

IPS-ESS Workshop

Fiscal Policy in Singapore

May 2004

This is a summary report of a workshop on "Fiscal Policy in Singapore" jointly organised by the Institute of Policy Studies (IPS) and the Economic society of Singapore (ESS), on 5 May 2004. We offer this as an additional input to the policy-making community and others with a keen interest in the fiscal policies of Singapore.

We would greatly appreciate any comments or feedback you might have on this report. Please send them to Mr Manu Bhaskaran, Adjunct Senior Fellow at IPS (manub@pacific.net.sg).

INSTITUTE OF POLICY STUDIES – ECONOMIC SOCIETY OF SINGAPORE WORKSHOP ON FISCAL POLICY IN SINGAPORE

KEY THEMES

I PRESENTATION BY PARTHASARATHI SHOME

In his keynote presentation, Dr Parthasarathi Shome of the International Monetary Fund (IMF)¹ made the following points:

Once adjustments are made to isolate discretionary fiscal policy action from the cyclical and trend elements in the fiscal measures, Dr Shome indicated that recent literature reveals that fiscal policy was not as restrictive as conventionally thought. Moreover, where fiscal policy had been restrictive, it had been appropriately so as studies showed that a tighter fiscal policy (prior to the Asian financial crisis) would have helped East Asia better contain the damage from the crisis.

Nevertheless, it was likely that there did exist a structural fiscal surplus since Singapore had had near full employment for many years. This implied that there would be considerable room for manoeuvre for fiscal policy to tackle both cyclical as well as structural problems.

A strong case was made for greater fiscal transparency. In particular, there needed to be greater clarity in the following areas:

- a. The flow of funds among various accounts (such as Edusave) needs to be clarified.
- b. The treatment of investment income needs to be changed in order to clarify if all such income is included and the treatment of investment profits and losses should be brought into line with international norms.
- c. The accounting should move to an accrual concept instead of being a mix of both accrual and cash concepts.
- d. Data on extra-budgetary items such as pensions and income of the pension funds should be made fully available.
- e. More data should be made available on state-owned enterprises, statutory boards, government holding and investment management companies in order to facilitate the presentation of a complete consolidated public sector accounts.

¹ Dr. Shome made the presentation in his individual capacity upon the initiation of ESS and IPS. He indicated that his views do not necessarily reflect the views of the IMF, unless otherwise indicated.

While the provision of additional data is useful, Dr. Shome thought that it is equally important that the existing data in the budget book be presented in a more reader-friendly and analytic format so that it is more amenable to the researcher.

Fiscal transparency went beyond just the provision of such data. Dr Shome argued that the publication of a medium term budgetary framework was also important. After all, the ministries now worked off a multi-year budget and it naturally followed that the consolidated budget should also incorporate such a multi-year framework. Experience from other countries that have adopted such a medium term budgetary framework (eg the UK) suggests that, after a while, the public and market learn to treat forecasts of future revenues and expenditures as conditional projections subject to annual revision.

In relation to the issue of the right amount of government spending on social safety nets, Dr Shome provided an assessment of the Central Provident Fund (CPF), arguing that one should focus on the composition of returns and not so much on total returns, which he did not find to be unusually low in relation to experience elsewhere. Returns comprised both income flows as well as capital gains/losses from investment in assets such as real estate (returns of which were estimated to be quite high). Nevertheless, there was room for the CPF to be modified in order to be able to meet the retirement needs of a sizeable portion of the population.

Dr Shome agreed that the CPF should shift to emphasise retirement objectives with a concomitant reduction in the emphasis on the housing objective. Government should consider a shift to a multi-tier social insurance/social security scheme with the lowest tier to be financed from the budget – given the cross-country comparisons which showed Singapore's spending on these areas to be unusually low for its per-capita income level.

Dr Shome felt that government had no choice but to continue shifting from income taxes to indirect taxes such as the Goods and Services Tax. One reason was the exceptionally high vulnerability of corporate sector profitability to external shocks, and the unilateral harmonization of corporate tax rate across open economies.

II COMMENTARIES

Commentary by Dr Hoon Hian Teck, Singapore Management University

Dr Hoon agreed with Dr Shome regarding the structural nature of fiscal surpluses in Singapore. Since most of the decline in Singapore's unemployment beginning from 1965 onwards is structural in nature – excepting, perhaps, the rise in unemployment in 1986 and recently in 2003 that have large cyclical components – it can be argued that most of the fiscal surpluses have also been structural in nature.

A major reason for such structural surpluses was that as a country Singapore was able to do things that produced *exceptional* growth, that is, growth that far exceeded what we or anyone else could have anticipated. At given tax rates, and no corresponding proportionate increases in government spending, we were able to generate fiscal surpluses.

Thus, whether Singapore could hope to continue generating fiscal surpluses would depend on whether Singapore could maintain the capacity to produce exceptional growth – which, in this next phase of development, would require two things: (a) Institutions to generate economic dynamism; and (b) ability to maintain social cohesion.

Dr Hoon agreed that there was a rationale for maintaining surpluses. Surpluses were needed to build resilience against shocks which came along with our open economy and integration with global capital markets such as currency crises. Fiscal surpluses helped in the process of accumulating external surpluses. In addition, the demographic projections also pointed to the need for some degree of surpluses being built up now.

Dr Hoon also endorsed the need for greater transparency in the fiscal accounts, arguing that just as transparency in monetary policy helps give the market predictability, similar benefits apply to the conduct of fiscal policy.

On the issue of the appropriate structure of taxation, Dr Hoon cited the work of William Easterly of New York University. This showed that in cross-country regressions, when some measure of the quality of institutions was included alongside tax rates, the standard of living is affected to the first order by the quality of institutions. Tax rates do not have first-order importance in explaining the huge differences in the standard of living among nations. The work of Edmund Phelps showed that economic dynamism stemmed from possessing a set of factors that enabled an economy's participants to pick up new ideas and then obtain relatively easy financing for them.

Dr Hoon's chart relating government expenditure as a ratio of GDP to the degree of trade openness suggested that Singapore had been able to keep government spending as a ratio of GDP to about 20 percent, or about half the level of other

OECD countries - despite our high degree of openness. This was because the exceptional growth performance during Singapore's catch-up phase of growth meant that there was little need for social spending on items such as unemployment benefits.

Singapore has now moved into a different phase of innovation-driven growth. Changes in technology and comparative advantage work against the less skilled, necessitating more active redistributive measures favouring those at the lower end of the income scale just to maintain the same combination of efficiency and equity position we had before. In order to keep a policy of being integrated into the world economy viable, we will need to increase our share of the national pie on providing social safety nets.

In commenting on the related issue of longevity and sufficiency of CPF savings for retirement, Dr Hoon endorsed the views on reverse mortgages advocated by Prof Chia Ngee Choon and, in addition, suggested doing away with the mandatory retirement age.

Commentary by Mr Sanjeev Sanyal, Deutsche Bank

Mr Sanyal felt that there was a basic constraint on Singapore's use of monetary and fiscal policy as a result of the high import content in the economy which resulted in substantial leakages of demand abroad. He therefore did not support the active use of either monetary or fiscal policy. At most, fiscal policy can be used to provide some social support through targeted (and temporary) measures to allow the weaker sectors or segments of the populations to tide over sudden shocks such as the SARS epidemic.

He agreed with Dr Shome's recommendation for greater fiscal transparency, arguing that both accountability and public debate would benefit immensely from more comprehensible fiscal accounts. He did not believe that the risk that clear accounts would increase populist pressures was so great as to preclude this shift to greater transparency since Singaporean society was now more mature and educated and so better able to bear such pressures. Nonetheless, he does not see the purpose of a medium term policy framework.

On the issue of CPF and its impact on social spending, Mr Sanyal argued that it was unclear that the solution necessarily lay in greater use of fiscal policy. Rather, the solution might be for more action to make the property markets more liquid in order to allow seamless downgrading and reverse mortgaging. The alternative would be a complex system that would unnecessarily reduce the freedom of choice between assets. However, there are two caveats to his argument: First, the government needed to remove the considerable uncertainty surrounding leasehold property in order to allow efficient pricing and improve liquidity. Second, since large declines in property prices could jeopardize the value of assets owned by retirees and thereby affect their ability to monetize their

savings, government should use tools such as land sales to avoid sharp declines.

He was not in favour of a complex multi-tiered social security system which might affect work incentives and jam up labour markets as in Continental Europe. In particular, he took issue with the argument that an enhanced social safety net would encourage people to take risks and shift to new sectors and thus allow Singapore to move up the value chain more efficaciously. Far better for government to overcome such problems as skill mismatches by investing in re-training rather than providing indiscriminate unemployment benefits. Such benefits would be especially complicated to administer in Singapore given the large proportion and turnover of foreign workers. While some form of social safety net is needed, a simple (and possibly single-tiered) minimum support system targeted at the poorest would suffice.

He criticized much of the discussion about fiscal surpluses arising out of concerns about an aging population. These discussions were based on simple projections of existing population dynamics and ignored the proposals to actively use large-scale immigration to build up Singapore as Asia's "Global City". Instead, one should think of a population dynamic in which there was a continuous inflow of people of working age into the city together with a steady outflow of retirees to the suburbs (in this case Johore and Batam).

Fiscal resources have an important role to play in fostering art and cultural activity. World history is testimony to the fact that centres of cultural excellence arose due to patronage from the state and from business. Merely allowing artistic freedom does not generate culture without monetary backing. Fiscal policy should also continue to play an important role in building and maintaining urban amenities. Thus, "public goods" should be supported while "public bads" should be taxed. A good example of this is the current system of taxing cars and investing in public transport. Such a system is necessary in order to avoid future grid-locking problems such as those being faced today in London.

Mr Sanyal's essential message was that fiscal policy in Singapore should continue to play a limited role in stabilizing output and concentrate on supply-side management. In particular, it should be aimed at longer term re-engineering of the city-state.

III DISCUSSION

A wide range of views emerged during the discussion session, with no clear consensus on several issues.

Do we know enough of the basics?

It was pointed out that we lacked some basic information on issues related to fiscal policy such as (a) what the actual levels of the surplus and stock of reserves were; (b) what potential GDP growth rate is going forward; and (c) how much health-related expenditures were likely to rise in future especially given our ageing population. There was thus a need for more research to be done so as to facilitate sufficient understanding of the issues in the first place.

Pro-active use of fiscal policy for demand management

Several arguments were put forward in favour of greater use of fiscal policy to smooth out demand fluctuations.

- First, given the likelihood of a greater frequency of shocks and the inadequacy of existing measures to deal with such shocks, government would need to employ fiscal policy more actively.
- Second, some discussants disagreed with the view that fiscal policy was ineffective because of leakages abroad – they felt that while leakages reduced the effectiveness of fiscal policy, they did not eliminate fiscal policy effectiveness altogether – there was virtue in using fiscal policy to “lean against the wind” given that, at the margin, fiscal policy would still have some positive impact on aggregate demand.
- Finally, if there were to be a very flexible labour market but insufficiently flexible monetary or fiscal policies, then a disproportionate share of the burden of adjustment would fall on workers – This would be socially inequitable or painful, especially in the absence of a sufficient social safety net or access to CPF savings.

Is there a role for fiscal policy to achieve income redistribution?

It was argued that income redistribution through fiscal policy was not as harmful as many seemed to argue. For instance, the chart provided by Dr Hoon showed that many of the countries with a high government spending to GDP ratios were the more successful Northern European countries. Similarly, it was argued that Hong Kong now had a much more extensive social security system than Singapore – yet it did not seem to slow Hong Kong’s adjustment to recent shocks, ie make labour markets more rigid or dampen labour supply. Too little was known about the impact of social safety nets. A well designed net targeted at the most needy that did not reduce the incentive to work was not inconceivable, given the broad experience of other countries.

Government fiscal surpluses

Some discussants pointed out that while fiscal surpluses were needed for a rainy day and other purposes, the key issue was to define the optimal level of fiscal reserves. It could well be that Singapore already had accumulated more than this optimal level and did not therefore need to continuously build up reserves through conservative fiscal policies.

A key issue here was how to sensibly partition returns from reserves between current and future consumption. This included returns from financial assets, private equity, as well as revenues from land sales. This was because these sources of revenue constituted several percentage points of GDP and represented significant potential fiscal resources. Long term returns could be plausibly calculated for the total reserves and for land sales which could serve as guidelines for spending rules between current and future consumption. This should be the subject of further study and debate

CPF and government liabilities

Considering the issue of CPF members retiring with inadequate savings for retirement, it was argued that this could represent a potential liability on the books of the government. Even if there were no explicit government obligation to compensate those in such a predicament, it was possible that political pressures would be so great that government would be forced to take on the obligations. It was also pointed out that part of the reason for the hole in CPF was due to how government policies had been previously designed. This being the case, it could not be argued that it was entirely up to the household sector to plug the gap by raising their own savings. There had to be a role for government.

The role of government to improve market imperfections to meeting the needs of retirement or rising medical cost of the aging population were also raised. For example, reverse mortgages may need some degree of government guarantee or support as it might not be commercially viable on its own. Similarly, the government may need to negotiate with insurance companies as a consortium and give some support to create an optimal health insurance system for the very aged (eg 70 years and above) where individual insurance companies could not give cover on their own.

It was also pointed out that the government might need to play a role to support the aging population, particularly the retirement of the baby boomers, who had invested most of their savings in properties. In a sense, the government had acted as a financial intermediary for the public by reinvesting the proceeds from land sales abroad. The returns from the investment can therefore be used to support the aging population whose wealth is mostly in the form of properties.

Fiscal policy and social objectives

A discussant pointed out that fiscal policy in Singapore was also employed to achieve social objectives such as increasing the fertility rate. In future, one might

envisage the imposition of “green taxes” to achieve environmental goals – in which case, these taxes could also become an additional source of revenues.

IV COMMENTS BY MR RAVI MENON, MINISTRY OF FINANCE

Role of fiscal policy in macro-economic management

If one considered the fiscal impulse rather than the headline budget balance over time, it would show that fiscal policy had become more activist as GDP became more volatile. Most of this was due to off-budget packages or discretionary measures rather than automatic stabilisers.

So the issue was whether Singapore needed more automatic stabilisers rather than depend on off-budget measures. One advantage of automatic stabilisers was that they operated with very little lags whereas off-budget measures were subject to recognition lags and decision lags. Automatic stabilisers also did not have the political problems of when and how to withdraw the stimulus which is the case with discretionary measures.

The challenge was how to build in more automatic stabilisers but to do so without compromising some of the basic values and parameters of government policy. There was also a question of administrative costs – for instance, a pay-as-you-earn taxation system would be a reasonably effective automatic stabiliser but it could turn out to be administratively more burdensome on businesses and individuals.

The need for surpluses

Fiscal policy was constrained by the constitutional bar against the current government spending surpluses built up by previous governments. However, economic cycles do not necessarily coincide with electoral cycles. This was why it was important for each government to try to achieve surpluses in good years so as to have the buffer to run deficits in bad years.

The second reason for accumulating surpluses is in anticipation of fiscal needs in the long run. Government expenditures will come under upward pressures principally from demographic trends. Government currently spends only about 1% of GDP on health, much less than other developed countries. It is very likely that health expenditures would have to rise as a percentage of GDP. Given the competing demands from defence, education, etc, it would be quite a challenge to meet the increase in government health spending as a percentage of GDP.

So the reason for accumulating surpluses was not so much to prepare for a rainy day in the sense of a major crisis. Rather Singapore would need a large stock of reserves that it could draw upon for a steady stream of income to help finance future budget deficits.

Government had to think hard about how best to balance the needs of current and future generations. It viewed the reserves as an endowment fund whose investment returns could finance current and future needs.

Fiscal transparency

Mr Menon agreed that more could be done to meet the growing demand for greater fiscal transparency. However, he noted that the optimal level of transparency was most likely one that stopped short of full transparency. For instance, detailing the full extent of the financial resources of the government might invite a populist urge to over-spend. Releasing details of the investment performance of our reserves might lead to pressures to manage the reserves on too short a horizon which would not maximise long-term returns.

The reason why the budget position is drawn up in the way it is – e.g. where the treatment of items such as investment income and land sales differed from standard IMF methodology – is to reflect what government was allowed to spend within our constitutional framework.

Direct vs indirect taxation

The shift from direct to indirect taxation would continue. Competitive pressures are likely to reduce income tax rates. Indirect taxes would have to rise to make up the shortfall.

Mr Menon believed that it was not impossible to have a wedge between the top rate of personal income tax and the corporate tax rate as we do not have a full imputation system.

Social expenditure

Mr Menon was of the view that while Singapore should avoid the pitfalls of a welfare society, there was a need to expand its social safety net somewhat. First, if we wanted to be a compassionate society, the increasing income dispersion that would come with greater competition and globalisation would have to be mitigated to some extent through support for those who might be left behind. Second, to allow economic restructuring to take place more quickly, some support for the most disadvantaged might be necessary to secure cohesion.

From a purely counter-cyclical perspective, this might be best achieved through direct but temporary transfers to the poorest segments of the population – since they spend most of what they receive and their spending tends to have the smallest import leakages. However, at present, such transfers were limited and discretionary in nature which made it politically difficult to remove. It would be better for such measures to be automatic and criteria-based.

For subsidies and transfers of a more permanent nature, there would have to be more recourse to means-testing to ensure that help is targeted at the truly needy. We cannot afford to give out too many general subsidies.

CPF

The challenge of the CPF system was to balance its multiple objectives – retirement adequacy, home ownership, and business competitiveness. Recent reforms were in the direction of refocusing on the retirement objective while ensuring cost competitiveness. The CPF system in the past might have resulted in a distortion of choices, with people effectively consuming more housing than they needed.

V AREAS FOR FURTHER RESEARCH

The workshop suggested the following as areas for further research:

- a. Robust forecast ranges for structural budget balances in Singapore over the next 5, 15 and 30 years given plausible scenarios for potential growth, final population size (eg 5 or 10 million) and associated demographic profiles.
- b. Key considerations in the above exercise would likely be government expenditures for supporting ageing population (eg health, pension support), the need to increase fiscal competitiveness by lowering corporate taxes and potential costs/benefits of raising indirect taxes.
- c. Likely long term average investment income from reserves (free of liabilities) and land sales on a 5, 15 and 30 year horizon and optimal spending vs saving rules for such income as a sustainable supplement to fiscal revenue.
- d. Role of government in overcoming market failure to provision of pension support and health care (eg in supervising and organising reverse mortgage market, elderly health insurance market etc).
- e. Benefits and costs of a multi-tiered social insurance scheme for cyclical unemployment and measures to address structural unemployment. A centralised review of adequacy of all existing support systems in a rapidly restructuring, highly open economy.

Such research should ideally also be undertaken by independent research agencies and academia besides government research agencies, and be the subject of thorough discussion and debate with economists, practitioners and policy makers. This would potentially both improve the quality of policy research and decision making as well as forge a stronger, better-informed political consensus on the direction to take in these major policy issues.

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