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ETHOS

Civil Service College
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EDITORIAL

The implications of globalisation are only just now hitting home. The phenomenal growth it has generated has also dramatically widened the gap between the haves and the have-nots, on a worldwide scale. Social provisions and national policies formulated a generation ago are struggling to cope with the demands of today's interconnected marketplaces and accelerated flows of capital and labour.

The fortunes of open economies, such as Singapore's, are particularly shaped by globalisation's opportunities and volatilities. A recent Merrill-Lynch report credits Singapore with having one of the fastest growing populations of high net-worth individuals in the world.[1] Yet we have also seen, in recent years, a stagnation in real incomes at the lower wage levels for the first time.

The problem is not one of income inequality per se, nor of the counter-productive politics of envy. Instead, there is a need to recognise that in a world of global outsourcing and cheap international labour, it may be possible to be gainfully employed and yet not earn enough to provide adequately for one's family—even during periods of rapid economic growth. NTU's Dr Ho Kong Weng has charted the relationship between wage equality and educational mobility, and warns that both are at risk of declining in the near future (see page 43). What then is a society's responsibility to its diligent but less able members—and also to their children, who might lag in the early investments necessary to do better for themselves later in life?

These are some of the difficult questions that confront policy-makers, not least because the market is unlikely to correct them on its own, or not without profound human and social cost. Economic strategist Yeoh Lam Keong argues that Singapore's basic social compact is premised on equality of opportunity for all, and the unspoken promise of fair reward and social mobility with due effort: it is the Singapore Dream that is under threat from globalisation.

Recent policy changes, such as the Workfare Income Supplement (WIS), are bold attempts to address some of these new realities in ways that preserve our economic competitiveness and social cohesion. Ethos takes a closer look at the thinking behind the innovative Workfare scheme, and considers its limitations. We speak with Professor Lawrence M. Mead on the US experience with work-based benefits over the past decade. We revisit the principles of self-reliance that underpin Singapore's social policies. We also examine a radically different model of social welfare: that of the Nordic states, which appear to be able to sustain both

extensive welfare provision and economic growth.

But income is only part of the picture in dealing with poverty and wealth, as noted intellectual Martha C. Nussbaum reminds us (see page 21). More can be done to mitigate the impact of wage stagnation and inequality through the provision of public assets and social infrastructure—quality childcare, good schools, libraries, public transport, affordable housing and healthcare—that disarm the sting of being less wealthy. There is cause for optimism, because these are areas that Singapore has traditionally been strong in, as the Federal Reserve Bank of New York's President Timothy Geithner suggests (see page 83). The challenge then is to maintain fair and open access to these and other forms of social spending in the years to come, and to approach these as canny investments rather than as expenditure. It is after all a strong and cohesive Singapore that is better able to ride the rising tide of global growth.

2007 also marks the 10th anniversary of the Asian Financial Crisis, perhaps the first true economic storm of the global era. It is not likely to be the last: the recent US sub-prime loan crisis is a timely reminder that much more needs to be done to fortify financial practices and regulatory systems around the world—nor are such structural vulnerabilities limited to developing countries only. In this issue's special sub-feature, CSC's Donald Low outlines the key factors behind the Crisis (see page 71)—many of them once again chillingly familiar: poor oversight, bad risk management, spill-over effects. In interviews with Adam Schwarz and Geithner, we assess the health of Asian economies in the aftermath of the Crisis, and its implications for governments seeking to inoculate their economies against future hazards. The lessons are stark: in a globalised world, the effects of policies—be they domestic or international in intent, sound or erroneous in judgement—are greatly accelerated and multiplied. The successful policymaker in this era may be one who is most keenly aware of just how narrow his margin for error is, and how far-reaching his decisions may be.

Once again I wish you a constructive read, and welcome you to take advantage of additional web-exclusive resources and articles at http://www.cscollege.gov.sg/ethos.

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NOTE

1. *World Wealth Report 2007* (USA: Merrill Lynch and Capgemini, 2007).

Yeoh Lam Keong

Rethinking a New Social Compact for Singapore

To address globalisation's unprecedented challenges, Singapore may need to rethink—and not just tweak—its social safety net.

At the heart of Singapore's success in governance lies the strength of its social compact. Since independence, the majority of citizens, including those at the bottom of the income pyramid, have enjoyed a steady rise in living standards. This prosperity has earned the Government the credibility and mandate it needs to implement difficult social and economic policies time and again, which in spite of initial hardship, eventually raises the nation's well-being. This virtuous cycle is at the core of Singapore's long-term, policy-driven success.

For decades, strong economic growth and full employment have raised wages and welfare for the majority of Singaporeans. In the 1990s, our per capita income rose towards average developed country levels. Since then, however, a fundamental change has taken place. Median real wages are no longer rising with robust growth. Instead, they have been roughly stagnating since 1998. For the bottom 60% of workers, individual wages have,

in fact, cumulatively declined by 7% to 15% over the last five years through 2006, in spite of 5% to 7% GDP growth and an unemployment rate below 3%. The poorest and least skilled have been the hardest hit. Median monthly starting pay for cleaners and labourers has fallen by nearly a third, from S$860 to S$600, between 1996 and 2006.

While household incomes, especially of the bottom 30%, have rebounded in 2006, this is due to jobs being plentiful enough for more family members working longer hours to bring in more income despite falling wages. Yet the poor have had to run faster just to stand still. The bottom 30% of working families have now experienced stagnating real household incomes for 8 to 10 years. Even the broad middle classes—the 30th to 80th percentile of households—saw a four- to five-year period of stagnating household income between 2001 and 2005.

GLOBALISATION AND WAGE STAGNATION

Such wage and welfare stagnation is new to modern Singapore. Yet they are underpinned by the underlying mega-trends of globalisation, which have taken two major new turns since the 1980s. The first is the "great doubling". For the first time in human history, the globally integrated labour force is in the process of rising from around 1.5 to well over 3 billion, driven by economic liberalisation of the huge populations of China, India, the ex-Soviet Bloc and newly-reformed emerging economies in Latin America and Asia. This cheap, massive and increasingly productive labour force competes for trade, investment and employment on a scale never before seen.

Since the mid-1990s, the "great acceleration" has also been raising developed country productivity growth as IT-driven process innovations spread to service industries and enable offshore outsourcing or "off-shoring" of ever more discrete tasks and occupations. So too, Moore's law relentlessly pushes down the price of exponentially more sophisticated IT capital goods and services relative to unskilled or semi-skilled labour, replacing people with IT systems managed by smaller, highly skilled teams. This reinforces the "great doubling", hollowing out swathes of less skilled, labour-intensive jobs in both manufacturing and services in rich countries, even as it creates large numbers of increasingly skills-intensive occupations globally.

This skills-biased, Schumpeterian job destruction and creation is leaving behind the less educated and skilled in developed economies. Unable to adapt and upgrade their human capital in time, they face increasingly structural long-term unemployment, which results in wage stagnation or decline. With social security budgets shrinking, and unable to afford skills upgrading, they risk becoming

permanently marginalised: a proletarian underclass at the developed core of global capitalism.

By now, many developed economies are beginning to recognise the all-too-common long-term symptoms—median wage stagnation combined with sharply rising income and wealth inequality—despite the strongest global growth and profitability, and lowest unemployment rates in over two decades. The US economy, with one of the most productive, flexible and open labour markets and the world's most innovative companies, shows these trends the most clearly. This has also spawned an insecure middle class increasingly sceptical of globalisation and susceptible to protectionist or populist policies.

THE INCOME GAP IN SINGAPORE

Singapore, with one of the most open economies in the world, is particularly vulnerable to these negative trends. In addition, we have two other dampeners of wage growth: first, one of the highest rates of unskilled and semi-skilled immigration in the world, and second, a legacy population of older, less-educated workers who represent a significant share of the resident workforce.

The implications of these trends for domestic welfare and poverty are clear. Our poorest decile, numbering some 90,000 to 100,000 households, still earn around S$160 per month per capita,[1] the equivalent of around S$640 a month for a family of four. This compares to a measure of average basic expenditure needs of S$1,040 estimated by the Department of Statistics,[2] and a guideline of around S$1,500 used by many public agencies to indicate the need for social assistance. Whether this constitutes "absolute poverty" may be contentious. What is clear, however, is that for many of these families, hardship has been a way of life for over a decade. They may have little left over for the enrichment opportunities that could gradually lift them out of poverty—such as tuition, training courses, computers or IT services—access to which mark the boundaries of true social inclusion.

Singapore, with one of the most open economies in the world, is particularly vulnerable to these negative trends.

With long-term wage stagnation, this wide poverty gap will not easily be whittled away. If wages continue to stagnate, there is a limit to poverty alleviation through working longer and harder, or driving the unemployment rate lower. An underclass of our own may well be emerging.

In the long run, this malign combination of median wage stagnation, low wage decline and rising inequality is potentially poisonous for the social compact underpinning globalisation and the bedrock of our virtuous cycle of strong governance.

> There is a limit to poverty alleviation through working longer and harder.

If the broad median faces medium-to long-term wage stagnation and rising income inequality, the credibility of tough policies—wage discipline, raising the Goods and Service Tax or public sector wages, further deregulation that demand sacrifice or pain in anticipation of future economic betterment—will be undermined and there could be increasing difficulty in garnering acceptance. Many will feel that their basic stake in the common enterprise of prosperity has been eroded. What is left will be the bitter, zero-sum politics of envy and dead-end populism.

A NEW PARADIGM FOR SOCIAL SECURITY

The experiences of other developed economies are only just now yielding a range of possible policy responses to this dilemma. A few broad conclusions, however, can perhaps be drawn.

First, these trends, in spite of cyclical ups and downs, are likely to be a long-term, multi-decade phenomenon. We need to continue to pay serious and immediate heed to long-term remedies, even if cyclical trends lift earnings for a few years.

Second, effective remedies are likely to require an integrated array of concerted and coordinated policy measures by different agencies to provide an adequate social safety net and enable our labour force to deal with these deep-rooted mega-trends. These measures also need to be tailored to Singapore's particular conditions. The challenge is to do this in a way that maximises work incentives, upward mobility and dignity.

Workfare, or a direct subsidy to work (recommended by Nobel laureates Milton Friedman and Edmund S. Phelps), is probably the principal, most micro-economically efficient tool that can be used to redistribute higher, skills-biased growth to workers right at the bottom of the pyramid. Coordinated with targeted work-oriented welfare and sufficient job opportunities, successful US welfare reform over the 1990s has shown us that this approach can result in a significant alleviation of poverty and more effective integration of lower income classes into the labour market.

What remains in Singapore is to appropriately scale up the relevant

magnitudes. Current net workfare payments of around S$80 to S$100 per month are a long way from being able to bridge the poverty gap between bare subsistence and the small surplus needed to invest in human capital at the household level. Yet they remain the fastest way of getting there without compromising work ethic and with relatively low cost.

> A stronger, direct social safety net may enable policy to take advantage of globalisation more quickly and boldly.

Other measures that should be studied for wider implementation include: social risk pooling for unemployment insurance, medical costs, retirement benefits, education risks or reverse mortgages; an expanded and well-integrated continuing education and training system. Perhaps a more discriminating immigration policy—against unskilled labour in non-traded sectors (for example, in the construction industry)—can also be sought even at the expense of maximising short-term output, in order to achieve a better combination of real wage growth and increased productivity.

The political will and policy framework for dealing with wage stagnation may be one of the biggest tests of compassion, pragmatism and policy innovation for Singapore. However, some subtle risks also arise from our traditional policy distrust of large-scale welfare, or direct social spending to address poverty. The latter is perhaps more difficult to deal with, as it has to more do with a policy paradigm that may also need radical change. A stronger, direct social safety net may now need to be seen both by policymakers and public as an institution that enables policy to take advantage of globalisation more quickly and boldly, rather than one that erodes work ethic, drains the budget or hamstrings reform.

With Singapore's per capita income at around US$31,000, it is undesirable that the bottom 10% of Singapore households still struggle to meet basic needs and have little means to invest in their family's betterment. However, this in itself is perhaps only half the story.

It is equally important for any policy paradigm to recognise that most of our advanced country competitors (such as the US, UK and Japan) will also be afflicted by similar trends of median wage stagnation and rising income inequality in the face of globalisation, with government budgets that are already badly overstretched. Singapore is one of the few countries with the fiscal reserves to afford the development of a wide, multi-

faceted, financially sustainable social safety net. In addition, our freedom from a debilitating legacy welfare system means we can design one largely from scratch, potentially making it structurally compatible with both work incentives and maximising human capital investment. This can not only redistribute the fruits of stronger growth more equitably and securely, but also provide an inherent, long-term source of competitive advantage that enables us to embrace globalisation more quickly and firmly than our competitors.

These then are the main challenges to rethinking Singapore's social compact. Faith in the old social compact, forged over 40 years of success, will not easily be worn away, but the new globalisation mega-trends will continue to erode it. Can we, as policymakers, be bold and creative enough to re-imagine and re-make a sounder new foundation for its renewal in coming decades?

Yeoh Lam Keong is Director, Economics and Strategy in the Government of Singapore Investment Corporation (GIC) Pte Ltd.

NOTES

1. Based on average monthly income from work per household member among non-retiree households by decile. Singapore Department of Statistics, *Key Household Income Trends, 2006* (Singapore: Ministry of Trade & Industry, 2007). www.singstat.gov.sg/pubn/papers/people/op-s12.pdf

2. For the Department of Statistics' estimate of S$1,040 minimum household expenditure required for a four-person family, see description of methodology in Yap, Mui Teng, "Poverty Monitoring and Alleviation in Singapore," in *Poverty Monitoring and Alleviation in East Asia*, K L Tang and C K Wong, eds (New York: Nova Science, 2003): 77-78.

Kenneth Chan

Growth with Equity: The Challenge of Income Distribution

"...the issue is not how much inequality there is, but how much opportunity there is for the individual to get out of the bottom classes and into the top."
– Milton Friedman

The rapid pace of globalisation, technology advances and economic restructuring over the last decade or so appear to have contributed to increasing income inequality and low wage stagnation and even decline in developed economies. In small and open economies such as Singapore's, this phenomenon may be felt even more keenly, weakening of the social consensus that has existed so far in favour of free markets and competition. What should the Government do to address this challenge?

The uneven nature of income distribution in human society has existed for centuries. Income distribution was one of the earliest and most well-known

examples of non-normal distributions that followed a power law. This statistical description was first recorded by 1896 by Vilfredo Pareto, the Italian economist who observed that 80% of all wealth resided with only 20% of the population—a phenomenon that eventually came to be known as the Pareto distribution—one of many kinds of power law distributions. In the 1980s, this also developed into an equally famous management dictum known as the Pareto principle, or 80–20 rule.

Yet although income inequality is not a new phenomenon in history, the urge for societies to seek a more equitable distribution has been hard to resist. For example, we communicate income data through statistics such as per capita Gross Domestic Product (GDP), or average and median household income to suggest that economic growth has raised incomes across-the-board. Indeed, the success of Singapore since independence has essentially been a story of "growth with equity", a story of how it managed to achieve economic growth while ensuring that the fruits of that growth are distributed to large segments of the population.

THE SITUATION FOR SINGAPORE

According to the Department of Statistics, the Gini Coefficient has been creeping up over the years (indicating more unequal income distribution), even when adjusted for retiree households, from 0.442 in 2000 to 0.472 in 2006.[1] Gross monthly income for the lowest 20% has also experienced much slower growth since 1997. There has also been negative growth in the household incomes of the lowest decile since 1997. From around 2000 onwards, increase in incomes for the 50th percentile and below also slowed substantially in nominal terms. Factoring in inflation, real income growth was negative for the bottom two deciles. Given the various exogenous shocks to the economy during this relatively recent period, the jury is still out as to whether this stagnation in the incomes of the middle is a long-term, and not just a cyclical, trend. However, these trends do indicate a widening income disparity and income stagnation, particularly in the middle-income segments since 2001. This is a trend felt by developed countries across the world, which are experiencing an accentuation of income inequality. The US recently reported that although productivity growth had increased substantially between 2000 and 2005, increases in the median wage have not kept pace.[2] Globalisation, and the structural changes it has wrought on economies, has been commonly identified as the main culprit. In essence, workers are working harder and smarter, but ending up with smaller shares of the growing economic pie.

WHAT IS TO BE DONE?

There are two main instruments that the Government could consider to address the issues of widening income disparities and low and median wage stagnation: redistributive measures and human capital development measures.

Redistributive Measures

Redistributive policies aim to transfer part of income gains enjoyed by higher-income earners and the owners of capital to the lower-income segments of the population hurt by global trade. However, if the wages of half the population are stagnant, simply enhancing existing redistributive measures may not be sufficient. Here, the Nordic model offers some insights on how taxation and social spending systems can be both pro-growth and socially equitable.

> Workers are working harder and smarter, but ending up with smaller shares of the growing economic pie.

The tax systems in the Nordic countries are far less redistributive and progressive than one would expect: capital is taxed lightly (compared with other industrialised countries), while consumption and labour bear the bulk of the tax burden. This conforms to economic theory: taxes that lean on consumption (which is less elastic) are less economically distorting that those which lean on capital, which is more mobile and hence more elastic in supply.

While the high labour taxes in the Nordic countries might discourage employment, one must also look at the other side of the tax-and-spend ledger. Nordic countries such as Sweden and Denmark spend up to a third of GDP on social transfers, not only in areas such as pensions and unemployment compensation, but also in areas that might yield high returns, such as child care subsidies. The social protection that the Nordic states provide to large segments of their populations also helps to build public acceptance for a not-so-equitable tax system.[3]

The Singapore Government has also tried to redistribute in a pro-growth way. The Workfare Bonus Scheme, introduced as a one-time transfer in 2006, targeted the lowest 20% of income earners. Recipients had to have worked for at least six months to be eligible for the bonus. This helped to encourage a work-for-reward ethic rather than one seeking handouts. However, a one-time transfer does not alter the income distribution and keep the lower segment of incomes up on a permanent basis, and the scheme was expanded in 2007 to become a

permanent support programme known as the Workfare Income Supplement, which operates very much like the Earned Income Tax Credit in the US or the Working Tax Credit in the UK.

The overriding consideration for the Singapore Government in implementing any new redistributive measure is to ensure that it does not undermine economic growth, erode the work ethic, or distort incentives. In this regard, the Government could consider measures to moderate the effects of job volatility through some form of unemployment insurance. As more segments of the working population become vulnerable to downward income volatility for extended periods, a basic unemployment insurance scheme might be a more efficient way of providing them some form of income security. Unemployment insurance helps workers pool their risks to fund key necessary expenditures when faced with a sudden loss of income. A publicly administered unemployment insurance system, integrated with assistance in job placement, re-training and targeted welfare, could also help the recovery of household incomes after recessions. If so, social insurance against the risk of unemployment could be an important component of Singapore's social safety net in the future.

Unemployment insurance helps workers pool their risks to fund key necessary expenditures when faced with a sudden loss of income.

Human Capital Development

If the Government wishes to avoid large social transfers of the Nordic variety, its main alternative would be to invest substantially more in human capital development. This can be done in a variety of ways.

One would be to provide subsidies to the lower-income households for expenditures beyond mere subsistence, so as to allow for human capital formation. Currently, low income households spend about 60% of their income on food, housing and utility bills, leaving them with little for investments in education and education-related areas. Some studies in the US have shown that children from lower income families develop persistent skills gap as early as the age of three compared to those from higher-income families, should they go without effective pre-school programmes.[4] Perhaps a suitable starting point to address poverty issues in a sustainable way would be to provide for assistance in the form of enhanced subsidies in early childhood education.

Simultaneously, the Government could expand existing retraining and re-skilling programmes to help workers transit from declining sectors of the economy to the new, faster-growing ones. This could be an important instrument to address the possible stagnation of median wages.

CONCLUSION

In any debate over helping the low-income, we are caught in a triangle of competing social goals: helping the affected income groups, maintaining incentives for them to work and strive for themselves, and keeping the programme budget affordable. Any movement within this triangle must move away from at least one goal. Yet societies care not just about the size of the economy, but also social peace and cohesion. Finding the right blend of pro-growth policies and redistributive measures will be critical for sustaining the Singapore story of growth with equity.

Kenneth Chan is Manager in the Strategy Unit, Strategic Policy Office of the Prime Minister's Office. He first started researching socio-economic issues during the 2005 National Scenarios project, which included developments in the income distribution, the impact of new media on a participative citizenry and the evolution of the Singapore identity with increased immigration. He is also interested in how companies selling to "bottom-of-pyramid" markets will impact ASEAN in the future.

NOTES

1. Department of Statistics, *Key Household Income Trends* (Singapore: Ministry of Trade and Industry, 2006).
2. The Economist noted that since 2000, real wages for the median US worker rose only about 1.5% even after accounting for health and pension benefits, even though productivity grew by as much as 15%.
3. Lindert, Peter H., *Growing Public: Social Spending and Economic Growth since the Eighteenth Century* (UK: Cambridge University Press, 2004).
4. Barnett, W. Steven and Belfield, Clive R., "Early Childhood Development and Social Mobility," (National Institute for Early Education Research, NIEER Policy Report, October 2006), http://nieer.org/docs/?DocID=152.

Opinion

Wong Chack-kie

Globalisation and the Challenges of Social Policy in Asia's Developed Open Economies

Globalisation is transforming developed open economies such as Singapore and Hong Kong in East Asia; their growth rates have declined and unemployment has increased as their economies have become more mature. At a time when public welfare appears to be losing its growth engine for raising additional resources, traditional family-based welfare is being threatened by socio-demographic changes and shifts in values between generations. Furthermore, while globalisation tends to reinforce the market orientation and anti-welfarist stance of the social-economic establishment, the outcomes of a global economy are often unwelcoming to the vulnerable classes who may find themselves relatively worse off at the end of the trickle-down process.

For instance, in Hong Kong, the pre-tax and pre-social transfer Gini ratio in 2006 rose to a new high of 0.533.[1] In Hong Kong's case, it is not uncommon for market incomes of the lowest class to be lower than the benefit payments of social assistance recipients. However, this is not so much to do with a welfare dependency culture, but with the fact that those at the lower end of the labour market are in a weaker position to compete for a decent wage.

For economically mature, affluent societies such as Singapore and Hong Kong, there are two challenging policy issues. First is the dilemma of assisting the working poor while avoiding the criticism of engendering welfare dependency. The second is the need to expand upward mobility for the poor and lower class, especially for succeeding generations.

One approach is to link social assistance to employment. Considering that the eligibility criteria for public welfare in East Asian societies are already stringent, the challenge is to ensure that it does not impose unnecessary hardship or invite hostility towards the system.

Active labour market policies (for

example, training, retraining, and re-employment support) and universal education are the usual policy tools to meet the second challenge of promoting income mobility; however, the effectiveness of this approach needs to be assessed in the wider economic context of global downward pressure on market wages, particularly at the lower end of the scale.

There is also a need to take a critical look at whether the existing arrangements in social security and education may in fact put the poor and lower classes in disadvantageous positions. Is the social security system for the unemployed flexible enough to allow easy entry, exit, and re-entry due to an increasingly open economy? In education, are there equal opportunities for children of different socio-economic backgrounds? For instance, Hong Kong has adopted the principle of local admission to primary and secondary schools, but the fact is that the best schools are often located in middle-class neighbourhoods.

AN ASSET-BASED APPROACH

There are, however, other noteworthy policy initiatives that have originated in East Asia and are particularly relevant to the present global context. Singapore has good asset-based policies associated with the Central Provident Fund. The term "asset" can mean financial wealth, tangible property, human capital, social capital, political participation, and influence. Here, I focus on financial and tangible assets in social policy. Property is a personal or family asset; one can fall back on it before seeking state assistance. The different personal savings accounts in Singapore under the Central Provident Fund are also helpful in times of financial uncertainties arising from life events and needs such as medical care. In contrast, asset-based policy tools are a new idea in the West. The Child Trust Fund for newborn babies in the UK under the Tony Blair administration is an example of such an initiative. While income-based policies are more about consumption as well-being, asset-based tools are about building one's capabilities; it is hence investment-oriented. Social and economic development are thus built into these policy instruments.

Asset-based policies provide dormant but somewhat ready-to-use resources, and can allow greater freedom of choice in life on the part of the holders. These policy approaches are particularly relevant to financial sector-dominated global economies like Singapore and Hong Kong. A financial economy is essentially about how to manage assets (particularly financial assets) well to avoid risks. Needless to say, in a financial economy where base resources, family capacity, and social relations are determinant factors for success, the playing field between the poor and the asset-rich is

anything but level. In the new economic context, where the virtues of an industrial economy—hard work and self-reliance—are no longer the most valued factors of success, there is a need for government to rethink its social role.

Asset-based policies provide dormant but somewhat ready-to-use resources, and can allow greater freedom of choice in life on the part of the holders.

The interesting thing about asset-based policies in an East Asian society like Singapore is this irony: if assets are simply to be redistributed, it becomes simply another form of welfarism. Of course, the mandatory savings and matching principle such as in Singapore may help to overcome this ideological hurdle, but in general, it is in the long-term interest of a government to narrow not only the income gap but also the asset gap in a globalised economy to a level that is in line with core social values. Nevertheless, it seems worthwhile to critically examine the effects of asset-based policies in comparison with traditional income-based policies in terms of alleviating poverty, reducing social inequalities, and enhancing social harmony.

Professor Chack–Kie Wong teaches in the Social Work Department of the Chinese University of Hong Kong. His research interests include public opinion of welfare, comparative social policy, poverty and social security, and welfare reforms in China.

NOTE

1. Census and Statistics Department, 2006 Population By-census, Thematic Report: Household Income Distribution in Hong Kong (Hong Kong : The Government of the Hong Kong Special Administrative Region, 2007). Available at: http://www.bycensus2006.gov.hk/FileManager/EN/Content_962/06bc_hhinc.pdf

Interview with Martha C. Nussbaum

Poverty, Capabilities and Social Justice

The renowned social philosopher discusses her concept of essential human capabilities, and their implications for dealing with poverty and social development.

You have developed the concept of a set of essential human capabilities: how might this approach help us to gain fresh insight into the problem of poverty?

My work is concerned with describing a minimum threshold conception of justice, in terms of a set of fundamental entitlements without which no society can lay claim to basic justice. I formulate this list of entitlements in terms of a set of "capabilities," or opportunities for functioning, in 10 central areas.

What I mean by essential capabilities is the combination of internal formation with external possibility. Thus, for the capability involved in the freedom of speech, we need an adequate system of education (internal formation) and then suitable political conditions favourable to actual free speech, the latter being supplied by protective laws.

Some of these capabilities, like the entitlement to freedom of religion, are not usually understood to be related to poverty; some, such as the entitlement to healthcare and housing, are closely related to poverty as traditionally conceived.

What is important to me, however, is that each of these is a separate item: they are not commensurable with one another. Many accounts of poverty ignore the plurality of value and convey the illusion that if people have enough of one thing (for example, wealth and income), they are then all right. Of course, this may not be the case.

All of these capabilities have a material foundation: thus someone too poor to go to school will not have the freedom of speech in a full way. But the traditional account of poverty is too unilinear and too narrow. The theory that a rising tide lifts all boats is simply not empirically true. Dreze and Sen,[1] in their field studies of the different Indian states, have shown that the pursuit of economic growth does not translate into improvements in healthcare and education.

The Central Human Capabilities

1. **Life.** Being able to live to the end of a human life of normal length; not dying prematurely, or before one's life is so reduced as to be not worth living.

2. **Bodily Health.** Being able to have good health, including reproductive health; to be adequately nourished; to have adequate shelter.

3. **Bodily Integrity.** Being able to move freely from place to place; to be secure against violent assault, including sexual assault and domestic violence; having opportunities for sexual satisfaction and for choice in matters of reproduction.

4. **Senses, Imagination and Thought.** Being able to use the senses, to imagine, think, and reason—and to do these things in a "truly human" way, a way informed and cultivated by an adequate education including, but by no means limited to, literacy and basic mathematical and scientific training. Being able to use imagination and thought in connection with experiencing and producing works and events of one's own choice, religious, literary, musical, and so forth. Being able to use one's mind in ways protected by guarantees of freedom of expression with respect to both political and artistic speech, and freedom of religious exercise. Being able to have pleasurable experiences and to avoid non-beneficial pain.

5. **Emotions.** Being able to have attachments to things and people outside ourselves; to love those who love and care for us, to grieve at their absence; in general, to love, to grieve, to experience longing, gratitude, and justified anger. Not having one's emotional development blighted by fear and anxiety. (Supporting this capability means supporting forms of human association that can be shown to be crucial in their development.)

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6. **Practical Reason.** Being able to form a conception of the good and to engage in critical reflection about the planning of one's life. (This entails protection for the liberty of conscience and religious observance.)

7. **Affiliation.**
   A. Being able to live with others, to recognise and show concern for other human beings, to engage in various forms of social interaction; to be able to imagine the situation of another. (Protecting this capability means protecting institutions that constitute and nourish such forms of affiliation, and also protecting the freedom of assembly and political speech.)

   B. Having the social bases of self-respect and non-humiliation; being able to be treated as a dignified being whose worth is equal to that of others. This entails provisions of non-discrimination on the basis of race, sex, sexual orientation, ethnicity, caste, religion, or national origin.

8. **Other Species.** Being able to live with concern for and in relation to animals, plants, and the world of nature.

9. **Play.** Being able to laugh, to play, and to enjoy recreational activities.

10. **Control Over One's Environment.**
    A. Political. Being able to participate effectively in political choices that govern one's life; having the right of political participation, protections of free speech and association.

    B. Material. Being able to hold property (both land and movable goods), and having property rights on an equal basis with others; having the right to seek employment on an equal basis with others; having the freedom from unwarranted search and seizure. In work, being able to work as a human being, exercising practical reason and entering into meaningful relationships of mutual recognition with other workers.

– Martha C. Nussbaum

The whole point of the capabilities approach was to conceive of the whole topic of human empowerment in radically different terms. People might be reasonably well off in terms of wealth and income, but deeply lacking in other areas fundamental to a dignified human life, such as political rights and liberties. And it is also true that two people might have equal amounts of wealth and income but be very differently placed in their ability to function in society because of entrenched social prejudice and inequality.

What are the implications of these capabilities on social mobility?

There are many different implications. One cannot rise in society if one has no healthcare, and education is of the very most central importance to social mobility. Women all over the world lack employment opportunities and political voice because of their differential access to healthcare and education. Political participation is also, of course, very central to changing one's living conditions, as the success of the panchayat system in rural India has shown: the rural poor now have a powerful political voice, and it is clear that it was they who determined the 2004 election. Another capability that is very important to social mobility is the freedom of speech: people who are not allowed to express themselves freely have no opportunity to challenge the society in which they live and to try to secure one that reflects their aspirations better. As for bodily integrity, it is extremely difficult to aspire and to move up in society if one is being beaten up at night at home.

To what extent are governments responsible for—and capable of—ensuring that all their citizens can exercise the essential capabilities, in order to ensure their own development?

In my conception, government is responsible for minimal social justice, and that is a very traditional conception of government. The capabilities on my list are only the ones that, I would argue, form part of a minimal conception of a decently just society.[2] There are, of course, many other capabilities that are of interest to people in their lives, but these will be determined by their own comprehensive conceptions of value, religious or secular.

That is where the role of government leaves off: if my religious conception tells me to pursue virtue in a certain way, government should not be assisting me, beyond giving me the basic wherewithal of a decent human life that it also gives to all others; it is not the business of government to pursue Christian virtue, atheist virtue, or Buddhist virtue. That is for the citizens themselves to do, once they have basic education, healthcare, employment opportunities, freedom of speech and religion, and so forth.

Governments should respect all citizens as equals, and that includes citizens with mental and physical disabilities, who are often not treated as equals. For instance, if a claim is made that we cannot afford to educate children with disabilities, then we can reply, as a US court did, that the inefficiencies of the school system (which had spent its money unwisely) cannot be permitted to bear more heavily on one group of children than on another.

Of course, many other things affect people's ability to exercise their capabilities, for example, their treatment within the family. That is one reason why John Rawls and I have both argued that the family is actually a political entity. Government does not directly structure the family, but it can do a great deal to render that structure more just: for example, by enforcing laws against domestic violence and child abuse, by ensuring all children have decent nutrition and a decent education, and by teaching about the equal worth of all citizens, in public schools. In India, there are many creative strategies that have empowered women, who often get unfair treatment in the family: one that has worked well is giving women one-third representation in the panchayats. This has led to much more emphasis on the education of girls, and in general to a stronger bargaining position for women in the family.

It is also important that government can delegate part of its role to nongovernmental bodies, such as the market or the family: but if citizens do not achieve the capabilities in that way, we ought to hold the government accountable and seek a better one. If one has the capabilities as one's goals, one can then experiment with different economic and social structures and see to what extent they deliver the desired results.

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NOTES

1. Dreze, Jean and Sen, Amartya, *India: Development and Participation*, 2nd ed. (USA: Oxford University Press, 2002).
2. For a discussion of how minimum thresholds and implementation priorities might be set in accordance to a nation's resources and economic conditions, see Nussbaum, Martha, "The Costs of Tragedy: Some Moral Limits of *Cost-Benefit Analysis*," in Cost-Benefit Analysis, ed. Adler, M. D. and Posner, E. (Chicago: University of Chicago Press, 2001).

Koh Tsin Yen

The Nordic Social Security Model: Squaring the Circle?

The Nordic states appear to have achieved an enviable balance between strong economic growth and generous welfare provisions, but they too face new pressures from globalisation.

The challenge facing many developed countries today is how to strike a balance between preserving economic growth, and enhancing social welfare to mitigate the ills of economic growth. Countries face pressure on the one hand to keep tax rates low and regulation light to stay competitive; on the other, to raise taxes in order to fund redistributive policies that reduce income inequality and strengthen social security.

There has been some attention of late on the Nordic states (Sweden, Denmark, Finland and Norway), who appear to have found a virtuous compromise between staying competitive and ensuring social security for their citizens. In December

2006, an inter-ministry team from Singapore made a study trip to Denmark and Sweden to study their social security system. This article highlights some of our findings.

MAKING IT WORK

The Nordic social security system is based on the belief that the state should strive to ensure equality of outcomes and social security. Redistribution, through taxes and transfers, is an explicit goal of Nordic social policy. Benefits are universal, and means-testing, to the extent that it is applied, determines only the amount of benefit a person shall receive, not whether he should receive any benefit at all. There are clear, publicly known rules governing how much social security benefits someone may receive and for how long.

> The Danish "flexicurity" system claims to combine labour market *flexibility* with employment *security*.

One of the key innovations of the Nordic model is the reconciliation of an efficient labour market with a comprehensive social security system. The Danish "flexicurity" system, for example, claims to combine labour market *flexibility* with employment *security*. (Although the term was coined by the Danish, the system is employed to varying degrees in all the Nordic states.) "Flexicurity" consists of three components:

(a) a flexible labour market;
(b) generous unemployment insurance (UI) benefits; and
(a) active labour market policies/ programmes (ALMPs).

All three are necessary to balance one another. A flexible labour market, for example in terms of hiring and firing workers, lowers the cost of labour for employers and enhances economic competitiveness. The uncertainty and volatility it creates for workers is mitigated by generous UI benefits, which are partly funded by worker contributions and mostly by the state.

Work-based Criteria

To reduce the disincentive to work created by the UI scheme, unemployed workers have to register at the state public employment offices and undertake to accept the first suitable job offered in order to receive their UI benefits. To help unemployed workers return to the workforce as quickly as possible, they can take part in ALMPs, which fall into four broad categories: adult training (encompassing both formal and informal training, work-related education and personal development programmes), job search services (such as job matching and

WHAT IS THE NORDIC MODEL?

Koh Tsin Yen

The "Nordic model" can be broadly characterised as a high-tax, high-expenditure social democratic welfare state — except with the labour market flexibility and economic competitiveness of a liberal welfare state.

Table 1 provides a simplified characterisation of different European social models.

TABLE 1. CHARACTERISATION OF SOCIAL MODELS[1]

	Nordic	Continental (France and Germany)	Anglo-Saxon (Ireland and UK)
Attitude to markets	Liberal	Interventionist	Liberal
Attitude to social welfare	High emphasis	High emphasis	Low emphasis

The Nordic states appear to have done well both on measures of competitiveness and social outcomes (Table 2).

TABLE 2. COMPARISON OF ECONOMIC AND SOCIAL OUTCOMES[2]

	European Models			US	Singapore
	Nordic	Continental	Anglo-Saxon		
Growth Competitiveness Index	5.66	4.94	4.99	5.81	5.48
Unemployment rate (%)	6.0	21.1	5.8	6.0	4.0
Gini coefficient	25.6	30.5	35.1	40.8	42.5
Human Developement Index	0.952	0.937	0.948	0.948	0.916
Social expenditure as % of GDP	26.7	27.9	17.8	14.8	6.8
Tax revenue as % of GDP	46.8	39.5	32.7	25.6	13.3

Note: The continental countries are France and Germany, and the Anglo-Saxon countries are the UK, Ireland, Canada and Australia.

As indicated in Table 2, the high emphasis on social welfare is paid for by some of the highest tax rates in the world (Table 3).

TABLE 3. TAX RATES AND COLLECTIONS IN SWEDEN, DENMARK AND SINGAPORE (2005)[3]

	Sweden		Denmark		Singapore	
	Top tax rate	% of total tax revenue	Top tax rate	% of total tax revenue	Top tax rate[4]	% of total tax revenue
Tax on labour income[5] (%)	50–55	62	43–63	56	20	17
Corporate tax (%)	28	7	28[6]	7	18	33
Consumption tax (%)	25 [tiered system][7]	18	Flat 25	21	7	15
Payroll taxes/ Social security contributions (%)	32.7 (employer) 7 (employee)		0 (employer)[8] 8 (employee)		13 (employer) 20 (employee)	
Tax wedge on labour[9] (%)	48.8		49.2		30.6	

Tax revenues have averaged at about 50% of GDP over the past five years. Although taxes on labour income are arguably high enough to be on the wrong side of the Laffer curve,[10] this is as efficient a tax mix as can be expected given their revenue needs, with higher taxes on labour income and consumption, and regionally comparable taxes on corporate and capital income.

Table 4 outlines the benefits enjoyed in the Nordic states, relative to comparable social measures in Singapore.

TABLE 4. COMPARISON OF BENEFITS IN SWEDEN, DENMARK AND SINGAPORE

	Sweden	Denmark	Singapore
Retirement	• Income-related pension is funded from social security contributions (16% of pensionable earnings) on a defined-benefit basis; any deficit in contributions is made up from tax revenue. • Premium pension: funded by contributions (2.5% of earnings). • Guaranteed pension for people with little or no income, which is financed by tax revenue. (85– 90% of participants in the public pension scheme are also covered by occupational pensions.)	• Basic old-age pension of about 50% of the average worker's wage. Means-tested, indexed to wages. Funded by the state. Comprises about 50% of total pension. • Small supplementary pension. Means-tested. Funded from social security contributions. Comprises about 2.5% of total pension. (90% of full-time employees also covered by occupational pensions.)	• CPF: funded by contributions (individual and employer) and ad hoc government top-ups.

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TABLE 4. COMPARISON OF BENEFITS IN SWEDEN, DENMARK AND SINGAPORE (continued)

	Sweden	Denmark	Singapore
Unemployment	• Unemployment insurance: funded partly by individual contributions and mostly by tax revenue. Covers 80% of earnings, subject to a cap.	• Unemployment insurance: funded partly by individual contributions and mostly by tax revenues. Covers 90% of earnings, subject to a cap.	• Temporary assistance for unemployed workers, through programmes like Work Support. Needs-tested and given on a household basis.
Childcare	• Subsidised public childcare; parents pay 0–25% group of operating costs, depending on family income. They may pay for private care.	• Subsidised public childcare.	• No public childcare, but there is the Baby Bonus and Children Development Account scheme for the second to fourth child, and a childcare subsidy for working mothers.

Note: Social assistance for the low-income group is seen as outside the social security framework. Both Sweden and Denmark provide additional assistance to those who are unable to make ends meet after exhausting other social security provisions.

NOTES

1. Schubert, Carlos Buhigas, and Martens, Hans, "The Nordic Model: A Recipe for European Success?" (European Policy Centre (EPC) Working Paper No. 20, September 2005).

2. Sources: Growth Competitiveness Report 2005, OECD Factbook 2006, UN Human Development Report 2005, and the CIA World Factbook 2006.

3. Sources: Swedish Ministry of Finance, Danish Ministry of Finance, Singapore Ministry of Finance (Budget Highlights 2005), and OECD Tax Database.

4. The top tax rate on labour income was lowered to 20% in YA2007 from 21% in 2005. The headline corporate tax rate lowered to 18% with effect from YA2008; and the GST rate increased to 7% with effect from 1 July 2007.

5. Tax on labour income includes payroll taxes for Sweden and Denmark. For Singapore, CPF contributions are excluded as they are not considered as part of government tax revenue.

6. In January this year, the Danish government lowered the top CIT rate from 28% to 22%.

7. There are reduced VAT rates for Sweden: 12% for food and hotel charges; 6% for personal transportation, publications, entrance fees to commercial sports activities and cultural events; and exemptions for healthcare and other services.

8. But an annual lump sum charge applies.

9. Figures for Denmark and Sweden are from the OECD Tax Database. The figure for Singapore is based on an average wage of S$3,444 (Labour Force Survey 2005), and the employer CPF contribution rate of 20%, employee contribution rate of 13%, $1,000 annual earned income relief and the personal income tax schedule for YA2006.

10. From the paper "Tax, Work and Equality – a Study of the Danish Tax and Welfare System," Rockwool Foundation Research Unit, 2006.

counselling) and sanctions on UI benefits if the work conditions are not complied with, incentive programmes for private sector employers (e.g., wage subsidies), and direct employment programmes in the public sector.

Consequently, employment churn is high: in Denmark, for instance, worker turnover is estimated to be about 30% in any given year, and it is considered normal to have five or six jobs over one's career with unemployment spells lasting about three to five weeks. About 60% of registered unemployed people find jobs after two months;[1] 22.6% of the total unemployed are considered long-term unemployed (generally more than one year of unemployment).[2] At the same time, at least 80% of workers are members in a UI fund (85% to 90% in Sweden), even though membership is voluntary, which is remarkable in a scheme that in theory should be too susceptible to adverse selection to be viable without mandatory participation.[3]

Partnership with Unions

The "flexicurity" system would not be possible without the cooperation of the "social partners", namely the trade unions and employers' organisations. However, unions are a double-edged sword: they both enable and lock in the present labour market policy. Having the unions on their side, for example, makes it difficult for the government to scale back on UI benefits, as the new Swedish government was trying to do. The union-negotiated wage forms the de facto minimum wage, as it applies to all workers in the industry, union member or not, citizen or foreigner.

The relationship between the government and the unions may be changing: Although unionisation rates are still very high, union membership is falling, in part because the young are less interested in the unions, especially when faced with a strong labour market, and in part because of the growing trend in part-time and informal work. At the time of our visit, the new Swedish government was considering making UI fund membership compulsory, to sever the historical link between UI fund and union membership, which would weaken the unions.[4]

The Cost of Welfare

The Nordic competitive strategy is familiar to Singapore, with its focus on rising above labour costs and moving up the value chain into more productive and knowledge-intensive industries. Strong economic fundamentals in the Nordic states present a stable and attractive environment for business. Sweden and Denmark, for example, have enjoyed budget surpluses of about 2.3% GDP over the past five years. Domestic inflationary pressures have also been kept in check,

averaging at about 1% to 2%. Strong international competition has also spilled over to industries competing in the domestic market and restrained cost inflation through higher productivity growth and lower wage growth. For both countries, low inflation reflects high productivity growth.

There is substantial emphasis on the development of human and knowledge capital. The Danes and Swedes, for example, are one of the best-educated populations in the world, with 35% of Danes and 42% of Swedes attaining tertiary education.[5] In addition to the formal education system, there are also long-standing traditions of life-long learning for adults.[6] The Nordic states also spend about 2% to 3% of GDP on research and development, but spending is not limited to government—60% of R&D expenditure in Denmark, Sweden and Finland comes from industry.

These strategies have enhanced Nordic competitiveness and contributed to the viability of the Nordic states so far. However, the welfare state still exacts its price. For example, one of Denmark's research institutes, the Rockwool Foundation Research Unit, recommended eliminating the highest tax bracket as a way to increase tax revenue for Denmark, in view of the strong disincentives for the top earners to work more.[7] Denmark and Sweden have both sought to strengthen incentives to work by introducing an Earned Income Tax Credit (EITC) scheme in 2004 and 2006 respectively, to make work more attractive, and to distinguish (in a philosophical departure) earned income from transfer income.[8]

> One future test for the Nordic model will be whether it is able to sustain an ageing population and the growing number of immigrants.

Changing Demographics and Social Norms

One future test for the Nordic model will be a demographic one—whether the state is able to sustain its ageing population and growing number of immigrants. Preliminary estimates by the Swedish government suggest that they will be able to sustain their social security system in the face of an ageing population, as long as they do not need to raise the level or quality of existing services. They will do so in part by maintaining a budget surplus of 2% GDP over the business cycle until 2015, which can be used to reduce public debt roughly to the 2005 debt level.

In response to this trend, the key strategy of the new Swedish government is to strengthen the labour market:

increase the demand for labour by reducing payroll taxes for older and younger workers, and increase the supply of labour by maintaining a high level of employment. Denmark, on the other hand, is projected to be in the red from 2016 onwards, with a total public deficit of about 8% by 2029. Nonetheless, the Danes are optimistic that the new Welfare Agreement cemented between all the major parties in 2006 will enhance the fiscal sustainability of their model, primarily by raising the retirement age for voluntary early retirement pensions and public old-age pensions from 2019, and by indexing the retirement age thresholds to the life expectancy of 60-year-olds, which is about 19.5 years, so that the government can reduce its outlay on old-age pensions and stabilise outlay even as life expectancies increase.

The other demographic challenge is immigration. This is in part an economic dilemma, because the Nordic countries take in a good number of political immigrants, who tend to have lower employment rates than locals. It is also a social challenge—the Nordic social security system is a pay-as-you-go scheme, and by definition depends on the willingness of each new generation to pay for the last one. An influx of immigrants who do not share the same social philosophy or work ethic (so far away from Max Weber) strains the intergenerational social compact that the Nordic model is built on.

The worry is not only with immigrants; some feel that the young seem to be more materialistic than in the past and less willing to pay top tax rates in exchange for social security.[9] Critics of the Nordic model point out that in some aspects, it is too good to be true: the official unemployment figures, for example, hide high public sector employment (about 30% of the total work force), participation in labour market programmes, including wage-subsidised jobs, and withdrawals from the workforce due to sick leave or early retirement. A McKinsey article in June 2006 estimated that the actual unemployment rate in Sweden was 17% (11% more than the official rate). This 17% included people on labour market programmes, latent job candidates, the under-employed and those excluded from the workforce but able to work (for example, on early retirement or sick leave beyond Sweden's normal historic levels from the 1970s).[10]

A QUESTION OF VALUES

It is tempting to talk about social security systems in abstraction, but a social security system depends, first and foremost, on the social values of the people who depend on it and who pay for it with their tax dollars. The Nordic model is an interesting way of incorporating work into the heart of a welfare system—if a welfare system is what is needed.

Citizens encountered in the course of the study trip seemed to be genuinely proud of their social security system; although aware of its faults, they seemed to feel that the social values embedded into the system were worth preserving, even at the cost of high taxes.

In terms of policy directions or programmes, it would difficult to import most features of the Nordic model into the Singapore system as it is premised on an entirely different social philosophy, and each component of the social security system is integrated with and dependent on the others. The question, at the end of the day, could simply be: what do we believe in? It starts there.

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NOTES

1. Meeting with the National Directorate of Labour, Denmark (5 December 2006).

2. *OECD Factbook 2006* (Paris: Organisation for Economic Co-operation and Development, 2006).

3. The replacement rate and duration of UI benefits in both Denmark and Sweden are among the highest in Europe. In Denmark, an unemployed person can receive UI benefits for up to four years, at a maximum replacement rate of 90%, subject to a cap. The average replacement rate is 69%. In Sweden, an unemployed person can receive UI benefits for 300 days, at a maximum replacement rate of 80%, subject to a cap. The average replacement rate is 63%. (Source: *OECD Employment Outlook - 2006 Edition*: Boosting Jobs and Incomes (Paris: Organisation for Economic Co-operation and Development, 2006). Membership fees are low; in Sweden, government funds covered about 90% of UI payouts, and membership fees only 10%. In Denmark, membership fees covered 50% of payouts in 2005, but only 25% a few years ago, when unemployment rates were higher. (Source: meetings with the Unemployment Insurance Board in Sweden, 27 November 2006, and the National Directorate of Labour in Denmark, 2 December 2006).

4. Meeting with Dr Lotti Ryberg-Welander, Stockholm University, Department of Social Work, 1 December 2006.

5. The Global Competitiveness Index 2006 ranked Denmark second in higher education and training, followed by Sweden in 3rd place. Finland took first place.

6. Expenditure on adult training programmes forms about 0.5% of Denmark's GDP, and 0.3% for Sweden (Nordic Social-Statistical Committee (NOSOSCO), 2006, Social Protection in the Nordic Countries 2004: Scope, Expenditure and Financing, pg.227.).

7. From the paper "Tax, Work and Equality – a Study of the Danish Tax and Welfare System," Rockwool Foundation Research Unit.

8. Meeting with the Swedish Ministry of Finance, 30 November 2006.

9. Meeting with Dr Lotti Ryberg-Welander, Stockholm University, Department of Social Work, 1 December 2006.

10. "Sweden's Growth Paradox," The McKinsey Quarterly, June 2006. Public sector employment figures from Hans Werner Sinn, "Scandinavia's Accounting Trick," Project Syndicate 2006.

Lim Xiuhui

Security with Self-Reliance: The Argument for the Singapore Model

Singapore's system of social security is based on enabling self-reliance, supported by strong family and social networks.

While the concept of social insurance is never used to describe Singapore's social safety net, it is often used to describe those of welfare states. The term "insurance" is evocative. Insurance is typically taken out against high impact, low probability events over which the individual has relatively little control. Hence, there is no insurance against suicide, but there is insurance against falling ill.

In a welfare state, it is often taken for granted that no one would choose to do anything that they knew would lead them to become destitute. Hence, anyone in that situation must have come to be so due to forces beyond his control or knowledge and, in a compassionate society, would be entitled to a relatively good standard of living, supported by the more fortunate members of society.

However, just as there are certainly things we can do to make it much more likely that we will fall ill (such as smoking or not exercising), so the Singapore model is based on the premise that people can often take steps to avoid the need for public assistance, for instance by saving in their earlier years, or relying on family and community support.

PRINCIPLES OF THE SINGAPORE MODEL OF SOCIAL ASSISTANCE

It is because we believe incentives towards self-reliance matter that Singapore's social assistance policies require people to exhaust their own resources, those of their families, and those of the community, before turning to the Government for help. This belief is often presented as the three principles of our social safety net, namely:

- Self-reliance: Assistance, not welfare; mutual obligation, not entitlement
- Family as the first line of support
- Many helping hands

Put together, these three principles are actually part of a single over-arching principle—that government help must be the last resort.

If we do not uphold this principle, we believe that people will modify their behaviour to become more reliant on the state than would otherwise be the case. This would reduce the incentive for the low-income group to provide for themselves and improve their lot.

Hence, Singapore's Public Assistance Scheme,[1] which can be seen as social insurance against becoming destitute, has eligibility criteria more stringent than those of most welfare states, and gives a lower amount of benefits.

Singapore's social assistance policies require people to exhaust their own resources, those of their families, and those of the community, before turning to government help.

KEEPING THE TAX BURDEN LOW

In order to fund welfare payments and social assistance services for lower income groups, welfare states impose high taxes on the higher-income group. Singapore, too, has a progressive regime of taxation: roughly only the top third of workers pay income taxes. However, while the distribution of taxation is progressive, the absolute amount of taxes is low. For example, income tax revenue is 7% of Gross Domestic Product (GDP) in Singapore,[2] compared to 29% in Denmark.[3]

Again, the underlying assumption in Singapore is that incentives matter. Not only might high taxes induce a brain drain of talent in the higher brackets, the lower-income group would have less incentive to upgrade their skills and work

hard, particularly if they knew they would be well taken care of by the state. This would reduce the competitiveness of Singapore's economy overall.

CHILDREN IN THE NON-WELFARE STATE

To a large extent, the Singapore Model adopts the philosophy that more generous social assistance should be extended to children, who cannot be expected to exercise full self-reliance. Spending on children's education is the one area in which Singapore most resembles a welfare state: Education is of high quality and very low cost, and primary school education for citizen children is not only an entitlement, but also compulsory.

However, there are differences. While children cannot control their destinies, parents are expected to exercise responsibility for their families. For instance, whatever social assistance we provide for children should not translate into incentives for parents to have more children than they can provide well for. Otherwise, we risk doing more harm to future generations who may become caught in a vicious cycle of poverty and reliance.

Hence, while children's kindergarten and primary education are heavily subsidised by the Government, regardless of the number of children a family has, childcare is not. Additional childcare assistance for the low-income working mother is available only for the 1st to 4th child, and rates are lower for the 3rd and 4th child. The Baby Bonus is likewise available only up to the 4th child. Unlike in other states with a more liberal welfare system, we do not give parents a yearly cash grant per child they have.

SUPPORTING SELF-RELIANCE, PROMOTING SOCIAL BONDS

Singapore policies ensure that people have incentives to be self-reliant, and to build and maintain strong family and community bonds. Incentives, alone, however, cannot be fully effective if people are willing but unable to act in the way that we wish them to. Hence, we can structure our social assistance system to make people want to be self-reliant, but unless we also help make them able to become self-reliant, many will try but fail.

For this reason, a large part of our social spending goes towards training. For example, in FY 2005, the Ministry of Manpower committed almost S$99 million to fund training for employees through the Skills Development Fund.[4] As a point of comparison, the Ministry of Community Development, Youth and Sports provides only about S$10 million a year in financial assistance to those on Work Support, a temporary assistance programme for those who are work-capable but in financial hardship.

In fact, Work Support has features to help ensure recipients are both willing and able to become self-reliant. Low

assistance amounts and strictly-enforced maximum programme lengths help provide incentives for people to help themselves. At the same time, training grants, funded by the Singapore Workforce Development Agency, and case management help ensure that those who want to help themselves are given the resources to improve their own lives.

Training grants funded by the Singapore Workforce Development Agency and case management help ensure that those who want to help themselves are given the resources to improve their own lives.

We also make it possible for families to maintain strong family ties by giving preference to couples who wish to live near or with their parents in our allocation of public apartments. We support the growth of a vibrant community life by providing financial support to organisations who wish to do their part to help others.

THE SOCIAL VALUE OF SELF-RELIANCE

There is also a positive social argument for the Singapore Model. The argument is that self-reliance and family and community support are valuable in their own right. Even if low-income individuals could be cared for by the state without economic ramifications, Singapore would be worse off if more of her people no longer saw value in working hard to support themselves and in not having to depend on the charity of others.

Even if the state could remove the need for family members to provide the first line of support for each other, society is likely to be worse off in terms of a weakening in family ties and a sense of shared responsibility. Even if the Government could completely take over the role of community organisations in providing assistance to the less fortunate, it cannot deliver assistance with the flexibility and warmth that community organisations can. The end result would be a lower quality of life for the very groups we want to help.

THE EVOLUTION OF THE SINGAPORE MODEL

There is no doubt, however, that the Singapore Model is evolving. Social assistance spending has been rising at a fast clip. Although the main source of the increase has been on child-related assistance, we have also been spending more on elderly and disability services. The Government will increasingly having to bear the burden of caring for these groups because traditional forms of support, primarily our families, are no longer as strong. Widening income gaps

and an ageing population will put a strain on traditional forms of social security and assistance. The recent CPF changes and Workfare scheme are just some of the measures introduced to help Singaporeans cope. It is likely that we will see new forms of social insurance evolving to meet these very different challenges in the years to come.

Lim Xiuhui was a Social Assistance Policy Officer in the ComCare and Social Support Division of the Ministry of Community Development, Youth and Sports.

NOTES

1. The Public Assistance Scheme is a needs-tested financial assistance schemes for those who are unable to work owing to old age, illness or disability, and who have no means of subsistence and no one to depend on.

2. The figure is based on two sources from the Department of Statistics, Ministry of Trade and Industry, Singapore: *Yearbook of Statistics 2007: Public Finance* (http://www.singstat.gov.sg/pubn/reference/yos/statsT-publicfinance.pdf) and the GDP at Current Market Prices (http://www.singstat.gov.sg/stats/themes/economy/hist/gdp2.html).

3. 2006, StatBank Denmark, http://www.statbank.dk/

4. Manpower Research and Statistics Department. *Singapore Yearbook of Manpower Statistics, 2007* (Singapore: Ministry of Manpower, 2007).

Opinion

Chua Hak Bin

Singapore's Social Support System: Two Anomalies

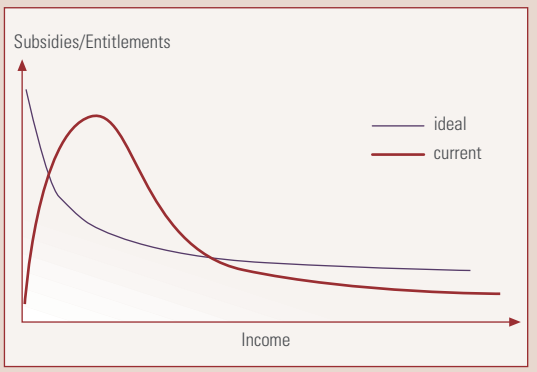
The Singapore economy is rising with the tide of globalisation, but not everyone appears to be prospering equally. A two-speed dual economy appears to be emerging, where divergent growth patterns between different income groups, businesses and even within certain asset classes have become quite stark.[1]

Closing the door on globalisation is not the solution, as protectionist policies will only hurt overall growth to the detriment of all. Tightening immigration policy, for example, may help protect low-wage jobs but may raise business costs, discourage investment and stifle growth. Fine-tuning the current social support or safety net system is preferable and probably necessary to address some of the negative distributional effects of globalisation.

There appear to be some peculiarities worth highlighting in Singapore's current social support system. The first pertains to the distribution of social support across the household income dimension, and the second to social support across the business cycle or time dimension. There is some scope to improve the design of social support on both counts.

First, the current distribution system of social transfers is heavily skewed towards the purchase of Housing and Development Board (HDB) flats.[2] The most generous government subsidies are HDB housing grants, which provide a S$30,000 to S$40,000 housing grant and a 20% price discount for purchases of new flats.[3] These HDB housing entitlements currently dominate payouts from the Workfare scheme.

FIGURE 1. DISTRIBUTIONS OF SUBSIDIES/ ENTITLEMENTS ACROSS HOUSEHOLDS—CURRENT (CONJECTURE) VERSUS IDEAL



Note: The "current" line reflects a possible distribution based on the author's interpretation of variations in subsidy consumption by household. It is not based on actual data.

Plotting subsidies or entitlement (on Y axis) against income (on X axis) will likely produce a skewed distribution with those in the lowest income group getting less government support than those who are slightly better off and able to purchase a HDB flat.

This is because those who are very poor are probably not likely to purchase a HDB flat and exercise their entitlement to the grant and discount. While HDB also offers hefty rental subsidies for lower-income households who cannot afford a basic HDB flat, not all of them may choose public housing. Some may opt to stay with their families or relatives to minimise their financial outlay.

The current system of social transfers is too heavily skewed towards the purchase of HDB flats.

It is probably not ideal to pressure those very poor to commit to the purchase of a HDB property (even with the subsidy) as these households should probably not assume the debt burden and may face difficulties servicing the HDB loan. But should this group be penalised because they are too poor to exercise their privilege? Should lower income households who do not exercise their right to buy a HDB flat be given the lump sum grant of S$30,000 to S$40,000 instead (perhaps into their Central Provident Fund accounts) upon reaching a certain age? Providing such an option may produce an outcome where the subsidy/entitlement is fairer and more a function of need rather than a decision tied to HDB home ownership or consumption of public housing.

The number of lower-income individuals who do not exercise their entitlement to purchase a subsidised HDB is probably not small. Back-of-the-envelope calculations suggest that a current home ownership rate of 93% imply that about 220,000 citizens currently do not live in their own homes. A significant fraction of these may not have exercised or cannot afford to exercise their entitlement to purchase a subsidised HDB flat. Some, but not all of them, may enjoy subsidised rental housing, but the remainder would have lost out in the current HDB-centred social support system because of their financial circumstances.

In the longer-term, a natural evolution will be for the current HDB-centred social support system to shift towards a more Workfare-centred social support system. The Workfare Income Supplement scheme is a significant shift to enhance the social safety net for the lower income segment. Workfare lifts the graph line upwards for the lower income segment, with the largest increases for the poorest segment. The chart line moves closer towards the ideal.

However, the inherent structural weakness of Workfare is that the income support stops during bad times, when

such help is most needed. The low-wage workers are moreover exactly the group most vulnerable to layoffs during downturns. Being retrenched is rarely of their choosing and finding a job is especially difficult during recessions.

> The inherent structural weakness of Workfare is that the income support stops during bad times, when such help is most needed.

The next recession will be the real test for Workfare. The scheme may have to be fine-tuned to allow for some continuation of an income supplement for some *fixed* time period upon retrenchment. Some trade-offs will be needed to reach a balance between providing support and minimising abuse.

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NOTES

1. This was highlighted in an important Department of Statistics General Household Survey 2005. The report showed that the lower income households saw their incomes falling from 2000–2005, while the top income segments saw a more than 2% annual rise. Income inequality appears to be widening.

2. The Housing and Development Board (HDB) is Singapore's public housing authority. HDB's role, as stated on its website, is to provide affordable and quality homes and to support larger national objectives such as social cohesion and strong family ties. As at 2006, 80% of the resident population own the flat they lived in.

3. See www.hdb.gov.sg for more details on the complexity of the HDB housing grant scheme.

Ho Kong Weng

Wage Inequality, Intergenerational Mobility and Education in Singapore

Wage equality and intergenerational educational mobility may be in long-term decline in Singapore.

Accompanying Singapore's phenomenal economic growth over the past four decades has been a rapid increase in educational attainment over the years:[1] in 1960, the mean years of schooling for residents aged 25 and over was 3.14 years; in 2006, it was 9.3 years. This dramatic increase in the supply of skilled labour in all sectors of the economy helped to power Singapore's high growth rates over the past few decades of economic development, which also saw declining wage inequality and high upward intergenerational mobility in education.

However, we need to ask if these trends will continue in the future and whether underlying socioeconomic and demographic changes may challenge or reverse the macroeconomic dynamics underlying Singapore's past decades of growth.

DIMINISHING UPWARD MOBILITY?

Singaporeans born in the first 10 years of independence were likely to have enjoyed high upward mobility for two reasons. First, they could easily overtake their parents in terms of educational attainment as the preceding generations tended to be more lowly educated on average. Second, there were tremendous investments and innovations in public education in the early years of nation building.

However, as the Singapore economy has matured to a lower steady-state growth rate, with average years of schooling reaching that of advanced countries, upward mobility in education is likely to be diminishing. In terms of wage inequality, the trend has been a downward path till the late 1990s, as observed by Ho and Hoon.[2] However, recent structural changes in the world economy have increased wage inequality in the small open economy of Singapore. These and other underlying trends may affect upward mobility in Singapore and determine areas of interest for future policies.

A SKILL BIAS IN PARENTAL INFLUENCE

Recent studies on advanced economies have shown that skill-biased technological progress has pushed up wage inequality. In the case of Singapore, as studied in Ho and Hoon,[2] international outsourcing has the same effect as skill-biased technological progress, and hence it opposes the impact of higher educational levels in reducing wage inequality.

There is another skill-biased process in educational transmission from parents to children. Skilled parents are usually more educated, earn a higher income, are more able to invest in the education of their children privately, and more capable of coaching their children in their studies. Educated women are more likely to marry educated men and have fewer children. All these behaviours of skilled parents combine to result in a skill-biased parental influence on the educational attainment of their children, resulting in a tendency towards lower mobility and lower wage equality. Empirically, Ng and Ho[3] found that the father's education has a statistical significant influence on the educational attainment of the youth: about 16.3% to 16.8% of this economic status is transmitted.

BROKEN FAMILIES REDUCE EDUCATIONAL ATTAINMENT

In 1980, Singapore's general divorce rate per thousand married resident females in 1980 was 3.4 but by 2006, it had escalated to 8.0 per thousand. More alarmingly, the general divorce rate for married resident males aged 20 to 24 in 2006 was 52.0 per thousand!

A divorced mother needs to devote more time in market activities to make a living. As a consequence, less time is given

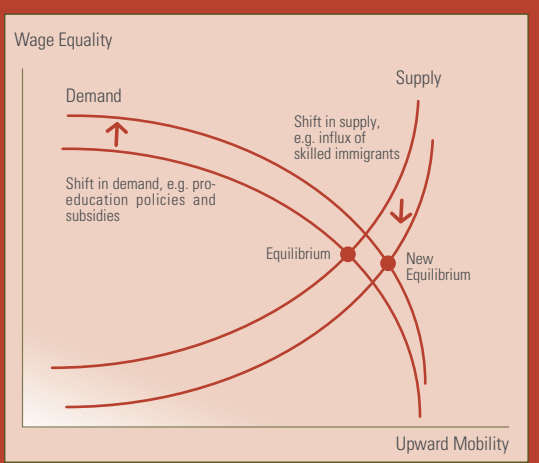
UPWARD EDUCATIONAL MOBILITY:
A DEMAND AND SUPPLY PERSPECTIVE

Wage inequality and intergenerational mobility in education are jointly influenced by variables such as structural changes in technology, demography, and government policies in education and the labour market.

A demand-supply framework of upward mobility allows us to analyse the impact of trends on wage inequality and intergenerational mobility simultaneously. Wage equality, defined as the ratio of unskilled wage to skilled wage, can be considered the price of upward mobility and influences how parents decide on educational investment in their children. When wage equality is low (unskilled wage is low relative to skilled wage), parents have a greater incentive to invest in their children's education because of the low opportunity cost and high return of educating an unskilled child into a skilled adult. The increased demand for education when wage equality is low will lead to high upward mobility. Socioeconomic, demographic, and policy shocks (for example, a change in government subsidy to public education) which influence returns and parental decisions on education, will shift the demand curve of upward educational mobility.

A high upward mobility will also imply a larger pool of skilled workers relative to unskilled workers. All else being equal, the level of skilled wages relative to unskilled wages will decrease, resulting in greater wage equality. This positive relationship between upward mobility and wage equality may be interpreted as a supply curve for upward mobility. Structural changes in technology or conditions in the labour market will shift the supply curve of upward mobility.

THE BALANCE BETWEEN WAGE EQUALITY AND UPWARD EDUCATIONAL MOBILITY



The intersection of the demand and supply curves will give the equilibrium level of upward mobility and wage equality in society. – Ho Kong Weng

to the child in educational supervision. The child may also incur some psychological cost as a result of the marital breakup. The Emotional Quotient and Social Quotient of a child from a broken family could be lower than that of children from intact families enjoying love and care from both parents.

Our study in Ng and Ho[3] has shown that youths whose parents are divorced will see a statistically significant reduction of their educational attainment by 1.8 to 1.9 years worth of schooling. A Swedish study has also demonstrated that children who have experienced family dissolution or reconstitution show lower educational attainment at age 16.[4]

Policies aiming to enhance upward mobility should therefore take into consideration changing trends in the structure of families in Singapore, particularly so in different ethnic and social groups. Consider the statistics in 2005: the general divorce rate for Malays was 15.5 per 1,000 married resident females, compared to that of the Chinese at 6.6 per 1,000; single parent-registered births per 10,000 female residents for Malays were also higher than the Chinese at 10.6 and 1.5, respectively; 5.4% of Malays in the primary one cohort were admitted to local publicly funded universities as compared to 30% for the Chinese community.

EXPANSION OF TERTIARY EDUCATION

High upward educational mobility in the past was mainly a result of the expansion of public education. The educational link to employability is important as a higher return to education via public subsidy will lead to higher mobility and higher wage equality.

The educational link to employability is important as a higher return to education via public subsidy will lead to higher mobility and higher wage equality.

As Singapore climbs up the educational ladder, there seems to be a call for diversity in educational products and providers apart from the Government, as well as an expansion of tertiary education. Diversity is good, but attention should be given to the marketability of human capital accumulated, that is, the market return on education. Economic models and empirical studies have shown that private schools could have a negative impact on educational mobility as they rely more on the contribution from parents both in terms of time and money. Skill-biased parental influence is more prominent in private schools. As Singapore moves to become the educational hub of the region and beyond,

we will see more private and international schools and universities entering the education industry. We have to be aware of the potential impact on educational mobility and wage equality, given a larger share of private schools in the economy.

POPULATION EXPANSION AND SKILL-BIASED IMMIGRATION

Singapore is targeting to achieve a larger population of 6.5 million, from the current level of 4.5 million, despite a low total fertility rate (1.26 per resident female in 2006). If the expansion of population is to be facilitated primarily by immigration, particularly skill-biased immigration, then skilled immigrant parents will have an advantage over less skilled residents in terms of educational investment in their children. As a result, skill-biased parental influence may be strengthened and upward mobility reduced because skilled parents will invest more in their children's education than unskilled parents. However, skill-biased immigration will also increase the number of skilled workers relative to unskilled workers, resulting in an increase in upward mobility. The net effect on upward mobility is therefore ambiguous. It is, however, unambiguous that wage equality will be reduced by both effects. With population expansion, increased investment in public education, especially tertiary education, is necessary; otherwise, competition for limited places in university will lead to higher wage inequality and lower upward mobility.

CONCLUSION

Skill-biased parental influence and the damage of dysfunctional families must be considered in any policy designed to deal with upward mobility and wage inequality. The targeted enlarged population may also bring about higher wage inequality if it is facilitated mainly via skilled immigration. While the net impact of an enlarged immigrant population on educational mobility is uncertain, increased public spending on education, especially tertiary education, may become necessary to prevent any possible decline in mobility.

Dr Ho Kong Weng is Assistant Professor with the Division of Economics, School of Humanities and Social Sciences, Nanyang Technological University. He has worked on Singapore and US data on wage inequality and various forms of intergenerational mobility. The views expressed here are his own.

NOTES

1. Singapore's real GDP (in 2000 market price terms) grew an average of 5.53% per capita per year from 1961 to 2006.
2. Ho, Kong Weng and Hoon, Hian Teck, "Service Links and Wage Inequality." (Working Paper 0301, Department of Economics, National University of Singapore, 2003).
3. Ng, Regina and Ho, Kong Weng, "Intergeneration Educational Mobility in Singapore: An Empirical Study", *YouthSCOPE* (2006): 58–73.
4. Jonsson, Jan O. and Gahler, Michael, "Family Dissolution, Family Reconstitution, and Children's Educational Careers: Recent Evidence of Sweden," *Demography* 34 (1997): 277-93.

Jacqueline Poh

Workfare: The Fourth Pillar of Social Security in Singapore

Singapore's latest labour policy is more than a wage supplement scheme—it is a bold new addition to the social safety net in today's volatile economic environment.

What is Workfare? Workfare is often thought to refer to the income supplement that will be given to low-income workers from January 2008.

It is more than that. Workfare in Singapore refers to the philosophy that work is the best form of social assistance. Anyone who is able to work should be helped to find a job and earn a salary that is enough to support himself and his family. Manifested in concrete policies, Workfare reinforces the work ethic of Singaporeans and makes it worthwhile for anyone at the margin to offer up his labour to the economy.

The development of Workfare marks a milestone in the history of social assistance to low-income Singaporeans. When it was announced, it came as a surprise to some Singaporeans weaned on a diet of strict anti-entitlement and anti-dependency rhetoric. As late as 2005, the nation's founding father Lee Kuan

Yew was reiterating the reasons why after a short-lived Fabian phase in the 1950s, the Government departed from the idea of creating a welfare state: "I soon realised that before distributing the pie I had first to bake it. So I departed from welfarism because it sapped a people's self-reliance and their desire to excel and succeed."

However, in spite of its generous trappings, Workfare is not a radical departure from the nation's fundamental values. It reinforces the values of hard work and self-reliance that had long existed in Singapore society. Workfare is firstly a pragmatic response to the effect of globalisation and technology on wage dispersion. Second, it is a creative way of boosting what you get for doing something.

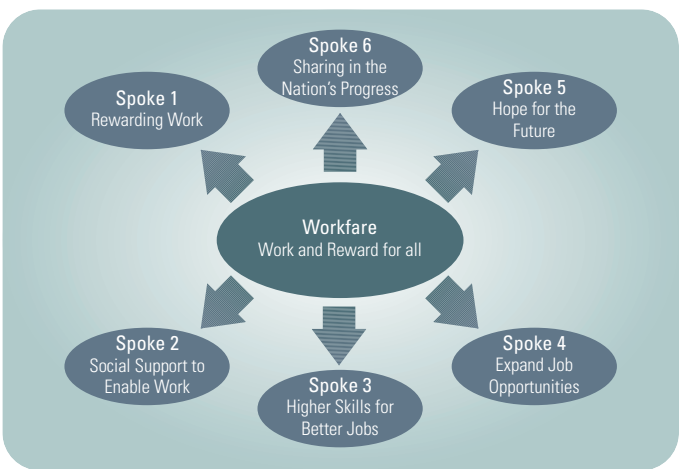
HOLISTIC FRAMEWORK

Although Workfare is often associated with its income supplementation component, it is actually a framework around which six major initiatives work in concert to ensure the well-being of low-wage and vulnerable but work-capable Singaporeans (Figure 1).

Workfare has to address not only the needs of the low-wage worker, but also those of his family; not only his ability to earn a living wage but his incentive to upgrade as well. If families suffer extended periods of unemployment, uncertainty and low wages, there is a danger that the negative attitudes and mindsets of discouraged workers could be transmitted to their children, doing irreparable harm to the work ethic and attitude of the next generation. Short-term assistance can easily drift into long-term dependency. By discouraging families from asking for help until they are at a crisis point, we are not solving problems that might benefit from early intervention.

Workfare aims to incentivise work and increase opportunities for low-wage workers to support themselves, build assets and facilitate social mobility.

FIGURE 1. SUPPORTING THE LOW-WAGE WORKER



The first thrust, "Rewarding Work", is targeted at encouraging inactive low-skilled Singaporeans to enter and stay in the workforce by making work financially worthwhile through the Workfare Bonus

Why Workfare?

Over the years, the primacy of economic growth has been coupled with a strong focus on almost free high-quality education and asset accumulation via the provision of subsidised housing for over 80% of Singaporeans. The former investment gave Singaporeans the wings to elevate their lot, and the latter gave them the roots to stay.

Social assistance was dispersed throughout the community and the family was regarded as the first avenue for support. There was no unemployment insurance or benefits, healthcare was subsidised but not free; food or transport vouchers were deemed unnecessary. Monthly Public Assistance payouts averaging S$309 were only given to about 3,000 Singaporeans incapable of work and bereft of family support. The philosophy was to give little and demand little.

As long as wages and the ranks of the middle class grew continuously, any poverty could be dismissed as a marginal or a cyclical issue best addressed with temporary measures. This was the approach during the recession in 1985–86, the Asian Financial Crisis in 1997, and the SARS downturn in 2003. The Government instituted programmes to help those who were temporarily unemployed such as the Interim Financial Assistance Scheme and the Work Assistance Programme

BEYOND THE FINANCIAL CRISIS

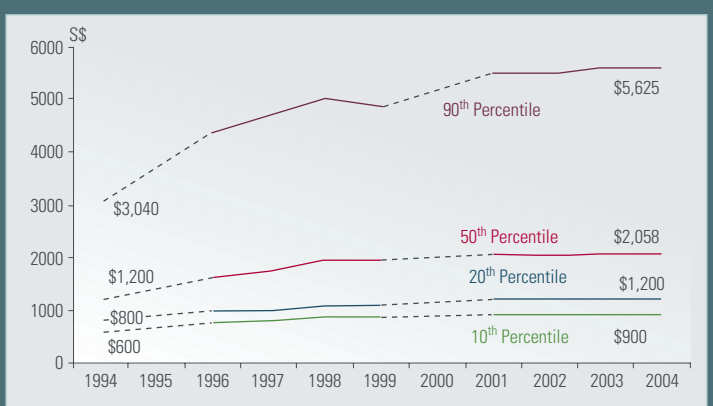
In May 2000, the media reported a Department of Statistics disclosure that the lowest 10% of society had an average monthly income of only S$75.81. The Government swiftly refuted this by pointing to their possession of hand phones and television sets, as well as home equity in HDB flats due to an aggressive home ownership policy. By 2003, the majority of the lowest 20% of Singaporean households owned HDB 3-room or 4-room flats with average home equity of at least S$100,000.

It only became obvious that the problem of the working poor was a structural and not a cyclical problem when the economy started to recover in late 2004. While the media focused on a Gini coefficient that had risen from 0.442 in 2000 to 0.468 in 2005,[1] growing income inequality was not in itself to be feared.

Indeed, some degree of income inequality was to be expected as a result of good growth.

The worrying phenomenon was real wage stagnation and structural unemployment. Wages at the low-end failed to keep pace for the first time since 1965. Despite a buoyant job market from 2004 to 2006, real wages of the lowest 30% of workers (i.e. those earning wages up to S$1,500) in Singapore fell by 0.5% per annum. Between 2000 and 2005, the average monthly household income from work among employed households in the first two deciles fell in real terms. By contrast, the real wages of the 9th decile worker rose by 2.9% p.a. in the same period.

FIGURE 1. GROSS MONTHLY INCOME BY PERCENTILES



The profile of the low-income group gave policymakers little to be optimistic about. Nearly two-thirds of the bottom quintile had below secondary education and another 24% had only secondary schooling. Of these, about 10% were drop-outs. Those with less education were empirically more likely to have greater employment insecurity and lower income potential in an increasingly skills-biased labour market.

Thirty per cent of low-income households earned less than S$1,625 or half the median resident gross monthly household income—a larger proportion of the resident workforce than a decade earlier. The majority were primary breadwinners. One startling fact was how vulnerable they and their families were to any kind of shock—sudden illness, injury, unemployment.

There were two obvious responses. The first was to introduce protectionist measures, including the reservation of jobs for Singaporeans or the imposition of a minimum wage. However, in a small open economy, this would only serve to lower competitiveness, retard economic growth and depress living standards across the board. The only other option was to specifically address the downsides of globalisation: to provide some kind of cushion for the worst affected, and hope for their children.

MAKING WORK PAY

The conundrum the Government faced was how to increase support for vulnerable workers without increasing dependency. This was a different question from countries with higher welfare and social transfers, who aimed to crimp benefits and reduce welfare rolls.

The first answer was to make work a condition of aid, but to expand the range and depth of assistance. The 'work-based' welfare reform enacted in places like Wisconsin, USA impressed Singapore policymakers because of the emphasis placed on a strong work ethic and personal responsibility. Most welfare systems (including Singapore's) fundamentally disbursed aid on the basis of need, even if some work and training requirements were loosely tied. In Wisconsin, the principle of reciprocal responsibility was brought to its logical conclusion—by making aid conditional on work. Flat grants were given regardless of the number of children that depended on the workfare recipient, just as workers get a flat salary independent of the number of children they have.

The second insight was that the Government should focus its aid not only on the unemployed or those on welfare assistance, but on the majority of low-wage workers. When work is not an obviously superior option, the rational decision for welfare recipients would be to remain on welfare. In Hong Kong, for example, it was not uncommon for an unemployed person in Hong Kong to get a better deal on welfare than in a low-paying job. Any expansion of our safety nets should therefore increase the incentives for people in work to work, as well as to entice those not working to participate. – Jacqueline Poh

and later the Workfare Income Supplement (see box story). It is also focused on helping low-wage workers to build up assets for the future, with additional housing subsidies for first-time buyers of Housing and Development Board (HDB) flats. The grant was recently expanded in August 2007 to an eligibility ceiling of S$4,000 and a maximum quantum of S$30,000.

The second and complementary move provides "Social Support to Enable Work" through the Self-Reliance Programme and the Work Assistance Programme. Assistance includes measures such as intensive case management to help low-income households with financial planning, and employment facilitation for the unemployed. Child care and student care subsidies were raised to reduce impediments to work. In line with the experience of Wisconsin, USA, sanctions such as blackout periods or disqualification are imposed on households who fail to cooperate in carrying out their employability plans, or reject jobs on offer.

The third key element ensures that Workfare recipients develop higher skills for better jobs. Many Workfare regimes elsewhere had emphasised inducements to work at the expense of training and upgrading programmes. Criticisms were rife that Workfare was pushing people to 'get a job, any job', condemning them to

WAGE SUPPLEMENTATION

Negative income taxes and a wide range of other programmes have existed for some time in which governments provide income support to workers based on their wages. Economic theory suggests that as long as the demand for labour is not inelastic, wage supplementation will help increase the incomes of workers as well as encourage more people to enter or remain in the workforce.

Despite criticisms that wage supplementation would reduce the intensity of effort, well-designed programmes appear to have been effective in moving people to work, without disincentivising them from working harder. In the US, labour force participation increased due to the Earned Income Tax Credit, without a corresponding decrease in hours worked.[1] This could be because the key decision faced by workers is whether to work, rather than *how many* hours to work.

While employers could theoretically game the system and negotiate away any increase in take-home pay, the higher the

elasticity of labour demand, the less likely employers will reduce wages in response. In view of the buoyant economic growth and the large number of jobs created in Singapore in the last two years, it was felt that labour demand was likely to be elastic, making it an ideal time to commence the supplementation scheme.

The Workfare Income Supplement (WIS) is unique among "negative income tax" schemes. Instead of being linked to the taxation system, it is tied to the Central Provident Fund (CPF) since it is the only scheme in Singapore where workers make universal contributions.

The Government would:

1. Give cash supplements to workers whose incomes are below a certain threshold but who can prove that they have worked for a minimum time over a specified period.
2. Adjust downwards the amount of contributions that employers make to the CPF of older low-wage workers, making it more attractive for them to hire this group and give them a chance to prove themselves.
3. Supplement the CPF savings of the low-income individual.

As a result, the worker would enjoy both a higher take-home pay and greater employability. The employer enjoys a reduced payroll and an incentive to hire vulnerable older workers. The payouts more than offset the reduction in the employers' contributions to their workers' CPF.

In the 2007 Budget, the WIS was finally made a long-term scheme, cementing Workfare as the fourth pillar of Singapore's social security system, along with the CPF for retirement, the 3Ms (Medisave, Medishield and Medifund) for healthcare and HDB subsidised housing. The WIS scheme is expected to benefit 438,000 Singaporeans up to $2,400 a year.

– Jacqueline Poh

NOTE

1. Eissa, Nada and Liebman, Jeffrey, "Labor Supply Response to the Earned Income Tax Credit," *The Quarterly Journal of Economics 111* (1996): 605-37.

a life of drudgery in various low-paying McJobs; Singapore, on the other hand, had the opposite bias, one towards the primacy of training over monetary benefits. Although the proportion of students progressing to post-secondary education has been rising with each cohort, a significant number still leave the system without post-secondary qualifications. Efforts have been made to ensure that children who are less academically inclined are still work-ready and equipped with employable skills, especially in the service sectors.

Since Workfare can only be effective if job seekers can find work, the fourth prong involves "job re-creation" efforts to redesign and scale up existing low-paying jobs such as cleaning and healthcare into higher-paying, higher productivity jobs for Singaporeans.

The last permanent initiative is to create "Hope for the Future". Most low-income households regard their children as a ticket to greater social mobility. It is critical for the nation's future to allow these children to progress educationally so that they would not be locked in a permanent underclass. It is important also to make quality preschool education available to all, to re-enthuse those in danger of dropping out of school, and to support the development of children from vulnerable households that face multiple challenges such as job loss, divorce and abuse.

The integrated case management approach that has been adopted departs from the looser many-helping-hands approach of conventional community support. While more intensive and more expensive, it should be capable of delivering more lasting outcomes.

CONCLUSION

Workfare is a multifaceted approach to a global problem, customised to Singapore's unique social conditions and institutions. It is also a creative attempt to combine elements of wage supplementation and subsidy models. Nevertheless, these are early days yet for the scheme and the jury is still out on its success in raising take-home pay, increasing labour supply and providing some income mobility. These trends will be monitored carefully over the next three years.

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Theresa W. Devasahayam

Aid for Work: The Singapore and US Models in Context

Theresa W. Devasahayam examines Singapore's workfare strategy in light of the US model on which it is based, and finds key points of departure that could inform policy development in future.

The past year has seen the implementation of Workfare in Singapore. Battered by globalisation and rapid economic restructuring over the last decade, lower-income groups in Singapore have seen their real wages stagnate and even decline. Recognising that this group requires more help to remain engaged in work, the Singapore Government embarked on its Workfare strategy, where aid is provided on the condition of work.

The idea of having individuals work in exchange for the aid they receive is not unique to Singapore. In developing its own responses to the phenomenon of low-wage stagnation, Singapore's policy-makers looked to welfare reform in other

parts of the world. The creation of the Workfare initiative in Singapore was to some extent inspired by the US Bill of welfare reforms designed to encourage economic self-sufficiency.

WORKFARE IN THE US AND SINGAPORE: *VIVE LA DIFFÉRENCE*?

Enacted in 1996, welfare reform in the US involved far-reaching amendments to public assistance. Encompassing a broad set of policy changes, welfare reforms include welfare-to-work efforts, state waivers to achieve state-driven programmes, the Earned Income Tax Credit (EITC)[1] expansions in Medicaid, as well as expansions in childcare subsidies and child support requirements.[2] Welfare reform in the US is expressed in numerous models, with each state evolving its own system of welfare provision based on the general stipulations outlined in the Bill.

It was the system developed by the state of Wisconsin that served as a model for Singapore because of its numerous successes. First, a dramatic drop in the number of recipients on welfare was recorded in Wisconsin. This was made possible by the new requirement that made aid conditional on work. Substantial numbers of welfare recipients left the welfare rolls and took on jobs. Those that remained on welfare were required to fulfil work obligations designed to mimic the demands of regular jobs. Many of these jobs were generated by the state government[3] and while they cost the state government more, it was considered necessary to induct long-term welfare recipients, many of whom lack working experience, into work. Second, former welfare recipients, if they had worked, were found to have earned an average annual income of US$5,000[4] more than what they would have received if they had relied on welfare benefits.[5] Third, it

SINGAPORE'S WORKFARE

The permanent implementation of Workfare in Singapore came a year after the Workfare Bonus Scheme (WBS) was introduced in 2006 as a one-off measure to boost the incomes of low-wage workers.

The Workfare Income Supplement (WIS) announced in the 2007 Budget is a long-term programme targeted at older low-wage workers. Owing to the competition low-wage workers face from foreign workers who are willing to accept lower salaries, Singapore's low-wage workers are encouraged not only to continue working under Workfare but also to seek relevant training to boost their prospects of securing better employment.

was found that a boost in the incomes of former welfare recipients had a positive effect on self-esteem.

While conditioning aid on work is a shared feature of both the Singapore and Wisconsin models, the underlying rationale for Workfare in the two places differs markedly. Workfare in Singapore was introduced with the primary purpose of helping low-wage workers increase their incomes. The plan has a stronger emphasis on increasing the financial capacity of low-wage workers through employment rather than to divert individuals away from welfare.

Welfare reform legislation of the US was aimed primarily at promoting work, which also reduced welfare dependence. To this end, workfare policies in the US were aimed at enabling the unemployed to take on wage employment. Stiff work requirements were imposed on those who remained in welfare. While in New York and Wisconsin, state governments took on the task of creating community jobs so that welfare recipients could fulfil work conditions to qualify for aid, in most states welfare recipients relied on jobs created by the private sector.

In contrast, Singapore does not have an extensive welfare system to begin with. Reducing welfare dependency is therefore *not* the main objective of Singapore's workfare, although the spectre of rising welfare costs and a weakening work ethic are seen as unintended consequences that could materialise if the Government allowed welfare programmes to expand over time. The dilemma that the Government grappled with in devising a sustainable workfare programme was how to provide aid without undermining work incentives.

A second point of departure is that welfare reform in the US was also aimed at strengthening marriage, and reducing child illegitimacy and child poverty.[6] There was growing evidence pointing to the fact that children raised by single mothers sustaining themselves on welfare were more likely to be trapped in a culture of poverty. This meant that children developed behavioural problems and low performance levels at school.[7] The promotion of marriage was seen as the solution since it would give the child a stable home. Welfare in the US gave little incentive for the majority of recipients, consisting mostly of single mothers, to get married since being a single mother was one of the eligibility criterion used for determining welfare status. The aim that welfare reform would promote marriage however was mostly rhetoric, as in practical terms welfare reform focused mainly on raising work levels. States were explicitly mandated to put in place measures to encourage work; in contrast, there was little pressure put on states to create initiatives to promote

marriage. Hence, it remains to be seen whether welfare reforms in the US will solidify marriages and promote more stable families in the long term.

WORKFARE: KEY DIFFERENCES BETWEEN THE US AND SINGAPORE

	US	SINGAPORE
Target Group	Single mothers	Older low-wage workers (LWWs)
Objectives	Promote work and reducing welfare dependence Promote marriage and reducing child illegitimacy and poverty	Help LWWs increase income, scale up their market value and increase job mobility
Financial benefits	Earned Income Tax Credit (EITC)	Graduated wage supplement
Education/ Training	Level of emphasis differs from state to state	Education and training regarded as critical
Other benefits	Child support and subsidies Health insurance	Additional public housing grants

In Singapore, the Government felt that the group in most serious need of help is older workers. Those who struggled to find work usually lacked relevant working skills. Thus, the target recipients of Workfare would be individuals who are already working or have worked for a defined period of time in the past year.

Like many pioneering states in the US, Singapore is at an experimental stage with Workfare. While strict time limits have been enforced on welfare recipients to secure jobs in the current Wisconsin system, Singapore's Workfare initiative is not characterised by similar constraints. Since the aim in Singapore is to support and encourage work rather than divert individuals off welfare, it may be the case that WIS would be granted indefinitely to encourage recipients to keep on working. Taking this step may prove to be fortuitous since after all families may not necessarily achieve full financial independence within a fixed span of time, as was found in the US.[8] Helping low-wage workers achieve greater financial independence may thus require sustained government intervention over a longer period of time.

RELATED INITIATIVES

That Workfare is supplemented by a cluster of related initiatives is a feature found both in Singapore and the US. One such initiative is education and training, which in Singapore is regarded as critical. The rationale is unambiguous: education and training are viewed as essential to expanding the skills of low-wage workers so as to boost their labour market value and increase job mobility, thereby enabling individuals to secure higher-paid jobs.

In contrast, Wisconsin eschewed training and emphasised work instead,[9] since it was found that work experience proved to be far more valuable than the additional retooling individuals would receive had they chosen instead to receive training first. Furthermore, programmes

that focused on work over training were regarded to be a more efficient use of resources.

> Emphasising work over welfare has numerous benefits aside from the financial advantages it accrues.

By no means does this suggest that education and training are not features in the US welfare reform model. Some states in the US, such as Washington and New Jersey, have also set aside more generous budgets for education and training.[10] Education and training by themselves, however, were not shown to reduce welfare dependence. These tools had to be complemented by child support and subsidies, the EITC, and health insurance in order to make a positive impact on the lives of welfare recipients.[11] Childcare subsidies in particular were received favourably as it enabled single mothers to go out to work.

The additional staples involved in Singapore's Workfare programme are uniquely Singaporean. Features such as additional public housing grants and special transfers of fiscal surpluses are substantially different from the US model. The rationale is to facilitate asset accumulation and to bring about some degree of income redistribution.

FINE-TUNING WORKFARE FOR SINGAPORE

Emphasising work over welfare has numerous benefits aside from the financial advantages it accrues: working engenders social inclusion; it raises the self-esteem of individuals; and it facilitates social mobility within and across generations. As in all policies and programmes, borrowing models from others should be done selectively because of different historical, cultural and social, and demographic orientations.

The design of Workfare would have to take into account local requirements and constraints. Currently, Singapore's Workfare model only admits individuals who work in the formal sector and, as a consequence, only those who contribute to the Central Provident Fund (CPF). As such, workers engaged in the informal sector may not be able to tap into the benefits of the Workfare programme. In this case, there may be a need to devise other methods of tracking an individual's work history other than using the CPF system. That low-wage workers do not have to contribute to CPF also makes this an ineffective tracking method, although there are efforts to try to bring every low-wage worker under the CPF net.

Another area where Workfare

policymakers in Singapore are likely to have to grapple with is whether women should be given more attention, since they are more likely than men to face difficulties in achieving financial self-sufficiency. The predicament in which they often find themselves is a consequence of structural, social and cultural factors. As in many parts of the world, Singaporean women generally earn less and, more often than men, find themselves in lower-paying jobs. Even if they have worked, many spend fewer years of their lives in paid employment compared with men, as they are obliged to enter and exit the labour force to provide care for their children and aged parents in keeping with social and cultural demands that posit that they are primary caretakers of their families.[12] These factors suggest that women end up with less savings than men to sustain themselves in old age. Furthermore, that married women outlive their husbands means that greater numbers would find themselves in dire straits especially if they were low-wage workers during their work life. Finally, the fact that women continue to undertake roles as primary caregivers in the family suggests that some of the assistance offered under Workfare should be extended to caregivers.[13] Hence, the design of Workfare may also need to take into account the demographic particularities of Singapore rather than subsuming all low-wage workers in a single, undifferentiated category.

Workfare may need to take into account the demographic particularities of Singapore.

State governments across the US have been experimenting with welfare reform for years or even decades before the Welfare Reform Bill was announced. Invariably, Workfare in Singapore should take into account developments in the US in so far as it wants to discover what works and what does not when helping low-wage workers. More importantly, Workfare in Singapore should evolve and adapt to its own demographic and economic circumstances. Already, the Prime Minister has announced that WIS would be increased by up to two times for eligible older workers aged above 55. These adaptations will require a good measure of discernment on the part of Singapore's Workfare policymakers. While it may be useful up to a point to import ideas from other countries, what is most critical in directing the future development of Workfare is to understand the profile and culture of Singaporean low-wage workers and how they respond to the current Workfare programme.

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NOTES

1. The Earned Income Tax Credit (EITC), otherwise called the Earned Income Credit (EIC), is a refundable federal income tax credit for low-income workers and families. The underlying rationale of the EITC is that a tax refund may be claimed if it exceeds the amount of taxes owed.

2. Blank, Rebecca, "What We Know, What We Don't Know, and What We Need to Know about Welfare Reform" (paper presented at the "Ten Years After: Evaluating the Long-Term Effects of Welfare Reform on Children, Families, Work and Welfare Conference" organised by the University of Kentucky Center for Poverty Research, Kentucky, USA, 12-13 April, 2007).

3. Mead, Lawrence M., personal communication, 21 June 2007.

4. Thompson, Tommy and Bennett, William J., "The Good News about Welfare Reform: Wisconsin's Success Story," *The Heritage Foundation*, 6 March 1997, http://www.heritage.org/Research/Welfare/HL593.cfm (accessed on 6 June 2007).

5. Rebecca Blank has cautioned not to homogenise the welfare recipient group as there are single women who have been found to be worse off after welfare reform particularly in finding and retaining jobs (see Note 2).

6. Evidently, the welfare system prior to 1996 indirectly encouraged the perpetuation of single-parent households for which the US federal government saw urgency to correct.

7. Duncan, Greg J. and Brooks-Gunn, Jeanne, *Consequences of Growing Up Poor* (New York: Russell Sage Foundation, 1997).

8. Under welfare reform 1996, it was found that few families in reality achieved full financial independence and, as such, most were not able to move away from assistance completely. See Cancian, Mary and Meyer, Daniel R., "Alternative Measures of Economic Success among TANF Participants: Avoiding Poverty, Hardship, and Dependence on Public Assistance," *Journal of Policy Analysis and Management* 23 (2004): 531-48.

9. While the state of California generally mandated education and training in its welfare reform, the county of Riverside was an exception as it emphasised work over education and training. Like Wisconsin, Riverside was characterised by high job placement rates and low rates of engagement in education and training which accounted for its success. Note also that Riverside did not provide financial benefits nor did it impose time limits. See Walker, Robert, et al., "Successful welfare-to-work programs: Were Riverside and Portland really that good?" *Focus 22* (2003): 11-18.

10. Cancian, Maria, et al., "Income and program participation among early TANF recipients: The evidence from New Jersey, Washington, and Wisconsin," *Focus 22* (2003): 2-10.

11. Lerman, Robert, "Increasing the Employment and Earnings of Welfare Recipients," *Welfare Reform: An Analysis of the Issues* (Washington: Urban Institute, 1995). http://www.urban.org/publications/306620.html.

12. Devasahayam, Theresa D. and Yeoh, Brenda S. A., *Working and Mothering in Asia: Images, Ideologies and Identities* (Singapore and Denmark: National University of Singapore Press and Nordic Institute of Asian Studies, 2007).

13. There is evidence demonstrating that poor women in Singapore struggle to negotiate adequate childcare provision, being forced instead to remain in the home or at best seek the services of Family Service Centre. See Davidson, Gillian M., "The Spaces of Coping: Women and 'Poverty' in Singapore," *Singapore Journal of Tropical Geography, 17* (1997): 113-31.

Interview with Lawrence M. Mead

Making Workfare Work: The US Experience

New York University's Professor Lawrence M. Mead discusses workfare and income inequality in light of the US experience after a decade of welfare reform.

Singapore has put in place a Workfare Income Supplement scheme as an additional social safety net for low-income workers. What can we learn from the US experience in work-for-benefit programmes?

It is important to distinguish American-style work enforcement from Singapore's workfare. The two initiatives are markedly different: in Singapore, workfare refers to the supplementation of wages, while in the US, workfare entails requiring people who receive aid to work.

The national Personal Responsibility Act of 1996 accelerated welfare reform. The Act meant that welfare was no longer a legal entitlement. However, there was no real reason to abolish the entitlement since the intention was to condition aid on work. Another excessive aspect of US welfare reform is the time limit enforced which only allows recipients to be on aid for a maximum of five years. This was unnecessary since reform was not aimed mainly at ending dependency, but instead at encouraging people to work.

One state, Wisconsin, even insisted on a universal and immediate work requirement, which was more severe than required. Wisconsin's strong administrative capacity, however, meant that welfare reform met with success in the state. Washington was another state that saw the smooth running of welfare programmes post-1996. Like Wisconsin, Washington had a strong tradition of good government.

US welfare reform was aimed mainly at raising work levels. Reducing dependency was secondary. The idea that the poor should be entirely non-reliant on the Government is never going to happen and it is even unnecessary. In reality, even the middle class is reliant on the Government. Strict self-reliance is not a meaningful goal. Instead, the goal of reform should be to achieve joint responsibility between citizens and the Government. The poor have to help themselves as much as others help them.

The focus on work rather than reducing dependency meant that welfare benefits were not generally cut. Most of the states which control benefit levels actually raised them in the sense that work incentives were increased. That is, recipients were allowed to keep more welfare if they worked. The combination of earnings with remaining welfare could raise incomes substantially. The cost of work incentives along with the childcare and healthcare provided to support working meant that welfare did not save money for the Government, contrary to what some commentators expected. Rather, spending increased.

Helping the poor move out of poverty also means that there is an attempt to close the widening income gap between the rich and the poor. What should governments do to deal with the challenge of inequality?

Inequality is a real issue but less important than may appear, for two reasons. First, the causes are not well understood. We do not know why inequality is rising. Some scholars find that the trend is related to the decline of labour unions, to the rising payoffs to higher education, and to a lesser degree, to growing trade and immigration, but these factors account for only part of the trend. Second, concern about inequality is mostly confined to academics. The ordinary person cares less about it and, as a consequence, politicians do not grant it much attention. A more pressing concern among ordinary Americans is whether they can secure a job and get ahead on their own. They are not particularly offended by the rich.

There appears to be greater political concern about inequality in Europe than there is in the US. This seems to be the case in Singapore as well. The political class in Singapore is concerned about inequality in a way that is not true in the US. Here the problem is a more serious political question.

If governments choose to tackle this problem, it is clear that one reason for growing inequality is disorganisation at the bottom of society and falling work levels among the poor. Welfare reforms and other efforts can help to raise work levels at the bottom. In the 1990s, the massive increase in earnings among the low-income as a result of welfare reform did slow trends toward inequality considerably. In fact, measures like this might even reverse the trends and reduce inequality. Hence, getting the lower-income population to work more steadily is the best thing governments can do to retard inequality.

Does making welfare recipients work for a reward facilitate upward mobility, for example, through increased earnings? Are there also other benefits or costs of working that should be taken into consideration?

Work does to some extent translate into social mobility. Recipients who go to work

typically experience some gains in income. That gain is less, admittedly, in states paying high welfare benefits, as the recipients lose more income when they leave welfare for work. But even in these states they are generally better off than they were before, at least in terms of income.

One can argue that the gains in income may not necessarily offset the strains and difficulties that come with working. Some academics have concluded that while mothers who work have higher incomes, they also have higher expenses than non-working mothers. Thus, they may not be better off than their non-working counterparts. However, welfare recipients typically also receive monies from other sources such as families or partners to whom they may not have been married. When they go to work they usually get more from these sources than they did while on welfare, so again they are usually better off than they were on welfare.

Clearly there is progression of earnings over time, provided a mother keeps working steadily. These gains are lost, however, if mothers drop in and out of work, as many do. Welfare recipients who work continuously usually get out of poverty within a few years.

Do the children of welfare recipients do better in future if their mothers work? Evaluations suggest that some young children do better in school if their mothers have to work, while some adolescents are more likely to get in trouble after school if their parents are working and unavailable to supervise them. But all these effects are small. In the longer term, we can only presume that it is good for the children to see their mothers get off welfare and start to work. Furthermore, the children may receive more stimulation in childcare than they would if they had stayed at home with a mother who does not work. As a consequence of having been in a stimulating environment, children of recipients may perform better in schools.

In the US, former welfare recipients are usually better off because they have additional rewards such as childcare support and the Earned Income Tax Credit (EITC),[1] a wage subsidy for low-paid workers much like what Singapore is instituting. This subsidy on earnings is different from traditional welfare since it is conditioned on work. While EITC does not spur people to work, as welfare work requirements do, it does make them better off if they work.

However, welfare recipients have not utilised this benefit to the fullest. Currently, they can receive this benefit for any amount of work they engage in. Many work in dribs and drabs and so do not use the credit as much as they could. One reason for that is that EITC subsidises

even very short working hours. It sets no minimum of hours before you get the subsidy. Some welfare reform experiments require clients to work 30 hours a week to get subsidised. This is to ensure that they get the maximum benefit.

Enforcing a threshold also has another good effect: it offsets the possible income effect that may be produced by receiving the subsidy. That is, the subsidy might permit people to cover their financial needs by working fewer hours than before, which is undesirable. Some policymakers are hesitant about increasing the EITC, as has been proposed, because this income effect might reduce rather than increase working hours among the poor. Instituting a 20- or 30-hour threshold for EITC would be one way to forestall this.

Many welfare reform programmes in the US have been carried out with the assistance of non-profit organisations and private agencies. Do you think this is a good strategy for success?

Initially I was hostile to sub-contracting of welfare reform programmes to non-profit bodies and profit-making companies. I thought this would complicate the structures and cause confusion among welfare recipients. However, there are many instances where contracting has played a constructive role in implementing reform, especially in implementing job search requirements for welfare recipients. It was the difficulty of building the job search aspect into welfare that caused many states to turn this task over to private agencies. Generally contractors have proven more constructive than I once thought, and I say now that we should consider this strategy. However, I still have doubts about extreme privatisation, such as in Australia where they abolished the public job service and now have a maze of private agencies.

One question this strategy raises is whether it cuts back on the Government's role in welfare reform. At one level, it might seem that the Government is heading in that direction when it turns to private agencies. That is one reason why privatisation may be impolitic. In reality, however, welfare reform is closely controlled by the Government even where private agencies are used. The benefits and the work requirements are always defined by elected officials, either at the federal or state level, and the funding is public.

Do you think that the workfare model would see success even in times of economic downturn when jobs are scarcer?

Whether or not poor people are expected to work by law has more effect on dependency than economic upturns and downturns. In determining whether welfare recipients work, the unemployment rate remains important, but it is

secondary to enforcement pressures. Even during a downturn, jobs are frequently available and there is a great deal of hiring and firing. The immigration rate shows that low-level jobs are still widely available. Job seekers may be unemployed for a little longer than if the economy was thriving. The more skilled probably face a tougher time because they seek higher-paying jobs, and these are less readily available.

In the US, people stay on welfare mainly because they are not even looking for work, not because jobs are unavailable. To be unemployed, you have to be available for work—that is, you have to have entered the labour force—but have not yet accepted a job. Most people who enter the labour force find jobs so quickly that they are never recorded as unemployed at all. Similarly, those who leave jobs are seldom left jobless—they also leave the labour force and so again are not classified as unemployed. Most welfare recipients are not in the labour force and are not even looking for work. That is a much bigger problem than unemployment.

Unemployment as a problem is enshrined in our collective memory in the US because of the Great Depression of the 1930s, when jobs clearly were lacking and a quarter of the labour force was unemployed. Joblessness has been far less of a problem since then. It is a problem mostly for the higher reaches of the income hierarchy. They tend to have expectations of getting certain kinds of jobs, with conditions they think are optimal. So they do not accept just any job and unemployment for this group tends to be longer-lasting. In contrast, among the poor, the overwhelming problem is not employment or even unemployment but just getting into the workforce and staying there.

Is there a proper time to implement welfare reform? Are there certain conditions that should be in place before making workfare a permanent feature of the social safety net?

In the US, welfare reform did not come too early since we had a history of prior experimentation going back as far as the 1960s. In fact, there was already a work dimension in welfare policies as early as 1961. It increased in intensity up until the late 1980s when the Family Support Act was enacted. The enforcement of work in the US did not begin with the Personal Responsibility Act of 1996, although that legislation accelerated the process. The earlier experimentation taught that enforcing work in welfare was possible and how best to do it.

In Singapore, the Government is not acting too soon because the Workfare Income Supplement is not so radical as to change everything. Furthermore, it is designed in such a way that ongoing adjustments are possible. The Workfare

Bonus Scheme, which preceded the Supplement, might be an even better idea. These proposals respond to your welfare problem, which is mostly about low-income workers and not, as in the US, getting people to work.

While it is not too soon to act, it is also critical to research the effects of the current bonus system and the Workfare Income Supplement, to see their actual effects and for the purpose of fine-tuning.

Singapore might want to learn from the US model, but bear in mind that every government that reforms welfare has to generate its own consensus about how to do that. In the US, every state made its own decisions about reform, although within federal rules. There was less borrowing from other states than many had expected. Even the more influential states, such as Wisconsin, had little influence on how welfare reform occurred in other states.

Singapore will have to justify what it has done based on its own experience. The example of Wisconsin is worth only so much to you! Only after a series of experiments will you know how best to help your low-wage workers and get support for your policies.

Lawrence M. Mead is Professor of Politics at New York University, where he teaches public policy and American government. Professor Mead is an authority on the problems of poverty and welfare in the US. Among academics, he was the principal exponent of work requirements in welfare—the approach that now dominates US national policy. He is also a leading scholar of the politics and implementation of welfare reform, subjects on which he has written several books and over a hundred publications. These works have helped shape welfare reform in the US and abroad. Professor Mead visited Singapore as a Distinguished Visitor of the Centre for Governance and Leadership (CGL), Civil Service College, where he met with senior policymakers and delivered a New Insights Lecture on "Welfare Reform in America: Successes and Limitations". This article was extracted from an interview conducted by Dr Theresa Devasahayam, CGL Senior Researcher, on 23 June 2007.

NOTE

1. The Earned Income Tax Credit (EITC), sometimes called the Earned Income Credit, is a refundable federal income tax credit for low-income working individuals and families. Congress originally approved the tax credit legislation in 1975 in part to offset the burden of social security taxes and to provide an incentive to work. When the EITC exceeds the amount of taxes owed, it results in a tax refund to those who claim and qualify for the credit. To qualify, taxpayers must meet certain requirements and file a tax return, even if they did not earn enough money to be obligated to file a tax return.

Opinion

Hoon Hian Teck

The Singapore Model of Workfare: Three Suggestions

In a market economy, pay and volume of joblessness are jointly determined. Any policy, such as the Workfare Income Supplement (WIS) scheme, which affects a person's pay will invariably affect the other factor, unemployment. In the current environment of rising property prices, upward revisions of medium-term growth forecasts, and declining unemployment, this point might seem moot. Yet, the establishment of Singapore's fourth pillar of social security provides the opportunity to look much farther ahead, of some 20 to 30 years.

LONG-TERM RATE OF UNEMPLOYMENT

In my research, I found that based upon our historical experience from 1967 to 2002, the minimum growth rate of real Gross Domestic Product (GDP) required to keep the current unemployment rate from rising is 7.1%.[1] A more detailed analysis with Ho Kong Weng by sub-periods, however, showed that the minimum real GDP growth rate required to keep the unemployment rate steady fell from 9.1% for the period 1967 to 1984 to 6.3% for the period 1984 to 2003.[2] The pickup of the economy in the last three to four years, and the revision of growth forecast upwards to the 4% to 6% range over the next five to 10 years, may paradoxically set the stage for rising joblessness if growth fails to hit or exceed the high end of the forecast. If this analysis is correct, we may want to evaluate whether the WIS scheme is able to boost the pay of low-skilled workers as well as to reduce joblessness.

WIS: THREE DESIGN MODIFICATIONS NEEDED

The broad design features of the WIS appear to this writer to have the potential both to boost the pay of low-skilled workers and to expand their employment. The large presence of older workers in the current cohort of the less skilled workforce and retirement income inadequacy among older workers arising from increased longevity have led the Government to tune the WIS to boost pay

and employment of older workers (i.e., over the age of 35). However, it is likely that in the future, some of its features may need to be tweaked.

With a view to shifting the demand to low-skilled workers, a larger portion of the income supplement should be given directly to firms that employ these workers. It is sometimes suggested that firms attach a social stigma to workers whose employment fetches a subsidy. There is no apparent reason why this should be so when the employment subsidy scheme is a national initiative. Moreover, it boosts workers' sense of worth when they receive their full pay directly from their employers rather than from the Government.

The next point is the size of the subsidy to be paid compared to spending on workers' retraining. An optimal policy very likely combines financial incentives with schemes for retraining, job redesign and job-matching. However, the latter schemes could involve significant administrative costs such as assigning more administrators to track and manage individual cases of those receiving training. Such costs ought to be factored into a cost-benefit calculation of how effective the last tax dollar is being spent to help low-wage workers but risk being left out since they are much less explicit.

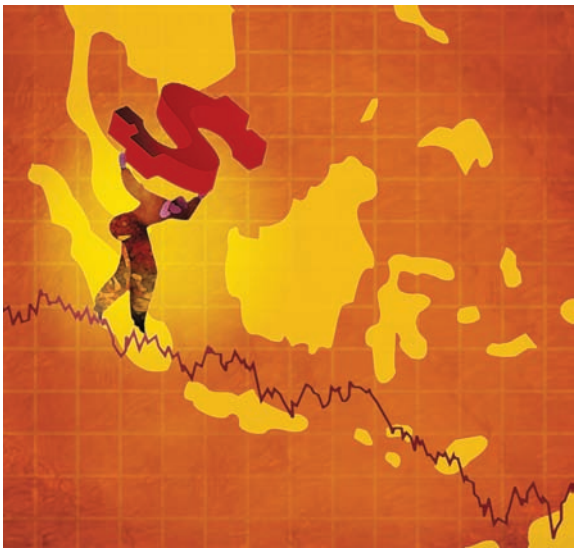
The third suggestion is to extend the WIS scheme to any full-time worker receiving a low wage—regardless of age—so long as it is above the legal age to work. This will allow a worker to be integrated into the mainstream of work early in life and when he or she starts a family. This should help WIS fulfil a more comprehensive role as an effective fourth pillar in Singapore's social safety net.

The author is Professor of Economics at the Singapore Management University. The views expressed here are his own. His research attempts to identify the determinants of unemployment. A 1992 paper co-authored with the 2006 economics Nobel Laureate, Edmund Phelps, entitled "Macroeconomic Shocks in a Dynamized Model of the Natural Rate of Unemployment", published in the *American Economic Review*, reformulated the labour-turnover model of the natural rate to pay attention to dynamics. They studied the consequences of a low-wage employment subsidy scheme in a model of the natural rate in "Low-Wage Employment Subsidies in a Labor-Turnover Model of the 'Natural Rate'", in E Phelps (ed.), *Designing Inclusion: Tools to Raise Low-End Pay and Employment in Private Enterprise* (Cambridge: Cambridge University Press, 2003).

NOTES

1. Hoon, Hian Teck, "Future Job Prospects in Singapore," in *The Economic Prospects of Singapore*, eds. Koh, Winston and Mariano, Roberto, (Singapore: Addison-Wesley, 2005, pp. 47–78).

2. Koh, Winston and Mariano, Roberto, "Distance to Frontier and the Big Swings of the Unemployment Rate: What Room is Left for Monetary Policy?", Kiel Working Paper No. 1347, Kiel Institute for World Economics (paper originally presented at conference entitled "The Phillips Curve and the Natural Rate of Unemployment" organised by Kiel Institute, Kiel, Germany, June 3–4, 2007).



Donald Low

The Asian Financial Crisis
In Hindsight

The Asian Financial Crisis might well be the first major crisis of globalisation. Donald Low examines its causes and implications ten years on.

The 1997/98 Asian Financial Crisis hit the fastest growing economies in the world, and prompted the largest financial bailouts by international financial institutions (IFIs) in history. It brought to an end decades of strong economic growth among Asian economies that were previously lauded for their sound economic policies of export orientation, balanced budgets, and high savings and investment rates.

Beginning in Thailand and spreading to Indonesia, South Korea, Malaysia and the Philippines, the contagion effects of the crisis were felt as far as Russia and Brazil. It dealt a sharp blow to fragile and over-extended banking systems, resulted in a severe tightening of credit in the Asian economies, forced a sharp depreciation of all their currencies, and led to a major economic contraction in Asia.

THE ORIGINS OF THE CRISIS

The essence of the crisis was a huge, sudden reversal of capital flows. Asian economies that were previously attracting large amounts of foreign capital suddenly experienced withdrawals of short-term lines of capital, an exodus of portfolio investments, and capital flight by domestic investors. Net capital inflows of US$93 billion into the five most affected Asian economies (South Korea, Indonesia, Thailand, Malaysia and the Philippines: the Asian-5) in 1996 were suddenly replaced by a net capital *outflow* of US$12 billion in the second half of 1997. Most of the turnaround arose from a US$73 billion reversal in net bank lending flows, with the sharpest outflows recorded in Thailand and Korea of some US$18 billion each.[1]

During and immediately after the crisis, much of the debate among economists centred on whether the Asian crisis was caused by weak economic and financial fundamentals, or by financial panic unrelated to economic conditions. Certainly, most of the macroeconomic indicators of financial stability gave little reason to expect a major crisis in any of the affected countries at the time. Budgets were generally in balance or showing surpluses. By emerging country standards, inflation rates were relatively low (below 10%), and stable or declining. Savings and investment rates were high and generally rising prior to the crisis.[2] Indeed, the crisis was largely unanticipated because the economies were pursuing the export-led model of growth that had sustained the Asian economic miracle of the preceding two decades. Confidence was buttressed by the glowing reviews these economies received in various World Bank and Asian Development Bank reports, and in International Monetary Fund (IMF) assessments.

Ironically, the optimism of the IFIs had helped to create a general bullishness among governments, investors and borrowers in the long-term economic prospects of the East Asian economies, obscuring serious *microeconomic* problems that beset their corporate and financial sectors. These included a legacy of bad lending and investment practices fostered by a climate of relationship-based lending; disincentives to monitor risk due to the implicit guarantee of government bailouts; and inadequate supervision and regulation of domestic financial institutions. These vulnerabilities, combined with financial sector liberalisation from the 1990s onwards and de facto fixed exchange rate regimes, led to increasing exposures to credit risks and ever more fragile financial systems. Bank claims on the private sector grew exponentially in the years leading up to the crisis.[3]

The abundance of inexpensive capital from abroad, combined with lending based on non-economic considerations,

led to a misallocation of capital into speculative and uncompetitive ventures, particularly in real estate and equity markets. Even before the crisis struck, bank and non-bank balance sheets were already deteriorating as the quality of investments in the Asian-5 countries declined and the proportion of non-performing loans increased substantially.

FINANCIAL PANIC AND THE SPREAD OF THE CRISIS

In 1996 and early 1997, the asset bubble created by cheap foreign capital and excessive lending began to burst in some countries, notably Thailand and Korea, where stock market and real estate prices fell sharply. The emergence of wide losses and defaults in the corporate sector also highlighted the low profitability of past investment projects. This led to a massive capital withdrawal, although the immediate triggers differed from country to country.

Once the bubble bursts, panic in financial markets played a key role in explaining why the crisis was more severe than weak fundamentals alone might suggest. Domestic investors began to look more critically at weaknesses that had been previously ignored; new information in an environment with poor disclosure further amplified concerns about the quality of investments, the size of foreign borrowings, and the stability of the financial system. As the crisis expanded, domestic residents became less willing to hold assets in domestic financial institutions and foreign creditors became less willing to roll over their loans, causing a liquidity squeeze that led to the bankruptcy of financial institutions as well as private firms that had borrowed from them. Thus the initial loss of confidence turned into a self-reinforcing creditors' panic.

Panic in financial markets explains why the crisis was more severe than weak fundamentals alone might suggest.

In many cases, policy mistakes on the part of Asian governments after the crisis had begun and the political constraints they faced added to the instability and volatility. When their currencies came under attack, the central banks of Thailand, Korea and Malaysia mounted expensive but futile currency defences by intervening in the forward markets. These did little to reduce pressures on their currencies, but shrunk their foreign exchange reserves further, causing already jittery creditors to be even less willing to roll over their loans. In Indonesia, which suffered the sharpest depreciation of its

currency (of 81% between June 1997 and January 1998), there was an inherent tension between the vested interests of the Suharto regime and the structural reforms needed to restore market confidence. The Indonesian government's backtracking on many of the promises it had made under the IMF programmes further undermined the credibility of its commitment to reform.

INTERNATIONAL FINANCIAL INSTITUTIONS: A CASE OF BAD PRESCRIPTIONS?

Much of the subsequent debate on the Asian Financial Crisis has revolved around whether the remedial policy prescriptions of the IFIs were largely correct or made the situation worse. The recurrent theme of the criticisms of the IMF is that it should have concentrated on reassuring markets instead of disciplining countries—for instance, in demanding fiscal austerity from countries that did not have budget problems.[4]

> IMF failed to understand the panic element in the Asian crisis, and that its response should have been to focus on providing liquidity, aided possibly by temporary capital controls.

Critics of the Fund argue that the IMF failed to understand the panic element in the Asian crisis, and that its response should have been to focus on providing liquidity, aided possibly by temporary capital controls (which the IMF objected to on ideological grounds). Joseph Stiglitz, for instance, argues that the IMF shared a significant part of the blame for the onset of the crisis because it had encouraged capital market liberalisation in emerging economies before their institutional and regulatory capabilities were sufficiently developed to manage the large capital inflows. He further argues that the IMF misdiagnosed the problem and prescribed the same anti-inflationary strategies that it had applied in Latin American crises (which had been caused by profligate government spending and loose monetary policy).[5] The problem in Asia was not with the governments' macroeconomic policies, but the mounting debts of the corporate sector.[6] In this context of insufficient (rather than excess) demand, the policy prescriptions of fiscal contraction, tight domestic credit and high interest rates were inappropriate and deepened the downturn.

Other critics such as Jeffrey Sachs have also pointed out the IMF's "poorly thought-out approach to the banking system" which forced a closure of weak banks without a comprehensive financial restructuring plan or measures to strengthen the rest of the banking system,

set off a bank run that undermined the rest of the system, including healthy banks, and increased the costs of the IMF's tight money policy.[7] Others point to the IMF's imposition of wide-ranging conditions, including those on matters that seemed to have little to do with financial stability, which may have distracted attention from the urgent issues at hand.[6]

In the IMF's defence, three arguments must be highlighted. First, it should be emphasised that the root of the crisis was a loss of confidence, arising from underlying structural and financial problems as well as a sudden re-evaluation by investors of the attractiveness of the country as a place to invest. A developing country gripped by financial panic and capital flight "does not have luxury of borrowing more or of cutting interest rates without worsening the panic."[8] To the extent that fiscal probity and tight credit policies were necessary for restoring confidence, it was not a policy choice that the crisis-hit countries could have avoided—even if the tough measures deprived indebted companies and banks of much-needed liquidity.

Second, it should be noted that the hesitation and lack of commitment on the part of governments in many cases were probably more to blame for causing greater market uncertainty than the supposedly intrusive and inappropriate reforms prescribed by the IMF.

Third, the crisis was *not* just a case of pure panic. Even if panic did amplify the effects of the crisis, there were serious flaws in the Asian economies, especially in their financial systems. The IMF could *not* have acted simply as a lender of last resort. With its limited resources, "it cannot offer an open-ended credit line to liquidity-constrained countries in the same way that the Federal Reserve can for liquidity-constrained banks".[4]

AFTERMATH: POLICY LESSONS FROM THE CRISIS

The Asian crisis raised key questions not just for the economic policies of emerging economies, but also for the role of the IFIs in crisis prevention and crisis management. Nevertheless, calls for their abolition—on the argument that they first caused the crisis and then exacerbated it—were largely exaggerated and misplaced. In a world characterised by increasing economic interdependence and financial linkages, institutions promoting global governance and economic development ought to be strengthened, not weakened.

There are, however, fundamental questions about the appropriateness of the policy prescriptions of the IFIs, the desirability of the liberalisation policies they advocated, and how the international financial architecture might be reformed. There certainly appears to be the case for the IMF to focus more narrowly on its core mission of financial stability, rather

than to spread its energies and resources thinly across a wide range of social and developmental issues. Furthermore, it would be prudent for IFIs to be less ideological and more pragmatic in their policy prescriptions in crisis management even if neo-liberal economic prescriptions are the norm under ordinary circumstances.

The Asian crisis is evidence that economic growth and financial stability are related but separate policy objectives, and that IFIs cannot afford to ignore financial and corporate health and vulnerabilities even if macroeconomic fundamentals appear healthy.

It is also a cautionary tale about financial liberalisation in emerging markets. While the case for liberalising long-term foreign direct investment[9] remains sound, the crisis suggests that a *more nuanced and sequenced approach to capital market liberalisation,* particularly in ensuring that the requisite regulatory institutions are in place, would be more prudent. To a large extent, this lesson has been taken on board by the IFIs. The IMF, for instance, now emphasises the need to build stronger regulatory regimes and financial institutions alongside more open capital markets, reducing the risks of instability.

The crisis made clear the *dangers of fixed or semi-fixed exchange rate regimes* (or soft pegs). Fixed rates may reduce volatility and uncertainty; they can also be useful in providing a price anchor in high-inflation countries. But because fixed rate regimes do not allow for nominal rate adjustments, they tend to cause currencies to become misaligned (e.g. over-valued) with the economy's fundamentals.

To the extent that the severity of the crisis was in large part due to panic, a key policy thrust of the IFIs *must be to improve disclosure and transparency in emerging economies* before crises occur. In the Asian economies, poor information environments created uncertainty and led to markets over-reacting and assuming the worst when new information—for example, concerning the strength of a particular bank—was revealed. Such over-reactions are less likely if banks, financial institutions and governments comply with international and stricter codes and standards on financial, statistical and fiscal reporting.

The Asian crisis is evidence that economic growth and financial stability are related but separate policy objectives.

The Asian crisis also demonstrated the need for *market-based mechanisms that could facilitate more orderly private debt workouts.* The complication with the Asian crisis was that it involved a large number of private-sector debtors, rather than a

sovereign debtor. This calls for a debt restructuring mechanism that would impose a generalised standstill on a country's debt servicing obligations, in tandem with bringing together debtors and creditors for collective rollovers and debt renegotiation. This would have reduced the need for costly IMF bailouts and a reduction in the moral hazard created by these bailouts. Investors and creditors would also exercise greater due diligence and focus appropriately on risk in good times, since they would have to bear the consequences of their decisions. One market-based alternative that has been taken up by some emerging economies is to set collective action clauses in bond issues, requiring investors to authorise a third party to represent their collective interests in the event of default.

Finally, the crisis revealed *the need for stronger social safety nets in most emerging economies.* Strengthening governments' capabilities to sustain essential social services to the most vulnerable segments of their populations should become a priority area for development lending and assistance. This in turn requires institutions such as the World Bank and regional development banks to develop the expertise in fiscally sustainable unemployment insurance/assistance programmes that do not undermine work incentives. In many emerging economies, families and local communities have tended to play a bigger role than the state in delivering such assistance. In this context, the IFIs should look to strengthen and build on these existing structures rather than require governments to supplant these traditional institutions of providing assistance.

This article is extracted from a case study prepared by the author, as Director of the Institute, for teaching within the Institute of Policy Development, Civil Service College.

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NOTES

1. Staff team led by Charles Adams, Donald J. Mathieson, Garry Schinasi, and Bankim Chadha, "The Asian Crisis: Capital Markets Dynamics and Spillover," in *International Capital Markets: Developments, Prospects, and Key Policy Issues* (Washington, D.C.: International Monetary Fund), 13.

2. Glick, Reuven, *Thoughts on the Origins of the Asian Crisis: Impulses and Propagation*, Pacific Basin Working Paper Series PB98-07 (San Francisco: Federal Reserve Bank of San Francisco, September 1998), 3.

3. Between 1990 and 1996, the ratio of bank lending to GDP, grew by 60% or more in Thailand (from 64% to 102% of GDP) and the Philippines (from 19% to 49% of GDP), 30% in Malaysia (from 71% to 93% of GDP), and 10% in Korea (from 52% to 62% of GDP) and Indonesia (from 46% to 55%). In Indonesia, modest bank lending to the private sector masked high levels of direct foreign borrowing by private firms.

4. Krugman, Paul, *Will Asia Bounce Bank*, Speech for Credit Suisse First Boston, Hong Kong, March 1998.

5. Stiglitz, Joseph, *Globalization and Its Discontents* (USA: W. W. Norton & Company, Inc., 2002), 104

6. Feldstein, Martin, "Refocusing the IMF", *Foreign Affairs*, March/April 1998.

7. Radelet, Steven, and Sachs, Jeffrey, *"What Have We Learned, So Far, from the Asian Financial Crisis?"* Mimeo, Harvard Institute for International Development, January 1999

8. Rubin, Robert E., and Weisburg, Jacob, *In an Uncertain World: Tough Choices from Wall Street to Washington* (USA: Random House, 2003), 258.

9. Foreign direct investment levels to the Asian-5 countries remained relatively stable throughout the crisis.

Interview with Adam Schwarz

Indonesia in the Financial Crisis: Advent and Aftermath

In your book *A Nation in Waiting: Indonesia's Search for Stability*, you argue that Indonesia suffered more than any other country in the Asian financial crisis not because its economic situation was more dire or because the International Monetary Fund (IMF) had prescribed the wrong kind of solution, but because the country's political system was "fatally flawed". Could you elaborate?

What distinguishes Indonesia's experience from that of, say, the Thais, Koreans or Malaysians is the fact that Indonesia essentially went through three major crises more or less at the same time. It went through a financial crisis not dissimilar to that experienced by the other Asian countries. It had a balance sheet mismatch at the national level in the sense that it had excessive dollar-denominated liabilities. It had weaknesses in the banking system from a regulatory point of view. And then, when the currency slipped, the banks were vulnerable and the companies that had borrowed cheap dollars were caught in a bind. That story is not dissimilar to some of the other countries that suffered from the financial crisis although there were some important differences.

The second was a political crisis. There was a change of administrations in Thailand and in Korea during the crisis as well as considerable political tension in Malaysia between then Prime Minister Dr Mahathir and his deputy Anwar Ibrahim. But what one saw in Indonesia was not so much a change of administration as a change in the form of government. Indonesia had had thirty-three years of authoritarian rule, during which many "modern" political and economic institutions, ranging from parliaments and supreme courts to regulatory bodies and watchdog agencies, were either not present or had been badly eroded. When you switch overnight from an entrenched authoritarian regime to a new system of government, the transition can be traumatic. Indeed, ten years on, Indonesia is still trying to develop the basic infrastructure to run a modern democracy effectively.

The third crisis that Indonesia experienced happened a little later—around 2000/2001—and it was related to the second crisis. Jakarta, once the omnipotent centre of power, came under increasing pressure to share the spoils of power. Laws passed at that time devolved considerable economic and political

power from Jakarta to the regions. But the regions were not institutionally prepared for such a delegation of power. There were no functioning bodies at the provinces and districts that could handle large-scale investments or taxation, for instance. The provinces and districts were starved for money as the centre was not dispensing the finances that it had said it would under the law. On the other hand, when the regions did receive the promised monies they failed in many cases to deliver public services effectively. This in turn deterred both domestic and foreign investment and led to an increase in corruption.

In short, there occurred, in a very short period of time, three fundamental transitions: from a healthy economy to near insolvency; from authoritarianism to democracy; and from an all-powerful Jakarta to a more decentralised system of government. And, in my view, that's why Indonesia's situation was worse by orders of magnitude than the other financial crises in the region.

That explains why Indonesia took a longer time to get out of the crisis, but what factors made Indonesia vulnerable in 1997?

In May 1997, at the beginning of the crisis when the Thai baht first devalued, the conventional wisdom was that Indonesia was not going to be seriously affected. In fact, some economists argued at the time that because strong fundamentals were in place and economic management was in safe hands, the rupiah would remain stable or even appreciate.

Obviously, it did not turn out that way. The rupiah started to weaken in July/August of 1997. An IMF package was worked out in October 1997, which, at that time, was pronounced impressive. Among other things, the package called for the closure of some weak-performing banks. However, President Suharto's children and some of his close allies started to undermine the package almost immediately by trying to get exceptions for their business interests. The message this sent—that the political needs of the Suharto family trumped broader economic considerations—was extremely damaging because it undermined the assumption that Indonesia's economy was in good hands. In January 1998, Indonesia agreed to a new reform package with the IMF which finally recognised that the country was in crisis mode. However, Suharto immediately started to undermine that agreement also, signalling to the markets that his stance had not really changed. Things started spiralling out of control thereafter.

At that point, the Central Bank was just funnelling money to the banks instead of closing them down for violating legal lending limits. The lack of financial prudence in lending at many of the large, conglomerate-owned banks created a

vicious cycle of bad monetary management, spiking the money supply and inflation, which in turn worsened the currency depreciation.

On the political front, crisis management was in bad hands. Suharto by that time was almost completely cut off politically, surrounded by confidantes and loyalists, and was seemingly unaware of the magnitude of the financial crisis facing Indonesia.

Do you disagree with critics like Jeffrey Sachs who argue that the IMF measures were incorrectly prescribed and exacerbated the crisis?

There is some validity to that view. But my own view is that the IMF had few choices to the path it took. Hypothetically speaking, if the IMF had adopted a much more hands-off approach, I am not sure things would have been better. The IMF did not create the economic weaknesses which left Indonesia vulnerable to a financial crisis in the first place, nor the country's personalised form of government, which made responding effectively to the crisis so difficult. The IMF certainly made mistakes in assembling the stabilisation packages in October 1997 and January 1998, but these were not, in my view, the main determinants of the crisis. Far from it.

Could things have been better? Certainly some public relations could have been undertaken to forestall capital flight after the bank closures were announced in October 1997. But this was something the Indonesians needed to do, not the IMF. At any rate, the bank closures did not work because Suharto's children were reopening those banks under different names within two weeks. Everyone knew that the people who owned the closed banks were far more politically powerful than the Central Bank as regulator. So they had strong suspicions that legal lending limits and other legal requirements were not being respected and, as it later turned out, all the suspicions were absolutely right. It is not right to pin the blame for this on the IMF.

One little discussed aspect here is the role of Suharto's economic technocrats. They well knew about the structural deficiencies and the damaging roles played by Suharto's cronies but were not politically strong enough to stop these activities. But the financial crisis presented an opportunity for them to address some of these deficiencies. The IMF did not on its own come up with the list of 50 structural reforms which formed the heart of the January 1998 stabilisation package. That list was very similar to the technocrats' wish list of things they would have liked to do but could not do for political reasons. Understandably, the IMF relied heavily on the technocrats for identifying the key reforms to extract Indonesia from crisis.

In sum, when you look back at the financial crisis in Indonesia, you cannot separate it from the political crisis. After October 1997, it became increasingly unlikely that Indonesia could solve its burgeoning crisis through financial measures alone.

A lot has changed in Indonesia, but would it now be able to ride out a similar crisis? What key political and economic challenges will Indonesia still have to address?

Economically, Indonesia has struggled to return to pre-crisis growth levels. For example, it has not benefited as much as it could have from the global commodities boom, which should have drawn far more investment into its oil, gas, nickel, copper and gold mining industries, among others. On the contrary, Indonesia has gone rapidly from major oil exporter to net oil importer. The decentralisation programme is partly at fault here. The regions do not have the capacity in terms of government institutions that the central government has to exploit these economic opportunities. Additionally, Indonesia has a long way to go in strengthening laws and policies to promote economic development—there remain many statutes on the books that deter legitimate businesses and scare away capital.

But Indonesia ten years on is a lot less vulnerable to the kind of financial crisis we saw in 1997 and there are several things to note in this respect. First, there is greater transparency in the system. We know more of what's going on, probably not quite as much as one would like, but certainly a lot more than we did pre-crisis. Second, economic institution-building is underway. There is an oil and gas sector regulator, a telecommunications sector regulator and a strengthened capital markets regulator. A strong law preserving independence for the Central Bank was passed.

Third, the gradual transition to direct elections at the national, provincial, district and municipal levels is building more transparency, accountability and trust into the political system, even if progress is far slower than many Indonesians would like. And, finally, the anti-corruption campaign of the current president, Susilo Bambang Yudhoyono, has finally begun to make inroads into an important problem that has bedevilled Indonesia since its independence. Ten years post-crisis, Indonesia's economy is a lot less flashy but considerably more stable.

Adam Schwarz is an Associate Partner currently based in the Singapore office of McKinsey & Company, the management consultancy. Schwarz is a regional specialist, with almost 20 years' experience working in Southeast Asia and China, including Indonesia,

Thailand, Vietnam, Singapore and Hong Kong. He has served several of McKinsey's public-sector clients in Indonesia and elsewhere in Southeast Asia on issues ranging from economic policy, organisational change and post-disaster reconstruction. He is currently leading a large-scale corporate transformation programme with a major natural resources company in the region. For the ten years leading up to early 1997, Schwarz was a correspondent for the *Far Eastern Economic Review* in different Asian countries, covering a broad range of business, financial, political, and economic issues. He is author of the highly acclaimed study on contemporary Indonesia, *A Nation in Waiting: Indonesia's Search for Stability* (Westview Press, 1999).

This article was extracted from an interview conducted by Premarani Somasundram, Principal Researcher, Centre for Governance and Leadership, Civil Service College on 10 September 2007.

Interview with Timothy F. Geithner

Asia After the Crisis: What Now, What's Next?

Timothy F. Geithner, President and CEO of Federal Reserve Bank of New York, discusses monetary and fiscal policy in the region a decade after the Asian Financial Crisis.

You were very much involved in trying to resolve the Asian Financial Crisis. Ten years on, with the benefit of hindsight, is there anything you would have done differently, in terms of international financial institutions and governments?

This is a hard question to answer because the right test to policy is based on what you could know then, not what you know now. Of course, it is very important to recognise that most of what made the crisis traumatic and damaging were decisions made before the crisis and the conditions that existed at that point. Those conditions gave governments very poor options. Most of what made the crisis traumatic was the size of the balancing problem and the constraints on how some policymakers could react.

One way to see this is to contrast the Malaysian experience with those of many other crisis countries—Singapore being an exception. Malaysia had been through an earlier crisis in the banking system and had largely cleaned that up. For this and other reasons, they entered that period of crisis in 1997 with a much stronger balance sheet and much less vulnerability.

Given the initial environment, it would have been very hard at the time for governments at that point to have done much to mitigate the crisis. Of course, if there had not been an election in Korea, political uncertainty in Thailand and a succession crisis in Indonesia, and if the governments had, at that point, put in place the set of policies they ultimately adopted three, six or even nine months later, the crisis might have been less damaging. But those are conditions that they probably could not have pushed for.

Given that the pre-existing conditions determined the magnitude of the crisis, could more have been done to prevent it, such as through increased surveillance and other measures by international financial institutions?

No, these conditions were essentially the consequences of choices made by governments, and I do not believe you

can expect to live in a world where governments will agree to constrain their sovereignty—in a way that will give an international organisation, such as the International Monetary Fund, the mandate to influence the country's exchange policies ahead of a crisis. It is a good idea for countries to be exposed to a system where you can have a second pair of eyes or alternative points of view and good advice to call on. But it would not be realistic to design an international surveillance regime that could make a substantial contribution to crisis prevention on this scale.

It is a good idea for countries to be exposed to a system where you can have a second pair of eyes or alternative points of view.

Nevertheless, Asian countries have generally learnt the right lessons in the dramatic policy moves they have made since the crisis. You could argue that the focus on foreign reserve accumulation is not the most compelling defence against crisis. In some ways, it is a reflection of market distortions and a lack of options, but you cannot but conclude that this policy has been very effective in addressing the set of initial vulnerabilities in a crisis that had been so traumatic.

It is one thing for governments to have dealt with the conditions that led to this Asian financial crisis, but are they sufficiently prepared for the next crisis to come, one that could be very different in nature?

The thing about crises is that the causes are largely unanticipated factors and the vulnerabilities are not the ones you can identify ex ante. This is a natural feature of markets. It is important to acknowledge that a lot of mature industrial countries with much more developed banking systems, financial systems, supervisory systems and government frameworks also go through periods of stress and financial crises. For some countries, such as Japan in the late 80s, or in parts of Scandinavia before that, there had been very challenging systemic financial crises even though they did not enter a period with the type of acute balancing vulnerability found in Asia.

The basic policy prescription is relatively straightforward: make sure fiscal policy is reasonably prudent; monetary policy has the flexibility and independence to address threats to price stability and sustainable growth; the banking systems have strong enough cushions; and moral hazard does not destroy incentives so that the financial system can absorb much more volatility. Overall, of course, you want an economy that is flexible enough to absorb shocks.

There are two basic options for dealing with a world with a more open capital account. One is to insulate the economy from constrained volatility. Another is to prepare to live with it more freely and comfortably. Often this is the only viable path for very open economies like what you see in Asia in general.

In your view, what is the new role of monetary policy, particularly in the face of asset price volatility and the disinflation effect of China prices?

The academic consensus on the China effect is not very well developed. Some would say that the impact of this huge increase in the global oversupply is going to provide a sustained downward pressure on manufacturing goods and prices and so on. Others argue that this huge increase in demand for commodities could result in a completely different net effect.

I think now that you see more pressure on resources and on goods inflation in a place like China, there may be early signs that the disinflation effect may be diminishing.

The broader impact on monetary policy in general is more complicated. I think countries that are still trying to tightly manage the volatility of the exchange rate—particularly those that are more closely integrated with the United States and China—face a risk that over time, it will become harder to sustain that commitment to exchange rate stability with a commitment to price stability. In much of Asia, you don't really have that pure combination of an independent central bank with a clear price stability mandate. The typical construct in Asia is a more mixed model where you have a much more closely managed exchange rate, and central banks with a range of different objectives and not fully independent.

In terms of asset price volatility in the world of price stability, the overwhelming consensus among academics and central bankers now is that if you get the monetary policy wrong, you could amplify the volatility of asset bubbles. You might make the bubbles worse and you might make it harder for monetary policies to cushion the effects of the bubble.

In some ways, the definition of a good monetary policy means that you can't effectively use monetary policy to defuse these potential bubbles ex ante. There are two arguments for this: One is that you don't really know about asset price bubbles until after the fact. Even if they look obvious in the present, you can't tell for sure whether they are in the early stages. You don't know the scale of the mispricing. The second argument is that monetary policy could act to defuse the bubbles but the damage it might cost might not be worth the benefit.

Singapore was an early globaliser and this has benefited all segments of society. Yet the fruits of economic growth brought about by globalisation are becoming much more unevenly distributed now than before. What do you think is the role of fiscal policy in helping economies adjust to the inequitable distribution of economic growth?

This is a challenge common to countries both rich and less rich. The consensus in the US is to look less at fiscal policy as the solution to that problem and to look more to areas where Singapore is already exceptionally good, such as improving the evenness and the quality of educational outcomes, as well as adapting important features of the safety net, particularly in terms of health insurance and pension funds. The approach is to make people more comfortable living in a world where they're going to change jobs many different times, where they must face more uncertainties and more anxieties about the stability of the economic future. Of course, you have to finance these things and there is going to be rich debate on the optimal ways to finance these measures over time.

The US has had a long period of expansion, relatively low unemployment, and good average increase in incomes. Our demographic trends are a little bit later than in many countries. Our initial fiscal stances also give us a bit more room to manoeuvre. As a result, there hasn't been enough pressure yet to force political resolution over these kinds of challenges. You see the beginnings now of a necessary debate over evolution of the tax regime, health insurance and social security, but we're at the early stages on these issues.

One of the nice things about central banks, even a central bank like ours that does many different things besides monetary policy, is that our responsibility ends before fiscal policy, education and healthcare and all these other areas.

> The challenge is to make people more comfortable living in a world where they must face more uncertainties about the stability of the economic future.

That said, we are not quite the same as the more common and classic central banking system which leaves the central bank with only monetary policy and takes everything else out. We're more like Singapore in the sense that we do broader surveillance and other functions. I think that a more integrated model is a better model and a more comfortable model. The broader question about integration with fiscal and monetary policy is a complicated one.

I have to say I look at many aspects of your system with a lot of envy, because

you have an exceptionally meritocratic, high quality civil service and the capacity to do things with public policy that governments have to do. Hopefully, our own policy system will be up to the challenge in the future.

Mr Timothy F. Geithner became the ninth President and Chief Executive Officer of the Federal Reserve Bank of New York on 17 November 2003. In that capacity, he serves as the Vice Chairman and a permanent member of the Federal Open Market Committee, the group responsible for formulating the monetary policy of the US. Mr. Geithner was Director of the Policy Development and Review Department at the International Monetary Fund from 2001 until 2003. He served as Under Secretary of the Treasury for International Affairs from 1999 to 2001, and was closely involved in the response of the international community to the Asian Financial Crisis. He was in Singapore as the guest-of-honour and speaker at the Economic Society of Singapore's Annual Dinner 2007, and was interviewed by Donald Low, Director of the Institute of Policy Development, Civil Service College, Singapore on 13 June 2007.

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