PUBLIC FINANCE

Diploma stage
June 2005

MARKING SCHEME

CIPFA

Question 1

This question draws upon material in study sessions 3 and 9 of the open learning material.

(a) **(i)** Treasury bills are bills issued by the Debt Management Office at a discount to their value at maturity as the major means by which the government undertakes its short-term borrowing. Their maturity dates are 1, 3 or 6 months after the date of issue.

An active secondary market exists for treasury bills, enhancing their liquidity.

1 mark per point well made to a maximum of 5

(ii) (d = (R-P)/R.n;
d = (100,000 – 99,250)/(100,000 x 0.167)
= 750/16,700
= 0.045
= 4.5% *3*

(iii) An interest rate swap occurs when two borrowing organisations swap a fixed rate interest rate commitment for a variable one, while both retaining their obligations to the original lenders. *2*

(b) The Prudential Code treasury management indicators are as follows:

1) Compliance with the CIPFA Code of Practice for Treasury Management in the Public Services; this would help ensure compliance with a range of technical and management good practice. *2*

2) Upper limits on fixed interest rate and variable interest rate exposures on borrowing and lending; this limits the cash flow implications of these activities, which is particularly important for variable rate borrowing. 3

3) Upper and lower limits for the amounts of debt that are due to mature during given periods; these should ensure that large proportions of debt are not due to mature during a given period, which could expose Camford to excessive refinancing costs. *3*

4) Upper limit for amounts due to mature each year for principal sums invested for periods longer than 364 days; this will limit the risk that Camford may have to go liquid at a time when the prices of its assets have fallen. *3*

This section to be marked on the basis of 1 mark per point well made; above mark allocations are indicative.

(c) According to the case, interest rates are expected to fall over the next six months. That means that the returns on financial assets generally and particularly new issues of government bonds will fall. This will mean that the price of Camford's bonds in the secondary market will rise. If Camford were to liquidate their bonds during this period they could make a substantial capital gain. This would be particularly worthwhile if rates rose again after the six-month period so funds could be reinvested at the new higher rates.

1 mark per point well made to a maximum of 6

(d) The Debt Management Office was set up in 1998 and is responsible for the issuing, redemption and general management of government debt.

In 1997 the Bank of England had been given independent responsibility for setting interest rates as well as carrying out the above debt management activities. The major conflicts of interest that this created were:

- if the Bank increased interest rates to reduce inflation, this would make the issuing of new government bonds more expensive
- frequent changes in interest rates might be necessary to control inflation but this would lead to frequent changes in bond prices and make them seem a riskier asset to hold.

1 mark per point well made to a maximum of 7

(e) **(i)** Credit and counterparty risk – ie risk of borrowing institutions defaulting on either interest or principal payments; typically managed by lending only to approved counterparties and diversifying across a number of them. *3*

(ii) Liquidity risk – ie risk that cash will not be available when it is needed and that this will lead to extra costs. Management requires good cash flow forecasting and minimisation of periods/amounts for which borrowing required. *3*

(40)

Question 2

(a) This section requires the student to draw upon arguments presented in study sessions 1 and 3 of the OLM. A good answer would contain points along the following lines:

During economic downturns tax revenues typically fall as both personal and corporate income are depressed.

At the same time, public expenditure will tend to rise, notably on social security payments that are triggered by unemployment and low levels of income.

The effect of increased government expenditure and reduced tax revenues is likely to be a need for increased borrowing.

1 mark per point well made to a maximum of 4

(b) The relevant theories are presented in session 1 of the OLM. They are as follows:

- the theory of bureaucratic over supply; this sees public officials as at least partly motivated by their own interests, which include salary, career progression, status etc. As these are linked to officials' budgets and/or the size of their departments, officials will act to increase government expenditure or resist cuts in it.
- Lack of incentives to efficiency; this holds that public sector bodies (or at least unreformed ones) face weaker incentives to efficiency than private sector organisations as follows -

  a) Lack of profit motive – for private sector organisations increased efficiency generates increased profitability; for unreformed public sector bodies funding is/was unaffected by organisational performance
  b) Lack of competition is/was more widespread in the private sector than the public sector; competition provides an incentive to efficiency as failure to match competitors' efficiency can lead to loss of activity and revenue to them.

- Baumol's disease; this categorises economic activity into –

  a) technologically progressive activity – capital intensive activity, where significant increases in labour productivity occur over time, rewarded by corresponding increases in wage rates
  b) technologically non-progressive activity – labour intensive activity; little opportunity for increases in labour productivity over time.

  Baumol saw technologically non-progressive activities being disproportionately located in the public sector; wage rates there are pulled up above what would be justified by any increases in labour productivity; this is to maintain acceptable differentials with progressive activities where growth in labour productivity is accompanied by corresponding growth in wage rates.

The outcome of this is that unit labour costs remain broadly constant in progressive activities but rise in non-progressive activities. This contributes to unit costs in the public sector growing and consequently, ceteris paribus, public expenditure rising.

One mark per point well made up to a maximum of 14. Baumol's disease is more complex than the other 2 theories; suggest maximum marks allocations of 5, 5 and 9 respectively subject to overall maximum of 14

(c) This section draws upon arguments presented in sessions 1 and 3 of the OLM.

The effect of government borrowing depends upon from whom the government borrows.

a) from the money markets – it is argued that this increases the liquidity of financial institutions thus increasing their willingness to lend. This in turn can lead to inflation which can have the following negative consequences
   i. reduces the country's international competitiveness thus tending to contribute to balance of payments problems
   ii. reduces the real value of fixed incomes, such as many pensions
   iii. high inflation tends to be volatile reducing investment as investors become uncertain about the real value of future returns.

b) from the capital markets; sale of large volumes of government bonds to the capital markets tends to increase interest rates to divert funds away from alternative financial assets; this
   i. makes borrowing more expensive thus reducing expenditure financed by credit
   ii. increases the interest payable on variable rate borrowing such as mortgages
   iii. makes inward financial investment more attractive thus increasing the demand for the domestic currency; ceteris paribus this will increase the value of the domestic currency, also reducing international competitiveness.

1 mark per point well made up to a maximum of 12

(30)

Question 3

This question draws upon material from study sessions 5, 7 and 9 of the open learning material.

(a) The EU structural funds aim to increase economic and social cohesion within the EU.

The 3 objectives are as follows:

a) to promote the development of areas of the EU whose GDP per head is below 75% of the EU average
b) to support areas which are undergoing significant processes of adjustment, for example, as a result of significant changes in economic activity
c) to support the modernisation of education, training and employment policies and systems in all areas of the EU except those eligible for objective 1 funding

1 mark for general purpose; up to 2 marks for description of each objective

(b) Better evaluation of projects in progress needed to establish whether they continue to deliver value for money.

23% public sector bodies surveyed by the National Audit Office felt that value for money had fallen during PFI projects

Guidance and training needed to focus more on managing PFI contracts rather than negotiating them.

High prices charged by private sector partners for contract variations.

Little continuity between staff responsible for negotiating contracts and those responsible for contract management.

Staff recruited from private sector should be trained in proper conduct of public sector activity.

1 ½ mark per point well made

(c) The OLM uses seven criteria to evaluate different sources of public sector finance; obviously students need not replicate that list but would be expected to use similar or related criteria if they depart from them. Below we set out the criteria and a brief evaluation of PFI against them.

Financial cost ie the financial cost to the recipient organisation in terms of the magnitude of any of required cash outflows - PFI scores low against this criterion, especially compared to grant funding as the project is financed via its unitary payments abut nb, deals will only proceed if they offer better value for money than conventional procurement, which increases its score slightly.

Flexible use ie how far is the use of the funds received by the organisation restricted - In general there is relatively little restriction as the organisation specifies its own outputs. Use is constrained as certain projects, for example low cost ones, will not offer better vfm or in some circumstances would not be allowed to proceed.

Flexible availability ie how far can the organisation influence how much funding it will receive - PFI scores quite highly as the organisation can negotiate the amount required for the project.

Administrative complexity ie the resource costs of procuring and administering the funding - low because of complexity and cost of negotiating and managing contract.

Political attractiveness ie how far the recipient would be placed in a favourable political light by its receipt of the funding - PFI gains a middle score here; support of and opposition to PFI to an extent align with political views.

Wider objectives ie the ability of the recipient organisation to use the funding mechanism to meet wider objectives - PFI scores high as it can be used to engage and incentivise the private sector.

Certainty of amount ie how far is the amount to be received known with certainty - PFI scores high again but certainty is constrained to an extent by problems encountered in negotiating contract variations.

1 mark per correct criterion; 1 mark per valid evaluation

(30)

Question 4

This question draws upon material from study sessions 4 and 6 of the open learning material.

(a) Gearing. Broadly, about 25% of revenue expenditure for English local authorities and 20% for Welsh ones is accounted for by council tax receipts. This means that any increase in council expenditure that needs to be funded from council tax increases leads to percentage council tax increases on average four times (and in Wales five times larger) than the percentage increases in overall council expenditure.

Some argue that this leads to reductions in or constraints on council services to avoid unacceptable increases in council tax. Others see this as imposing a desirable discipline upon council spending. *5*

Relatedly some argue that reducing the level of gearing would lead to greater transparency as there would be a clearer link between council tax bills and local spending decisions.

This would also move the system of local taxation in the direction of the Layfield Enquiry's first principle that the part of government responsible for incurring expenditure should also be responsible for raising the revenue to fund it. In this context it should be said that identifying the specific responsibilities of local and central government for public services is by no means straightforward. *4*

It has also been argued that the significant level of dependence of local government on central government grants leaves local government vulnerable to significant changes in grant allocation.

However, the recent introduction of floors and ceilings on Revenue Support Grant allocations to individual authorities has largely addressed this issue.

Such high levels of central government grant also facilitate central government making allowance in its grant allocations for local spending needs and tax raising capacity. *4*

It is also argued that the high rates of gearing contribute to the very low turnouts at UK local elections; it is however, difficult to find any evidence of any such correlation. *2*

1 mark per point well made to a maximum of 15
Above mark allocations are purely indicative

(b) One argument for public sector charging is that it scores well against the criterion of equity, defined as relating payment to people's receipt of benefits. Thus

(a) non-users do not subsidise users as they often do when services are financed by tax revenues, for example families without children subsidising education of those with children

(b) the charge can reflect the extent of usage of a service, for example the longer one parks the more one pays.

Charging for services also acts as a form of rationing; it ensures that services are accessed only by those who value the service at least as much as the charge they are required to pay for it. It is argued that this avoids the over-supply of services made available free at point of use, for example healthcare, or on a subsidised basis, for example travel by road.

In addition it is argued that charging for services helps to develop a relationship of accountability between provider and recipient; people are more likely to hold organisations to account for services that they pay directly for and it is more likely that they can identify a point of contact to assist them in doing so than when services are financed out of general taxation.

It is also argued that people are more likely to care for and economise the use of something that they have paid for directly.

Charging for services can assist organisations in pursuing high level objectives: for example environmentally friendly policies can be furthered by road user charging or increasing charges for parking in town centres.

This section is to be marked on the basis of 1 mark per point; ½ mark is available for for each relevant example up to a maximum of 3 marks. This marking scheme does not include arguments for full cost pricing but credit can be given for discussion of that area

(30)