



Office of Advocacy

*A Voice for Small Business*

# **A Guide for Government Agencies**

## **How to Comply with the Regulatory Flexibility Act**

**Implementing the President's Small Business Agenda  
and Executive Order 13272**

**May 2003**

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## INTRODUCTION

In June 1976, Congress created the Office of Advocacy, headed by a Chief Counsel appointed by the President from the private sector and confirmed by the Senate. Congress concluded that small businesses needed a voice in the councils of government—a voice that was both independent and credible. Congress specifically required the Office of Advocacy to measure the costs and impacts of regulation on small business. The Chief Counsel's mandate, therefore, is to be an independent voice for small business in policy deliberations—a unique mission in the federal government.

The Regulatory Flexibility Act (RFA),<sup>1</sup> enacted in September 1980, requires agencies to consider the impact of their regulatory proposals on small entities, analyze effective alternatives that minimize small entity impacts, and make their analyses available for public comment. The RFA applies to a wide range of small entities, including small businesses, not-for-profit organizations, and small governmental jurisdictions.

The RFA does not seek preferential treatment for small entities, require agencies to adopt regulations that impose the least burden on small entities, or mandate exemptions for small entities. Rather, it requires agencies to examine public policy issues using an analytical process that identifies, among other things, barriers to small business competitiveness and seeks a level playing field for small entities, not an unfair advantage.

The size of the business, government unit, or not-for-profit organization being regulated has a bearing on its ability to comply with federal regulations. For example, the costs of complying with a particular regulation—measured in staff time, recordkeeping, outside expertise, and other direct compliance costs—might be roughly the same for a company with sales of \$10 million as for a company with sales of \$1 million. In a larger business, however, the costs of compliance can be spread over a larger volume of production. For small entities, a burdensome regulation could affect the ability to set competitive prices, to devise innovations, or even to make a profit.<sup>2</sup> In some cases, a small business may be unable to stay in business because of the cost of a regulation. Simply stated, fixed costs have a greater impact on small entities because small entities have fewer options for recovering them. For firms employing fewer than 20 employees, the annual regulatory burden is nearly \$6,975 per employee—almost 60 percent more than that of firms with more than 500 employees.<sup>3</sup> Without the necessary facts, it is possible for an agency to cause serious unintended or unforeseen adverse impacts on small businesses.

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<sup>1</sup> Regulatory Flexibility Act, Pub. L. No. 96-354, 94 Stat. 1164 (codified at 5 U.S.C. § 601).

<sup>2</sup> See Todd A. Morrison, *Economies of Scale in Regulatory Compliance: Evidence of the Differential Impacts of Regulation by Firm Size*, report no. PB85-178861, prepared by Jack Faucett Associates, Inc., for the U.S. Small Business Administration, Office of Advocacy (Springfield, Va.: National Technical Information Service, 1985).

<sup>3</sup> See W. Mark Crain and Thomas D. Hopkins, *The Impact of Regulatory Costs on Small Firms*, report no. PB2001-107067, prepared by Hopkins and Crain for the U.S. Small Business Administration, Office of Advocacy (Springfield, Va.: National Technical Information Service, 2001).

In essence, the RFA asks agencies to be aware of the economic structure of the entities they regulate and the effect their regulations may have on small entities. To this end, the RFA requires agencies to analyze the economic impact of proposed regulations when there is likely to be a significant economic impact on a substantial number of small entities, and to consider regulatory alternatives that will achieve the agency's goal while minimizing the burden on small entities. The concept underlying this analytical requirement is that agencies will revise their decisionmaking processes to take account of small entity concerns in the same manner that agency decisionmaking processes were modified subsequent to the enactment of the National Environmental Policy Act (NEPA).<sup>4</sup> The RFA then acts as a statutorily mandated analytical tool to further assist agencies in meeting the rational rulemaking standard set forth in the Administrative Procedure Act, just as NEPA was intended to rationalize decisions concerning major federal actions that would affect the environment.

The Small Business Regulatory Enforcement Fairness Act (SBREFA), enacted in March 1996,<sup>5</sup> amended the RFA and provided additional tools to aid small business in the fight for regulatory fairness. The most significant amendments made by SBREFA were:

- Judicial review of agency compliance with some of the RFA's provisions.
- Requirements for more detailed and substantive regulatory flexibility analyses.
- Expanded participation by small entities in the development of rules by the Occupational Safety and Health Administration (OSHA) and the Environmental Protection Agency (EPA).

This compliance guide should be utilized by regulatory agencies as a tool for following the requirements of the Regulatory Flexibility Act. In preparing this guide, the Office of Advocacy has received input from regulatory agencies, the Office of Management and Budget, small business associations, and Congress. This new compliance guide also reflects Advocacy's 22 years of experience with the RFA and contains the spirit of interagency cooperation and small business' vital importance to the economy recognized in Executive Order 13272.<sup>6</sup> Advocacy hopes the guide will be a useful tool and welcomes comments on ways to improve its usefulness to regulatory agencies.

The guide includes how-to information on determining when the RFA applies to a proposed regulation, performing initial and final regulatory flexibility analyses, and meeting other RFA requirements, including periodic review of existing rules and small business compliance guides. Also included are a section on litigation so that agencies may learn how courts have ruled on RFA compliance, as well as examples, where available, of actual agency regulatory analyses. For more assistance, contact the Office of Advocacy at (202) 205-6533, or one of the Advocacy contacts listed in Appendix F.

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<sup>4</sup> See *Associated Fisheries of Maine v. Daley*, 127 F.3d 104, 114 (1<sup>st</sup> Cir. 1997) noting parallels between NEPA and the RFA.

<sup>5</sup> Small Business Regulatory Enforcement Fairness Act of 1996, Pub. L. No. 104-121, 110 Stat. 857 (codified at 5 U.S.C. § 601 et seq.).

<sup>6</sup> Exec. Order No. 13,272, 67 Fed. Reg. 53,462 (Aug. 16, 2002). The Executive Order was signed by President Bush on August 13, 2002. See Appendix E.

## CHAPTER 1 WHERE DO WE BEGIN? FIRST STEPS OF RFA ANALYSIS

We begin by briefly examining the general purpose of the Regulatory Flexibility Act and its overall requirements. The Regulatory Flexibility Act requires agencies to consider the impact of their rules on small entities.<sup>7</sup> When the proposed regulation will impose a significant economic impact on a substantial number of small entities, the agency must evaluate alternatives that would accomplish the objectives of the rule without unduly burdening small entities. Inherent in the RFA is a desire to remove barriers to competition and encourage agencies to consider ways of tailoring regulations to the size of the regulated entities.<sup>8</sup>

The RFA, like the National Environmental Policy Act, imposes analytical requirements on federal agencies. Both statutes require disclosure of effects and mechanisms to reduce adverse consequences and improve beneficial consequences.<sup>9</sup> The RFA does not require that agencies necessarily minimize a rule's impact on small entities if there are significant, legal, policy, factual, or other reasons for not minimizing impact. The RFA requires only that agencies determine, to the extent practicable, the rule's economic impact on small entities and to explore regulatory alternatives for reducing any significant economic impact on a substantial number of such entities. Once that process is finished, agencies must explain the reasons for their ultimate regulatory choices.

The goal of Congress in creating the RFA was to change the regulatory culture in agencies and mandate that they consider regulatory alternatives that achieve statutory purposes, while still minimizing the impacts on small entities. Regulatory flexibility analyses built into the regulatory development process at the earliest stages will help agency decisionmakers achieve regulatory goals with realistic, cost-effective, and less burdensome regulations.

The following chart shows an overall picture of the RFA decisionmaking process. This chapter focuses on the first steps, highlighted in the chart.

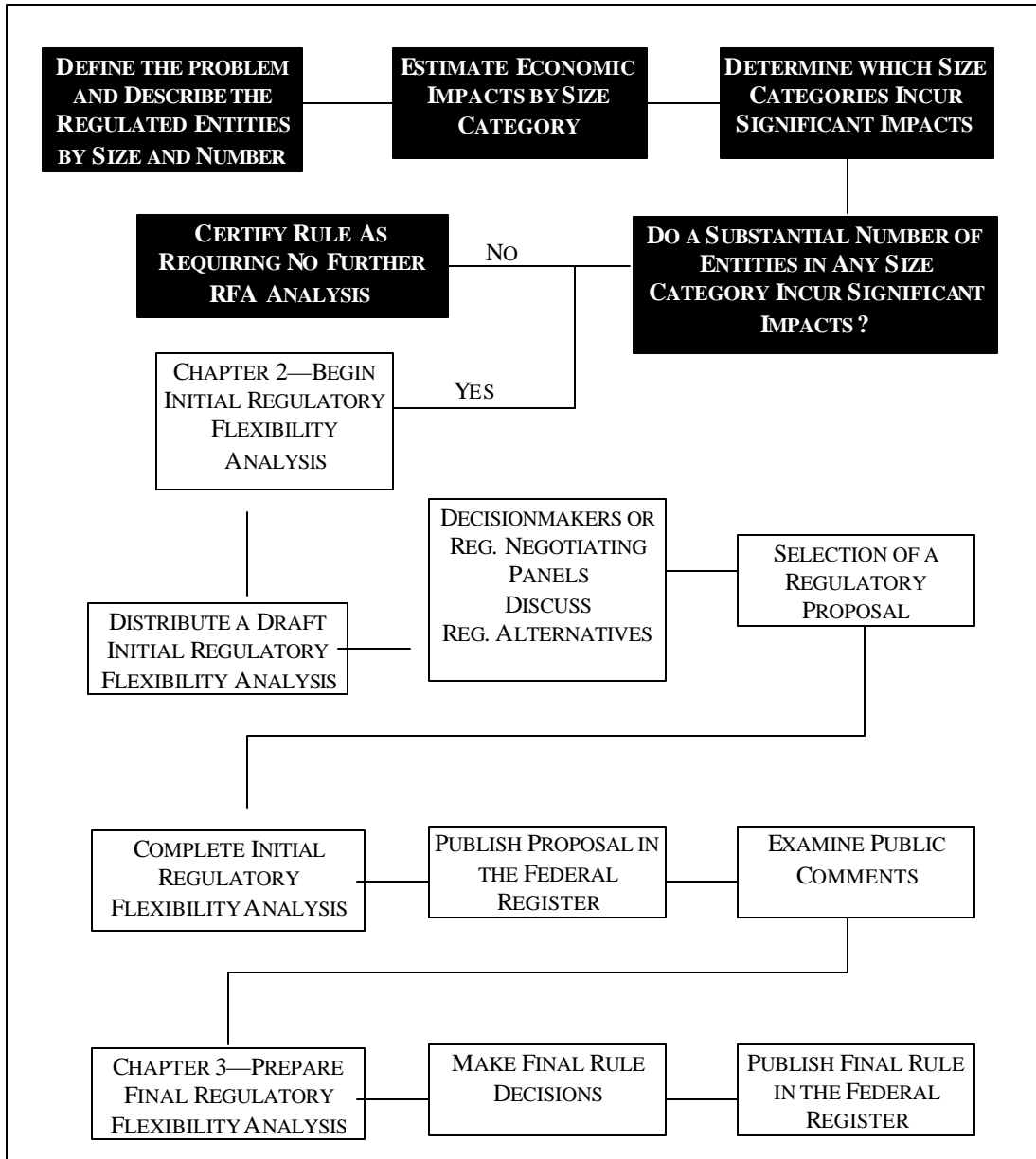
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<sup>7</sup> See this chapter's section on p. 11 titled "What is the definition of a small entity?"

<sup>8</sup> See generally, FINDINGS AND PURPOSES, SEC. 2(a)–(b).

<sup>9</sup> Nothing in the RFA states that an economic impact must be adverse prior to performing an analysis.

# The RFA decision process





Using the NAICS classifications, SBA defines small businesses in terms of firm revenues or employees. Different criteria may be helpful to agencies in assessing the composition of a small entity sector. The IRS categorizes firm (corporation and partnership) size by assets. Industry associations apply some or all of these three criteria (revenues, employment, and/or assets) and often add to or replace them with their own technical criteria. In addition to SBA definitions, federal regulators may use any one or multiple criteria to identify their universes of small regulated entities.<sup>53</sup>

### ***Definition of “significant” and “substantial”***

The agency’s second step in a threshold analysis is to determine whether there is a significant economic impact on a substantial number of small entities. The RFA does not define “significant” or “substantial.” In the absence of statutory specificity, what is “significant” or “substantial” will vary depending on the problem that needs to be addressed, the rule’s requirements, and the preliminary assessment of the rule’s impact. The agency is in the best position to gauge the small entity impacts of its regulations.

Significance should not be viewed in absolute terms, but should be seen as relative to the size of the business, the size of the competitor’s business, and the impact the regulation has on larger competitors. For example, a regulation may be significant solely because the disparity in impact on small entities may make it more difficult for them to compete in a particular sector of the economy than large businesses. This may relate to their ability to pass costs through to customers or to reduce the marginal cost of such a regulation to an insignificant element of their production functions.

One measure for determining economic impact is the percentage of revenue or percentage of profits affected. For example, if the cost of implementing a particular rule represents 3 percent of the profits in a particular sector of the economy and the profit margin in that industry is 2 percent of gross revenues (an economic structure that occurs in the food marketing industry, where profits are often less than 2 percent), the implementation of the proposal would drive many businesses out of business (all except the ones that beat a 3 percent profit margin). That would be a significant economic impact.

However, the economic impact does not have to completely erase profit margins to be significant. For example, the implementation of a rule might reduce the ability of the firm to make future capital investment, thereby severely harming its competitive ability, particularly against larger firms. This scenario may occur in the telecommunications industry, where a regulatory regime that harms the ability of small companies to invest in needed capital will not put them out of business immediately, but over time may make it impossible for them to compete against companies with significantly larger capitalizations. The impact of that rule would then be significant for smaller telecommunications companies.

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<sup>53</sup> The SBA definitions here are found in § 3(a)(2) of the Small Business Act and are not the RFA definitions referenced above.

Other measures may be used; to illustrate, the impact could be significant if the cost of the proposed regulation (a) eliminates more than 10 percent of the businesses' profits; (b) exceeds 1 percent of the gross revenues of the entities in a particular sector or (c) exceeds 5 percent of the labor costs of the entities in the sector.

Some agencies have already developed criteria for determining whether a particular economic impact is significant and whether the proposed action will affect a substantial number of small entities. Standards must be flexible enough to work for the individual agency. The following examples are meant to be illustrative of different types of criteria that may be used. They are not meant to imply a standard, acceptable formula. Advocacy welcomes input from other agencies on their standards.

- The Department of Health and Human Services has determined that a rule is significant if it would reduce revenues or raise costs of any class of affected entities by more than 3 to 5 percent within five years. This approach may work well for an agency, depending upon the circumstances. It becomes complex, however, in the attempt to apply a simple rule fairly to varied industries and regulatory schemes. A 2 percent reduction in revenues in one industrial category would be significant if the industry's profits are only 3 percent of revenues. More than 60 percent of small businesses do not claim a profit and do not pay taxes; therefore, an agency would not be able to apply a profit-based criterion to these firms.
- The EPA has prepared extensive guidance for its rulewriters concerning "significant economic impact" and "substantial number." With respect to small businesses, the agency advises that the offices compare the annualized costs as a percentage of sales ("sales test") to examine significant economic effect. For the same purpose, it also discusses alternative uses of a cash flow test and a profits test.<sup>54</sup>

The absence of a particularized definition of either "significant" or "substantial" does not mean that Congress left the terms completely ambiguous or open to unreasonable interpretations. Thus, the Office of Advocacy relies on legislative history for general guidance in defining these terms.<sup>55</sup>

**Legislative history of "significant economic impact."** With regard to the term "significant economic impact," Congress said:

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<sup>54</sup> *Revised Interim Guidance for EPA Rulewriters.*

<sup>55</sup> Admittedly, throughout this guide, references are made to "adverse" impacts and efforts to "mitigate" impacts. This, after all, is the primary concern of the law. Legislative history, however, makes it clear that Congress intended that regulatory flexibility analyses also address "beneficial" impacts. Therefore, an agency cannot certify a proposed rule if the economic impact will be significant but positive. If an agency so finds, it should conduct a regulatory flexibility analysis to determine if alternatives can enhance the economic benefits flowing to small entities. See discussion in this chapter on adverse versus beneficial impacts.

The term ‘significant economic impact’ is, of necessity, not an exact standard. Because of the diversity of both the community of small entities and of rules themselves, any more precise definition is virtually impossible and may be counterproductive. Any more specific definition would require preliminary work to determine whether the regulatory analysis must be prepared.<sup>56</sup>

Congress also stated that,

Agencies should not give a narrow reading to what constitutes a “significant economic impact”...a determination of significant economic effect is not limited to easily quantifiable costs.<sup>57</sup>

Congress has identified several examples of “significant impact”: a rule that provides a strong disincentive to seek capital;<sup>58</sup> 175 staff hours per year for recordkeeping;<sup>59</sup> impacts greater than the \$500 fine (in 1980 dollars) imposed for noncompliance;<sup>60</sup> new capital requirements beyond the reach of the entity;<sup>61</sup> and any impact less cost-efficient than another reasonable regulatory alternative.<sup>62</sup> Note that even below these thresholds, impacts may be significant. Other, more specific examples are contained in the House of Representatives Report on the RFA.<sup>63</sup>

**Legislative history of “substantial number.”** To affect a substantial number, a proposed regulation must certainly have an impact on at least one small entity. At the other end of the range, legislative history would not require agencies “to find that an overwhelming percentage [more than half] of small [entities] would be affected” before requiring an IRFA.<sup>64</sup> Legislative history also says that the term “substantial” is intended to mean a substantial number of entities within a particular economic or other activity.<sup>65</sup> The intent of the RFA, therefore, was not to require that agencies find that a large number of the entire universe of small entities would be affected by a rule. Quantification of “substantial” may be industry- or rule-specific. However, it is very important that agencies use the broadest category, “more than just a few,” when initially reviewing a

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<sup>56</sup> 126 Cong. Rec. S10,942 (Aug. 6, 1980).

<sup>57</sup> *Id.* at S10,940.

<sup>58</sup> *Id.* at S10,938.

<sup>59</sup> *Id.*

<sup>60</sup> 126 Cong. Rec. H24,578 (Sept. 8, 1980).

<sup>61</sup> *Id.* at H24,593.

<sup>62</sup> *Id.* at H24,595.

<sup>63</sup> “A gas station owner spent 600 hours last year filling out just his federal reporting forms. An Idaho businessman paid a \$500 fine [in 1980 dollars] rather than fill out a federal form that was 63 feet long. A New Hampshire radio station paid \$26.23 in postage to mail its license renewal back to Washington. A dairy plant licensed by 250 local governments, three states, and 20 agencies had 47 inspections in one month. A butcher had one federal agency tell him to put a grated floor in his shop one month and then the next month was told by another federal agency he could not have a grated floor. A company was forced out of the toy business because one of its main products was inadvertently placed on a federal ban list. An Oregon company with three small shops received federal forms weighing 45 pounds.” 126 Cong. Rec. H8,467 (Sept. 8, 1980).

<sup>64</sup> 126 Cong. Rec. S10,941 and 10,942 (Aug. 8, 1980) (Section-by-Section Analysis of the Regulatory Flexibility Act).

<sup>65</sup> *Id.* at S10,938.

regulation before making the decision to certify or do an initial regulatory flexibility analysis. The goal at this stage of the process is to ensure that the broadest possible impacts are fully considered. The interpretation of the term “substantial number” is not likely to be five small firms in an industry with more than 1,000 small firms. On the other hand, it is important to recognize that five small firms in an industry with only 20 small firms would be a substantial number. Depending on the rule, the substantiality of the number of small businesses affected should be determined on an industry-specific basis and/or on the number of small businesses overall. For example, the Internal Revenue Service, when changing the tax deposit rules, would examine the entire universe of small businesses to see how many would be affected. On the other hand, a change by the Food and Drug Administration in the regulation of meat irradiators might affect only 15 firms, but that would be the entire industry.

### ***Direct versus indirect impact***

The courts have held that the RFA requires an agency to perform a regulatory flexibility analysis of small entity impacts only when a rule directly regulates them.

The primary case on the issue of direct versus indirect impacts for RFA purposes is *Mid-Tex Electric Cooperative, Inc., v. FERC (Mid-Tex)*.<sup>66</sup> In *Mid-Tex*, the Federal Energy Regulatory Commission (FERC) was proposing regulations affecting how generating utilities included construction work in progress in their rates. Generating utilities were large businesses, but their customers included numerous small entities, such as electric cooperatives. FERC authorized large electric utilities to pass these costs through to their transmitting and retail utility customers. This increased the cost to the transmitting utilities, which may or may not have been able (because of regulation by their rates commissions) to pass the costs on to their residential and business customers. These smaller utilities challenged the rule, asserting that the impact on them should have been considered. The court concluded that an agency may certify the rule pursuant to section 605(b) when it determines that the rule will not have a direct impact on small entities.<sup>67</sup>

The U.S. Court of Appeals for the District of Columbia applied the holding of the *Mid-Tex* case in *American Trucking Associations, Inc., v. EPA*<sup>68</sup> (hereafter *ATA*). In the *ATA* case, EPA established a primary national ambient air quality standard (NAAQS) for ozone and particulate matter. The basis of the EPA’s certification was that the NAAQS regulated small entities indirectly through state implementation plans. The court found that since the states, not EPA, had the direct authority to impose the burden on small entities, EPA’s regulation did not have a direct impact on small entities.

Although it is not required by the RFA, the Office of Advocacy believes that it is good public policy for the agency to perform a regulatory flexibility analysis even when the impacts of its regulation are indirect. In the case of the NAAQS standard at issue in *ATA*,

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<sup>66</sup> *Mid-Tex Elec. Coop v. FERC*, 773 F.2d 327 (D.C. Cir. 1985).

<sup>67</sup> *Id.* at 342.

<sup>68</sup> *American Trucking Ass’ns v. EPA*, 175 F.3d 1027, 1044 (D.C. Cir. 1999), *aff’d in part and rev’d in part on other grounds*, *Whitman v. American Trucking Ass’ns*, 531 U.S. 457 (2001).

During the preparation of a proposed rule, an agency must prepare an initial regulatory flexibility analysis (IRFA) if it determines that a proposal may impose a significant economic impact on a substantial number of small entities.<sup>86</sup> (If the agency determines that the proposed rule does not have such an impact, it should certify the rule as discussed in Chapter 1 of this guide.)

The RFA requires agencies to publish the IRFA, or a summary thereof, in the *Federal Register* at the same time it publishes the proposed rulemaking.<sup>87</sup> The IRFA must include a discussion of each element required by section 603 of the RFA, and the agency must also send a copy of the IRFA to the Chief Counsel for Advocacy.<sup>88</sup> Executive Order 13272 requires agencies to notify Advocacy when the agency submits a draft proposed or final rule to the Office of Information and Regulatory Affairs (OIRA) under Executive Order 12866, or at a reasonable time prior to publication of the rule by the agency.<sup>89</sup> Moreover, the earlier a copy of the IRFA is provided to Advocacy, the more opportunity exists for constructive involvement and feedback to the agency. If an agency is preparing a series of closely related rules, it may, to avoid duplicative action, consider the one rule for the purposes of complying with the IRFA requirement.<sup>90</sup>

## Issues to be addressed in the analysis

Section 603 of the RFA requires agencies to perform a detailed analysis of the potential impact of the proposed rule on small entities.<sup>91</sup> In order to perform this analysis, an agency must enumerate the objectives and goals of the rule, as well any additional reasons the agency is pursuing the rule.

The agency then must examine the costs and other economic implications for the industry sectors targeted by the rule.<sup>92</sup> Impacts include costs of compliance and economic implications that derive from additional compliance costs such as economic viability (including closure), competitiveness, productivity, and employment. The analysis should identify cost burdens for the industry sector and for the individual small entities affected. Costs might include engineering and hardware acquisition, maintenance and operation, employee skill and training, administrative practices (including recordkeeping and reporting), productivity, and promotion. The agency must also consider alternatives to the proposed regulation that would accomplish the agency's goals while not disproportionately burdening small businesses. As part of the discussion of the alternatives under section 603(c), it is recommended that the agency address, in less detail than in the proposal, the costs and other economic implications.

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<sup>86</sup> For a full discussion of "significant economic impact on a substantial number of small entities," and the requirements of a proper certification statement, see Chapter 1 of this guide.

<sup>87</sup> 5 U.S.C. § 603(a).

<sup>88</sup> *Id.*

<sup>89</sup> Exec. Order No. 13,272, § 3(b).

<sup>90</sup> 5 U.S.C. § 605(c).

<sup>91</sup> *Id.* at § 603(b)-(c).

<sup>92</sup> When such data are unavailable, the agency should state why and request comments.

Some of the important questions the agency should address in preparing an IRFA are:

- Should the agency redefine “small entity” for purposes of the IRFA?
- Which small entities are affected the most? Are all small entities in an industry affected equally or do some experience disparate impacts such that aggregation of the industry would dilute the magnitude of the economic effect on specific subgroups?<sup>93</sup>
- Are all the required elements of an IRFA present, including a clear explanation of the need for and objectives of the rule?<sup>94</sup>
- Has the agency identified and analyzed all major cost factors?
- Has the agency identified all significant alternatives that would allow the agency to accomplish its regulatory objectives while minimizing the adverse impact or maximizing the benefits to small entities?
- Can the agency use other statutorily required analyses to supplement or satisfy the IRFA requirements of the RFA?
- Are there circumstances under which preparation of an IRFA may be waived or delayed?
- What portion of the problem is attributable to small businesses (i.e., is regulation of small businesses needed to satisfy the statutory objectives)?
- Does the proposed solution meet the statutory objectives in a more cost-effective or cost-beneficial manner than any of the alternatives considered?

The results of the analysis should allow interested parties to compare the impacts of regulatory alternatives on the differing sizes and types of entities affected by the rule. It will enable direct comparison of small and large entities to determine the degree to which the alternatives chosen disproportionately affect small entities or a specific subset of small entities. Further, the analysis will examine whether the alternatives are effectively designed to achieve the statutory objectives.

The agency must balance the thoroughness of an analysis and practical limits of an agency's capacity to carry out the analysis. Agencies should consult available information on how to conduct an economic analysis, such as the guidelines in OMB's *Economic Analysis of Federal Regulations under Executive Order 12866* and should review small business data, including data referenced in Appendix C, “Small Business Statistics for Regulatory Analysis.”

If economic data are available, an agency should utilize the data in preparing an IRFA. When data are not readily available, the agency should consult with industry sources or other third parties to collect data. If the data collection is inadequate, then agencies should solicit the data as part of the proposed rulemaking.

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<sup>93</sup> See discussion on pp. 14-15 of this guide on this issue.

<sup>94</sup> An agency may want to avoid repeating relevant text by cross-referencing the needs and objectives of the rule in its IRFA.

## Elements of an IRFA

The preparation of an IRFA should be coordinated with the development of the data and analysis the agency will use in preparing the proposed rule under the requirements of the Administrative Procedure Act. In doing so, the agency should be mindful of the requirements of the RFA and collect data based on size. The development of a rational rule will require the acquisition of data that describe the scope of the problem, the entities affected, and the extent of those effects. Without such information, the agency will be unable to develop a rational rule.<sup>95</sup>

Under section 603(b) of the RFA, an IRFA must describe the impact of the proposed rule on small entities and contain the following information:

1. A description of the reasons why the action by the agency is being considered.
2. A succinct statement of the objectives of, and legal basis for, the proposed rule.
3. A description—and, where feasible, an estimate of the number—of small entities to which the proposed rule will apply.
4. A description of the projected reporting, recordkeeping, and other compliance requirements of the proposed rule, including an estimate of the classes of small entities that will be subject to the requirement and the types of professional skills necessary for preparation of the report or record.
5. An identification, to the extent practicable, of all relevant federal rules that may duplicate, overlap, or conflict with the proposed rule.

Section 603(c) requires an agency to include a description of any significant alternatives to the proposed rule that minimize significant economic impacts on small entities while accomplishing the agency's objectives. The approach an agency takes while developing an IRFA depends on such factors as the quality and quantity of available information and the anticipated severity of a rule's impacts on small entities subject to the rule. Section 607 of the RFA requires agencies to develop a quantitative analysis of the effects of a rule and its alternatives using available data. If quantification is not practicable or reliable, agencies may provide general descriptive statements regarding the rule's effects.<sup>96</sup> This second option is a last resort when it is not practicable for the agency to complete a significant quantitative analysis.

The principal issues an agency should address in an IRFA are the impact of a proposed rule on small entities and the comparative effectiveness and costs of alternative regulatory options. Each of the specific elements of the IRFA is discussed in turn below.

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<sup>95</sup> *Bowen v. AHA*, 476 U.S. 610, 643 (1986); *National Ass'n of Home Health Agencies v. Schweiker*, 690 F.2d 932, 949 (D.C. Cir. 1982); *Chocolate Mfrs. Ass'n v. Block*, 755 F.2d 1098, 1103 (4<sup>th</sup> Cir. 1985).

<sup>96</sup> 5 U.S.C. § 607.

### ***Reasons action is being considered***

For the first element of the IRFA, the agency must discuss the reasons it is considering the proposed rule.<sup>97</sup> The agency should list any issue to be addressed in the rulemaking and should be thorough in listing its reasons as this section provides insight into the need for the rule.

Generally, the agency addresses this topic in the preamble to the rule. The agency can summarize its discussion in the rulemaking, if the rulemaking addresses all the reasons the agency is considering the action. The discussion of the reasons leads directly into the objectives of the rule, the next element of the IRFA.

### ***Objectives of the proposed rule***

For the second element of the IRFA, the agency must list the objectives of the proposed rule.<sup>98</sup> Again, the agency should be thorough when discussing its objectives, as this discussion conveys to the public the goals of the rulemaking and why the agency is taking specific actions contained within the proposed rule. This section provides the justification for the agency's actions, balancing the compliance requirements against the need for the rule. Such a discussion should include how the rule is achieving the statutory objectives. Compliance with this requirement should not be difficult since agencies are required to explain their proposed actions and the reasons underlying those proposed actions in order to elicit comment from the public as required by section 553 of the APA.<sup>99</sup>

As with the reasons for the proposed rule, the agency is likely to have addressed this topic in the rulemaking. The agency can draw from the language of the rulemaking to satisfy this section of the IRFA, as long as it lists all the objectives of the proposed rule that would entail compliance requirements with a significant economic impact on a substantial number of small entities.

### ***Description and estimate of the number of small entities***

The third element of the IRFA requires the agency to identify the classes of small entities affected by the proposed rule and provide an estimate of the number of small entities in each of those classes.<sup>100</sup> In particular, the agency should pay special attention to small entities expected to face disproportionate impacts relative to other entities in the industry, whether those entities are large or small. Classification requires the development of a profile for the affected industry or industries and categorization by various size classes within each affected industry. It is crucial that the agency list all industry classes affected by the rule. Specifically, if the agency imposes a compliance requirement on a class of small entities, it must identify that class of small entities in this section of the IRFA.

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<sup>97</sup> *Id.* at § 603(b)(1).

<sup>98</sup> *Id.* at § 603(b)(2).

<sup>99</sup> *See* *Spartan Radiocasting v. FCC*, 619 F.2d 314, 321 (4<sup>th</sup> Cir. 1980).

<sup>100</sup> 5 U.S.C. § 603(b)(3).



As a default, section 601 of the RFA requires agencies to use size standards set by the SBA in determining whether businesses are small businesses. SBA's Office of Size Standards set these standards using the North American Industry Classification System (NAICS).<sup>101</sup> Agencies must identify each of the affected classes according to their NAICS code. Once the agency has identified all the affected industries by code, it can use the NAICS code in combination with the U.S. Census data<sup>102</sup> to gain an estimate of the number of entities in each class. To help agencies with this element of the IRFA, the Office of Advocacy provides a full listing of NAICS codes along with the U.S. Census data for each class on its web page.<sup>103</sup>

If the agency determines that the existing SBA size standards for small businesses are not appropriate, the RFA permits the agency, after notice and comment, to establish one or more alternative definitions of a small entity that are appropriate for the rule.<sup>104</sup> The RFA requires an agency to consult with the Office of Advocacy when performing an RFA analysis using a different small business size standard than that provided by the SBA.<sup>105</sup>

### ***Estimating compliance requirements***

For the fourth element of the IRFA, the agency must describe and estimate the compliance requirements of the proposed rule.<sup>106</sup> This is one of the two most important elements in the IRFA, because the alternatives the agency examines in the IRFA will be designed to minimize these compliance burdens. Provision of a list in the IRFA enables small entities to more easily identify potential burdens and tailor their comments in the rulemaking process to those burdens that most affect them without wading through many *Federal Register* pages.

As stated by the RFA, some of the costs the agency must describe in the IRFA include the costs of any recordkeeping; professional expertise, such as lawyer, accountant, or engineering, needed to comply with recordkeeping; and reporting requirements. Section 603 also requires that the agencies examine other compliance requirements, which may include, for example, the following: (a) capital costs for equipment needed to meet the regulatory requirements; (b) costs of modifying existing processes and procedures to comply with the proposed rule; (c) lost sales and profits resulting from the proposed rule; (d) changes in market competition as a result of the proposed rule and its impact on small entities or specific submarkets of small entities; (e) extra costs associated with the payment of taxes<sup>107</sup> or fees associated with the proposed rule; and (f) hiring employees dedicated to compliance with regulatory requirements.

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<sup>101</sup> See <http://www.sba.gov/size/>.

<sup>102</sup> See <http://www.census.gov/>.

<sup>103</sup> Office of Advocacy, Economic Statistics and Research (visited Sept. 26, 2002), [http://www.sba.gov/advo/stats/us99\\_n6.pdf](http://www.sba.gov/advo/stats/us99_n6.pdf).

<sup>104</sup> See the size standard discussion in Chapter 1.

<sup>105</sup> 5 U.S.C. § 601(3).

<sup>106</sup> *Id.* at § 603(b)(4).

<sup>107</sup> In the case of regulations from the Internal Revenue Service, it should include an estimate of the amount of additional tax that will be paid by the class of small entities as a result of the change in regulations.

Since all rules are different and impose different compliance requirements, the RFA contemplates that agencies will prepare analyses to determine all significant long- and short-term compliance costs. Agencies should list the compliance requirements separately to provide greater transparency.

The IRFA should also, to the extent practicable, compare the costs of compliance for small and large entities to determine whether the proposed rule affects small entities disproportionately, to analyze the ability of small entities to pass on these costs in the form of price increases or user fees, and to assess the effects on firms' profitability or their ability to provide services. This should be done in conjunction with an estimation of the costs of compliance relative to changes in market structure and the competitive status of various subclasses of small entities as well as the competitive positions of small entities in comparison with larger entities.<sup>108</sup>

### ***Significant alternatives considered***

The keystone of the IRFA is the description of any significant alternatives to the proposed rule that accomplish the stated objectives of applicable statutes and that minimize the rule's economic impact on small entities.<sup>109</sup> It is the development and adoption of these alternatives that provides regulatory relief to small entities.

Analyzing alternatives establishes a process for the agency to evaluate proposals that achieve the regulatory goals efficiently and effectively without unduly burdening small entities, erecting barriers to competition, or stifling innovation. This process provides an additional filter by which the agency conducts rational rulemaking mandated by the APA. Rather than focus on the overall costs and benefits of a particular regulation (as might be required by statute, such as the best achievable control technology, or by the regulatory analysis requirements of E.O. 12866), the RFA requires the agency to undertake an analysis in order to discover the least costly method of attaining the statutory objectives of the rulemaking agency. Instead of analyzing the impacts of its regulatory actions on all

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Regulatory changes made by the IRS frequently garner additional revenue without the impetus of legislation. *See* Excise Taxes: Definition of Highway Vehicle, 67 Fed. Reg. 38,913 (REG-103829-99).

<sup>108</sup> Competitive status is not relevant when the small entities regulated by the proposed rule are not-for-profit organizations or governmental jurisdictions. In regulations that are limited to nonprofits or governmental jurisdictions, changes in regulatory costs should not affect the competitive status of the entities. However, there are certain nonprofit and governmental jurisdictions that do compete with for-profit enterprises, such as electric cooperatives. In preparing an IRFA, the agency must be mindful of the type of small entity regulated and tailor its analytical requirements to those entities.

<sup>109</sup> 5 U.S.C. at § 603(c). Since the RFA is an economically neutral statute, the IRFA should examine alternatives to ensure that the proposed rule is maximizing any beneficial impact on small entities. In the case of a rule that has a significant beneficial effect, the failure to consider alternatives that enhance the beneficial effect means that the agency has not examined alternatives that "minimize" the economic impact of the proposed rule. For example, if a rule increases revenue to a small entity by \$100 and an alternative exists that meets the statutory objective of the agency and increases revenue by \$200, then the agency has not complied with the RFA if it did not examine the second alternative. The failure to provide the small entity with a potential extra \$100 in revenue in essence does not minimize the economic impact on small entities.