CIPFA

PUBLIC FINANCE

Diploma stage examination

13 December 2006

From 2.00pm to 4.00pm
plus ten minutes reading time from 1.50pm to 2.00pm

Instructions to candidates

*Answer **three** questions in total:*
One** compulsory question from **Section A
Two** of the three questions from **Section B

The question in Section A carries, in total, 40 marks
The questions in Section B each carry a total of 30 marks

Where a question asks for a specific format or style, such as a letter, report or layout of accounts, marks will be awarded for presentation and written communication.

AT THE HEART OF
YOUR CAREER

SECTION A (Compulsory)

1 Midheart City Council is considering extending its urban tramway into Hayley Heights, a densely populated residential area on the outskirts of the city. The financial implications of the proposal are considerable and the Director of Finance is currently considering the most appropriate means of financing the proposed project. After some months of discussions and negotiations two possible options remain for consideration. One is to borrow long-term from the capital markets. The capital cost of the scheme has been estimated to be £150 million. The fact that the council has long had a commitment to this and other ambitious capital schemes means that the required borrowing could be accommodated comfortably within the council's existing prudential indicators for capital expenditure.

The other option is to participate in a Private Finance Initiative for the design, build and operation of the extension. Preliminary discussions have been held with several potential partners, including the company that was responsible for the construction of the original tramway.

Not surprisingly the issue of the tramway extension has had a high profile in Midheart for some time with the local media devoting a good deal of attention to it. The council has promised to undertake a large-scale consultation exercise before any decision is made about its construction. The cabinet member responsible for the tramway has asked the Director of Finance for her views as to the most appropriate means of financing the scheme before a decision is made to proceed to consultation.

- **Requirement for question 1**

(a) Using an appropriate set of criteria, discuss the relative merits of funding the proposed tramway by means of long-term borrowing or a PFI arrangement. *17*

(b) If the PFI option were to be chosen, an exercise to allocate risks across partners would need to be undertaken.
(i) Give three examples of substantial risks within the tramway project that might need to be allocated between partners. *3*
(ii) What are the main actions concerning risk that should be taken by the partners during the negotiation and planning of a PFI project? *7*

(c) What are the main issues and challenges likely to face the council in the ongoing management of a PFI project if it decides to pursue that option? *5*

(d) If Midheart elected to borrow to fund the project it could raise the finance via a bond issue. In the context of such a bond, explain the following terms:
(i) par value *2*
(ii) coupon rate *1*
(iii) residual maturity *1*
(iv) redemption yield *2*

(e) If a government bond is issued with a purchase price of £98.50, a maturity of 20 years and a coupon interest rate of 5%, define and calculate its running yield. *2*

(40)

SECTION B (Answer two questions from this section)

2

Modern governments finance their expenditure primarily by means of taxation and borrowing. The relative amounts raised from each source and the total amount of government expenditure is central to government fiscal policy. Different governments have had different views about the appropriate proportions of each of the above and have also had differing views about the proportions of total taxation to be drawn from different individual taxes.

- **Requirement for question 2**

(a) The government can borrow from either the capital or the money markets.
(i) Explain how the government borrows from each of these sources. *3*
(ii) Describe and distinguish between the economic consequences of the government borrowing significant amounts of money from these two sources. *10*

(b) Using UK taxes as examples, explain the difference between a direct and an indirect tax. *5*

(c) Define the term 'price elasticity of demand' (PED) giving the formula by which it can be measured. *3*

(d) Explain how the concept of PED can assist in the assessment of the impact of an increased rate of indirect tax imposed upon a demerit good. *4*

(e) (i) Explain what is meant by a product with a PED of less than one and a product with a PED of more than one. *2*
(ii) What are the implications of these figures for the revenue raising potential of any indirect taxes levied upon these products? *3*

(30)

3

Under New Labour growth in public expenditure has been substantial, particularly to fund increased investment in public services. Despite the government's strong public commitment to not raising tax rates, particularly rates of income tax, some of this increased expenditure has been financed by increases in so-called 'stealth taxes'. At the same time substantial growth has occurred in the opportunities and scope for public sector bodies to levy charges upon end users of services.

- **Requirement for question 3**

(a) Define taxation and explain how typical end user charges levied by public sector bodies depart from this definition. *3*

(b) What are the general principles with which charging by the UK central government has been required to comply? *4*

(c) Using examples as appropriate, describe the main arguments in favour of public sector bodies charging end users for goods and services? *10*

(d) Describe William Baumol's explanation for the growth of government expenditure over time as a percentage of gross domestic product. *9*

(e) Discuss the current government's significant investment in public services in the light of Baumol's theory. *4*

(30)

4

Local authority borrowing and investment are substantial, standing at £49.76 billion and £21.14 billion respectively at March 2004.

- **Requirement for question 4**

(a) (i) Describe the role of the Public Works Loans Board in local authority borrowing. *4*
(ii) Compare and contrast the approaches to investment typically taken by local government internal and external investment managers. *3*

(b) Outline the main characteristics of the following money markets and instruments issued within them and discuss how appropriate they would be for local government and other public sector treasury managers:
(i) certificate of deposit market *4*
(ii) commercial paper markets *3*
(iii) discount market *5*

(c) Describe the treasury management indicators which are required by the CIPFA Prudential Code for Capital Finance in Local Authorities, explaining how each indicator will assist in managing different aspects of treasury management risk. *11*

(30)