119 Government policy

The role of government in the economy

Governments play a number of roles in an economy which affect business.

- Government creates the legal and regulatory framework which govern the way in which businesses and individuals relate to each other. In the UK, for example, government gives rights of ownership to private property. This is fundamental to businesses. Without this right, they would not be able to protect their property, from land and buildings, to stocks of goods to intellectual property such as patents and copyright. UK law also regulates contracts. All businesses buy and sell. Without an effective law of contract, this process would become uncertain and discourage businesses from operating. The impact of the law on business is discussed in more detail in the unit titled 'Business and the law'.
- Government provides goods and services from health and education to roads and the police.
- The government uses taxes and spending to influence the way individuals and businesses behave. For example, it taxes cigarettes to discourage individuals from smoking. It subsidises training of workers to encourage individuals to become more skilled.
- It uses its powers of spending and tax to influence the amount of demand in the economy. This can help prevent the economy from suffering a recession or experiencing rising inflation. Some of the same effects can also be had through its power to control the rate of interest.

Government provision of goods and services

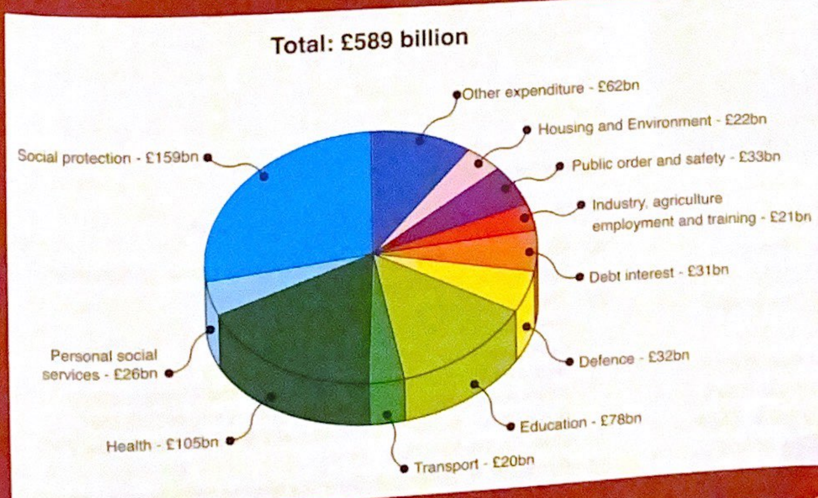
In the UK, government (i.e. the public sector) accounts for between 40 and 45 per cent of all the goods and services produced in the economy. In addition, it redistributes income through a variety of welfare benefits. Some of the main areas of government spending, shown in Figure 1, are:

- social protection or welfare benefits such as the State old age pension and Child Benefit;
- health which is mainly spending on the National Health Service;
- education including primary and secondary schools as well as universities;
- transport including roads and subsidies for rail transport.

Businesses benefit directly from the provision of goods and services by government. For example, the workers they employ have mainly been educated in the British education system. Roads allow their goods to be transported between business premises. Spending on the police and the judiciary ensure that property rights are respected.

Some of what is provided by government is produced by state owned enterprises and organisations. For example, education in schools is provided mainly by local authorities. But a significant proportion of public sector goods and services are produced by the private sector. For example, new roads are built by private construction companies under contract from government. Tanks and military aircraft are purchased by government from private sector companies. Social services departments purchase residential care for the elderly from private businesses. Supplying products to the public sector is a major sales opportunity for many businesses.

Figure 1: Government spending, 2007-08



Changing what is bought and how it is produced

In most circumstances, the prime purpose of taxes is to raise revenues that will pay for government spending. But sometimes, taxes are used deliberately to change the behaviour of businesses and consumers. For example:

- taxes on alcohol and tobacco are used to discourage consumption of these drugs;
- taxes on cars and petrol are used to encourage the purchase of 'green' cars and discourage the purchase of cars with high emissions and heavy fuel use; they are are also used to reduce the level of traffic to reduce congestion on roads;

- pollution and environment taxes such as the Landfill Tax are used to encourage businesses to adopt more environmentally friendly practices;
- tax allowances on investment encourage businesses to invest.

Governments also sometimes use **subsidies** to alter behaviour. A subsidy is a grant given to lower the price of a good. For example, governments may subsidise businesses to train workers by paying part of the costs of training. Governments may subsidise some elements of the costs of a business start-up to encourage more people to set up their own business. Governments may also provide subsidies to businesses that set up in a high unemployment area to encourage job creation.

Fiscal policy

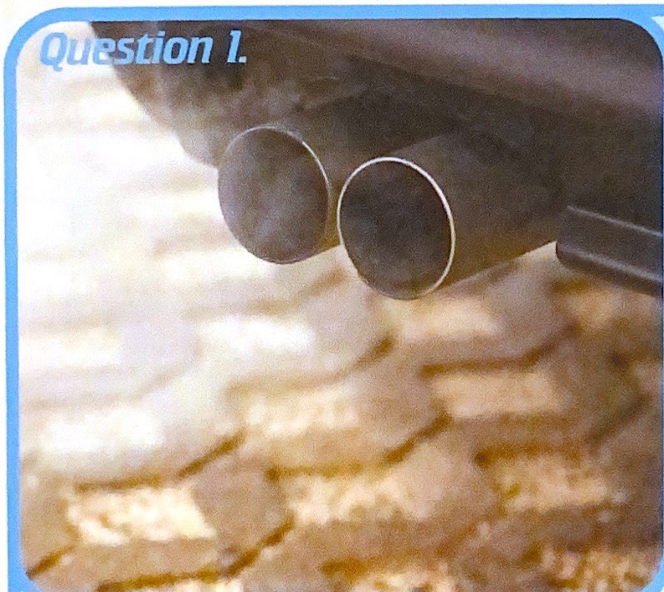
FISCAL POLICY is the government use of its spending, taxes and its borrowing to influence economic activity. Fiscal policy can be used to influence the behaviour of individuals and businesses as described above. However, it can also be used to influence the economy as a whole.

When governments increase their spending more than they increase taxes, total spending in the economy rises. For example, if the government increases spending by £20 billion but taxes only rise by £5 billion, then there is an increase in spending by the government sector of £15 billion. The exact impact of this on the economy is complex. However, this net increase in spending will give a boost in the short term to total demand (or **aggregate demand**). The economy will expand. Hence this is called **expansionary fiscal policy**.

Expansionary fiscal policy should be used by government when the economy is going into a **recession**. This is when unemployment is rising and spending is slowing down or even falling. Businesses should therefore benefit from expansionary fiscal policy. This explains why, when trading conditions are difficult, business groups such as the CBI call for the government to adopt expansionary fiscal policies by either increasing its spending or cutting taxes.

Restrictive fiscal policy is the opposite of expansionary fiscal policy. It occurs when the government raises taxes more than any increase in its spending. It reduces demand from government in the economy. It should be used by the government when the economy is overheating at the top of a boom and there is too much spending. Too much spending

Question 1.



Zaphrom is a UK company which manufactures pharmaceutical products. It currently provides 70 cars to its employees, from the Chief Executive to senior managers to sales staff. In his 2008 budget, the Chancellor announced major changes to the tax payable on cars. The tax on cars which emit high levels of CO2 (carbon dioxide) would increase substantially. From April 2009, companies would only be allowed to write off 10 per cent of the value of a car emitting more than 160 gm of CO2 per kilometre compared to 25 per cent as at present. This would substantially increase the cost to the company of owning cars. In addition, from 2010, road tax (the cost of the tax disk on cars) would increase substantially for the first year of a car's life. For example, on the Chief Executive's Land Rover, it would increase from the current £500 to £950. On the Finance Director's Jaguar, it would increase from the current £400 to £750. Given that the company buys cars from new and then sells them after two or three years, this would lead to a significant rise in the cost of the company car fleet.

The HR director, who is responsible for making decisions about the company car fleet, wants to see the car fleet become greener so as to minimise the effects of the Chancellor's budget. Inevitably, some staff will be told that they will no longer be supplied with the model of car they have grown to like. She is going to 'sell' the changes in terms of the company's contribution to reducing greenhouse gas emissions, helping to solve the global warming problem and 'doing our bit' to save the planet. This will go down well with some staff. But she hasn't yet decided how to tell the Chief Executive that he can no longer have his Land Rover. She wonders how he would take it if she suggested he might like to trade it in for a Vauxhall Astra.

Source: adapted from *The Financial Times*, 14.3.2008.

(a) Explain how the Chancellor can use taxes to alter the behaviour of companies on green issues.

(b) The HR Director has chosen to change the composition of the company car fleet. (i) What would have been the impact on the company if she had decided to make no change? (b) The change could have both a positive and a negative impact on the motivation of staff. Evaluate whether the net impact is likely to be positive.

(c) Evaluate whether the Chief Executive would seriously consider making the switch from a Land Rover to a Vauxhall Astra.

Question 2.

The US economy is threatening to slide into a recession. Faltering spending led to fierce lobbying by business groups for the government to give a fiscal boost to the economy. Earlier this month, their lobbying was rewarded when Congress approved a $152 billion package of tax cuts. Tax payers will receive a one-off rebate sometime between May and the end of the summer. Cheques for up to $600 (£300) will be sent to individuals earning up to $75,000 (£37,500) and $1,200 for married couples who earn up to $150,000 (£75,000). Families with children will gain an additional $300 (£150) per child.

The National Retail Federation, representing US retailers, estimates that 40 per cent of the rebates will be spent, with the rest either used to pay off debts or saved. Not every retailer, though, will be a winner from the rebates. Past experience shows that consumers increase their basic spending but don't increase their discretionary spending when given tax rebates in a recession. So consumers will purchase lower-margin food and small basic household items like a new kettle. But they won't go out and buy luxuries like a new $2,000 high definition television. They might buy ice cream from Wal-Mart but they will think twice about going out to a restaurant. Wal-Mart, the largest supermarket chain in the USA, whose core customer is the average to below average income earner, could benefit. Starbucks, the coffee chain, which has already reported fewer customers visiting its outlets, might see little benefit.

Source: adapted from the *Financial Times*, 19.2.2008.

(a) Explain why Wal-Mart could be a beneficiary from the tax rebates but Starbucks and furniture retailers might see little benefit.

(b) A chain of US electrical retailers sells kitchen equipment like fridges, cookers and electric kettles, entertainment equipment such as televisions, games consoles and DVD players, and a range of computers and printers. In February 2008, it was having to make some decisions about its stock levels for the next 9 months. Discuss much stock it should buy and what sort of stock it should hold compared to the nine months to December 2007.

leads to inflation and is unsustainable in the long term.

Using fiscal policy to smooth out booms and recessions in the business cycle benefits business in the long term. It creates a more predictable economic climate which allows businesses to plan with greater certainty. It reduces risk and encourages investment.

Monetary policy

MONETARY POLICY is policy which uses interest rates to influence the economy. Control of interest rates has been given by the UK government to the Bank of England. Each month, the Bank of England has to decide whether to raise interest rates, leave them at the same level or reduce them.

The Bank of England uses interest rates to control inflation in the economy. Rises in interest rates reduce total spending by households and businesses. This reduces total demand for goods and services and moderates the rate of inflation. Falls in interest rates tend to come when the Bank of England believes the rate of inflation will fall below its target level, currently 2 per cent per annum. Falls in interest rates will boost spending by households and businesses.

High levels of inflation in general harm business and business activity. Controlling inflation is therefore important for businesses. Changing the rate of interest also helps smooth out the business cycle.

How businesses might respond to changes in interest rates is covered in more detail in the unit titled 'Interest rates'.

Supply-side policies

Fiscal policy and monetary policy is used to affect aggregate demand. By adjusting its total spending, level of taxes or interest rates, the government can increase or reduce the amount of total spending in the economy. This can then have a short-term impact on economic variables such as inflation, unemployment, and the business cycle.

However, a key long-term aim of the government is to increase the productive capacity of the economy. Growth in capacity is often called the 'underlying rate of economic growth' to distinguish it from growth in GDP. Policies to increase the productive capacity of the economy are called SUPPLY-SIDE POLICIES. This is to distinguish them from fiscal and monetary policies which affect aggregate demand. There are three main ways in which supply-side policies can increase the productive capacity of the economy.

Increasing investment The government can use policies to promote investment by businesses. For example, it can give tax relief on money used to buy investment goods. Or it can give grants to pay for investment. It can also invest itself. Building new roads and bridges or reclaiming derelict land are examples of infrastructure spending which will benefit business.

Improving the quality of the labour force A workforce which is better educated and trained and has more experience will be more productive than one which is less well trained. So the average UK worker might be able to produce more in money terms than the average Indian or Thai worker. Through better education and promoting training, the government can therefore increase long-term economic growth.

Making sure that both capital and labour are fully utilised Businesses can invest in new machines but if those machines stand idle, they won't be productive. Similarly, if workers are out of work or their skills are underutilised, then the economy will not grow as fast as it could. So a key role of government is to ensure that resources are being used productively. Policies which encourage employment, such as the New Deal or increased vocational training, help to achieve this. So do macroeconomic policies which smooth out the business cycle. Sound financial policies which result in low inflation will encourage investment. So too will a legal system which allows businesses to own property, sign enforceable contracts and trade goods without too much fear of crime. Countries that do not have a sound legal and financial framework often fail to grow as fast as they could as a result.

There are other examples of supply-side policies used by government in an effort to increase the efficient use of resources in the economy. For example, there are regular attempts by government to simplify 'red tape', the rules and regulations ranging from tax returns to health and safety inspections to labour laws. Red tape imposes considerable costs on businesses, particularly small businesses. There are also regular changes to amount of tax paid by businesses or workers to encourage them to work more efficiently.

Privatisation

One example of a supply side policy is PRIVATISATION. This was a policy introduced in the 1980s where state owned industries and assets were sold off to the private sector. For example the gas, electricity, coal, water, steel, post office, telecommunications, airline, airports and railway industries were all partly or fully owned by the UK government before 1980. The arguments in favour of NATIONALISATION, the government buying assets from the private sector , owning them and then providing goods and services, are:

- by providing on a large scale, as with the National Health Service, the government can gain economies of scale and so lower costs of production to citizens;
- essential services can be provided which would otherwise not be provided in sufficient quantities by free markets;
- by eliminating the profit made by businesses, the cost to the citizen of those products would be lower.

However, there have been major criticisms of state owned industries and strong arguments in favour of privatisation.

- State owned monopolies did not have the profit or competitive incentives to reduce cost wherever possible. Hence, when industries such as gas and electricity were privatised, their new private owners stripped out huge layers of costs making them far more efficient than before. Despite now earning large profits, the new businesses were able to lower their prices to customers.
- There was no incentive for industries to innovate. Privatised industries have often introduced new services better able to cater for the needs of their customers.
- Government often starved industries of investment because it wanted to reduce its spending. The result was a lack of essential investment in industries such as water and the railways. When these industries passed into private hands, investment increased because the privatised businesses saw that they could increase their profits by investing more.
- As a one-off advantage to taxpayers, the government sold off these assets to the private sector for billions of pounds. This was used to pay off part of the government debt, reducing interest payments and allowing for lower taxes.

Some privatised industries, such as gas, electricity, water, telecommunications and the railways, were privatised in such a way that there was not always enough competition in the industry to prevent the new businesses charging high prices and exploiting customers. For this reason, the industries were given REGULATORY BODIES. These include ofcom for the telecommunications industry and ofwat for the water industry. They have the power to fix maximum prices in the industry. In the case of the telecommunications industry, ofcom has tended to force prices down to take account of increased efficiency in providing telecommunication services. They also have the power to force existing monopoly businesses to open up individual markets to competition. For example, BT has been forced to allow competitors to provide broadband services which use BT landlines to reach customers.

Intervention vs laissez faire

The role of government has changed over time. Traditionally, government had two main functions. One was to maintain armed forces in time of war. The second was to administer justice. Taxes were raised to pay for both of these. Gradually, the role of government has expanded. Today, various branches of government in the UK are responsible not just for defence and the justice system, but also for education, health care, roads, welfare benefits as well as many other areas. Government is also responsible for running the economy as a whole and for regulating many areas of economic and social activity.

There is a debate, however, about the extent to which government should interfere in the workings of the economy and society.

Laissez faire approach The LAISSEZ FAIRE approach is that government should intervene as little as possible. 100 years ago, for example, government did not feel it had any responsibility for unemployment or inflation. There was little regulation of the labour market. 'Red tape' was minimal. Those who favour a laissez faire approach argue as follows.

KNOWLEDGE

1. Why are property rights important for businesses?
2. How do businesses benefit from government spending?
3. Explain the difference between a tax and a subsidy.
4. How might expansionary fiscal policy benefit businesses?
5. What might be the impact on businesses of a fall in the Bank of England's interest rate?
6. How might supply-side policies benefit businesses?
7. What are the possible advantages and disadvantages of privatisation as a supply side policy?
8. Briefly summarise the arguments in favour of (a) a laissez faire approach to the economy and (b) an interventionist approach.

- Government intervention has to be paid for by taxes. The more government intervention, the higher the taxes needed, whether to pay for inspectors to monitor health and safety legislation, or doctors to provide a free health service. The money raised in taxes would be better used if it were in the hands of those being taxed, consumers, workers and businesses. High taxes also discourage investment and enterprise. Foreign companies thinking of setting up in the UK would be discouraged by a high tax regime.
- Government intervention often does more harm than good. For example, attempts to reduce inflation can lead to higher inflation or very high unemployment. Protecting workers rights by setting minimum wages can lead to firms being forced out of business because of higher wage costs and unemployment increasing. Heavy regulation discourages investment and reduces international competitiveness because it adds to the costs of running a business. Foreign businesses wanting to set up in the UK could be discouraged by a heavy regulatory framework.
- Free markets usually provide a better outcome than regulated markets or no markets at all. Everything from health care to railways and even motorways can be more efficiently provided by markets.
- Where free markets fail, it is usually better for government to persuade firms in the industry to regulate themselves, for example by adopting voluntary codes of practice. In advertising, the Advertising Standards Authority regulates advertising without the need for government intervention.

Intervention approach Those who argue in favour of government INTERVENTION would disagree with the laissez faire approach.

- Macroeconomic management of the economy is essential to avoid the dangers of high inflation and high unemployment. Governments have not always been successful at this but a pure laissez faire approach would result in very deep recessions and unsustainable booms.
- Consumers, workers and citizens demand ever more stringent regulation from government. Consumers demand that they are fairly treated by businesses from which they buy goods and services. Workers want protection from employers who treat them unfairly. Citizens want the environment to be clean and healthy.

KEYTERMS

Fiscal policy - the government use of its spending, taxes and its borrowing to influence economic activity.
Monetary policy - government policy which uses monetary variables such as the rate of interest to influence the economy.
Nationalisation - the transfer of firms or assets from private sector ownership to state ownership.
Interventionism - an economic philosophy which argues that government should intervene in the workings of the economy whenever the free market mechanism fails to optimise society's welfare.
Laissez faire - an economic philosophy which says that government should intervene in the workings of the economy as little as possible because free markets are the best way to maximise welfare for society.
Regulatory bodies - bodies set up in the UK by government which oversee the workings of certain privatised industries where competition is restricted.
Supply-side policies - government policies aimed at increasing the productive capacity of the economy.

115 Taxation

Taxation

TAXATION is the charges that the government makes on the activities, earnings and income of businesses and individuals. The government uses the money raised by taxation to:
- pay for government spending on a wide variety of public sector activities including transport, education, health, defence and housing;
- to affect factors in the economy such as inflation and unemployment;
- to redistribute income, from those with higher incomes, to those who need it most;
- to influence patterns of consumer expenditure.

Taxes are sometimes classified into **direct** and **indirect** taxation. Direct taxes are taxes taken directly from the income of businesses or individuals, such as income tax. An indirect tax is a tax on a good or service, taken from income when it is used or spent, such as VAT.

Types of direct taxation

What are the main types of taxation in the UK?

Income tax This is a tax on the income or earnings of individuals. It includes charges made on the wages or salaries of employees and on the income of sole traders. It includes other earnings, such as the dividends paid to directors or limited companies. People do not pay tax on all their income. There are some allowances, such as a personal allowance on which people do not pay tax. After these allowances are taken into account, tax is charged on the remaining **taxable income**.

Income tax is a **progressive** tax. The more people earn the higher the proportion of their income that is paid in tax. This is because some of their income, their personal allowance, is tax free. Top income earners pay the highest rate of tax at 40 per cent but this top rate is only payable on the proportion of their taxable earnings which exceed around £30,000.

Other factors might also be taken into account when calculating income tax. For example, employees can claim a mileage allowance without tax for using company cars for business purposes. Certain gifts to charities by businesses are not liable for tax.

National Insurance contributions These are payable by employers, employees and the self-employed. They are calculated mostly as a percentage of income. For employers, they act as a tax on employment, adding to the total cost of employing workers. For employees and the self-employed, they are a substantial tax on earnings like income tax.

Corporation tax This is a tax on the profits of private and

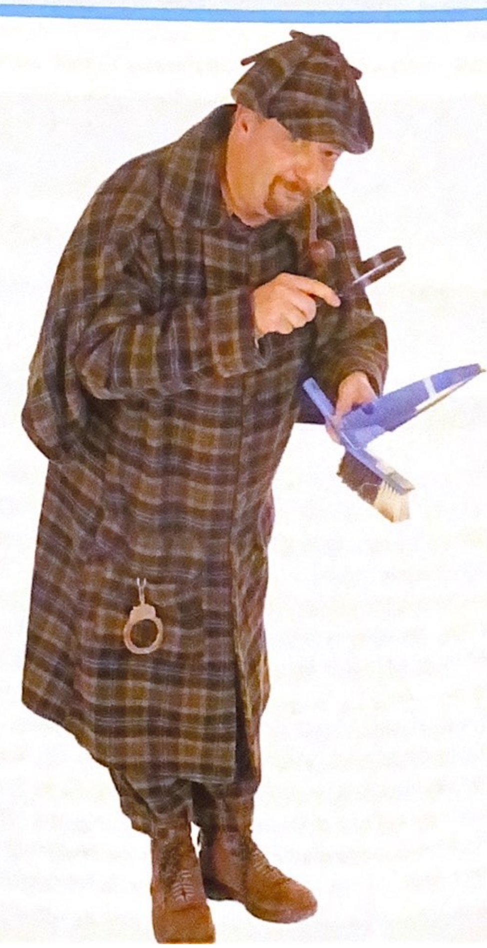
Question 1.

Stuart Elliott runs a Victorian Experience tourist attraction in London. Go into the building and you step back in time to the world of Charles Dickens and Sherlock Holmes. He was disappointed with the last government Budget. The Chancellor put up corporation tax rates, although he didn't put up Employers' National Insurance contributions as had been widely predicted.

Of course, there were also all the hidden increases. Whenever Stuart puts up his ticket prices, for example, 17.5 per cent of the increase immediately goes to the Chancellor in extra VAT. When he gives his workers a pay increase, he has to pay over 10 per cent of that increase to the Exchequer in Employers' National Insurance contributions. Like many entrepreneurs, Stuart feels he is overtaxed and doesn't get many benefits from the government.

(a) Explain five different taxes that Stuart Elliott and his business would pay.

(b) Examine how a rise in (a) the rate of corporation tax and (b) Employers' National Insurance contributions would affect the business and the decisions that Stuart might make about its future operations.



public limited companies. There are lower rates for small companies than for larger companies.

A business can claim capital allowances. This is where it is able to claim allowances against certain types of spending, such as building hotels in enterprise zones or expenditure on research and development. It would not have to pay as much corporation tax if it could claim such allowances.

Capital gains tax This is a tax on the sales of capital assets. Capital gains usually involve the sale of shares, although they can involve non-business assets such as rental property owned by individuals.

Inheritance tax This is a tax on money left on death. If a person leaves money to a husband or wife, the transfer of money is tax free. Otherwise, the first approximately £300,000 is tax free and the rest is taxed at 40 per cent.

Types of indirect tax

Value Added Tax (VAT) VAT is charged on goods or services which are made and bought in the UK. There were three rates of VAT in 2008:

- the standard rate was 17.5 per cent. This applies to most goods and services bought in the UK;
- the zero rate of 0 per cent. This applies to certain goods in the UK which are subject to VAT, but at a nil rate. Examples include food, books and children's clothing and footwear;
- the reduced rate of five per cent. This applies to a narrow category of products including womens' sanitary products, children's car seats and installation of energy saving items.

It is often argued that, within the standard rate band, VAT is a **regressive** tax. The more you earn, the less as a proportion of your income you pay in tax. The main reason for this is that higher income earners tend to save more of their income and so don't pay VAT on the income they don't spend. This reduces their average rate of tax on VAT as a proportion of their income.

Customs duty This is a tax on goods and services imported into a country. Customs duties are usually charged as a percentage of the value of the imported goods. They are often placed on imports of foreign businesses, to raise the price of their goods in an attempt to protect home businesses from competition. A problem, however, is that businesses importing supplies have to pay higher prices.

Excise duties Excise duties are a tax on the sale of a narrow range of products including alcohol, cigarettes and petrol and diesel fuel. Because excise duties are very high, they are a substantial money raiser for the government.

Council tax This is a charge paid by residents of domestic housing in the UK to local authorities. The charge people pay is based on the council tax band in which the valuation officer places a dwelling. The bands are based on the size, location, layout and character of the property. The valuations are designed to show what the property would have been sold for on the open market, given certain assumptions. Different local authorities have different bands.

Business rates Business rates, or national non-domestic rates (NNDR), are annual charges on the rateable value of business premises. The rateable value is broadly the yearly rent for which the property could be let out.

Stamp duty This is a tax paid on the purchase of land, property, leases and certain types of shares and securities.

Insurance premium tax Insurance premium tax is a tax on all general insurance such as cars, homes and travel insurance.

Environmental taxes There is a variety of indirect taxes which are used to change the behaviour of individuals and businesses to benefit the environment. The **landfill tax** is a charge on waste disposed in landfill sites. The **aggregates levy** is a tax on sand, gravel and crushed rock extracted in the UK or imported from abroad. The **climate change levy** is a charge on fuels used by business. **Air passenger duty** is a tax on each passenger flying by air. VAT and excise duty on fuel for cars and heavy goods vehicles can also be seen as environmental taxes.

Effects of changes in taxation on business

How might changes in taxation affect businesses in the UK?

Consumer spending Changes in certain types of taxation are likely to increase the income consumers have left after tax. These include reductions in income tax rates, increases in personal allowances and an increase in the limits on which inheritance tax is paid or a reduction in the rate of inheritance tax. If consumers have more income left they might increase spending on the products of businesses. Increases in income tax, National Insurance contributions and council taxes are all likely to leave consumers with less income and could reduce spending on products.

Prices An increase in VAT or excise duty will raise the costs of a business. Businesses often pass this on to customers by raising the price of goods. An increase in customs duty will increase the price of goods being imported into a country.

Business costs, revenue and profits Increases in some taxes might raise the costs of business. For example, VAT will raise costs. A business might try to raise prices to cover this and maintain profit. However, higher prices can reduce sales and so profit could still be affected if revenue falls. Rises in corporation tax, business rates, employers' National Insurance contributions and landfill tax will all tend to reduce business profits. Reductions in taxes are likely to increase the profits of a business.

Business spending and investment Increases in costs and reduced profits mean that businesses have less retained profit. This can affect the ability of the business to pay its debts, buy stocks and meet other expenses. It can also affect whether it invests in new factories or machinery.

Shares Changes in capital gains tax and stamp duty might affect shareholding. For example, an increase in capital gains tax might deter shareholders or delay sales of shares.

Importing and exporting Increases in customs duties can affect businesses. For example, if the UK raised customs duties on imported products a UK business might benefit because as imports against which it competed would then have a higher price. However, UK businesses buying imported supplies would have to pay higher prices.

Business operations and employees Increases in National Insurance contributions of employers might deter employers from recruiting extra workers. Changes in taxation on company cars or mileage allowances might also changes how a business offers these benefits to employees.

Other effects Certain types of business might be affected by changes in tax. For example, an increase in landfill tax might encourage businesses to recycle. A rise in passenger duty could discourage holiday makers and reduce the demand for holidays.

Tax avoidance and evasion Increases in taxation often lead businesses to try to avoid paying the tax. For example, they might not hire workers to avoid higher National Insurance contributions or switch from buying imports to avoid customs duties. In some cases they might even try to evade the law, for example dumping waste in the countryside to avoid landfill taxes, which is illegal.

KEYTERMS

Taxation – the charges made by government on the activities, earnings and income of businesses and individuals.

KNOWLEDGE

1. What is the difference between a direct and an indirect tax?
2. State six types of tax in the UK.
3. Why is income tax progressive and VAT regressive?
4. State three taxes that might reduce company profits if they rise.