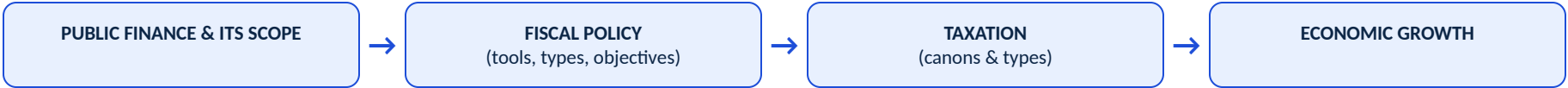


1 CHAPTER ROADMAP

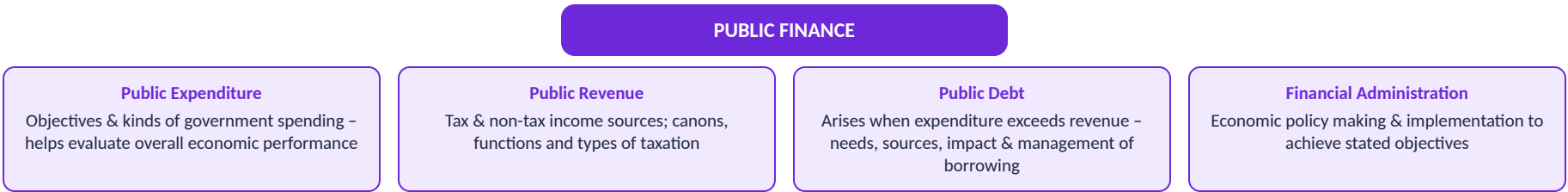


Theme: public finance is the study of how government raises and spends money to maximize social welfare. This chapter covers its four segments, the fiscal-policy tools built from taxes & spending, the rules (canons) and types of taxation, and finally economic growth – how it is achieved, measured, and its costs & benefits.

2 KEY DEFINITIONS

Public Finance Studies the income and expenditure of public authorities and the adjustment between them – how government raises finance for its ever-increasing expenditure.	Fiscal Policy Government measures to stabilize the economy, especially by manipulating taxes and government expenditure.
Expansionary Fiscal Policy Increases money supply/spending in the economy (spending ↑ or tax ↓) to fight deflation/recession.	Contractionary Fiscal Policy Contracts money supply/spending (spending ↓ or tax ↑) to hinder inflationary pressures.
Crowding Out A policy effect where increased government spending decreases the size of the private sector (e.g. by raising interest rates and discouraging private investment).	Direct Tax Burden CANNOT be shifted to anyone else – impact and incidence fall on the same person (e.g. Income Tax, Wealth Tax).
Indirect Tax Burden CAN be shifted to someone else – collected by adding to product prices (e.g. General Sales Tax, Excise Duty).	Progressive / Proportional / Regressive Tax Progressive: rate ↑ as tax base ↑ . Proportional: rate stays FIXED regardless of base. Regressive: poor bear a proportionately GREATER burden than the rich.
Economic Growth (Friedman) An expansion of the economic system in one or more dimensions without a change in its structure – reflected by an outward shift of the PPF.	

3 SCOPE OF PUBLIC FINANCE – FOUR SEGMENTS



4 PUBLIC FINANCE VS PRIVATE FINANCE

Aspect	Public Finance	Private Finance
Income & expenditure adjustment	Moves from EXPENDITURE to income (spend first, then raise revenue)	Moves from INCOME to expenditure (spend within means)
Budgeting	Annual budgeting is OBLIGATORY	Annual budgeting is OPTIONAL
Borrowing	Internal AND external borrowing possible	Only EXTERNAL borrowing available
Primary objective	Social welfare	Profit
Secrecy	Government is bound to be transparent to the public	Secrecy is a personal choice

5 TOOLS OF FISCAL POLICY

TOOLS OF FISCAL POLICY

Government Revenue

Tax revenue: income tax, property tax, sales tax, gain tax, wealth tax
Non-tax revenue: fines/penalties, trading profits, rental income, fees, post office income, royalties

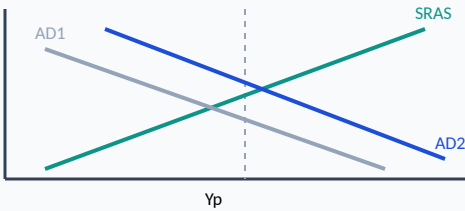
Government Expenditure

Development: transport, agricultural development, dams, social services, roads
Non-development: defence, law & order, civil administration, debt servicing

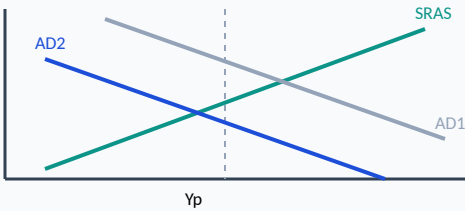
6 EXPANSIONARY VS CONTRACTIONARY FISCAL POLICY

	Expansionary (Anti-Deflationary)	Contractionary (Anti-Inflationary)
Used when	Economy in recession; AD1 intersects SRAS BELOW potential GDP (Yp)	Economy overheating; AD1 intersects SRAS BEYOND potential GDP (Yp), high inflation at P1
Policy actions	Reduce taxes; increase government spending	Increase taxes; reduce government spending
Effect on AD	AD shifts RIGHT (AD1→AD2), price rises to P2 at potential GDP Yp	AD shifts LEFT (AD1→AD2), price falls to P2 at potential GDP Yp

Expansionary: AD1→AD2 (rightward)



Contractionary: AD1→AD2 (leftward)



7 OBJECTIVES OF FISCAL POLICY

KEEP INFLATION LOW

- Stable price level economy-wide

KEEP EMPLOYMENT HIGH

- Social objective of the government

STEADY ECONOMIC GROWTH

- Consistent, gradual growth preferred

BOP EQUILIBRIUM

- Imports & exports value kept equal

BALANCED BUDGET

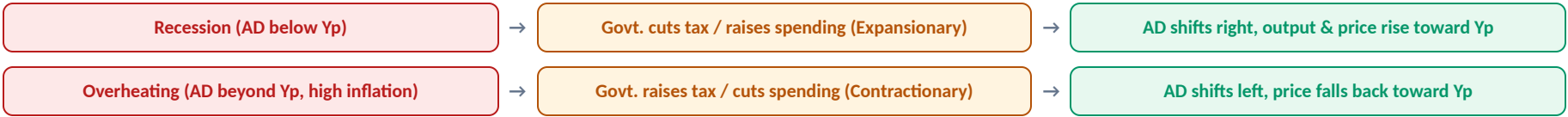
- Spending matched by what govt. can pay for, no mini-budgets needed

8 LIMITATIONS OF FISCAL POLICY

- Forecasting:** policy is built on economic predictions, which can be inaccurate
- Time lag:** delay between when action is needed and when its impact is actually felt
- Crowding out:** higher govt. spending funded by borrowing raises interest rates, discouraging private investment – offsetting the original stimulus
- Negative impact of tax:** raising taxes to cool AD can demotivate work, reducing productivity/aggregate supply
- Lack of coordination with monetary policy:** fiscal policy success depends on alignment with the central bank's actions

Crowding-out example: Govt. plans Rs.100bn spending, financed via heavy borrowing → market interest rate rises → cost of private projects rises → private investors invest less → the fall in private investment OFFSETS the rise in government spending.

9 CAUSE & EFFECT: FISCAL POLICY IN ACTION



10 FUNCTIONS OF TAXATION

FISCAL

- Main source funding development & non-development expenditure

ALLOCATION

- Progressive tax reduces income disparities between groups

REGULATORY

- Manages demand by adjusting tax base/rates

INCENTIVE

- Tax cuts/special arrangements to encourage investment

11 CANONS (PRINCIPLES) OF TAXATION – ADAM SMITH'S CORE FOUR

Canon of Equality

Tax should be proportional to each person's ability to pay (their income). Higher income → higher tax rate.

Canon of Certainty

Time, manner, and quantity of tax payment must be CLEAR & not arbitrary – for both the taxpayer and the government.

Canon of Convenience

Tax should be levied at the time/manner most convenient for the taxpayer to pay it (e.g. GST added at time of purchase).

Canon of Economy

Cost of collecting the tax should be small – minimal amount should be lost between the taxpayer's pocket and the treasury.

12 OTHER CANONS OF TAXATION

FISCAL ADEQUACY

- Tax should generate enough revenue to meet government expenses; a small tax yielding large revenue beats a heavy tax yielding little

FLEXIBILITY

- Tax system should adjust (not rigid) to changing economic conditions

SIMPLICITY

- Should be simple enough for everyone to understand – complexity invites corruption/oppression

DIVERSITY

- A variety of direct & indirect taxes across sectors (industry, agriculture, services, trade)

13 CLASSIFICATION OF TAXES

TAXATION

By Ability to Shift Burden

Direct Tax: collected directly from who has ability to pay; shifting IMPOSSIBLE
Indirect Tax: collected via product price; shifting POSSIBLE

By Tax Rate

Progressive: rate & base directly proportional
Proportional: rate fixed regardless of base
Regressive: poor bear proportionately more burden

14 DIRECT TAX: ADVANTAGES VS DISADVANTAGES

Advantages	Disadvantages
Equitable – higher income pays more	Easy to evade (falsify income declared)
Economical – low collection cost	Unpopular – people resist visible deductions
Relatively certain revenue for planning	Discourages savings/investment if too high
Elastic – rises automatically with income/wealth	Less incentive to work harder
Anti-inflationary – reduces disposable income, shifts AD left	

15 INDIRECT TAX: ADVANTAGES VS DISADVANTAGES

Advantages	Disadvantages
Can correct externalities (e.g. tax on cigarettes)	Regressive – poor feel more burden than rich
Difficult to evade (built into price)	Causes cost-push inflation
Allows consumer choice (pay only when buying)	Can create a black market if prices too high
Wide-ranging – reaches those exempt from direct tax	Uncertain revenue (falls in recessions)
Helpful in discouraging demerit goods (e.g. alcohol)	Distorts market equilibrium for taxed goods

16 PROGRESSIVE TAX: ADVANTAGES VS DISADVANTAGES

Advantages	Disadvantages
Built-in stabilizer (auto-adjusts with income)	Discourages economic activity/saving at high rates
Equitable – rich pay more, poor pay less	Encourages tax evasion among high earners
Relatively certain (well-defined tax slabs)	Seen as invasion of individual rights by opponents
Anti-inflationary – restrains high-income spending	Revenue loss from evasion (usually a direct tax)

17 PROPORTIONAL TAX: ADVANTAGES VS DISADVANTAGES

Advantages	Disadvantages
Unambiguous – flat rate, no confusion	Fails canon of equality – poor feel more burden
Relatively justified – no discrimination by income group	Relatively inelastic – contributes less total revenue
Does not discourage work/saving incentive	Widens income inequality over time

Regressive tax example: a 17% GST on food means a poor family buying 1 unit and a rich family buying 100 units BOTH pay 17% – but the poor family feels a much heavier relative burden. GST/VAT are classic regressive-tax examples.

18 TAX TYPES – DON'T CONFUSE!

	Progressive	Proportional	Regressive
Rate vs base	Rate ↑ as base ↑	Rate constant	Burden falls more on the poor
Example	Income tax	Zakat / Withholding tax	GST / VAT

19 ROSTOW'S STAGES OF ECONOMIC GROWTH

1. **Traditional Society** — primitive, agriculture-based, no technology/scientific knowledge
2. **Pre-Takeoff Stage** — shifting from traditional to modern farming, limited mechanization
3. **Takeoff Stage** — industrial revolution begins; agriculture still dominant but less relatively important
4. **Drive to Maturity** — technology more relevant; industry diversifies
5. **Age of Mass Consumption** — leading sectors produce consumer durables; per-capita income & living standards rise

20 INDICATORS OF GROWTH & RECESSION

Indicator	What It Shows	Timing
Leading	Forecasts an upcoming peak or trough	3–12 months BEFORE it happens
Coincident	Confirms current stage of the economy	AT the same time as the peak/trough
Lagging	Confirms past economic trends	3–12 months AFTER it happened

Exam clue: "Leading" predicts the future, "Coincident" describes the present, "Lagging" confirms the past – remember by their position relative to the business-cycle turning point.

21 COSTS & BENEFITS OF ECONOMIC GROWTH

Advantages	Disadvantages
Higher living standards (more comforts of life)	Environmental concerns (pollution, negative externalities)
Increased employment opportunities	Income inequality – gains concentrated among few
Fiscal benefits – more tax revenue for government	Inflation risk (demand-pull, as AD rises)
Reduction in poverty	Social cost – less leisure/health as people work more
	Current account deficit (reliance on imported machinery)

22 EXAM PATTERNS & MCQ QUICK CLUES

"Burden cannot be shifted to anyone else"	→ Direct Tax
"Included in the price of the product"	→ Indirect Tax
"Poor bear more relative burden than rich"	→ Regressive Tax (e.g. GST)
"Government cuts tax / raises spending"	→ Expansionary Fiscal Policy
"Private investment falls due to govt. borrowing"	→ Crowding out
"Forecasts a peak/trough 3-12 months ahead"	→ Leading indicator

⚠ ECONOMICS EXAM TRAPS

- Trap: Confusing Progressive Tax (rate rises with base) with Proportional Tax (rate fixed) – both are direct-tax-style but behave differently.
- Trap: Assuming all indirect taxes are automatically regressive in NAME only – regressive specifically means the poor bear a proportionately larger burden.
- Trap: Mixing up expansionary (tax ↓ /spending ↑ , fights recession) with contractionary (tax ↑ /spending ↓ , fights inflation) fiscal policy.
- Trap: Reversing Leading vs Lagging indicators – Leading predicts ahead, Lagging confirms after the fact.
- Trap: Forgetting that Public Finance moves from EXPENDITURE to income, the reverse of Private Finance's INCOME to expenditure.

23 COMPLETE CHAPTER DECISION TREE

QUESTION GIVEN → Public finance scope, fiscal policy, taxation, or growth question? → Identify the specific concept (canon, tax type, policy type, indicator) → Match to its defining feature → Apply relevant comparison (Direct/Indirect, Progressive/Proportional/Regressive, Expansionary/Contractionary) → Interpret & select final answer

PRC-3 ECONOMICS – CHAPTER 8 IN 60 SECONDS

- Public finance: 4 segments – expenditure, revenue, debt, financial administration.
 - Fiscal policy tools: government revenue (tax/non-tax) & expenditure (development/non-development).
 - Expansionary: tax ↓ /spending ↑ (fights recession). Contractionary: tax ↑ /spending ↓ (fights inflation).
 - Fiscal policy limits: forecasting, time lag, crowding out, tax disincentive, monetary coordination.
- 4 canons (Smith): Equality, Certainty, Convenience, Economy (+Adequacy, Flexibility, Simplicity, Diversity).
 - Direct tax = burden can't shift (income tax); Indirect tax = burden can shift (GST).
 - Progressive = rate rises with base; Proportional = flat rate; Regressive = poor bear more.
 - Rostow's 5 stages: Traditional → Pre-Takeoff → Takeoff → Drive to Maturity → Mass Consumption.
 - Indicators: Leading (before) / Coincident (during) / Lagging (after).

24 CHAPTER MEMORY MAP

