Impact of Government Policy Index

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Cebr

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About FSB

As experts in business, FSB is a non-profit campaigning organisation for small businesses and the self-employed. Established over 40 years ago, FSB offers its members a wide range of vital business services, including advice, financial expertise, support and a powerful voice in Government. Its aim is to help smaller businesses achieve their ambitions.

London, January 2019

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Foreword

This is the second Impact of Government Policy Index (IGPI) that the Centre for Economics and Business Research (Cebr) has produced for FSB.[1] It is important that policy debate is based upon a clear picture of the impacts on smaller businesses of some of the UK Government's major social and economic policy measures. This latest version of the Index continues the work of the first in helping to build that picture.

Smaller firms are central to the UK's current and future prosperity. They:

- Create the majority of new jobs in the economy.
- Are a vital source of competition in markets.
- Undertake and help spread productivity-enhancing innovations through the economy.

However, they do all these activities under constant pressure. Some of this comes from competitors which is expected and indeed necessary. However, a significant number of constraints on smaller enterprises come from some aspects of government policy which can hinder the enterprising spirit of smaller businesses, with sub-optimal consequences for both business and economic growth.

The costs that smaller firms bear as a result of a host of major government policies are substantial, as this Index helps show. Further, the overall trend in those costs since 2011 is upwards. This means the benefits to the small business community of improvements to the business environment e.g. reducing corporation tax (heralded as making the UK the best place in the world to set-up, run and grow a business) are offset and exceeded by increased costs generated through a range of other taxes, regulations and policy decisions.

In other words, there are growing constraints on smaller firms from public policy decisions made by Ministers, many of which may seem justified on their own but cumulatively bear down on the small business community's capacity to innovate, raise productivity and grow. The cost of government policy is not limited to those reflected in this Index, which covers the period from 2011 to 2017 as that is the period for which robust and confirmed data is available. Obligations on smaller enterprises also include the administrative burden associated with the UK's complex tax system, which FSB estimate to be in the region of £5,000 annually for an individual small business.[2] We've also estimated that the regulatory environment (excluding obligations such as the NLW) has been costing smaller enterprises in the UK around £183 billion a year in direct costs.[3]

Smaller firms face considerable burdens as a result of government policy. Yet, if government wants smaller businesses to further increase their already considerable contribution to employment growth and the lowering of unemployment, intensification of competition in industries, and consequent generation of greater levels of productivity and innovation, there must be careful consideration of the additional costs being placed on businesses. Specifically, policy needs to be aimed at significantly lessening the constraints and obligations on enterprise. **Smaller firms can boost the economy, but they need the freedom to be able to do it**.

1 The IGPI is referred interchangeably in the following pages as 'IGPI' and 'the Index'.
2 FSB. Taxing Times: routes to reform for small businesses as taxpayers. 2018.
3 FSB. Regulation Returned: what small firms want from Brexit. 2017.
This estimate does include tax administration costs. It excludes the wider indirect costs to businesses, industries and the economy of regulation e.g. investment foregone, innovation not undertaken, business models changed and employees not hired.

This Index is an important contribution to the debate around the ‘cost of doing business'. It helps to lay the foundation for Ministers across government to think about how they can help stem the flow of new costs and reduce existing ones. It provides vital evidence for policy-makers in all parties looking to be pro-enterprise and address the regulatory burden for small businesses in the medium to longer term. The pay-off for such a change in policy approach would be a richer, more prosperous country.

Martin McTague

FSB Policy and Advocacy Chairman

Introduction

Government raises the 'cost of doing business' through the imposition of taxes and regulations.[4] The costs which result from government measures are felt disproportionately by smaller firms.[5] This leads to lower investment, less innovation, fewer people employed by smaller enterprises and higher prices. The ultimate result is less efficient markets.

To help policymakers develop a clearer picture of the costs borne by smaller firms as a result of government policy, FSB and Cebr have collaborated to undertake (for a second year) an analysis of a range of government measures and their cost consequences for smaller businesses. The policies which the Index analyses are:

- A number of social policy obligations such as the National Living Wage (NLW), National Insurance and (auto-enrolment) pension payments.
- Many of the key taxes that fall upon smaller enterprises e.g. income tax, corporation tax and business rates.

This short paper outlines the key findings of the latest edition of the IGPI (Impact of Government Policy Index). The Index illustrates the upward trend, since 2011 in the costs borne by UK smaller firms, as a result of a range of government policies.[6] The Index finds that the average cost increase for small businesses over the period 2011 to 2017 is in the order of £60,000. It also breaks the trends down by sector, revealing that some industries such as construction, among others, have experienced very substantial (i.e. 20 per cent or more) public policy-induced cost increases. This second edition of the Index has addressed the specific issue of whether profit growth is distorting the index by inflating corporation tax obligations by showing the overall trends in costs in a counterfactual Index, which controls for the possibility of a corporation tax distortion. The results of the two indices remain aligned. Both show that, over the period examined, costs have risen by a similar magnitude across the smaller business population.

The data utilised by the Index is not exhaustive because of the limitations on what information is available and timescales. Therefore, the Index reflects only part of the total range of costs that smaller firms face due to government policy.[7] For example, the Index does not reflect the administrative burden that comes with tax compliance. Nor does it include estimates of the annual regulatory burden (e.g. health and safety, product

4 These measures are introduced by Government to pursue both economic and social policy goals. Frequently the dividing line between economic and social policy is opaque. Some of these measures can be seen as serving goals that fall into both categories.
5 Various estimates suggest that for smaller firms the per-employee cost of regulation is between 17 and 40 per cent higher than it is for larger enterprises. Source: FSB. Regulation Returned: what firms want from Brexit. 2017.
6 It is important to note the cost increases in the index are not attributable to 'inflation'. Inflation tracks changes in prices of baskets of goods and services. In contrast, this Index is tracking costs and savings arising from policy interventions which intentionally exclude market determined input prices. Therefore, inflation is not a suitable comparative metric for such purposes.
7 The Index is purely focussed on a-number-of Government policy interventions which bear upon the running of a business and employing people in a business and for which there is sufficient robust Government data to utilise in order to compile an Index. The Index does not take into account market determined inputs such as the costs of materials, other supplier costs (e.g. energy, fuel, telecoms) and labour (above the NLW/ Minimum Wage) etc.

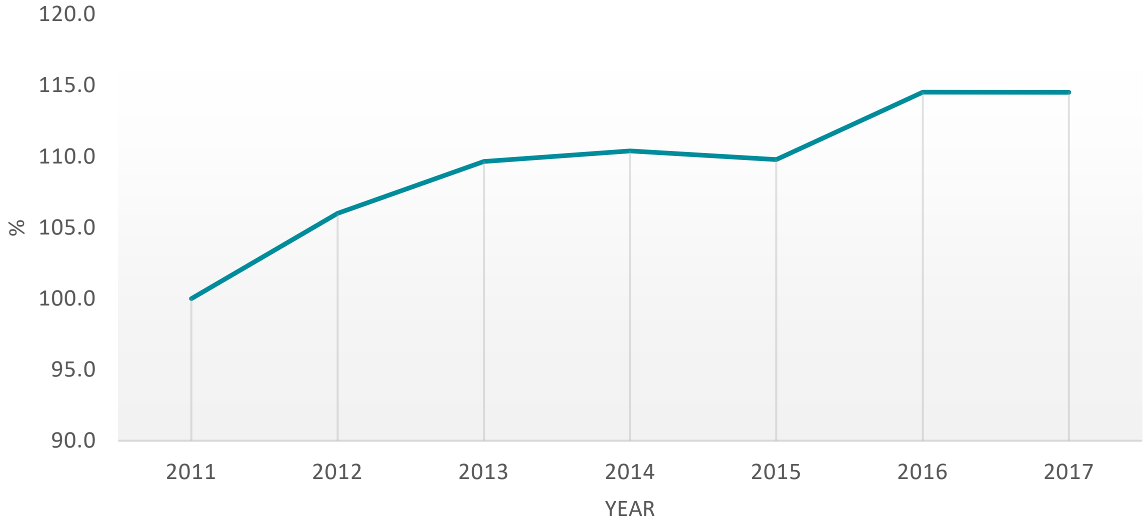
standards, personal data protection, employment law, etc.) that smaller businesses face, to varying degrees.

Nevertheless, for policymakers aiming to encourage smaller firms to grow, it helps provide part of the explanation for why this ambition is not being realised on the scale that is needed to shift the UK economy onto a permanently higher growth trajectory.

1 Key Trends

1.1 The UK small business community and government policy cost trends

Figure 1: Overall trend in the 'cost of doing business' for the UK's smaller businesses population due to major Government policy interventions



Source: ONS data and CEBR calculations

- Figure 1 highlights that from 2011 to 2017 the costs to UK smaller businesses of the various policy measures included in the Index have increased by nearly 15 per cent.
- The average cost (to UK smaller enterprises) of the various obligations placed upon firms as a result of Government policies, has grown to £480,788, up from £419,863 in 2011. As Table 1 below shows.

Table 1: Average cost per business of government (social and tax) policy across the small business population in £'s

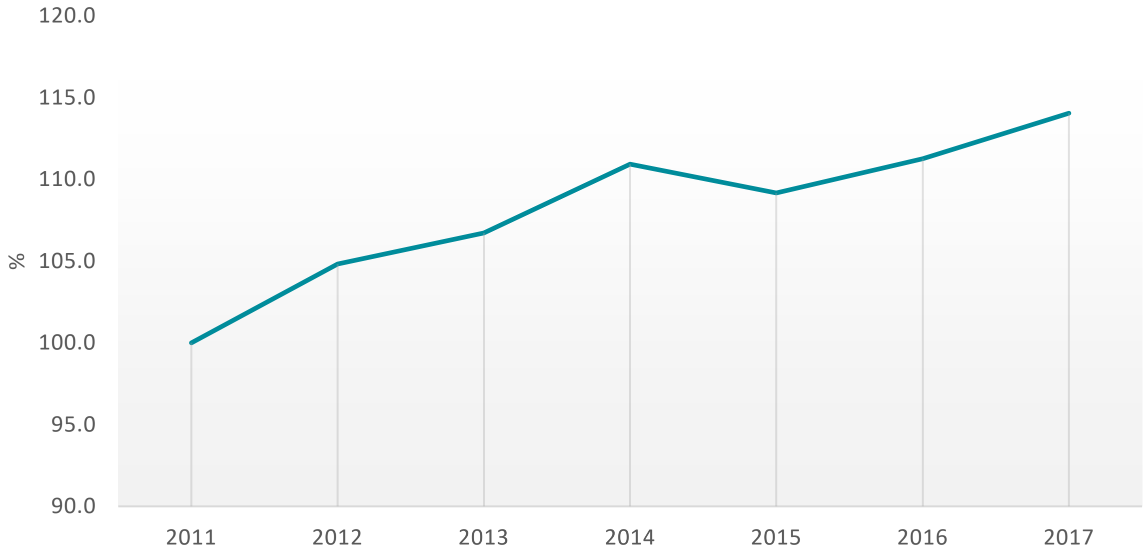
	2011	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**Total Increase: 2011 - 2017**
Cost	£419,863	£445,071	£460,417	£463,500	£460,984	£480,854	£480,788	£60,924

Source: ONS data and CEBR calculations

- The near 15 per cent growth in costs equates to an average increase of more than £60,000 for smaller businesses in the UK over the period, or more than £8,000 a year.
- Estimates of the profitability of UK smaller businesses, which suggest that the median profit for UK smaller firms in 2016 was around £8,000, provide an indication of the

opportunity cost resulting from the annual approximate increase in the 'cost of doing business' as a result of the policies included in the Index.[8]

Figure 2: Overall trend in the 'cost of doing business' for UK smaller businesses due to major government policy interventions (excluding corporation tax)



Source: ONS data and CEBR calculations

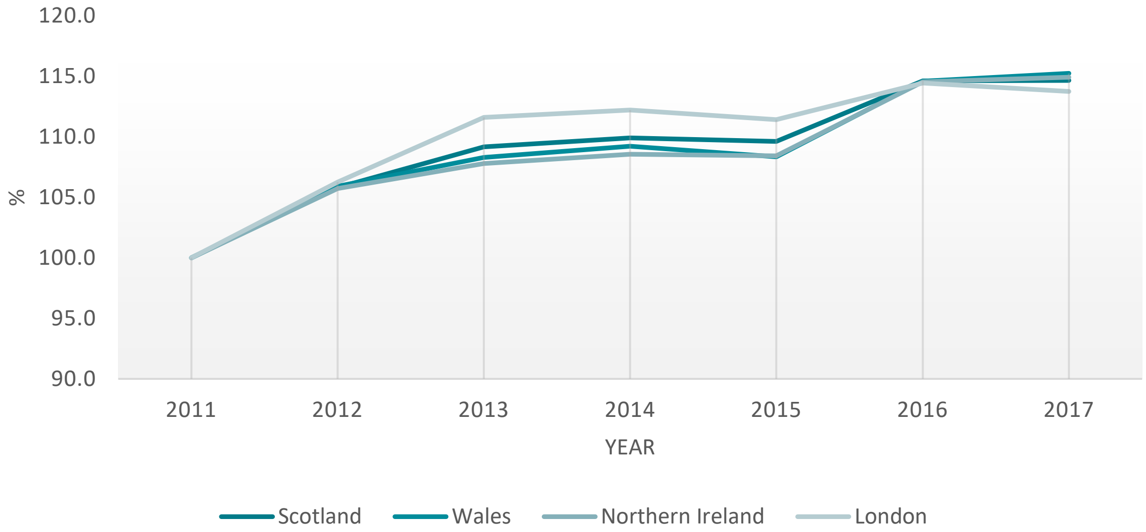
- Taking account of possible distortions due to growth in profits, a counterfactual Index stripping out corporation tax finds a similar overall cost trend picture to the original IGPI. Notably, the trend line follows a somewhat different trajectory (in Figure 2 there is a spike in 2014 that is not present in Figure 1). However, both end with a broadly similar overall percentage increase over the seven-year period.

1.2 Geographic patterns

Scotland, Wales, Northern Ireland and London all have varying degrees of devolved government. Consequently, across a number of areas policies towards small businesses can be different. However, as the geographic breakdown of the Index shows in Figure 3, the costs generated by the range of policy measures included in the Index have grown, at the aggregate level, with considerable uniformity for smaller firms across Scotland, Wales, Northern Ireland and London.

8 Statista. Average profit of SMEs in the UK 2014-2016, by enterprise size. 2019.

Figure 3: Geographic breakdown of the cost impact of key government policy interventions on smaller firms in Scotland, Wales, Northern Ireland and London

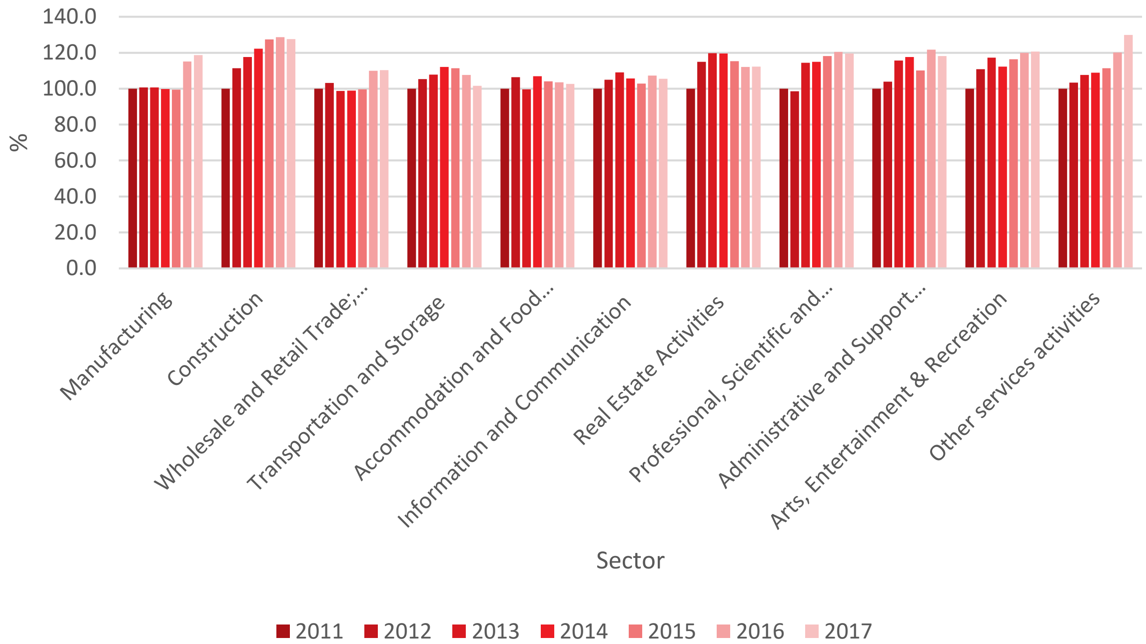


Source: ONS data and CEBR calculations

- Over the years 2011 to 2017 businesses in Wales (15.2%) and Northern Ireland (14.9%) have borne a marginally higher increase in the cost of doing business due to the range of Government policy measures analysed in the Index, compared to smaller enterprises in London and Scotland.
- A notable aspect of the trends illustrated in Figure 3 is the higher growth in costs among London smaller businesses, particularly between 2012 and 2013, compared to Scotland, Wales and Northern Ireland. However, in 2015 to 2016 London smaller businesses experienced slower cost growth leading to marginally lower increase in costs over the full period (13.7%).
- It is possible to conclude from the data presented in Figure 3 that by the end of 2017 the key government policies included in the Index were broadly impacting the operating costs of smaller enterprises in Wales, Scotland and Northern Ireland to the same extent. Meanwhile, London firms have seen costs increase the least.

1.3 Sectoral differences in cost trends

Figure 4: Sectoral breakdown of key government-policy driven costs borne by smaller firms



Source: ONS data and CEBR calculations

- The Index shows that the trends in government policy-related costs for smaller firms can vary considerably by sector. Figure 4, above, illustrates this phenomenon. For example:
  - There has been a near 19 per cent increase in the costs experienced by manufacturing businesses between 2011 and 2017.
  - Businesses in the construction sector experienced a more than 27 per cent increase in costs across the period.
  - In the Professional, Scientific and Technical (PST), as well as the Administrative and Support Services and Arts, Entertainment and Recreation sectors, there was an approximate 20 per cent growth in costs.

2 Social policy costs

The Index enables a degree of focus to be placed on different aspects of government policy, allowing the specific cost implications for smaller enterprises of those different policies to be drawn out. Looking specifically at the impacts of key government social policy measures i.e. National Insurance, National Minimum/ Living Wage and pension (auto-enrolment) costs reveals that, across all size categories of smaller business, a majority of enterprises have experienced increases in costs as a result of their implementation and on-going changes.[9]

Figure 5: Share of businesses in each size category that has seen government social policy-related costs rise – 2011 to 2017

Source: ONS data and CEBR calculations

- Figure 5 highlights that more than two-thirds of sole traders have seen their government social policy-related costs rise over the 2011 to 2017 period. Meanwhile more than half of micro-businesses faced increases in such costs in the same period.
- All businesses in the small and medium-sized categories have suffered from higher costs due to the government policies analysed in the Index.

2.1 The problem of growing government social policy-related costs

Increasing the 'cost of doing business' for smaller firms through government policy interventions, whether they are taxes or social policy measures such as pension obligations (auto-enrolment) and National Insurance contributions, comes with downsides for the business community. The impact on smaller enterprises of such policies are highlighted in the Government's own research:

9 This specific focus on social policy measures necessitates the exclusion of the numerous tax measures that the Index includes. Therefore the calculations and estimates in this section exclude income tax, business rates, corporation tax etc.

- BEIS data on smaller businesses with employees finds that workplace pensions are a 'major obstacle' to small business success for 21 per cent of smaller firms.[10] FSB research found that workplace pensions reduced profitability, impacted the scope that smaller firms had for workforce expansion and had negative consequences for the ability of firms to innovate.[11]
- According to BEIS's 2017 Small Business Survey (SBS), the NLW is a 'major obstacle' to business success for one in five smaller enterprises with employees.[12]
- Recent survey results published by BEIS found that 41 per cent of smaller enterprises with employees identified taxes such as National Insurance (among others) as 'major obstacles' to business success.[13]

Together the package of social policy driven costs included in the Index create disincentives to:

- Creating new jobs and taking on more labour because of the higher cost of employees.[14] The disincentive to take on more people will have implications for the central role that small businesses play in net employment generation, and in particular the scope for smaller enterprises (whether start-up, steady-state or scale-up) to 'soak up' the inevitable 'churn' in the labour market as resources such as labour shift from one kind of activity to others in response to economic trends.[15]
- Increasing wages as resources are directed towards paying National Insurance contributions, for example, rather than directly into the wage packets of employees.
- Starting-up and growing businesses, especially innovative businesses.[16] Hurdles to starting up as a sole trader (e.g. National Insurance liabilities) or to taking on an employee that enables a business to expand, end-up making sectors less competitive, with a knock-on impact on the industry and aggregate productivity and growth.
- Investing more in training and skills. Valuable resources that could be used by a small firm to increase the labour productivity of their workforce through investment in the training and skills of their employees, or new capital equipment, are instead spent on tax and employment obligations which the Government has placed upon smaller firms.

10 BEIS. Small Business Survey: SME Employers. 2017. Available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/710553/LSBS_2017_cross-sectional_SME_Employer_report.pdf
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3 Annex

The aim of the IGPI is to track and evaluate policy changes relating to VAT-registered sole traders and small and medium-sized enterprises (SMEs), while also stimulating the debate about the costs and merits of various government interventions.[17] It is a representative measure of government-driven business costs faced by SMEs and VAT-registered sole traders in the UK. The IGPI spans 11 industries, accounts for businesses of various sizes and covers over 70% of the UK's economic output. It shows how various Government policies are adding to the cost pressures for firms across almost all sizes and industries.

This year's publication updates the 2017 IGPI and shows the latest changes in costs for businesses due to direct government interventions. Factors such as changes in taxation, adjustments in reliefs and other government charges and benefits are tracked for each company by size. The index does not include costs that are largely determined by market forces such as the cost of raw materials or commercial rents. The cost of labour is captured only insofar as it is shaped by government policy, e.g. the minimum wage or pension contributions due to auto-enrolment. We further excluded costs that are not directly related to the operation of a business, e.g. capital gains tax on the disposal of company shares. These indirect costs are difficult to track for a few reasons. Firstly, it is difficult to estimate how many businesses are impacted in a specific year. In the case of capital gains tax, for instance, it only applies when businesses or shares are sold. Hence, it does not impact the vast majority of businesses in any given year. Secondly, it would be misleading to measure indirect costs of government policy without accounting for indirect benefits of government action, which are similarly difficult to measure. For example, infrastructure investment helps businesses in various ways but it is hard to isolate the exact businesses that benefit, and even more difficult to quantify that benefit in monetary terms.

Since much of the available data only covered the period until 2016, we 'nowcast' some of the inputs to the index on the basis of Cebr's in-house economic models and changes in policy in 2017.

3.1 Components of the index

The index is built up by aggregating the results at an industry and business-size level. For each industry and business size, we construct a 'model enterprise' based on profits, taxes and tax reliefs accruing to that model company. This is done by allocating data from official data sources to the respective size-industry split. The majority of the data is based on the ONS' Annual Business Survey, which presents data sorted by business size and industry. For indicators where such a split is not available, we used several methods to allocate the tax or relief amounts accruing to each model enterprise.

The starting point for our model enterprise is a measure of profits, in our case gross operating surplus for SMEs or income from self-employment for sole traders. From this measure of profit, we subtract R&D tax credits, the annual investment allowance and tax

17 Cebr and FSB also publish a quarterly Small Business Index, which measures operating costs for small businesses, such as the cost of labour, utilities, finance, and exchange rates. Many of these costs are not factored into the IGPI since they are not direct costs or benefits imposed by Government.

relief on employer pension contributions to achieve 'profits net of tax'. Based on this measure of net profits we calculate corporation tax liabilities accruing to each model enterprise. For each year we use the appropriate tax rate, i.e. the main rate or small profit rate for that year. In the case of sole traders, we deduct the annual investment allowance and calculate income tax based on the taxable income.

In terms of employment costs, we have estimated the additional cost incurred by employers due to government policies, i.e. the excess cost resulting from legislation such as mandatory auto-enrolment into workplace pensions and increases in the NLW. These estimates make it necessary to formulate a counterfactual scenario, which tells us what these costs would be without any government intervention. In the case of increases in the NLW, we considered the incremental increase in the NLW in each year as the additional costs imposed by government. Of course, not all employers pay wages at the rate of the NLW. We therefore only considered businesses affected by these changes by looking at the share of employees in each industry earning at or below the NLW threshold for each year.

The cost of auto-enrolment is calculated as the incremental cost of employer pension contributions caused by the rise in enrolment rates above 2012 levels.

We further modelled the cost of National Insurance Contributions for each model enterprise deducting the employment allowance in each year (currently standing at £3,000 per business).

Ultimately, we considered business rates, insurance premium tax and other duties and levies on the cost side of the index.

3.2 Index weighting

Headline index

The index is based on the calculated differences between costs and benefits for each model enterprise in each year. Results are first grouped by business size and indexed so that the 2011 value is equal to 100. The resulting matrix contains index values for four business sizes across 11 industries for each year. We use SME employment by business size to group these results by industry to reflect differences in the employee distribution of the various industries.[18] The resulting matrix contains a single index value for the 11 industries for each year. These industry indices are presented separately in the results sheet. Finally, we use the GVA share of each sector as a weight to collapse industry scores into a single UK-wide index value for each year.

Indices by business size

18 For example, sole traders make up only 4 per cent of SME employment in the manufacturing sector, but 20 per cent in the Information and Communication Sector. When grouping the results by business size, sole traders in manufacturing will, therefore, be assigned a lower weight for the overall manufacturing score than sole traders in Information and Communication for its respective sector score.

By applying the GVA share of each sector to the matrix of industry scores by business size, we are able to produce indices by business size.

Regional indices

Regional indices are calculated by using regional GVA weighting scores. This accounts for the fact that London, Wales, Scotland and Northern Ireland have vastly different economic structures meaning that government policies will affect costs differently in the nations and London.

3.3 Alternative IGPI index

The updated edition of the IGPI also contains an alternative index that excludes the impact of profit growth and corporation tax on the index. This is done by using average profits over the 2011 – 2017 time period for each model enterprise. This way the companies have constant profits with no annual variation. We further excluded corporation tax as a cost when creating the index figures for each model enterprise.

Results

A comparison of the main index and the counter-factual index (see Figures 1 and 2 in the main body of this document for the individual figures demonstrating the cost trends in both versions of the index) shows that, while there are some small differences in the annual movements, the overall trend of both indices is largely the same with a difference of just 0.5 points between the two 2017 results.

Motivation for the alternative index

The IGPI is driven by changes in the costs and reliefs for businesses due to government policies. A significant driver of business costs is corporation tax liabilities, which are in turn driven by a firm's profits, meaning that model enterprises which experience higher profit growth also see their corporation tax bill increase. This dynamic creates a challenge for the index insofar as corporation tax is an important cost factor that we want to track over time and reflect in the index, while we are also aware of the role profits play in the determination of the size of the corporation tax bill. By complementing the IGPI with an alternative index that excludes the effects of profits and corporation tax, and comparing these results with the original IGPI, we can infer how important these influences are for the overall index.

The fact that the alternative index shows a similar growth trend when compared to the original IGPI indicates that rising corporation tax bills due to higher profits are not the (sole) driver of the index. Other factors that drive the index include R&D tax credits, the annual investment allowance, business rates, national insurance contributions, the cost of auto-enrolment and other duties and levies. The alternative index, therefore, delivers an incomplete picture when analysed on its own, but is a helpful addition when taking together with the main IGPI.

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