ARTICLE FOR THE EDGE

SINGAPORE: POLICY OPTIONS FOR FUNDING RISING SOCIAL SPENDING

The unveiling of the Budget for 2018 has triggered a healthy debate on how the likely pressures for more government social spending in Singapore should be funded. The government has proposed a two-percentage point rise in the goods and services tax (GST) sometime after 2021, believing that this would be the best option out of the alternatives available.

There are three key considerations that will determine the direction Singapore's fiscal trajectory will take:

- First, what is the actual starting point in our fiscal position, if we use the approach recommended by international bodies to compute the fiscal position of a country?

- Second, what is the gap between future revenues and future spending given the extra social spending needed? The government has maintained that it will be a lot but we have not seen any rigorous quantitative projections.

- And third, given that shortfall, is a GST or other tax hike the optimal way to plug that gap? Or is it better to use more of the investment income?

First, what is the size of the reserves and the actual income received from it?

Before we assess what the fiscal challenges are, it is worth pointing out that the Singapore government's approach to presenting the fiscal accounts differs from the International Monetary Fund's approach. In the period, 2011-2015, on average the IMF computed an overall Singapore government fiscal balance that was roughly 4 to 7 percentage points of GDP higher than what the government presented. In other words, if the IMF's approach is accepted, the Singapore government's starting fiscal position is vastly stronger than the government suggests.

Unlike most other countries, Singapore has the luxury of a massive hoard of savings which yield a sizeable flow of investment income. In fact, in fiscal year 2017, close to 20% of total government expenditure was funded by something the government calls the "net investment returns contribution" or NIRC.

The actual value of the total fiscal savings is a closely guarded secret. So is the actual income received in any one year. Unfortunately, not knowing the full details makes it difficult to decide whether Singapore really needs to raise taxes on its people. So, we are forced to make some assumptions in order to estimate Singapore's actual fiscal position.

The NIRC figure given in each budget is not the actual investment income earned each year by government. The NIRC is very conservatively defined as up to 50% of the long-term expected real returns (including capital gains) of the relevant assets – there is no scientific basis to this 50%, rather it has been used as a rule of thumb. Since the term "relevant assets" suggests that not all the actual assets are included and since the value of the "assets" to be calculated is based on a long term historical average of a growing pool of savings, the asset value used in calculating the NIRC is probably quite a bit lower than the actual asset value in any one year. Moreover, since NIRC is computed as an expected real return, there is considerable discretion as to what the expected nominal returns are over time and what the inflation rate is likely to be. It is not unreasonable to guess that the Singapore government, being very prudent and keeping an eye out for future risks, sensibly employs very conservative assumptions in all these areas.

In other words, it would not surprise us if the actual flow of investment income each year was more than double the NIRC figure used to compute the budget.

Second, what is the actual shortfall in funding?

This depends on the actual investment income estimates and their likely upside over the years; how other revenues will grow; and the projected rise in social and other spending. It would help the discourse if the government could provide projections for the rapidly rising components of government expenditures so that a clearer picture can be had. But, so far, Singaporeans have been given a scenario of ever-rising spending pressures but not rigorous projections. Following is our best effort to put some numbers to the discussion, based on the limited information that the public has.

First, we need to project total operating revenues going forward. If we assume that nominal GDP grows by around 4% a year and that there are no changes to taxation or other policy parameters, we should see operating revenues grow from around 17% of GDP in fiscal 2017 to about 19.5% of GDP by 2025 as Singapore's "tax buoyancy" (the rise in tax revenue for a given rate of economic growth) is above 1.

Assuming reasonable rates of growth for spending – i.e., faster growth in social spending and conservative growth in non-social spending, we get a rise in total government spending as a proportion of GDP to about 20% of GDP by 2025 from close to 17% in fiscal 2017.

Thus, on quite conservative and reasonable assumptions, the shortfall that requires a rise in taxes is quite small, at about half of 1% of GDP. This is the amount that needs to be financed, either by higher taxes and other conventional revenues or through higher investment income. Given the relatively small amount, it seems plausible that it can be easily funded by the likely growth in the NIRC, even using the extremely conservative assumptions and definitions that the government uses.

Third, is there anything inherently wrong about depending more on investment income as a source of revenues?

Our view is that, so long as the source of the investment income is stable and secure, there is no reason not to use more of it – at a judicious pace so that our revenue sources remain quite diversified and we do not depend disproportionately on it. Moreover, it can also be argued that there are some advantages to using investment income instead of tax revenues to fund spending.

How do we ensure that the reserves from which that investment income is derived are managed well? The only circumstances under which the reserves will be severely depleted would be (a) fraud or corruption or gross incompetence in the management of the reserves; (b) an existential crisis which required Singapore to consume its reserves just to survive.

On the first, nothing works better than diversification, transparency and a robust system of checks and balances. It is not clear that we have achieved this. It is probably advisable to have the reserves managed by a diverse set of managers rather than one (GIC) as is currently the case. GIC has proven to be a competent manager but we cannot be sure that this will be the case all the time in future. With many managers with diverse styles and characteristics, even if there are problems with one or two managers, the remaining funds are likely to still be safe since it is highly unlikely that all the diverse managers are incompetent or dishonest.

It is also vital to have substantial transparency in the management of the reserves as Norway does. It would be harder for any malfeasance to occur if key elements of the management of the reserves are constantly in the public domain and subject to independent investigation and verification. The current practice where citizens do not even know the size of the assets nor the annual returns from those assets is highly inadvisable and almost an invitation to disaster in the long term.

It might also make sense to have a more comprehensive set of checks and balances such as commissions independent of the political leadership to oversee and audit the managers of the reserves.

On the second risk – that of an existential crisis – this might be a low probability event but as Kuwait found out when it was attacked and occupied in 1990-91, not low enough to ignore. What this means is that Singapore does need a much larger hoard of fiscal reserves than a country like Norway – and cannot afford to reduce defence spending as some suggest. But, even here, there should be an effort to quantify the amount of reserves that are needed in such an eventuality rather than mindlessly accumulating savings without end. Our suspicion is that our reserves are already well ahead of what is needed even in the case of a calamity.

Having said that, it makes sense to have diversified sources of revenues, Singapore should not be overly dependent on any one source such as investment income. There is room for a conversation about this. Our own view is that the current 20% dependence is safely low and we can afford to go to a third without compromising this principle of not depending disproportionately on any one source of revenues.

Fourth, in some cases, using more investment income might actually be superior to raising taxes.

After all, taxes of any kind impose a deadweight loss on society. Most taxes, be they income-based or consumption-based cause losses. Income taxes reduce incentives to work and increase the incentive to find distorting ways to make the income less exposed to taxes. Consumption-based taxes reduce spending power and so depresses consumer welfare. Worse still, consumption-based taxes tend to be regressive since the lower-income groups spend proportionately more of their incomes than richer ones. Of course, the Singapore government is right to say that this regressivity can be offset through schemes such as the GST vouchers. But if we can achieve our revenue targets without having to resort to a regressive tax in the first place, would that not be preferable?

Another argument for using investment income to fund old age-related spending instead of GST is that it is more equitable to use income from the accumulated savings of the older generation to pay for their expenditures than to tax the current generation.

In addition, because Singapore has such an unusually high savings rate, it has massive current account surpluses, amounting to double-digit shares of GDP in the past decade. Given such high savings, it is not necessary for the government to pile on even more savings by conserving investment income while taxing Singaporeans.

In Singapore's case, there are other reasons to avoid the GST: In the context of an economy where there is an extraordinarily high profit share of GDP, is it appropriate that households bear a higher proportion of taxation than corporates? Our very rough estimate is that the direct taxes plus indirect taxes plus various levies paid by the household sector amount to about 11% of GDP whereas the equivalent for the corporate sector is around 6%. Given that foreign shareholders earn roughly half of the profits accruing to the corporate sector, the burden on Singapore households seems already to be unevenly high. This being the case, it does not seem appropriate to increase the burden on the household sector even more by increasing the GST rate.

There are wider economic consequences from increasing the GST. As it is, Singapore has an unusually low share of consumer spending in GDP. Since it is consumer spending which determines welfare, and we have a low share, imposing a higher GST tax rate which will further depress consumer spending and therefore welfare does not seem like the best way to move ahead especially given the high level of wealth and income inequality already prevailing in Singapore.

The bottom line

And this brings us to the nub of the issue: what is the optimal savings rate for a country like Singapore? Savings is not an end in itself, it is the welfare of the citizens which is the end. Simply accumulating savings continuously is not the right thing to do – the right approach is to look holistically at all the determinants of welfare and then decide an optimal savings rate.

The thrust of the discussion above essentially leans to a view that Singapore is probably already saving enough and may even have exceeded the optimal savings rate. In that context, the better approach to funding rising social spending is to use more of the income from investments and not to raise taxes, be it the GST or some other tax.

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