CIPFA

PUBLIC FINANCE
REPUBLIC OF IRELAND

Diploma level examination

11 June 2007

MARKING SCHEME

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 up to a maximum of (6)

(c) The advantages to the EU in ensuring that grants paid to member states are both ear-marked and matching include:

- They can ensure that their assistance is directed towards those areas that they deem to be high priority.
- They can be more certain that the money will be spent where it is intended as, from, the recipient's perspective, grant-aided services become relatively cheaper than other services. This is referred to as the substitution effect.
- The fact that the grant is ear-marked means that it is less likely that the grant will "leak" into local tax reductions, whereby the recipient of the grant uses it to reduce the level of local taxation below that which would have been necessary I the absence of the grant.

The limitations associated with the use of ear-marked matching grants include:

- The restrictions placed around the use of such grants usually means that they may not be spent as efficiently as other general grant revenue. This is because there is little incentive for seeking out productive efficiencies where the recipient manages to deliver the same output at a lower cost. The recipient has no incentive to seek out productive efficiency, as any resulting saving cannot be channeled into other services.

- It is also possible that the restricted use of the grant may result in the grant being targeted towards areas which, although in keeping within the terms of the grant, may not represent the most effective spending at local level.

3 ½ marks per advantage & disadvantage (2 each) up to maximum of (14)

(c)

- The University should give consideration to the following issues in weighing up the options around user charging
- Given that the imposition of charges frequently gives rise to opposition, the University should consider its stated objectives. For example, it is unlikely that the imposition of car parking charges is at odds with the overall objectives of the University. Conversely, charges to current students for the use of library facilities might be considered to be in contravention with study and research objectives.
- The University should also consider where charging can be used to encourage desirable behaviour. For example, as stated above, the imposition of a charge on current students for use of the library may be considered to be counter to learning objectives. However, the imposition of fines for the late return of library materials is not.
- It is also worth considering the likely response to the imposition of a charge as measured by Price Elasticity of Demand (PeD). In terms of generating revenue, it is better to impose charges in areas/ activities where there are no close substitutes. For example, if public transport links are poor, then the imposition of a charge for parking is likely to result in very little change in behaviour and the generation of a good revenue yield is more likely.
- Lastly, good practice in setting charges would dictate that the charge (or price) should cover the cost of supply. This mimics the private market in that consumers can decide where to allocate scare resources across public and private goods, using price as a signal.

2 marks per correctconsideration up to a maximum of (8)

(e) (i) The key differences between PPP and traditional procurement methods can be summarized as follows:

- There is far greater involvement from the private sector in the design elements of the project.
- The private sector can in some cases take ownership of the asset for a certain period of time.
- The public sector partner typically tenders for the required output of the asset.

3

(ii) The advantages to the University of choosing the PPP option might include:

- Large capital savings during the construction of an asset. If these capital savings can be re-routed into current spending, then the funding shortfall can be alleviated. It should be stressed, however, that the use of PPPs should only be considered where overall value for money can be assured.
- Cheaper running costs associated with the asset in the long term, given enhanced design specifications
- The unitary charge can ensure that the quality of the asset is maintained over its life.

4

(7)

(40)

Question 2

(a) The terms of the Stability and Growth Pact are met when the general government deficit does not exceed 3% of GDP and the level of outstanding debt does not exceed 60% of GDP. In addition, the government must strive to maintain the budget balance "close to balance or in surplus" in the medium term. *(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 political reputation for effective economic management.

If tax increases were adopted, this would damage our reputation as a low-tax economy and the level of Foreign Direct Investment sould suffer as a result. *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.

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.

Up to 2 ½ marks for each of the four categories up to a maximum of (10)

(e) Financial management reform could provide a better information set on which to base future spending decisions. Examples include:

- Accruals-based information can reveal the true resource cost of current policies.
- Balance sheet information can draw attention to sustainability issues.
- The incorporation of non-financial performance information can provide better information as to the results and impacts of policies.
- The conduct of evaluation can provide better evidence as to the success or otherwise of policies.

(6)

Unless otherwise stated 1 mark per point made up to specified maxima

(30)

Question 3

(b) Over many years the Department of Finance had been responsible for issuing government bills and bonds and for managing the stock of debt. In 1990, this function was transferred to the National Treasury Management Agency (NTMA). The reason this stand-alone agency was established was in recognition of the fact that debt management is a specializsed area, requiring a level of expertise. In addition, the cost of the problem (in terms of large debt servicing costs) warranted a dedicated resource to effectively manage the area.

(4)

(b) Issuing bonds

Existing interest rate, which would largely determine the interest rate offered on new bonds and discounts accepted on issues of bills and corresponding returns on equivalent government bonds issued by European governments.

Remits for the issue of bonds received from the Department of Finance.

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.

5

Managing Debt

Ensuring systems exist for payment of interest and principal. *1*

(6)

(c) If the NTMA seeks a large issue of Irish government bonds on the Irish market, it may have to offer an increased yield on these bonds to ensure that the required debt is successfully raised. This will affect the market for existing government bonds in that their yield is now relatively lower than newer bonds. Their price will fall to reflect this.

A second impact on European interest rates could arise. This occurs if the higher return on government bonds drives up the interest rates generally in the European economy. If the return on government bonds becomes more attractive, those banks may have to offer a higher rate on deposit to attract savings. Higher interest rates are damaging to economic growth, in that they make the cost of borrowing more expensive and erode the rate of return on investments. This second effect is less likely, as the size of Ireland's economy is small relative to the rest of Europe. However, it does have relevance at the European level and would arise if, say, some of the larger European governments sought to raise public debt levels at the one time.

Higher interest rates within Europe can increase demand for investment within Europe. This creates demand for the Euro currency and it may appreciate relative to other currencies such as the dollar or sterling. This can adversely affect competitiveness, making European exports relatively more expensive and foreign imports relatively cheaper.

(10)

(d) Traditionally, governments were committed to balanced budgets and borrowing was only to fund major non-routine expenditure (eg war). During the 1970s and 1980s, the accepted Keynesian theory dictated that budgets be deliberately unbalanced broadly to run surpluses during economic downturns and deficits during upturns in order to stabilise the economic cycle. Broadly though, the budget was expected to balance over an entire economic cycle. In other words, a deficit in one year should be matched by a corresponding surplus in a subsequent year.

However, the pursuit of this policy led to prolonged budget deficits during the 1970s. The government found itself within a cycle of low growth, (in itself creating pressure for higher public spending) in conjunction with increasing debt servicing costs as a result of a large build-up of debt. Attempts to reduce the deficit by raising taxes failed o narrow the deficit. It was not until the late 1980s that order was restored to the public finances with the announcement of spending cuts. These cuts were directed at difficult areas of current spending such as social welfare and the public sector pay bill.

From 1997, the government has been bound by the provisions of the Stablity and Growth Pact. This Pact forms a condition of our Euro-membership and strives to prevent a build-up of debt within the EU. Under the terms of the Pact, the government is required to "..set the medium term objective of the budget close to balance or in surplus". While deficits are not outlawed under the provisions of the SGP, they cannot exceed 3% of GDP in any year. In addition, the outstanding level of debt cannot exceed 60% of GDP.

The present government has performed well within the SGP criteria. Since the introducion of the Pact, the general government deficit has not approached the 3% limit and the present debt/ GDP ratio stands at 25%.

(10)

For this question, unless otherwise stated one mark per point made up to specified maxima

(30)

Question 4

(a) Charging for services plays an important role in Local Government finance in this country.
According to the most recent study (Indecon, 2005), charging for services accounts for the largest proportion of local authority finance at 31% of the total.

In terms of the role for charging, these charges serve a key purpose in raising revenue for local authorities that would otherwise have to be met from other sources such as central government grants or commercial rates.

Secondly, they enhance the accountability of the locally elected members in that local residents will associate the charge with the delivery of the local service.

Finally, local authorities can use local charges to influence behaviour. For example, the pay-by-weight refuse service encourages the activity of recycling. The more local residents engage in recycling, the lower their refuse charge. *(4)*

(b) Arguments against the use of charging in the public sector include the following:

(1) They cannot be applied to public goods (such as defence or foreign diplomacy services). This is because these goods are not normally excludable, or to make them excludable would be prohibitively expensive. The levying of a charge is meaningless, therefore, if citizens can enjoy the public good regardless of whether they have paid ir not for its consumption.
(2) There is a moral argument against the levying of charges within the public sector. For example, access to healthcare and other socially desirable goods should not depend on one's willingness to pay. Many public goods and services are provided for social reasons rather than economic ones. *(4)*

(c) The Casemix system represents an application of charging in the Irish health system.

Within the Casemix model, a standard price is derived for standard treatments. This is compared to the actual costs incurred (for the same treatments) and comparisons can be drawn across hospitals.

Those hospitals that can demonstrate efficiency are rewarded with higher budget allocations in the subsequent year and the opposite is the case for those hospitals that are inefficient. The entire system is budget-neutral in that the 'losers' compensate the 'winners'. As the system evolves, a greater proportion of the budget will be re-allocated in this way year on year. *(4)*

(d) (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 by 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 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)*

(e) 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.

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)