

PUBLIC POLICY AND TAXATION

Professional 2
June 2002

MARKING SCHEME

The logo for CIPFA, consisting of the letters 'CIPFA' in a serif font. The letter 'I' is stylized with a decorative flourish that loops over the top of the 'P'.

Question 1

(a) **Fiscal Policy**

It involves management of the UK economy through taxation and public spending. *1*

It is the UK Government (largely the Treasury/Chancellor of the Exchequer) that determines fiscal policy. *1*

It is associated with demand-management (Keynesian) policies whereby governments intervene in the economy to correct such problems as high unemployment, balance of payments deficits and budget deficits. *1*

Since the early-1980s, however, the role of fiscal policy has effectively been “relegated”/limited to securing a balanced budget over the medium term. *1*

Monetary Policy

It involves management of liquidity and inflation in the UK economy through the adjustment of interest rates. *1*

It is the Bank of England, through its Monetary Policy Committee, that manages monetary policy, independent of Government influence. *1*

Historically, all governments have pursued monetary policies. Such policies have, since the 1970s, become inextricably linked with supply-side policies which aim to create a free-market, low inflation environment for private sector organisations. *1*

Since the early-1980s, monetary policy has become the dominant tool of UK economic management. *1*

(8)

(b) **Direct Taxation**

Direct taxation is where the incidence of tax is on individuals or organisations. *1*

Examples include income tax, capital gains tax and corporation tax. *1*

Direct taxes are administered by the Inland Revenue. *1*

Indirect Taxation

Indirect taxation is where the tax falls on goods and services where the formal incidence of tax is different to the effective incidence of tax. 1

Examples include VAT and excise duties on petrol. They are formally turnover taxes payable by business but effectively (since the taxes are passed on to customers), they are borne by these who buy the goods and services from the businesses. 1

Indirect Taxes are administered by HM Customs and Excise. 1

(6)

- (c) Progressive taxes tend to be direct taxes such as UK income tax. They are progressive because the average rate of tax payable increases as income rises. 1 ½

There are two reasons why income tax is progressive. Firstly, tax allowances account for a larger proportion of a poor person's income than a rich person's. Secondly, above certain levels of income, higher marginal rates of tax have to be paid. 1 ½

Regressive taxes tend to be indirect taxes such as UK VAT. They are regressive because the average rate of tax falls as income rises. (ie the proportion of income or wealth paid in tax falls as the amount of income or wealth rises) 1 ½

The reason for this is that the rich tend to spend a smaller proportion of their income than the poor. The poor cannot afford to save, the rich can. 1 ½

(6)

- (d) The argument relates primarily to the UK's freedom to manage the economy through monetary policy. The argument concerns the loss of freedom of the Bank of England and the MPC (rather than the Government) to exercise this freedom. UK membership of the Eurozone would mean that the European Central Bank (ECB) rather than the MPC of the Bank of England would set UK interest rates. 2

The freedom of the UK government to manage the economy through fiscal policy will be relatively unaffected by Eurozone participation. However, the principle of economic convergence amongst Eurozone members places limitations on the maximum size of budget deficits (as percentages of GDP) and thus on fiscal policy options. 2

Some of the core Eurozone members (notably Germany) are advocating much more centralized EU management of Eurozone members' fiscal policy in the long run. 1

(5)

Question 2

- (a) Definition: A pressure group is any organisation (normally working through lobbying rather than standing for office) that seeks to influence public policy and decisions at local, national, EU or international levels, usually within a particular, quite limited sphere. 2

Pressure groups, unlike political parties, do not normally contest elections. 1

On those occasions when pressure groups do contest elections, it is not usually with the aim of forming a government. Instead, the aim is normally to make a political point by indicating the level of public concern on an issue (eg the environment) or by drawing support away from the government on a key issue (eg Sir James Goldsmith's Referendum Party). 2

Pressure groups typically have narrower concerns than political parties. They generally contribute selectively to the political debate from a particular standpoint or in a specific field of concern. They do not adopt a comprehensive programme which seeks to cover the entire field of politics, as political parties do. 2

(7)

- (b)

- (i) Distinction in terms of what the groups represent:

Sectional groups

Exist to further/protect the interests of people engaged in certain professions, trades and occupations. Membership is limited to those with a shared "economic" interest. 1

One example needed (eg TUC, CBI, BMA, NUT, etc). 1

Cause groups

Exist to further some belief, attitude or principle that generally promotes public welfare as perceived by the membership. Membership is open to all sharing the same attitude, ideology or principal. 1

One example needed (eg Greenpeace, Child Poverty Action Group, Amnesty International, BMA). 1

The distinction between cause and sectional groups is not absolute. Some pressure groups may be both (eg the BMA which promotes the economic interests of doctors but also campaigns on more general health issues (eg smoking, alcohol)). 1

(5)

- (ii) Distinction in terms of the groups' strategies and relations with government:

Insider Groups

Are consulted regularly by government. 1

One example needed (eg MENCAP, Howard League for Penal Reform). 1

Outsider groups

Either do not wish to become closely involved with government or are unable to gain government recognition. 1

One example needed (eg Animal Rights Group). 1

The distinction between insider and outsider groups is dynamic, with insiders becoming outsiders and vice versa. The insider/outsider groups cut across the sectional/cause distinction. Both cause and sectional groups can, for example, be insider groups but not all sectional/cause groups are insider groups. 1

(5)

- (c) *Candidates are not expected to recall all of the following arguments in order to gain the maximum 8 marks. Appropriate credit should be given for arguments presented by candidates but which are not included amongst the examples annotated below.*

Examiners must display pragmatism when marking this section. A good answer will be a balanced account that:

(i) *Contains at least 3 significant reasons why pressure groups distort democracy.*

(1 mark each up to a maximum of 3 marks)

(ii) *Contains at least 3 significant reasons why pressure groups enhance democracy.*

(1 mark each up to a maximum of 3 marks)

(iii) *Contains a clear expression of the candidate's view about whether or not pressure groups distort democracy.*

(Maximum of 2 marks)

- (i) **Arguments that pressure groups enhance democracy** *(Maximum of 3 marks)*

PGs increase **participation in and access to political system** – they complement and supplement electoral democracy by providing a mechanism through which electors can influence government between elections and by enabling the intensity of feeling on issues to be considered and opinion to be weighed.

PGs **improve government** by providing a mechanism for consultation between government and affected groups. It makes government more efficient by enhancing the quality of information made available to government and thus the decision making process.

Pluralism. PGs are a product of freedom of association, a fundamental principle of democracy. Freely operating PGs are essential to the effective functioning of democracy by serving as intermediary institutions between government and society, assisting in the dispersal of political power; and by providing an important counterweight to government power.

PGs promote **Social progress** by enabling new concerns and issues to reach the political agenda.

PGs increase **Social cohesion** by providing a safety valve outlet for individual and collective grievances and demands.

PGs promote **Opposition** to government by exposing information that otherwise might be kept secret. In this way, they improve the accountability of decision makers to the electorate.

- (ii) *Arguments that pressure groups distort democracy.* (Maximum of 3 marks)

PGs promote **sectionalism and selfishness** – they benefit the well organised, but disadvantage the weakly organised. In this sense they work against the public interest.

PGs promote **anti-parliamentary democracy.** PGs and government form behind-the-scenes networks and policy communities that engage in consultation that is not in the public domain. Also many groups themselves are dominated by their leaders, giving their membership little opportunity for effective participation.

PGs reinforce existing class and power structures and, hence, **elitism.**

PGs promote **pluralistic stagnation** by slowing down or blocking desirable change.

PGs can increase **Social disharmony and dislocation** by intensifying the feeling of social frustration/injustice felt by disadvantaged and excluded sections of society.

PGs mount **Ineffective opposition** against government because, in the secretive UK political system, they generally lack adequate information.

- (iii) *Candidate's view about whether or not pressure groups distort democracy.*

To gain the maximum mark, a candidate's view must be clearly expressed and be consistent with the arguments already presented in 2(c).

(Maximum of 2 marks)

(8)

(25)

Question 3

(a) (i) Selflessness – decisions should reflect only public-interest considerations. 1

Integrity – holders of public office should not place themselves under any financial/other obligation that might affect the performance of their public duties. 1

Objectivity – when carrying out public business, holders of public office should make choices based solely on merit. 1

Accountability – public office holders are accountable for their decisions and actions, and are open to public scrutiny. 1

Openness – public office holders must be as open as possible about all of their decisions and actions – such information should only be withheld when to do so is clearly in the public interest. 1

Honesty – public office holders must declare any private interests relating to their public duties and take steps to resolve any conflicts that arise between their private interests and public duties. 1

Leadership – holders of public office should support and promote these principles by example and leadership. 1

(7)

(b) (i) *This part requires the candidate to evaluate the impact of marketisation and privatisation policies. This is a politically sensitive and thus subjective issue where there is no simple right or wrong answer, and where there are likely to be significant differences in candidates' answers. All candidates need to show an understanding of the aims of efficiency and effectiveness (maximum of 2 marks). Beyond this, examiners are required to use their discretion and to award credit for all well argued answers, regardless of whether or not they are included amongst the examples below, up to a maximum of 7 marks.* (9)

Efficiency – refers to the cost of a service relative to its output (unit costs of production). 1

Effectiveness – refers to quality considerations and the extent to which organisations satisfy customer needs and wants. 1

The results of privatisation and marketisation have been mixed.

Media emphasis tends to focus on problem areas (eg the railways). But some of the difficulties of problem areas have little to do with privatisation (eg Railtrack problems are largely due to its inheritance of a railway infrastructure that had been seriously neglected whilst in public ownership).

Media tends to give relatively little attention to successful areas (eg public utilities have made huge gains in efficiency, though this has been at the expense of shedding 180,000 jobs).

Some sectors that have improved their efficiency have failed to also improve their effectiveness (eg bus deregulation has significantly improved efficiency, achieved largely via withdrawal of conductors from buses – but this often slows buses' progress along routes, makes other traffic slower, and increases passengers perception of their exposure to threats of theft/violence/etc from other passengers).

Since privatisation, consumers have paid less for gas, electricity and telephones in real terms (but was this to do with privatisation or more to do with falling oil prices and technological advances?). Since privatisation, water bills have risen by one-third in real terms (was this because of privatisation or because of the ageing/inefficient system prior to privatisation?).

Perceived problem of “snouts in the trough”/“fat cats” (CEOs of privatised organisations). Connected with this is the huge shareholder gains when on-selling privatised companies (eg Eversholt Leasing sold two years after privatisation for twice its original price).

Fears that old public sector monopolies (especially utilities) are being replaced, through the process of Merger and Acquisition (M&A), by new private sector monopolies. In such instances, the regulatory system (in particular, the Competition Commission and/or the Secretary of State) often seems reluctant to interfere with these moves (through M&A) towards private sector monopolies and their associated potential efficiency gains.

7

(9)

- (ii) Basic argument is that regulation is a necessary evil. It is needed to correct market dysfunctions. For example, some companies may be natural monopolies while others (eg City financial institutions) might fall prey to unscrupulous use of information advantages such as insider dealing (information asymmetries).

2

- (iii) *There is a wide variety of potential answers to 3 (b) (iii). Examiners must be flexible and give credit for relevant issues not in the following marking scheme. Such issues might include regulatory capture, problems of self regulation, weakness (in terms of sheer size) of regulators relative to the organisation they regulate.
Maximum of 3 marks per well argued issue – overall maximum of 7 marks*

Regulation has a poor record in preventing fraud and scandal.

Bank of England failed to prevent depositor losses with BCCI.

Barings collapsed with huge debts.

IMRO failed to prevent Maxwell from plundering Mirror Group pension fund.

Utility regulators have been ineffectual.

Unable to enforce compliance or effectively punish.

Utility regulators have “tunnel vision” when deciding what is in the public interest.

Insistence on promotion of competition has resulted in short-term advantage (the “dash for gas” in energy, for example) over long-term benefits (coal resources).

(7)

(25)

Question 4

(a)

	£	£	
Net profit per accounts		442,600	
<i>Less: Non-trading income:</i>			
Debenture interest	11,250		½
Dividends received	30,150		½
Profit on sale of building	50,000	91,400	½
	<hr/>	<hr/>	
		351,200	
<i>Add: Disallowed expenses:</i>			
Loss on sale of computer	1,600		½
Depreciation	42,700		½
Bad debts (£500 + £3,200)	3,700		½
Patent royalties	8,600		½
Legal costs	3,500	60,100	½
	<hr/>	<hr/>	
		411,300	
<i>Less: Capital allowances:</i>			
Industrial buildings (W1)	(22,000)		2
Plant and machinery (W2)	47,630	25,630	3
	<hr/>	<hr/>	
		385,670	
Schedule D Case I		11,250	½
Schedule D Case III		12,400	2
Chargeable gain (W3)		<hr/>	
		409,320	
<i>Less: Charges</i>		5,000	½
PCTCT		<hr/>	
		404,320	
FII £30,150 x 100/90		33,500	1
Profits		<hr/>	
		437,820	
£404,320 @ 30%		121,296	
<i>Less: Marginal relief</i>			
1/40 x (£1,500,000 - £437,820) x (£404,320/£437,820)		24,523	
Corporation tax due 1 January 2002		<hr/>	3
		96,773	(16)

Workings

W1 IBA's	£
Cost in y/e 31/3/1995	110,000
WDA @ 4% y/e 31/3/1995 and 1996	8,800
	<u>101,200</u>
Notional WDA y/e 31/3/1997	4,400
	<u>96,800</u>
WDA @ 4% y/e 31/3/1998 to 2000	13,200
WDV before sale	<u>83,600</u>

The building was sold for more than original cost and the balancing charge is restricted to the allowances actually given ie £8,800 + £13,200 = £22,000.

W2 Plant and machinery		Main pool	Shortlife asset 1	Shortlife asset 2	Expensive car	Total
	£	£	£	£	£	£
WDV b/f		123,200	4,130			
Acquisitions					20,000	
Disposals			2,300			
Balancing allowance			<u>1,830</u>			1,830
WDA @ 25%		30,800				30,800
WDA (restricted)					3,000	3,000
		<u>92,400</u>				
Acquisitions	18,000			12,000		
FYA @ 40%	<u>7,200</u>	<u>10,800</u>		<u>4,800</u>		12,000
WDV c/f		<u>103,200</u>		<u>7,200</u>	<u>17,000</u>	
Total allowances						<u>47,630</u>

W3 Chargeable gain	£
Disposal proceeds	250,000
Cost	200,000
	<u>50,000</u>
<i>Less: IA</i>	
(171.1 – 144.0)/144.0 = 0.188	
0.188 x £200,000	37,600
	<u>12,400</u>

(b) Trading losses may be:

- Carried forward under s393(1) and set against first available profits arising from the same trade in future accounting periods. 1
- Under s393A(1)(a), set against total profits of the loss-making accounting period, before deducting charges. 1
- Under s393A(1)(b), set against total profits of the previous 12 months (after deducting trade charges but before deducting non-trade charges) so long as a claim has already been made under s393A(1)(a) and part of the loss remains unrelieved. 1

Factors to consider when planning how to utilise the loss include:

- The expected amount of future profits (if any) arising from the same trade.
 - The rates of corporation tax payable by the company in the loss-making period, in the previous 12 months and in future periods (expected rates).
 - The company's cash flow situation (which may dictate that loss relief should be obtained as soon as possible).
 - The possibility that non-trade charges may be unrelieved.
 - The need to maximise the tax saved via loss relief claims. 3
- (6)

(c)

- Instalments are generally payable by companies which pay corporation tax at the full rate without any deduction for marginal relief. 1
- A company which pays tax at the full rate but which has a tax liability of less than £10,000 or has PCTCT not exceeding £10 million (and was not a large company in the previous 12 months) is exempt from paying instalments. 1/2
- Instalments are based on the company's own estimated CT liability. Interest arises on overpaid or underpaid instalments. 1/2
- For a 12-month accounting period, there are 4 equal instalments, payable on the 14th day of the 7th month of the AP and then at 3-monthly intervals. 1/2
- For AP's ending between 1 July 2000 and 30 June 2001, 72% of the liability is payable by instalments. This will rise first to 88% and then (by 1 July 2002) to 100%. 1/2

(3)

(25)

Question 5

(a)

	£	£	
Salary		50,000	
Bonus		4,570	1/2
Car 1:			
£18,720 @ 15% x 5/12		1,170	1
Fuel £2,170 x 5/12		904	1
Car 2:			
£19,680 @ 25% x 7/12		2,870	1
Fuel £3,200 x 7/12		1,867	1
Parking space		-	
Employer pension contributions		-	
Lunches 230 x £5		1,150	1
Loan of computer (benefit less than £500)		-	
Loan of camera £900 x 20%		180	1
BUPA subscription		540	1/2
Workplace gymnasium		-	
Personal loan £2,800 x 4.25%		119	1
Mortgage £70,000 x 3.25%		2,275	1
Staff suggestion scheme award		-	
CIM subscription paid by company		300	1/2
		65,945	
<i>Less: Expenses</i>			
CIM subscription	300		
Clothing	-	300	1/2
Schedule E assessment		65,645	

*(Up to 2 marks awarded for statements re non-taxable amounts)
Maximum (10)*

(b)

	£	
Class 1 contributions (Drothy):		
(£27,820 - £3,952) x 8.4%	2,005	1/2
Class 1 contributions (Company)		
(£27,820 - £4,385) x 9.2%	2,156	
(£54,570 - £27,820) x 12.2%	3,263	
	5,419	1/2
Class 1A contributions (Company)		
(£65,945 - £54,570 - £300) x 12.2%	1,351	1
		(2)

(c) Tests which distinguish between employment and self-employment:

- Control.
- Financial risk.
- Provision of equipment.
- Work performance and correction.
- Holidays and sickness.
- Exclusivity.

½ mark for each with further 1 mark for explanation 4

Benefits of self-employed status include:

- Wider range of expenses deductible under Schedule D Case I than under Schedule E. *1*
- Later payment of tax under Schedule D Case I. *1*

(6)

(d) The main pitfall is that the arrangement may fall foul of the IR35 legislation. Main features are as follows:

- Concept of a “relevant engagement”. *1*
- IR35 does not apply if individual receives all income from the intermediary in a form which is taxable under Schedule E and has no right to further income or capital. *1*
- Deemed Schedule E payment on last day of tax year is subject to both income tax and NIC’s. *1*
- Intermediary’s allowable expenses include a flat-rate 5% of income. *1*
- Deemed salary paid out as a dividend is not assessable under Schedule F. *1*

The main benefits include:

- Corporation tax rates are lower than income tax rates. *1*
- Dorothy may choose when and how (salary or dividends) value is extracted from her company and make choices which minimise her tax liability. *1*

(Up to 3 marks awarded for general pros and cons of self-employment)

(Maximum 7)

(25)

Question 6

(a)

- *Correction of market imperfections* in the provision of goods and services: 1
 - Explanation of such imperfections and why they exist. 1
 - Concept and examples of public goods. 1
 - Concept and examples of merit/demerit goods. 1
 - Concept and examples of external benefits/costs. 1
 - Idea of government intervention to correct market imperfections. 1

- *Redistribution of wealth*: 1
 - Need for redistribution. 1
 - Role of charity and taxation. 1

- *Stabilisation of the economy through fiscal policy*: 1
 - Use of taxation as a tool for managing the economy and influencing the level of economic growth. 1

(11)

(b)

- Explanation of the concept of a user charge. 1
- Examples of user charges. 1
- Enhanced public accountability. 1
- Difficulty in ensuring payment of non-compulsory user charges. 1
- “Free rider” problem. 1
- Difficulty in collecting user charges for public goods. 1
- Regressive nature of user charges. 1

(7)

(c)

	£	£	
<i>Output tax:</i>			
Fees £39,000 @ 17.5%		6,825	<i>1/2</i>
Rents (exempt)		-	<i>1/2</i>
Fuel scale charge		35	<i>1</i>
		<u>6,860</u>	
<i>Input tax:</i>			
Attributed to taxable supplies:			
£7,680 @ 17.5% x 39,000/41,600	1,260		<i>1</i>
Attributed to exempt supplies			
£7,680 @ 17.5% x 2,600/41,600 (< £625 per month)	<u>84</u>	1,344	<i>1</i>
Payable to HM Customs and Excise		<u>5,516</u>	<i>(4)</i>

(d)

- No problem if all of the items are chargeable to VAT at the same rate. *1*
 - Otherwise (*mixed supply*) need to apportion the value of the supply between its various elements and apply appropriate rate of VAT to the value of each element. *1*
 - If this apportionment is not possible (*composite supply*) the supply as a whole is considered in order to determine the applicable rate of VAT. *1*
- (3)*
- (25)*