NUS National University of Singapore

Headlines: Making The Case For GST Roll-back
Source: *The Straits Times,* Review, pA18
Date: 26 January 2009

ECONOMIC WATCH

Making the case for GST roll-back

By Basant K. Kapur

THE Budget proposals presented to Parliament by the Finance Minister Tharman Shanmugaratnam last week contain many positive features, such as the Jobs Credit Scheme, the enhanced Workfare Supplement and the limited drawing on past reserves. However, in one important respect, it would appear that more could have been done.

As Mr Shanmugaratnam stated, the Resilience Package is "mainly a supply-side approach, aimed at keeping jobs". Supply side measures have been a hallmark of fiscal policy here, the justification being that in a highly open economy like ours, the stimulation of, say, consumption demand would not be particularly effective owing to high import leakages. But the facts do not entirely bear this out.

According to the Singapore Input-Output Tables 2000 (the latest available), the import content of consumption expenditure in Singapore is only 34.1 per cent. The "total (domestic) value-added" content is 53.7 per cent, with a further 12.2 per cent comprising import duties and "other taxes on products". By contrast, the import content of investment expenditure is as high as 55.9 per cent, and of exports 59.2 per cent.

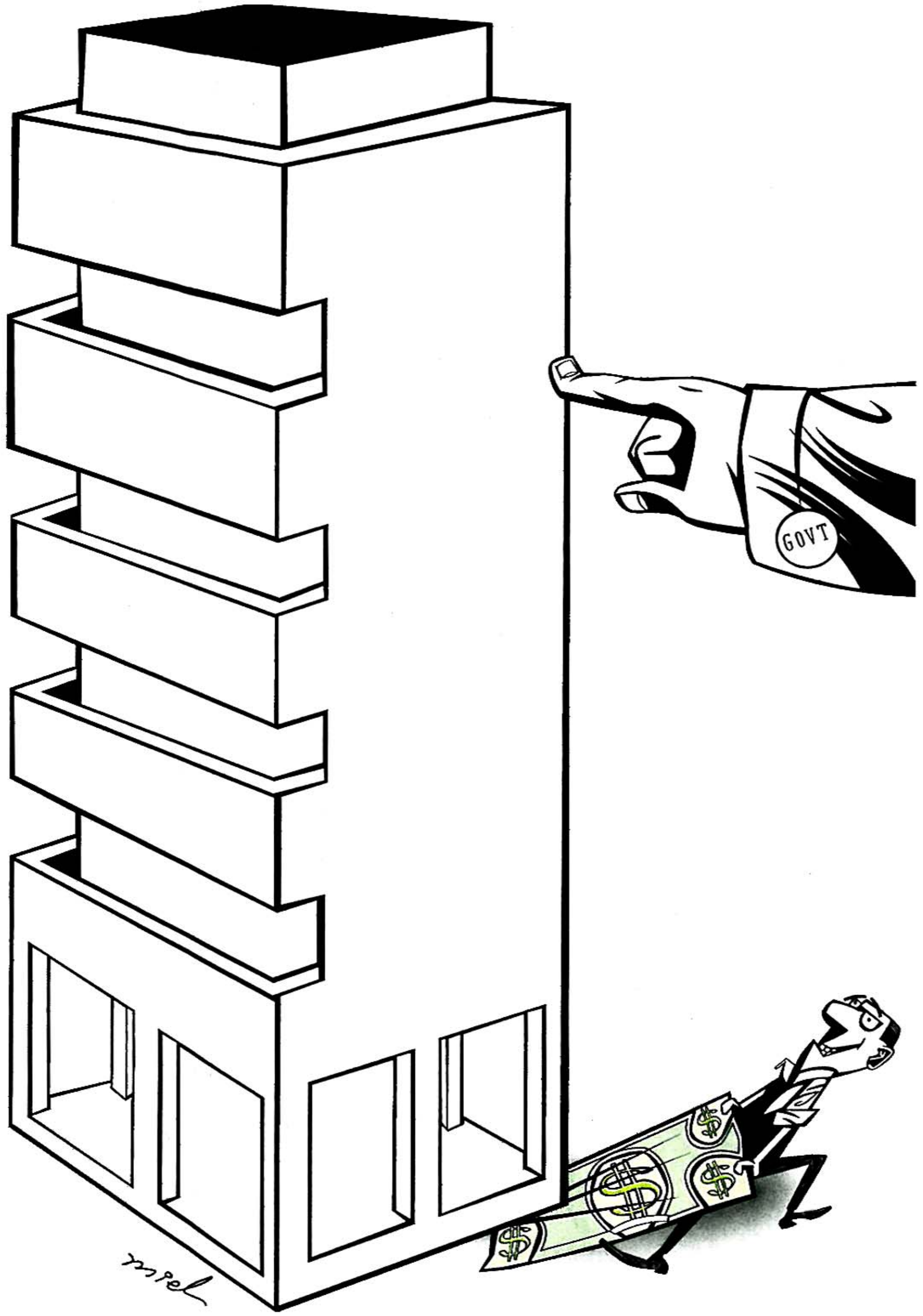
Stimulation of domestic consumer demand, to the extent feasible, would thus appear to be advisable. Lowering the cost of keeping workers employed will not suffice to maintain employment if there is insufficient demand for the products of firms. So both demand and supply sides deserve attention.

More specifically, as Professor Tan Khee Giap pointed out in these pages last week, domestic demand is of particular importance to our small- and medium-sized enterprises, which account for 55 per cent of our total employment, and to the wholesale, retail and commerce services sectors.

How, then, might consumption demand have been stimulated through Budget measures? The most direct measure would have been to roll back the two percentage point increase in the Goods and Services Tax (GST) that was instituted in 2007. Many observers, myself included, had argued against this increase. This year's Budget proposal to increase GST credits and to target them at the less well-off, is not likely to provide as broad-based a stimulus to consumption as an across-the-board two percentage point reduction in the GST.

This is particularly likely to be the case if what economists term the "real balance effect" is also taken into consideration – the fact that higher prices reduce the real value of fixed-nominal-value assets (such as bank deposits), and thereby exert a negative wealth effect on consumer spending.

Some figures in this regard are instructive. In its Macroeconomic Review of January 2003, the Monetary Authority of Singapore estimated that a 1 percentage point GST increase would increase the



Consumer Price Index (CPI) by about 0.4 percentage points in the same year, and by about 0.75 percentage points in total eventually. Thus, the two percentage point GST increase can be expected to increase the CPI by about 1.5 percentage points. Another way of looking at this is to say that the GST increase has contributed to the negative real interest rates earned by fixed nominal-value-assets over the past year.

What is the size of these assets? The two key items would appear to be M3 (currency in circulation plus deposits), and CPF balances. According to MAS and CPF Board figures, these amounted to about $306 billion and $136 billion respectively in 2007. Thus, a GST-induced 1.5 percentage point increase in the CPI would generate a one-time $6.6 billion reduction in the real value of these assets – a sizeable capital loss. It imposes a welfare loss to the holders of these assets, Singaporean or foreign, and also tends to diminish the attractiveness of Singapore-dollar-denominated fixed-nominal-value assets as a "store of value".

To be sure, not all of these assets are held by Singaporeans, and the depressing effect on consumer demand here would be correspondingly less. However, there would certainly be a negative effect. Right now, our economy needs "all the help it can get", and even a modest stimulus to consumption from a GST roll-back would be welcome.

An estimated tax revenue loss from a 2 percentage point GST roll-back – about $1.8 billion – is well within the Government's capabilities to absorb. In fact, the revenue loss should be less than this, since the need for enhanced GST offsets would be lessened by a roll-back, and if, as I would argue, the roll-back induces an increase in consumption spending.

Finally, a brief discussion of related, longer-term issues. In a recent article in this newspaper, economists Sim Moh Siong and Kit Wei Zheng pointed out that "consumption constitutes less than 40 per cent of Singapore's GDP – and the figure has been falling consistently". By contrast, the figure for "another equally open economy", Hong Kong, is over 60 per cent. This certainly increases the vulnerability of Singapore to external shock. They also suggested that one reason for Singapore's low consumption-GDP ratio is the high levels of home ownership here.

This raises further issues which are worthy of investigation. It is frequently argued that high housing prices in Singapore, including prices of HDB resale flats, are due to "market forces". However, as the main provider of housing properties in Singapore, the Government is certainly in a position to influence market forces. Increased supply of HDB flats would tend to reduce their prices below what they would otherwise be, and induce some substitution of HDB for private accommodation, thus reducing the prices of private properties as well.

In my view, this is a longer-term policy option which deserves careful consideration. Some decline in housing prices would not be disruptive. At the very least, over the longer term, further increases in housing prices should be significantly moderated.

The writer is Professor of Economics and Director, Singapore Centre for Applied and Policy Economics, Department of Economics, National University of Singapore.