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THE FOUR MYTHS OF INEQUALITY IN SINGAPORE

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Whether measured by the Gini coefficient, or by the ratio of incomes between the top and bottom quintiles, the evidence points to an incontrovertible fact: income inequality in Singapore has risen significantly in the last ten years or so. While this fact is beyond dispute, there is little agreement in the government on whether it represents a problem that merits serious policy action.[1]

The Singapore government's approach to inequality is grounded in a number of implicit, but strongly-held, assumptions about the objectives of economic policy and the relationship between economic growth and social equity. These assumptions have attained an almost mythical status in Singapore, both among policy circles and among

Singaporeans at large. They are reflexively applied in any debate on inequality, and form a common point of reference—an internally consistent paradigm—against which alternative ideas for organising the social security system are evaluated.

The purpose of this essay is to articulate these mythical assumptions and subject them to a closer examination. Like all myths, they contain an element of truth. But it behooves the policymaker to question and assess the validity of these myths in light of economic theory and evidence. Only then can they approach the problem of inequality in a pragmatic way devoid of dogma and ideology.

Myth #1: Inequality is a necessary counterpart of economic dynamism and competitiveness

What the Myth Says

The first myth is the belief that rising inequality is an inevitable consequence of rapid economic growth, or put more strongly, a necessary condition for economic competitiveness. Since unequal rewards spur individual effort and enterprise, it has been argued that policies that reduce inequality invariably reduce incentives for people to work and strive.

Governments that try to mitigate the unequal consequences of globalisation—through more progressive taxation, more redistributive spending, and a stronger social safety net—will raise costs for businesses and capital owners, who are now far more mobile than before. In doing so, they kill the goose that lays the golden eggs. They sacrifice economic dynamism. There is an inescapable trade-off between economic growth and social equity. This is the "Golden Straightjacket" that Thomas Friedman famously expounds in *The Lexus and the Olive Tree (*1999): when countries join the globalisation system, they find that their economy grows and their politics shrinks.[2] If they want their economies to grow, governments have no choice but to slash income taxes, cut spending on social protection programmes, and roll back state provision.

Prime Minister Lee Hsien Loong also alluded to this trade-off between economic performance and social equity in his speech at the ComCare appreciation lunch in 2010:

> "If you look at America and Europe, they have different models. In America, somewhat less welfare and greater emphasis on self-reliance. In many countries in Western Europe, a very comprehensive welfare state. You can see the result of these different approaches and the way the two societies and two economies feel. America has a more dynamic and competitive economy with fiercer competition. Europe has more generous benefits, more solidarity, not so strong competitiveness but the Europeans believe that they have made a rational choice, a rational trade-off. In return for less growth, they enjoy more welfare, more solidarity and they felt that they were the happier for their circumstances. But it was not entirely as happy as that. In fact, Europe was living beyond its means. It took some time for the problems to show up but I think Judgment Day has been brought forward by the financial crisis. After the huge hole in their budgets because of the rescue of the banks over the last couple of years, the Western Europeans have woken up to a very serious problem and they have been forced to make very tough choices."[3]

What the Evidence Says

At first glance, this myth seems consistent with international evidence and economic theory. Income inequality in almost all the rich countries has risen in the last 20 to 30 years. The reasons for this are fairly well-known though they remain subjects of academic debate. Rapid technological advances have pushed up the wages of highly educated, highly skilled workers (paying them what economists call the "skill-biased premium"), while globalisation and the entry of large numbers of low wage workers from China, India, and other developing economies have held down the wages of the less-skilled in rich countries.

Other policy and institutional factors have also contributed to the rise of inequality in rich countries. The collapse of unions in the US, for instance, has reduced the bargaining power of labour relative to capital-owners. Immigration in some rich countries has brought low wage competition to the non-tradable sectors of the economy. Meanwhile, reductions in corporate and personal income tax rates in many countries—partly in response to increasing global competition—have reduced the progressiveness of tax systems and accentuated inequality within countries.

But does the relationship between inequality and economic growth stand up to closer scrutiny? It appears not. Despite its intuitive logic, there is little evidence to show that more unequal countries do better economically, or that more equal ones pay a large economic price in terms of competitiveness.

Developed countries that spend less on social welfare—such as the US—are not necessarily richer than those that spend more. What about the claim that Europe's social security systems are unsustainable? True, many of them need to be reformed for their ageing populations and be put on a stronger fiscal footing. But the countries that are facing the most severe fiscal problems—Greece, Italy, Portugal and Spain—are hardly known for their generous welfare systems. The ones with the most generous social provisions are the northern European countries: Germany, Netherlands, Denmark, Sweden, Finland, and Norway. These are export-oriented, surplus economies with sound fiscal balances and strong social safety nets. The claim that Europe's fiscal mess is the result of overly generous social welfare systems simply cannot be substantiated.

More importantly, we should question whether the economic performance of countries should be measured only in terms of income (or per capita GDP). Surely, what citizens care about is not some abstract notion of aggregate production that does not take into account how that "national income" or GDP is distributed or how society values the stuff that is produced. Various economists have therefore suggested that governments, in measuring economic progress, should also take into account other indicators of well-being. These include consumption, health and longevity, leisure time, and yes, how fairly incomes are distributed. By these measures, Singapore does not do as well as its per capita GDP suggests.[4]

The conclusion that inequality neither contributes to economic growth nor is its necessary consequence should not be surprising at all. Economic growth is a complex process involving a number of technological, policy, and institutional factors. It is not apparent that a country's income inequality has a statistically significant correlation with economic growth or competitiveness. Even if it does—to the extent that citizens care about the distribution of income and other indicators of well-being, and not just the level of per capita income—nothing in economics says that countries should pursue only per capita GDP growth at the expense of the broader indicators of well-being. That some countries do is a consequence of their own values and politics, not of economic logic.

Myth #2: The best way to help the poor is to help the rich

What the Myth Says

A common refrain that one hears in the Singapore government is that we first have to grow the economic pie before we can share it. Like it or not, it is the rich and talented who invest, spot, and exploit economic opportunities, and create jobs for the rest. Depriving them of their just rewards by levying high income or wealth taxes on the rich simply reduces the incentive for them to create wealth, thereby hurting the poor and the rest of society. In the long run, the best way to help the poor is to help the rich grow the pie. Societies can afford more generous redistribution when the economy is doing well and governments can afford to increase social spending. “Equity needs growth” is the common refrain from the PAP government.

What the Evidence Says

Have pro-rich policies led to faster economic growth, which then raised the incomes at the bottom? The evidence on this is mixed at best. Among rich countries over the last 60 years, the evidence in fact suggests the opposite: countries tended to grow faster in the years they were doing more for the poor than in the years they were trimming social safety nets and cutting taxes for the rich. Following the Second World War, there was rapid growth in progressive taxation and welfare spending in most of the rich capitalist countries. Despite this (or perhaps, partly because of this), the period between 1950 and 1973 saw the highest-ever growth rates in these countries. Since then, rich countries have never managed to grow faster than that.

When growth slowed in the mid-1970s onwards, the diagnosis in many developed economies was that the reduction in the share of income going to capital owners was the reason for the slowdown. Across the rich world, and especially in the US and Britain, policies that reduced the redistributive role of the state were introduced. There were tax cuts for the rich (top income tax rates were brought down) even as social welfare spending was reduced. Financial deregulation created huge opportunities for speculative gains as well as astronomical pay cheques for top executives and financiers. Unions were weakened, making it easier for employers to sack their workers. And trade barriers were dismantled, putting downward pressure on low-end wages in the rich world.

During this period, income inequality is the US, already the highest in the rich world, rose to a level comparable to that of some Latin American countries. Much of this was driven by the rise of the super-rich in the US. Between 1979 and 2001, the top 5 per cent in the US saw their share of national income increase from 15.5 per cent to 21 per cent. This was mainly because of the astronomical increase in executive pay, which in the aftermath of the 2007–09 financial crisis appears both unjust and unjustified.

Trickle-down economics may be justified if the benefits of growth do in fact trickle down. Again, the evidence from highly unequal countries such as the US suggests that this does not occur if simply left to market forces. In contrast, countries with a strong welfare state find it much easier to spread the benefits of economic growth. Through more redistributive fiscal systems, northern European countries have much more equal income distributions than the US even though their income distributions before taxes and transfers are not all that different from the US's.

To sum up, there is no reason to presume that trickle-down policies will accelerate growth or benefit the poor. Even when there is more growth, the trickle-down that occurs through the market mechanism is very limited.

What about Singapore's experience? Has trickle-down worked? It is less clear whether the increase in income inequality in Singapore over the last decade has been accompanied by a similarly perverse distribution of income to the super-rich as experienced in the US. Nevertheless, there are some reasons for concern. To begin with, the state may have become less redistributive at a time when its redistribution functions are needed most. Government policies over the decade may have accentuated the rising income inequality wrought by market forces. For instance, the tax system has become less progressive. Corporate and personal income taxes have been reduced significantly while the Goods and Services Tax (GST), a regressive tax, has more than doubled. More liberal foreign worker policies might also have worsened income inequality in Singapore.

If these tax and labour policies had in fact generated more growth, and if the government had been aggressively redistributing the fruits of growth to large segments of the population affected by wage stagnation, trickle-down economics may not be all bad. But while the Singapore government has increased spending on lower income segments of the population, through Workfare and discretionary fiscal transfers, its redistribution has simply not been aggressive enough. This is demonstrated by fact that the income inequality after taxes and transfers has worsened at about the same rate as the income inequality before government redistribution. Indeed, income inequality today, after taking into account government taxes and transfers, is worse than it was a decade ago *before* accounting for government redistribution. This implies that the growth that Singapore has enjoyed in the last decade or so has not translated into proportionate gains for those at the lower end of the income distribution, and that growth has not reduced inequality.

Myth#3: Inequality is not really a problem as long as there isn't extreme poverty and incomes are rising across-the-board

What the Myth Says

The third myth says that policymakers should not worry about inequality per se. As long as there are opportunities for all to a good education, high social mobility will dampen people's demands for a fairer distribution of income. Furthermore, as long as everyone's incomes are rising, the fact that incomes at the top are rising much faster than those at the bottom is not a cause for concern. An analogy would be that as long as the rising tide lifts all boats, the fact that some boats (the yachts for instance) are being lifted up much faster than the rest should not matter. Meanwhile, extreme poverty can be addressed with targeted measures such as social assistance. These limited welfare programmes for the indigent and those who cannot work and have no other means of financial support are affordable so long as they are strictly means-tested. There is no need for measures that redistribute incomes significantly since the problem—poverty—is a relatively limited one that can be surgically addressed.

The underlying assumption behind this myth is that people care only about their absolute, and not relative, levels of income. So long as my income is rising, I should be happy and should not begrudge my neighbour's income rising at a faster rate. To do so is irrational, and governments should not pander to my irrationality or green-eyed envy by redistributing income from my neighbour to me. Parents should also teach their children to be satisfied with what they have and not compare themselves with those who have more.

What the Evidence Says

To begin with, conventional economics does not prescribe that distributional concerns should be subordinate to growth objectives. Even if one takes a purely utilitarian view, there is a case to be made for redistribution. Since an additional dollar is worth more to the poor person than it is to the rich person, a utilitarian perspective says that any growth in incomes should accrue to the poor and that this should continue until everybody's marginal utility is the same. Furthermore, to the extent that increasing inequality reduces society's well-being, it hurts the rich as much as it does the poor, and redistribution would enhance overall welfare. For instance, inequality has been shown to increase crime, which hurts the interests of everyone, not just the poor.

People's general psychology also provides additional reasons for redistribution. Behavioural experiments have suggested that people care just as much about fairness and relative income as they do about absolute gains. In the ultimatum game, for instance, people routinely reject offers that they consider too low even though they are better off accepting whatever offer that is made to them. This suggests that people believe that windfall gains should be shared with others in society.

We should also try to understand the effects of inequality and why people care about them. One line of argument emphasises the role of positional goods (i.e., goods in which people's utility depends on how much they own relative to others). The point about positional goods—and of fashions and brands in general—is their relative attractiveness. Owning a better car or the latest branded fashion item gives me more utility when others do not have it, much like how buildings are valuable because of their location. With such goods, the rising tide does not lift all boats. I yearn to be not merely richer, but richer than my neighbours. The more important brands, fashion, houses, cars and other positional goods are in a society, the more relative income and inequality matter.

Rising inequality causes people to be more conscious of their status and to channel more of their spending to positional goods. Because the incomes of the rich are rising faster than everyone else's when inequality is increasing, they can afford to spend more on such goods. Their spending causes "expenditure cascades" that induce others lower on the income ladder to also spend more just to keep up. But in an era of rising inequality, the incomes of the middle class and the lower income groups are not rising as fast; they can only spend more on positional goods by diverting resources from non-positional goods (such as leisure time, or having babies) or by taking on more debt.

What about the claim that equality of opportunity ensures social mobility and so governments need not worry about rising income or wealth inequality? Again, while this has some intuitive appeal, it is not borne out by empirical evidence. Countries that are more unequal, such as the US, also tend to be less mobile (as measured by how much of a person's income is predicted by his parents' income) than countries that are more equal, such as Canada or the welfare states of northern Europe. Why should this be? It turns out that equality of opportunity cannot be easily separated from equality of outcomes. Unequal resources easily translate into unequal access to opportunities, say to quality education. Families with more resources have greater means to ensure that their children have a better education. A more unequal society therefore finds it harder to achieve genuine equality of opportunity and social mobility than a more equal one.

To sum up, there are sufficient reasons—both theoretical and empirical—for policymakers to start taking inequality seriously even when incomes across-the-board are rising. They should also reject the glib and empirically false dichotomy between equal opportunities and equal outcomes. Being an opportunity society requires active government redistribution of incomes if market forces are producing more unequal outcomes.

Myth #4: Since pay is tied to ability, rising inequality is simply the result of increasing differences in people's ability

What the Myth Says

In a market economy, people are paid according to their marginal productivity. If the worker in the top 20th percentile earns ten times more than the worker in the bottom 20th percentile, it is simply because the former is ten times more productive than the latter. While this outcome may be difficult to accept, it is nevertheless the case that there are wide differentials in people's ability and that these are reflected in wide income disparities. Attempts to reduce these pay differences—say by introducing minimum wage legislation—lead only to inefficient and rigid labour markets. Consequently, it follows that the best way to increase the incomes of middle and low wage Singaporeans is to increase their productivity. That their wages have been growing slowly in the last decade is the result of their stagnant productivity levels.

What the Evidence Says

As with the first three myths, this one also contains a kernel of truth. There is some evidence to suggest that Singapore's workers in the service industries are less productive than their counterparts in other rich countries. Cleaners, service staff, and construction workers are probably more productive in, say, Sweden than they are in Singapore.

But the question still remains: why has inequality increased at a time when quality education in Singapore has become widely available? The democratisation of education suggests that differentials in productivity should have narrowed, which in turn suggests that wage differentials should also have been reduced. Singapore prides itself in having one of the world's most successful education systems that not only enables bright children to do well, but also everyone else. If so, why should a lower-wage Singaporean worker, who has benefitted from the state education system, be less well-paid than his Swedish or Swiss counterpart doing a similar job? Is it possible that something else other than individual productivity determines our wages?

In reality, wages are not just a function of one's productivity levels.

The other important determinant of market wages in rich countries is immigration. Low-skilled workers in many European countries earn more because of tight immigration controls. If these countries were to import large numbers of low-skilled workers from poor countries, it is hardly conceivable that their low-skilled workers can continue to earn the wages they do now, their relatively higher productivity levels notwithstanding. A Swedish bus driver, for instance, probably earns 30 times what his Indian counterpart does. If Sweden were to allow Indians and other immigrants from poorer countries to enter its labour market, simple economics tells us that the wages of bus drivers in Sweden will be immediately depressed.

If the above analysis is correct, it suggests that to raise the wages of our low-skilled workers, the emphasis should *not* be on raising their productivity, but on reducing our intake of low-skilled foreign workers. All societies have limited capabilities to absorb immigrants. How open a society wants to be to immigrants is not just an economic choice, but also a political choice with social and economic consequences. Too rapid an inflow leads not only to more competition for jobs and reduced wages, but also stretches the country's physical and social infrastructures.

What about the high incomes of top-earners in Singapore? Aren't their high incomes the result of their higher ability and productivity? Yes, but only to a point. It is not only, or even mainly, because they are more clever and better-educated that the rich in Singapore earn many more times what their counterparts in poor countries do. They achieve this because they live in an economy that has better technologies, better infrastructure, better organised firms, better institutions, and better government—all things in large part products of collective actions taken over generations. As Warren Buffet said in a television interview in 1995:

> "I personally think that society is responsible for a very significant percentage of what I've earned. If you stick me down in the middle of Bangladesh or Peru or someplace, you'll find out how much this talent is going to produce in the wrong kind of soil. I will be struggling 30 years later. I work in a market system that happens to reward what I do very well—disproportionately well."

Why These Myths Matter

The myths matter for public policy because they shroud almost every discussion of inequality and of how our social security system should be organised in a thick and unquestioned set of assumptions. They act as an ideological blinker, and cause the policymaker to respond reflexively to any suggestion to redistribute incomes and reduce inequality with the argument that doing so will compromise the efficient working of markets. The myths matter because they reduce the ability of the Singapore government to pursue pragmatic and creative solutions to the challenge of inequality. And like many other myths and ideologies, they prevent a comprehensive and objective assessment of the policy alternatives successfully pursued by governments elsewhere.

As cognitive psychologists have found, having a strong predisposition to a particular worldview deeply influences our assessment of the evidence. People—including policymakers—suffer from confirmation biases. This means that we seek and pay more attention to evidence that supports our existing worldviews rather than revise our worldviews constantly in light of new evidence. When confronted with contrarian evidence, or evidence that goes against our worldviews, the result is cognitive dissonance. This is uncomfortable and so we react by denying the evidence altogether (e.g., "the northern European countries are not as successful as they are made out to be") or by discounting the veracity and credibility of the evidence (e.g., "your data is suspect", or "your methodology is flawed"). That policymakers also suffer from such cognitive biases is well-documented.

Questioning these myths opens up a number of possibilities for public policy in Singapore. At the broadest level, it throws up the question of whether the object of economic policy should be to maximise growth or per capita GDP regardless of its distributional consequences. Even if we assume that there is a trade-off between economic growth and social equity, the implication is not that societies should maximise the former at the expense of the latter. A trade-off means that governments should try to find the right balance of economic growth and social equity that reflects society's preferences.

In Singapore's context, given that per capita GDP is by some measures already the highest in the world, the marginal gains in society's well-being from further increases in income at the expense of social equity are likely to be very small. Put another way, Singaporeans are likely to be happier with a more equitable distribution of income (at the margin) than with further increases in per capita GDP that are not equitably distributed. The old adage of concentrating on growing the economic pie before worrying about how it is distributed—which may have been valid and relevant when Singapore was relatively poor—is no longer adequate as a guide for policymaking today.

Another implication is that policymakers should try to decipher the apparent mysteries around the more successful European economies. Once these myths are jettisoned, policymakers will be liberated to ask: Why have these countries been able to combine high levels of economic performance and productivity with high levels of equality? What economic and social policies have enabled them to achieve this? Why do their citizens appear willing to accept the high rates of taxation that are necessary to finance their generous social provisions? How do they deal with the problems created by moral hazard and free riders? What lessons can we draw from them in designing our own social safety nets?

My study of the issue suggests that what matters more for economic growth and competitiveness is not how generous a country's social protection system is, but how it is designed. It is not the level of social welfare spending that determines whether a country is on the efficiency-equity frontier but the way its social welfare programmes are organised and the incentive effects they create. Good design means paying attention to individual incentives, structuring the programmes in a way that encourages work, and redistributing incomes without reducing the incentive for investments. In short, the question governments should be asking themselves is not whether they can improve social equity without reducing growth but how they can achieve this.

Governments, including Singapore's, have more choices than they think. They can expand the range of choices they have by first discarding these myths about inequality.

Notes

1. I wrote this essay in March 2011. It has been slightly modified for this collection.

2. Thomas Friedman, *The Lexus and the Olive Tree* (New York: Harper Collins Publishers, 1999).

3. Speech by Prime Minister Lee Hsien Loong at the Comcare Appreciation Lunch, 2 Dec. 2010, http://www.pmo.gov.sg/content/pmosite/mediacentre/speechesninterviews/primeminister/2010/December/speech_by_prime_ministerleehsienloongatcomcareappreciationlunch2.html

4. Jones and Klenow for instance show that while Singapore's per capita GDP in 2000 was 83 per cent of the US's, Singaporeans' well-being (measured by consumption adjusted for factors such as leisure, longevity, and income inequality) was only 44 per cent of the US's level. Charles I. Jones and Peter J. Klenow, "Beyond GDP? Welfare Across Countries and Time", NBER Working Paper No. 16352 (2010), http://www.nber.org/papers/w16352