



**Pakistan Institute
of Public Finance Accountants**

Model Solutions

Public Finance

CGA | PMAD | PRAD

Winter Exam-2025

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Solutions – Public Finance

Q.1. Private Finance: Private Finance refers to the management of income and expenditure by individuals, households, or private businesses. It focuses on how money is earned, saved, invested, and spent to meet personal needs or gain profit, within available resources.

Public Finance: Public Finance is the study of how governments raise and utilize funds to provide public goods and services. It involves taxation, public expenditure, borrowing, and fiscal management aimed at promoting the welfare of society.

Similarities between Private and Public Finance:

- 1. Resource Management:** Both aim to manage limited financial resources efficiently to meet objectives.
- 2. Budgeting and Planning:** Both require proper planning, budgeting, and control of income and expenditure.
- 3. Borrowing:** Both may borrow funds when income is less than expenditure.
- 4. Objective of Financial Balance:** Both seek a balance between revenue and expenditure to avoid deficits.

Differences between Private and Public Finance:

- 1. Objective:** Private Finance aims at personal satisfaction or profit; Public Finance seeks societal welfare.
- 2. Nature of Spending:** Private spending is voluntary and based on personal choice, while public spending is mandatory to fulfil national needs.
- 3. Secrecy vs. Transparency:** Private financial matters are usually kept confidential, while public finances require transparency and accountability.
- 4. Revenue Sources:** Private individuals earn income through wages, profits, or investments. Governments raise funds through taxation, borrowing, and printing currency.
- 5. Decision-making Authority:** Private financial decisions are made independently. Public financial decisions involve legislation and are often guided by public policies and law.

Q.2. Private Goods: Private goods are goods and services that are produced and consumed by individuals and firms for personal use and benefit. They are the most common type of goods in a market economy and are usually provided by the private sector for profit.

Main Properties of Private Goods:

- 1. Excludability:** Private goods are *excludable*, meaning producers can prevent people who do not pay from consuming them. For example, you cannot use a loaf of bread or a bottle of milk unless you buy it.
- 2. Rivalry:** Private goods are *rivalrous* in consumption, meaning one person's consumption reduces the quantity available for others. For example, if you eat an apple, no one else can eat the same apple.
- 3. Rejectability:** Consumers can choose not to consume private goods. If you do not want a product, you simply do not buy it.
- 4. Provided through Market Mechanism:** Private goods are typically produced and sold in markets, where price determines supply and demand. Producers seek to maximize profit, and consumers aim to maximize utility.

Examples:

Food items, clothing, cars, houses, electronic gadgets, and many household items are typical examples of private goods.



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Q.2. Capital budgeting is the process used by governments or businesses to plan and decide on spending for long-term projects. These are projects that require a large amount of money and will benefit the economy or organization over many years.

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Examples include building roads, bridges, schools, hospitals, power stations, and factories. The main aim is to choose projects that will give good returns in the future and help in development.

How is it Related to Long-Term Development Planning?

Capital budgeting is closely linked with long-term development planning in the following ways:

- 1. Supports Development Goals:** It helps in selecting and funding projects that match national development plans, such as improving transport, health, and education.
- 2. Ensures Proper Use of Funds:** It makes sure that money is spent on useful and productive projects, not wasted on less important ones.
- 3. Encourages Future Growth:** Projects chosen through capital budgeting create jobs, improve services, and support economic growth in the long run.
- 4. Involves Multi-Year Planning:** Since these projects take time, capital budgeting helps plan their funding and progress over several years.

Q.3. **Fiscal Policy** refers to the use of government spending and taxation to influence a country's economic conditions. In a developing economy, fiscal policy plays an important role in guiding economic growth and improving people's welfare.

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Primary Objectives of Fiscal Policy in a Developing Economy:

1. Economic Growth: A main goal is to promote rapid and stable economic growth by investing in infrastructure, industry, and agriculture. Public spending on roads, power, and communication encourages private investment and boosts productivity.

2. Employment Generation: Developing countries often face high unemployment and underemployment. Fiscal policy aims to create jobs through public works programs, rural development projects, and support for small industries.

3. Reduction of Inequalities: Fiscal policy is used to reduce income and wealth gaps. Progressive taxation (higher taxes on the rich) and increased spending on health, education, and social welfare help uplift poorer sections of society.

4. Price Stability: Developing economies often experience inflation. Fiscal measures such as controlling unnecessary spending and raising taxes help control excessive demand and keep prices stable.

5. Mobilization of Resources: Governments use fiscal policy to raise more revenue through taxes and savings. This helps fund development projects without relying too much on foreign loans.

Q.3. **Annual Budget Statement:** The Annual Budget Statement is an official document presented by the government each year. It shows the estimated receipts (income) and expenditures (spending) of the government for the coming financial year. It helps the government plan and manage its finances properly.

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Two items included in it:

1. **Revenue Receipts:** income from taxes, duties, and fees.
2. **Development Expenditures:** spending on new projects like roads, schools, and hospitals.

Q.4. Merits of Indirect Taxes:

- a 1. **Convenient:** They are easy to pay because they are included in the price of goods and services.
2. **Broad-based:** They are collected from a large number of people, so the burden is widely shared.
3. **Can control harmful goods:** They can discourage the use of harmful products like cigarettes and alcohol by making them more expensive.

Demerits of Indirect Taxes:

1. **Regressive:** They take a larger share of income from the poor than the rich, increasing inequality.
2. **Increase prices:** They raise the prices of goods and services, leading to higher cost of living.
3. **No civic consciousness:** People often do not realize they are paying tax, so it does not encourage civic responsibility.

b) How does the Elasticity of Demand affect the incidence of an Indirect Tax?

Q.4. Effect of Elasticity of Demand on Tax Incidence:

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The incidence of an indirect tax means who bears the burden of the tax — the buyer or the seller. This depends on how sensitive (elastic) the demand is to price changes.

1. **Inelastic Demand:** If demand is inelastic (people buy the good even if the price goes up), most of the tax burden falls on consumers because they keep buying at higher prices. Example: petrol, salt.

2. **Elastic Demand:** If demand is elastic (people easily reduce or stop buying when the price rises), producers bear more of the tax burden because they cannot raise prices much without losing customers.

Q.5. Wagner's Hypothesis:

- a Adolph Wagner, a German economist, proposed that as an economy grows, the public expenditure (government spending) naturally increases both absolutely and relatively (as a percentage of national income).

Key Assumptions:

1. **Economic and Social Progress:** As income and development increase, people demand more public services like education, health, law and order, and welfare.
2. **Expansion of Administrative Functions:** With economic growth, the government's role expands to regulate and manage complex economic and social activities.
3. **Provision of Welfare and Cultural Services:** A growing economy leads to higher demand for welfare activities, cultural services, and social security measures.



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- Q.5. Benefit Received Theory:** This theory says people should pay taxes in proportion to the benefits they receive from government services.

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Why it is less applicable in modern welfare states:

- 1. Focus on Equity:** Modern welfare states aim to help the poor and reduce inequality. Many services (like free education, healthcare, and social security) are provided based on need, not on how much a person pays.
- 2. Difficulty in Measuring Benefits:** It is hard to exactly measure the benefit each person gets from services like defence, law and order, or environmental protection.
- 3. 3. Social Justice:** A welfare state uses progressive taxation — taxing the rich more — to redistribute income, which goes against the idea of paying strictly for individual benefits.

- Q.6. Macroeconomic Consequences of High Public Debt:**

- a** High levels of public debt can have several negative effects on investment and economic growth in an economy:

- 1. Crowding Out of Private Investment:** When the government borrows heavily, it competes with the private sector for funds in financial markets. This can raise interest rates, making borrowing more expensive for businesses, and discouraging private investment.
- 2. Reduced Fiscal Space:** A large portion of government revenue goes toward interest payments on debt, leaving less money for productive investments like infrastructure, education, and health — all of which are important for long-term growth.
- 3. Investor Uncertainty:** High debt may create uncertainty about future tax increases or spending cuts, reducing business confidence and delaying investment decisions.
- 4. Risk of Inflation or Currency Devaluation:** If debt is financed by printing money, it may lead to inflation. High debt may also reduce investor confidence in the country's currency, affecting exchange rates.
- 5. Burden on Future Generations:** Persistent debt accumulation may require higher taxes in the future, reducing disposable income and possibly slowing economic growth over time.
- 6.** In short, high public debt can discourage private investment, limit growth-promoting spending, and create economic uncertainty, all of which can slow down economic growth in the long run.

- Q.6. Conditional Grants:** These are grants given by a higher level of government (like the federal government) to a lower level (like provincial or local governments) with specific conditions on how the money must be spent.

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Example: A grant to build schools or hospitals only.

Unconditional Grants: These are grants given without specific spending conditions. The receiving government can use the funds as it sees fit, according to its local needs and priorities.

Example: A general financial grant to support a local government's budget.



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Q.7. Public Expenditure refers to the financial resources spent by the government on goods, services, and welfare programs to meet the needs of its citizens and to promote the general welfare. This includes spending on infrastructure, healthcare, education, defence, social security, and various other public services.

Importance of Public Expenditure in a Modern Welfare State:

- 1. Economic Stability and Growth:** Public expenditure plays a key role in stabilizing the economy, especially during periods of recession. By increasing government spending, the state can boost demand for goods and services, stimulate employment, and foster economic growth.
- 2. Redistribution of Wealth:** A modern welfare state uses public expenditure to reduce income inequality. Through welfare programs like unemployment benefits, pensions, and healthcare services, the government ensures that basic needs are met for all citizens, particularly for the less privileged.
- 3. Provision of Public Goods and Services:** Many essential goods and services, such as healthcare, education, and infrastructure, are either underprovided or inefficiently provided by the private sector. The government uses public expenditure to fill this gap, ensuring that everyone has access to these vital services.
- 4. Social Welfare and Protection:** A modern welfare state allocates public funds to social welfare programs, including unemployment benefits, housing assistance, and food security. This ensures that people can maintain a certain standard of living, even in times of financial hardship.
- 5. Social Equity and Justice:** Through targeted spending, the government can address social inequalities, ensuring that all citizens, regardless of their socioeconomic background, have access to opportunities and services that promote social justice and fairness.
- 6. Support for Economic Development:** Governments invest in long-term projects like infrastructure development (roads, railways, electricity, etc.), which lay the foundation for economic growth and increase the overall productivity of the economy.
7. In essence, public expenditure is vital for the functioning of a modern welfare state as it helps to maintain social order, promote economic stability, and ensure a higher standard of living for all citizens.

Q.8. Assessment of the Impact of the 2010 Order on Inter-Provincial Fiscal Equity:

- (i)** The 2010 Order, officially known as the **7th National Finance Commission (NFC) Award**, was a significant milestone in Pakistan's fiscal federalism. It redefined the distribution of federal divisible resources among the provinces and had a considerable impact on inter-provincial fiscal equity.
 - 1. Increased Provincial Share:** Under the 2010 NFC Award, the provincial share in the divisible pool was increased substantially from about 47.5% to 57.5%. This strengthened the financial autonomy of provinces, allowing them to better address regional development needs and reduce fiscal disparities.



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- 2. New Criteria for Distribution:** Previously, population was the sole basis for resource allocation. The 2010 Order introduced a multi-factor formula, including population (82%), poverty/backwardness (10.3%), revenue collection/generation (5%), and inverse population density (2.7%). This change addressed historical imbalances by recognizing poverty levels and revenue efforts, thus promoting fairer distribution.
- 3. Better Fiscal Balance Among Provinces:** The inclusion of backwardness and population density factors benefited less developed provinces such as Balochistan and Khyber Pakhtunkhwa. For instance, Balochistan's share was significantly increased, providing it with more resources to tackle underdevelopment and security challenges.
- 4. Strengthened Provincial Responsibility:** With increased transfers, provinces gained greater fiscal responsibility and accountability for service delivery. This shift aimed to enhance local governance and align expenditures more closely with regional priorities.
- 5. Remaining Challenges:** Despite these positive impacts, challenges remain. Issues such as weak capacity to generate own-source revenue, reliance on federal transfers, and inefficient public spending continue to limit the full benefits of enhanced fiscal equity.

Overall, the 2010 Order made inter-provincial fiscal transfers more equitable by considering multiple socio-economic factors. It marked progress towards a more balanced fiscal federation, though further reforms are needed to build provincial revenue capacity and improve fiscal discipline.
