The compacts we need

Fiscal policies will have to be fundamentally repurposed to bring advanced countries' debts down to safe levels, avoid global instability and renew social solidarity.

Tharman Shanmugaratnam

When I started off as an economist at the Monetary Authority of Singapore in the early 1980s, the Latin American debt crisis was threatening global financial stability. Debts in several of the continent's economies surged to 70 per cent of GDP on average – well beyond the threshold considered sustainable at the time. It took a whole decade to resolve the crisis.

Today, it is the advanced economies that feature many of the same traits, but on a much larger scale. The G-7 countries have government debts averaging 120 per cent of GDP. Governments depend on central banks to keep interest rates down to avoid a self-reinforcing escalation of debts. And with polarised and fragmented politics, governing parties find it difficult to tighten the fiscal belt without losing the next election.

A GROWING SYSTEMIC RISK

What's different is that they are accumulating debts without the constraints that emerging markets face. They can borrow in their own currencies, they have deeper bond markets, their central banks have relative independence, and the markets simply give them favour as advanced countries.

But it is this very leeway that allows them to run up systemic risks. No one knows exactly where the limits lie, but ever-growing debt ratios will increase the interest rates that lenders demand, lead to chronic financial instability, erode trust in reserve currencies, and ultimately weaken growth globally.

Sentiment can also change suddenly, as we saw in the UK bond market revolt in September 2022 – the so-called "Liz Truss" moment. And markets today are more fragile for the fact that key participants, like hedge funds, are themselves highly leveraged.

Yet the largest fiscal challenges still lie ahead. Government budgets will be strained by ageing societies, the unavoidable need to address climate change, and the bolstering of defences in several countries amidst geopolitical disorder.

Governments can no longer rely on inflation to deflate the value of their debts, the way they did in the decades after the Second World War. Today's older electorate will surely resist this. The only realistic solutions involve higher taxes or lower spending, and in most cases both. But the longer countries put this off, the larger will be the needed reforms, and more excruciating the political choices. It will risk imposing an unbearable cost on today's younger workers and the next generation, and unravelling the social fabric on which democracies depend.

NOT JUST AUSTERITY

But this cannot simply be an agenda for fiscal austerity. The real challenge is to repurpose fiscal policy more fundamentally and with positive ambition. People must be able to see the value in the government spending that their taxes support, and have reason to be confident of the future. They must also know that everyone is contributing fairly to revenues based on their resources.

The key, too, is to ensure economic growth. Without it, fiscal health cannot recover, and any form of social solidarity becomes harder to sustain. There is fortunately good evidence that certain tax increases, closing of loopholes, and spending reforms, can be implemented without much harm to growth.

Bringing government debts back on track hence requires a new ethos, not just technical targets. It needs a few major reorientations in fiscal policy thinking.

PRIORITISE PUBLIC GOODS

First, to refocus spending on public goods, not just on individual benefits: especially effective public education and healthcare, modernised energy grids and public transport systems, R&D and lifelong learning institutes, and sporting and recreational parks that benefit all.

Bear in mind that high-quality, accessible public services, from pre-schools to playing fields to rail systems, benefit ordinary people the most. They are in effect redistributive, without relying on explicit transfers to individuals. And as research shows, public facilities foster interaction among people of diverse backgrounds, itself helping to promote social mobility.

FOCUS ON ECONOMIC INSECURITIES

Second, to rebalance the welfare state itself to focus on what concerns people most: dealing with major insecurities in life. Surveys show that the broad majority of people are more worried about insecurity than inequality per se. Inequalities certainly rankle, but are not their biggest concern.

All the more today, as jobs become less assured, and as people live longer and are more worried about their well-being in retirement or being suddenly saddled with a major hospital bill.

It takes us back to the idea at the heart of the original social democratic vision, shared by both the centre-left and centre-right in virtually every advanced nation although they termed it in different ways. It was focused on social insurance as a means of helping people deal with insecurity and misfortune. The post-war Beveridge plan in the UK epitomised this. Everyone would contribute something to a common pool, knowing that they stood to get some protection if they fell on hard times.

The idea was grounded on risk-sharing, rather than redistribution. But here too, the people to benefit the most were those at the lower rungs of the income ladder. It is they whose jobs are most precarious, who are more likely to drop out of the workforce because of ill health, and who lack the savings to deal with setbacks. And the payouts from social insurance have always meant much less to those with higher incomes.

There must always be adequate support for the poorest and most vulnerable in society. That, however, is not the major expense in today's welfare states. The real challenge is to rebalance the system: away from transfers to individuals on a much larger scale, beyond those most in need, and towards benefits of a more collective nature. In other words, to put the "social" back into social democracy.

Putting government finances on a sustainable track will be an enormous political challenge in many advanced countries. It can only be achieved with new fiscal and social compacts that help rebuild collective optimism in the future, says President Tharman Shanmugaratnam, adding that fiscal policy must be repurposed for the common good. PHOTO: AFP

PREPARE FOR CRISES

Third, to think longer term. It means moving from an excessive focus on smoothening the economic cycle, towards building the buffers needed to address the much larger crises that can devastate our societies, and the needs of ageing populations.

Crises exact an inevitable cost. However, for many years now we have seen heavy doses of macroeconomic stimulus being applied with each crisis and downturn, without then being withdrawn with the same robustness when things recover. The result has been perpetually large budget deficits, and prolonged ease in monetary policy, that leaves little space to address the next major crisis.

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We must expect crises to keep coming at us. They are baked into the new global landscape. Covid-19 is unlikely to be the most lethal pandemic we will experience. Climate change will demand sustained fiscal effort, both to invest in the transition to clean energy and to respond to increasingly frequent disasters.

BEND HEALTHCARE COSTS

Healthcare and retirement security will be the major drivers of government spending in the years ahead. They also highlight the fiscal compacts needed to ensure both fairness and sustainable finances.

There is no one healthcare model to be emulated internationally. But a few features are common among countries that are achieving better health outcomes, at affordable cost.

First, they have universal healthcare insurance. It may be run publicly, or by publicly regulated private insurers as is the case in Switzerland. But the essential feature is ensuring everyone is in the pool, including the young, the healthy and the well-off, who may otherwise opt out of a national scheme. Without such a diversified pool, the cost of covering the seriously ill will be much higher.

Second, however, we cannot rely too heavily on insurance to pay the bills. Experience shows how it can lead to more expensive drugs and treatments being prescribed than are clinically necessary, and for patients to willingly take them on as they don't think they are paying for them. It leads to higher costs for everyone over time.

Co-payments by patients are hence necessary to keep a check on costs. But equally, we need means-tested subsidies to help those with lower incomes to pay for both their insurance premiums and out-of-pocket payments. It keeps them protected, and avoids anyone being discouraged from seeing the doctor.

Universal insurance, co-payments by patients, and robust means-testing of benefits hence make for systems that are both fairer and more affordable. Healthcare that is instead free at the hospital or point of service, as it still is in some countries, is far from progressive. It simply gives those who are wealthy the same benefits as the poor.

Third, more effective spending can bend the trajectory of healthcare costs. And we know the highest fiscal and social returns come from spending to help people stay healthy, starting from childhood, so they reduce the need for healthcare itself.

Hence the critical need to shape children's diets and ensure they are active in school. Recent research also shows that "deaths of despair" in the US – from drugs, alcohol or suicides – are linked most strongly to people being detached from the workforce, and being less integrated in the community. They are among the examples that show that the social determinants of health are greatly important – and can be addressed at much lower cost than medical care.

REFORM RETIREMENT SECURITY

Pension reforms are urgently needed, but have been the most difficult to make politically. Calls from the left and right of the political spectrum are even made to undo previous reforms. Yet, a sustainable system of retirement security is indispensable for social solidarity.

Traditional, state-organised social security schemes are still the mainstay of retirement income for ordinary people in most advanced countries. However, while benefits are fixed in advance ("defined benefits"), they are not funded in advance. Payouts to retirees are instead funded each year by current workers, and as societies age the burden on those still working will become untenable, without reforms.

Denmark and Sweden made adjustments early. Governments explained the choices: people have to either work for longer, or accept lower incomes in retirement, or have existing workers increase their contributions to fund retirees. They came to a consensus that it was fairest to raise the retirement age in step with life expectancy. Germany is debating similar reforms. But time is running out on many other defined benefit schemes.

Part of the solution has been to rely increasingly on individual retirement accounts – where the amount you withdraw in retirement depends on the contributions you made into your account and the investment returns that you earned. The payouts from these "defined contribution" schemes are hence prefunded, unlike defined benefit schemes.

However, the shift to individual accounts has posed two challenges, which have been neglected in most countries. First, equity. As there is no longer any redistribution of benefits within a common pool, the poor are often left without adequate income in retirement. So defined contribution schemes have to be complemented with other ways of supporting them.

In Singapore, we do that through the government budget. The Government supplements the retirement savings of lower-income workers – through Workfare during their working years; through home ownership grants that enable asset appreciation; and by topping up their accounts in retirement itself. Those with smaller balances also get higher returns on their savings.

Second, the move from defined benefit to defined contribution schemes has, in practice in most systems, shifted investment risks onto the shoulders of the individual. The results have been troublingly uneven. Left to their own investment decisions, ordinary people often underperform the simple market indices over time. And in systems like the US, where you are allowed to withdraw your money each time you leave a job, the median worker has seen little accumulation of retirement savings.

There are, however, alternatives. The Netherlands, Denmark and Singapore have each adopted collective defined contribution schemes, where savings are pooled and managed by an independent body. In the Singapore case, individuals are also sheltered from the risk of capital market volatility, which is borne on the Government's own balance sheet instead.

These examples show how the pitfalls of defined contribution schemes can be overcome. They are an important middle ground, of retirement schemes that can serve the needs of ordinary workers while ensuring financial sustainability.

SUSTAINING PROSPERITY ITSELF

Putting government finances on a sustainable track will be an enormous political challenge in many advanced countries. It can only be achieved with new fiscal and social compacts that help rebuild collective optimism in the future.

We have to repurpose fiscal policy for the common good – by refocusing on much-needed public goods that everyone can benefit from, rather than large-scale transfers to individuals; by addressing the job, health and retirement insecurities that are the major concerns of both the poor and the middle class, more than inequalities at large; and by thinking ahead and seeking to avert major crises that can inflict lasting damage on our societies.

It is how we renew the sense of solidarity that sustains prosperity, and undergirds democracy itself.

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