



**PUBLIC FINANCE
REPUBLIC OF IRELAND**

Diploma stage examination

12 December 2007

MARKING SCHEME



Question 1

(a) Possible points include:

- Raising the profile of grants activity and ensuring adequate resources are assigned to it.
- The above includes clearly assigning responsibility for reviewing legislation and other information about possible new sources of grant income.
- Having a single person responsible for supervising work and applying good project management principles to it.
- Incorporating grant income into budget systems to monitor claiming for entitlement.
- All documentation concerning grant eligibility to be read by an assigned person and relevant information distributed to those who need to know it.
- Effective liaison with external audit to ensure that claims requiring external certification receive it in good time.
- Use made of internal audit to assure accuracy of data and of the systems generating it.
- Develop management information systems covering areas such as grant claims made and amounts received, time spend by staff on each application etc.
- Figures contained in claims should be supported by comprehensive working papers.
- Appropriate training should be given in claims and application compilation.

1 mark per point up to maximum of (10)

(b) The EU structural funds aim to increase social and economic cohesion within the EU by allocating funds against three main objectives, relating to relative GDP per head, structural adjustment and modernisation of education, training and employment systems. They include the European Regional Development Fund and the European Social Fund. Steps to access funding from these funds would include:

- Identify national institutions responsible for administration of structural fund programme.
- Identify requests for tenders for project participation and prepare and submit tender.
- Commence project if tender is successful and put into place appropriate monitoring procedures.
- Submit to European Commission (EC) progress monitoring reports and evidence of appropriate expenditure as required.
- Send project evaluation reports to EC for approval.

*Up to 3 marks for discussion of structural funds;
up to 5 for steps in accessing them,
up to an overall maximum of (8)*

(c) Advantages:

- Provides an objective basis for grant allocation.
- Any judgements made in the construction of the formulae can be made explicit.
- Allows grant allocation to reflect differences in local authorities' demographic, economic, social etc characteristics.
- Can facilitate equalisation of resources available to disparate local authorities.
- Data used in formulae can be kept up to date.
- Economic to administer for both central and local government.

Conditions necessary for effective operation:

- Availability of required data at good quality, consistent standard across all local authorities.
- Development of technically robust allocation formulae.

1 mark per point up to maximum of (8)

- (d)** The term Public Private Partnership (PPP) in its widest sense refers to collaborative activity between the public and private sectors. More narrowly it is often used to refer to arrangements which bring private sector funding into partnership arrangements between public and private sector organisations. Typically, the private partner will finance, construct and operate the asset for a certain timeframe in exchange for annual payments from the private partner.

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The advantages to the University of using PPP arrangements include the following:

- The use of PPPs frees up the capital budget for other purposes.
- There is a greater likelihood that the contract will be completed on time and to budget given the strong incentives on the part of the private contractor to complete in order to commence the revenue flow.
- The design and maintain solution should lead to innovative and cost effective design solutions.

2 marks per point up to maximum of 2

The limitations to the University of using PPP arrangements include the following:

- The university is locked into a service contract obligation for a long time period.
- There is usually a very long lead time in terms of designing an output specification, tendering for contracts and drawing up contracts.
- The private partner is usually the technical owner of the asset during the contract period and can take decisions regarding the use of the asset which may be contrary to the university's objectives.

2 marks per point up to maximum of 2

(8)

- (e) Traditionally many PPP projects have been 'off balance sheet'. This is because the private partner is the technical owner of the asset, bearing the associated risks and rewards for the duration of the contract. Thus the public sector balance sheet does not disclose either the asset or the associated liability in terms of the aggregate future liability of the government in annual payments.

This position was confirmed by a Eurostat decision on this issue. This decision was necessary in terms of reporting under the *Stability and Growth Pact*. The question concerned the treatment of future payments under a PPP contract and whether these should be accounted for upfront within the General Government Balance (which, under the terms of the Pact cannot exceed 3% GDP)

Eurostat determined that in the case where both the construction risk and either the availability or demand risk was borne by the private partner, then the asset could be considered to be off balance sheet. This way, only the annual unitary payments are included in the general government balance as they are incurred every year.

It could be argued that this arrangement promotes the use of the PPP option, as it facilitates the delivery of key infrastructure without impacting on either government borrowing or the general government balance. The government, however, has stressed that the PPP option is favoured only when the PPP route can be shown to deliver better value for money than the traditional route.

1 mark per point up to maximum of (6)

(40)

Question 2

- (a) The recent Indecon Review of Local Government Funding, in common with all previous reviews on the topic, recommended that a greater proportion of local government funding be raised locally.

The advantages to such an arrangement would include:

- Less opportunity for fiscal illusion. When local taxpayers associate the payment of local taxes with the provision of local services, then they should value those local services appropriately and would be less inclined to over-consume them.
- It becomes easier to assess relative value for money across local authorities when local taxes comprise the primary source of funding for the provision of local services. Such competition should promote efficiencies in the delivery of those services.
- Allocative efficiency is improved when local authorities are in control of the public spending/ taxation mix. This is particularly true when service levels should differ according to local circumstances (eg. coastal areas vs. land-locked areas).

2 marks for any two relevant points up to a maximum of 4

The disadvantages associated with greater local autonomy in the delivery of local services include:

- An inequity might result whereby some local authorities are not in a position to fund even the most basic level of service (eg. in sparsely populated areas).
- Local provision might prove to be more expensive. This may be the case where central government co-ordination of service delivery is more economical due to economies of scale.
- Local authorities may be more unwilling to undertake service improvements (that involve higher public spending) when they are faced with funding most/all of the funding themselves.

2 marks for any two relevant points up to a maximum of 4

(8)

- (b) (i) Equity

Equity can be considered in two ways. Under the benefit principle, those who benefit more from local services should pay more in local taxation. If we are of the view that local businesses benefit more than domestic households, then the levying of commercial rates is justified and vice versa. We could argue that they roughly accord with the second equity principle of ability to pay, as those commercial enterprises with larger, more valuable properties pay higher rates.

- (ii) Accountability

Under the accountability criterion, the decision to provide local services should be taken in conjunction with the decision as to how to fund those same services. This principle should promote efficiency in supply. Under the present system, accountability is not strong. This is because rates are not the dominant source of local authority funding, providing only a quarter of total funding in 2004.

- (iii) Buoyancy
This principle refers to the buoyancy of the yield relative to economic activity. Ideally, the yield should increase in line with higher economic activity. The relationship between rates revenue and economic activity is somewhat loose. At some level, higher economic activity encourages more start-up business in an area. In reality, this is most likely subject to a significant time lag.
- (iii) Efficiency
A tax is efficient if it does not unduly distort economic activity. In this way, rates may be considered inefficient if they have a bearing on the decision regarding size of the (rateable) business premises. Given their scale, and given that they are one of several taxes levied on commercial entities, this is unlikely to be the case.

In respect of each criteria, 1 mark for an explanation of the criteria and 2 marks for the evaluation of rates

(12)

- (c) (i) Vertical equalisation seeks to redress the imbalance between local authority revenue-raising capability and local service provision. Although central government may decree that local authorities should provide for a certain minimum level of service provision, they do not match that requirement with revenue-raising power. Rather, they usually choose to retain tax-raising power centrally. Thus, a grant mechanism is necessary to make up the shortfall between the need for local service provision and local revenue sources. 3
- (ii) Horizontal equalisation seeks to redress the imbalance across local authorities. While local authorities may be charged with the same (equal) level of service provision, some may find that, due to the demographic structure of the authority area, that they need different types/ levels of taxation to raise the same level of revenue. This may occur where there is a larger proportion of non-earning residents (eg. children/ pensioners) in the population. If left uncorrected, residents in some authority areas will find that they have to pay much higher levels of tax than their counterparts in other areas. Central government will usually strive to allocate more central government funding to those areas where the tax base is lower. 3

(6)

- (d) Matching grants are payable on condition that the recipient matches the level of grant with their own resources. They are normally conditional on (a) being matched by local revenue and (b) on being spent on a particular area. They are considered appropriate when the paying authority wishes to direct the spending towards a certain area. This is because the receipt of the grant makes provision of that service relatively cheap from the recipient's point of view. For example if spending on service x is 100% matched by central government revenue, then additional spending on service x is half as expensive to provide as additional spending on service y. (4)

(30)

Question 3

- (a) The theory of Baumol's disease would suggest that improvements could be generated by investments that make government funded provision more technologically progressive; this would increase labour productivity and tend to reduce the growth of the unit labour costs of such provision. However, one would need to monitor the effect of introducing more technology into such provision upon the quality/effectiveness of service delivery. 3

Secondly supply side theory would suggest that this could be achieved by the extension of commercial incentives to efficiency and effectiveness such as the extension of profit motives and competition. This could involve the introduction of both greater user choice and price mechanisms and similar commercial incentives as has been the case with the Casemix system within the health service. 2

Thirdly theory suggests that weakening the power and ability of politicians and civil servants to reflect their self interested agendas and policy decisions could increase efficiency and effectiveness. This could be achieved by systems of greater accountability being introduced into both the civil service and parliament. 2

1 mark per point, up to the maxima shown for each theory and an overall maximum of (7)

- (b) The main theories are as follows:

- Most developed economies are experiencing an ageing population ie growth in the percentage of the population over 65. This has led to an increase in the demand for services such as healthcare, social services and pension provision. For example, concerning health care, it is estimated that annual health care provision costs on average six times more for a person over 65 than for one aged less than 65. 3
- Economic theory suggests that some public sector provision consists of 'luxury goods' ie goods whose demand grows more than proportionately as a country's income grows eg education. Consequently as national income grows over time demand for such provision grows significantly. 2
- Most countries experience urban development over time; it is held that this can lead to increased demand for public expenditure to counter its side-effects such as increased crime and the effects of more congested living space. 2
- The theory of 'fiscal illusion' suggests that voters underestimate the cost of public provision either because they do not understand the complex tax system or because some of the tax they pay is 'hidden' eg VAT. This is compounded by much public provision being subsidised or free at point of use. Underestimating the cost of public sector provision leads to people voting at elections for parties with more generous expenditure plans than would have been the case had they been appreciated the true costs of provision. 3

1 mark per point, up to the maxima for each theory and a maximum of (10)

- (c) (i) Other things remaining equal, reduced long term borrowing by European governments should lead to downward pressure on European interest rates. This in turn is likely to lead to:
- Increased borrowing and reduced saving, increasing expenditure; this will tend to lead to increased levels of economic activity generally impacting upon output, income and employment. Inflation may also rise as a result of increased economic activity and higher levels of employment.
 - Reduced European interest rates will tend to reduce inward financial investment, thus reducing the demand for the Euro; this will lead to a currency depreciation making imports more expensive and exports cheaper. This is likely to improve the balance of payments and further encourage economic activity.
- (ii) Reduced rates of income tax are, according to supply side theorists, likely to reduce the disincentive effects of the tax upon the desire to work hard to gain promotion or work overtime and to reduce the incentive to emigrate to more favourable income tax regimes. In addition reduced rates of income tax are likely to reduce the automatic stabilisation effect of income tax.
- (d) Achievement of the deficit rule, i.e. that the general government deficit should not exceed 3% of Gross Domestic Product should be easier with less government debt. This is because less government debt means lower servicing costs. Reduced long term borrowing means less growth in Public Sector Debt which makes the debt limit, i.e. that general government debt should remain below 60% Gross Domestic Product easier to achieve.

5

3

(8)

1 mark per point up to maximum of (5)

(30)

Question 4

- (a) Road space is a scarce commodity; currently it is provided free at point of use, which according to economic theory, is likely to lead to excess demand for it. Consequently charging for road space is a means of rationing demand.

A further rationale for charging is the fact that driving on the roads generates negative externalities (eg exhaust fumes). While this could be countered by taxation to make the polluter pay (eg road tax, excise duty on fuel etc) road charging offers more opportunity to relate the amount paid to the extent of usage. Finally, of course, road pricing can produce a significant stream of revenue that can be used, if desired, to fund further transport related expenditure.

1 mark per point up to maximum of (5)

- (b) Public goods have two characteristics, they are:

- Non-excludable, ie use by one person does not exclude use by others.
- Non-depletable, ie use by one person does not deplete the amount of benefit available to others.

It is agreed that this may lead to an incentive to be a 'free rider' ie people may refuse to pay charges for such services knowing that failure to do so would not lead to exclusion from or depletion of benefit. Consequently, any price based attempt to raise revenue for the provision of such products is likely to lead to a financial shortfall and/or undersupply.

1 mark per point up to maximum of (5)

- (c) Redistribution - this rationale seeks to respond to the perception that an unequal distribution of income and wealth is generating unfair economic outcomes. Government activity within this rationale, which involves taxation, includes:

- Provision of some goods and services, proportionately bought in greater quantities by poorer people, on a subsidised or free at point of use - typically financed by taxation.
- Implementation of taxes upon income, wealth etc., which are progressive ie the proportion of the tax base paid as tax increases as the tax base itself increases eg income tax.

Stabilisation of fluctuating economic activity is an additional rationale for government intervention via taxation.

Increases in tax receipts during economic upswings and declines during economic downturns contribute to the stabilisation of economic activity, along with corresponding movements of government expenditure in the opposite directions.

This stabilisation effect of taxation is accentuated by progressive income tax structures.

1 mark per point up to maximum of 5 for each rationale up to an overall maximum of (10)

- (d)** Efficiency; an efficient tax is a tax which minimises its effects upon people's choices and behaviour. As is well documented, income tax, at least when levied with high marginal rates of tax, has been considered to be inefficient by supply side economists, who see such rates as generating a disincentive to work.

Equity; this can be defined in two ways:

- Equity in relation to means – the more progressive is an income tax structure the more it scores well against this criterion.
- Equity in relation to benefits received – in the absence of hypothecation it is hard to evaluate income tax against this criterion. However, generally, as many benefits from and elements of government provision are received disproportionately by those on low incomes, income tax scores poorly against this criterion.

Simplicity and low administration cost: this includes both administrative costs for government and compliance costs for others; income tax would score generally moderately but compliance costs fall on both employers via PAYE and employees and the self-employed via self assessment.

Certainty: ie people can forecast their tax liability in different circumstances with a high level of confidence with fairly small predictable changes in allowances with marginal rates. Income tax performs quite well here.

Up to 2 marks for each criterion/sub-criterion up to a maximum of (10)

(30)