22.1 Fiscal Policy

1. Fiscal policy refers to intentional changes or adjustments in government expenditure and/or taxes to achieve certain economic goals.

2. Four basic principles of taxation put forward by Adam Smith:

- Equity: Taxpayers pay their taxes in proportion to their income.
- Certainty: Rules about and procedures for the processing of tax returns and the collection of tax should be clearly defined.
- Convenience: The methods of processing tax returns and paying tax should be as convenient as possible for both taxpayers and the government.
- Economy: The cost of administering the tax system should be kept as low as possible.

3. A direct tax is a tax of which the burden cannot be shifted to other parties while an indirect tax is a tax of which the burden can be shifted from the party being taxed to other parties.

4. The following table shows a certain tax of a country.

Income ($)	10,000	15,000	20,000	25,000
Tax payment ($)	1,500	2,250	3,000	3,750

The above tax is a proportional tax, because when income increases, the average tax rate remains unchanged.

5. The following table shows two different tax systems.

	Tax payment ($)	
Income ($)	Tax system A	Tax system B
5,000	80	50
7,000	100	140
9,000	120	270

Tax system A is a *(progressive tax / regressive tax / proportional tax)* while tax system B is a *(progressive tax / regressive tax / proportional tax)*. To improve income equality in society, *(tax system A / tax system B)* is a better choice.

6. The salary earned by a Hong Kong resident from working in the UK *(would / would not)* be taxed in Hong Kong, because according to the source principle of taxation, income not derived from Hong Kong *(would / would not)* be taxed by the Hong Kong government.

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7. Determine whether each of the following taxes in Hong Kong is a direct tax or an indirect tax.

	Direct tax	Indirect tax
(a) Salaries tax	✓	
(b) Profits tax	✓	
(c) Bets and sweeps tax		✓
(d) Property tax	✓	
(e) Stamp duties		✓
(f) Air passenger departure tax		✓
(g) General rates		✓
(h) Motor vehicles first registration tax		✓
(i) Duties		✓
(j) Royalties and concessions		✓

8. The size of the public sector can be measured by the ratio of public expenditure to GDP. The higher the ratio, the *(larger / smaller)* the quantity of society's resources that is controlled by the government.

9. Complete the following table.

	Explanation
Surplus budget	the government's planned expenditure is *(more than / less than / equal to)* its planned revenue
Balanced budget	the government's planned expenditure is *(more than / less than / equal to)* its planned revenue
Deficit budget	the government's planned expenditure is *(more than / less than / equal to)* its planned revenue

10. Suppose Country A reaches a fiscal balance. An increase in private consumption expenditure will result in a *(budget surplus / budget deficit)*, i.e. the government's actual expenditure will be *(more than / less than / equal to)* its actual revenue.

11. When the government adopts fiscal policies that lead to an increase in both government expenditure and taxes by the same amount, the effect on aggregate demand is *(expansionary / contractionary / neutral)*.

12. An expansionary fiscal policy refers to *(an increase / a decrease)* in government expenditure and/or *(an increase / a decrease)* in net taxes (net taxes = taxes – transfer payments) by the government. A contractionary fiscal policy refers to *(an increase / a decrease)* in government expenditure and/or *(an increase / a decrease)* in net taxes by the government.

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13. Determine whether each of the following policies is an expansionary fiscal policy or a contractionary fiscal policy.

	Expansionary fiscal policy	Contractionary fiscal policy
(a) increasing government expenditure	✓	
(b) decreasing transfer payments		✓
(c) lowering the profits tax rate	✓	
(d) increasing the tax rebate on salaries tax	✓	
(e) increasing the income tax allowance	✓	
(f) increasing the progressivity of salaries tax		✓
(g) increasing the property tax rate		✓

14. Suppose the government increases its expenditure on infrastructure. With the aid of the following diagram, explain how this will affect the price and output levels of the economy in the short run.

The government increasing its expenditure on infrastructure will lead to an increase in government expenditure. Aggregate demand will increase. In the short run, the price and output levels will increase.

22.2 Monetary Policy

15. Monetary policy refers to intentional changes in money supply and/or the interest rate by the central bank or the government to achieve certain economic goals.

16. An expansionary monetary policy refers to *(an increase / a decrease)* in the money supply and/or *(an increase / a decrease)* in the interest rate by the central bank or the government. A contractionary monetary policy refers to *(an increase / a decrease)* in the money supply and/or *(an increase / a decrease)* in the interest rate by the central bank or the government.

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17. Examples of an expansionary monetary policy and its short run effects

Examples	Short run effects
● *(buying / selling)* government bonds to/from the public ● *(raising / reducing)* the discount rate ● *(raising / reducing)* the required reserve ratio ● printing more money	The money supply will *(increase / decrease)*. ➔ The interest rate will *(increase / decrease)* . ➔ Consumption/investment will *(increase / decrease)* . ➔ Aggregate demand will *(increase / decrease)* . ➔ In the short run, the price and output levels will *(increase / decrease)* .

18. Examples of a contractionary monetary policy and its short run effects

Examples	Short run effects
● *(buying / selling)* government bonds to/from the public ● *(raising / reducing)* the discount rate ● *(raising / reducing)* the required reserve ratio	The money supply will *(increase / decrease)* . ➔ The interest rate will *(increase / decrease)* . ➔ Consumption/investment will *(increase / decrease)* . ➔ Aggregate demand will *(increase / decrease)* . ➔ In the short run, the price and output levels will *(increase / decrease)* .

19. Refer to the following AS-AD diagram of an economy.

With the aid of the above diagram, explain the short run effects of raising the interest rate by the central bank on the price and output levels.

When the interest rate increases, consumption/investment will decrease. Aggregate demand will decrease. The price and output levels will decrease.

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