange staff and workloads and provide for redundancy payments. It seems to us that in the case of many employers with only several employees the application of TCR provisions would impose a considerable burden and potentially discourage engagement of employees.*[14]

48. 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

[14] QIRC Full Bench Decision, 16 January 1997, No B1625 of 1996.

learning. Small businesses are far more likely to cease operations than all other businesses (twice as likely in 1994-5 and 1995-6).[15]

49. Furthermore, over 50 per cent of small businesses will have ceased operation within 15 years of commencement, compared with about 30 per cent for large businesses.[16]

50. It is also important to recognise that the cost of retrenching a given number of employees is proportionately greater for a small business compared with a large business – "*redundancies occurring would represent a greater proportion of the overall labour costs of the business*".[17]

51. As we have indicated, the ACTU's submission fails to address the lynchpin issue of the relative lack of financial resilience of small business. Instead, the ACTU argues that small business can cope with severance pay because many are profitable. This argument completely misses the point recognised by industrial tribunals when they created the exemption. The fact that a small business might make a profit over a number of years does not mean that it is financially resilient. It does not mean that the business has sufficient reserves to cover severance pay. Nor does it mean that the business can obtain sufficient additional finance to cover severance pay. It therefore does not mean that the business can cope if an external shock causes it to have to retrench employees and pay significant amounts of severance pay. This is particularly the case if the shock is in the form of a sudden drop in demand or other financial stress.

52. When industrial tribunals created and confirmed the small business exemption, they were well aware that many small businesses make a profit in any given year. This is not news. The reason for the exemption is relative lack of financial resilience. This does not equate at all to profitability. The ACTU has erected and attacked a straw man.

53. The ACTU has attempted to build on its flawed 'profitability' argument by claiming that most small business closures are not due to financial problems. The ACTU argues that the single greatest reason for small business closure is to realise a profit. The ACTU appears to be suggesting that, if businesses retrench their staff and exit to realise a profit, they have the capacity to pay severance out of those profits.

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[15] Bickerdyke, I., Lattimore, R. and Madge A. (2000) *Business Failure and Change: An Australian Perspective* Productivity Commission Staff research Paper. Exhibit ACTU 3, Tab 2, Page 45.
[16] Ibid, Page 52.
[17] Queensland TCR test case decision, 171 QGIG 1417 at paragraph 100.

54. The ACTU relies for its argument on a statement in a Productivity Commission Research Paper that "*The Watson and Everett study also provides revealing information about the reasons for business exits (figure 2.6). The single greatest reason was to realise a profit (contributing around 3.5 percentage points).*"[18] The ACTU has fallen into error because it has misinterpreted this statement. The statement refers to 'exits', not 'business closures' or 'cessations'. So the statement does not show that most businesses that close and retrench do so to realise a profit. A proper analysis of the research on which it is based shows exactly what would be expected – most business exits that realise a profit involve the sale of the business, not its closure. As expected, most of the business exits that are undertaken to realise a profit involve the sale of the business. They do not involve closures and retrenchments. To the contrary, most closures result from adverse financial circumstances, including insolvency. The ACTU is clearly mistaken when it suggests that businesses that close and retrench are able to pay severance pay because they are closing to realise a profit. A more detailed analysis of this issue is presented in **Appendix 9**.

55. A further argument advanced by the ACTU is that the small business exemption cannot be justified primarily as a measure designed to create employment. The ACTU relies in large part on an Industry Commission Staff Research Paper by Revesz and Lattimore that presents some arguments against the provision of special incentives and/or concessions to small business as an aid to job creation.[19] Again, the ACTU has entirely missed the point of the small business exemption. It is not an attempt by industrial tribunals to create jobs. It is designed to protect small businesses from severance pay obligations that they cannot cope with due to their lack of financial resilience. It therefore will protect small businesses that would otherwise be pushed into insolvency by severance pay and it will therefore protect the jobs in those small businesses. But its primary reason for existence is not job creation.

56. Finally, the ACTU argues that there is no evidence that the introduction of severance pay for small business employees in the South Australian jurisdiction has damaged those small businesses. As we have discussed earlier, the fundamental premise of this argument is flawed. The argument stands or falls on the premise that it would be immediately

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[18] Bickerdyke, I., Lattimore, R. and Madge A. (2000) *Business Failure and Change: An Australian Perspective* Productivity Commission Staff research Paper. Exhibit ACTU 3, Tab 2, Page 52.
[19] Revesz, J & Lattimore, R. (1997) 'Small Business Employment' *Industry Commission Staff Research Paper*. Exhibit ACTU 3, Tab 3.

obvious if severance pay has had a serous 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 severance pay.

57. Significantly, both the ACTU's and the ACCI's expert economic witnesses (Professors Webber and Lewis respectively) confirm this principle. Both witnesses acknowledged the need to control for the many relevant variables that operate in these situations if the effect of severance pay is to be isolated, and both acknowledged the great difficulty in doing this:

> *[Vice President Ross] The point you make is that the variables are so many that it is just not possible to isolate.*
>
> *[Mr Stewart] That is right?*
>
> *[Professor Webber] In a sample of six states. That is the problem with Australia. It ought to have more states and then you can have more observations in order to do these kinds of statistics. But perhaps that isn't a sufficient - - -*
>
> *(Transcript, 28 May 2003, PN 1407-08)*
>
> *a*nd
>
> *[Mr Watson] Yes, which is just another way of saying is it not, that when you do the multi varied analysis you have got to try and control for those factors?*
>
> *[Professor Lewis] Well, I would say it is almost impossible to control. For instance in France, the French they actually provide quite significant subsidies for firms to keep on workers who would have otherwise been retrenched and they also provide quite generous retirement schemes for older workers who have been retrenched, which I suppose backs up the thesis that if you reduce labour costs by subsidies then you increase employment and hence if you increase costs you will of course have loss of jobs.*
>
> *(Transcript, 23 June 2003, PN 4033)*

58. An examination of time series data that compares bankruptcy rates between states demonstrates that many factors other than severance pay are determining outcomes, and that it is impossible to disentangle the

relative impact of these factors without a sophisticated analysis that controls the relevant variables. It is immediately evident from Table 3.4 in the Productivity Commission's Staff Research Paper on Business Failure and Change that there have been very significant relative changes in bankruptcy rates between States and Territories during periods when there has been no relative change in severance pay requirements. [20]

59. The fact that many other factors are at play in determining economic outcomes for small business is illustrated by the time series of business bankruptcy rates. It would be foolish and irresponsible to infer from the absence of this research that the imposition of severance pay does not have a serious impact on South Australian small businesses. This is a very clear case in which absence of evidence should not be taken as evidence of absence.

60. As we also discussed earlier, the strong employer reaction to the first 1984 TCR decision counts against the ACTU's view that there is no evidence that any of the decisions that have imposed severance pay on small businesses have had a serious impact. The first 1984 decision granted severance pay to small business employees. The strength of employer concern at that decision was unprecedented. The supplementary decision appears to have acknowledged this by varying the original decision to exempt small businesses.

61. Significantly, the ACTU recognises elsewhere that small businesses are more vulnerable than larger businesses to significant increases in labour costs. Its 2002 submission to the HREOC's Paid Maternity Leave Inquiry states at paragraph 3.42 that "*the ACTU would not oppose exemptions from payment of its proposed levy for employers based on number of employees employed. Similarly, the ACTU would not oppose the provision of additional payments to small business to cover any additional administrative costs associated with the payment of paid maternity leave.*" The ACTU here clearly recognises that small businesses have trouble funding additional payments, for whatever reason.

62. For the reasons we have set out, the removal of the exemption would have a devastating impact on the small business sector. The detrimental impact on small businesses of a particular level of severance pay would be significantly higher than for larger businesses. The ability of

[20] Bickerdyke, I., Lattimore, R. and Madge A. (2000) *Business Failure and Change: An Australian Perspective* Productivity Commission Staff research Paper. Exhibit ACTU 3, Tab 2, Page 71.

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 severance pay.

63. Due to their lack of financial resilience, small businesses would have a powerful incentive to avoid retrenchments if the exemption were 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.

> *Doubling the existing entitlement to severance pay will inevitably discourage potential purchasers … from having a go and saving those businesses … and their jobs which are on their knees.*[21]

64. Another way in which small businesses could attempt to avoid the need for retrenchments would be to make greater 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. Employment opportunities in the small business sector would be significantly restrained, as illustrated by the following evidence:

> *The proposal is a complete disincentive for taking on permanent employees. I am fairly of the view that if this claim is granted that it will be at the expense of employment opportunities in small businesses such as mine. .. Apart from the stresses associated with owning a business, maintaining business work flow, its cash flow etc, I face the ever present threat of losing everything I own should the business fail due to personal guarantees insisted on by corporate suppliers.* [22]
>
> *The ACTU claim is, in my view, anti-employment, and constitutes a disincentive for small business to take on permanent employees. If granted, the severance obligations would be a matter I would need to take into consideration if contemplating hiring additional staff.* [23]

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[21] Exhibit AIG 12, witness statement of Mr Colebatch at paragraph 22.
[22] Exhibit AIG 12, witness statement of Mr Edwards at paragraph 17.
[23] Exhibit AIG 12, witness statement of Mr Brooks at paragraph 19.

65. 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. "*An obligation to make severance payments has the very real potential to result in the insolvency of a number of small businesses*." [24]

66. The ACTU has failed to provide any evidence that disturbs the long-accepted view that small businesses have a lesser ability than larger businesses to make severance payments.

The ACTU has seriously underestimated the cost impact of the claim

67. As we have shown earlier in this submission, the ACTU has substantially underestimated the overall economic impact of the claim. Furthermore, it has not specifically estimated the cost impact of the claim on small business. To provide such an estimate, we have corrected the ACTU's estimates along the lines discussed earlier and disaggregated them to identify the specific cost impact on small business (details are given in **Appendix 9**).

68. The ACTU's corrected estimates show that the direct cost of the claim to small businesses who retrench in a given year and who are covered by federal awards would be 7.7 per cent of their total annual wages bill (assuming recessionary rates of retrenchment). Even under the current favourable economic conditions, the direct cost would be about 4.6 per cent. This is a very large impact, and 7.7 per cent represents double the wage increase that applied at the C10 level due to this year's Safety Net Review. The combined labour cost impact of the removal of the small business exemption and of regular Safety Net Review increases would be economically unsustainable for many small businesses.

69. Using the corrected and disaggregated ACTU estimates we show in **Appendix 9** that the contingent liability that would be imposed by the claim on all small businesses (not just those who retrench in any year) would represent nearly 16 per cent of their wages bill.

70. The claim would significantly increase the hiring costs of small business – the claim would increase the total wages costs of hiring a new

[24] Queensland TCR test case decision, 171 QGIG 1417 at paragraph 100.

employee for between one and six years by around 5 per cent over the entire period. Furthermore, a small business would incur an additional liability equivalent to 7.7 per cent of wages already paid when an employee commences his or her second year with the business.

71. Using the same assumptions as the corrected ACTU costings in relation to the employment duration of retrenched workers, we also estimate that a single retrenchment by a small business would cost over $6100 on average. Significantly, this average covers the retrenchment of part-time as well as full-time permanent employees.

72. Due to their relative lack of financial resilience, small businesses would not be able to cope with these very substantial cost imposts that would be created by the removal of the small business exemption.

Arbitral authority does not support the claim

73. Arbitral authority is against granting this claim. The unique characteristics and the less robust financial position of small businesses have been specifically recognised by Australian industrial tribunals. As we have indicated, in 1994 the NSW Commission, when deciding to retain the exemption, pointed to the *"relative lack of financial resilience of small business"* [25] and the Queensland Commission reaffirmed this lack of financial resilience in its 2003 TCR test case decision.

74. While the ACTU's claim has taken the general approach of imitating the NSW TCR provisions established in 1994, it fails to reflect the retention by the NSW Commission of the small business exemption. The ACTU has ignored the fact that NSW has taken exactly the same approach to small business as the federal Commission and, indeed, most other jurisdictions across the nation.

75. The reasons the federal Commission in 1984 and the NSW, Victorian, Queensland and Western Australian Commissions chose to exempt small businesses from severance pay obligations still apply today. The ACTU has totally ignored these reasons and has failed to provide material that would show that the small business environment is relatively more favourable today than it was 19 years ago when the exemption was granted.

[25] 53 IR 419 at 444.

76. Various tribunal decisions deleting the exemption from particular awards do not provide precedent for removing the exemption from the standard TCR clause and imposing an across the board obligation on small businesses. Where awards have been varied to remove the small business exemption, it has been done on the basis of characteristics specific to coverage under that award. An examination of the major federal decisions clearly shows that these individual decisions are not authority for the proposition that the general TCR standard should be varied. None have been founded on evidence that small businesses in general have the ability to bear the costs of severance pay.

Arbitral history of the small business exemption

77. An examination of the arbitral history of the small business exemption shows that the rationale for this exemption remains sound.

Key points are:

- Businesses with less than 15 employees were excluded from the process prescribed under the NSW *Employment Protection Act 1982* in respect to notification of redundancies.
- The federal Commission excluded small businesses from the requirement to make severance payments in the 1984 test case.[26]
- The exemption was continued by the NSW Commission in 1987 in *Re Clerks (State) Award & Other Awards,*[27] and was again specifically reaffirmed in 1994 when the NSW Commission rejected a claim by the unions to remove the small business exemption from the NSW standard clause. In rejecting the claim the Commission 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."* [28]
- The Queensland Commission exempted small businesses from having to make severance payments in its 1987 test case, and reaffirmed this stance in 2003.
- The Victorian and Western Australian Commissions also exempted small business employers from their severance pay standards. The

[26] 9 IR 115.
[27] 21 IR 29.
[28] 53 IR 419 at 444.

Tasmanian Commission has not set a standard while only the South Australian Commission requires small businesses to adhere to its severance pay standard.

78. Further detail follows about the history of the exemption in the federal, NSW and Queensland jurisdictions.

NSW Employment Protection Act 1982

79. The development of standard redundancy provisions and severance benefits in the NSW jurisdiction preceded the federal TCR test case. The jurisdiction of the NSW Commission operated against the background of statutory provisions for employment protection.

80. The NSW *Employment Protection Act 1982* established machinery to ensure that on the intended termination of employment of an employee, an industrial tribunal could review the circumstances and make an appropriate order. It included provisions to ensure that the Industrial Registrar was given prior notification of proposed terminations and set in place procedures for the Commission to consider the proposed terminations.

81. From its origins the Act did not apply to those employers with less than 15 employees. The second reading speech delivered by Minister Hills, the then NSW Minister for Industrial Relations and Technology, best describes the intention and operation of the Act:

> *I emphasise … that the proposed measure in no way attempts to legislate for redundancy payments or entitlements. … The purpose of the legislation is to enable the New South Wales Industrial Commission, where necessary, to investigate and determine the reasonableness or otherwise of particular conditions of termination or redundancy. To achieve this, the Act will require employers of fifteen or more employees to notify the Industrial Registrar of their intention to terminate the employment of one or more employees at least seven days before the employer gives the employee or employees notice of termination of employment.*
>
> *….Upon receipt of the notice, the registrar must notify both the President of the Industrial Commission and the registered unions involved … The Industrial Registrar is empowered to report to the President of the Industrial Commission … The President may allocate any Industrial Registrar's report to any member of the Industrial Commission or any Conciliation Commissioner to consider and inquire into the matter …*

> *… the Tribunal may make orders in relation to the termination and these orders may include … severance payments … Before making such an order, however, the Industrial Commission will be required to have regard to the financial and other resources of the employer involved, and the probable effect the order, if made, will have in relation to the employer.*[29]

Federal TCR standard

82. When faced with the ACTU's claim for redundancy provisions in 1984, the federal Commission was also conscious that the impact of redundancy provisions would not apply equally to all businesses. In its August 1984 decision the Full Bench noted that *"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"*.[30] Even though the Commission was of the opinion that the cost of its decision would be small compared with overall labour costs, it made provision in its decision for employers to argue incapacity to pay in a particular redundancy case.

83. Following the Commission's August 1984 decision, employers presented further evidence detailing the vulnerability of small businesses. Employers claimed the decision did not make due recognition of the devastating impact the severance pay obligation would have on small businesses. The new evidence was extensive and compelling, establishing that:

- an imposition of severance pay would severely hit at business viability by the creation of a large and unfunded contingent liability;
- the implementation of severance pay could cause businesses to fail because of the inability to attract finance;
- many businesses cannot get further finance and proprietors risk their own personal assets to enable their businesses to remain viable;
- to fund redundancies, proprietors may need to make payments out of their capital because there are no profits in the business for them to pay the liabilities and there is an inability to borrow further from financial institutions;

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[29] Second Reading Speech, Employment Protect Act 1982, Minister Hills, Minister for Industrial Relations and Technology, 1 December 1982.
[30] 8 IR 34 at 61.

- severance pay will impose a disincentive in respect to the desirability of employing employees permanently;
- there is a real fear of approaching the Commission in terms of the incapacity to pay provisions as the Commission'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.

84. Indeed, this evidence was so compelling and persuasive that the Commission in its December 1984 decision introduced a new provision exempting small employers from the impost of severance payments:

> *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.*[31]

Current NSW position – 1987 and 1994 decisions

85. In 1987, in *Re Clerks (State) Award & Other Awards*, the NSW Commission adopted the federal TCR provisions with some modifications for clerks, electricians and plant operators.[32] Although the NSW Commission maintained its different rationale for severance pay, it granted provisions that were generally consistent with the federal provisions, including consistency with regard to the small business exemption.

86. Removing the small business exemption was a major issue to be decided in the 1994 NSW case. In that case the unions criticised the exemption as unrealistic and inappropriate.[33] 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

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[31] 9 IR 115 at 136-137.
[32] 21 IR 29 at 29.
[33] 53 IR 419 at 424.

argument.[34] In deciding to retain the exemption, the NSW Commission was particularly mindful of 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.*[35]

87. In contrast to its claim for increased severance pay, the ACTU does not seek that part of the NSW standard that deals with small businesses. The NSW standard exempts businesses with less than 15 employees, as does the federal standard. The reasons the federal Commission in 1984 and the NSW Commission in 1987 chose to exempt small business from severance pay obligations still apply today. The removal of the current exemption would be devastating to small business and to its important employment generating capacity.

Current Queensland position – the 1987 and 2003 test case decisions

88. Likewise, in 1987 the Queensland Commission adopted a TCR standard that generally exempted small businesses from an obligation to make severance payments. In this year's Queensland TCR test case – the most recent full consideration of this matter by an industrial tribunal – the Queensland Commission cited the continuing "*lack of financial resilience in small business*" and recognised that "*[m]any small businesses operate in marginal circumstances*" where an "*obligation to make severance payments has the very real potential to result in the insolvency of a number of small businesses*".[36]

Specific cases do not justify varying the test case standard

89. Since 1984 a number of federal decisions relating to specific industries and awards have removed the severance pay exemption for small businesses.

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[34] Ibid at 428.
[35] Ibid at 444.
[36] Queensland TCR test case decision, 171 QGIG 1417 at paragraph 100.

90. The Commonwealth submits that these specific decisions do not provide any authority or precedent for varying the test case standard.

91. The most recent Full Bench decision that considered whether the small business exemption should be removed is a decision in the graphic arts industry in 1996.[37] This decision succinctly summarises other key Commission decisions which have considered the inclusion, modification or exclusion of the small business exemption. Examination of these decisions reveals that each case has been treated on its own merits and, where the exemption has been removed, it has been for industry-specific reasons.

92. The concluding comments by the Full Bench in the Graphic Arts decision make it clear that industry-specific decisions cannot vary the general standard and, if there are not industry-specific circumstances warranting departure from the general standard, the only way a claim can be granted is through a fresh test case. The Bench concluded, in part:

> *…We do not consider that the characteristics of the industry rejected by the two awards are relevantly distinguishable from other industries where the Commission has decided to delete the exemption. However, we are concerned as to whether in these circumstances it is appropriate to treat the issue of the deletion of the exemption as being one now appropriate to be considered entirely on an industry by industry basis. There is a logical difficulty in accommodating a sectoral departure from the TCR standard and at the same time accept that there is a standard TCR provision intended to be applied consistently and across all industries. Additionally there are well based apprehensions about inconsistency between federal and state awards at points where the two systems interface ...*
>
> *We are unable to accept that the industry covered by the two awards before us is likely to be sufficiently distinguishable or severable from other industries, some of them closely related, for it to be realistic to expect that a decision to delete the exemption in this matter will be other than the effective removal of the last barrier to a more general round of applications to delete the provision…*
>
> *It is, in our opinion, opportune and more appropriate that this element of TCR test case standard provisions be reconsidered and reviewed against the background of decisions and circumstances to which we have referred, and such other general circumstances as may be thought to be relevant. In that context the relevance of legislative changes that have occurred since the test cases can also be considered….*

[37] Print N7314, 16 December 1996.

> *For these reasons, we are not persuaded that we should grant the application….We will bring this decision to the attention of the President. She may wish to consider whether the bench should be reconstituted to deal generally with the exemption provision in the TCR test case standard.*[38]

93. Further examination of the key decisions referred to in the Graphic Arts decision highlights the very industry-specific nature of the decisions and the circumstances surrounding each case. The industries or awards where the exemption has been removed have been limited, covering local government, mining, timber, building, clothing and furniture industries and the family day care sector.

94. When considering the application to remove the exemption from the Family Day Care Services Award in 1995, the Full Bench concluded that, based on a review of other Commission decisions, the following considerations were important in determining issues about retention of the exemption:

- any special characteristics of employment in the industry in question;
- whether a significant proportion of the employees covered by the Award are being denied the benefits of the TCR standard;
- whether a significant proportion of the employers covered by the award employ less than 15 employees and hence are exempt from the TCR standard;
- evidence of structural change in the industry such that the award entitlements of employees are being affected;
- the industrial relations implications of employees working side by side and receiving different redundancy entitlements; and
- the uncertainty of knowing when the 15 employee threshold is to be applied.[39]

95. It is obvious that these considerations will not be present in every award or industry – they are special circumstances applicable to a relatively minor number of awards or industries. The incidence of these characteristics in a particular industry certainly does not justify a general departure from the standard small business exemption. As Commissioner Lewin concluded in respect to the *Timber Industry Award 1990*, the small

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[38] Ibid.
[39] Print L9065, 3 February 1995.

business exemption can be varied in particular factual circumstances.[40] Such variation has only been justified in isolated cases as further examination of major federal cases will reveal.

96. In the local government area the Full Bench considered that the inclusion of the exemption provision was not warranted as local authorities were not profit making enterprises and, as their funds were assured under legislation, redundancy payments could be anticipated.[41]

97. In the building industry in 1989 the small business exemption was omitted from the standard clause because of the special characteristics of employment in that industry. It was submitted that employee numbers fluctuated due to the nature of sub-contracting in the industry. In addition, it was likely disputation would occur if different conditions of employment existed on the one site. In this particular case a number of employers had agreed to the removal of the exemption provision.[42] Similarly, later the same year Commissioner Oldmeadow omitted the exemption in relation to two mining awards, recognising the difficulties that may arise where employees working side by side in the same mine may or may not be entitled to TCR benefits depending on the size of the contract team.[43]

98. The removal of the exemption provision from the *Clothing Trades Award 1982* was based in part on the fact that in various areas of the industry there were very many employers that each employed only a small number of persons and that the number of employees without protection was a significant proportion of the total number of clothing industry employees. The Commission was also cognisant of evidence suggesting that particular corporate structures adopted in the industry established separate entities for different functions each employing a small number of employees, and that such structures rendered the redundancy provisions susceptible to abuse and avoidance.[44] Similarly, in respect to the *Furnishing Trades Award 1981*, the Full Bench noted that *"enterprises in the furniture and furnishing industries, like those in TCF, are predominantly small-scale. In both sets of industries the anomalies of the threshold are more apparent than in industries dominated by large businesses".*[45] The relevance of corporate business structures was also a factor in the decision to remove the exemption.

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[40] Print M1434, 8 May 1995.
[41] Print G1801, 24 January 1986.
[42] Print H7465, 22 March 1989.
[43] Print H9084, 3 August 1989.
[44] Print K7074, 23 March 1993.
[45] Print L5424, 26 September 1994.

99. However, the similarities between the Clothing Industry Award case and the *Building and Construction Industry (ACT) Award 1991* were not enough to convince the Commission later in the same year that the exemption should be removed from the latter award. While the Commission noted that the case may have some merit based on what was allegedly happening at some building sites, the Commission was:

> *most concerned about setting any new standards through isolated action taken in the ACT, particularly when weighted against an existing standard which encompasses all other States. From that aspect there is also a need to consider the confusion such change might impose on employees and employers who crisscross the ACT border to work. It seems to be a far more realistic situation for any change of the level contemplated to come from the national arena. I might not have shared these concerns had redundancy currently not appeared as an almost Australia wide standard.*[46]

100. It is clear that there is no general arbitral precedent that would dictate that the small business exemption has reached its use-by date and should be removed. Rather, the Commission has only removed the small business exemption from particular awards where special factors have justified its removal. Where it has not been justified for industry-specific reasons, the Commission has refused such applications. Each case has been treated on its own merits.

<u>The incapacity to pay provision is not an alternative to the exemption</u>

101. The incapacity to pay provision currently in the standard TCR provision is not an effective substitute for the small business exemption. In 1984 the federal Commission rejected the proposition that the incapacity to pay provision could be substituted for the exemption and awarded the exemption in addition to the incapacity to pay provision. They serve different purposes. NSW took this same position.

102. The Queensland Commission also took this position, noting in its 2003 test case decision that:

> *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*

[46] Print K8779, 10 August 1993.

> *greater access to financial resources) seeking an exemption from the application of severance pay provisions.*[47]

103. Far from being able to protect small business, the incapacity to pay provision has not even been able to serve the more limited function for which it was designed. History and experience demonstrates that it has not been able to protect larger businesses with incapacity to pay. A search of electronic databases revealed only seven decisions where an employer has sought relief under the incapacity to pay provisions of the TCR standard. The existence of the provision has not assisted the many, many more businesses with 15 or more employees that have become insolvent over the same period of time.

104. The inclusion of the current incapacity to pay provision was not directed at small businesses when the Commission handed down its final decision in December 1984. Small businesses were separated out from other businesses and exempted totally from the redundancy provisions.

105. It is clear from an examination of major federal decisions that the small business exemption was not founded on an assumed incapacity to pay. In a decision concerning the clothing industry, Commissioner Oldmeadow considered a union claim that small businesses using the exemption should also demonstrate incapacity. In rejecting the union's proposition, the Commissioner stated:

> *... I do not accept that the comments of the majority decision lead to this conclusion. First there are two separate provisions in the standard TCR clause, an exemption subclause and an incapacity subclause. The incapacity subclause can be availed of by a company of any size. Had the TCR Full Bench required a company with less than 15 employees to demonstrate incapacity the TCR provisions would have reflected this requirement. The standard provisions however distinguishes companies with less than 15 employees. There is no requirement for a company falling with 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.*[48] *[our underlining]*

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[47] Queensland TCR test case decision, 171 QGIG 1417 at paragraph 100.
[48] Print K9342, 12 October 1993.

106. The decision to which Commissioner Oldmeadow referred dealt with, among other things, the applicability of the small business exemption to local government in Western Australia. The Full Bench in that decision considered the interrelationship between the small business exemption and the incapacity to pay provision:

> *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 to pay.*[49]

107. The incapacity to pay provision is seldom used. In order to examine the viability of the existing incapacity to pay provision as an alternative means of providing relief from severance pay for small businesses, DEWR performed a search to identify industrial tribunal decisions that involved applications by employers for exemptions from the severance pay provisions of relevant awards, orders or agreements.

108. The search material included an electronic version of the Australian Industrial Law Reports published by CCH Australia, the Australasian 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.

109. In the first federal decision dated 1 November 1989 concerning the clothing industry, the Commission 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.*[50]

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[49] Print G1801, 24 January 1986.
[50] Print J0115, 1 November 1989.

110. In another case in the clothing industry in 1990, the Commission 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.*[51]

111. A third 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 Commission, 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.*[52]

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

> *Finally, I am unable to accept Mr Bennett's arguments about incapacity to pay. The employees are entitled to benefits (including payment in redundancy situations) by virtue of their service with the employer. Very stringent tests have quite properly been set by the Commission in this regard as it is a very serious step indeed to take away entitlements which accumulate as a result of years of*

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[51] Print J6078, 21 December 1990.
[52] Print K2453, 3 April 1992.

service and I have not been persuaded that this case is one where I should exercise my discretion.[53]

113. In the fifth decision dated 18 October 2000 in relation to the *Clothing Trades Award 1999* the Commission 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.[54]

114. The sixth 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 Commission 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 Fazzini on the basis of the 0.4 of the severance payment to which she would ordinarily be entitled.[55]

115. A decision of the Tasmanian Industrial Commission 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

[53] Print K5635, 24 November 1992.
[54] Print T2228, 18 October 2000.
[55] Print PR926033, 19 December 2002.

> *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 this case I accept the Union's submission as a minimum standard and I so decide.*[56]

116. The inference that can be drawn from the results of this search is that applications for exemption from the payment of severance pay provisions are relatively uncommon and, where applications have been made, they are rarely 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 severance pay obligations either in situations where the employer is facing financial difficulties or even after the employer has become insolvent.

117. Many thousands of businesses have become insolvent since the TCR incapacity provisions were established and none appear to have been protected in any way by the incapacity to pay provisions. There are a number of reasons why the incapacity to pay provisions have proven so ineffective:

- businesses are reluctant to claim incapacity to pay because it might cause creditors to discontinue credit;
- the time and cost of making and prosecuting an application are considerable (particularly for an employer that is struggling to survive);
- to prosecute an application a business has to open up its financial affairs to external scrutiny; and
- the likelihood of success is minimal.

118. In a matter concerning the *Vehicle Industry – Repair Services and Retail – Award 1983* the Commission asserted that:

> *the fact there has been only a very small handful of such claims before the Commission would reflect a reluctance on the part of employers to reveal their inner workings to third parties"* [57]

119. It is clear that the incapacity to pay provision is not a viable substitute for the current small business exemption. Most of the reasons

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[56] Case No. T5500 of 1995, 6 July 1995.
[57] Print K2453, 3 April 1992.

why the provision has proved ineffective at protecting large businesses are magnified for small businesses. The incapacity to pay provisions would not be able to protect small businesses if the small business exemption is removed.

120. In any case, this is hardly surprising given that the small business exemption was never aimed at incapacity to pay in the first place.

121. In its final written submission the ACTU raises two points about the incapacity to pay provision that need comment.

122. First, the ACTU states that a "*proper reading"* of the federal decisions referred to above *"show that there have been a number of negotiated outcomes between the relevant award parties in an attempt to find a satisfactory resolution of the matters with some outstanding matters being subject to hearing and determination*".[58] On the contrary, a careful reading of these decisions shows clearly that parties are not settling disputes about incapacity to pay through negotiation. The decisions indicate clearly that, while there may have been some negotiation about some matters in some of these cases, in no instance did the parties reach complete agreement about whether or not an employer had the capacity to make severance payments to retrenched employees. Indeed, in only one case did a union agree that some (but not all) retrenched employees should be exempted from receiving severance pay under the incapacity to pay provision, though the circumstances of this case were fairly unusual – the employees the union agreed to exempt had been retrenched and had received full severance payout entitlements previously, then been re-engaged as casuals, then converted to full-time employees before being retrenched a second time in the space of two years.[59] This sole instance of agreement in one unusual case does not add weight to an argument that the incapacity to pay provision is working effectively.

123. Second, the ACTU asserts that the incapacity to pay provisions are not failing because not many businesses are closing without a capacity to pay severance pay. The ACTU uses the 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' severance entitlements. Assuming that about this number of medium or large firms fail each year in the federal system without capacity to pay entitlements, we can extrapolate that over 2000 firms similarly failed without capacity to pay

[58] Paragraph 212.
[59] Print J0115.

redundancy entitlements in the 18 years between 1985 and 2002. Yet only six firms appear to have sought relief from the federal Commission under the TCR standard incapacity to pay provisions – and not one was successful. Contrary to the ACTU's position, the GEERS statistics confirm that the incapacity to pay provision is not working effectively for medium and large firms.

124. The ACTU also appears to miss another key point. If the incapacity to pay provisions were working effectively, they would also be used to protect firms that need to restructure to remain viable, but that cannot afford the severance payments needed for the restructuring. There are no cases since 1984 where the incapacity to pay provisions have been used successfully to facilitate restructuring in these circumstances.

125. In summary, it is clear that the incapacity to pay provisions would not be able to protect small businesses from severance pay requirements that they cannot afford – the provisions have so far failed to secure the futures of thousands of medium and large businesses.

Other considerations

State governments do not support the removal of the exemption

126. No State Government that is participating in this case is supporting the removal of the small business exemption. In fact, no participant in this case who has responsibility for broad economic management supports the removal of the exemption.

127. The Western Australian Government submits that it:

> *… is not in favour of the removal of the exemption for employers employing fewer than 15 employees.*

> *… the Western Australian Government … is not convinced at this stage that removal of the current exemption is warranted. Supporting small business whilst providing protection for employees is a delicate balance. In this instance WA would fall on the side of caution.*

This proposal could have a concentrated impact on small business, as redundancy payments would represents greater proportion of the overall labour costs to small business, than it would for larger enterprises.

It is to be noted that the NSW Standard still remains an exemption for small business, and that the Queensland Government also did not support removal of the exemption in the recent case Termination Change and Redundancy before the QIRC.[60]

128. The Queensland Government submits that:

… the Queensland Government position recognises the particular difficulties faced by small business employers and does not support any additional burden being placed on this section of the economy.[61]

129. The NSW Government notes that:

[t]he proposal that employers who employ less than 15 employees should no longer be exempt from redundancy provisions is inconsistent with the New South Wales standard … Furthermore, it is inconsistent with major industry awards under which redundancy provisions are only applicable to employers who employ 15 or more employees.[62]

130. Clearly, the removal of the current exemption provision would impact unfavourably upon small businesses and increase divergence between federal and State systems.

<u>The claim would produce inconsistency between jurisdictions</u>

131. Removal of the exemption in the federal jurisdiction would clash with State awards in most States. The Queensland Commission has just reaffirmed the small business exemption. Significantly, its decision to continue the exemption was not one of the issues which it indicated it would revisit in the light of the decision in this case. The NSW Commission has also reaffirmed the exemption in the last decade.

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[60] Queensland Government Submission to Queensland TCR Case 2002, section 7.
[61] Queensland Government Submission, page 3, second paragraph.
[62] NSW Government Outline of Contentions, section 3.2.3.

132. Almost without exception, industrial tribunals across the country have recognised and embraced the benefits of having uniformity of minimum conditions of employment. The difficulties that arise where employees work side by side with different employment arrangements, and the potential for industrial unrest which this creates, has been an important consideration in the deliberations by tribunals. When the federal Commission exempted employers with less than 15 employees in December 1984, it did so *"in the interests of uniformity with New South Wales".*[63]

133. Unions themselves have used arguments on the inequity of different conditions for employees working side by side or within the same industry in relation to TCR provisions. The *National Joinery and Building Trades Products Award 2002* does not have an exemption for small business. In a Queensland case seeking removal of the exemption from the equivalent State award, the relevant union submitted *"that to refuse the application would continue an inequitable situation in that employees under the Federal Joinery Award would be subject to more beneficial TCR provisions than employees under the State Award in question."* [64] In this particular case the application was refused as the Commission found there was only one employer in Queensland under the federal award. However, it highlights the recognition by all parties that consistency between federal and State jurisdictions is the preferred situation.

Maintenance of the exemption is consistent with Australia's international obligations and international practice

134. Australia's existing legislation is already in line with the relevant ILO instruments – the *Termination of Employment Convention 1982* and the *Termination of Employment Recommendation 1982*. Both these international instruments permit – not require – the exemption of small businesses from certain termination of employment obligations.

135. A stated objective of the WR Act is to assist in giving effect to Australia's international obligations in relation to labour standards. The ILO develops, adopts and supervises international labour standards. These labour standards may be instruments with treaty status (Conventions and Protocols) or non-treaty status (Declarations and Recommendations). Once instruments have been adopted it is up to member States to decide whether to ratify the Conventions or accept the

[63] 9 IR 115 at 137.
[64] QIRC Full Bench Decision, 16 January 1997, No B1625 of 1996.

Recommendations. If a decision is taken to ratify an ILO Convention, binding international obligations are created for member countries.

136. International obligations in relation to redundancy have been set out in the ILO's *Termination of Employment Convention 1982* (C158) and *Termination of Employment Recommendation* 1982 (R166). Australia ratified this Convention on 26 February 1993.

137. C158 authorises the exemption of small businesses in Article 2 paragraph 5 where it states, "…*measures may be taken….to exclude from the application of this Convention…employed persons in respect of…..the size or nature of the undertaking that employs them*." R166 also authorises the exemption of small businesses with a similarly worded section.

138. Australia's existing legislation is already in line with the relevant ILO instruments. Both C158 and R166 recognise and authorise the need for exemptions such as for small business in regards to severance pay.

139. Although many advanced economies do not have a legislated obligation for employers to provide severance pay,[65] exemptions based on business size are common amongst countries that do. For example:

Germany	Businesses with less than 20 employees are exempt from notice periods. Casuals with less than three months' service are not provided with notice periods. The Civil Code, as amended in 1996, excludes establishments regularly employing less than 10 full-time equivalent employees from severance payments (that is, not counting vocational trainees and part-time workers).
Korea	The Labour Standards Act of 1997 exempts businesses and workplaces with less than five permanent workers from severance payments.
Canada	Severance pay only applies where 50 or more employees are made redundant during a four week period.
Belgium	Companies employing less than 20 employees must retain 10 workers or more to be exempt from severance payments.
Luxembourg	Companies with fewer than 20 employees may increase notice periods instead of awarding severance payments. These extended notice periods range from five months for those

[65] For example: USA, UK, Japan, Sweden, Norway, Finland, Denmark and the Netherlands.

	between five and 10 years service to 18 months for white collar staff with over 30 years' service. Employees with at least five years service are entitled to a severance payment.
Spain	A business with less than 10 employees must dismiss at least five employees for the dismissal to be deemed a redundancy. Companies with less than 100 employees must dismiss at least 10 employees to be obligated to pay severance pay. Where businesses with less than 25 employees make a collective dismissal, a wage guarantee fund pays 40% of the severance payment.

Sources: Termination of employment digest, International Labour Organisation, 2000. Losing Work, Moving On: International Perspectives on Worker Displacement, P.Kuhn, Upjohn Institute for Employment Research, Michigan USA, 2000. European Industrial Relations Review, Issue 306 July 1999. International Labour Review, vol. 140, no.1, 2001/1, *Redundancy, business flexibility and workers' security: Findings of a comparative European survey,* Morin, M. and Vicens, C., International Labour Organisation, Geneva. European Industrial Relations Review, Issue 308 September 1999. European Industrial Relations Review, Issue 311 December 1999.

140. While the ACTU advances a number of criticisms of these international comparisons, these miss the point.[66] Significantly, the ACTU does not contest our central points, which are that:

- both the ILO instruments recognise the need for and permit exemptions for small businesses in regard to severance pay;
- Australia's existing legislation, including the current small business exemption, is in line with the relevant ILO instruments; and
- exemptions based on business size apply in many countries that do have a legislated obligation for employers to provide severance pay, as has been provided for in the relevant ILO instruments.

Bargaining tests affordability

141. Where severance pay is affordable for small business, enterprise bargaining is available for employers and employees to negotiate severance pay. This is far more preferable than removing the exemption and imposing an across the board obligation on small businesses that cannot afford severance pay.

[66] Exhibit ACTU 8 at paragraphs R95-R96.

Redundancy disputes proposal

142. The small business exemption also needs to be retained in relation to the parties' proposed redundancy dispute resolution procedures. Such an exemption would be consistent with the December 1984 TCR decision which established the current small business exemption. This decision exempted small businesses from all the requirements of the redundancy clause including the requirements to provide information and consult about alternatives once a definite decision had been made to implement redundancies. Thus, the original small business exemption applied to similar requirements to those that are now included in the proposed redundancy dispute resolution clause.

143. The exemption of small businesses from the types of requirements included in the proposed clause is, therefore, the arbitral *status quo*.

144. The onus to demonstrate that the exemption should not apply clearly rests with the ACTU.

145. The exemption of small businesses from the redundancy dispute resolution procedure is also consistent with the approach taken by the Parliament in giving effect to the relevant provisions of the Termination of Employment Convention and to sections 170FA and 170GA of the WR Act which relate, among other things, to consultation and information sharing about redundancies – sections 170FA and 170GA apply only to cases in which the employment of 15 or more employees is to be terminated. Article 13 Paragraph 2 of the Convention allows exemptions along these lines.

146. The employers' proposed small business exemption provision is at clause 3.2.4 of the parties' agreed document [underlined]:

> *Clauses 3.2.5 and 3.2.6 impose additional obligations on an employer where an employer contemplates termination of employment due to redundancy and a dispute arises ("redundancy disputes"). <u>These additional obligations do not apply to employers who employ less than 15 employees.</u>*

147. Finally, the Commonwealth notes that the parties have agreed that the outcome of this proposal to exclude small businesses from the redundancy dispute resolution procedures should be consistent with the

overall outcome of the general small business exemption provision, as acknowledged by Mr Watson:

> *We have agreement from the major parties for the insertion of specific clauses in relation to the settlement of redundancy disputes. So we are not pursuing the FB at all in that context. As I indicated at the outset, there is a live issue about whether there should be a small business exemption for that agreed redundancy dispute procedure. Essentially, our primary position on that is we stand or fall on our arguments about whether small business should be exempt generally. (PN 410)*

148. The Commonwealth strongly supports the retention of the existing small business exemption and, consequently, it strongly opposes this part of the ACTU's application.

Conclusion

149. This element of the ACTU's claim should be rejected chiefly because:

- it is against authoritative arbitral precedent recognising that small businesses are different;
- removal of the small business exemption would have a devastating impact on the sector because of the relative lack of financial resilience of small businesses;
- small businesses would be unable to set aside the large amount of funds needed to cover the contingent liability that would be imposed by this claim for severance pay obligations;
- the existing incapacity to pay provision is not an appropriate substitute for the small business exemption;
- it would increase disparity between federal and State jurisdictions; and
- severance pay for small business employees is more appropriately dealt with through workplace bargaining and therefore consistent with the objects of the WR Act.