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

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EXECUTIVE SUMMARY

Singapore

1. The principles of fiscal policy are to: (a) avoid persistent budget deficits; (b) implement fiscal policy which should promote economic development and improve efficiency and productive capacity of the economy; and (c) keep the size of the public sector small.

2. The government recorded budget surpluses between Fiscal Year 1988 and Fiscal Year 2000. 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 have caused a budget deficit in Fiscal Year 2001.

3. Singapore's reserves are managed by the Government of Singapore Investment Corporation which is wholly owned by the government. The Constitution of Singapore has provisions for safeguarding the country's fiscal reserves.

Norway

4. The principles of fiscal policy are to: (a) allocate resources for public consumption, public investment and transfers to achieve the highest possible welfare over time; and (b) contribute to a stable and sustainable economic development. To adhere to these two principles, the government sets out two guidelines for fiscal policy which are (a) the government should stabilize fluctuations in the economy; and (b) the government should use the expected return on the Government Petroleum Fund (GPF) to finance government spending.

5. The GPF serves as the government's fiscal reserves and has two purposes: (a) 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; and (b) it will be used to pay for the expected rising social security expenditures in future years as a result of demographic changes.

6. Norges Bank, the Central Bank of Norway, is responsible for investing the GPF. The value of the GPF is estimated to reach Nok 650 billion at the end of 2001 (about 15.5 months of government expenditure).

New Zealand

7. The government enacted the Fiscal Responsibility Act which sets out four principles to govern fiscal policy: (a) government debt should be reduced to a prudent level; (b) the government should maintain a balanced budget on average over the medium to long term; (c) the government should manage fiscal risks prudently; and (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.

8. Following the implementation of the Fiscal Responsibility Act, New Zealand recorded fiscal surpluses from Fiscal Year 1994 onwards. However, there is still no fiscal reserve. The country uses its budget surpluses to pay off government debt and to fund its public pension scheme.

<u>Argentina</u>

9. Although the government attempted to reduce budget deficits and balance the budget over the medium term, the country's fiscal position continued to deteriorate. Government debt continued to increase to an uncontrollable level. To finance government debt, Argentina relies heavily on funding from multilateral lending agencies. In January 2002, the government defaulted on its debt when it failed to interest payments.

10. Argentina established a currency board system in 1991 to peg the Argentine peso at one-to-one to the US dollar. The Central Bank is required to maintain the country's foreign reserves which should be equivalent to at least 100% of the monetary base to defend the fixed exchange rate system. However, the government is not required to use fiscal reserves, if there are any, to defend the linked exchange rate regime. In January 2002, intending to restructure the economy, the government abolished the currency board system and allowed its currency floating in the foreign exchange market.

<u>The United States of America (US)</u>

11. The principles of fiscal policy which called for restraining budget deficits were set out in the Budget Enforcement Act in 1990. This Act set a specific dollar limit on government spending 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 so as to prevent the deterioration of budget deficits.

12. The government recorded budget surpluses between Fiscal Year 1998 and Fiscal Year 2000 mainly due to strong economic growth which boosted government revenues at a rate faster than the growth in government spending. At the same time, the government has to finance its debt by issuing notes and bonds of various sizes and time to maturity.

13. The government uses budget surplus to finance economic stimulus packages. The Economic Growth and Tax Relief Reconciliation Act was enacted in May 2001 to provide for a US$1.35 trillion tax cut in 10 years. The centrepiece of this law is an across-the-board cut in income tax rates. In addition, the Job Creation and Worker Assistance Act has been enacted in March 2002 which adds a 13-week extension to unemployment benefits for the unemployed and provides business with further tax cuts.

Hong Kong

14. The Hong Kong Special Administrative Region Government (the Government) accumulates the annual surplus in fiscal reserves which are placed with the Exchange Fund for investment purposes. The Exchange Fund and fiscal reserves are two different entities. The Exchange Fund is primarily used for the regulation of the exchange value of the Hong Kong dollar. In addition, it may be used to maintain the stability and integrity of the monetary and financial systems of Hong Kong with a view to maintaining Hong Kong as an international financial centre. Meanwhile, the present functions of fiscal reserves are to meet operating and contingency requirements.

15. The Financial Secretary entrusted the Hong Kong Monetary Authority (HKMA) with the responsibility of investing fiscal reserves which are placed with the Exchange Fund.

16. The principles of fiscal policy are set out in the Basic Law. 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.

17. In his 2002-03 Budget Speech on 6 March 2002, the Financial Secretary announced a revised target level of fiscal reserves. Under the new guidelines, fiscal reserves are considered to be at an appropriate level if they amount to some 12 months of government expenditure to meet **operating** and **contingency** requirements. A few academics have commented that a reserve equivalent to 12 months of government expenditure is acceptable.

18. The balance of fiscal reserves continued to rise to HK$457.5 billion at the end of Financial Year 1997-98 although there were various external shocks (e.g. world stock market crash in October 1987, the Gulf War in August 1990, the exchange rate mechanism turmoil in Europe in September 1992, the Mexican currency crisis in January 1995, the Asian Financial crisis in the period between July 1997 and 1998) which might have affected the stability of the exchange rate system.

19. However, the fiscal reserve balance has declined since the end of Financial Year 1999-2000 for financing budget deficit. Fiscal reserves are projected to total HK$369.8 billion (19 months of government expenditure) by 31 March 2002. To finance the expected budget deficit in the next three financial years, the balance of fiscal reserves is projected to drop to HK$271.0 billion (13 months of government expenditure) at the end of Financial Year 2004-05 and remain more or less stable at that level onwards.

20. In addition to giving views on the guidelines on the purposes and target level of the fiscal reserves, academics and experts invited to the Financial Affairs Panel meeting on 3 July 2001 also commented on the present size of fiscal reserves. The majority of the academics are of the view that there is an excess of fiscal reserves in Hong Kong, and that any freely disposable fiscal reserves should be employed for uses other than fulfilling the monetary requirement.

PRACTICES OF OVERSEAS JURISDICTIONS IN BUILDING UP OR MAINTAINING THEIR FISCAL RESERVES

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. The forecast for economic growth in 2002 is in the range of 1% to 3%.

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.

Managing Fiscal Reserves

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].

Safeguarding Fiscal Reserves

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.

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.

[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 2). 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 (about 42% of GDP or 15.5 months of government expenditure). 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 2.4 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. The Federal Reserve expects a modest and gradual recovery in the economy by mid-2002. GDP is projected to grow by 2-2.5 % in 2002, after an estimated 1.2% 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.

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[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

<u>Government's Fiscal Position Between Fiscal Year 1995 and Fiscal Year 2000</u>

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 was 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.

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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

<u>The Economic Growth and Tax Relief Reconciliation Act of 2001</u>

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 Job Creation and Worker Assistance Act of 2002

21.9 In the wake of the 11 September terrorist attacks, President Bush proposed a US$100 billion economic stimulus package in October 2001 which focused mostly on further tax cuts for businesses and individuals to stimulate economic growth. The package aimed at accelerating write-offs for businesses, accelerating tax cuts scheduled to take effect under the tax relief package and distributing a US$300 tax rebate to each low-income worker.

21.10 The Congress was unable to reach compromise on the bill. After months of deadlock in the legislature, the Congress has recently approved the second economic stimulus package to spur business investment and create jobs[67]. The legislation (i.e. the Job Creation and Worker Assistance Act of 2002) adds a 13-week extension to unemployment benefits[68] for the unemployed and provides business with tax cuts. The major business provision of the new law is a 30% depreciation tax break of investments in new factories and equipment for the next three years.

21.11 The government has projected the cost of the package will be about US$51 billion in 2002, US$43 billion in 2003 and US$29 billion in 2004. The estimated cost over 10 years is about US$42 billion because some tax breaks will generate government revenue in later years.

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67 There are signs of economic recovery. For example, the unemployment rate in February fell to a four-month low of 5.5%.

68 The package extends regular 26-week unemployment benefits by 13 weeks and allows additional automatic extensions in states with high unemployment rates.

PART 7 - HONG KONG

22. Current Economic Situation

22.1 Real growth in Hong Kong's Gross Domestic Product (GDP) is estimated to slow down to 0.1% in 2001, in view of the high comparison base of growth in 2000[69], slackening consumer spending[70], rising unemployment[71] and slower global demand[72]. The Hong Kong Special Administrative Region (HKSAR) Government (the Government) has projected a 1% real GDP growth in 2002, and 3% real growth over the medium term.

23. Exchange Fund and Fiscal Reserves

23.1 The Government accumulates the annual surplus in fiscal reserves which are placed with the Exchange Fund for investment purposes. The Exchange Fund and fiscal reserves are two different entities.

23.2 According to the 12 April 2001 Viewpoint article entitled *Fiscal Reserves and the Exchange Fund* by Mr Joseph YAM of the Hong Kong Monetary Authority (HKMA), "*although the Exchange Fund and the Government's fiscal reserves were managed and invested together, they were two separate and distinct entities. Fiscal reserves represented money borrowed for the account of the Exchange Fund, but the corresponding assets, managed along with other assets of the Fund, could be used for the monetary purposes for which the Fund was established*."

23.3 The Financial Secretary entrusted the 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.

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

70 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.

71 The labour market showed signs of slackening in recent months. The unemployment rate increased to 6.7% for the period of November 2001 - January 2002.

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

Functions of the Exchange Fund and Fiscal Reserves

23.4 The Exchange Fund is primarily used for the regulation of the exchange value of the Hong Kong dollar. In addition, it may be used to maintain the stability and integrity of the monetary and financial systems of Hong Kong with a view to maintaining Hong Kong as an international financial centre.

23.5 Meanwhile, as indicated by the Financial Secretary in his 2002-03 Budget Speech regarding the new guidelines on purposes and level of fiscal reserves, the functions of fiscal reserves are to meet operating and contingency requirements (see paragraph 25.6 below for details).

Functions of the Various Components of the Exchange Fund

23.6 At the end of December 2001, the total assets of the Exchange Fund were at HK$980.6 billion, representing a decrease of HK$42.8 billion from HK$1,023.4 billion at the end of December 2000 (see Table 7).

23.7 Part of the Exchange Fund is formed by the monetary base which is defined, at the minimum, as the sum of the currency in circulation (banknotes and coins) and the balance of the banking system held with the central bank (the reserve balance or the clearing balance). In Hong Kong, the monetary base comprises Certificates of Indebtedness (for backing the banknotes issued by the note-issuing banks), coins issued, the balance of the clearing accounts of banks kept with the HKMA, and the Exchange Fund Bills and Notes.

23.8 Under the currency board system, the monetary rule requires changes in the monetary base to be matched by corresponding changes in foreign reserves in a specified foreign currency at a fixed exchange rate. At the end of 2001, the monetary base amounted to HK$229.7 billion in Hong Kong. The backing assets amounted to HK$256.5 billion. In other words, the backing ratio (i.e. the ratio between the backing assets and the monetary base) stood at 111.7%. According to the HKMA, under the linked exchange rate system, the backing ratio should be at least 105%.

23.9 At the end of 2001, the accumulated surplus of the Exchange Fund (i.e. the total net profit earned by the Exchange Fund) amounted to HK$302.7 billion. It is noteworthy that the annual investment of the Exchange Fund and the accumulated surplus are not treated as recurrent income of the Government. In reply to our enquiry regarding the function of the accumulated surplus, the HKMA says that the Exchange Fund functions as a single entity and is not broken down or differentiated in functions according to its component parts, so there is no segregation of the accumulated surplus for any specific use.

Table 7 - Exchange Fund Balance Sheet (in millions of Hong Kong dollars)

	As at end of year											
	1990	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**
Assets [1]												
Foreign Currency Assets	192,323	225,333	274,948	335,421	381,233	428,547	493,802	588,475	701,239	755,115	856,680	878,847
Hong Kong Dollar Assets	3,874	10,788	12,546	12,973	24,617	32,187	40,715	48,198	211,036	247,641	166,683	101,717
Total Assets	**196,197**	**236,121**	**287,494**	**348,394**	**405,850**	**460,734**	**534,517**	**636,673**	**912,275**	**1,002,756**	**1,023,363**	**980,564**
Liabilities [1]												
Certificates of Indebtedness [2]	40,791	46,410	58,130	68,801	74,301	77,600	82,480	87,015	86,465	118,195	99,265	107,545
Coins in Circulation	2,003	2,299	2,559	2,604	3,372	3,597	4,164	5,399	5,778	5,777	5,918	5,691
Balance of Banking System [3]	480	500	1,480	1,385	2,208	1,762	474	296	2,527	7,960	669	671
Exchange Fund Bills and Notes	6,671	13,624	19,324	25,168	46,140	53,125	83,509	89,338	98,334	101,828	109,288	118,157
Placements by other HKSAR government funds [4]	63,226	69,802	96,145	115,683	131,240	125,916	145,898	237,629	424,562	392,206	417,162	380,602
Other Liabilities [5]	391	4,834	3,220	7,135	22,815	38,600	45,130	26,770	52,364	85,932	83,962	65,154
Total Liabilities	**113,562**	**137,469**	**180,858**	**220,776**	**280,076**	**300,600**	**361,655**	**446,447**	**670,030**	**711,898**	**716,264**	**677,820**
Accumulated Surplus [6]	**82,635**	**98,652**	**106,636**	**127,618**	**125,774**	**160,134**	**172,862**	**190,226**	**242,245**	**290,858**	**307,099**	**302,744**

Notes: (1) Assets and liabilities include the following accounts:

(a) Investment
The Fund is invested in interest-bearing placements with banks and other financial institutions both in Hong Kong and outside Hong Kong and in a variety of financial instruments, including bonds, notes, treasury bills and equities.

(b) Foreign currency assets distribution
A large proportion of the Fund's foreign currency assets is held in US dollars. Apart from US dollar, the Fund also holds assets denominated in other foreign currencies, including the Canadian dollar, Euro, Japanese yen and pound sterling.

(c) Location of assets
The assets are held in deposit, trustee and safe-keeping accounts with banks, central banks and custodial organisations situated in Hong Kong and other major financial centres.

(d) Valuation of assets and liabilities
Debt securities, equities and Exchange Fund Bills and Notes are valued in the accounts at market value at the balance sheet date. Placements with banks and other financial institutions, certificates of deposit, consideration received or paid under repurchase and resale agreements, securities lending agreements, placements by banks and other financial institutions, placements by other HKSAR government funds for which interest is payable at market-based rates and placements by Hong Kong statutory bodies are valued according to a price matrix of discounted cash flows using applicable interest rates for discounting. The consequential change in value of the asset or liability is reflected in the carrying value of the relevant asset or liability in the Balance Sheet except in the case of placements by other HKSAR government funds for which interest is payable at market-based rates, which are stated in the Balance Sheet at the principal amounts payable at the balance sheet date with the revaluation differences included in other liabilities. Placements by other HKSAR government funds for which interest is payable at rates determined by reference to the investment income of the Fund are stated at the principal amounts payable at the balance sheet date.

(e) Translation of foreign currency assets and liabilities
Assets and liabilities denominated in foreign currencies are translated into Hong Kong dollars at the rates of exchange ruling at the balance sheet date. Exchange gains and losses on foreign currency assets and liabilities are included in the Income and Expenditure Account.
Certificates of Indebtedness and with effect from 1 April 1999 Coins in Circulation, both of which are denominated in Hong Kong dollars but are issued and redeemed in US dollars at the linked exchange rate of US$1=$7.80, are stated in the accounts at their Hong Kong dollars face value. At the balance sheet date, the difference between their Hong Kong dollar face value and the market value of the US dollars required for their redemption is included in other assets.

(2) As backing for the bank note issues, each note-issuing bank is required to hold a non-interest bearing Certificates of Indebtedness issued by the Financial Secretary. Payments for the issuance and redemption of notes against these Certificates are made in US dollars at a fixed rate of US$1=HK$7.80.

(3) Under the interbank payment system based on Real Time Gross Settlement principles, all licensed banks maintain a clearing account with the Monetary Authority for the account of the Exchange Fund. The aggregate balance in these accounts represents the total level of liquidity in the interbank market.

(4) These represent placements by other HKSAR government funds with the Exchange Fund. Until 31 March 1998, all placements by other HKSAR government funds bore interest at market-based rates. With effect from 1 April 1998, the basis of interest payable on certain placements by other HKSAR government funds was amended from market-based rates to rates determined by reference to the investment income of the Fund.

(5) Other liabilities include placements by banks and other financial institutions, placements by Hong Kong statutory bodies, interest payable to Exchange Fund Notes and placements by other HKSAR government funds, revaluation losses on off-balance sheet items which are marked to market, other accrued expenses and provisions and the revaluation differences of placements by other HKSAR government funds for which interest is payable at market-based rates.

(6) The accumulated surplus of the Exchange Fund is the total net profit earned by the Exchange Fund since 6 December 1935.

Source: The Hong Kong Special Administrative Region Government, *Hong Kong Annual Report*, Various Issues.

24. Principles of Fiscal Policy

24.1 The principles of fiscal policy are set out in the Basic Law. 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.[73]

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

25. Guidelines on Purposes and Level 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[74], allowing a margin of plus or minus 25%, is necessary.

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73 Article 109 of the Basic Law.

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

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 were considered at an appropriate level if they stayed between the limits of 15 months of government expenditure plus 125% of Hong Kong Dollar money supply under the M1 definition (i.e. the upper limit) and nine months of 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. The Government's accumulated fiscal reserves as at 31 March 1998 were at HK$446 billion.[75]

25.4 In Financial Years 1998-99 and 2000-01, the Government used fiscal reserves to finance consolidated deficits at HK$23.2 billion and HK$7.8 billion respectively.

25.5 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, part of it being fiscal reserves, to take appropriate measures in the stock and futures markets to counter speculative activities.

25.6 In his 2002-03 Budget Speech on 6 March 2002, the Financial Secretary announced a revised target level of fiscal reserves in the light of the prevailing conditions of the economy and public finances. He said that "*in the wake of the Asian financial crisis, the HKMA has implemented a series of measures to reinforce the stability of the Hong Kong Dollar exchange rate. In addition, the accumulated surplus of the Exchange Fund has now reached HK$300 billion. These developments have greatly enhanced the Exchange Fund's ability to maintain exchange rate stability. I see no further need to link the level of fiscal reserves to money supply. In my view, it should be sufficient to have fiscal reserves equivalent to around 12 months of government expenditure to meet* ***operating*** *and* ***contingency*** *requirements. Although it is no longer necessary to link the level of fiscal reserves to money supply, the Government's fiscal reserves will continue to be placed with the Exchange Fund, thereby providing even more resources for the Exchange Fund to maintain the stability of the Hong Kong Dollar and our monetary system.*"[76]

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

76 The Hong Kong Special Administrative Region Government, *The 2002-03 Budget*, 6 March 2002, paragraph 62.

25.7 As the Government's fiscal reserves will not be kept separately from the Exchange Fund and they would also form part of the resources to maintain the stability of the Hong Kong Dollar, the purpose of fiscal reserves for monetary requirements still stands.

25.8 The estimated government expenditure in Financial Year 2002-03 was HK$254.3 billion. The new guidelines on the level of fiscal reserves should be equivalent to around 12 months of government expenditure, i.e. around HK$254.3 billion, to meet **operating** and **contingency** requirements. As of 31 January 2002, the Government's accumulated fiscal reserves amounted to HK$389.7 billion which was equivalent to about 19.5 months of government expenditure.

Views on the Guidelines on Purposes and Level of Fiscal Reserves

25.9 Prior to the revision of the guidelines on the level of fiscal reserves, academics and experts were invited to speak at the Financial Affairs Panel meeting on 3 July 2001, the majority view seems to suggest that fiscal reserves should be employed to fulfil both the operating and contingency requirements. There is reservation regarding using fiscal reserves for the monetary requirement. There are doubts on whether it is appropriate to include such a purpose in the requirement of fiscal reserves. Following the announcement of the new guidelines, views were invited from those who had formerly given views to the Panel. As of the publication date of this research report, Professor HO Lok-sang and Professor Leonard CHENG Kwok-hon have provided their views on the new guidelines. They have responded that a reserve equivalent to 12 months of government expenditure is acceptable. A summary of the relevant opinions on the subject is presented in Table 8.

Table 8 - Views of Academics and Experts on the Guidelines on Purposes and Level of Fiscal Reserves

Academics and experts	Details
Professor HO Lok-sang	Professor HO has commented that the Government's guidelines on the level of fiscal reserves to support the linked exchange rate system are meaningless. On the other hand, achieving budget balance at full employment is important if the linked exchange rate system is to be maintained. He is all for a stable fiscal policy that aims at balanced budget at full employment and the Government should tolerate cyclical budget deficits but not structural deficits. He agrees that there is no need to maintain a huge fiscal reserve. A reserve equal to one year's expenditure is quite acceptable.
Professor TANG Shu-hung[77]	The government had an unofficial guideline in the 1950s when fiscal reserves was set to be not less than government revenue at the corresponding budget year. This guideline was not achievable until several years later. Then in 1962-63, the guideline was amended that fiscal reserves should not be less than 50% of the budgetary operating expenditure. The Government's 1998-99 guidelines were too conservative and much higher than the previous guidelines. The restrictive guidelines did not allow the Government to adopt a deficit budget in 1998-99 when the economy experienced a negative growth. Under a currency board system, the Central Bank does not need to intervene in the foreign exchange market to maintain the stability of the currency. It only needs to hold foreign reserves equivalent to some 105% - 112% of its monetary base. The HKMA used some HK$296.4 billion to support the Hong Kong dollar in August 1998. The accumulated surplus of the Exchange Fund at that time was close to HK$300 billion, which implied that HKMA had enough foreign reserves to support Hong Kong dollar and did not need fiscal reserves to further support the system. He suggests to adopt the following amended guideline: At the beginning of a financial year, the level of reserves should be 50% of the government expenditure for the year.

[77] Interested readers can read his original views on fiscal reserves in full as published in the Hong Kong Economic Times dated 14 June 2001 and 15 June 2001.

Academics and experts	**Details**
Professor Wilson WONG Wai-ho	Fiscal reserves should fulfil the purposes of operating and contingency requirements only, while the monetary requirement is not justified. To meet the two former requirements, fiscal reserves at the level of 12 months of public expenditure should be sufficient. If necessary, the Government can borrow money to meet any shortfall in expenditure.
Professor Stephen Y L CHEUNG	Fiscal reserves should fulfil the purposes of operating and contingency requirements only, but it is difficult to understand the rationale behind the monetary requirement. A rule of thumb is that fiscal reserves should be sufficient to pay for three or four months' worth of imports. In addition to the ratio of reserves-to-imports, Professor CHEUNG also looks at reserves-to-expenditure and reserves-to-Gross Domestic Product (GDP). He suggests that the ratio of reserves-to-GDP can be used as a benchmark in measuring the adequacy of fiscal reserves. Lower and upper limits can be set to reflect short-term fluctuations in the economy.
Professor Francis LUI Ting-ming	Although the establishment of guidelines on fiscal reserves is quite arbitrary, it will enhance the transparency and credibility of the Government's fiscal policy. However, in the event that reserves falls below the lower limit if it was set too high, it may hurt the public's confidence. Therefore, it may be necessary to preserve a certain degree of constructive ambiguity in the Government's fiscal position to prevent speculation on the currency.
Mr Vincent KWAN	There is no hard and fast rule of thumb in determining an appropriate level of fiscal reserves, both theoretically or economically. The "proper level of fiscal reserves" is circumstantial in nature which needs to be determined from time to time by taking into account of the specific situation of the economy and its public finance.
Professor Leonard CHENG Kwok-hon	Fiscal reserves should fulfil the purposes of operating and contingency requirements. The monetary requirement is not justified given the existence of a very sizeable Exchange Fund. Hence, fiscal reserves at a level between 12 to 15 months of government expenditure will be adequate to address the needs mentioned above. He supports the Financial Secretary's new guideline on the level of fiscal reserves.

26. Government's Fiscal Positions from Financial Year 1983-84 to Financial Year 2001-2002

Fiscal Positions

26.1 In the last 10 Financial Years[78], the Government recorded surpluses in Financial Years 1992-93, 1993-94, 1994-95, 1996-97, 1997-98 and 1999-2000 but had deficits for Financial Years 1995-96, 1998-99 and 2000-01 (see Table 9).

26.2 For Financial Year 2001-02, government revenue and government expenditure are projected to total HK$173.8 billion and HK$239.4 billion respectively, leading to an estimated deficit of HK$65.6 billion (equivalent to 5.2% of GDP). The large deficit has been a result of decreased revenues from three major sources (namely, investment income on fiscal reserves, land premiums and the sale of Mass Transit Railway Corporation shares).

26.3 Another concern of the Government is that operating expenditures have continuously exceeded operating revenues since Financial Year 1998-99. In the 2002-03 Budget, the Government has projected to record operating deficits after investment income from fiscal reserves in the next few years until Financial Year 2006-07.

Fiscal Reserve Balances

26.4 The Government's fiscal reserves[79] comprised the accumulated balances of the General Revenue Account and seven funds[80], 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.

26.5 As mentioned in paragraph 23.1, the Government accumulates the annual surplus in fiscal reserves. The fiscal reserve balance amounted to HK$21.8 billion at the end of Financial Year 1983-84 when the Government established the linked exchange rate system in October 1983. The balance of fiscal reserves continued to rise to HK$457.5 billion at the end of Financial Year 1997-98 despite the fact that there were various external shocks (e.g. global stock market crash in October 1987, the Gulf War in August 1990, the exchange rate mechanism turmoil in Europe in September 1992, the Mexican currency crisis in January 1995, the Asian Financial crisis between July 1997 and 1998) which might have affected the stability of the exchange rate system. 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 investment held by the former Trustees of the HKSAR Government Land Fund.

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

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

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

Table 9 - Government's Fiscal Position between Financial Year 1983-84 and Financial Year 2001-2002 (in millions of Hong Kong dollars)

	1983-84	**1984-85**	**1985-86**	**1986-87**	**1987-88[a]**	**1988-89**	**1989-90**	**1990-91[b]**	**1991-92**	**1992-93[c]**	**1993-94**	**1994-95**	**1995-96[d]**	**1996-97**	**1997-98[e]**	**1998-99**	**1999-00**	**2000-01**	**Estimated 2001-02[f]**
Government Revenue [1]	32,813	38,511	43,695	48,603	60,877	72,658	82,430	89,524	114,701	135,311	166,602	174,998	180,045	208,358	281,226	216,115	232,995	225,060	173,830
Government Expenditure[1]	35,346	36,087	40,845	42,704	48,375	56,592	71,366	85,557	92,192	113,332	147,438	164,155	183,158	182,680	194,360	239,356	223,043	232,893	239,350
Surplus / (deficit)	(2,533)	2,425	2,850	5,899	12,502	16,066	11,064	3,967	22,509	21,979	19,164	10,843	(3,113)	25,678	86,866	(23,241)	9,952	(7,833)	(65,520)
Fiscal Reserve Balance at the end of Financial Year	**21,772**	**24,197**	**27,047**	**32,946**	**45,448**	**61,514**	**72,578**	**76,545**	**99,054**	**121,033**	**140,197**	**151,040**	**147,927**	**173,605**	**457,543[2]**	**434,302**	**444,254**	**430,278**	**369,760**

Remarks: External shocks which occurred since the establishment of the linked exchange rate system in October 1983 and might/did affect the exchange rate system in Hong Kong

(a) World stock market crash (October 1987)
(b) Gulf War (August 1990)
(c) Exchange rate mechanism turmoil in Europe (September 1992)
(d) Mexican currency crisis (January 1995)
(e) Asian financial crisis (July 1997 - 1998)
(f) Abolishment of Argentina's currency board system (January 2002)

Notes: (1) Figures exclude 'transfers between the General Revenue Account and Funds'.
(2) Including net worth of HK$197,072 million received from Trustee of the former Special Administrative Region Government Land Fund at 1 July 1997.

Sources: The Hong Kong Special Administrative Region Government, *Hong Kong Annual Digest of Statistics*, Various Issues.
The Hong Kong Special Administrative Region Government, *Press Release: 2000-01 Government Final Accounts*, 6 July 2001.

26.6 However, the fiscal reserve balance has declined since the end of Financial Year 1999-2000: from HK$430.3 billion at the end of Financial Year 2000-01 to HK$389.7 billion at 31 January 2002. The Financial Secretary has projected that fiscal reserves will amount to HK$369.8 billion (19 months of government expenditure) by 31 March 2002, and HK$325.6 billion (15 months of government expenditure) by 31 March 2003 (see Table 10).

Table 10 - Projected Government's Fiscal Position (in millions of Hong Kong dollars)

	2001-02	**2002-03**	**2003-04**	**2004-05**	**2005-06**	**2007-08**
Consolidated surplus/(deficit)	(65,630)	(45,210)	(38,760)	(15,870)	60	50
Fiscal reserves at 31 March	369,760	325,580	286,910	271,040	271,100	271,150
As number of months of government expenditure	19	15	14	13	13	12

Source: The Hong Kong Special Administrative Region Government, *The 2002-03 Budget*, 6 March 2002.

26.7 The Government has projected that there will be consolidated deficit in the coming three financial years, amounting to HK$45.2 billion in Financial Year 2002-03[81], HK$38.7 billion in Financial Year 2003-04 and HK$15.9 billion in Financial Year 2004-05. This implies that the estimated consolidated deficit for the coming three financial years will total HK$99.8 billion. Accordingly, fiscal reserves will be drawn to finance the deficit. Hence, the balance of the fiscal reserves is projected to drop to HK$271.0 billion (13 months of government expenditure) at the end of Financial Year 2004-05 and remain more or less stable at that level onwards (see Table 10).

Investment Income from Fiscal Reserves

26.8 Investment income[82] from fiscal reserves is used to finance government expenditure. It is noteworthy that investment income from fiscal reserves decreased rapidly from HK$36.8 billion for Financial Year 1999-2000 to zero for Financial Year 2001-02 (see Table 11).

81 The expenditure estimates for 2002-03 have accounted for the assumed 4.75% civil service pay reduction and the corresponding reduction in subventions for salary-related expenses to subvented organisations, which are assumed to take effect from 1 October 2002 onwards.

82 The Exchange Fund recorded investment income of HK$7.0 billion in 2001.

Table 11 - Investment Income from Fiscal Reserves between Financial Year 1991-92 and Financial Year 2001-02 (in billions of Hong Kong dollars)

	1991 -92	**1992 -93**	**1993 -94**	**1994 -95**	**1995 -96**	**1996 -97**	**1997 -98**	**1998 -99**	**1999 -2000**	**2000 -01**	**2001-02 latest forecast**
Investment Income from Fiscal Reserves	3.0	1.8	3.4	4.9	5.9	5.6	15.0	31.6	36.8	19.5	0.0

Source: The Hong Kong Special Administrative Region Government, *The Final Report of the Task Force on Review of Public Finances,* February 2002

Views on the Size of Fiscal Reserves

26.9 In addition to giving views on the guidelines on purposes and target level of fiscal reserves, academics and experts invited to the Financial Affairs Panel meeting on 3 July 2001 also commented on the present size of fiscal reserves. The majority of the academics are of the view that there is an excess of fiscal reserves in Hong Kong. A summary of their views is presented in Table 12.

Table 12 - Views of Academics and Experts on the Size of Fiscal Reserves

Academics and experts	Details
Professor Y C JAO	The administration's explanation that it has to adhere to the two budgetary principles enshrined in Article 107 of the Basic Law is not sufficient to justify the size of fiscal reserves. Therefore, the size of fiscal reserves needs to be justified by sound economic arguments. However, a large size of fiscal reserves is justified because of the following arguments: (a) It acts as a buffer against the adverse effects of an unanticipated crisis or contingency since Hong Kong is an exceptionally open economy; and (b) It provides room for manoeuvre during the downward phase of the economic cycle because Hong Kong's monetary policy is constrained under the linked exchange rate system. He does not agree that Hong Kong's huge foreign reserves are strong enough to protect Hong Kong against external shocks, allowing fiscal reserves to be freely used for spending. He argues that the stability of the linked exchange rate by itself does not guarantee the absence of currency or financial crisis, thus it must be strengthened by fiscal soundness and probity. Any fiscal imprudence that results in a significant decrease in the size of fiscal reserves will give wrong signals to both investors and speculators, ultimately undermining confidence in Hong Kong.
Professor HO Lok-sang	It is not meaningful to determine the optimal size of government since the relevant question is whether each spending area is optimally sized. To achieve an optimal government, it is important to quantify benefits versus costs for each spending area. In any event, Professor HO is worried that Hong Kong is suffering from structural deficits, which if continues, will draw fiscal reserves down.
Professor TANG Shu-hung	Professor TANG has commented that the size of fiscal reserves may be too big based upon the 1998-99 guidelines.
Professor Wilson WONG Wai-ho	There is an excess of fiscal reserves, even if monetary requirement is taken as a primary and legitimate objective of fiscal reserves. There are other more useful and cost-effective ways of defending the linked exchange rate that do not require enormous fiscal reserves.

Academics and experts	Details
Professor Stephen Y L CHEUNG	There is an excess of fiscal reserves. Fiscal reserves are important to maintain public confidence in Hong Kong and a sudden drop in reserves may attract adverse attention from the international investment community, particularly from credit rating agencies. Holding large reserves per se cannot prevent crisis. Nonetheless, countries that had big reserves, on average, did better than those with small reserves. However, holding an excessive amount of reserves may indicate that the Government is too conservative in investing in our economy. Large reserves are costly because they represent a lot of money sitting idle in the bank; the opportunity to invest this money in the economy is lost. In most developed economies, holding large reserves seems unjustified, especially since these economies can borrow on the world capital market when needed.
Professor Francis LUI Ting-ming	Professor LUI has commented that fiscal reserves of some HK$100 - $200 billion should be sufficient to deal with any imbalances in the Government's operation. Therefore, there are excessive fiscal reserves. Even during the Asian Financial Crisis, less than HK$10 billion were shorted compared to around HK$230 billion of foreign reserves backing up the linked exchange rate system. Accordingly, the linked exchange rate system does not need the additional protection of some HK$400 billion fiscal reserves. Larger fiscal reserves may encourage higher government expenditure, which will increase both the pressure of the occurrence of fiscal deficits and the ratio of government expenditure to GDP. Studies have discovered that the expansion in government may lead to lower long-term economic growth.
Professor Richard Y C WONG	The burning question to consider is the optimal level of Government spending.
Mr Vincent KWAN	Hong Kong's huge fiscal reserves were built up between 1985 and 1997 as a result of the booming property market.
Professor Leonard CHENG Kwok-hon	Hong Kong's fiscal reserves, in absolute terms and as a fraction of its GDP, are huge by international standard. However, if the formula proposed in the 1998/99 Budget Speech were to be applied to previous years, then Hong Kong's fiscal reserves would have been grossly inadequate, with the exception of 1997/98, the year the Land Fund became part of fiscal reserves.

27. Uses of Excess Fiscal Reserves

27.1 The majority of academics invited to the Financial Affairs Panel meeting on 3 July 2001 are of the view that any freely disposable fiscal reserves should be employed for uses other than fulfilling the monetary requirement. A summary of their views is presented in Table 13.

Table 13 - Views on the Uses of Excess Fiscal Reserves

Academics and experts	Details
Professor Y C JAO	The priorities of using "freely disposable fiscal reserves" are: (a) job training or retraining for unemployed and under-employed; (b) "Comprehensive Social Security Assistance"; (c) education and high technology; and (d) tax cut or relief.
Professor HO Lok-sang	Professor HO has proposed the Government to limit its spending only to social projects with a good rate of return so as to improve the livelihood of the general public and to stimulate the economy.
Professor Terence CHONG	If the reserves are at or below the level under the Government's guidelines, the reserves should be used only when Hong Kong is under catastrophic circumstances. The Government should not use the reserves simply for the improvement of the living standard of the public which is already well above the subsistence level. Professor CHONG has suggested the Government to set up a Relief Fund if the reserves are above the maximum level. The interest income of the Fund can be used to help low-income groups.
Professor TANG Shu-hung	The Government should utilize the substantial reserves to improve the economy and to invest in projects for the long-term benefits of Hong Kong.

Academics and experts	**Details**
Professor Wilson WONG Wai-ho	The Government should use the excess fiscal reserves 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. In deciding the best way of using the excess fiscal reserves, the Government should follow the principles of: (a) avoiding long-term financial commitment since the excess fiscal reserves are not recurrent revenues; (b) allowing the private sector to take the initiative in using the excess fiscal reserves and limiting the role of the public sector; and (c) emphasizing investment, not consumption, to yield returns for Hong Kong. Professor WONG has suggested that an endowment fund can be created to privatize universities, health services and housing in Hong Kong. The Government can also use the excess reserves to finance or subsidize education for low-income classes and provide support services (e.g. child care).
Professor Stephen Y L CHEUNG	Excess amount of fiscal reserves can be invested in projects that will enhance Hong Kong's sustainable economic growth. These projects should generate a higher rate of return than that of the Exchange Fund. For example, infrastructure projects to improve the hardware (e.g. railway and reclamation) and software (e.g. education) for economic development can attract more investments to Hong Kong.
Professor Francis LUI Ting-ming[83]	Instead of preserving fiscal reserves to maintain the stability of Hong Kong dollar, the reserves should be used to improve the economic environment, which in turn would help maintain the stability of the exchange rate. The Government should invest fiscal reserves to enhance the productivity and competitiveness of Hong Kong. Investments made should help alleviate the problem of uneven distribution of wealth and provide benefits to the entire society rather than selected classes of people. The investment should best be undertaken by the private sector. In respect of specific investment programme, about HK$200 billion should be earmarked to set up a tertiary education fund for the long-term development of tertiary education in Hong Kong.

83 Professor LUI has further explained that there are two ways to deal with the reserves. One is to earmark part of the reserves for some projects that may improve Hong Kong's economic development or to set up a fund to pay for government liabilities (e.g. civil servants' pensions). The other is to earmark the reserves for the purpose of investing in US bonds. The investment will generate a steady flow of dividends every year, which will form part of the government income. However, once earmarked, only the dividends should be spent, but not the principal of the investment.

Academics and experts	Details
Professor Richard Y C WONG	Fiscal reserves can be leveraged to make expenditure cutting more palatable to society and to directly affected parties. Expenditure cutting will help preserve Hong Kong's commitment to a limited government system. It will also help the Government budget for the structural deficit that Hong Kong is likely to face. Things to do include: (a) fully fund civil service pensions, which will then be removed from recurrent public expenditure; (b) reform the public housing policy and end the Home Ownership Scheme programme; (c) privatize government-owned assets, like the Airport Authority, the Water Authority and tunnels; (d) increase private participation in infrastructure development projects; (e) enhance incentives for the private provision and funding of health care to stem the growth of public medical and health expenditures; and (f) endow universities and reduce recurrent spending on education.
Mr Vincent KWAN	The current fiscal reserves have not been built up intentionally for specific purposes. Mr KWAN suggests that any proper use of fiscal reserves should fall into the following categories: (a) accumulate for planned expenditure and investments in the future; (b) accumulate for generating recurrent investment income; (c) cover unforeseen budget deficits; (d) use the reserves for fiscal stimulation of the economy; and (e) use the reserves for specific capital investments. The Government may consider setting aside certain amount of reserves to finance pension payments for civil servants.
Professor Leonard CHENG Kwok-hon	Professor CHENG does not think fiscal reserves should be kept in preparation of future speculative attacks on the Hong Kong dollar. Fiscal reserves should be used to invest in Hong Kong's economic foundation by upgrading knowledge, skills and technology. The key areas that Hong Kong should invest in are: (a) education and human resources; (b) physical environment, including urban development and cleaning up pollution; (c) cultural environment, including arts and sports; and (d) technology, in particular technology that reinforces Hong Kong's traditionally strong industries and technology that creates new and sustainable advantages.

PART 8 - ANALYSIS

28. References for Hong Kong

28.1 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.

28.2 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 that 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 fiscal reserves; how effective these measures are;

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

(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.

28.3 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.

Principles of Fiscal Policy

28.4 All jurisdictions studied in this research have their own fiscal policies. In the cases of New Zealand, Argentina, the US and Hong Kong, these principles of fiscal policy are set out in laws. 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. Hence, most of the governments of the jurisdictions studied strive to balance the budget and avoid deficits.

Measures to Achieve a Balanced Budget

28.5 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.

28.6 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.

Practices of Maintaining Budget Surpluses/Fiscal Reserves

28.7 The jurisdictions studied in this research have different practices in maintaining budget surpluses/fiscal reserves. In Norway, the government accumulates budget surpluses in a stabilization fund, i.e. the Government Petroleum Fund, which is invested in foreign financial assets. In Singapore, fiscal reserves, along with foreign reserves, are managed by the Government of Singapore Investment Corporation which is owned by the government. In Hong Kong, fiscal reserves are placed in the Exchange Fund which is managed by the Hong Kong Monetary Authority (HKMA).

Ways to Finance Budget Deficits/Government Debt

28.8 In our research, Singapore and Hong Kong record budget deficits but have incurred no government debt in the time period studied. Both Singapore and Hong Kong have used fiscal reserves to finance budget deficits.

28.9 New Zealand has incurred government debt which is financed by raising funds from domestic and international markets and selling government-owned enterprises.

28.10 Argentina and the US have recorded budget deficits and have government debt. Argentina finances its budget deficits/government debt by raising funds from multilateral lending agencies, including the International Monetary Fund, the US government and institutional investors. The US finances its budget deficits/government debt by raising funds from domestic and international markets.

28.11 The implications for the different ways to finance budget deficits/government debts are as follows:

(a) If the use of fiscal reserves to finance deficits is to be continued, it may lead to scarcity of financial resources available for future use and lack of flexibility for financing means to meet changing needs of the jurisdiction; and

(b) Borrowing will have an impact on public expenditure due to interest payments, as well as on the interest rates to attract capital to cover deficits, and financial burden on future generations.

<u>Use of Fiscal Reserves/Budget Surpluses to Finance Economic Stimulus Packages</u>

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

28.13 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;

(g) issuing New Singapore Shares; and

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

28.14 In the US, the government uses budget surplus to finance economic stimulus packages. The Economic Growth and Tax Relief Reconciliation Act was enacted in May 2001 to provide for a US$1.35 trillion tax cut in 10 years. The centrepiece of this law is an across-the-board cut in income tax rates. In addition, the Job Creation and Worker Assistance Act was enacted in March 2002 which lengthens a 13-week extension of unemployment benefits for the unemployed and provides business with further tax cuts.

Guidelines on the Level of Fiscal Reserves

28.15 Among the jurisdictions studied, Hong Kong is the only place which has guidelines on determining the level of fiscal reserves. Based on information available to us[84], we are not aware of any guidelines adopted by overseas jurisdictions for determining the appropriate level of fiscal reserves. It appears that there are no explicit guidelines on fiscal reserves announced by other governments. As a matter of fact, most governments do not have fiscal reserves. Singapore has fiscal reserves but it does not have any public guidelines on the level of fiscal reserves.

28.16 In Hong Kong, under the new guidelines announced by the Financial Secretary in the 2002-03 Budget, fiscal reserves are considered to be at an appropriate level if they amount to around 12 months of government expenditure to meet operating and contingency requirements.

28.17 It is noted that prior to 1998, the Government did have an unofficial guideline of setting fiscal reserves at not less than 50% of the budgetary operating expenditure.[85] While the guidelines adopted in 1998 represented a significant raise in the definition of the appropriate level of fiscal reserves, the new guidelines have reduced the definition to a lower level.

Fiscal Reserves to Meet Monetary Requirement

28.18 Argentina is the only overseas jurisdiction in our study which had 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.

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[84] We are awaiting information from the International Monetary Fund (IMF), the Organisation for Economic Co-operation and Development (OECD), the Inter-American Development Bank, Brookings Institution and the Institute for Fiscal Studies regarding whether any overseas jurisdictions have laid down guidelines for determining the appropriate level of fiscal reserves.

[85] TANG Shu-hung, *Submission on Proper Use of Fiscal Reserves*, LC Paper No. CB(1) 1646/00-01(04).

28.19 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.

28.20 In Hong Kong, under the currency board system, fiscal reserves are placed with the Exchange Fund and thus form part of the resources used to maintain the stability of the Hong Kong dollar. The monetary base, comprising Certificates of Indebtedness and coins issued, the Aggregate Balance[86] 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 by the Exchange Fund. Under this system, Hong Kong dollar is linked at the exchange rate of HK$7.8 to one US dollar.

28.21 The majority view of the academics and experts invited to speak at the Financial Affairs Panel meeting on 3 July 2001 is that it is doubtful if monetary requirement should be included as one of the purposes of fiscal reserves.

28.22 In our study, both Singapore and Norway have fiscal reserves, but they are not required to use their fiscal reserves for monetary purpose. Based on information available to us, we are not aware of any overseas jurisdictions which use fiscal reserves for monetary purpose.

29. Matters for Consideration

29.1 Based upon the practices of other jurisdictions and academics' views, Members may wish to consider the following issues:

(a) whether the Government should establish guidelines to determine purposes and level of fiscal reserves;

(b) whether the present purposes of fiscal reserves are appropriate and whether the reserves should be kept separately from the rest of the Exchange Fund for accounting purposes;

(c) for operating purpose, whether it is necessary to have a reserve exceeding three months of government expenditure and whether this can be absorbed within the reserve for meeting contingency purpose;

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[86] 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.

(d) for contingency purpose, whether it is necessary to have a reserve exceeding the projected fiscal deficit for the current and the following, say, four financial years; or the aggregate of five consecutive years with the highest deficits recorded, whichever is greater;

(e) for monetary purpose, how far and to what extent could fiscal reserves be utilized for such a purpose, and could this requirement be fulfilled by the accumulated surplus in the Exchange Fund instead;

(f) in the event of excess fiscal reserves, whether the excess could be used to finance relief programmes to reduce the hardship of the public under the current economic situation, as well as other designated programmes; and

(g) what other incomes the Government has, e.g. through its investments in other public services or projects, which can be placed with designated funds/reserves for the purpose of financing specific social services or contingent relief measures.

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 14 - 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 1.2%	• The Government has estimated a 0.1% real GDP growth
Growth forecast in 2002	• GDP growth forecast is in the range of 1% to 3%	• A higher GDP growth rate of 2.7%	• An estimated 1.5% GDP growth	• GDP is projected to contract by a further 1.1%	• An estimated 2-2.5% GDP growth	• The Government has projected a 1% real GDP growth

	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 six-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$65.6 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 two economic stimulus packages implemented in May 2001 and March 2002	• 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 which was equivalent to about 15.5 months of government expenditure	• Nil	• Nil	• Nil	• Yes • Amounted to HK$389.7 billion at 31 January 2002 which was equivalent to about 19.5 months of government expenditure
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 around 12 months of government expenditure to meet operating and contingency requirements
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

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