

Proper Use of Fiscal Reserves

A Paper for Legislative Council Panel on Financial Affairs

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Appropriate Level of Fiscal Reserves

1. There is no hard and fast rule of thumb in determining an appropriate level of fiscal reserves, both theoretically or economically. In my view, any so-called “proper level of fiscal reserves” is circumstantial in nature which needs to be determined from time to time by taking account of the specific situation of the economy and its public finance.
2. The present guidelines governing Hong Kong’s fiscal reserves, which were set at 75% to 125% of HKD M1 plus 9 months to 15 months government expenditure, probably has an implied assumption of maintaining normal government operation for a long period of time when the source of revenue is in serious jeopardy, and with additional 100% reserve for Hong Kong’s M1.

Proper Use of Fiscal Reserves – A Theoretical Approach

3. Regardless of any specific economic consideration, any proper use of fiscal reserves should fall into the following categories:
 - Accumulate for planned expenditure and investments in the future;
 - Accumulate for generating recurrent investment income;
 - Cover unforeseen budget deficits;
 - Use the reserves for fiscal stimulation to economy; and
 - Use the reserves for specific capital investments.
4. The government must have good reasons either in building up or running down its reserves as a matter of prudent fiscal management.

Proper Use of Fiscal Reserves – The Hong Kong Case

5. Hong Kong's present huge fiscal reserves were built up between 1985 and 1997 as a result of the booming property market. The SAR Land Fund contributed HKD197 billion in one stroke to the fiscal reserves in 1997, while HK government's own reserves rose from HKD24 billion in March 1985 to HKD173 billion in March 1997.
6. The current fiscal reserves of over HKD400 billion were not built up intentionally for specific purposes. Therefore, tapping on the reserves, which would mean the government incurring budget deficits, has nothing wrong inherently if reserves are ever to be used. However, some specific issues have to be considered.

Experiences between Fiscal 1998/99 to 2000/01

7. Investment income from the fiscal reserves formed a substantial part of government revenue during this period, thus contributing a lot in cutting down the size of the budget deficit or turning the deficit into a surplus. Table 1 shows that Hong Kong suffered from shortfalls in revenue during the past three years, but were compensated partly from investment income which on average accounted for about 10% of government revenue.

Table 1 - Budget Deficits for Fiscal 1998/99 to Fiscal 2000/01

	Investment Income	Budget Balance	
		Actual	Excl. Investment Income
98/99	31,648	-23,241	-54,889
99/2000	36,779	9,952	-26,827
00/01	19,175	-11,351	-30,526

8. Investment income is a function of two factors: size of the reserves and investment yield. Running down the reserves through successive budget deficits would inevitably reduce investment income, which would in turn increase the burden on public finance and raise the likelihood of future budget deficits.

9. To avoid such negative impact to the budget, it appears prudent that there should be reasonable expectations that the budget could return to surpluses some time in future before tapping on the fiscal reserves on a large scale.

The Revenue Shortfall: Cyclical or Structural?

10. Given that land sales revenue is unlikely to be as significant as before, the questions regarding the revenue shortfall in the past three years are:

- Can the budget return to surplus through the existing tax base?
- Are there new revenue sources which can compensate for the drop in land revenue?
- If the fiscal reserves are being utilised, can such uses generate new income sources to fill the gap left by the lower investment income?

The Pension Payments for Civil Servants

11. At present, the government finances its pension payments through its recurrent expenditure in the annual budget. While this is an established government practice, it might be appropriate for the government to set aside certain amount from its reserves with an aim of smoothing out annual pension payments.
12. The issue of setting aside the full potential liabilities for its pension schemes from the reserves, as the case in private sector firms, is a complex issue which require further study and needs long time to achieve.

Conclusion

13. The fiscal reserves, under the present circumstance, can serve to bridge short-term revenue shortfalls and to finance one-off capital investment. However, those investment should be able to generate return in future to compensate for the drop in investment income.

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