

# OCR A Level Business Studies Update

## Module 2871

### Businesses, Their Objectives and Environment

(sample pages)

# 5. Governmental Opportunities and Constraints

## 5.1 The Budget of 2004

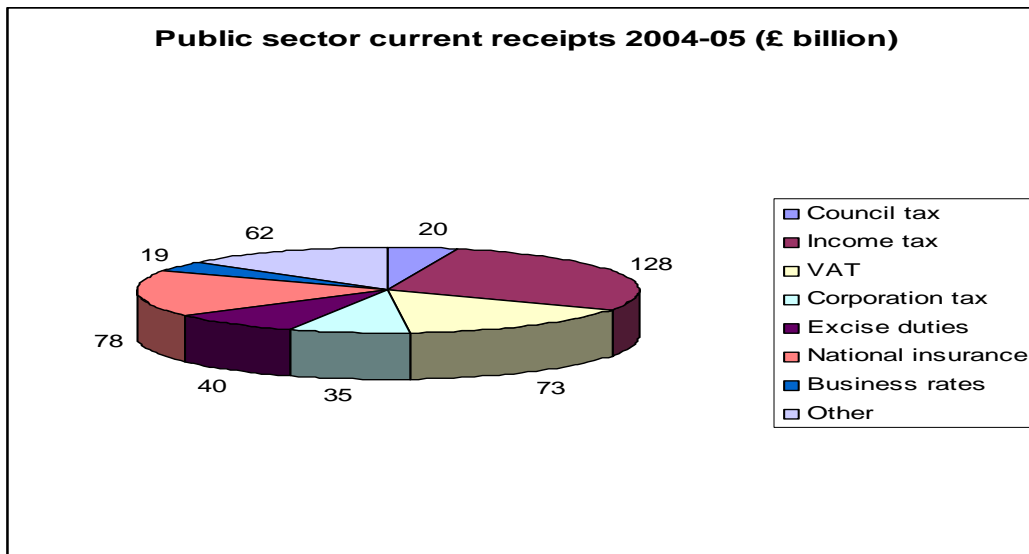
A budget is a financial plan. It outlines spending and income proposals for a set time. The government's Budget for the UK is presented by the Chancellor of the Exchequer each year and outlines the government's spending and income proposals. It is also an opportunity for the Chancellor to report on economic performance and to present any changes to fiscal or monetary policies that the government has planned. The Budget measures summarised in Box 2.1 below are those directed at businesses.

### Box 2.1 The Budget of 2004

- The rates on corporation tax, capital gains tax, income tax, insurance premium tax and betting levies are all frozen.
- The VAT threshold for small businesses is raised to £58,000 – the most generous rate in Europe.
- Venture capital trust tax relief will be extended to the top-rate tax payers up to £200,000. This is designed to encourage investors to back unquoted and fledgling companies.
- To cut 'red tape', the Chancellor has agreed to pay working tax credits directly to employees. This is expected to save businesses £90 million in administration costs. Also, a review of the inspection scheme is planned. In particular, overlaps between the Health and Safety Executive, the Environment Agency and the Food Standards Agency will eventually be eliminated.
- Small brewers were given extra tax breaks. Those producing between 18,330 and 36,660 barrels per year would be eligible for tax reduction. This should reduce the disincentive for small brewers to grow into bigger brewers.
- More manufacturers will benefit from the 80% discounts to the climate change levy, the energy tax on business.
- There are plans to merge the Inland Revenue and Customs & Excise. This should help to cut administration costs incurred by business.
- Film producers will benefit from increased tax benefits. Relief on production budgets under £15 million will be raised from 15% to 20%.
- Anti-tax avoidance provisions for partnerships, finance leases and VAT were proposed. It is expected that manufacturers could lose up to £1 billion of tax relief over the next three years as a result of tax avoidance measures on sale and leaseback schemes.

## 5.2 Sources of government revenue 2004-05

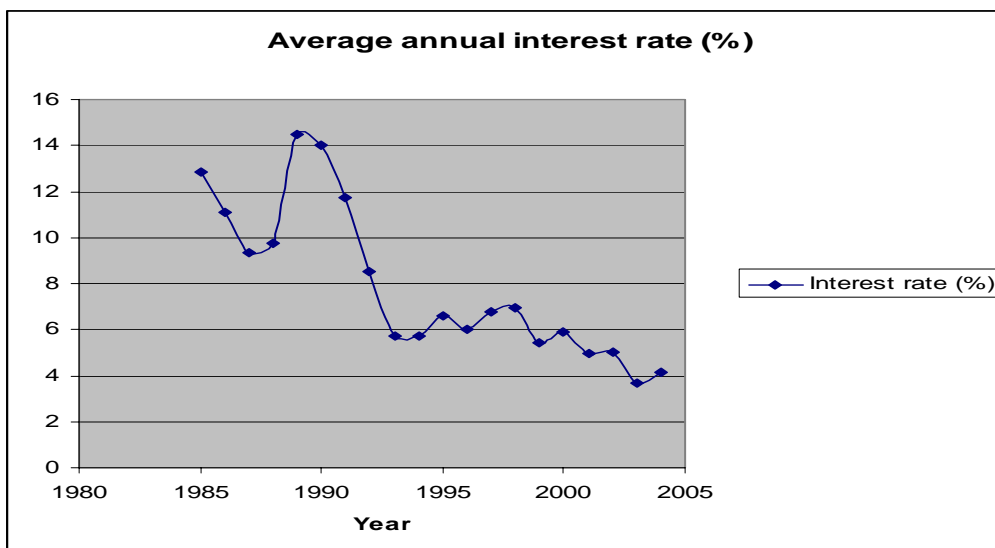
The government raises revenue to fund its expenditure from a number of sources. A significant proportion comes from the business sector. The pie chart below shows the various sources.



Source: the *Financial Times*, 18 March 2004.

## 5.3 Interest rates

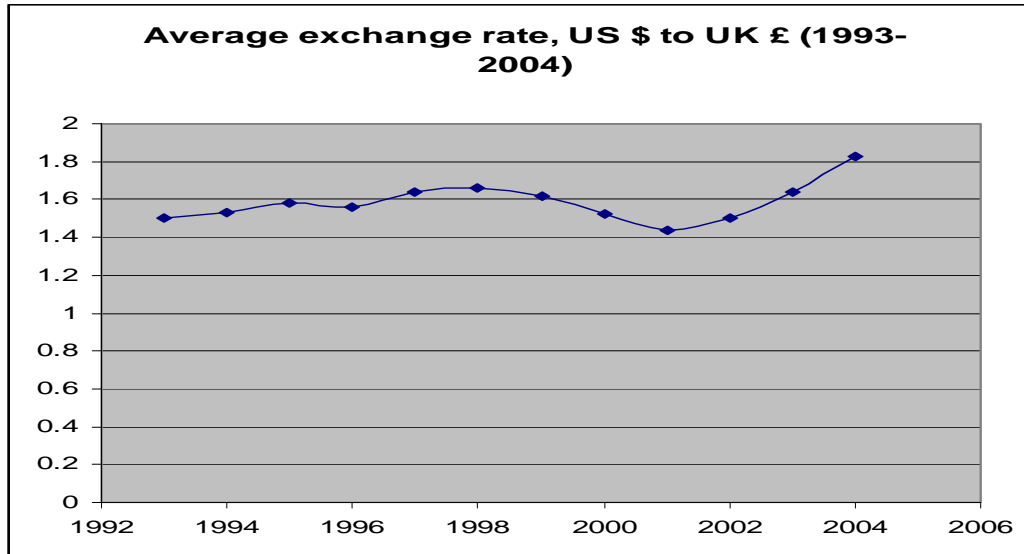
Interest rates in the economy can have a powerful influence on business activity. Generally, high interest rates are bad for business produce a fall in demand, higher borrowing costs and a drop in investment. The base rate is set by the Bank of England's Monetary Policy Committee. Its aim is to set a rate that will deliver the government's inflation target. However, other economic factors are usually taken into account – such as the level of consumer spending and house prices. The graph below shows the average interest rate in each of the years between 1985 and 2004. The figure for 2004 is based on the rate up to May.



Source: [www.houseweb.co.uk](http://www.houseweb.co.uk), 27 May 2004.

## 5.4 Exchange rates

Exchange rates effect businesses involved in international trade. If the pound grows stronger against other currencies, exports become more expensive. As a result, demand for exports is likely to fall. On the other hand, a strong pound means that imports become cheaper. This helps to keep the cost of imported goods down. The two most important foreign currencies in the UK are the dollar and the euro. The graph below shows the exchange rate between the pound and the dollar between 1995 and 2004. Note that the figures for 2004 are based on those available from January to April.



Source: [www.buzzacott.co.uk](http://www.buzzacott.co.uk), 27 May 2004

## Questions

1. Define the following terms: (i) corporation tax; (ii) fiscal policy; (iii) finance lease; (iv) real GDP.
2. Explain two benefits that all businesses might enjoy as a result of the 2004 budget.
3. Using examples from the pie chart, explain the difference between direct and indirect taxes.
4. Explain the effect that: (i) excise duties; (ii) business rates; have on businesses.
5. What has happened to the value of the pound against the dollar between 1993 and 2003?
6. Given the changes identified in Question 5, evaluate the effect on a UK sports car manufacturer that imports components from Spain and sells most of its output to America.
7. On 16 March 2004, £1 = \$1.795. Calculate the cost in dollars, to a US buyer, of £2.5m goods from a UK manufacturer.
8. If interest rates continue to rise, as they started to at the end of 2003, what might be the effects on: (i) the housing market; (ii) a major supermarket chain such as Tesco. Explain your answer.

## Sample answers

## Question 1

Define the following terms: (i) corporation tax; (ii) fiscal policy; (iii) finance lease; (iv) real GDP.

### Sample answer

(i) Corporation tax is a direct tax charged on the profits made by limited companies. It is levied at different rates depending on the size of the corporation. Small companies are charged at a lower rate.

(ii) Fiscal policy is designed to influence aggregate demand in the economy by adjusting the level of taxation and government expenditure. For example, if the government cut income tax, people would have more disposable income, so aggregate demand is likely to rise.

(iii) A lease is a contract in which a business acquires the use of resources – some machinery, for example – in return for regular payments. With a finance lease, the arrangement is often for three years or longer and, at the end of the period, the business is given the option of buying the resource.

(iv) GDP stands for 'gross domestic product' and is one of the measures of national income. It is the total amount of income generated in the economy in one year less net property income from abroad. Real GDP means that the GDP figure has been adjusted for inflation.

## Question 2

Explain two benefits that all businesses might enjoy as a result of the 2004 Budget.

### Sample answer

One benefit of the 2004 budget is the measure to cut red tape. The Chancellor has agreed to pay working tax credits directly to employees. This is expected to save businesses £90m in administration costs. Also, a review of the inspection scheme is planned. In particular, overlaps between the Health and Safety Executive, the Environment Agency and the Food Standards Agency will eventually be eliminated. This will also help to reduce the administrative burden when complying with industry regulation.

The tax rates on business profits have been frozen. There will be no increases in corporation tax or income tax. This means that businesses will not have to hand over any extra money to the government. This might encourage business investment.

## Question 3

Using examples from the pie chart, explain the difference between direct and indirect taxes.

### Sample answer

Direct taxes are those levied on income. This includes personal income and business income. Income tax (PAYE) is levied on people's earnings. This includes the profit made by sole traders and partnerships. Corporation tax is levied on both private and public limited companies. Other examples of direct taxes include capital gains tax and national insurance contributions.

Indirect taxes are levied on spending. Again, this includes both personal and business spending. VAT is main indirect tax in the UK. It is levied on most goods and services at a rate of 17.5% (except for domestic fuel where the rate is 5%). However, some goods such as books, food and baby clothes are zero-rated. This means that VAT is 0%. Another example of an indirect tax is excise duty.

## Question 4

Explain the effect that: (i) excise duties; (ii) business rates; have on businesses.

### Sample answer

(i) Excise duties are indirect taxes levied on a selective range of goods sold in the UK. The goods targeted by the government tend to be those that are price inelastic, such as alcohol, tobacco and petrol. Excise duties are levied at very high rates and make the goods much more expensive for consumers to buy. The industries producing these goods often protest to the government saying that the duties are discriminatory. They argue that demand for their products would be higher if excise duties were lower.

(ii) Business rates are paid by businesses to the local council. The amount a business pays depends on the value of the premises they operate from. Rates are a fixed cost incurred by a business. They have the effect of reducing profit.

## Question 5

What has happened to the value of the pound against the dollar between 1993 and 2004?

### Sample answer

Between 1993 and 1995, the pound rose slightly against the dollar, the level staying near the \$1.50 mark. The pound fell slightly in 1996 and then rose in 1997 and 1998. It then fell back in the following years, reaching its lowest level in 2001. Since 2001, the pound has risen steadily, passing the high of 1998 in 2003. It broke the \$1.80 barrier for the first time in 2004.

## Question 6

Given the changes identified in Question 5, evaluate the effect on a UK sports car manufacturer that imports components from Spain and sells most of its output to America.

### Sample answer

A UK business that imports components from Spain will find that they are more expensive when the pound falls against the euro. This will raise the costs of the UK sports car manufacturer. Unfortunately, the effect of a strong pound against the dollar are also adverse for this company. When the pound rises, exports become more expensive. Consequently, the manufacturer might find that demand in the American market falls.

## Question 7

On 16.3.04, £1 = \$1.795. Calculate the cost in dollars, to a US buyer, of £2.5m goods from a UK manufacturer.

### Sample answer

The dollar cost of the UK goods will be given by:

$$£2.5 \text{ million} \times \$1.795 = \$4,487,500$$

## Question 8

If interest rates continue to rise, as they started to at the end of 2003, what might be the effects on: (i) the housing market; (ii) a major supermarket chain such as Tesco. Explain your answer.

### Sample answer

(i) Interest rates are likely to have a significant effect on the housing market. This is because most people have to borrow money when they buy a house. As a result, when interest rates go up, demand for houses is likely to fall because the cost of borrowing will rise. This makes it more expensive to buy a house.

(ii) Supermarkets are not likely to be affected too much by an increase in interest rates. This is because most of their products are food items or household products. Spending money food or household products is not usually funded with borrowed money. However, as supermarkets extend their product range to include 'non-essential' products such as leisure goods, consumer durables and leisure wear, they might find that demand for such products is more sensitive to changes in the interest rate.