The impact of taxation and government spending

Specification -The impact of taxation and government spending on businesses.

Fiscal Policy and the Budget.

Fiscal policy is based on how the government raises revenues - taxation, and how the government spends these revenues - government expenditure. The Chancellor of the Exchequer, in the Budget speech, (the Finance Bill) in March or April of each year, sets out in detail the expected pattern of government revenues and expenditure for the next tax year. So levels of taxes and spending are set for the following financial year, which commences on the 6th of April and ends the following 5th of April. The Chancellor will also give outlines of expected revenue and expenditure for subsequent years.

When income exceeds expenditure the budget is said to be in surplus. During the late 1980's there was a period of 3 years when revenues exceeded expenditure, and this was repeated between 1999-2001. Surpluses are most likely to occur when the economy is booming, but not all booms have led to surplus budgets.

When government expenditure exceeds income, then the budget is said to be in deficit. Deficits are far more common than surpluses and the government must fund a deficit through borrowing, this adds to the national debt. It is expected because of recessionary conditions in the UK (2013), that the government might need to borrow £120 billion in the year 2012-13!

Taxation.

Taxes can be broadly split into two types, these are;

- direct taxation - taxation on income,
- indirect taxation - taxation on spending.

The major direct taxes in terms of revenue raising are Income Tax, National Insurance, and Corporation Tax (tax on company profits). Income Tax revenues for the year 2012-13 were expected to be £155 billion, National Insurance Revenues £106 billion, and Corporation tax revenue £45 billion.

Income tax comes in four bands, nil rate (incomes below £8,400) the basic rate at 20%, the higher rate of 40%, and top rate band of 45%. No one pays tax on their first chunk of earnings (around £8400), but then anything earned over this amount is taxed at 20%. Anyone earning enough to be in the higher rate bands pays 40% on all earnings in this band. National insurance, sometimes called a contribution, but in reality a tax, is also paid on taxable earnings at a rate of 11% for most earners. National insurance was introduced to pay for sickness, pension and unemployment benefits, but the money raised goes into the general government pot, to be spent how the government decides. Most businesses pay Corporation Tax on their profits at a rate of 21%

The major indirect taxes in terms of raising revenue are VAT (Value Added Tax, currently at 20%), paid on most goods and ser-

vices bought, but not on food, children's clothing, and books. There is a lower rate of VAT of 5% paid on Gas and Electricity. Total VAT revenue for the government in the year 2012—13 was around £102 billion Excise Duties are taxes placed on cigarettes, alcohol and petrol, these raise around £48 billion a year for the government. Total government taxation revenues for the year 2012-13 are expected to be around £592 billion.

Businesses are directly affected by a number of taxes, changes in which can increase or decrease their costs or affect demand levels for their products. Recent increases in fuel duty on diesel and local business rates, has pushed up costs of many firms. The government does at times listen to those most affected and can delay the introduction of increased taxes. National Insurance (paid by employer and employee), is sometimes described as a tax on jobs, as increases in this tax, increase the costs of employing workers. Recently the brewing and pub industry has been complaining about the level of taxes on beers and spirits, arguing that increases in taxes on these products is depressing demand noticeably.

Expenditure.

The public sector (all sorts of government activity), currently (2013) spends over £683 billion a year, that is over £10000 for every man women and child in the UK. The largest areas of expenditure are (2012-13); Social protection £207 billion, Health £130 billion, education £91 billion and defence £39 billion. £43 billion a year is spent on paying the interest on the national debt!

The government back in July 2002 announced a massive increase in expenditure on education, healthcare and other 'front line' services. The view expressed by Gordon Brown then the Chancellor was that this spending would encourage long term economic growth. A large proportion of this government money creates demand directly for industry, such as building, contracted out contracts etc., and much of the rest helps increase consumption through salaries being spent. So business always gains from increases in govt, expenditure—that is as long as it is not inflationary!

Expenditure is sometimes targeted at specific industry sectors or alternatively subsidies can be paid to industries. Currently the government is looking to encourage investment in green industry, it has been paying subsidies to renewable energy providers for a number of years, but has more recently focused on electric vehicles.

Economic Management Using Taxation and Expenditure. - Fiscal Policy

Taxation can be adjusted to increase demand. A fall in the general level of taxation will leave individuals with more income available to spend, this increased spending power will increase levels of overall demand in the economy. This increased demand will lead to increased economic activity, more jobs and therefore even more spending. A fall in tax levels can therefore create prosperity, increase incomes and lead to growth in demand for businesses. Also as incomes rise, more money can be saved, leading to more

capital being available for investment. The cost of borrowing should therefore fall, making investment by businesses easier and cheaper. All of this is good for the economy.

But there are problems with cutting taxes. Increased demand does create inflationary pressure. As people spend more, shops are able to increase prices. Buoyant demand gives retailers confidence to push up prices and still maintain sales levels. This can start an inflationary spiral. Increasing prices cause workers to push for higher wages, in turn pushing up costs, so again leading to higher prices.

So we see simply increasing individuals disposable incomes, may create more problems than it solves.

An increase in the general level of taxation, can be used by the government, if demand is seen as being too high i.e. inflationary. An increase in taxation reverses the effect above. Individual's disposable income will be cut, therefore reducing demand, and removing inflationary pressures. But unemployment increases as demand falls, and investment falls as firms are unable to look to the future with confidence.

Government expenditure can also be used to manage demand in the economy. The theory is simple. Governments should borrow money when demand is low and unemployment is high. The borrowed money should be spent on 'jump-starting' the economy. Spending on social housing, or road schemes, and investment in education are straight forward examples of what could be done. Increased government spending may increase business confidence, causing increased investment. The money spent by the government will increase the number of people in jobs, and the money spent by these newly employed workers will further increase demand, creating more jobs. This 'multiplier effect', should lead to a return to low levels of unemployment and a booming economy.

But there are problems. Firstly the government has in the past got its timing badly wrong. It has tried to increase demand, when in fact the economy was already recovering. This mistiming of injections of cash into the economy leads to high levels of inflation and even more instability in the economy.

Secondly, people have learnt not to entirely trust the government. Higher government spending does not any more naturally cause individual's and business confidence to suddenly bloom, causing them to rush out and buy new cars or invest in new plant and workers. Government jump-starting is not therefore likely to succeed without other factors, such as stability of employment, low mortgage rates and low inflation, being present.

Also high government borrowing can 'crowd-out', other borrowers. This means that because the government is borrowing so much money, businesses either find borrowing expensive or unobtainable. Banks will find the government a better lending bet. Even if when lending to the government, the long-term return is lower, this is balanced by a much lower risk.

When the economy is booming the government should cut expenditure, firstly in an attempt to reduce demand, and secondly to repay the money it has previously borrowed to increase demand. Unfortunately, this repayment of debt does not always happen. Much government spending is 'locked -in', this means the government will find it hard to reduce its spending by a great deal. Even big spending departments such as Social Security, which should see a fall in expenditure during boom periods, seem to be unable to reduce expenditure at any stage of the economic cycle.

Fiscal policy is still used to achieve specific aims, such as reduction in private car use through the imposition of higher and higher excise duties on petrol, or encouragement of specific industries e.g. freezing the excise duties on spirits to help the Scottish Whiskey industry. But the explanation above has shown us that Fiscal Policy is a clumsy tool to use to manage the whole economy. Many economists and politicians argue that Fiscal Policy is too unwieldy to use to achieve desired effects and often the results of using Fiscal Policy as a tool of demand management, are far from those desired.

The current government (Labour 1997 on) has operated a 'broadly neutral' Fiscal Policy, this means that the budget is used as a revenue raising tool, not as a demand management tool. It did for a while seem unlikely that Fiscal Policy would be ever again used as the main focus of large scale (macro) economic management of the UK economy., but this suddenly changed in early 2009, with governments around the world agreeing on a huge fiscal stimulus in a coordinated attempt to prevent world wide recession.

Notes