

Proper Use of Fiscal Reserves

Comments to the Legislative Council Panel on Financial Affairs

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25/6/2001

Introduction:

To understand the critical issues underlying the fiscal reserve, we should first examine a few fundamental questions. These questions include the objectives of the fiscal reserve and the level we should set for the fiscal reserve in order to attain the agreed objectives. By answering these two sets of questions, there is an excess in our existing fiscal reserve. In my opinions, the fiscal reserve should be sufficient to perform its legitimate purposes if it is kept at the level of 12-month of public expenditure.

This excess of fiscal reserve provides the government with an opportunity and extra capacity to address some of the policy problems and pressing social issues in Hong Kong. Because of the one-time-off nature of the excess fiscal reserve, the government should avoid making long-term and mandatory commitment that will easily increase the financial burden of the government in the long run. To promote economic growth and facilitate the economic restructuring of Hong Kong, it is advised that the private sector, not the government, should take the initiative in the spending of the excess fiscal reserve. The government should take a more “back-seat” role. Moreover, the spending should be more investment-driven rather than consumption-driven.

Fundamental Questions:

The proper use of fiscal reserve is a complex issue but we can still understand it in a better way by breaking it down into two fundamental questions:

- (1) What criteria should we use in determining the amount of fiscal reserve we should have?
- (2) If there is an excess in the fiscal reserve, what criteria should we use in considering its use?

Following these questions, we would encounter some sub-questions that I would also answer in my following comments. For example, following the first fundamental question, we should find out what is the appropriate level of fiscal reserve for attaining the agreed criteria. Similarly, following the second fundamental question, we should look at the question of what options for using the excess fiscal reserve are available under the agreed criteria of spending the excess fiscal reserve.

Question Number One:**(a) Does the Existing Criteria Make Sense?**

While the management of the fiscal resources in the government is always considered to be prudent, we do not have a fixed standard for our fiscal reserve until the 1998-1999 budget speech of the then Financial Secretary, Mr. Donald Tsang. According to his Budget Speech, there are three criteria in setting the level of fiscal reserve: operating requirement, contingency requirement, and monetary requirement. The operating requirement refers to the need to meet the cash flow requirement of the operation of the government. The contingency requirement refers to the need to have fund reserved for some unexpected and urgent uses. The monetary fund refers to the need to maintain stability in the exchange rate of our currency.

I think there is little wrong with the criteria given by the Financial Secretary but there should be a priority in the objectives set above for the purposes of our fiscal reserve. The operating and contingency requirements are two very common purposes for fiscal reserve in most countries. However, it is doubtful whether the monetary requirement should also be taken as a priority of the fiscal reserve. Usually, in most countries, the stability of the currency is managed by an independent or more “politically neutral” body such as the Federal Reserve Bank of the United States. The Exchange Fund managed by the Hong Kong Monetary Authority in Hong Kong is also created exactly for that purpose.

The problem of mixing the role and purpose of the Exchange Fund with the fiscal reserve is that this may led to conflicting objectives in the use of both the Exchange Fund and the fiscal reserve. Moreover, it may be dangerous and self-defeating to use the fiscal reserve to serve the purpose of the Exchange Fund as, in most countries, the creation of a separate monetary body is to avoid the monetary policies being influenced too heavily by political pressures.

Even if we take a step back and accept the government’s claim that monetary requirement should also be taken as a primary and legitimate objective of the fiscal reserve, I would still consider the fiscal reserve at the current level is too big. It is because while a higher level of fund always can help a bit to maintain the stability of our exchange rate, there are many different ways to do so which do not necessary require such a large amount of fiscal reserve as we currently have.

After the Asian Financial Crisis, some local scholars have already made some very ingenious solutions that do not require the large fiscal reserve to maintain our exchange rate. Some of them include the borrowing of funds from the international market and the Americanization of the Hong Kong Dollars (i.e., the use of American dollars as the legal tender in Hong Kong). Certainly, careful management of our public finance and political stability are also very necessary to maintain our exchange rate. It will still be useless to have an extremely large fiscal reserve if the fundamentals of our public finance and the general governance of Hong Kong are not well maintained.

(b) Do We have an “Excess” in the Fiscal Reserve?

Yes, there is an excess in our fiscal reserve at the moment. From the discussion above, I think the two legitimate purposes should be operating requirement and contingency requirement only. For the monetary requirement, for the sake of clearer accountability and better management, it should be deferred to the Exchange Fund.

Under the primary objectives of the operating requirement and contingency requirement, I would suggest that a fiscal reserve that is equivalent to the public expenditure for 12 months should be enough to fulfill the above two purposes. We have to remember that the government always have the access to the money market. It can always borrow money to meet its operating and contingency requirements. Moreover, the resources of government are only limited by the resources in society. Therefore, the 12-month requirement should already give the government an extremely safe standard for the fiscal reserve.

There are many important reasons that we do not have to worry that the use of a 12-month expenditure as the standard of our fiscal reserve will affect our monetary requirement negatively. First of all, this amount of reserve, plus the Exchange Fund, will already give the government a very large amount of money for the monetary requirement. Secondly, even if we use the current criteria of using M1 as one of the standard for the fiscal reserve, it still will not be sufficient to defend our exchange rate completely. It is because it is not only M1 but also M3 (M1 plus other accounts and money such as saving accounts, time deposits or money in a broader sense) that will affect our exchange rate. It is difficult to control M3 unless we impose some limit on the inflow and outflow of capital in Hong Kong. Most importantly, there are many effective and important means of maintaining our exchange rate stability, including maintaining the political stability and a carefully managed budget. If these means do not hold, even if we have a much larger fiscal reserve, this will still not be enough to defend our fixed exchange rate.

According to forecast of the government, the fiscal reserve will reach 430.3 billions in the financial year of 2000-1, which is equivalent to 23 months of public expenditure.¹ Using a 12-month expenditure as the standard for the fiscal reserve, the excess fiscal reserve the government can use for this current financial year will be as much as 224.5 billions.

Question Number Two:

As there will be an excess of fiscal reserve of 224.5 billions, the government should make good use of it to address some of the critical issues and major problems faced by Hong Kong, such as the promotion of economic growth and the restructuring of the economy. While I do not want to dictate the options of the government on how to make use of the excess fiscal reserve, there are certain principles I think the government must keep in mind in deciding how to use the excess fiscal reserve.

¹ Information provided in the Annex: General Background Note of the Legislative Council Panel on Financial Affairs for the meeting on Tuesday, 3 July 2001.

(a). Long-Term Commitment vs. Short-Term Commitment

First of all, we must understand that the excess fiscal reserve is a one-off fund, not a recurrent revenue of the government. Therefore, it should not be used to create some long-term financial commitment of the government which may weaken the strength of our public finance in the long run. Therefore, using it to subsidize a tax cut will not be a good idea. Hong Kong already has a low tax rate compared to many other industrial countries. Lowering the tax rate will also reduce the revenue generating capacity of the government. The problem will be especially serious if we do not cut down the service demand on our government at the same time.

(b). Government Spending Vs. Private Spending

As government is not subject to the discipline of the market forces, government is easily subject to waste and inefficiency. Consequently, unless the services must be run by government due to some market failures, the government should let the private sector to take the initiative in using the excess fiscal reserve. Moreover, the reducing of the fiscal reserve can reduce the size of the public sector in Hong Kong and check the expansions of the power of the bureaucracy in society.

Combining the arguments of avoiding long-term financial commitment and the advantage of the market forces, a more creative way of spending the excess fiscal reserve will be to use this short-term fund to cut down the long-term financial commitment of the government and reduce its intervening role in many markets. A major characteristic of the public finance system in Hong Kong is that the government play a major role in many services that can be provided more effectively and efficiently in the market, such as the university education and health services. In fact, university education and health services are very often provided successfully by the private sector, instead of the public sector, in many countries.

What the government can do is to create an endowment fund to privatize the universities and the health services. The endowment fund can ensure the systems will be self-sufficient financially or at least can phase out the dependence of the services on government finance gradually. If the government worry that some users may not be able to use the services, such as university education, after privatization, the government can always create loans and other subsidies with the endowment fund too. The key point is that the government can reduce the distortion in these sectors caused by its intervention and decrease its financial burden in the long run.

(c). Investment Vs. Consumption

Finally, the last principle the government should follow is that it should spend the money more on investment items, rather than consumption items. As mentioned by Antony Leung, our new Financial Secretary, investment will yield returns for our society while consumption will simply lead to the disappearance of the resources.

In this sense, education should be a key item for using the excess fiscal reserve. Education is important for Hong Kong to promote its economic growth and restructure its economy to the knowledge society too. In addition, tax refund or increase in welfare

payment will not be good choices for the spending of the excess fiscal reserve. Because of the nature of the tax system in Hong Kong, tax refund is not very equitable. In general, tax refund cannot help the lower class because most of them do not have to pay salaries tax.

Increase in welfare payment is not desirable because it is not the best way to help the low income class. Low income in Hong Kong is mainly due to unemployment or the holding of low-pay jobs, in other words, lower productivity. Increase in welfare payment will not solve the problem in the long run and may in fact create a poverty trap. Therefore, using the resources on increasing their productivity through education will be a much better way to resolve the low income problem. In addition to financing or subsidizing the education of low income class, the government can also consider using the excess fiscal reserve to provide support services (e.g., child care) that can reduce the barriers of the lower income people in accessing the education services.

Conclusion

The two most important purposes of the fiscal reserve are operating and contingency requirements. The monetary requirement should be a primary objective of the Exchange Fund, not the fiscal reserve. Mixing up the objectives of the fiscal reserve with the Exchange Fund may lead to self-defeating outcomes and conflicting roles. Most importantly, even if we accept the monetary requirement as one of the main objectives of the fiscal reserve, increasing the fiscal reserve will not be an effective and efficient way of maintaining the stability of the exchange rate of our currency. There are many other more useful and cost-effective ways of defending our exchange rate that do not require an enormous fiscal reserve as we currently have.

Considering that, a fiscal reserve of 12-month of our public expenditure should be good enough in meeting our requirements. Using this standard, we should have an excess of 224.5 billions in fiscal reserve. This provides some extra resources for our government in addressing the critical problems and pressing issues of our society. In deciding the best way of using the excess fiscal reserve, we should follow the principles of: avoiding making long-term financial commitment; limiting the role of the public sector; and emphasizing investment, not consumption.