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Practices of Overseas Jurisdictions in Building up or Maintaining Their Fiscal Reserves

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C O N T E N T S

<u>PRACTICES OF OVERSEAS JURISDICTIONS IN BUILDING UP OR MAINTAINING THEIR FISCAL RESERVES</u>

PART 1- INTRODUCTION

1. Background

1.1 The Panel on Financial Affairs requested the Research and Library Services Division to conduct a research on "Practices of Overseas Jurisdictions in Maintaining Their Fiscal Reserves" in April 2001, and the outline was endorsed in September 2001.

2. Selection of Economies for the Research

2.1 We have selected the following countries for this research study --

(a) Singapore,
(b) Norway,
(c) New Zealand,
(d) Argentina, and
(e) the United States of America (US).

2.2 Singapore maintains strong fiscal reserves to sustain long-term economic growth. In fact, it has run budget surpluses since 1988, even in the midst of the Asian financial crisis.

2.3 Norway recorded budget surpluses from 1994 to 2000. In addition, the country has set up a stabilization fund to provide a mechanism for adjusting government spending in response to changes in the economic situation and fluctuations in the level of revenue. The study explores how Norway manages its stabilization fund.

2.4 New Zealand also recorded budget surpluses from 1994 to 2000.

2.5 In addition to the above three countries which have recorded budget surpluses for a number of years, we have selected Argentina because, similar to Hong Kong, it had a currency system based on the currency board arrangement. The study also aims to find out whether the Argentine government had any guideline to maintain its level of reserves to defend the linked exchange rate regime.

2.6 We have also studied the case of the US although the country only recorded budget surpluses in recent years, i.e. between 1998 and 2000. The study aims to examine the US fiscal policy which has provided tax relief for the Americans as a means to enhance economic growth and to improve the livelihood of the general public.

3. Scope of the Research

3.1 The scope of the research, as agreed by the Panel, covers:

(a) current economic situations of the countries studied;

(b) principles of fiscal policies adopted by the governments of the countries studied;

(c) practices of the five countries in maintaining their fiscal reserves or financing their government debts, depending on their fiscal situations; and

(d) the experiences of these five countries in maintaining their fiscal reserves or financing their government debts.

4. Methodology

4.1 The research involves a combination of information collection and analysis. In addition to making reference to materials available in the LegCo Library, we also use reference materials acquired through the Internet and other outside sources.

PART 2 -- SINGAPORE

5. Current Economic Situation

5.1 In 2001, the Singapore economy fell into a recession due to the sluggish domestic economic performance, as well as weakening global demand and diminishing growth in international trade. Singapore's Gross Domestic Product (GDP) contracted by an estimated 2.2% in 2001[1], after a 9.9% GDP positive growth in 2000.

5.2 The government has pointed out that the economic outlook in 2002 is uncertain. In view of the sharp economic decline in the second half of 2001, the economic growth in the first half of 2002 may stay negative. However, economic growth in the second half of 2002 may turn positive, depending on the global situation. To reflect the economic uncertainties, the preliminary forecast for economic growth in 2002 is in the range of -2% to +2%.

6. Principles of Fiscal Policy

6.1 The Singapore government always emphasizes that a prudent fiscal policy is the foundation for macro-economic stability. Although the principles of fiscal policy are not set out in laws or in fiscal guidelines, the government has outlined the following principles of fiscal policy in various occasions[2]:

(a) The first principle is to avoid persistent budget deficits. The government's aim is to build up budget surpluses in good years to augment its fiscal reserves, providing an important financial buffer for the country. A healthy reserve position also instills confidence among foreign investors and underpins Singapore's status as a major financial centre.

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1 The manufacturing sector fell by an annual rate of 9.6% in January - September 2001, being hurt by depressed global demand.

2 These are: (i) Ministry of Finance, *An Overview of Singapore Tax System*, 2001; (ii) Dr Richard Hu (Minister for Finance and Chairman of the Monetary Authority of Singapore), Macroeconomic Policies in Singapore: Principles, Milestones and Future Prospects, 22 March 1997; and (iii) Radm Teo Chee Hean (Minister for Education), Getting it Right: Responding Successfully to Globalisation, 31 January 1998.

(b) The second principle is to implement fiscal policy which should promote economic development and improve efficiency and productive capacity of the economy rather than encourage consumption. Through productive investments, the country will be equipped to overcome challenges ahead.

(c) The third principle is to keep the size of the public sector small. The government believes that the market mechanism of the private sector can allocate resources more efficiently. The government's role is to provide a stable and conducive environment for the private sector to thrive.

7. Practices of Maintaining Fiscal Reserves

Government's Fiscal Position Between Fiscal Year[3] 1995 and Fiscal Year 2000

7.1 The government recorded budget surpluses between Fiscal Year 1988 and Fiscal Year 2000. Even in the midst of Asian financial crisis, the Singapore government recorded a budget surplus of S$3.4 billion for Fiscal Year 1998 (see Table 1). The accumulated budget surpluses between Fiscal Year 1995 and Fiscal Year 2000 amounted to S$35.4 billion[4].

7.2 To support the shrinking economy, the government introduced two separate off-budget fiscal stimulus packages in July and October 2001 respectively. These fiscal stimulus packages are expected to stimulate consumer spending and lower business costs, but may also result in an estimated budget deficit of S$4 billion in Fiscal Year 2001[5]. (Please refer to paragraphs 7.7 to 7.9 for a detailed discussion of the two off-budget packages.)

Table 1 - Government's Fiscal Position between Fiscal Year 1995 and Fiscal Year 2000 (in billions of Singapore dollars)

	1995	**1996**	**1997**	**1998**	**1999**	**2000**
Government Revenues	24.8	28.0	30.6	28.2	28.6	33.5
Government Expenditures	15.6	19.1	25.9	24.8	24.9	28.0
Budget Surpluses	9.2	8.9	4.7	3.4	3.7	5.5

Source: Singapore Ministry of Information and the Arts, *Singapore 2001*, 2001.

3 Fiscal year begins on 1 April and ends on 31 March.
4 The average exchange rate of Singapore dollar to US dollar in 2000 was S$1.73 = US$1.
5 The Singapore government has not announced the revised government revenues and government expenditures for Fiscal Year 2001 as of the date of the publication of this research report.

<u>Managing Fiscal Reserves</u>

7.3 Singapore's reserves, consisting of fiscal reserves and foreign reserves,[6] are managed by the Government of Singapore Investment Corporation (GIC)[7] which is wholly owned by the government. The GIC manages over US$100 billion of the country's reserve assets. However, the amount of fiscal reserves is not revealed to the public.

7.4 The investment objective is to achieve sustainable long-term returns to protect the real value of the assets. The GIC's investments are carried out overseas, largely in the form of portfolio investments in equities, fixed-income and money market instruments, real estate and special investments[8].

<u>Safeguarding Fiscal Reserves</u>

7.5 The Constitution of Singapore has provisions for safeguarding the country's fiscal reserves. First, Article 147(5f) of the Constitution provides the President with veto powers to safeguard fiscal reserves of the past government (i.e. fiscal reserves not being accumulated by the government during its current term of office[9]). Essentially, the government is required to achieve a balanced budget over the term of the government in order not to draw on past fiscal reserves.[10]

7.6 Second, Article 142 of the Constitution stipulates that the government is required to safeguard at least 50% of the Net Investment Income[11] (NII) earned from past fiscal reserves.[12] In other words, the government can only use up to 50% of the NII to finance its expenditures. The rest of NII is kept in fiscal reserves.

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6 Singapore's foreign reserves amounted to US$75.5 billion at the end of September 2001.

7 The formation of the GIC had its roots in the late 1970s. At that time, Singapore had a high saving rate among a young population, which was expected to contribute to the country's balance of payments surpluses for some time. The country's foreign reserves were also expected to grow continuously. Under such circumstances, the GIC was established in 1981 and has been responsible for investing the reserves in long-term, high-yielding assets. The current chairman of the GIC is Senior Minister Lee Kuan Yew.

8 Special investments include venture capital, infrastructure, mezzanine financing and corporate restructurings.

9 The President is the Head of the government and holds office for a term of six years.

10 Gisbert Flanz, *Constitution of the Countries of the World: Constitution of Singapore*, September 1995.

11 NII is the interest and dividend income earned from government's fiscal reserves, net of expenses on investment and borrowing charges.

12 *Singapore Government Gazette*, 23 November 2000.

Uses of Fiscal Reserves to Finance Two Off-budget Packages

7.7 To help Singaporeans and local businesses cope with the economic downturn, the Singapore government has used fiscal reserves to finance two separate off-budget support packages introduced in July and in October 2001 respectively. The measures of these two economic stimulus packages are discussed below.

First Off-budget Package

7.8 In July 2001, the Singapore government introduced a package of measures worth S$2.2 billion, equivalent to 1.4% of GDP, to stimulate the economy. The measures were classified into the following three categories:

(a) Accelerate the construction of infrastructure projects
-- developing Jurong Island, performing drainage and sewerage works, constructing road and public transport facilities, and upgrading information technology projects at polytechnics and universities.

(b) Cut costs
-- reducing foreign worker levy to hold down business costs;
-- extending a 25% property tax rebate for one year from 1 July 2001 to 30 June 2002;
-- extending rental rebates for public housing flats for one year until 30 June 2002;
-- offering a 20% port dues concession to container ships and commercial harbour craft; and
-- allowing local companies to access financing by
(i) raising the government's risk-sharing percentage of the Local Enterprise Financing Scheme[13] (LEFS) from 50% to 70% for one year until July 2002;
(ii) increasing loan availability under LEFS; and
(iii) introducing a loan insurance scheme to help small and medium-sized companies obtain loans from banks.

[13] This is a fixed-interest financing programme designed to encourage entrepreneurship and assist local enterprises in strengthening their operations. The scheme is administered by the Productivity and Standards Board, a government agency.

(c) Help the unemployed and promote worker retraining
- -- expanding job matching services by increasing the number of career centres[14];
- -- offering a new "People for Jobs" Traineeship Programme[15] for older and less educated workers;
- -- expanding the Skills Redevelopment Programme[16] (SRP) to help less educated workers acquire certifiable skills;
- -- providing incentives such as course fee support and absentee payroll support for employers to send less skilled workers for training; and
- -- introducing two training programmes, the National Information Technology Literacy Programme[17] and the Critical Enabling Skills Training Programme[18], for the unemployed and less educated workers.

Second Off-budget Package

7.9 As Singapore's economic conditions continued to worsen in the third quarter of 2001, the government introduced another fiscal stimulus package in October 2001 to tide the economy over the downturn. The size of the economic stimulus package was S$11.3 billion, equivalent to 7% of GDP. These measures were classified into eight categories:

(a) Tax and fee rebates and reductions for businesses and individuals
- -- granting corporate income tax rebates and personal income tax rebates for Years of Assessment 2001 and 2002;
- -- increasing property tax rebates for commercial and industrial properties[19];
- -- reducing stamp duty rates by 30% on all instruments (relating mostly to property and stock transactions), petrol excise duty by 40%, and diesel tax for taxis[20] by the amount of S$400; and
- -- granting a one-time S$100 road tax rebate for cars, taxis, goods vehicles and buses, and a 10% rebate on landing fees to airlines.

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14 The centres provide information on labour market trends, advice on job and training opportunities and employment assistance.

15 Under the programme, the government provides financial support for companies employing retrenched workers and companies agreeing to put in place a traineeship arrangement to help those workers.

16 This programme is jointly operated by the government and the National Trade Union Congress.

17 This programme aims to improve the employment prospect for Singaporeans by equipping them with basic computer and Internet skills.

18 This programme aims to provide seven core skills, such as "Learning-to-Learn", "Literacy", and "Problem Solving and Creativity", to enhance the employability of an individual worker.

19 The government gave a fixed rebate of up to S$8,000 per year to landlords of all commercial and industrial properties, and a further rebate of 30% for any balance of property tax payable.

20 The government charges taxis a diesel tax of S$5,100 per year.

(b) Assistance to local enterprises
- -- helping local enterprises access funds easier by
  - (i) reducing the interest rates for LEFS loans;
  - (ii) increasing the government's risk-sharing percentage under the LEFS from 70% to 80% for one year until July 2002; and
  - (iii) launching a new loan programme for very small companies;
- -- offering cash grants to market stall-holders (S$15,000) and cooked food stall-holders (S$19,000); and
- -- upgrading hawker centres.

(c) Land/Property-related stimulating measures
- -- suspending the sale of industrial land for the rest of 2001 and 2002, and extending the projected completion period for all government industrial land sale projects[21];
- -- suspending the sale of residential and commercial sites for 2002;
- -- removing income tax on gains from the sale of property;
- -- exempting property tax for land under development; and
- -- extending rental rebates for commercial and industrial tenants of government properties.

(d) Acceleration of infrastructure projects
- -- accelerating more than 100 infrastructure projects, which include upgrading the National University of Singapore (NTU) campus, expanding NTU teaching facilities, and constructing new clinics and hospitals.

(e) Employment assistance for workers and executives
- -- funding training and skills upgrading programmes;
- -- expanding the "People for Jobs" Traineeship Programme;
- -- enhancing the Skills Redevelopment Programme;
- -- increasing funding support for training through Skills Development Fund and the National Trade Union Congress Education and Training Fund; and
- -- intensifying employment assistance services.

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[21] Currently, developers of industrial sites are granted projected completion periods of eight or 10 years. The periods will be extended by two years for land sites already awarded, thus increasing the average projected completion period to 10 to 12 years.

(f) Help for the lower-income and unemployed citizens
  - -- freezing undergraduate and polytechnic tuition fees;
  - -- suspending repayment of tuition fees loans and study loans for one year;
  - -- easing the cash flow requirement for new public housing buyers by extending the down-payment period;
  - -- providing financial assistance for public housing mortgagors;
  - -- reducing electricity tariffs by 4% from 1 November 2001 onwards and by a further 6% from 1 January 2002 onwards;
  - -- offering rebates on utilities bills to help public housing tenants;
  - -- extending Service and Conservancy rebates for public housing tenants;
  - -- extending rent-free periods and rental rebates for public housing tenants until March 2003;
  - -- implementing Hospitalisation Fee Assistance Scheme to help Singaporeans meet their medical costs; and
  - -- introducing a new Economic Downturn Relief Scheme to help Singaporeans pay for essential expenses, such as food and school fees.

(g) New Singapore Shares
  - -- giving New Singapore Shares (NSS)[22] to adult Singapore citizens as a means of distributing part of fiscal reserves to the population. The distribution is weighted in favour of less well-off Singaporeans to help them during the current economic downturn. Qualified citizens will receive a package of 200 NSS to 1 400 NSS, depending on income levels for employed citizens, and housing types for self-employed and unemployed citizens.

(h) Measures related to wage costs
  - -- recommending wage freeze or appropriate wage cost reduction;
  - -- reducing civil servants' 2001 year-end payments; and
  - -- reducing the monthly salaries of political appointees and senior civil servants by 10% from 1 November 2001 onwards for 12 months.

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22 NSS is worth S$1 per share. NSS will earn annual dividends in the form of bonus shares for five years, from 2002 to 2007, at a guaranteed minimum return of 3% per annum. An extra dividend will be declared yearly, equal to the GDP growth (if positive) of the previous calendar year. In other words, the better the economy performs, the higher will be the number of bonus shares issued.

PART 3 -- NORWAY

8. Current Economic Situation

8.1 After a 2.3% Gross Domestic Product[23] (GDP) growth in 2000, Norway's GDP growth is projected to slow down to 1.6% in 2001 due to the deteriorating international economic environment. The global economic downturn has affected the performance of both Norwegian exports[24] and domestic consumption. Nevertheless, the government forecasts a higher GDP growth rate of 2.7% in 2002 on the back of expected increased investment from the manufacturing, petroleum and residential construction sectors.

9. Principles of Fiscal Policy

9.1 The government has stated the following principles of fiscal policy in the Guidelines for Economic Policy:[25]

(a) to allocate resources for public consumption, public investment and transfers to achieve the highest possible welfare over time; and

(b) to contribute to a stable and sustainable economic development.

9.2 To adhere to these two principles, the government set out the following guidelines for fiscal policy:

(a) The government should stabilize fluctuations in the economy with a view to controlling inflation and ensuring low unemployment.

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[23] The petroleum sector plays an important role in the Norwegian economy, accounting for approximately 18% of GDP and 29% of government revenues respectively in 2000.

[24] Norway's major exports are petroleum, fish and aluminium. In 2000, petroleum exports accounted for about 55% of the total exports.

[25] The Ministry of Finance, *Guidelines for Economic Policy*, March 2001.

(b) The government should estimate the expected return on the Government Petroleum Fund[26] (the Fund) at the beginning of a fiscal year[27] and then allocate the corresponding amount of capital out of the Fund to finance government spending. For example, if the expected rate of return on the Fund is 4% and the value of the Fund amounts to Nok 650 billion, under this guideline, the government may transfer Nok 26 billion (i.e. Nok 650 billion x 4%) from the Fund to finance government expenditures.

10. Practices of Maintaining Fiscal Reserves

Government's Fiscal Position Between Fiscal Year 1997 and Fiscal Year 2000

10.1 Government revenues grew by 29% to reach Nok 643.6 billion[28] in Fiscal Year 2000 over Fiscal Year 1999 (see Table 1). The substantial growth was attributed to a surge in revenues from petroleum activities. Budget surplus rose by 475% in Fiscal Year 2000 over Fiscal Year 1999 to reach Nok 153.4 billion, equivalent to about 10.8% of GDP. The accumulated budget surpluses between Fiscal Year 1997 and Fiscal Year 2000 amounted to Nok 280.3 billion[29].

Table 2 - Government's Fiscal Position between Fiscal Year 1997 and Fiscal Year 2000 (in billions of Nok)

	1997	**1998**	**1999**	**2000**
Government Revenues	478.2	471.3	499.6	643.6
Government Expenditures	411.5	443.7	467.0	490.2
Budget Surpluses	66.7	27.6	32.6	153.4

Source: Ministry of Finance

26 Norway recorded budget surpluses between Fiscal Year 1995 and Fiscal Year 2000. The government has set aside the accumulated budget surpluses into a stabilization fund known as the Government Petroleum Fund. (Please refer to paragraphs 10.2 to 10.7 below for a detailed discussion of the Government Petroleum Fund.)

27 Fiscal year begins on 1 January and ends on 31 December.

28 The average exchange rate of Norway kroner to US dollar in 2000 was Nok 8.5 = US$1.

29 We do not have data for Fiscal Year 1995 and Fiscal Year 1996.

Practices of Maintaining Fiscal Reserves

10.2 The government established the Government Petroleum Fund in 1990 through enacting the Petroleum Fund Act to transform budget surpluses into foreign financial assets. It is noteworthy that the Government Petroleum Fund serves as the government's fiscal reserves.

Purposes of the Government Petroleum Fund

10.3 The Government Petroleum Fund has two purposes. First, it acts as a financial buffer to smooth variations in petroleum revenues, which helps maintain the robustness of the Norwegian economy and allows the government to have greater room for manoeuvre in its economic policies.

10.4 Second, the Government Petroleum Fund will be used to pay for the expected rising social security expenditures[30] in future years as a result of demographic changes. The government has emphasized that Norway's population is ageing. The ratio of Norwegian citizens aged 67 or older to the labour force is projected to increase from 26% in 2001 to 43% by 2050. The fiscal cost of social security is estimated to increase from 8% of GDP in 2001 to about 20% of GDP by 2050.

Management of the Government Petroleum Fund

10.5 Norges Bank, the Central Bank of Norway, is responsible for investing the Government Petroleum Fund in accordance with the investment guidelines provided by the Ministry of Finance.

10.6 The Petroleum Fund Act stipulates that capital in the Government Petroleum Fund should be invested in equities and fixed-income instruments abroad. The government states that investing the Government Petroleum Fund in foreign assets can protect the Norwegian economy from both fluctuations in demand and price pressures that may occur if the volatile petroleum revenues are used to relax and constrain government expenditures which will then move in the same volatile cycle.

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30 Norway has a comprehensive social welfare system. All Norwegian citizens are insured compulsorily under the National Insurance Scheme, which is financed by contributions from employers, employees and tax revenues. This scheme confers a wide range of benefits, including old-age pension benefits, disability benefits, family allowances, medical benefits, and cash benefits for sickness, maternity and unemployment. These benefits are linked to a basic amount, which is adjusted on a discretionary basis, generally annually, by Parliament.

Size of the Government Petroleum Fund

10.7 The government has accumulated substantial foreign assets in the Government Petroleum Fund. The value of the Government Petroleum Fund is estimated to reach Nok 650 billion at the end of 2001 (or about 42% of GDP). The government has projected that the Government Petroleum Fund may continue to increase to about Nok 1,450 billion at the end of 2005 (or about 90% of GDP).

PART 4 -- NEW ZEALAND

11. Current Economic Situation

11.1 New Zealand's Gross Domestic Product (GDP) expanded by 2.6% in 2000 and 2.3% in the first half of 2001. However, the government has projected that the GDP growth will fall to 1.5% in both 2001 and 2002 owing to the global economic downturn. Slower export growth and uncertainty around the world are expected to make firms think twice before hiring new staff and undertaking new investment.

12. Principles of Fiscal Policy

<u>The Fiscal Responsibility Act</u>

12.1 New Zealand faced serious fiscal problem at the beginning of the 1990s. During that period, the government adopted a lax fiscal policy which allowed government expenditures to grow to over 40% of GDP. High spending caused large and persistent budget deficits. The government had to finance its operations through borrowing. In Fiscal Year[31] 1993, budget deficits and government debt reached highs of 8.8% of GDP and 52% of GDP respectively.

12.2 The government recognized that the deteriorating fiscal position would affect the country's economic condition and long-term economic performance. To promote consistent, good quality fiscal management, the Fiscal Responsibility Act was enacted in 1994. This Act sets legal standards for transparency of fiscal policy and reporting, and holds the government formally responsible to the public for its fiscal performance.

12.3 The Fiscal Responsibility Act sets out the following four principles to govern fiscal policy:

(a) Government debt should be reduced to a prudent level.
  - This principle acknowledges that the level of government debt was too high in 1994, and that the government needs to run budget surpluses for a period of time to reduce outstanding government debt.

[31] Fiscal year begins on 1 July and ends on 30 June.

(b) Once government debt is down to a prudent level, the government should maintain a balanced budget on average over the medium to long term.
-- This principle implies that the government can pursue counter-cyclical fiscal policy, but that over time budget deficits and budget surpluses are required to balance out.

(c) The government should manage fiscal risks prudently.
-- This principle calls for attention to fiscal risks such as shifts in the demographic structure of the population which may have an impact on fiscal position. For example, an ageing population will imply higher government expenditures on health services.

(d) The government should pursue policies that are consistent with a reasonable degree of predictability about the level and stability of tax rates for future years.
-- This principle recognizes the importance of tax stability for private sector planning.

12.4 It is noteworthy that these four principles of responsible fiscal management are stated in general terms in the legislation and do not mandate any specific fiscal targets. The government may specify its meaning of the relevant fiscal terms such as "a prudent level" and "a reasonable degree" in the Budget Policy Statement.

12.5 The Fiscal Responsibility Act also allows the government to deviate from these four principles only if such a deviation is temporary. In the event of a deviation, the Fiscal Responsibility Act requires the government to specify the reasons for the deviation, the actions the government intends to takes to return to the principles, and the time period it expects to take to return to the principles.

12.6 In accordance with the Fiscal Responsibility Act, the government has to update its long-term fiscal objectives in the Budget Policy Statement. The long-term fiscal objectives specified in the Budget Policy Statement 2001 were to:

(a) limit government expenditures at the level of 35% of GDP;

(b) raise sufficient government revenues to fund government expenditures;

(c) run budget surplus on average over the economic cycle; and

(d) reduce government debt to below 30% of GDP.

13. Practices of Maintaining Budget Surpluses

Government's Fiscal Position Between Fiscal Year 1994 and Fiscal Year 2000

13.1 Following the implementation of the Fiscal Responsibility Act, New Zealand recorded fiscal surpluses from Fiscal Year 1994 to Fiscal Year 2000 (see Table 3). Nonetheless, the annual budget surplus dropped continuously from 3.7% of GDP in Fiscal Year 1994 to 0.4% of GDP in Fiscal Year 2000.

13.2 To attain the long-term fiscal objectives, the government controlled its expenditures at around 35% of GDP between Fiscal Year 1994 and Fiscal Year 2000. The government is committed to maintaining its spending at this level in the next few years.

Table 3 - Government's Fiscal Position between Fiscal Year 1994 and Fiscal Year 2000 (in percent of GDP)

	1994	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**
Government Revenues	38.2	38.0	36.2	36.3	36.4	34.5	34.2
Government Expenditures	34.5	34.4	34.3	34.9	35.8	34.2	33.6
Budget Surpluses	3.7	3.6	1.9	1.4	0.6	0.3	0.4
Government Debt	50.1	44.9	37.5	38.6	36.7	34.0	31.9

Sources: International Monetary Fund, *Staff Country Report: New Zealand*, October 2000.
The Treasury, *Budget Economic and Fiscal Update 2001*, May 2001.

Uses of Budget Surpluses

13.3 Although New Zealand has recorded budget surpluses from Fiscal Year 1994 onwards, there is still no fiscal reserve. The country uses its budget surpluses to pay off government debt and to fund its public pension scheme.

Paying off Government Debt

13.4 A top priority of the government's agenda is to repay government debt. In addition to using budget surpluses, the government raises funds from domestic and international markets and sells government-owned enterprises to finance its debt. Accordingly, the government debt was reduced from the peak of 52% of GDP in Fiscal Year 1992 to 31.9% of GDP in Fiscal Year 2000.[32]

Funding New Zealand Superannuation

13.5 New Zealand has a universal public pension system called New Zealand Superannuation which is funded with tax revenues. The amount of pension benefit is based on the pensioner's marital status and the nation-wide average wage. Pension benefits are paid from age 65 onwards, and are set at 65% of the average wage.

13.6 The government has emphasized that New Zealand's population is ageing. The proportion of the population aged over 65 is expected to increase from the current 12% to 25% by 2050. In addition, falling birth rates and increasing life expectancy are expected to result in future superannuation payments being much higher than present levels. The cost of New Zealand superannuation is projected to rise gradually from its current level of about 5% of GDP to over 10% of GDP by 2050.

13.7 To meet the present and future cost of New Zealand superannuation, the New Zealand Superannuation Act was enacted in October 2001. Under this Act, the government is empowered to start funding part of the future superannuation payments out of budget surpluses[33] beginning in Fiscal Year 2001.[34] Meanwhile, tax revenues will continue to be part of the contribution.

[32] Government debt amounted to US$16 billion in Fiscal Year 2000.

[33] The government entity responsible for administering and investing the New Zealand Superannuation Fund is the Guardians of New Zealand Superannuation. The Guardians are required to invest the Fund on a prudent and commercial basis. The Board of Guardians is appointed by the government on the basis of their commercial expertise.

[34] The estimated cumulative contributions will be about 3% of GDP by the end of Fiscal Year 2003.

PART 5 -- ARGENTINA

14. Current Economic Situation

14.1 Argentina's Gross Domestic Product (GDP) contracted by 3.4% in 1999 and by another 0.5% in 2000 mainly due to declined investment in the construction and manufacturing sectors. The International Monetary Fund (IMF) has forecasted Argentina's GDP to contract by 2.7% in 2001[35] and by another 1.1% in 2002. The economy is expected to remain in recession in 2002 due to weak investment sentiment, sluggish domestic demand and social unrest[36].

15. Principles of Fiscal Policy

15.1 Argentina's fiscal position was on a decline in the 1990s. Government debt increased from US$96.5 billion in 1989 to US$134.5 billion in 1999 because of increased expenditures on social security, health-care services, government administration and debt service payments[37].

15.2 The Argentine government recognized that the magnitude of government debt and mounting debt service costs would constrain its ability in implementing fiscal policy to stimulate the country's economic growth.

15.3 To reduce government debt over the medium term, the Fiscal Responsibility Act was enacted in August 1999, which requires the government to reduce future budget deficits and to balance the budget by Fiscal Year[38] 2005. The medium-term fiscal consolidation is based on the freezing of government spending at the level of Fiscal Year 2000, and the strengthening of structural reforms in tax administration, social security system and public administration.

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35 The economy contracted 4.9% in the third quarter of 2001 and the unemployment rate was at a high 18.3% in October 2001.

36 There are ongoing public protests in Argentina in the wake of the country's current economic crisis and political turmoil.

37 Government debt service payments in 1999 represented about 6% of GDP.

38 Fiscal year begins on 1 January and ends on 31 December.

15.4 The Fiscal Responsibility Act stipulates that the government should establish a target for the budget deficit in a fiscal year. For instance, the targeted budget deficit was 1.8% of GDP in Fiscal Year 2000[39]. However, the government was unable to meet the fiscal target for Fiscal Year 2000 because of increased government debt service payments[40] and lower-than-expected government revenues[41].

15.5 To be eligible for accessing the IMF funds, the Argentine government is required to meet the IMF's loan conditions[42]. An important reform carried out by the government was to enact the Zero-deficit Act in August 2001. Under the Zero-deficit Act, the government is required to limit its monthly spending to match the monthly tax revenues. If tax collection after debt service payments is not enough to cover government expenditures, payments to civil servants and pensioners will be reduced so as to match spending to revenue.

16. Practices of Financing Government Debt

Government's Fiscal Position Between Fiscal Year 1995 and Fiscal Year 2000

16.1 The government has recorded budget deficits since the early 1980s. The budget deficit as a percentage of GDP ranged from 2% to 4.1% between Fiscal Year 1995 and Fiscal Year 2000 (see Table 4).

Table 4 - Government's Fiscal Position between Fiscal Year 1995 and Fiscal Year 2000 (in percent of GDP)

	1995	**1996**	**1997**	**1998**	**1999**	**2000**
Government Revenues	23.2	22.1	23.1	23.7	24.2	24.5
Government Expenditures	25.5	25.3	25.1	25.3	28.3	28.1
Budget Deficits	2.3	3.2	2.0	1.6	4.1	3.6

Source: International Monetary Fund, *Argentina: Selected Issues and Statistical Annex*, December 2000.

39 The fiscal target for Fiscal Years 2001 and 2002 is 1.3% of GDP and 1.7% of GDP respectively.
40 Government debt service payments continued to increase because of increased government debt and higher costs of new borrowing.
41 The government revenue shortfall was mainly caused by weaker-than-expected economic activities.
42 In September 2001, the IMF asked the Argentine government to cut spending by US$8 billion in Fiscal Year 2002.

Practices of Financing Government Debt

16.2 The Argentine government does not have any fiscal reserves because the country has been running budget deficits for more than two decades. Government debt has increased to the current level of US$162 billion. To finance government debt, Argentina relies heavily on funding from multilateral lending agencies, including the IMF, the United States of America (US) Government and institutional investors[43].

16.3 In early January 2002, the Argentine government formally entered into default on its debt, when it failed to pay US$28 million in interest payments due on lira-denominated bonds. To restructure government debt and strengthen its fiscal position, Argentina has been seeking funds from the IMF, the World Bank and the US government. The IMF has responded that it will not consider providing any additional support for Argentina until the country has developed a plan to put the economy back on a sustainable track.

17. Argentina's Convertibility Programme: the Currency Board System

17.1 Argentina fell into hyperinflation in early 1990. Inflation reached a monthly rate of 95% in March 1990, and the economy collapsed as residents scrambled to find alternative means for setting prices, protecting savings and conducting economic transactions.

17.2 In April 1991, Argentina launched a Convertibility Programme which established a currency board through enacting the Convertibility Act to peg the Argentine peso at one-to-one to the US dollar so as to improve policy credibility and to maintain macro-economic stability.

17.3 The Convertibility Act requires the Central Bank of Argentina to maintain the country's foreign reserves[44] which should be equivalent to at least 100% of the monetary base[45] to defend the fixed exchange rate system[46]. The Convertibility Act does not require the Argentine government to use fiscal reserves, if there are any, to defend the linked exchange rate regime. As discussed in paragraph 16.2 above, the Argentine government does not have any fiscal reserves and has to raise funds from multilateral lending agencies to finance government debt.

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43 For example, in November 2001, multilateral lending agencies provided funds for the Argentine government to meet its debt obligations of US$132 billion to avoid a default.

44 The assets forming the foreign reserves may include: securities, bonds, fixed-interest instruments, gold, precious metals, US dollars and other major foreign currencies.

45 The monetary base in the Argentine peso is formed by outstanding currency plus any deposits of financial entities with the Central Bank of Argentina.

46 Under the convertibility arrangement, the Central Bank of Argentina has to maintain at least US$13 billion -- an estimated amount of Argentine pesos in circulation – of foreign reserves to defend the linked exchange rate system. At the end of October 2001, Argentina's foreign reserves amounted to US$18.3 billion.

17.4 To help the export sector and to revive economic growth, the legislature amended the Convertibility Act in June 2001 to introduce a dual exchange rate mechanism. Trade transactions were converted at an exchange rate based on a 50% US dollar and 50% Euro currency basket,[47] while investment transactions were converted at the fixed exchange rate of one peso to one US dollar. The Argentine government indicated its intention of replacing the peso's link to the US dollar with a link to the 50% US dollar and 50% Euro basket when the Euro reaches parity with the US dollar[48]. In other words, the Argentine government planned to peg the peso to the average exchange rate between the US dollar and the Euro.

17.5 Although the Argentine government insisted on retaining the currency board system, the peso came under heavy pressure in the last few months owing to high rates of deposit withdrawals[49] and falling foreign reserves. There were fears of currency devaluation and debt default.

17.6 On 6 January 2002, Argentina abolished the currency board system and devalued its currency by 29% to the new exchange rate of 1.40 pesos to one US dollar. The government also allowed its currency floating in the foreign exchange market. The peso's value has declined further against the US dollar in the free market. The current exchange rate is 2.0 pesos to one US dollar.

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[47] Since the appreciation of the Argentine peso -- caused by the strong US dollar – had made Argentina's exports expensive, this arrangement devalued the peso for trade transactions by around 5% in June 2001.

[48] This means that the exchange rate between the US dollar and the Euro is one to one.

[49] In January - November 2001, 17% of bank deposits (equivalent to US$14.5 billion) were withdrawn from the banking system. In an effort to restrict bank deposit withdrawals, Argentina imposed banking and exchange controls in early December 2001. Under this regulation, Argentines could withdraw only US$250 a week in cash from each bank account, or a maximum of US$1,000 a month. The government also limited transfers of funds abroad. Argentines were not allowed to take more than US$1,000 abroad in cash and companies had to obtain clearance to make foreign payments above that amount.

PART 6 -- THE UNITED STATES OF AMERICA

18. Current Economic Situation

18.1 The economy of the United States of America (US) expanded continuously between 1992 and 2000[50], being supported by strong consumer spending and business investment. However, the pace of economic growth had slowed significantly since the fourth quarter of 2000 and the expansion turned negative in the third quarter of 2001 when Gross Domestic Product (GDP) contracted by an annual rate of 1.3%[51]. The weak third-quarter economic performance reflected the decline in both consumer spending and business investment in new plants and equipment, which was exacerbated by the 11 September terror attack.

18.2 In an attempt to revive the economy, both fiscal[52] and monetary policies[53] have been relaxed. Although the US economy is probably entering into a recession, the Federal Reserve expects a modest and gradual recovery in the economy by mid-2002. GDP is projected to grow by 0.7 % in 2002, after an estimated 1.0% rise in 2001.

19. Principles of Fiscal Policy

19.1 In the US, the principles of fiscal policy which call for restraining budget deficits are set out in laws.

19.2 Prior to the 1980s, the US government's budget deficits did not cause much concern. Budget deficits became an issue of concern in the 1980s when the size of deficits increased rapidly as a result of surging defence spending and sagging economic growth.

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50 Gross Domestic Product growth in 2000 was 5%.

51 The unemployment rate rose to 5.8% in November 2001, its highest level since August 1995.

52 Please see section 21 for details of the economic stimulus packages.

53 In an effort to restore economic growth, the Federal Reserve reduced the Federal Funds Rate 11 times in 2001 to 1.75% in December, its lowest level in nearly four decades. The cumulative cut of interest rates was 4.75% in 2001.

19.3 By the mid-1980s, the government became worried about the ever-rising budget deficits, which significantly increased the government's debt burden. The government recognized that rising budget deficits were unhealthy because of the following adverse consequences:

(a) Rising budget deficits forced the government to allocate billions of dollars for interest payments on government debt.

(b) Rising budget deficits forced the government to raise interest rates to attract capital to cover the deficits. Accordingly, less money was available for corporate and private borrowing, which constrained investment and subsequently economic growth.[54]

(c) Rising budget deficits raised the likelihood of fiscal instability for future generations of Americans, which was morally wrong.

19.4 To restrain budget deficits, the Balanced Budget and Emergency Deficit Control Act was enacted in 1985. This Act required the budget deficit be reduced by a specified dollar amount for a fiscal year[55] and the budget be balanced by Fiscal Year 1991. Although budget deficits went down somewhat in the late 1980s, the statutory targets were not met.

19.5 As a result of that failure, the Budget Enforcement Act[56] was enacted in 1990 which set a specific dollar limit on government spending[57] for a fiscal year and created a "pay-as-you-go" (PAYGO) provision which required the costs of new or expanded government programmes be explicitly covered through either higher taxes or lower expenditures in other programmes. The PAYGO requirement is designed to prevent the further deterioration of budget deficits.

19.6 These budget mechanisms were effective means in restraining the growth in government spending and controlling budget deficits. The fiscal position improved progressively in the 1990s, being aided by the prolonged economic expansion.

54 This is known as the "crowding-out" effect which states that the rise in interest rates with an expansionary fiscal policy may result in an offsetting reduction in private expenditures.
55 Fiscal year begins on 1 October and ends on 30 September.
56 The Balanced Budget and Emergency Deficit Control Act of 1985 was supplanted by the Budget Enforcement Act of 1990.
57 The controls of deficit targets were replaced by the restrictions on government expenditures.

20. Practices of Financing Government Debt

Government's Fiscal Position Between Fiscal Year 1995 and Fiscal Year 2000

20.1 The US government recorded budget surpluses between Fiscal Year 1998 and Fiscal Year 2000. In Fiscal Year 1998, the government's budget surplus amounted to US$69.2 billion[58]. The budget surplus grew to US$124.6 billion in Fiscal Year 1999 and US$169.0 billion in Fiscal Year 2000 (see Table 5). However, the budget surplus in Fiscal Year 2001 fell to US$127 billion,[59] reflecting a weakening economy.

20.2 The improvement in fiscal position between Fiscal Year 1998 and Fiscal Year 2000 was mainly due to strong economic growth which boosted government revenues at a rate faster than the growth in government spending. Additionally, the end of the Cold War had slowed down the expansion in defence spending.

Table 5 - Government's Fiscal Position between Fiscal Year 1995 and Fiscal Year 2000 (in billions of US dollars)

	1995	1996	1997	1998	1999	2000
Government Revenues	1,351.8	1,453.1	1,579.3	1,721.8	1,827.5	2,025.2
Government Expenditures	1,515.8	1,560.6	1,601.3	1,652.6	1,702.9	1,856.2
Budget Balances	-164.0	-107.5	-22.0	69.2	124.6	169.0

Source: Office of Management and Budget, *The Budget For Fiscal Year 2002: Historical Tables*, p.22.

[58] This was the first budget surplus since 1969.
[59] It marked the first time in a decade that the government's fiscal position did not show an improvement.

Practices of Financing Government Debt

20.3 The gross government debt is divided into two categories: debt held by the public[60] and debt the government owes itself[61]. At the end of Fiscal Year 2000, the gross government debt totalled US$5.63 trillion. Government debt held by the public was US$3.41 trillion and government debt held by government accounts was US$2.22 trillion respectively (see Table 6).

20.4 Government borrowing involves the sale of notes and bonds of various sizes and time to maturity. The cumulative amount of borrowing from the public -- i.e. the government debt held by the public -- is a more important measure of government debt because it determines how much interest the government pays to the public.[62]

Table 6 - Government's Debt Position between Fiscal Year 1995 and Fiscal Year 2000 (in trillions of US dollars)

	1995	1996	1997	1998	1999	2000
Government Debt Held by the Public	3.60	3.73	3.77	3.72	3.63	3.41
Government Debt Held by Government Accounts	1.32	1.45	1.60	1.76	1.97	2.22
Gross Government Debt	4.92	5.18	5.37	5.48	5.60	5.63

Source: Office of Management and Budget, *The Budget For Fiscal Year 2002: Historical Tables,* p.116-117.

20.5 It is noteworthy that the US government used budget surpluses accumulated between Fiscal Year 1998 and Fiscal Year 2000 to pay down the outstanding government debt held by the public. As a result, government debt held by the public were down from US$3.77 trillion at the end of the Fiscal Year of 1997 to US$3.41 trillion at the end of Fiscal Year 2000.

60 This is the cumulative amount of money the government borrowed from the public.

61 The debt the government owes itself is the sum of all trust funds surpluses which the law requires to be invested in government securities over the years. The major trust funds are: Social Security Trust Funds, Medicare Trust Funds, Retirement Trust Funds and Postal Service Fund.

62 Interest payments on government debt were about 10% of government expenditures in Fiscal Year 2000.

21. Economic Stimulus Packages

The Economic Growth and Tax Relief Reconciliation Act of 2001

21.1 To provide tax relief to taxpayers as a means to enhance economic growth and to improve the livelihood of the general public, the Economic Growth and Tax Relief Reconciliation Act of 2001 was enacted in May 2001. It provides for a US$1.35 trillion tax cut in 10 years. The major provisions contained in the Act are summarized as follows:

Income Tax Rate Cuts

21.2 The centrepiece of the new tax law is an across-the-board cut in income tax rates. Prior to the enactment of the new law, income tax rates ranged from 15% to 39.6%. The Economic Growth and Tax Relief Reconciliation Act of 2001 makes two major changes to the tax system.

(a) Create a new 10% tax bracket
   -- The new law lowers the tax rate from 15% to 10% for the first US$12,000 of taxable income for married couples and US$6,000 for singles. The tax rate cut was retroactive to the beginning of 2001.[63]

(b) Across-the-board cut in marginal income tax rates[64]
   -- The top income tax rate will be lowered by 4.6 percentage points in three stages, and the other tax rates -- except for the 15% rate -- will be lowered by three percentage points. The first cut took effect in July 2001, the second will take effect in 2004, and the third in 2006. The top rate will eventually drop from 39.6% to 35%; the 36% rate to 33%; the 31% rate to 28%; and the 28% rate to 25%.

Child Tax Credit

21.3 The child credit[65] for families with children under age 17, which was worth up to US$500 per child in Fiscal Year 2000, will be gradually increased to US$1,000 in Fiscal Year 2010.

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63 The government sent out tax rebate cheques to taxpayers between July and September 2001.

64 The President's tax plan recognizes the important role of constructive tax policy in stimulating long-term growth. Reduction in marginal tax rates may encourage greater work effort and provide more inducement for personal saving and business investment.

65 Parents can use the child tax credit to offset taxes owed.

Dependent Care Tax Credit

21.4 The amount of expenses eligible for the dependent care credit will be increased from US$2,400 in Fiscal Year 2000 to US$3,000 in Fiscal Year 2003 for each dependent.

Standard Deductions for Married Couples

21.5 The new law will increase the standard deductions for married couples beginning in Fiscal Year 2005. This measure is aimed at easing the so-called "marriage penalty", which causes many two-earner couples to pay more tax than they would pay as single individuals.

Retirement Savings Incentive

21.6 The new law will provide a tax credit for contributions to Individual Retirement Accounts to encourage lower-income workers[66] to save for retirement. The credit is available from Fiscal Year 2002 through Fiscal Year 2006. The credit ranges from 10% to 50% of the contribution, depending on the taxpayer's income. The maximum annual contribution eligible for the credit is US$2,000.

Employer-Provided Educational Assistance

21.7 The new tax law makes the tax exemption for employer-provided educational assistance permanent. The tax break was originally slated to expire at the end of Fiscal Year 2001. The new law also extends the exemption to graduate-level studies beginning in Fiscal Year 2002.

Estate Tax Repeal

21.8 Federal estate taxes will be steadily reduced and eventually abolished in Fiscal Year 2010.

66 Taxpayers with annual incomes below US$25,000 for singles and US$50,000 for couples are eligible for the tax credit.

The Second Economic Stimulus Package: Current Development

21.9 In the wake of the 11 September terrorist attacks, President Bush proposed a US$100 billion economic stimulus package which focuses mostly on further tax cuts for businesses and individuals to stimulate economic growth. The package aims to accelerate write-offs for businesses, accelerate tax cuts scheduled to take effect under the tax relief package and distribute a US$300 tax rebate to each low-income worker. The Republican-controlled House of Representatives approved this economic stimulus package in October 2001.

21.10 However, as of the date of the publication of this report, the Democrat-controlled Senate is still at odds over the contents of the economic stimulus package as they want to spend more on unemployment benefits.[67] The Bush Administration has repeatedly urged the Senate to pass the economic stimulus bill in the face of a weak economy.

67 The Democrats have proposed the offer of a 13-week extension of unemployment benefits and vouchers for laid-off people to pay for health insurance.

PART 7 -- HONG KONG

22. Current Economic Situation

22.1 Growth in Hong Kong's Gross Domestic Product (GDP) is estimated to slow down to 0% in 2001, in view of the high comparison base of growth in 2000[68], slackening consumer spending[69], rising unemployment[70] and slower global demand[71]. The International Monetary Fund (IMF) has projected a 1% GDP growth for Hong Kong in 2002.

23. Principles of Fiscal Policy

23.1 The principles of fiscal policy are set out in the Basic Law. The Hong Kong Special Administrative (HKSAR) Government (the Government) maintains that in drawing up the budget, it has to follow the principles set out in Article 107 of the Basic Law of keeping expenditure within the limits of revenues, striving to achieve a fiscal balance, avoiding deficits and keeping the budget commensurate with the growth rate of GDP. These constitutional provisions for financial prudence are crucial in maintaining the status of Hong Kong as an international financial centre.[72]

23.2 At present, the time frame adopted by the Government to strive a fiscal balance is the five-year forecast period for the Medium Range Forecast.

24. Government's Fiscal Position Between Financial Year 1995 and Financial Year 2001

24.1 The Government recorded surpluses in Financial Years[73] 1996-97, 1997-98 and 1999-2000 but had deficits for Financial Years 1995-96, 1998-99 and 2000-01 (see Table 7).

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68 The Hong Kong economy recorded a high 10.5% GDP growth in 2000.

69 Consumer spending continued to be dragged down by the lingering weakness in the asset markets and the worsening labour market condition. Retail sales value dropped by 4.2% year-on-year in November 2001.

70 The labour market showed signs of slackening in recent months. The unemployment rate increased to 6.1% for the period of October - December 2001.

71 Merchandise exports fell 4.8% year-on-year to US$159.6 billion in January - October 2001.

72 Article 109 of the Basic Law.

73 Financial year begins on 1 April and ends on 31 March.

Table 7 - Government's Fiscal Position between Financial Year 1995-96 and Financial Year 2001-02 (in billions of Hong Kong dollars)

	1995-96	**1996-97**	**1997-98**	**1998-99**	**1999-2000**	**2000-01**	**April to November 2001**
Government Revenues	180.0	208.4	281.2	216.1	233.0	225.0	99.7
Government Expenditures	183.2	182.7	194.4	239.3	223.0	232.8	154.6
Consolidated Balances	-3.2	25.7	86.8	-23.2	10.0	-7.8	-54.9

Sources: The Hong Kong Special Administrative Region Government, *Hong Kong Annual Report*, Various Issues.
The Hong Kong Special Administrative Region Government, *Press Release: 2000-01 Government Final Accounts*, 6 July 2001.
The Hong Kong Special Administrative Region Government, *Background Information for the Financial Secretary's Consultations with LegCo Members.*

24.2 For Financial Year 2001-02, Government revenue amounted to HK$99.7 billion and expenditure totalled HK$154.6 billion for the period April to November 2001, resulting in a deficit of HK$54.9 billion. According to the Financial Secretary in December 2001, the fiscal deficit may increase to some HK$60 billion in Financial Year 2001-02 because revenues from three major sources (namely, investment income on fiscal reserves, land premiums and the sale of Mass Transit Railway Corporation shares) are expected to be much lower than the original estimates.

24.3 Another concern of the Government is that operating expenditures have continuously exceeded operating revenues since Financial Year 1998-99. In the 2000-01 Budget, the Government estimated an operating deficit of HK$16.6 billion, HK$9.3 billion, HK$5.6 billion and HK$4 billion respectively for Financial Years 2001-02, 2002-03, 2003-04 and 2004-05. The updated scenario for Financial Year 2001-02 is likely to be an operating deficit of HK$37 billion.[74]

[74] An internal task force has been set up to review the public finance to determine whether the projected successive operating deficits are cyclical or structural in nature. The task force is expected to submit its findings to the Financial Secretary in the near future.

25. Guidelines on Purposes and Levels of Fiscal Reserves

25.1 A set of guidelines to determine the level of fiscal reserves was provided by the then Financial Secretary when he presented the 1998-99 Budget on 18 February 1998. He defined three purposes for which fiscal reserves are needed, namely, to meet **operating**, **contingency** and **monetary** requirements.

(a) The **operating** requirement provides money on hand to meet day-to-day cash flow needs and to cover those months in a financial year when expenditure exceeds revenue. An amount equivalent to three months of Government expenditure is considered adequate.

(b) The **contingency** requirement is to meet the Government's financial requirements when its revenues decline during a downswing in the economic cycle, or to cope with the consequences of unforeseen global events that would have serious implications for the public finance. An amount equal to nine months' expenditure, allowing a margin of plus or minus three months' expenditure, is considered sufficient.

(c) The **monetary** requirement underpins the exchange rate stability. An amount equal to the Hong Kong Dollar money supply under the M1 definition[75], allowing a margin of plus or minus 25%, is necessary.

25.2 Under the aforementioned guidelines, the level of fiscal reserves should be the sum of 12 months' government expenditure and Hong Kong Dollar money supply under the M1 definition, with a margin of plus or minus 25%. It means that fiscal reserves are considered to be at an appropriate level if they stay between the limits of 15 months' government expenditure plus 125% of Hong Kong Dollar money supply under the M1 definition (i.e. the upper limit) and nine months' government expenditure plus 75% of Hong Kong Dollar money supply under the M1 definition (i.e. the lower limit).

25.3 In his 1998-99 Budget Speech, the Financial Secretary pointed out that the guidelines were proposed in light of the Asian financial crisis in 1997 and 1998. The guidelines might be reviewed when the Government had built up some experience in following them. At that time, the estimated Government expenditure in 1997-98 was HK$198 billion. M1 money supply averaged HK$202 billion in 1997. This indicated that, to meet the guidelines, fiscal reserves should lie between HK$300 and HK$500 billion.

[75] M1 refers to the sum of legal tender notes and coins held by the public plus customers' demand deposits placed with licensed banks.

25.4 The Government's accumulated fiscal reserves of HK$446 billion as at 31 March 1998 fell within the range needed to cover all the requirements mentioned above.[76]

Size of Fiscal Reserves

25.5 The Government's fiscal reserves[77] comprise the accumulated balances of the General Revenue Account and seven funds[78], namely, Capital Works Reserve Fund, Capital Investment Fund, Civil Service Pension Reserve Fund, Disaster Relief Fund, Innovation and Technology Fund, Land Fund and Loan Fund. The entire balance of fiscal reserves is placed with the Exchange Fund[79] (please see paragraphs 25.10 - 25.13 for details.)

25.6 The Government accumulates the annual consolidated surplus in fiscal reserves. The fiscal reserve balance rose from HK$147.9 billion at the end of Financial Year 1995-96 to HK$457.5 billion at the end of Financial Year 1997-98 (see Table 8). It is noteworthy that fiscal reserves saw a big increase in Financial Year 1997-98 as a result of the establishment of the Land Fund on 1 July 1997 to receive the HK$197.1 billion worth of investments held by the former Trustees of the HKSAR Government Land Fund.

25.7 However, the fiscal reserve balance has declined since the end of Financial Year 1999-2000. It fell from HK$430.3 billion at the end of Financial Year 2000-01 to HK$375.3 billion on 30 November 2001, a drop of HK$55 billion.

Table 8 - Government's Fiscal Reserve Balance at the end of Financial Year (in billions of Hong Kong dollars)

	1995-96	**1996-97**	**1997-98**	**1998-99**	**1999-2000**	**2000-01**	**30 November 2001**
Fiscal Reserves	147.9	173.6	457.5	434.3	444.2	430.3	375.3

Sources: The Hong Kong Special Administrative Region Government, *Hong Kong Annual Report*, Various Issues.
The Hong Kong Special Administrative Region Government, *Press Release: Financial Results for Eight Months Ended 30 November*, 31 December 2001.

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76 The Hong Kong Special Administrative Region Government, *The 1998-99 Budget*, 18 February 1998, paragraphs 57-63.

77 Foreign reserves of Hong Kong amounted to US$111.2 billion at the end of December 2001. In terms of foreign reserves ranking, Hong Kong is the world's fourth largest holder of foreign reserves, after Japan, Mainland China and Taiwan.

78 These funds are established under section 29 of the Public Finance Ordinance to finance specific activities.

79 Exchange Fund was established for the purpose of maintaining the stability of the Hong Kong dollar.

<u>Uses of Fiscal Reserves</u>

25.8 The Government used fiscal reserves to finance consolidated deficits in Financial Years 1998-99 (amounting to HK$23.2 billion) and 2000-01 (amounting to HK$7.8 billion). The estimated deficit of some HK$60 billion in Financial Year 2001-02 will also be financed by drawing down fiscal reserves.

25.9 Fiscal reserves are also used as a source of income in Hong Kong as investment income of the reserves is used to fund government expenditures. For Financial Year 2000-01, investment income on fiscal reserves, totalling HK$23.5 billion, funded about 10% of that year's total government spending. For Financial Year 2001-02, the Government forecasts an investment income of HK$12.5 billion[80], which is expected to fund about 6.4% of the year's estimated total government spending.

25.10 The Financial Secretary entrusted the Hong Kong Monetary Authority (HKMA) with the responsibility of investing fiscal reserves which are placed with the Exchange Fund. Under Section 8 of the Exchange Fund Ordinance, the Financial Secretary is empowered to transfer money from the Exchange Fund to general revenue, after satisfying certain conditions. One condition is that the Financial Secretary should be "satisfied that such transfer is not likely to affect adversely his ability to fulfil any purpose for which the Exchange Fund is required to be or may be used under section 3(1) and (1A)." These sections deal with the exchange value of the currency of Hong Kong, the stability and the integrity of the monetary and financial systems of Hong Kong and maintaining Hong Kong as an international financial centre.

25.11 On 14 August 1998, the Financial Secretary, with the support of the Exchange Fund Advisory Committee and the consent of the Chief Executive, asked the HKMA to use the Exchange Fund to take appropriate measures in the stock and futures markets to counter speculative activities. Since fiscal reserves are placed with the Exchange Fund, the investment income of the Exchange Fund from these activities has formed part of the investment income of fiscal reserves.

<u>Investment Income on Fiscal Reserves</u>

25.12 At the end of December 2001, the total assets of the Exchange Fund had dropped to HK$980.6 billion, representing a decrease of HK$42.8 billion from HK$1,023.4 billion at the end of December 2000.

25.13 Investment income[81] on fiscal reserves decreased rapidly from HK$41.9 billion for Financial Year 1999-2000 to an estimated HK$12.5 billion for Financial Year 2001-02 (see Table 9).

80 The original forecast was HK$35.5 billion.
81 The Exchange Fund recorded investment income of HK$7.0 billion in 2001.

Table 9 - Investment Income on Fiscal Reserves between Financial Year 1997-98 and Financial Year 2001-02 (in billions of Hong Kong dollars)

	1997-98	**1998-99**	**1999-2000**	**2000-01**	**2001 Updated Estimate**
Investment Income on Fiscal Reserves	17.9	39.3	41.9	23.5	12.5

Source: The Hong Kong Special Administrative Region Government, *Background Information for the Financial Secretary's Consultations with LegCo Members*

PART 8 -- ANALYSIS

26. References for Hong Kong

26.1 The subject of fiscal reserves has been discussed on quite a number of occasions in the Legislative Council, namely at meetings with the Financial Secretary and the Secretary for the Treasury at the Finance Committee and the Financial Affairs Panel. Members are particularly concerned about the current arrangement in maintaining fiscal reserves and they question whether this arrangement would provide sufficient room for Hong Kong to face adversities and economic difficulties. Reference may be made to the practices in other jurisdictions in maintaining fiscal reserves and in financing fiscal deficits.

26.2 In this analysis, we have highlighted the following aspects for comparison purposes:

(a) In what manner a budget is proposed; whether the proposed budget is subject to any statutory regulation or fiscal policy;

(b) In the event that a balanced budget is required, the measures taken to ensure this is achieved;

(c) In what manner surpluses are kept and maintained; under what circumstances and with whose authority surpluses could be utilized;

(d) In what manner deficits are paid off; whether other alternatives are adopted apart from maintaining a fiscal reserve; how effective these measures are;

(e) In the event that a fiscal reserve or fund is in existence to pay off fiscal deficits, whether yardsticks are instituted to determine the level of reserve/fund;

(f) Whether the level of fiscal reserves/funds is a consideration when preparing the budget;

(g) Whether the fiscal reserves/funds are also used for objectives other than fiscal purposes; and

(h) In what manner fiscal reserves/funds are managed and invested; and under whose authority the reserves/funds can be used.

26.3 To facilitate Members' discussion, a comparison table of the findings of the jurisdictions covered in this study is provided in the Appendix. The information highlighted in the following paragraphs may be of relevance for further study.

Fiscal Policy

26.4 In Singapore, New Zealand, Argentina, the United States of America (US) and Hong Kong, the principles of fiscal policy are to avoid or reduce budget deficits, and to maintain a balanced budget on average over the medium to long term. In the cases of New Zealand, Argentina, the US and Hong Kong, these principles of fiscal policy are set out in laws. Hence, most of the governments of the jurisdictions studied strive to balance the budget and avoid deficits.

Measures to Achieve a Balanced Budget

26.5 In New Zealand, there are guidelines for raising sufficient government revenues to fund government expenditures and running budget surplus on average over the economic cycle.

26.6 In the US, there is a "pay-as-you-go" (PAYGO) provision in the Budget Enforcement Act of 1990 which requires the costs of new or expanded government programmes be explicitly covered through either higher taxes or lower expenditures in other programmes.

Ways to Finance Budget Deficits/Government Debt

26.7 In our research, Singapore, Argentina, the US and Hong Kong record budget deficits in the time period studied. Meanwhile, New Zealand, Argentina and the US have government debt.

26.8 Singapore has used fiscal reserves to finance the budget deficit in Fiscal Year 2001. New Zealand has financed government debt by raising funds from domestic and international markets and selling government-owned enterprises. Argentina has financed its budget deficits/government debt by raising funds from multilateral lending agencies, including the IMF, the US government and institutional investors. The US has financed its budget deficits/government debt by raising funds from domestic and international markets. In Hong Kong, the Government has used fiscal reserves to finance the deficits in Financial Years 1995-96, 1998-99 and 2001-02.

Issues Relating to the Ways to Finance Budget Deficits/Government Debt

26.9 In our study, the governments of the jurisdictions studied have adopted various ways to finance budget deficits/government debt.

26.10 Fiscal reserves are used to finance deficits in Singapore and Hong Kong. This practice, if continued, may imply scarcity of financial resources available in the future.

26.11 In New Zealand, Argentina and the US, budget deficits/government debt are financed by borrowing. The adverse consequences might include:

(a) the allocation of resources to service interest payments on government debt;

(b) forcing the government to raise interest rates to attract capital to cover deficits; and

(c) imposing financial burden on future generations.

Uses of Fiscal Reserves/Budget Surpluses to Finance Economic Stimulus Packages

26.12 Both Singapore and the US have implemented economic stimulus packages to help revive the economy and to minimize the impact of economic downturn.

26.13 In the case of Singapore, the government used fiscal reserves to finance two separate off-budget support packages introduced in July and October 2001 respectively. The major measures of these two packages included:

(a) accelerating the construction of infrastructure projects;

(b) providing tax and fee rebates;

(c) reducing business costs;

(d) helping the unemployed and promoting worker retraining;

(e) providing assistance to local enterprises;

(f) implementing land/property-related stimulating measures;

(h) issuing New Singapore Shares; and

(i) reducing the salaries of political appointees and civil servants.

26.14 In the US, the government used budget surplus to finance a tax relief plan through enacting the Economic Growth and Tax Relief Reconciliation Act in May 2001. This plan provides for a US$1.35 trillion tax cut in 10 years. The centrepiece of the new tax law is an across-the-board cut in income tax rates.

Level of Fiscal Reserves

26.15 Among the jurisdictions studied, Hong Kong is the only place which has guidelines on determining the level of fiscal reserves.

26.16 Under the Guidelines, fiscal reserves are considered to be at an appropriate level if they stay between the limits of 15 months' government expenditure plus 125% of Hong Kong Dollar money supply under the M1 definition (i.e. the upper limit) and nine months' government expenditure plus 75% of Hong Kong Dollar money supply under the M1 definition (i.e. the lower limit).

26.17 The estimated Government expenditure in 2000-01 was HK$226.1 billion. M1 money supply averaged HK$231.2 billion in the first three quarters of 2001. Therefore, to meet the Guidelines, fiscal reserves at that time should stand at a level between HK$342.9 billion and HK$571.6 billion.

26.18 The Government's accumulated fiscal reserves amounted to HK$375.3 billion as at 30 November 2001, which fell within the range needed to cover all the requirements mentioned in paragraph 26.16.

Fiscal Reserves to Meet Monetary Requirement

26.19 Argentina is the only overseas jurisdiction in our study which implemented a currency board system. It is noteworthy that the Central Bank of Argentina was not required to use fiscal reserves, if there were any, to defend the linked exchange rate system. In fact, the country does not have any fiscal reserves but has a huge government debt amounting to US$162 billion.

26.20 The other jurisdictions studied, including Singapore, Norway, New Zealand and the US, all implement a floating exchange rate system. In theory, they do not need to fix the exchange rate at a determined margin. In reality, the central banks of these jurisdictions may use their reserves to intervene the foreign exchange market so as to stabilize the exchange rate from time to time.

26.21 In Hong Kong, under the currency board system, fiscal reserves are placed with the Exchange Fund which is used to maintain the stability of the Hong Kong dollar. The monetary base, comprising Certificates of Indebtedness and coins issued, the Aggregate Balance[82] of the banking system and Exchange Fund Bills and Notes issued, amounting to HK$229.7 billion at the end of December 2001, is fully backed up by the Exchange Fund. Under this system, Hong Kong dollar is linked at the exchange rate of HK$7.8 to one US dollar. It is Government's policy that fiscal reserves should also be used to meet monetary requirement.

[82] The sum of the clearing balances of the licensed banks held with the HKMA for the purpose of effecting the clearing and settlement of transactions between the banks themselves and also between the HKMA and the banks.

Appendix

Overall Comparison of the Experiences of Singapore, Norway, New Zealand, Argentina, the United States of America (US) and Hong Kong in Maintaining Fiscal Reserves or Financing Government Debt

Table 10 -- Comparison of the Experiences of Singapore, Norway, New Zealand, Argentina, the United States of America and Hong Kong in Maintaining Fiscal Reserves or Financing Government Debt

	Singapore	Norway	New Zealand	Argentina	The United States of America	Hong Kong
Economic Situations in 2001 and 2002						
Economic Growth in 2001	• In recession • Gross Domestic Product (GDP) is estimated to contract by 2.2%	• An estimated 1.6% GDP growth	• An estimated 1.5% GDP growth	• Recession for the fourth consecutive year • GDP is estimated to contract 2.7%	• GDP is forecast to grow at an estimated 1%	• The Government has estimated a 0% GDP growth
Growth forecast in 2002	• GDP growth forecast is in the range of -2% to +2%	• A higher GDP growth rate of 2.7%	• An estimated 1.5% GDP growth	• GDP is projected to contract by a further 1.1%	• A 0.7% GDP growth	• The International Monetary Fund (IMF) has projected a 1% GDP growth (the Government has not provided an estimate)

	Singapore	Norway	New Zealand	Argentina	The United States of America	Hong Kong
Principles of Fiscal Policy						
Laws or Fiscal Guidelines	• Nil • However, the government has outlined the principles of fiscal policy in various sources such as government's websites and high-ranked government officials' speeches	• Guidelines for Economic Policy	• Fiscal Responsibility Act of 1994	• Fiscal Responsibility Act of 1999 • Zero-deficit Act of 2001	• Budget Enforcement Act of 1990	• Basic Law (Article 107)
Principles of Fiscal Policy	• Avoid persistent budget deficits • Promote development and improve efficiency and productive capacity of the economy • Keep the size of the public sector small	• Allocate resources for public consumption, public investment and transfers to achieve the highest possible welfare over time • Contribute to a stable and sustainable economic development	• Reduce government debt to a prudent level • Once government debt is reduced to a prudent level, the government should maintain a balanced budget on average over the medium to long term • Manage fiscal risks prudently • Ensure tax stability for private sector planning	• Reduce future budget deficits and balance the budget by Fiscal Year 2005 • Restrain monthly government spending to match monthly tax revenues	• Reduce budget deficit for a fiscal year by a specified dollar amount	• Keep government expenditure within the limits of revenues in drawing up the budget • Strive to achieve a fiscal balance and avoid deficits • Keep the budget commensurate with the growth rate of GDP

	Singapore	Norway	New Zealand	Argentina	The United States of America	Hong Kong
Principles of Fiscal Policy						
Guidelines for Upholding the Principles of Fiscal Policy	• Nil	• Stabililize fluctuations in the economy • Transfer the expected return on the Government Petroleum Fund to finance government spending	• Limit government expenditures at the level of 35% of GDP • Raise sufficient government revenues to fund government expenditures • Run budget surplus on average over the economic cycle • Reduce government debt to below 30% of GDP	• Nil	• Nil	• Strive a fiscal balance in the five-year forecast period for the Medium Range Forecast

	Singapore	Norway	New Zealand	Argentina	The United States of America	Hong Kong
Government's Fiscal Position						
Budget Surpluses/ Budget Deficits	• Recorded budget surpluses between Fiscal Year 1995 and Fiscal Year 2000 • However, the government expects to record budget deficit in Fiscal Year 2001	• Recorded budget surpluses between Fiscal Year 1997 and Fiscal Year 2000	• Recorded budget surpluses between Fiscal Year 1994 and Fiscal Year 2000	• Recorded budget deficits between Fiscal Year 1995 and Fiscal Year 2000	• Recorded budget deficits between Fiscal Year 1995 and Fiscal Year 1997 • However, the government recorded budget surpluses between Fiscal Year 1998 and Fiscal Year 2001	• Recorded surpluses in Financial Years 1996-97, 1997-98 and 1999-2000 • However, the Government recorded deficits in Financial Years 1995-96, 1998-99 and 2000-01 • A budget deficit amounting to some HK$60 billion is projected for Financial Year 2001-02

	Singapore	**Norway**	**New Zealand**	**Argentina**	**The United States of America**	**Hong Kong**
Budget Surpluses						
Uses of Budget Surpluses	• Accumulate budget surpluses in fiscal reserves	• Accumulate budget surpluses in fiscal reserves (the Government Petroleum Fund)	• Pay off government debt • Fund its public pension scheme	• Not applicable	• Pay off government debt • Finance a tax relief plan implemented in May 2001	• Accumulate surpluses in fiscal reserves
Fiscal Reserves						
Availability of Fiscal Reserves	• Yes • However, the amount of fiscal reserves is not revealed to the public	• Yes • Amounted to Nok 650 billion (US$76.5 billion) at the end of 2001	• Nil	• Nil	• Nil	• Yes • Amounted to HK$375.3 billion at 30 November 2001
Law which Safeguards Fiscal Reserves	• Constitution of Singapore -- President with veto powers to safeguard fiscal reserves of the past government -- Safeguard at least 50% of the Net Investment Income earned from past fiscal reserves	• Nil	• Nil	• Nil	• Nil	• Nil

	Singapore	**Norway**	**New Zealand**	**Argentina**	**The United States of America**	**Hong Kong**
Fiscal Reserves						
Guidelines on Determining the Level of Fiscal Reserves	• Nil	• Nil	• Nil	• Nil	• Nil	• Yes • Cover the sum of 12 months' government expenditures • Underpin the exchange rate stability by maintaining an amount which is equivalent to the Hong Kong Dollar money supply under the M1 definition, with a margin of plus or minus 25%
Authority for Using Fiscal Reserves	• The President	• Ministry of Finance	• Not applicable	• Not applicable	• Not applicable	• Financial Secretary
Authority for Managing Fiscal Reserves	• Government of Singapore Investment Corporation	• Norges Bank (i.e. the Central Bank of Norway)	• Not applicable	• Not applicable	• Not applicable	• Hong Kong Monetary Authority

	Singapore	Norway	New Zealand	Argentina	The United States of America	Hong Kong
Fiscal Reserves						
Uses of Fiscal Reserves	• Finance two separate off-budget economic stimulus packages introduced in July and October 2001 respectively	• Act as a financial buffer • Pay for the expected rising social security expenditures in future years	• Not applicable	• The country does not have any fiscal reserves • The recently abolished currency board arrangement did not require the Central Bank to use fiscal reserves, if there were any, to defend the linked exchange rate system	• Not applicable	• Use fiscal reserves to finance fiscal deficits • Use investment income on fiscal reserves to fund government expenditure

	Singapore	Norway	New Zealand	Argentina	The United States of America	Hong Kong
Budget Deficits						
Practices of Financing Budget Deficits	• Use fiscal reserves to finance the expected budget deficit in Fiscal Year 2001	• Norway did not record any fiscal deficits between Fiscal Year 1997 and Fiscal Year 2000 • No information is available on government's fiscal position prior to Fiscal Year 1997, hence no information to confirm how the government financed budget deficits in the past	• New Zealand did not record any fiscal deficits between Fiscal Year 1994 and Fiscal Year 2000 • However, the country had persistent budget deficits prior to 1994 due to government borrowing • See below for the practices of financing government debt	• Raise funds from multilateral lending agencies, including the IMF, the US government and institutional investors	• Raise funds from domestic and international markets to finance government debt by selling government notes and bonds of various sizes and time to maturity	• Use fiscal reserves to finance the deficits in Financial Years 1995-96, 1998-99 and 2001-02

	Singapore	Norway	New Zealand	Argentina	The United States of America	Hong Kong
Government Debt						
Amount of Government Debt	• Nil	• Nil	• Amounted to US$16 billion (or 31.9% of GDP) in Fiscal Year 2000	• Amounted to US$162 billion in January 2002	• Amounted to US$5.63 trillion in Fiscal Year 2000	• Nil
Practices of Financing Government Debt	• Not applicable	• Not applicable	• Raise funds from domestic and international markets and sell government-owned enterprises to finance its government debt	• Raise funds from multilateral lending agencies, including the IMF, the US government and institutional investors	• Raise funds from domestic and international markets to finance its government debt by selling government notes and bonds of various sizes and time to maturity	• Not applicable