



**Pakistan Institute
of Public Finance Accountants**

Model Solutions

Public Finance

CGA | PMAD | PRAD

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Q.1. Public finance contributes to equitable income distribution in the following ways:

a

- 1. Progressive taxation:** Governments impose higher tax rates on higher-income groups and lower rates on those with less income. This reduces the income gap and ensures that the wealthy contribute a fair share toward national development.
- 2. Transfer payments and subsidies:** Through pensions, unemployment benefits, and social welfare schemes, income is redistributed to support vulnerable groups. In addition, subsidies on essential goods and services such as food, education, and healthcare help low-income families meet basic needs and improve their quality of life.
- 3. Public expenditure on social services:** Government spending on education, health, and housing raises the living standards of disadvantaged populations and enhances their opportunities for upward mobility, promoting long-term equality.
- 4. Employment generation and regional development programs:** Fiscal policies that fund infrastructure projects and invest in underdeveloped areas create jobs and encourage balanced regional growth, thereby narrowing income and opportunity gaps across society.
- 5. Price stabilization measures:** By controlling inflation through fiscal and monetary coordination, the government protects the purchasing power of low- and middle-income groups, preventing the poor from being disproportionately affected by rising prices.

Q.1. Characteristics of Public Goods and Market Failure Explanation

b

- 1. Non-excludability:** Public goods are those from which no individual can be excluded once they are provided. For example, national defense or street lighting benefits everyone, whether they pay for it or not. Since people cannot be prevented from using these goods, private firms find it difficult to charge users directly.
- 2. Non-rivalry in consumption:** The use of a public good by one person does not reduce its availability for others. For instance, one person's enjoyment of clean air or a lighthouse's light does not limit others from benefiting from it. This feature allows multiple individuals to consume the same good simultaneously without additional cost.

Why the Private Market Fails to Provide Public Goods Efficiently:

Because of non-excludability and non-rivalry, private producers cannot easily charge users or prevent non-payers (free riders) from benefiting. This leads to the free-rider problem, where individuals expect others to pay for the good while they still enjoy its benefits. As a result, private firms have no financial incentive to produce these goods, leading to underproduction or complete absence of public goods in the market.

Therefore, the government steps in to provide and finance public goods through taxation, ensuring efficient provision and equitable access for all members of society.

Q.2. Merits and Demerits of Indirect Taxation:

a

Indirect Taxation : Indirect taxes are those taxes that are levied on goods and services rather than on income or profits. They are paid by consumers when they purchase goods or services, but collected and remitted to the government by producers or sellers. Examples include sales tax, excise duty, customs duty, and value-added tax (VAT).

Merits of Indirect Taxation:

- 1. Convenience:** Indirect taxes are easy to pay because they are included in the price of goods and services. The taxpayer often pays them without direct awareness.
- 2. Wide Coverage:** Since they are imposed on goods and services, indirect taxes cover a large number of people and contribute significantly to government revenue.



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3. **Elastic Source of Revenue:** As production and consumption increase, the revenue from indirect taxes also rises automatically.
4. **Easy Collection:** These taxes are collected at the production or sale stage, making administration simpler and reducing the chances of tax evasion.

Demerits of Indirect Taxation:

1. **Regressive in Nature:** Indirect taxes affect the poor more than the rich because everyone pays the same tax on a product, regardless of income.
2. **Inflationary Effect:** Since they increase the prices of goods and services, indirect taxes can contribute to inflation.
3. **Uncertain Revenue:** Revenue from indirect taxes depends on the level of consumption, which may fall during recessions.
4. **Discourages Production and Trade:** High indirect taxes can raise production costs, reduce demand, and discourage investment and trade.

b) Discuss how tax incidence affects equity and efficiency in the economy.

Q.2. Tax Incidence and Its Effects on Equity and Efficiency

b

Meaning: Tax incidence refers to who ultimately bears the burden of a tax consumers, producers, or both after-market adjustments.

Effect on Equity:

- If the poor bear a higher share of taxes, it reduces fairness and makes the system regressive.
- Progressive taxes improve income distribution by placing more burden on the rich.
- Unequal tax burdens can harm both vertical and horizontal equity.

Effect on Efficiency:

- Taxes can distort prices and reduce production or consumption of certain goods.
- High taxes may discourage work, saving, and investment.

Market distortions caused by taxes lead to inefficiency and deadweight loss.

Q.3. Criteria Used by the National Finance Commission (NFC) for Distribution of Revenues among Provinces:

a

The major criteria used by the NFC for revenue distribution among provinces are as follows:

1. **Population:** Population has traditionally been the main criterion for revenue distribution. Provinces with larger populations, such as Punjab, receive a higher share to meet their greater expenditure needs.
2. **Poverty and Backwardness:** This criterion ensures that underdeveloped provinces receive additional resources to promote regional equality and social justice. Provinces like Balochistan and Khyber Pakhtunkhwa benefit from this consideration.
3. **Revenue Generation and Collection:** Provinces that contribute more to the national exchequer through taxes or natural resources are rewarded with a higher share. This encourages provinces to improve their tax collection efficiency.



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4. **Inverse Population Density (Area):** Provinces with large areas but low population density face higher costs in infrastructure and administration. Therefore, area or inverse population density is also considered to compensate them.
5. **Fiscal Discipline:** In recent NFC Awards, maintaining sound financial management and reducing fiscal deficits have been considered as additional factors to encourage responsible spending by provinces.

Q.3. **Wagner's Hypothesis and Its Implications for Fiscal Management in Pakistan:**

b

Wagner's Hypothesis suggests that as an economy grows, public expenditure increases because governments expand their role in providing social services, infrastructure, and welfare.

In Pakistan, this has several implications for fiscal management:

1. **Rising Government Spending:** Economic and population growth have increased demands for education, health, and defense, leading to higher public expenditure.
2. **Revenue Mobilization:** The government must enhance tax collection and broaden the tax base to finance growing spending needs.
3. **Fiscal Deficits:** If expenditure rises faster than revenue, fiscal deficits and debt accumulation may occur, requiring careful control.
4. **Development Priorities:** Spending should focus on productive sectors like infrastructure, education, and health to ensure long-term growth.
5. **Fiscal Discipline:** Efficient use of funds and reduction in wasteful expenditure are vital for maintaining stability.

Q.4. **Merit Goods:** Merit goods are those goods and services which the government believes individuals will under consume if left to the free market. These goods have strong social benefits, and their consumption is encouraged for overall welfare.

a

- They are rival and excludable in nature (people can be prevented from using them if they don't pay).
- They create positive externalities — their benefits extend beyond the individual user.
- The government often provides them at low cost or free to ensure equitable access.

Examples:

Education and healthcare.

Public goods are those goods that are available for everyone's use and cannot be confined to paying users only. The market fails to provide them efficiently because of the free-rider problem.

- They are non-rival (one person's use does not reduce availability for others).
- They are non-excludable (no one can be prevented from using them).
- They are financed and provided collectively by the government.

Examples:

National defense, street lighting, public parks, and flood control. For example, street lighting benefits everyone on the road without reducing its use for others.



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- Q.4. Fiscal Expansion:** Fiscal expansion refers to an increase in government spending or a reduction in taxes aimed at stimulating economic growth. It is used to boost aggregate demand, create employment, and raise output during periods of economic slowdown or recession.

Debt Sustainability: Debt sustainability means the government's ability to meet its debt obligations—both interest and principal—without resorting to excessive new borrowing or causing economic instability. It ensures that the level of public debt remains manageable in the long term.

Trade-offs between the Two

- Fiscal expansion helps in short-term economic recovery but increases public borrowing.
- Rising debt leads to higher interest payments, reducing funds for development.
- Excessive borrowing may cause inflation and weaken the currency.
- High debt can lower investor confidence and increase future borrowing costs.

To balance both, governments should use borrowed funds productively and maintain fiscal discipline.

Q.5. Internal Public Debt:

a

- Borrowing made within the country from domestic sources such as banks, financial institutions, and the public.
- Repayment and interest payments are made in the local currency, so there is no pressure on foreign reserves.
- Example: Government borrowing through national savings schemes or treasury bills.

External Public Debt:

- Borrowing made from foreign sources, including international organizations, foreign governments, or private lenders.
- Repayment and interest payments are made in foreign currency, affecting the balance of payments.
- Example: Loans from the IMF, World Bank, or foreign countries.

Q.5. Role of Public Expenditure Policy in Reducing Regional Disparities:

b

- 1. Development of Backward Areas:** Public expenditure can be directed toward less developed regions by investing in infrastructure such as roads, electricity, water supply, and communication networks, helping integrate them into the national economy.
- 2. Promotion of Social Services:** Increased government spending on education, healthcare, and housing in underprivileged regions improves living standards and reduces inequality among provinces and districts.
- 3. Industrial and Agricultural Support:** Subsidies, credit facilities, and industrial zones established in backward areas attract investment and create employment opportunities, reducing migration to developed regions.
- 4. Balanced Allocation of Funds:** Through equitable distribution of resources under fiscal mechanisms like the National Finance Commission (NFC) Award, public expenditure ensures fair sharing of national income among provinces.
- 5. Poverty Reduction and Welfare Programs:** Government welfare schemes, cash transfers, and rural development programs help uplift marginalized populations in lagging regions.



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Q.6. Relationship between Debt Burden, Inflation, and Exchange Rate Stability:

a

Debt Burden: The debt burden refers to the total amount of money a government owes, including both domestic and external debt, along with the cost of servicing it (interest payments). When public debt grows faster than national income, it becomes difficult for the government to repay, leading to financial stress.

Link between Debt Burden and Inflation:

- When governments borrow excessively from the central bank or print more money to repay debt, it increases the money supply, causing inflation.
- Inflation reduces the real value of debt in the short term but increases borrowing costs in the long run.
- Persistent inflation weakens public confidence and makes future borrowing more expensive.

Link between Debt Burden and Exchange Rate Stability:

- A high external debt increases demand for foreign currency to make repayments, leading to pressure on the exchange rate.
- If investors fear default or instability, they may withdraw capital, causing depreciation of the domestic currency.
- Currency depreciation raises the cost of repaying foreign-denominated debt, further worsening the debt burden.

Link between Inflation and Exchange Rate Stability:

- High inflation reduces the purchasing power of the currency, making exports cheaper and imports more expensive.
- Continuous inflation leads to currency depreciation and exchange rate instability.
- Stable inflation supports investor confidence and helps maintain a stable exchange rate.

Q.6. Challenges of Tax Evasion and Avoidance in Pakistan's Fiscal System

b

1. **Weak Tax Administration:** Poor enforcement, corruption, and lack of modern monitoring systems allow individuals and businesses to evade taxes with little risk of detection.
2. **Large Informal Economy:** A significant portion of Pakistan's economy operates outside official records, making it difficult to track income and collect taxes effectively.
3. **Complex Tax Structure:** Complicated tax laws and frequent changes in policies create loopholes that taxpayers exploit to avoid paying their fair share.
4. **Low Tax Morale:** Many citizens feel that tax money is not used transparently or efficiently, leading to low willingness to comply with tax obligations.

Q.7. Comparison of Surplus, Deficit, and Balanced Budgets:

A government budget is a financial statement that outlines estimated revenue and expenditure for a specific fiscal year. Depending on the relationship between revenue and expenditure, budgets can be categorized as surplus, deficit, or balanced.

1. **Surplus Budget:** A surplus budget occurs when the government's total revenue exceeds its total expenditure. It indicates that the government is earning more than it spends. Such a budget is usually implemented during periods of inflation to reduce excessive demand and control rising prices.



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Example: If the government collects Rs. 1,200 billion in revenue and spends Rs. 1,000 billion, the surplus budget is Rs. 200 billion.

2. Deficit Budget: A deficit budget arises when the government's expenditure exceeds its revenue. It is generally used during periods of economic slowdown or recession to stimulate growth through higher public spending. The government may borrow money or print currency to cover the deficit.

Example: If total revenue is Rs. 900 billion and total expenditure is Rs. 1,100 billion, the budget deficit is Rs. 200 billion.

3. Balanced Budget: A balanced budget occurs when government revenue equals expenditure. It reflects financial discipline and stability but may not always be suitable for developing economies that need higher spending to promote growth.

Example: If both revenue and expenditure are Rs. 1,000 billion, the budget is balanced.

Q.8. Straight Transfers vs. Grants-in-Aid

Definitions:

- **Straight Transfers:** Payments made by the government to individuals or institutions without requiring any goods or services in return. Examples include pensions, unemployment benefits, and social security payments.
- **Grants-in-Aid:** Payments made by a higher level of government to a lower level for specific purposes or projects, often with conditions on how the funds are used. Examples include federal grants to provinces for education or infrastructure.

Key Differences:

- **Purpose:** Straight transfers aim at individual welfare; grants-in-aid aim at supporting government functions or regional development.
- **Recipients:** Straight transfers go to individuals or households; grants-in-aid go to other government levels or institutions.
- **Conditionality:** Straight transfers are unconditional; grants-in-aid are usually conditional on project completion or use.

Importance:

- **Straight Transfers:** Reduce income inequality, provide social welfare, and stabilize consumption in the economy.

Grants-in-Aid: Promote balanced regional development, help lower-level governments carry out projects, and ensure national policies are implemented effectively.
