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Abstract

This essay argues that Singapore's growth model for the past 50 years has been founded upon a political economy of subsidy. Overconfidence in the logic of subsidies as incentives to achieve policy goals has masked the numerous negative consequences of such a logic, resulting in a bloated, inefficient economy that encourages fraud and rent-seeking. Reforms necessary to raise the productivity and innovation capacity of the Singaporean economy requires a sharp vision of what Singapore's political economy of innovation is going to be, a clear understanding of the institutions necessary to support such a political economy, and political will. In particular, three existing features of Singapore's sacred labor market institutions must be considered for the slaughter house – the current system of foreign labor immigration, unemployment insurance, and power asymmetry between employers and employees.

What are the limitations and challenges facing Singapore's current growth model? What changes and reforms do you think necessary, particularly in terms of raising productivity and the innovation capacity of the Singaporean economy?

Since the Productivity and Innovation Credit (PIC) scheme was introduced by Deputy Prime Minister Tharman Shanmugaratnam in Budget 2010, billions of dollars have been poured into the program. Initially estimated to cost the Singapore Government $480 million a year over five years,[1] the PIC scheme's cost has now ballooned to an estimated $1.2 billion a year between 2016 to 2018.[2] The result? Multifactor productivity growth's contribution to Singapore's GDP between 2011 to 2014 stands at -1.5%.[3] Attempting to raise the productivity of Singapore's economy is worse than the Sisyphean task of pushing at the end of a string.

This vignette serves to lay bare the facts, and demonstrate the central thesis of this essay: Singapore's growth model for the past 50 years has been founded upon the logic of the political economy of subsidy. This policy logic, steeped in conventional models of rational choice, promises to harness market forces to fuel Singapore's growth, but in fact, undermines the very basis of a dynamic capitalist economy. Weaning off this feeding trough of subsidies requires the drastic but necessary slaying of cows that are too sacred to be even pricked at the moment. Successful slaughter will not only require the sharp blade of knowledge, but also the political will of the butcher. As some say, it is all in the mind.

The Political Economy of Subsidy

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[1] Annual Budget Statement 2010.
[2] Annual Budget Statement 2014.
[3] The benefits of the PIC scheme were first distributed in 2011. Author's calculations from Singapore's Yearbook of Statistics 2015.

The political economy of subsidy is fundamentally rooted in the language and reasoning of economic incentives – give, and your (policy) wishes will be fulfilled. In Singapore's early years after independence, the Economic Development Board gave generous tax breaks to multinational companies to incentivize them to build factories in the country, generating mass employment, rising incomes, and prosperity for all. Full employment was achieved in 1970, a mere five years after independence.

The *direct* subsidies of tax breaks and cheap land were the least of our worries, however. The stampede of multinational firms into Singapore generated such an excess demand for labor that – to preserve our competitive advantage in the face of rising wages – the *indirect* subsidy of these companies through the massive liberal import of foreign labor was the next natural policy to adopt.[4] This policy seemed particularly justified in the mid-1970s in light of the 1973 oil crisis and stagflation in the Western industrialized economies. Wages were depressed, the multinational firms stayed, and unemployment remained low despite the troubled global economy.

As has been extensively discussed, this addiction to cheap foreign labor would be Singapore's cross to bear for the next several decades. Access to cheap labor fuelled increased capital inputs, which in turn generated a greater thirst for labor inputs, resulting in the giddy heights of near 10% economic growth. But the subsidy of cheap labor also meant persistent low wages and low productivity.[5]

Consequently, the Singapore government first attempts to wean the economy off the subsidy of cheap labor began in 1979 through what is commonly known as the Second Industrial Revolution.[6] But what is less well known is that Albert Winsemius, the chief architect of Singapore's first industrialization drive, was actually the one who instigated the

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[4] Pang Eng Fong and Linda Lim. 2016. "Labor, Productivity, and Singapore's Development Model." In Linda Lim ed. *Singapore's Economic Development: Retrospection and Reflections.* Singapore: World Scientific.
[5] Krugman, Paul. 1994. "The Myth of Asia's Miracle." *Foreign Affairs*; Young, Alwyn. 1993. "A Tale of Two Cities: Factor Accumulation and Technical Change in Hong Kong and Singapore." NBER Macroeconomics Annual Vol 7.
[6] Lee Kuan Yew School of Public Policy, Present(ing) Futures Issue 1: *Singapore's Productivity Challenge: A Historical Perspective.* pp.14-16.

government to do so.[7] In his oral history interview, he mentioned that one of the key mistakes that he made during his tenure in Singapore was that he compromised with employers to give too low wage increases through the National Wages Council in the mid-1970s. Having realized his own fault in pushing Singapore down path of addiction to the subsidy of cheap labor, on 6 May 1979, a Sunday night at the Shangri-La Hotel, he penned,

> "…the shortest report I have ever written in Singapore. Two pages which told the whole story because the story was a few statistics, comparing wage increases, productivity of three/four countries, competing countries, and showing the tremendous increase of our guest workers. On Monday, we started discussions and I invited practically everybody at that time. We had the younger ministers, everybody concerned and I recommended to have three times, three consecutive years of wage increase of 20%... …In my opinion, the best I ever wrote. Because the problem was so clear…"[8]

The Malaise of the Political Economy of Subsidy

In any case, the promising fruits of achieving one's policy goals through the iron logic of subsidies as incentives often masks the adverse consequences of such a policy tool. There are at least three forms of such negative externalities that are sometimes whispered, but never directly confronted.

[7] Oral history interview of Dr. Albert Winsemius. Economic Development of Singapore, Accession Number 000246, Reel/Disc 13 of 18. Last accessed at http://www.nas.gov.sg/archivesonline/oral_history_interviews/record-details/1c28707b-115f-11e3-83d5-0050568939ad
[8] Transcript of oral history interview of Dr. Albert Winsemius. pp. 160-163. Last accessed at http://www.nas.gov.sg/archivesonline/viewer?uuid=1c28707b-115f-11e3-83d5-0050568939ad-OHC000246_013

In the first instance, direct subsidies as incentives not only rewards a policy's intended objective of "good" behavior, such as more investments in skills training or machinery upgrading, but it almost always encourages "bad" behavior too. That is, subsidies as incentives generate a moral hazard problem. Unscrupulous men plot their way to applying for and benefitting from subsidies, leading to a gross waste of public funds. A Straits Times article on 21 February 2016 reported that about 30,000 applications filed by the self-employed for $358 million worth of PIC funds were rejected or reclaimed since 2010, or about 6,000 applications every year.[9] This means that every single day, there are at least 16 separate conspiracies trying to fraudulently siphon tens of thousands of dollars from the public coffers! Only 8 people have been prosecuted for PIC fraud thus far.

More importantly, moreover, the false confidence of direct subsidies as incentives rewarding "good" behavior also absolves policymakers from building reliable monitoring, evaluation, and sanctioning mechanisms for such programs. There is no constant assessment of how subsidies are put to use, no estimate of what is the actual effect of new equipment bought, and no credible punishment for abusing the subsidies. "Does it actually work on the ground?" is a question that no senior policymaker has a good answer to. No wonder an online pimp found it easy to obtain $24,000 worth of PIC grants for a "customer relationship management software system."[10] I am sure his customers must have been pleased. Not so sure about skills and productivity though.

Last, but not least, the direct and indirect subsidies that firms enjoy in Singapore also serve as a protective safety net for low productivity companies that should have long been destroyed by the market. In our drive to preserve "competitiveness," we mollycoddle inefficient companies with easy-to-obtain direct cash subsidies and the spigot of cheap foreign labor, ensuring their continued leeching on the state. The challenge with

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[9] Accessed at http://www.straitstimes.com/singapore/consultants-or-con-men-iras-on-alert.
[10] Accessed at http://www.straitstimes.com/singapore/courts-crime/online-pimp-jailed-and-fined-for-evading-more-than-26000-in-income-tax.

entrepreneurship in Singapore is not that there are not enough new entrepreneurs entering the market. Rather, it is that not enough rotten firms exit the market.

Institutions and Reforms

Examining the roots of the political economy of subsidy is beyond the scope of this essay, but suffice to say, raising the productivity and innovation capacity of the Singaporean economy through any reforms first requires having a clear understanding of the political economy of innovation. A basic model to learn from is Hall and Soskice's *Varieties of Capitalism* framework.[11] For them, liberal market economies (LMEs) like the United States and the United Kingdom have institutional structures that support radical innovation. Flexible labor markets, nimble firms, centralized management power, and impatient venture capital support start-ups like Facebook and Uber. In contrast, coordinated market economies (CMEs) like Germany and Sweden encourage incremental innovation. Protected labor markets, enduring firms, decentralized and devolved management powers, as well as patient cross-shareholding capital support engineering giants like Siemens, ABB, and Robert Bosch GmbH.

As Carney and Loh have argued, Singapore's political economy of innovation is caught in a cross-cutting conflict between these two types of institutional structures.[12] On the one hand, local firms are typically state-linked or family-owned, resulting in the use of patient capital that typically extends a company's time horizon, which makes it conducive for incremental innovation. On the other hand, an extremely flexible labor market characterized by low employment and unemployment protection leads to high turnover. Employees have extremely short time horizons, seeking visible high-impact results to pack their CV, so as to leverage for higher pay within their existing firms, or to job hop for higher pay elsewhere. It

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[11] Hall, Peter, and David Soskice. 2001. *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage.* Oxford: Oxford University Press.
[12] Carney, Richard, and Loh Yi Zheng. 2009. "Institutional (Dis)Incentives to Innovate: An Explanation for Singapore's Innovation Gap." *Journal of East Asian Studies*. 9(2): 291-319.

is not uncommon for local bosses to lament about how their employees are disloyal to the firm. Accordingly, there are completely no incentives for bosses to invest in workers' training because employees will job hop after training anyway. In other words, employers and employees are stuck in the "Defect-Defect" Nash equilibrium in a Prisoner's Dilemma.[13] Overall, "the contradiction manifests itself in a low level of both incremental and radical types of innovation."[14]

The reforms necessary to upend this state of affairs requires a clear-eyed vision of whether Singapore imagines itself as a CME or a LME. At the moment, the vision appears to be leaning towards a CME future. Deputy Prime Minister Shanmugaratnam has mentioned numerous times about the need to "cherish and respect the mastery of skills," and about how the Swiss and the Germans have the necessary institutional history to support such a long-term venture, but not Singapore.[15] If that is indeed the case, then reforms that challenge the current dominant paradigms of our policymakers must be contemplated.

The first immediate short-term reform is to thoroughly overhaul our indirect subsidy of cheap foreign labor immigration. The current non-transparent, tiered, and anything-goes system of work permits, S passes, and employment passes is untenable. Instead, we need fixed quotas for foreign labor, and establish clear, high bars for eligibility and qualifications. For instance, a points system covering language skills, educational qualifications, and wages has been mooted numerous times in parliament. The immediate effect is both to plug the deluge of cheap labor subsidies, and to send a clear signal of resolve to firms that the government is changing course. Instead of merely repeating the rhetoric of "There is no turning back," the government must act decisively to signal determination.

[13] In a one-shot Prisoner's Dilemma game, cooperation between both players leads to better outcomes. But rational self-interest leads both players to play "Defect" as the dominant strategy, leading to worse outcomes.
[14] Carney and Loh. pp. 300.
[15] Last accessed http://news.asiaone.com/news/singapore/beyond-competence-towards-mastery-skills?nopaging=1

In the middle-term, we need to build institutions that allow firms and employees to "escape" the "Defect-Defect" equilibrium of the under-provision of skills training. One way to do this is for government to encourage both players to play TIT-FOR-TAT.[16] In this strategy, both players reciprocate what the other player did in the previous move, and the outcome is that utility is maximized for all over the long run. When an employer invests in a worker in good times, the worker must stay and contribute back to the firm. This can be tied through long-term bonds and increased wages, not unlike our present scholarship system. When an employer retrenches a worker, however, the worker must be protected and the employer must be punished. A national unemployment insurance scheme where the employer pays a significant portion of the employee's previous salary for at least six months is a possible punishment. The goal is to force employers to reconsider retrenchment and to think harder of alternative ways to improve innovation and productivity, rather than cut manpower costs as a simple way to ride out the vagaries of tough times.

Finally, in the long-term, the devolution of management power and increased worker autonomy is the surest path towards a CME world of incremental innovation. Everyday frontline workers understand the subtle demands of customers, and are empowered to proactively innovate and respond to their needs. Japanese customer service should be our role model. At the management level, Germany's form of co-determination, where both shareholders and workers sit on the boards of directors, intertwines the fate of both players to the firm. Shared fate leads to mutual collaboration for difficult, incremental innovation pushing against the production possibility frontier.

To be sure, these recommendations more than chafe against the dominant paradigms of Singaporean policymakers. How can you add rigidity to the labor market? How can you let workers have an equal say in management? Instead of these instinctive knee-jerk reactions,

[16] One of the most significant findings of game theory is that utility is maximized for both players in an iterated Prisoner's Dilemma game when both players play the TIT-FOR-TAT strategy. See Axelrod, Robert. 1984. *The Evolution of Cooperation.* Basic Books.

perhaps we wish to reflect upon the tradeoffs of our existing political economy of subsidy, and consider if we have come down on one side for far too long. Recall that billions of dollars have bought us -1.5% of multifactor productivity growth. What will be the cost of a lack of political will?

(1999 words)