



GOVERNANCE AND PUBLIC POLICY

Diploma stage examination

8 June 2006

MARKING SCHEME



Question 1

- (a) (i)** Monetary policy involves management of liquidity and inflation in the UK economy through the adjustment of interest rates. 2

The Fisher equation is $MV=PT$
M = volume of money supply
V = velocity of money circulation
P = price level
T = number of transactions

Fisher claimed that V and T were always constants.

Therefore there is a direct linkage between the volume of money in circulation and the price level (ie inflation). 2

(4)

- (ii)** It is the Bank of England (BoE), through its Monetary Policy Committee, that decides upon monetary policy, though it is the government that sets policy targets (currently an HCPI target range of 2%). 2

Prior to the 1998 Bank of England Act, it was the Treasury/Government that set both the inflation target and interest rates. The change took place to remove "political considerations" from decisions about monetary policy. 2

(4)

- (iii)** Since the early 1980s, the role of monetary policy has become more important as a tool of economic management than fiscal policy. This reflects the priority that the UK and most other developed countries give, as part of a broader supply-side policy, to keep inflation under control. Given the perceived link between money supply and inflation, such control is seen as being best achieved by influencing the supply of money through interest rates. 2

In the UK the role of fiscal policy has effectively been "relegated"/limited to securing a balanced budget over the medium-term. However, the current "New Labour" government has, to some extent, re-instated the traditional role of fiscal policy by massively increasing public spending in the early years of the 21st century in order to stimulate economic activity. 2

(4)

- (b) (i)** Reduces a country's international competitiveness, thus tending to contribute to the balance of payments problems. 1

Reduces the real value of fixed incomes such as pensions. 1

Can reduce investor confidence and investment as high inflation makes investors uncertain about the real value of future returns. 1

(3)

(ii) Subject to other economic conditions, you would normally expect the MPC to raise interest rates. 1

But the MPC is also required to support the government's growth and employment objectives; if growth or employment were problematic, then the MPC might delay an inflation-busting rise in interest rates. 1

(2)

(iii) The problem with too-low inflation (and especially deflation) is that it reduces consumer price expectations and delays consumer purchases, thus dampening the pace of current economic activity. 2

In extreme circumstances (such as those seen in recent years in Japan), this can lead to recession. 1

(3)

(c) (i) Interest rates are a major influence on exchange rate levels (generally higher interest rates lead to a stronger currency and vice versa, but other factors may interfere with this normal relationship). 1 ½

If inflation is the major policy target, then interest rates will normally be the major policy tool that is employed. But, as mentioned above, you cannot be sure that a higher interest rate will lead to stronger exchange rate and vice versa. 1 ½

A choice, therefore, has to be made – either target inflation, through interest rate management, or target the exchange rate through interest rate management. Governments/monetary authorities cannot expect to successfully target both of these variables simultaneously. 1

(4)

(ii) Exchange rate movements are monitored because:

A strengthening exchange rate will reduce imported inflation, but it will make UK exports less price competitive and thus detract from growth and employment prospects. 1

A weakening exchange rate will increase imported inflation, but it will make UK exports more price competitive and thus improve growth and employment prospects. 1

The impact of exchange rate movements on inflation may be offset/reduced/exaggerated by degrees of competition and price elasticity of demand. 1

Exchange rate volatility can also impact on foreign investor confidence in the UK. 1

(4)

In part (d), award up to 2 marks for each relevant point well made, subject to overall maximums of 11 marks in (d) (i) and 11 marks in (d) (ii)

- (d) (i)** Short-term market interest rate expectations, with a 0.25 percentage point rate cut priced in for this month's decision, a strong expectation of a second rate cut later in the year and the possibility of a further reduction in early 2006, but it was important not to attach too much weight to the market's central expectation.

Economic developments in the euro-area had seemed slightly more encouraging and, looking ahead, pointed to a moderate recovery in growth.

The oil price had risen around 5% over the past month, and was just over 20% higher than its level at the time of the *May Inflation Report*. Existing spare oil production capacity was historically low and new supply capacity – through, for example, development of new oil and gas fields and building of refineries – would take a considerable time to come on-stream in response to expectations of sustained higher prices. Continued robust expansion of world activity was unlikely to be consistent with a significant easing in the growth of oil demand.

The preliminary estimate of UK GDP growth was 0.4% in 2005 Q2, a little weaker than expected. Official estimates of GDP growth had now been below trend for four consecutive quarters, although such early estimates were highly uncertain.

Investment intentions had fallen in both manufacturing and services. That picture had been broadly corroborated by the latest business surveys. This softer outlook had been factored into the Committee's near-term projections for investment.

There had not been much labour market news on the month, but the data still seemed consistent with a gentle labour market loosening since the turn of the year. That was, in turn, consistent with below trend output growth over the past few quarters.

Average earnings growth, as measured by the average earnings index (AEI), had eased a little since the start of the year.

The fall in input and output price balances across a range of manufacturing and services surveys over recent months had been striking, leaving many close to their series averages.

The balance of risks for activity was slightly to the downside in the near-term.

(11)

- (ii)** The sterling ERI had depreciated by 1% over the month, and had fallen by more than 3% since the *May Inflation Report*. That was one of the largest changes in the exchange rate between *Inflation Reports* since the Committee's inception in 1997. The recent depreciation could be explained only partly by movements in relative interest rates. It was possible that it reflected further reaction to previous soft UK data releases and changing views about monetary policy.

Equity prices had increased over the past month in the United Kingdom, the United States and the euro-area.

Economic developments in the euro-area had seemed slightly more encouraging and, looking ahead, pointed to a moderate recovery in growth. Industrial confidence had picked up a little in the larger euro-area economies, and both the manufacturing and services purchasing managers' indices had risen a little in July. Employment was growing moderately, and bank lending to private non-financial companies had picked up.

In the United States, GDP growth in 2005 Q2 had been in line with expectations. Most indicators for consumption, investment, and the labour and housing markets suggested that prospects remained firm. Both core producer and consumer price inflation had eased in June.

Overall, there were some mildly encouraging signs in the UK's primary export markets, consistent with continuing steady growth in world demand. Corroborative evidence of this view came from the rise in equity prices and from the Bank's regional agents, whose contacts reported an improvement in export prospects.

The survey indicators in July had been mixed, but had not shown signs of a further slowing of GDP growth in Q3. Overall, the indicators had pointed to service sector growth in Q3 at around the same rate as in Q2, and flat manufacturing output.

Turning to consumption, retail sales had bounced back strongly in June. Anecdotal evidence suggested that sales might have been boosted by protracted discounting, although the series itself was an erratic one. Retail sales data, coupled with a modest recovery in private car registrations, had pointed to stronger consumption growth in Q2.

CPI inflation was on target at 2.0% in June, a little higher than expected. The oil price was likely to have played a sizable role and looked set to do so for some time given the continued rise in oil prices. The pressure of demand on supply in early 2004 was also likely to have played a significant role in the rise in inflation towards the target.

The central projection for CPI inflation, on the market-based assumption about the path of official interest rates, was for it to move above the 2% target in the near term and then to dip, as the impact of recent increases in oil prices moderated and pressures on capacity eased. Inflation was then projected to rise above the target once more, as output growth picked up and the contribution from import prices increased. The central projection was a little higher in the near-term, and also somewhat higher in the final year of the projection, than in the May *Inflation Report*.

The balance of risks to inflation was correspondingly slightly on the downside, in the longer term.

(11)

(50)

Question 2

- (a) *The principles applicable to the case are shown in bold. 1 mark for each principle identified and explained, up to a maximum of 6. 1 mark for each principle identified as being relevant to the case, up to a maximum of 4.*

Integrity

It is essential for members to retain a reputation for: integrity, honesty, trustworthiness, fair dealing and truthfulness (is it appropriate for the new accountants to report on a subject that directly affect them).

Objectivity

Decisions should be based on available evidence and not on personal opinions or prejudices (should the new accountants disqualify themselves from the new benefits package?).

Competence and Due Care

Members should not agree to carry out tasks for which they are not competent (do the new accountants have the necessary skills to draw up the package?).

Confidentiality

Members must respect the confidentiality of information about an employer's or client's affairs.

Proper Conduct

Members must not engage in conduct that would prejudice public confidence in their professional capacity (should the new accountants be involved in meetings that discuss their personal situations?).

Technical and Professional Standards

Must comply with standards set by CIPFA, IFAC, Parliament, Accounting Standards Board, etc.

(10)

(b) Suggested Course of Action

There is a case to be made for the team not to be involved in the report's authorship at all, but assuming that this option has been rejected, the following course of action is suggested.

The team needs to provide a comprehensive report that clearly sets out the full implications, costs, benefits and tax implications, which apply.

The team should take professional human resource advice to ensure that the report is based on sound human resource management principles in addition to financial considerations.

The report should provide an assessment of the likely effect the new benefits package is expected to achieve, so the board can form its own view on the value for money to be attained.

The report should clearly declare the team’s personal interest in the matter and should be a joint report from the team and the head of human resources. With respect to the team’s personal position it should ask the head of human resources to write this aspect of the report. The report should also recommend to the board that, in future, such matters should be dealt with by a remuneration committee.

Before the report is presented to the board, the team should ensure that the chief executive is fully aware of the issues and it’s personal interest. The team should ask the head of human resources or the chief executive to present the report to the board. The team should not be present at any meeting that considers the personal position of its members.

*1 mark for each relevant and reasonable point well made,
subject to an overall maximum of 6*

(c) The above course of action would enable the team to demonstrate:

Integrity, by:

- Asking the head of human resources to author that part of the report which affects it.
- Asking that officer or the chief executive to present the report.

1 ½

Objectivity, by:

- Recognising the conflict of interest and submitting a joint report to the board from the team and the head of human resources, setting out all the implications.
- Recommending that a remuneration committee be set up.
- Providing the board with continuing professional advice and information on the outcomes of the scheme.

1 ½

Competence and due care, by drawing on human resources expertise, both for the general benefits package and its specific application to members of the team.

½

Proper conduct, by being absent from any meeting when the team members’ personal cases are being considered.

½

(4)

(20)

Question 3

- (a) **Local government as agency for central government**, whereby local authorities simply implement/administer policies for central government. 1 ½

The central-local relationship is seen as a **partnership** with both sides working to common ends. Central government is invariably the more powerful partner, but local government is not totally subordinate as in the agency relationship. 1 ½

The **stewardship** model whereby central government, in the role of “master”, delegates considerable authority and discretion to local government. 1 ½

The **power-dependence model**. Here, each side has sources of power that it can exert against the other. The relationship is one of bargaining, exchange and negotiation. 1 ½

(6)

- (b) The principal arguments are:

Northern Ireland, Scotland and Wales receive more government spending per person. These figures are based on calculations made in the 1970s at which time Scots were, for example, on average much poorer than the English. Since that time, the two countries have become far more equal, yet the inequality in spending continues. 2

England should be treated like the three other countries. The fairest system would involve a federal system based on the three countries and a number of English regions. 2

Politicians of the three countries are able to vote at Westminster on internal English issues, but English MPs cannot vote on internal Scottish issues (eg the West Lothian question). 2

(6)

- (c) Devolution of government to Northern Ireland, Scotland and Wales has not eroded UK parliamentary sovereignty. 1 ½

Powers that are devolved are effectively retained by parliament and can (like devolution itself) be revoked at any time. 1 ½

(3)

(15)

Question 4

(a) Categories of Groups

Candidates are expected to select any 3 from the following list. One ½ marks (up to a maximum of 2 marks) for each category of group identified. 1 mark (up to a maximum of 4 marks) for a brief description of each selected category

Sectional or Interest 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 (eg TUC, CBI, BMA, NUT, etc.).

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 principle (eg Greenpeace, Child Poverty Action group, Amnesty International, BMA).

Insider Groups

Are consulted regularly by government (eg MENCAP, Howard League for Penal reform).

Outsider groups

Either do not wish to become closely involved with government or are unable to gain government recognition (eg Animal Rights Group).

New Social Movements

Are political organisations. Have broader concerns than many interest and cause groups, but are more loosely knit than political parties.

Episodic Groups

Are not normally political. But may become so when circumstances require (eg Rum Importers Association).

Fire Brigade Groups

Formed to fight a specific issue and dissolves when the issue is over (eg Anti-Poll Tax Federation).

Peak Associations

Are “umbrella” organizations that co-ordinate the activities of different pressure groups in the same area of interest (eg TUC, CBI, Amnesty International, Red Cross, Save the Children).

Crossbench Groups

Political groups that try to maintain party neutrality, knowing that they must deal with which ever party is in power. Their name derives from the crossbench (non-party) members of the House of Lords.

(6)

(b) Pluralism

Decision-making is a continuous process of interaction between a wide range of pressure groups and governing institutions. Groups have unequal resources, but no group becomes completely dominant because:

- Groups counterbalance each other (eg CBI/TUC)
- No group tries to influence more than a limited area
- Membership of groups overlaps

2

The large-scale expansion of cause groups since the 1960s supports the pluralist theory, but the model may be somewhat naïve about the issue of the real exercise of power.

1

Corporatism

A situation where consultation is limited to that between government and major sectional groups over economic policy. These pressure groups then implement or enforce agreements on economic policy and conduct.

2

It is limited as a general theory because it applies only to producer groups and to a fairly brief era that ended when Mrs. Thatcher came to office in 1979.

1

Policy Networks

Policy making is compartmentalized into a series of separate areas based in government departments, each of which has a distinct relationship with pressure groups. Government, together with institutions with interests in particular areas, constitute "policy communities" that co-operate on the development of policy.

2

This is the most accurate description of the current relationship between government and pressure groups in the UK.

1

(9)

(15)

Question 5

There are a range of possible answers to this question which, therefore, needs to be marked pragmatically. Below are examples of likely "answers" from most candidates. But credit should be awarded for alternative answers. The marking scheme allows a maximum of 1 mark for each well-made point, subject to an overall maximum of 8 marks for part (a) and 7 marks for part (b).

(a) Bureaucratic Approach

Advantages

- For managers it maintains hierarchical control structure and is relatively simple to operate.
- It helps government departments to maintain control.
- For customers/clients, spending plans can aim for quality of service nationwide.
- Relatively low cost to taxpayers of administering this simple system.

Disadvantages

- For managers, spending decisions tend to be made at the top of the hierarchy. Unspent funds lead to the reduction of future budgets. Funds are allocated on past performance rather than on future needs.
- For government departments, allocation is based on inputs rather than outputs, giving less incentive to improve efficiency.
- For clients/customers, quality of service may be poor.
- For taxpayers, there is little incentive for the quality of service to be improved.

(8)

(b) Market Approach

Advantages

- For managers, it devolves accountability, encouraging improvements in efficiency. May increase job satisfaction.
- Improves efficiency of government departments.
- Improves quality of service to customers/clients.
- Probably improves efficiency and reduces cost for taxpayers.

Disadvantages

- May increase managers' job-related stress. Needs management training, both in finance and management.
- For government departments, it highlights variable nature of service provision.
- For clients and customers, it may reduce the number of service providers.
- For taxpayers, fragmentation may increase overall administrative costs.

(7)

(15)