PUBLIC FINANCE

Diploma stage
December 2005

MARKING SCHEME

Question 1

(a) Council tax requirement = £480m - £420m = £60m. *1*

Banded properties are as follows

A	12,300
B	27,230
C	45,680
D	107,550
E	206,580
F	77,103
G	55,620
H	17,658
	549,721

2

Consequently band D council tax bill, ignoring discounts and exemptions and the expected collection rate = $\frac{\pounds 60m}{549{,}721} \times 9$

= £109.15 x 9 = £982.35 *3*

Adjusting for:

- discounts = $\pounds 982.35 \times \frac{100}{88}$
  = £1,116.31
- collection rate = $\pounds 1{,}116.31 \times \frac{100}{97}$
  = £1,150.84 *4*

(b) **(i)** Equity: one strand of the equity criterion states that a tax is equitable if the amount paid in taxation is related to the value of the benefit received from taxation financed public expenditure.

Equity: the second strand of the equity criterion states that a tax is equitable if the amount of tax paid is related to the means of the taxpayer.

Cost of administration: a good tax should minimise the sum of the administrative and compliance costs generated by the tax.

Ability to maximise number of local taxpayers: it is argued that maximising the number of people upon whom the formal incidence of the tax falls increases the awareness of the local electorate of local taxation issues.

Difficulty of evasion: a low level of evasion is important in its own right and also to avoid undermining other criteria, particularly the first equity criterion above. *5*

(ii) Equity in terms of benefits received: council tax scores poorly as property values are not good predictors of the value and benefits received from taxation financed public expenditure.

Equity in terms of means: council tax scores better here as property values will correlate to an extent with ability to pay, but by no means perfectly. Discounts and means tested benefits mprove performance.

Administration costs: compared to those of community charge, council tax administration costs are significantly lower fewer bills sent out; data easier to maintain, compliance costs remain broadly the same.

Numbers of local taxpayers: formal incidence is upon the residents of domestic properties generating quite a wide formal incidence, wider than formal incidence of rates on owner occupiers.

Ease of evasion: collection rates in the high 90% range are achieved, generating a high score against this criterion. *5*

(iii) National Non-Domestic Rates (NNDR) are levied on business and commercial properties and calculated as a function of the rateable value of the property and an NNDR multiplier.

National features of NNDR include:
- NNDR multipliers are set nationally (separately for England, Wales and Scotland)
- Yield of NNDR pooled nationally and distributed to local authorities on bases set by central government

Local features include:
- Collected locally by district and borough councils (unitary authorities in Wales and Scotland)
- Additional levy can be raised to fund Business Improvement Districts (BIDs) if majority of NNDR payers within BID area vote in favour *5*

Good answers might also mention local authority business growth incentive scheme (in England and Wales) as additional local feature and also other national variations.

(c) The code requires authorities to set the following prudential indicators.

Over a three year period:

- estimates of ratio of financing costs to net revenue stream (HRA and non HRA).
- estimates of impact of capital investment decisions on council tax (average weekly rent for HRA investment).

After the year end:
- actual ratio of financing costs to net revenue stream.

Over a three year period:
- estimates of capital expenditure.
- estimates of capital financing requirement.
- authorised limit for external debt.
- operational boundary for external debt.

After the year end:
- actual capital expenditure.
- actual capital financing requirement.

- actual external debt. *10*

(d) For the proposition

- The code does not set prescriptive ratios in the way that the proposed code for NHS Foundation trusts does; instead it simply provides a framework for self regulation.

Against the proposition

- The code's accountability lies in the impact of prudential borrowing upon council tax levels (and council rents for HRA borrowing).
- The council tax gearing effect accentuates this form of accountability along with local authority accountability at local elections.

Possibly weaknesses in local democracy reduce the strength of this accountability. *5*

(Sections b – d to be marked on the basis of one mark per point made up to the specified maxima)

(40)

Question 2

(a) **(i)** Public goods are goods that are non-depletable and non-excludable, ie one person benefiting from a public good does not exclude anybody else from benefiting and nor do they deplete the amount of benefit that can be obtained by others.

Examples are rare but include street lighting and elements of national defence.

Economists hold that, without government activity, markets will undersupply public goods as in an unregulated market situation people have an incentive to act as free riders, ie not pay for a public good as they know they cannot be excluded from benefiting from it and their benefit will not deplete the benefit obtained by others. Consequently there is a role for government to identify how much of a public good should be provided and to finance its provision from public funds. Taxation is an appropriate way of doing this, especially as its compulsory nature helps address the free rider problem. *8*

(ii) A monopoly is a market where there is only one supplier, consequently the incentives to provide value for money to customers provided by competition are lacking. A natural monopoly is a situation where cost considerations make competition infeasible, eg major infrastructure such as railway or power distribution networks. Here government needs to regulate the market to ensure value for money for customers and taxation is an appropriate means of raising the revenue to pay for this. *5*

(iii) A merit good is a good that the government believes that, left to themselves, people would purchase too little of in an unregulated market situation. Examples include education and healthcare. It is argued that government can stimulate the production and consumption of merit goods by means of some form of subsidy, even to the extent of providing the goods free at point of use. Some form of taxation could be used to fund such subsidy. *5*

(b) Most developed economies, including the UK, are experiencing an ageing population, ie the proportion of the population aged over 65 has increased significantly over time. This has led to an increase in the demand for services such as social care for the elderly, many health care services and for pension provision. As many of these services are provided by the public sector this increases public expenditure.

In terms of economic theory, some services provided by the public sector are ‘luxury’ goods, ie their demand increases more than proportionately as a country’s income grows, eg education. Shown in significant increase in demand for higher and further education.

Most countries experience increased urban development over time. Evidence suggests that greater urbanisation leads to an increased demand for public expenditure to counter issues such as increased crime and the effects of more congested living space.

The theory of ‘fiscal illusion’ suggests that voters underestimate the cost of public services either because they do not understand the complexities of the tax system or because some of the tax they pay is hidden, eg Value Added Tax (VAT) which is levied on private sector goods and so makes them more expensive and public sector provision seem correspondingly cheaper to voters. The result of voters underestimating the cost of public services is that they are prepared to vote at elections for parties who are offering higher levels of public expenditure compared to how they would have voted had they appreciated the real cost of public services. *12*

To be marked on the basis of one mark per point made up to the specified maxima

(30)

Question 3

(a) **(i)** A primary financial market is a market in which financial assets are initially issued and bought.

(ii) A secondary market is one in which existing financial assets are bought and sold prior to their maturity. *3*

(iii) A financial asset is liquid if it can be converted into cash quickly and with little risk of capital loss. If it can be traded in a secondary market it can be quickly converted into cash; whether doing so entails a significant risk of capital loss depends largely on the behaviour of interest rates and other market variables which can affect its value adversely at the time its holder needs to go liquid. *5*

(b) d = (R – P) / Rn = 500,000 – 485,000/500,000 x 0.5

$$= \frac{15,000}{250,000} = 6\%$$ *3*

(c) The standing of the third parties it deals with; the terms and maturities of its borrowing; the legal powers and statutory duties of itself and the organisations it deals with; decisions and transactions undertaken to ensure a full audit trail exist; its contractual responsibilities and liabilities. *5*

(d) **(i)** Interest rate risk on borrowing; this is the risk that fluctuations in interest rates lead to increased costs.
Interest rate risk varies according to whether borrowing is:
fixed rate – here the risk is that interest rates move below the fixed rate at which one borrowed
variable rate – the risk is that rates rise above fixed rate at which one could have borrowed.

This could be managed by setting upper limits to fixed and variable rate exposures and by borrowing prudently in terms of allowing a greater exposure to fixed than variable rate debt. *7*

Also inform borrowing decisions with interest rate forecasts and if appropriate use financial derivatives: ie

- Forward rate agreements - allows locking into future fixed rate
- Interest rate future – standardised forward rate agreement
- Cap – option to set ceiling on variable interest rate

(ii) Refinancing risk – this refers to the risk that debt may mature at a time when interest rates are unexpectedly high and consequently refinancing costs become higher than expected. Effective management would set upper and lower limits on the proportions of total fixed rate debt that are due to mature during specified periods, and seek to forecast rates in periods when refinancing is required. *4*

(iii) Market risk is the risk that an organisation may need to liquidate some of its assets at a time when the prices of those assets have fallen. Management can be by setting an upper limit on the principal invested that is due to mature in each financial year end by effective forecasting of market conditions and asset values. *3*

(30)

Question 4

(a) **(i)** The golden rule, ie that the government's current budget will balance or be in surplus over an entire economic cycle, thus over the cycle the government will only borrow to invest. *2*

The sustainable investment rule, ie that government borrowing for investment will be managed so that public sector net debt (PSND) remains below 40% of gross domestic product (GDP). (PSND = outstanding debt – government held liquid assets.) *3*

(ii) The government feels that it is wrong to borrow long term in order to finance current expenditure as this would require interest payments in future years whilst the benefits of the corresponding expenditure would only be felt in the current year. However, it is right that future generations pay interest on long-term borrowing for investment as they will receive benefits from the investment.

The only constraint on borrowing to invest, according to these fiscal rules, is that additional borrowing does not tip PSND above 40% of GDP as the government would no longer feel comfortable about being able to afford the consequent debt servicing costs. *6*

(iii) The position on government borrowing taken by Keynesian economic theory is similar to that of the golden rule, although Keynesian theory expected the government budget as a whole to balance over an entire cycle, making no distinction between borrowing for capital and current expenditure.

As a result of the above, Keynes did not expect the government to engage in any net borrowing over the cycle, so there would be no upward pressure on outstanding debt, so no need for any equivalent to the sustainable investment rule. *4*

(b) General good practice in grant applications activity includes:

- ensuring appropriate staff resources are assigned to it and that a single person is responsible for the work's supervision and consideration
- applying good project management practice to monitor grants work to ensure deadlines are met.

In addition:

- all documentation relating to claim eligibility should be read carefully at an early stage by an assigned person; they should then circulate the relevant information to those who need to know it, for example, those whose expenditure can be reclaimed under the grant
- at least some grant income can be incorporated into budgets, thus allowing the authority's claiming of its entitlement to be monitored by the normal budgetary control procedures
- effective liaison should be carried out with external audit to ensure that claims requiring external certification receive it at a time consistent with meeting the claim deadline
- appropriate use should be made of internal audit to help assure accuracy of data and the robustness of data collection systems

- appropriate training in claims and applications compilation should be provided
- authorities should compile management information on grant claims and returns and performance in meeting deadlines to help monitor and improve performance. *8*

(c) Member state government submits proposed programme framework, which seeks to be consistent with structural fund objectives, to European Commission (EC).

Once EC has issued Community Support Framework (CSF) member state government fleshes out detailed programme consistent with CSF.

Appropriate member state government agencies request tenders for participation in projects.

Individual organisations would need to check their eligibility for project funding under the various structural fund objectives and submit a proposal if eligible.

Successful tenderers undertake projects.

Progress monitoring reports and evidence of appropriate expenditure are sent to the EC.

Finally evaluation reports are sent to the EC for approval by them.

1 mark per point made up to specified maxima 7

(30)