Chapter 4

Government and Economic Influences of Business

The impact of business activity on society

Business activity has a direct effect on society… there are some benefits and some undesirable effects…

The impact of business activity on society: *Advantages*

- **Production** of **useful goods** and **services** that people want to buy
- **Creation of jobs** and incomes. These increase workers' living standards
- **Introduction of new products and processes** that widen product range and reduce costs of production
- **Tax payments** made by business to governments help to finance essential public services
- By producing goods for export, **businesses earn foreign currency** that the country can spend on imports

The impact of business activity on society: *Disadvantages*

- **Profit motive** of business can lead to decisions to locate in cheap but unspoilt areas
- Managers aiming to **lower costs might offer very low wages** with poor and unsafe working conditions
- Some production methods lead to **serious pollution problems**
- Certain goods made by industry are **dangerous** or can add to the pollution problem, e.g. fast cars
- Profit motive can lead firms to merge and this can result in **monopoly control with less consumer choice**
- **Advertising** is very powerful and can be used to give a **misleading image or incorrect information** to persuade consumers to buy

The impact of business activity on society

The great problem for all governments therefore is this:

How can the **benefits** of business activity be ***encouraged*** whilst ***controlling*** or outlawing the **undesirable effects**?

The Government: Public Sector

We hear the word government a lot in our daily lives… can you write a paragraph explaining the role of the government in our daily lives? Use things you see and believe impact you, directly or indirectly.

Governments and the Economy

The government has economic activities that it considers desirable:

- Low **inflation**
- Low levels of **unemployment**
- **Economic growth**
- **Balance of payments** avoiding serious deficits *(equality between exports and imports)*

There was a time when we used to go out for a movie, grab a burger and a milkshake, go out dancing and I would buy flowers for your grandma for $0.50… You poor guys could barely use the subway for $0.50…

It's time to shop!

- You have $10.. Your shopping list includes a bottle of water, a loaf of bread, a bag of chips and a jar of jam.

Current prices

If you buy everything, how much do you have left?

$1	$1	$1	$1

New prices

If you buy everything, how much do you have left?

$2	$2	$2	$2

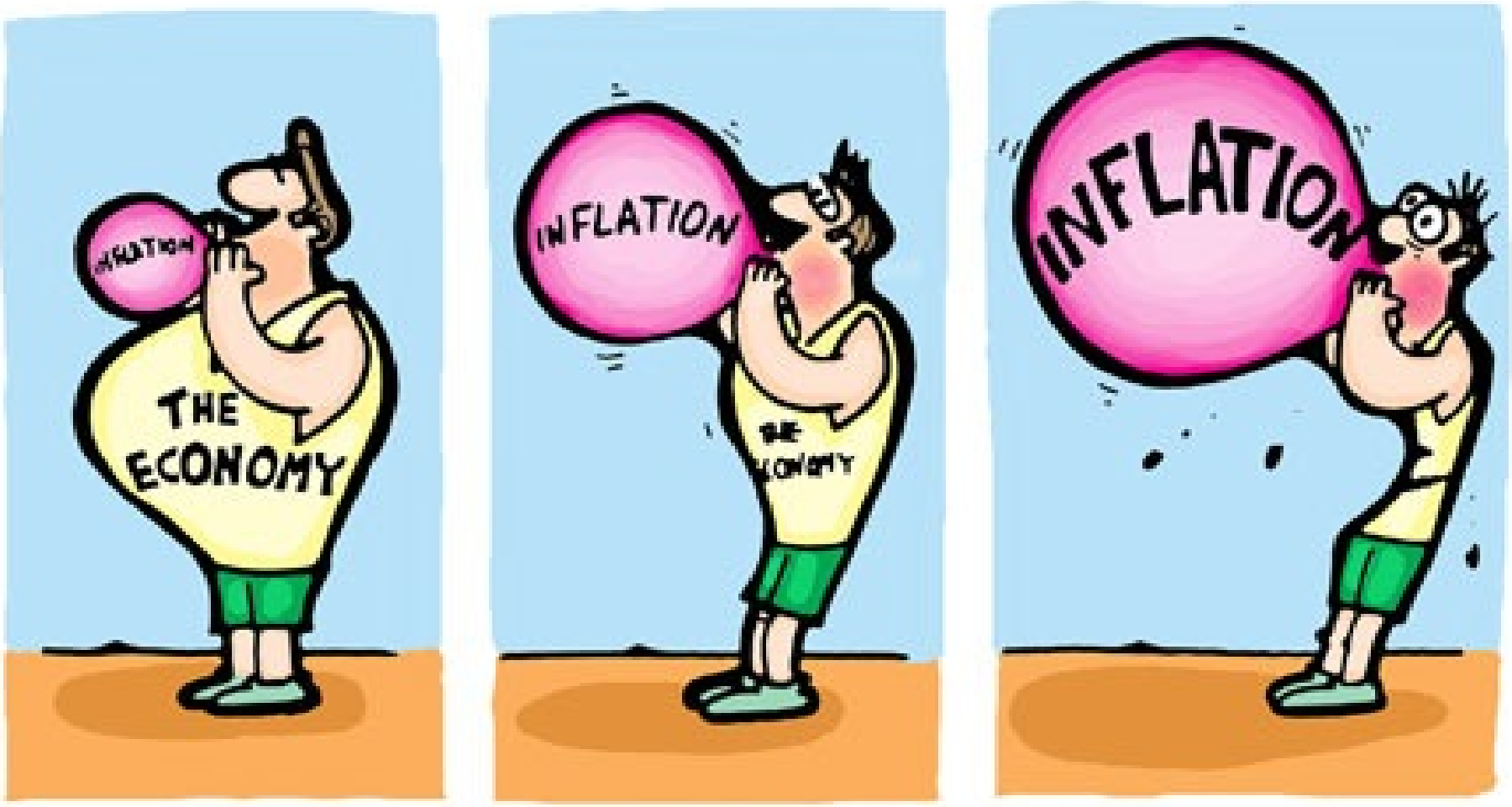
Latest prices

Is the $10 now enough for your needs?

$3	$3	$3	$3

Objective 1: *Low inflation*

Inflation occurs when **prices rise.** When the prices rise rapidly, it can be very serious for the whole country.


THE ECONOMY
INFLATION
INFLATION

Objective 1: *Low inflation*

Problems that occur as a result of inflation:

1. Real Incomes will fall.
   - This means that the **wages for the workers will not buy as many goods as before.**
   - Example:
     - Worker receives **6% wage increase**
     - But… **prices rise by 10%**
     - Then the worker's **real income has fallen by 4%.**
     - **This causes the workers to demand higher wages so that their real incomes increase.**

Objective 1: *Low inflation*

Problems that occur as a result of inflation:

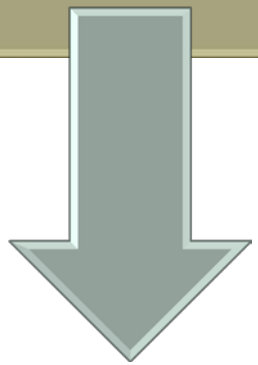
2. Prices of the goods produced in the country will be higher **than those in other countries**. People may then choose to buy the products from a foreign country because they're cheaper. **This will lead to jobs being lost.**
3. Business will be unlikely to want to expand and create more jobs in the future. **The living standards are therefore most likely to fall.**

Therefore, low inflation tends to

1. ***Encourage businesses to expand***

and it

2. Makes it easier for a country to sell its goods and services abroad



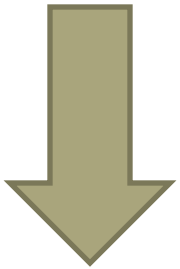
This causes a rise in the living standards of the people.

A frequently asked question:

What do you want to be when you grow up?

who we want to
doctors, some
w r politicians, or
work in volunteer work, or own their own businesses or work in fashion designing or become singers or actors/actresses or delve into the world of advertising…. Correct???

- In order to do that, people start working towards getting skilled in their potential line of work.
- We get a good school education and then get specialized when we go off to university.
- Therefore, we all want a secure job that will compensate us well after a long day's work.



But reality is not so sweet… and the real world is full of competition, limited job opportunities and a fierce market…

Governments and the Economy

Objective 2: *Low Levels of Unemployment*

Unemployment exists when people who are willing and able to work **cannot find a job**.

Governments and the Economy

Objective 2: ***Low Levels of Unemployment***

Problems that occur as a result of unemployment:

1. Unemployed people do not produce any goods or services.
   - This means that the **total level of output in the country will be lower than it could be.**
2. The government pays unemployment benefits to those without jobs.
   - This means that high unemployment will **cost the government a great deal of money**. The opportunity cost here is that this money can be spent on things such as schools and hospitals.

Therefore, low unemployment will help to

1. ***Increase the output of a country***

and it

2. Improve the workers' living standards

Governments and the Economy

Objective 3: *Economic Growth*

Q. When can we say that a country's economy is growing?

A. When the **total level of output** of goods and services in the country **increases**!

This value produced in one year in a country is called **Gross Domestic Product (GDP).**

When there is growth, there is a rise in the standard of living.

Governments and the Economy

Objective 3: *Economic Growth*

- When a country's GDP is falling, it has no economic growth. These are the problems this causes:

Unemployment will occur, since…

- Fewer workers are needed

The average standard of living will decrease, since…

- Consumers can no longer afford to buy goods and services
- Therefore, people will become poorer.

A decline in the expansion of businesses since…

- Business owners will not have enough money to spend on their products because people are not buying the products they are making.

Governments and the Economy

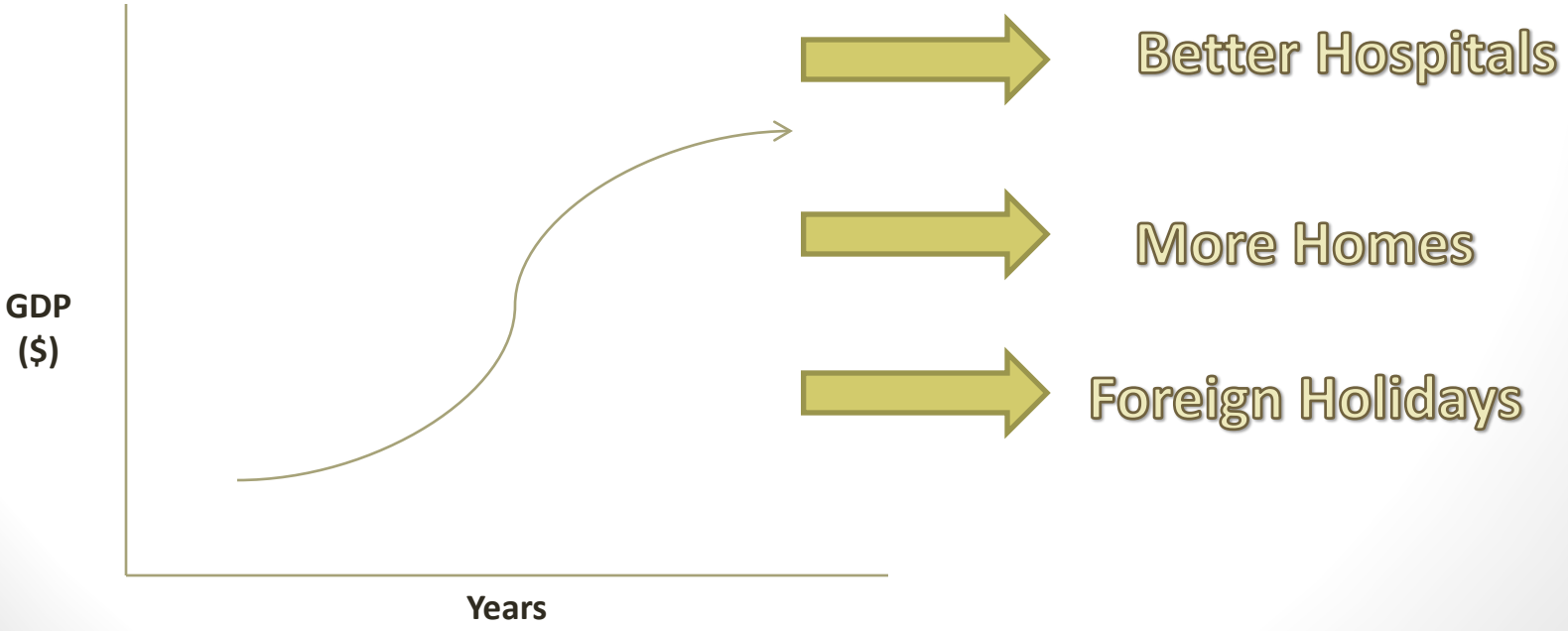
Objective 3: *Economic Growth*

Therefore, economic growth will help to

1. ***Make a country richer***

and it

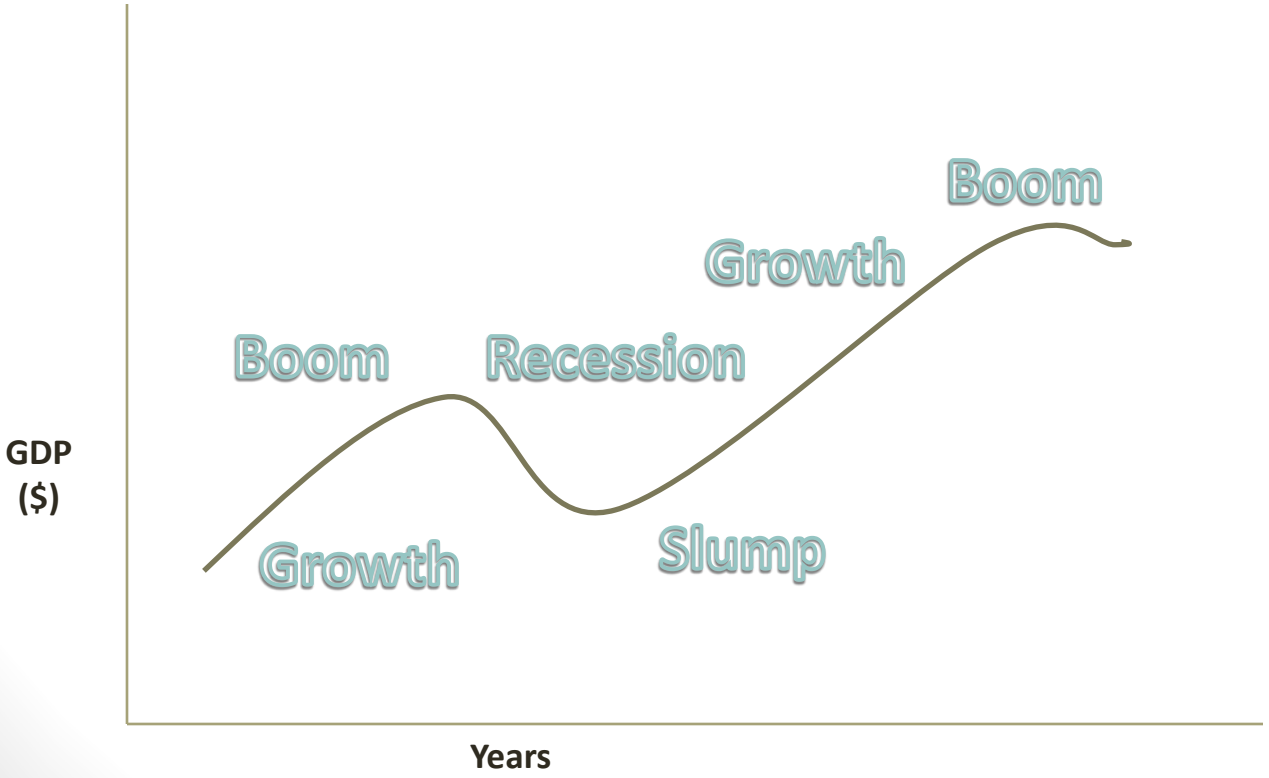
2. Allows living standards to rise



Governments and the Economy

Objective 3: *Economic Growth & the Trade Cycle*

Life is turbulent.. And economic growth is no different. It is not achieved every year and there are often years when there is no growth at all or when the value of GDP actually falls.
Economists have devised a pattern of this on the trade cycle diagram below.

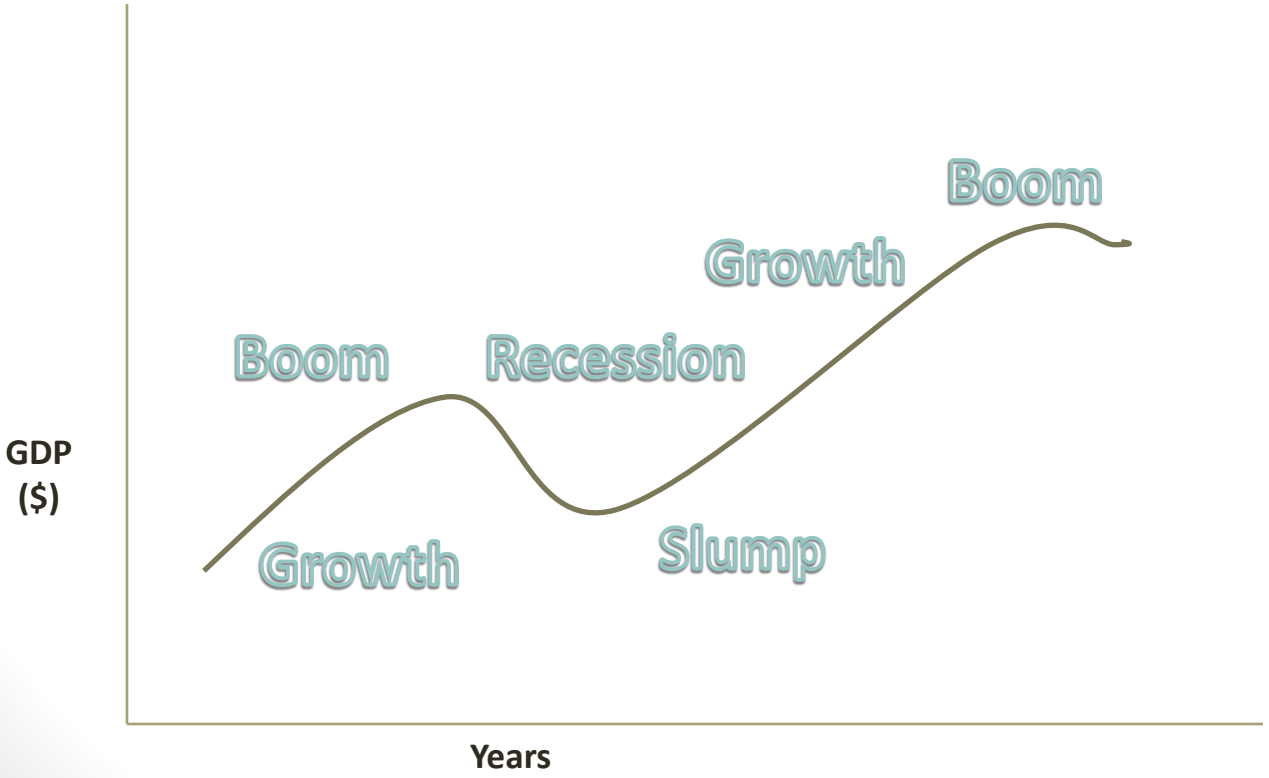


Governments and the Economy

Objective 3: *Economic Growth & the Trade Cycle*

The Trade cycle *(sometimes called the Business cycle)* has four main stages.

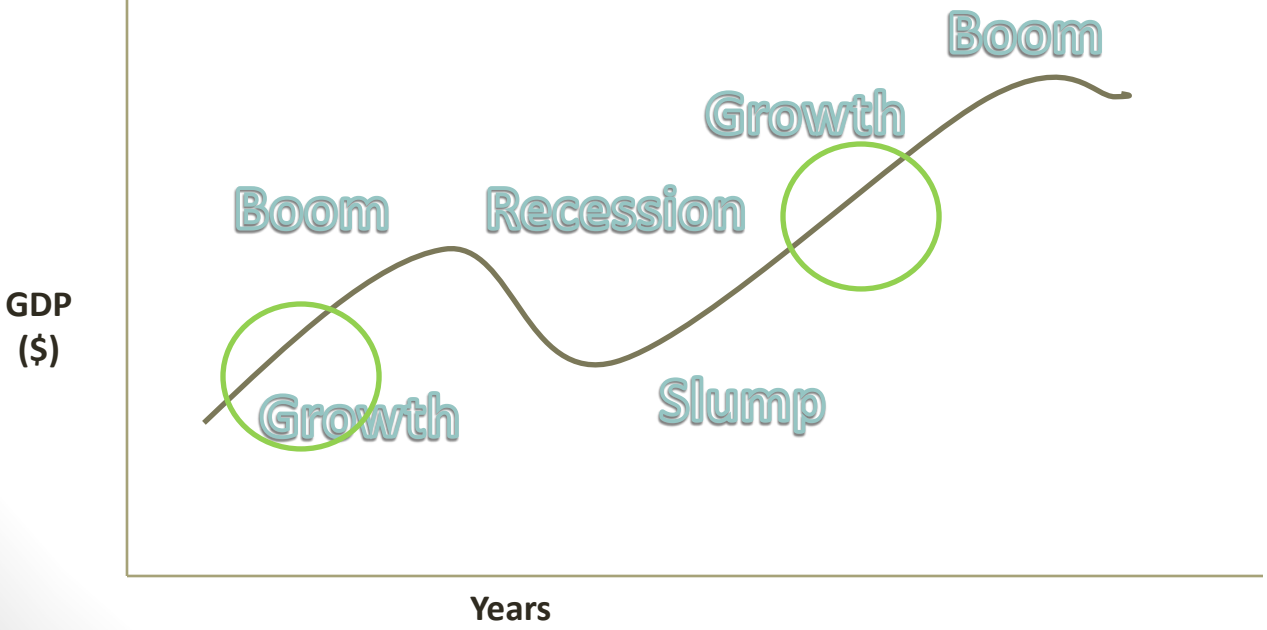
1. **Growth**
2. **Boom**
3. **Recession**
4. **Slump**



Governments and the Economy

Objective 3: *Economic Growth & the Trade Cycle*

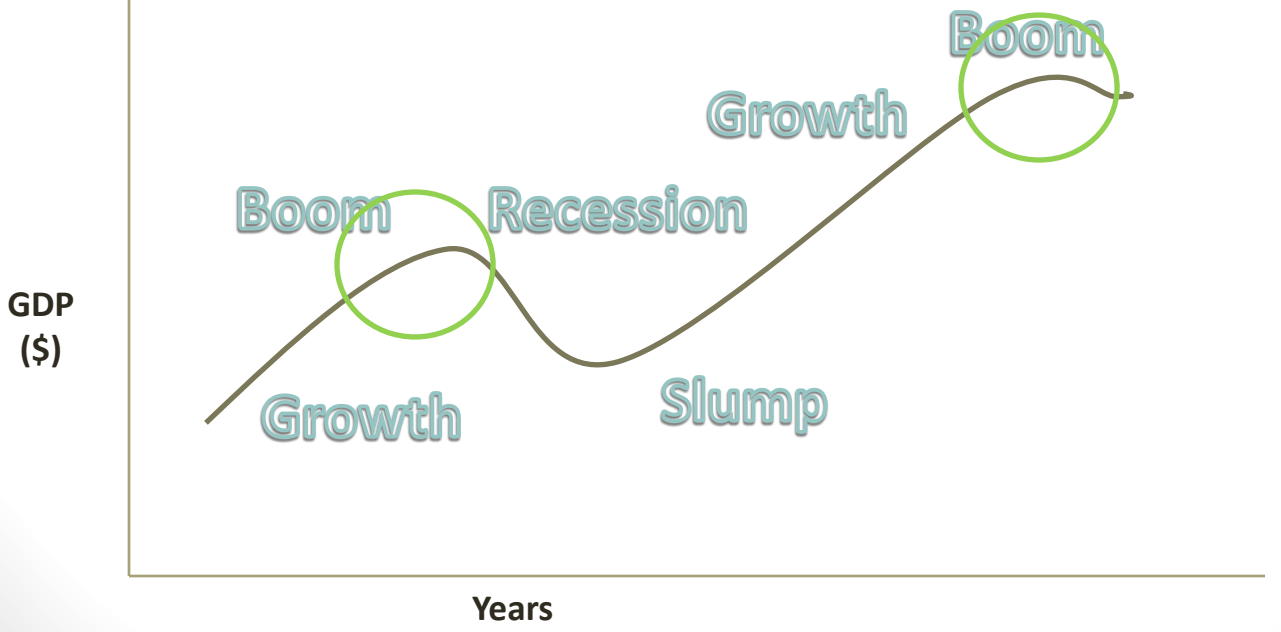
1. **Growth: This is when…**
   - i. GDP is rising
   - ii. Unemployment is generally falling
   - iii. Country is enjoying high standards of living
   - iv. Most businesses are doing well



Governments and the Economy

Objective 3: *Economic Growth & the Trade Cycle*

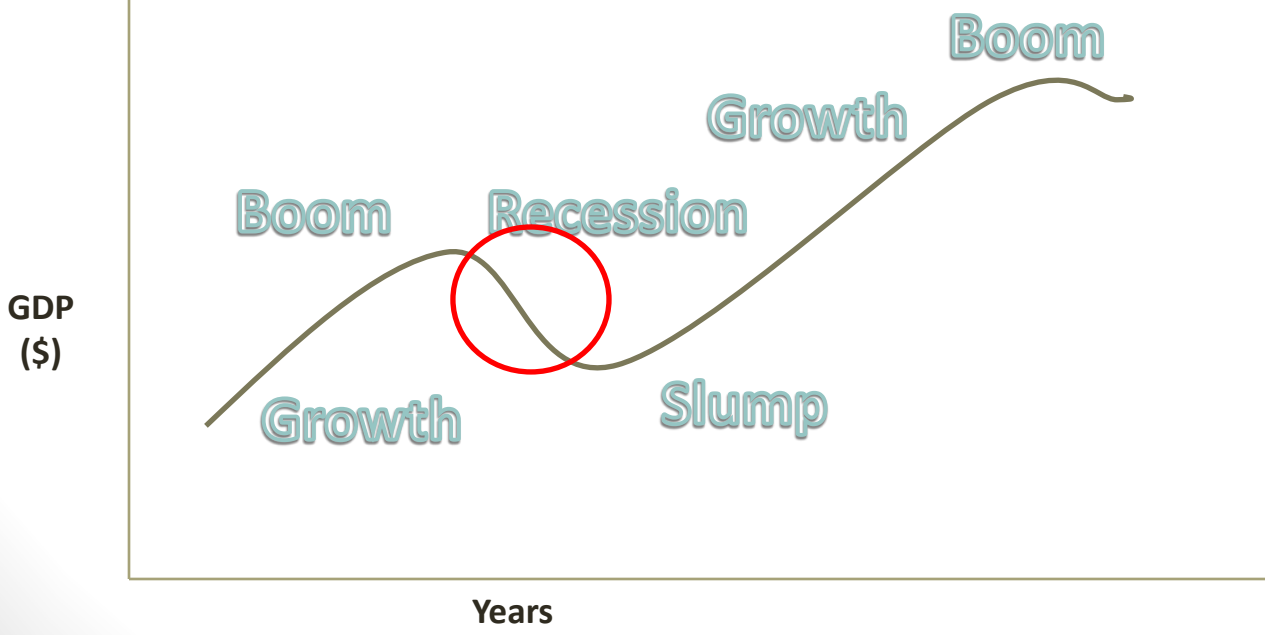
2. **Boom: This is when there is too *much* spending…**
    i. **Prices start to rise quickly**
    ii. **Shortages of skilled workers**
    iii. **Business costs are rising**
    iv. **Most businesses are uncertain about the future**



Governments and the Economy

Objective 3: *Economic Growth & the Trade Cycle*

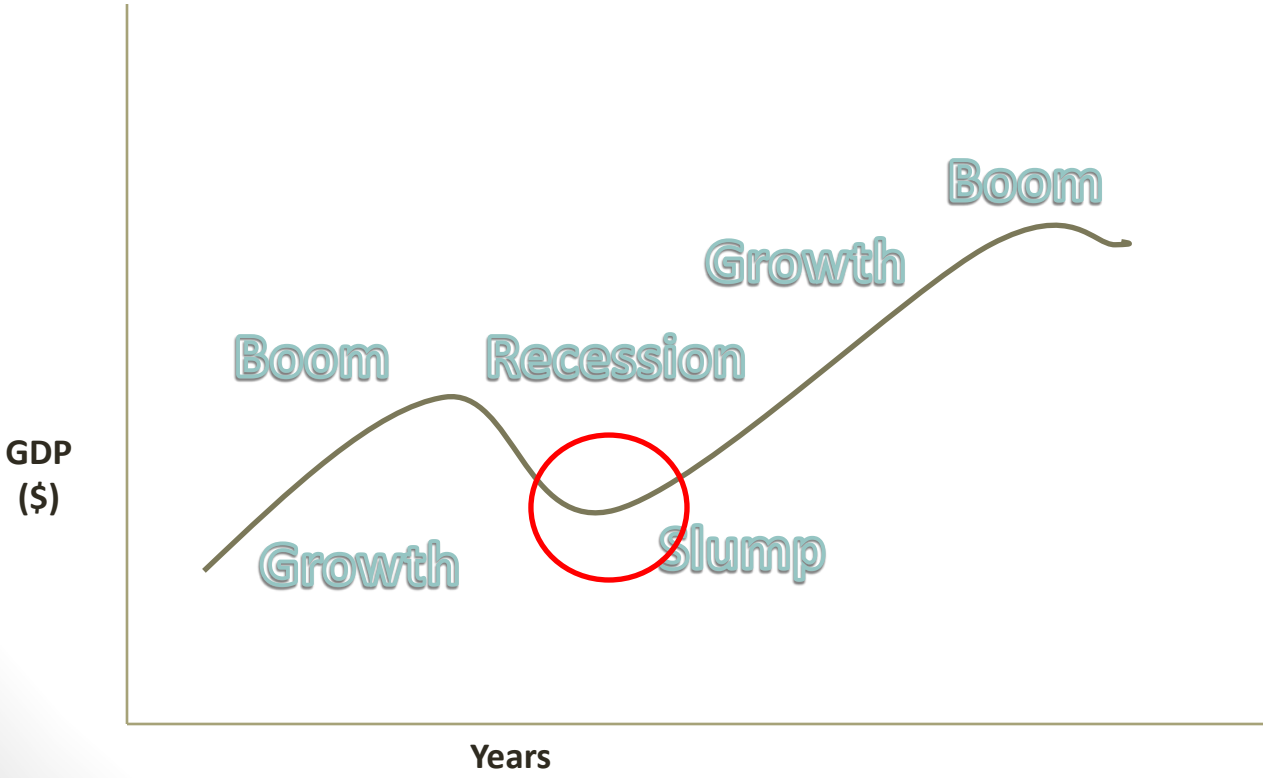
3. **Recession: This is when there is too *little* spending…**
    i. **GDP actually falls during this period**
    ii. **Most businesses will experience falling demands**
    iii. **Most businesses will experience falling profits**
    iv. **Workers may lose their jobs**



Governments and the Economy

Objective 3: *Economic Growth & the Trade Cycle*

4. **Slump: This is a serious and long-drawn-out recession…**
    i. **Unemployment will reach very high levels**
    ii. **Prices may fall**
    iii. **Many businesses will fail to survive this period**



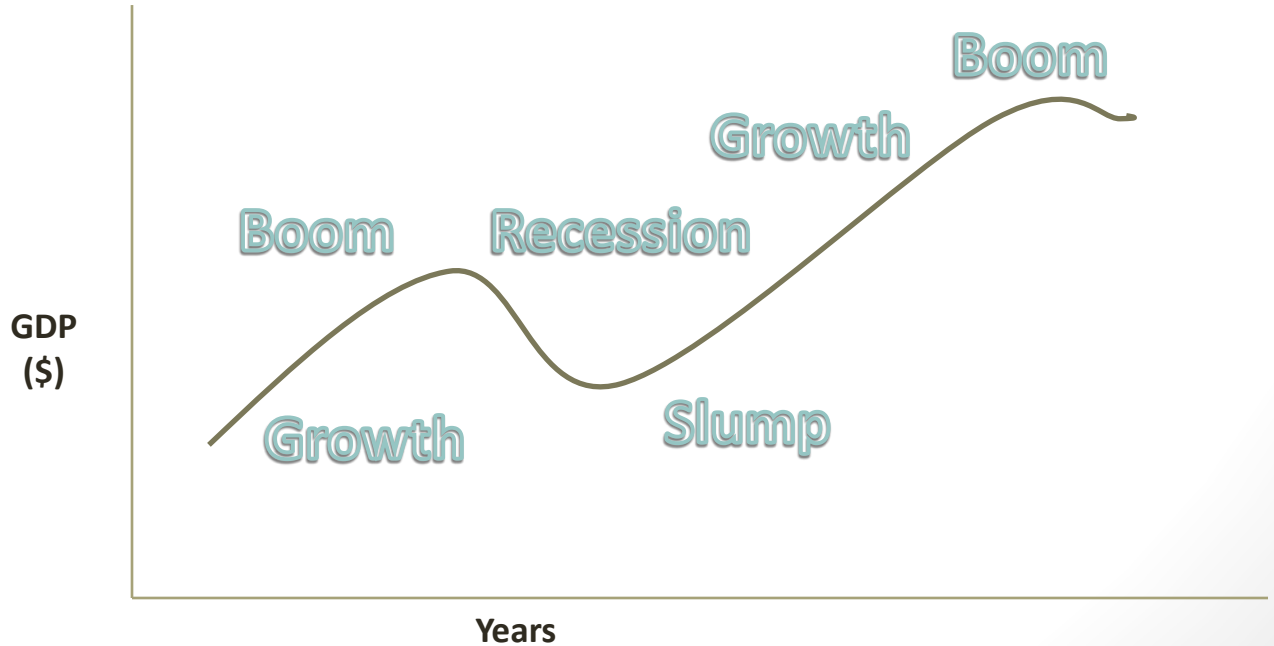
Governments and the Economy

Objective 3: *Economic Growth & the Trade Cycle*

Clearly, governments will try to avoid the economy moving towards a recession or slump, as well as also reduce the chances of a boom.

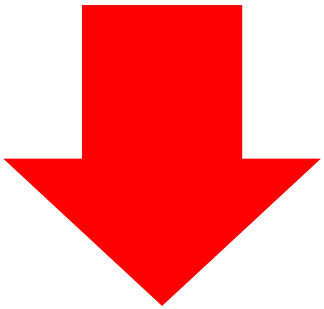
Why?

This is because the boom causes rapid inflation and high business costs, leading to a situation that will result in a recession.



Governments and the Economy

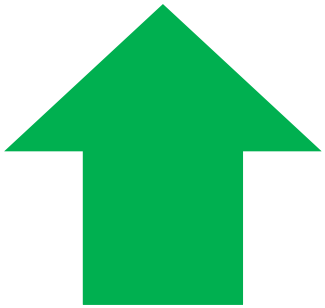
Objective 4: *Balance of Payments*



Imports

- Goods and services ***bought in*** from other countries.
- Purchased with foreign currency
- So lead to money ***flowing out*** of the country

Exports



- Goods and services ***sold to*** other countries.
- Bring in foreign currency
- So lead to money ***coming into*** the country

Countries are therefore always trying to make their **exports HIGHER than their imports.** **The difference between a country's exports and imports is called the *BALANCE OF PAYMENTS.***

Governments and the Economy

Objective 4: *Balance of Payments*

Case Study: **Assume that Country D imports more than it exports…**

When imports exceed exports it is called a *balance of payments deficit.*

Problems that arise from this are…

1. The country could 'run out' of other countries' currencies (foreign currencies) and it **may have to borrow from abroad.**
2. The price of Country D's currency against other currencies – **the Exchange Rate** - will be likely to fall. This is called the Exchange Rate Depreciation. Country D's currency will now buy less abroad than it did before depreciation.

Q. So what does the government do to achieve those four economic objectives?

A. It applies policies to achieve them such as :

Fiscal Policy (taxation)

Monetary Policy (Interest Rates)

Supply-Side Policies

Governments Economic Policies

Policy 1: *Fiscal Policy - Taxes and Government Spending*

All governments spend money. They spend it on schools, hospitals, roads, defense, and so on. This expenditure is very important for the people.

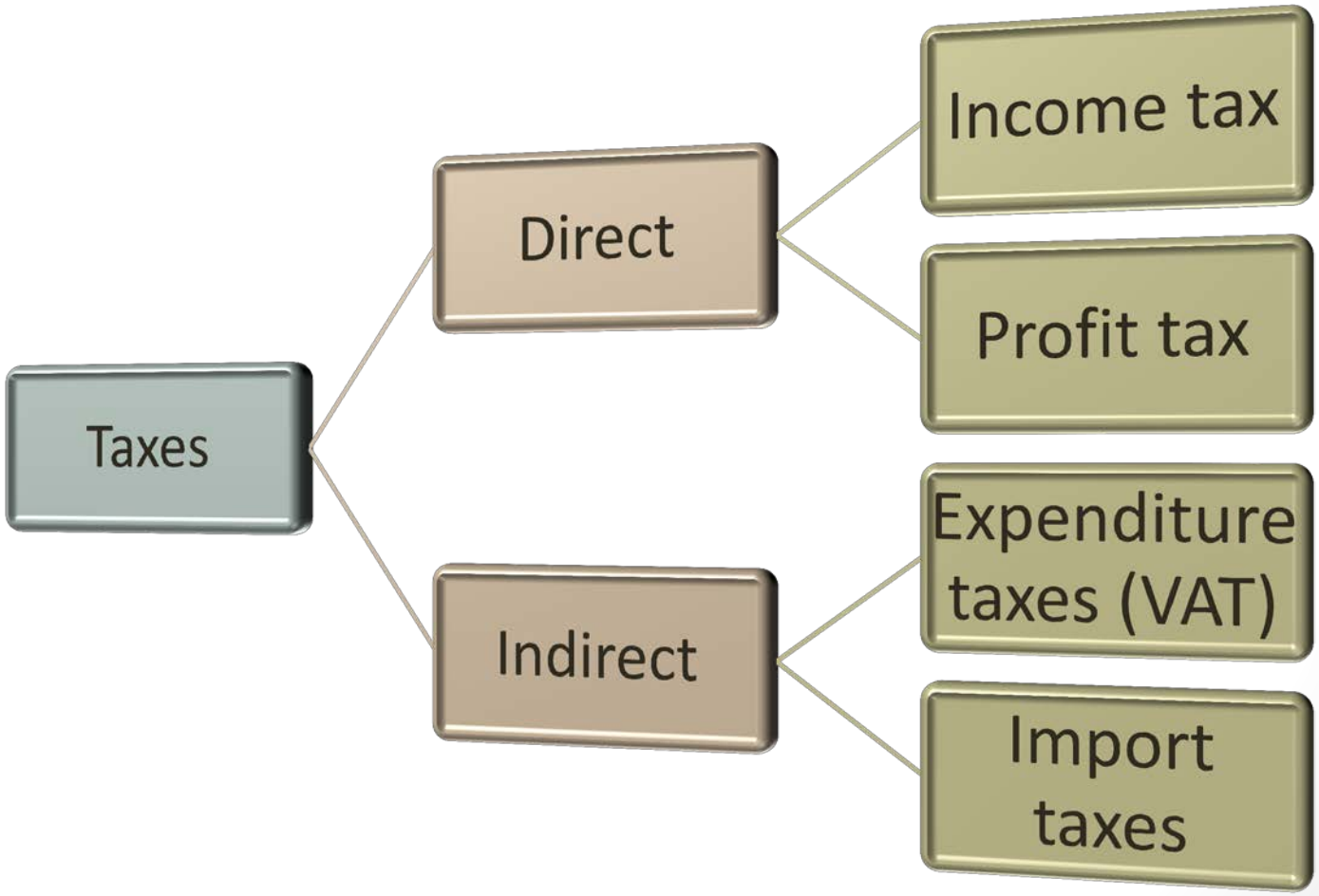
Q. Where do governments raise this money from?
A. Mostly from taxes on both individuals and businesses.

How do these taxes affect business activity?
Through applying four different types of taxes:

1. ***Income Tax***
2. ***Profits tax or corporation tax***
3. ***Indirect tax, for example Value Added TAX (VAT)***
4. ***Import duties and tariffs***

Governments Economic Policies

Policy 1: *Fiscal Policy - Taxes and Government Spending*



Governments Economic Policies

Policy 1: *Fiscal Policy - Taxes and Government Spending*

a. Direct taxes

i. Income Tax

- ***A tax used by most governments***
- ***It is a tax on people's incomes.***
- ***Usually, the higher a person's income, the greater will be the amount of tax they have to pay to the government.***
- ***It is set at a certain percentage of income.***
- ***It can be progressive, which means that the higher their income, the more they pay.***

Governments Economic Policies

Policy 1: *Fiscal Policy - Taxes and Government Spending*

a. Direct taxes

i. Income Tax

How are businesses affected by an increase in the rate of income tax?

- **Individual taxpayers** would have a ***lower disposable income***. They would then have ***less money to <u>spend</u> and <u>save</u>***.
- **Businesses** would be likely to experience a ***fall in sales.***
- **Managers** may decide to ***produce fewer goods and services*** as sales are lower.
- Some **workers** can ***lose their jobs.***

Which businesses are likely to be most affected by this increase in income tax rates?

- Businesses which **<u>produce luxury goods</u>** which consumers do not have to buy are most likely to be the most affected.
- Businesses producing essential goods and services will be less affected as consumers will still have to buy these products.

Governments Economic Policies

Policy 1: ***Fiscal Policy - Taxes and Government Spending***

a. Direct taxes

ii. Profits Tax or Corporate Tax

- ***It is a tax on the profits made by businesses – usually companies.***

Governments Economic Policies

Policy 1: *Fiscal Policy - Taxes and Government Spending*

a. Direct taxes

ii. Profits Tax or Corporate Tax

How are businesses affected by an increase in the rate of profits tax?

- **Businesses** would have ***lower profits after tax***. **Managers** will therefore have ***less money or finance to put back into the business***.
  The business would will find it ***more difficult to expand***. New projects, such as additional factories or shops may have to be cancelled.

- The **owners** will have ***less money to take*** after the taxes as a results of their original investment in the business. ***Fewer people will want to start their own business*** if they consider that the government will take a high amount of taxes from their profits.

Governments Economic Policies

Policy 1: *Fiscal Policy - Taxes and Government Spending*

b. Indirect taxes

i. Expenditure Tax: Value Added Tax (VAT)

- ***It is a tax on the price of products that we all buy.***
- ***They make products more expensive for consumers.***
- ***Governments avoid putting these taxes on essential items such as food, because this would conflict with their social objective of allowing all the needs for everyone in the community.***

Governments Economic Policies

Policy 1: *Fiscal Policy - Taxes and Government Spending*

b. Indirect taxes

i. Expenditure Tax: Value Added Tax (VAT)

How are businesses affected by an increase in an expenditure tax?

- Prices of goods in the shops would rise. **Consumers** ***may buy fewer items as a result.*** This will reduce the demand for products made by businesses.
- As prices rise so the **workers** employed by a firm notice that their ***wages buy less in the shops***. It is said that their ***real incomes have declined***.
- **Businesses** might therefore be forced to raise their wages which will lead to the ***costs of the products going up***.

Which businesses are likely to be most affected by this increase in income tax rates?

- Sales of luxurious goods and services (foreign holidays, jewelry) rather than the sales of the essential goods and services (bread, cooking oil) will be affected.

Governments Economic Policies

Policy 1: *Fiscal Policy - Taxes and Government Spending*

b. Indirect taxes

ii. Import Tariffs and Quotas

We've agreed before that countries always want a surplus from its balance of trade, therefore countries try to limit the imports that go into the country by two main methods:

Import Tariffs or duties

- ***It is a special tax on the imports of a country.***

Import Quota

- ***A physical limit on the quantity of a product that can be brought in.***
- ***Usually used selectively on certain industries.***

Governments Economic Policies

Policy 1: *Fiscal Policy - Taxes and Government Spending*

b. Indirect taxes

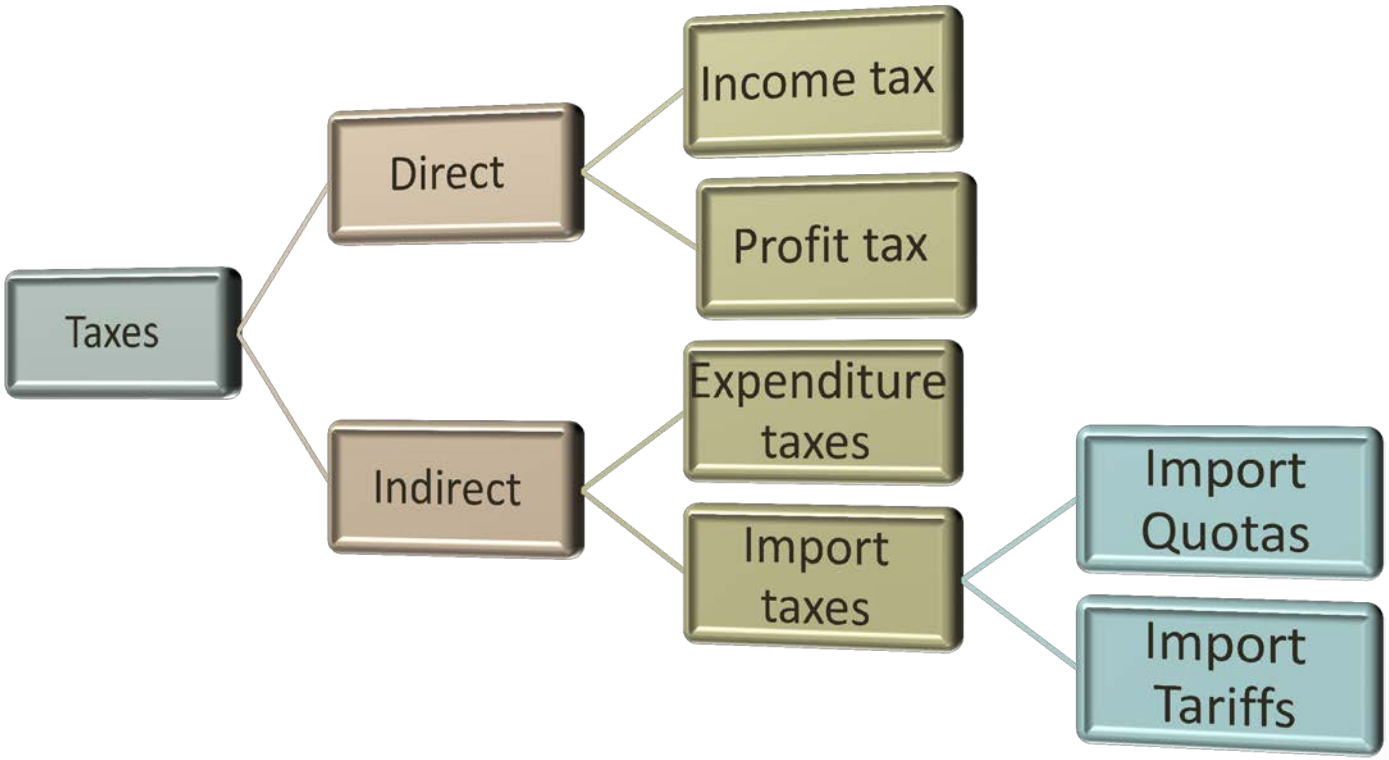
ii. Import Tariffs and Quotas

How are businesses affected by an increase in imports and quotas?

- **Firms** will benefit if they are ***competing with imported goods***. These will now become more expensive, leading to ***an increase in sales of home-produced goods.***
- **Businesses** will suffer ***higher costs*** if they have to import raw materials or components for their own factories. These will now be more expensive.
- **Other countries** may now take the same action and introduce import tariffs too. This is called ***retaliation***. A business trying to export to these countries will ***probably sell fewer goods than before.***

Governments Economic Policies

Policy 1: *Fiscal Policy - Taxes and Government Spending*



Governments Economic Policies

Policy 2: *Monetary Policy – Interest Rates*

An ***interest rate*** is the cost of **borrowing money**.

In most countries the level of the interest rates is fixed by the **government or the central bank** by the monetary policies.

Most of the people and businesses in the country will borrow money and they will have ***to pay interest on the loan***.

Governments Economic Policies

Policy 2: *Monetary Policy – Interest Rates*

How are businesses affected by an increase in the interest rates?

- **Firms** with existing loans will have to pay ***more in interest*** to the banks. This will reduce their profits.
- Lower profits means less is available to distribute to the **owners** and less is retained for expansion.
- **Managers** thinking about borrowing money to expand their business may delay their decision.
- ***New investment in business activity*** will be ***reduced.*** People hoping to start a new business ***may not now be able to afford to borrow the capital needed***.
- **Consumers** who have taken out loans such as ***mortgages*** to buy their houses, then the higher payments will reduce their disposable incomes. Demand for all goods and services could fall as consumers have less money to spend.
- **Consumers** will also be ***unwilling to borrow money to buy expensive consumer items*** like cars. These businesses may have to reduce output and make workers redundant.

Governments Economic Policies

Policy 2: *Monetary Policy – Interest Rates*

How are businesses affected by an increase in the interest rates?

- When the interest rates of a country are higher than other countries, **foreign banks and individuals** will be ***encouraged to deposit their capital in that country.*** They will be able to ***earn higher rates of interest on their capital***.

- By switching their money into this country's currency, they are increasing the ***demand for it***. This will cause the ***exchange rate to rise***, creating an exchange rate appreciation.

- **Local firms** will notice the demand for their products falling for this reason. This is because imports will become cheaper and the local products become more expensive.

How are businesses affected by interest rates?

Investment decisions and spending on capital goods

Exports/Imports (due to changes in the value of the currency)

Changes in the level of consumer spending

Repayment of loans becomes a burden

Opportunity cost of saving

Business Confidence

Debt burden: Worked example

A business borrows £100,000 for new equipment at an interest rate of 10% p.a.

Interest payments in year 1 would be?

If interest rates rise to 12.5% p.a., interest payments in year 1 would be? How would the business have to react to this?

If interest rates fall to 7.5% p.a., interest payments in year 1 would be? How might the business react?

Consumer Demand: Worked example

John borrows £30,000 as a bank loan for a new car at an interest rate of 10% p.a.

Interest payments in year 1 would be?

If interest rates rise to 12.5% p.a., interest payments in year 1 would be? How would he react to this?

If interest rates fall to 7.5% p.a., interest payments in year 1 would be? How would he react to this?

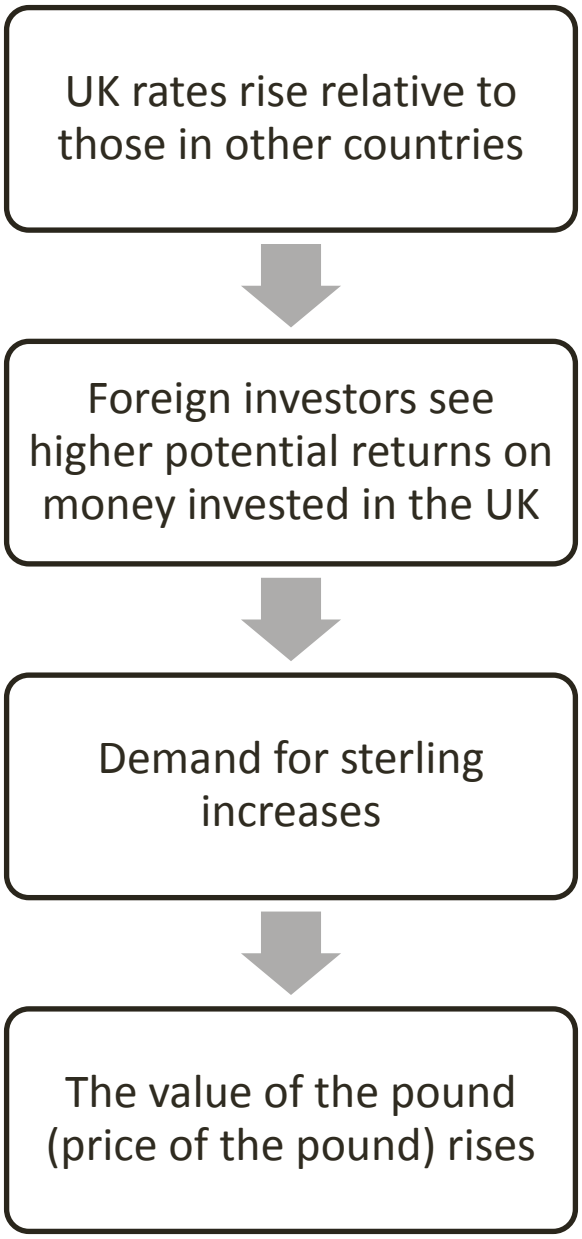
Effect on exchange rate

EXCHANGE RATE- based on the demand and supply of sterling.

How does a high interest rate cause a shift in the value of the currency?

Effect on exchange rate

Example: The interest rates increased from 10% to 12.5% in the UK.



Effect on imports and exports

Example: The interest rates increased from 10% to 12.5% in the UK.

The value of the UK pound rises as a result of high interest rates

Rise in export prices

Fall in import prices

Example: The interest rates decreased from 10% to 7.5% in the UK.

The value of the UK pound falls as a result of lower interest rates

Fall in export prices

Rise in import prices

- http://www.youtube.com/watch?v=c5bkr63RDX4

Governments Economic Policies

Policy 3: ***Supply Side Policies***

- The government aims to increase competitiveness and efficiency of industries ***against those from other countries***.
- Called Supply-Side Policies because they are trying to improve the efficient supply of goods and services.

Governments Economic Policies

Policy 3: *Supply Side Policies*

Privatization

- Use the profit motive to improve business efficiency

Improve Training and Education

- Governments plan to improve the skills of the country's workers.

Increase competition in all industries

- Reducing government controls over industries and take actions against monopolies

We now know the policies that are being applied by the governments to have a positive effect on the government and the economy in general. . But there are still more actions that the government takes to further control business activity directly…

- **Production of certain goods and services**
- **Consumer Protection**
- **Competition Policies: Control of Monopolies**
- **Protection of employees**
- **Location of industry**

Governments Control of Business Activity

Control 1: *Production of certain Goods and Services*

- Countries want to avoid the production of dangerous goods and services.
- Some countries also prohibit the sale and existence of items such as alcohol.

Governments Control of Business Activity

Control 2: *Consumer Protection*

- Weights and Measures Act
- Trade Descriptions Act (advertising must be truthful)
- Sale of Goods Act

Governments Control of Business Activity

Control 3: *Competition Policy: Control of Monopolies*

- A monopoly is when one firm controls or dominates the market for a good or a service.

Disadvantages

- Fix high profits since there are no competitors
- Prevent new firms from setting up to compete with them
- The monopoly is not encouraged to elevate the quality of the products

Look at the following adverts/articles and consider what laws they may be breaking and why

The Sales of Goods Act 1979

Coca Cola advertised this drink as nutritious implying it was healthy, when it actually contained 30g of sugar per 500ml.

The Sale of Goods Act 1979

http://www.guardian.co.uk/media/video/2008/nov/26/apple-iphone?INTCMP=ILCNETTXT3486

The Sales of Goods Act

http://www.guardian.co.uk/media/video/2010/jan/06/clean-and-clear-advert

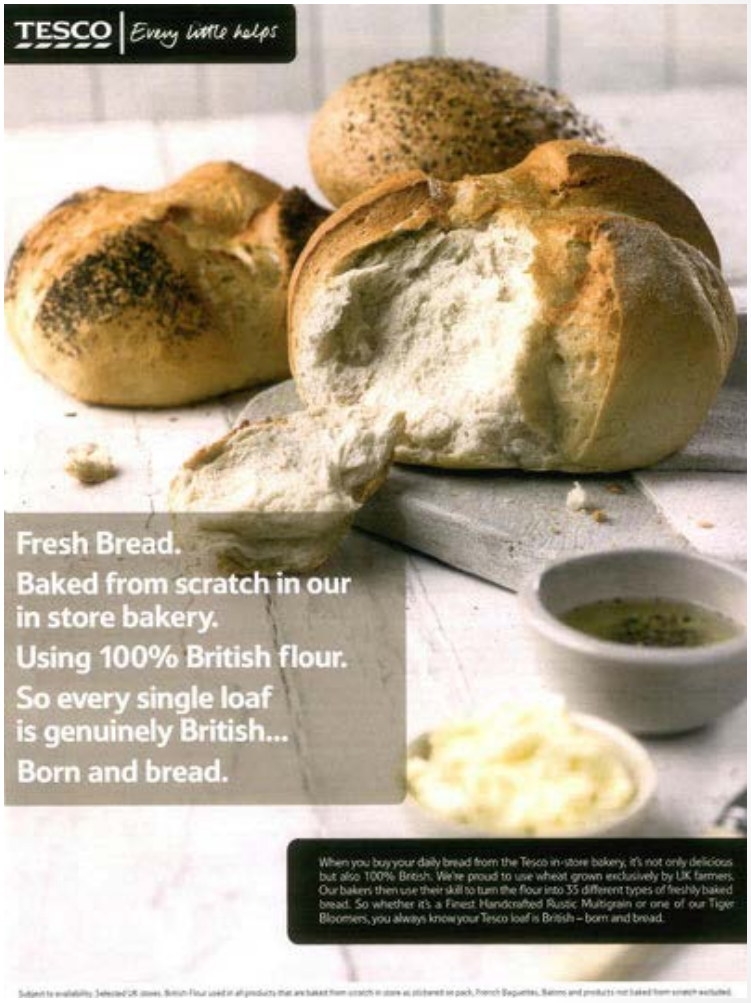
This advert uses makeup when advertising the effectiveness of its product.

Weight and Measures Act

- Janet Devers, 64, used imperial weighing scales instead of the metric scale, without an official stamp, on her fruit and veg stall at Ridley Road Market in Dalston.

- She was found guilty and given a conditional discharge.

What examples did you find ?



How do these legislations limit marketing ?

Governments Control of Business Activity

Control 3: *Competition Policy: Control of Monopolies*

- The government controls monopolies in two main ways:

1. Interferes with decisions taken by monopolists which are thought to be against consumer interests – such as trying to eliminate competitors or refusing to supply retailers which charge lower prices or sell competing products.

2. Proposed mergers or takeovers that will create a monopoly might be stopped.

Governments Control of Business Activity

Control 4: *Protecting Employees*

The government sets out to protect the employees that are working in any business…

Governments Control of Business Activity

Control 4: *Protecting Employees*

- The government protects employees in four ways:

1. Protection against **unfair discrimination** (race, color, gender, religion, age, disability)

2. **Health and safety** at work (protect from dangerous machinery, provide safety equipment, maintain reasonable temperatures, provide hygienic conditions and washing facilities, durations of shifts are reasonable and provide breaks in the daily workload)
    - When managers comply with these laws, they are making an ***ethical decision.*** This is a decision based on the moral code; doing what's ultimately right.

Governments Control of Business Activity

Control 4: *Protecting Employees*

- The government protects employees in four ways (continued):

3. Protection against **unfair dismissal** (No dismissals for joining a trade union, for being pregnant, without a warning).
    - ***Industrial Tribunal*** is a legal meeting which considers workers' complaints of unfair dismissal or discrimination at work.

4. Protections against **not being paid their wages**.
    - ***Contract of Employment:*** a legal agreement between employer and employee listing the rights and responsibilities of workers. (how much is paid, how frequently, deductions such as the income tax)
    - ***Minimum Wage:*** The lowest wage an employer can pay his employees per hour.

Governments Control of Business Activity

Control 4: *Protecting Employees*

- The **Minimum Wage** has advantages and disadvantages:

Advantages	Disadvantages
• It should prevent strong employers from exploiting unskilled workers who could not easily find other work. • Encourage businesses to train their workers to be worthy of the new minimum wage. • Encourages more people to seek work. • Low-paid workers will be earning more and so improving their standards of living.	• It increases business costs which will force them to increase prices. • Some employers will not be able to afford this minimum wage. They may be forced to let the workers go and so unemployment will rise. • Other workers will ask for a raise to be able to maintain the differential salary pay between them and the lower-skilled workers.

Governments Control of Business Activity

Control 5: *Location of Industry*

- The decisions taken by firms about where to locate their business can have a very important effect on the firm's profitability.
- Managers will want to place their businesses in the best possible area, taking into account factors such as cost of land, proximity of transport links and customers, availability of workers, and so on.

Governments Control of Business Activity

Control 5: *Location of Industry*

Why do governments try to influence these decisions?

1. To encourage businesses to develop and set up in areas of high unemployment – often called developmental areas.

2. To discourage firms from opening in overcrowded areas or areas that can be ruined due to its natural duty.

Governments Control of Business Activity

Control 5: *Location of Industry*

Governments take two types of measures for this…

1. **Planning controls** will legally restrict the business activities that can be undertaken in certain areas. Businesses can be refused ***planning permissions*** by the government if they government believes that their presence in a certain location will harm them.

2. Many governments provide **regional assistance** to businesses to encourage them to locate in undeveloped parts of the country. For example, low rentals or financial grants. These areas are known as ***developmental areas***, having high unemployment rates and there is a need for new jobs and possibilities.

Governments can Help Businesses too

As well as controlling business activities, governments can positively encourage businesses too by 3 main ways.

- Regional Assistance
- Small Firms Assistance
- Exporting of Goods and Services

Governments can Help Businesses too

Support 1: *Regional Assistance*

Serious social and economic problems can result from a country having some very rich areas and some very poor areas.

1. It is common for governments to try to make economic development more evenly spread.

2. The government uses financial grants and subsidies to attract new firms to areas of high unemployment or to persuade existing firms to relocate there.

Governments can Help Businesses too

Support 2: *Supporting Small Firms*

Small businesses have important advantages for an economy

1. They provide jobs to many workers.

2. Many small firms operate in rural areas where unemployment would otherwise be very high.

3. They can sometimes grow into very important businesses.

4. Even though they are small, they provide choice for the consumers and act as competition to larger firms.

5. They are often managed in a very flexible way, with the owners close to the consumers and can quickly adapt their goods and services to meet consumers' needs.

Governments can Help Businesses too

Support 2: *Supporting Small Firms*

Governments can provide assistance to entrepreneurs running their own small business or planning to set up by:

1. Low profit taxes
2. Giving grants or cheap loans to people setting up in business.
3. Providing advice and information centers
4. Providing college courses and other training programs.

Governments can Help Businesses too

Support 3: *Exporting Goods and Services*

Governments are very keen to encourage businesses in their country to export for the following reasons.

1. To ensure a positive balance of payments and so reducing the chances of foreign debts.

2. Exports earn a country foreign exchange. This can be used to pay for imports or to pay off foreign loans.

3. The more goods and services exported, the more people have to be employed to produce them.

4. Successful exporters will make profits and this will increase the money the government earns from profit taxes.

Governments can Help Businesses too

Support 3: *Exporting Goods and Services*

Governments can support exports by doing the following:

1. Encourage banks to lend to exporters at lower interest rates.

2. Offering subsidies or tax reductions to exporters.

3. Try to keep the exchange rate of the country as stable as possible so that exporters know how much they can earn from selling goods abroad.

4. Organizing trade fairs abroad to encourage foreign businesses to buy a country's exports.

5. Offering credit facilities to exporters so that if a foreign customer should refuse to pay for goods the government will guarantee payment.

Thank
You