CIPFA

PUBLIC FINANCE

Diploma stage examination

11 June 2007

MARKING SCHEME

AT THE HEART OF YOUR CAREER

Question 1

(a) The EU structural funds aim to improve economic and social cohesion within the EU by allocating funds to less prosperous areas of the EU. *1*

There are 4 main structural funds:

European Regional Development Fund
European Social Fund
European Agricultural Guidance and Guaranteed Fund
Financial Investment for Fisheries Guidance *2*

Each fund contributes to 1 or more of the 3 objectives of the structural funds. Areas qualifying for Objective 1 funding are those whose GDP per head is less than 75% of the EU average. However, Objective 1 areas are excluded from receiving funds under Objective 3, aimed at modernising education, training and employment policies and systems. *2*

(5)

(b) Gather information about project proposals developed by UK government bodies within EU structural fund Community Support Frameworks/Single Programming Documents.

Produce tender documentation to apply to participate in appropriate projects.

If successful, forward appropriate documentation, receipts etc to allow European Commission to verify that all expenditure was appropriate.

Ensure all project deadlines are adhered to in order to receive full funding.

Ensure that appropriate audit systems are in place.

Produce regular monitoring reports and a project evaluation.

I mark per correct task / responsibility(a maximum of 4 marks available for generic 'good practice' points up to a maximum of (6)

(c)

Criteria	**Evaluation of grant income**	**Evaluation of borrowing**
Financial Cost	No requirement to pay interest or repay principal.	Requirement to pay interest and repay principal.
Flexibility in use	Grants are invariably tied to particular uses.(Better students will distinguish between specific nd non specific grants)	No constraint or use of borrowed funds.
Flexibility in availability	Limited to an extent but also flexibility is a function of the case made for funding by recipients.	Flexible availability subject to affordability and lenders' perception of reasonable risk.
Administrative complexity	Quite substantial resource requirements needed in terms of production of proposal, progress reports on project and final project evaluation.	Resource requirements of searching for best value loan and ongoing servicing of borrowing not onerous.

Political attractiveness	Generally high given the zero financial cost.	Likely not to be high: partly will depend on university's ability to service debt comfortably.
Use to meet wider objectives	Not applicable to recipients although clearly providers of grant will do this to considerable extent.	No real scope for this.
Certainty of amount available	Uncertainty about whether application will be successful; once successful amount is certain.	High certainty about amounts to be borrowed: uncertainty about interest costs if loan at variable rate.

½ mark per correct criterion: 1 ½ marks for sensible evaluation against each correct criterion up to maximum of (14)

(d) Annual reporting requirements before the start of the year:

- Review of organisation's approved clauses, treasury management policy statement and practices.
- Strategy report on proposed treasury management activities for the year.

Reporting requirements during the year:

- Activities undertaken
- Variations from any agreed policies/ practices.
- Interim performance report

Annual reporting requirements after the year-end:

- Transactions executed and their revenue effects plus wider performance issues.
- Report on risk implications of year's activities.
- Compliance with agreed policies/practices, statutory/regulatory requirements and recommendations of CIPFA code.

1 mark per correct requirement up to a maximum of (8)

(e) **(i)** d = (R-P)/R.n
= (500,000 – 497,500)/500,000 x 0.08
= 2,500/40,000 = 0.06
= 6% *3*

(ii) Coupon rate is rate of interest paid by a bond expressed as a percentage of the bond's par value. *1*

Running yield is the annual interest paid by a bond expressed as a percentage of the purchase price. *2*

Thus running yield equals

5/98 x 100%
= 5.1% *1*

(7)

(40)

Question 2

(a) The golden rule is met when, over the economic cycle as a whole, the current budget is in balance or surplus. In other words, current expenditure (expenditure on services or assets of less than one year's life) is fully funded by taxation and other revenue receipts. Any deficits in the current budget are temporary and at least matched by corresponding surpluses during that cycle. *(4)*

(b) The adjustments possible are reducing government current expenditure or introducing policy to increase tax receipts. Policy to increase tax receipts would be the more likely as cuts in current expenditure would be practically difficult and politically very damaging. *2*

Economic consequences

These would depend upon the nature of the policy selected; assuming tax rates were increased, supply side economists would anticipate disincentive effects in the areas in which the relevant taxes were levied. This could contribute to an economic slowdown, which could make meeting the golden rule in the future increasingly difficult. *2*

Political consequences

Loss of Labour's reputation for effective economic management.

Some damage to Gordon Brown's reputation, particularly in light of previous redefinitions of the cycle. *2*

(6)

(c) Activities with harmful consequences for the environment are said to have negative externalities. It is argued that a free market (ie one with no government intervention) will over supply such activities. Increasing taxation upon the products of such activities will reduce their supply via increasing their prices and thus reducing demand for them.

(4)

(d) Raising finance for the funding of public goods (ie goods that are non-excludable and non-depletable and thus will not be capable of being charged for because of the free rider problem eg street-lighting).

Raising finance for the funding of merit goods (ie goods which the government believe people under-value and hence demand too little of, for example, health care). Taxes can pay either for free provision or subsidy. Similarly taxes may seek to reduce demand for demerit goods (ie goods government believes will be over supplied in a free market) as tax likely to be passed on to consumer impacting upon demand.

Raising finance for the regulation of natural monopolies (ie organisations whose cost structures make competition economically infeasible and places them in a position where they lack significant incentives to provide value for money).

Raising finance for goods or services with positive externalities where some of the benefits accrue to those who do not pay directly for the product. (Eg company training.) Subsidy or free at point of use provision helps address the problem of undersupply by a free market.

(10)

(e) The terms of reference of the Lyons Inquiry were to:

make recommendations as to how best to reform council tax.

assess the case for providing local authorities with increased flexibility to raise extra revenue and for making a significant shift in the balance of funding.

analyse options for supplementary sources of local revenue eg local income tax, reform of national non-domestic rates etc.

consider the implications of further devolution.

consider relative responsibilities of central and local government.

consider any implications of its recommendations for other parts of UK.

(6)

(30)

Question 3

(a) Over many years the Bank of England had been responsible for issuing government bills and bonds and for managing the stock of debt. In 1997 they were also given responsibility for the setting of interest rates. This generated conflicts of interest for them as follows:

- Increasing interest rates to control inflation would increase interest payments the government had to pay on its issues of bonds and increase the discount it may have to accept on bills.
- Frequent interest rate changes would make bond prices in the secondary market volatile thus making government bonds appear a riskier investment, requiring a higher interest rate by way of compensation.

Consequently responsibility for the issuing of bonds and bills and for management of outstanding debt were given to the DMO in 1998.

(6)

(b) **Issuing bills and bonds**

Existing interest rate, which would largely determine the interest rate offered on new bonds and discounts accepted on issues of bills.

Remits for the issue of bills and bonds received from the Treasury.

Government's short-term cash requirements for specific issues of bills.

Estimations of demand for bills and bonds and supply of similar financial assets eg private sector bills and bonds.

Views as to desirable maturity structure of bonds.

Managing Debt

Ensuring systems exist for payment of interest and principal.

(6)

(c) The majority of local authority borrowing occurs via the Public Works Loans Bond, part of the DMO. It is prepared to lend up to authorities' authorised limits for external debt at fixed or variable rates.

Concerning investment, local authorities typically invest in a risk averse way in bank deposits, building society deposits and relatively small amounts of money market instruments and government bonds. External fund managers appear to be slightly less risk averse than internal ones; eg making more use of government bonds.

HFE treasury management activity is governed by institutions' memoranda with their funding council. These tend to reflect the statutory background of the particular institution. Thus old established universities will carry out extensive treasury management activities encompassing cash flow management, money market investment and long-term investment in equities, bonds, hedge funds etc.

More recently established universities, tend to have a narrower range of treasury management powers' reflecting their previous status as local authority institutions. HE institutions recently have increased the proportion of borrowing undertaken at a variable rate.

(8)

(d) Pre-1945 governments were committed to balanced budgets and borrowing was only to fund major non-routine expenditure (eg war). During 1945-1979 Keynesian theory dictated that budgets be deliberately unbalanced broadly to run deficits during economic downturns and surpluses during upturns in order to stabilise the economic cycle. Broadly though the budget was expected to balance over an entire economic cycle.

The Thatcher government repudiated Keynesian theory and sought to reduce government borrowing as part of its monetarist counter inflationary policy and also to remove the upward pressure on interest rates generated by high levels of government borrowing. Broadly this policy approach continued under John Major.

From 1997 Labour developed previous policies by distinguishing between borrowing for current and capital expenditure. The current budget was to balance over an economic cycle (or be in surplus) thus permitting some short term cyclical borrowing. Borrowing for capital expenditure should be constrained by the requirement that public sector net debt shall not rise above 40% of GDP over an economic cycle.

(10)

(30)

Question 4

(a) The two roles are:

(1) Raising extra revenue for the NHS. This is done via charges (eg for catering and car parking), sales of land and assets and means tested charges (eg for prescriptions and sight tests).

(2) Using prices to allocate resources between NHS providers. Currently in England this is achieved via the Payment Results (PbR) system where hospitals charge for activities using a nationally set tariff.

(4)

(b) PbR sets a national tariff for NHS activity, based upon reported costs of providing care. (This national tariff is, however, adjusted using the 'market forces factor' to take account of regional cost differences.) The system has been introduced on a phased basis requiring all NHS providers to charge using the imposed fixed price tariff.

Since provider costs will generally differ from the tariff this rewards efficient providers with surpluses and penalises inefficient ones with losses. Thus, it seeks to encourage efficient provision, allowing efficient trusts to expand (eg by investing surpluses) and encouraging withdrawal by inefficient ones from provision that is uneconomic.

Thus in terms of the two roles at a) it allocates resources between providers but does not generate any new revenue for the NHS.

(8)

(c) **(i)** Economic theory holds that setting prices equal to full cost contributes to 'efficient resource allocation'. This is because people will only buy the product if they value it at least as much as its price; as price equals full cost, this means resources will only be used to produce products valued by customers more than the value of the resources themselves. Thus resources will not be used to produce products valued at less than the value of the resources. *4*

(ii) This clearly reduces the flexibility of organisations' pricing policies. Prices may only be reduced by correspondingly reducing unit costs (calculated on a full cost basis). Apart from this, costs cannot be reduced to eg compete more effectively against a non-constrained private sector provider, or to stimulate demand (and thus perhaps achieve scale-based cost reductions).

Similarly prices cannot be increased to ration demand or generate revenue from a product with a low price elasticity of demand. *4*

(8)

(d) Baumol divides economic activities into:

- Technologically progressive. These are capital intensive where technological progress increases labour productivity over time (eg car manufacturing).
- Technologically non-progressive. These are labour intensive where little scope exists for technological innovation and hence labour productivity remains broadly constant over time (eg social services).

Non-progressive activities are disproportionately located in the public services. Despite labour productivity remaining constant, wage rates tend to rise to maintain differentials with the high wage/high productivity progressive sector, putting upward pressure on unit costs and hence prices.

However, as technology develops capital investment becomes possible in some non-progressive activities (eg medical diagnosis, surveillance etc) making these activities more progressive, reducing unit costs via greater labour productivity and thus reducing upward pressure on prices.

(10)

For this question marks allocated on basis of 1 mark per point made up to specified maxima

(30)