Q.38

Topic:	Public finances of Hong Kong
Relevant economic topics:	Source of capital, externality, income inequality, aggregate demand and aggregate supply, government expenditure and revenue, fiscal budget, balance of payments
Types of material:	Graph, news excerpts, opinions
Question design: (total marks: 27 marks)	Elementary-level questions (13 marks); Advanced-level questions (14 marks)

(a) From 2025-26 to 2026-27, the government will have a deficit budget. From 2027-28 to 2028-29, the government will have a surplus budget. (2 marks)

(b) The size of the public sector can be measured by the ratio of public expenditure to gross domestic product. When the growth rate of public expenditure is lower than that of nominal GDP, the ratio will decrease, implying a decrease in the size of the public sector. (2 marks)

(c) The implementation of the two-tiered standard rates regime for salaries tax and tax under personal assessment will reduce the disposable income of high-income people, while low-income people will not be affected. The income gap between the rich and the poor will thus be narrowed and the income inequality in Hong Kong will improve. (2 marks)

(d) These infrastructure projects benefit the public. For example, strengthening transportation infrastructure makes travel more convenient. However, the public do not pay any compensation to the government, as the projects are financed by issuing bonds. A positive externality may be involved. (3 marks)

(e) The ability of the government to repay debts is generally greater than that of private enterprises, resulting in a lower risk of failing to repay the principal and the interest. (2 marks)

(f) A reason:
- As the government has an obligation to pay interest, issuing bonds will increase the government's interest expenditure in the future.
- Any reasonable answer
(Mark the FIRST point only, 2 marks)

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(g) Marks awarded for effective communication (EC: max 2 marks)

Marks	Performance
2	● *Arguments supported with the source/data and appropriate economic theories* ● *Relevant materials presented* ● *Well-organised and coherent answers presented without repetition of ideas* ● *Ideas clearly and fluently expressed with appropriate use of language/words/terms/symbols*
1	● *Arguments presented with some support of the source/data and economic theories* ● *Some irrelevant materials presented* ● *Answers presented in a less organised way with some repetition of ideas* ● *A clear message conveyed with some inappropriate use of language/words/terms/symbols*
0	● *Arguments presented with no support of the source/data and economic theories* ● *Materials unrelated to the gist of the question presented* ● *Inconsistent arguments presented* ● *Limited ideas expressed with inappropriate use of words/terms/symbols*

The maximum marks for content is 12 marks. Answers may include the following:

Aggregate output

<u>Proposal I:</u>

- Introducing a general sales tax will increase the cost of production of firms, reducing their profits from production. Short run aggregate supply will decrease. In the short run, aggregate output will decrease.
- Introducing a general sales tax will not affect Hong Kong's productive capacity. In the long run, aggregate output will not be affected.

Proposal II:

- Putting up more land for sale will lead to increases in the production of residential buildings, commercial buildings/shopping malls or factories. Investment expenditure will increase and aggregate demand will increase. In the short run, aggregate output will increase.
- Increases in the production of residential buildings, commercial buildings/shopping malls or factories will increase Hong Kong's productive capacity. In the long run, aggregate output will increase.

Evaluation:

Proposal II is better than proposal I because proposal II will lead to increases in aggregate output in both the short run and the long run, whereas proposal I will lead to a decrease in aggregate output in the short run and will not affect aggregate output in the long run.

Stability of government revenue

Proposal I:

- Introducing a general sales tax will broaden the tax base and the tax revenue generated will fluctuate less and the government revenue will be more stable.
- Fluctuation in consumption is smaller than that of income from land sales. The tax revenue generated from consumption will fall less during economic downturns, and thus the government revenue will be more stable.

Proposal II:

- The government revenue from land sales is more affected by economic conditions. The revenue from land sales may will decrease during economic downturns. The revenue generated from land sales will fluctuate more and the government revenue will be less stable.

Evaluation:

Proposal I is better than proposal II because the government revenue brought by proposal I is more stable, while the government revenue brought by proposal II is more affected by economic conditions and is less stable.

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Balance of payments

Proposal I:

- After the introduction of the general sales tax, the prices of goods and services sold domestically will increase. Goods and services sold domestically and those sold overseas are substitutes. If the tax rate is higher than regional or international norms, people may purchase more goods and services from abroad. Imports of goods and services may increase, reducing the current account surplus (enlarging its deficit). The balance of payments may be worsened.

Proposal II:

- Foreign developers may participate in the construction of residential buildings, commercial buildings/shopping malls or factories in Hong Kong. When foreign developers increase their investment in Hong Kong, the capital and financial account surplus will be enlarged (deficit will be reduced). The balance of payments will be improved.

Evaluation:

Proposal II is better than proposal I because proposal I will worsen the balance of payments while proposal II will improve the balance of payments.

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