

Singapore: FY2007 Budget Preview

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- We expect a higher-than-budgeted operating revenue to register a small fiscal surplus of S\$0.8bn in FY2006 instead of a S\$2.9bn deficit. Positive economic health and fiscal prudence will likely see the government announcing a budgeted surplus of S\$1.6bn in FY2007. Workfare scheme would be made a permanent feature in the Budget.
- Changes in the definition of Net Investment Income (NII) would imply a larger NII in FY2007 Budget, conservatively estimated at S\$3.5bn.
- Focus of FY2007 will be re-centered to emphasize on keeping Singapore competitive in the global arena.
- Corporate taxes likely to be cut by 2%age points to 18%, with the cuts staggered over two years.
- A one-time 2% GST hike to 7% in Jan 2008 as well as an equivalent offsetting relief package in FY2007 Budget is expected.
- Personal income tax rate cuts may also be on the cards, but likely to be capped at 18% from the current 20% till 2010.
- The government will be partially restoring the employer's CPF contribution rates, likely by 2%age points to 15% from the current 13% in FY2007 Budget. A variable component to the employer's CPF rate may also be introduced.

The Singapore government will be presenting the FY2007 Budget to the Parliament on 15 Feb (Thurs), a day after the release of the final 4Q06 GDP data - we expect only a slight revision of the 4Q GDP growth to 6% y/y from the Advance estimates of 5.9%, while full year growth in 2006 is revised up to 7.8% from 7.7%. Although GDP growth is expected to moderate slightly in 2007 to come in at 5.2%, the rate of expansion still remains healthy and we do not think the government will deviate from delivering a 'prudent and targeted' Budget this year. While the government would continue to help lower income/older workers and the elderly and share the fruits of its economic success with the less privileged, the budget will also likely to re-center its emphasis on maintaining Singapore's competitiveness in the global arena. Instead of a S\$2.9bn deficit budgeted last year, we estimate that the government is likely to accumulate a small surplus of S\$0.8bn in FY2006 on account of stronger operating revenue. The fiscal prudence stance will also likely ensure the current government will work towards a modest surplus of S\$1.6bn in FY2007 supported by higher investment income and lower expenditure.

NII Amended to Include Capital Gains

The higher investment income forecast is attributed to the government's decision to amend the Constitution and seek the President's approval to re-define Net Investment Income (NII) to include capital gains, as announced by PM Lee late last year. Presently, the Constitution defines NII as the dividends and interest earned from investing past reserves. The inclusion of capital gains could substantially increase the NII component within the Budget. The NII for 2006 is projected to be S\$2.4 billion and we have conservatively estimated NII this year to be higher at S\$3.5bn. If NII is much higher than our forecast, it will mean more distributable funds for Special Transfers component, which may imply a similar or better Progress Package given to the people this year. The increase in NII would also help offset the revenue reduction from lowered corporate tax rates and allow the government to embark on deeper corporate tax cuts, say 2% instead of just 1%.

Make Workfare a Permanent Feature in the Budget

While every Singaporean will get something from the Budget in the form of cash, rebates, top-ups etc, the bulk of the benefits accrue to the elderly and low income earners who have been most disadvantaged and "left behind" during the economic restructuring over the past years. The Workfare bonus scheme is specifically targeted at this segment of the population and the government intends to make it a permanent feature within the Budget. Last year, as part of the Progress Package, S\$0.4bn of workfare bonus was dished out. We can expect a better Workfare scheme package in FY2007 given the strong economic performance in 2006.

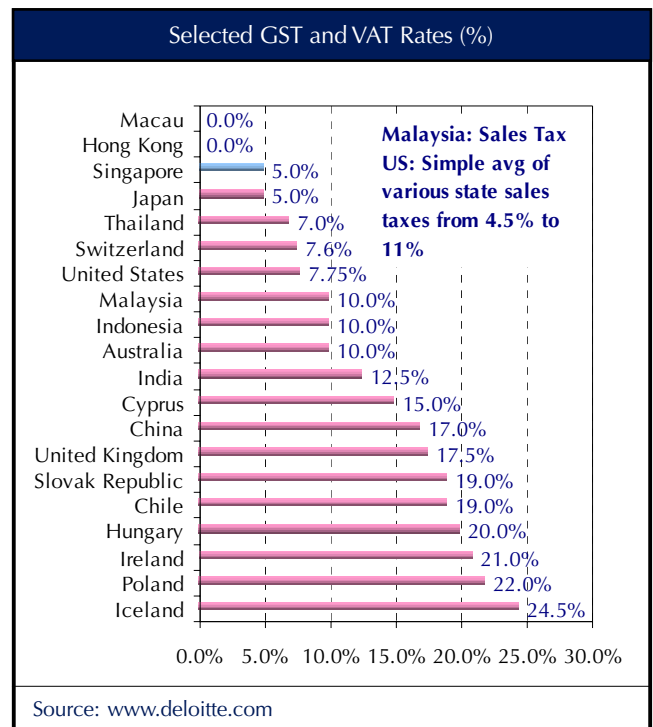
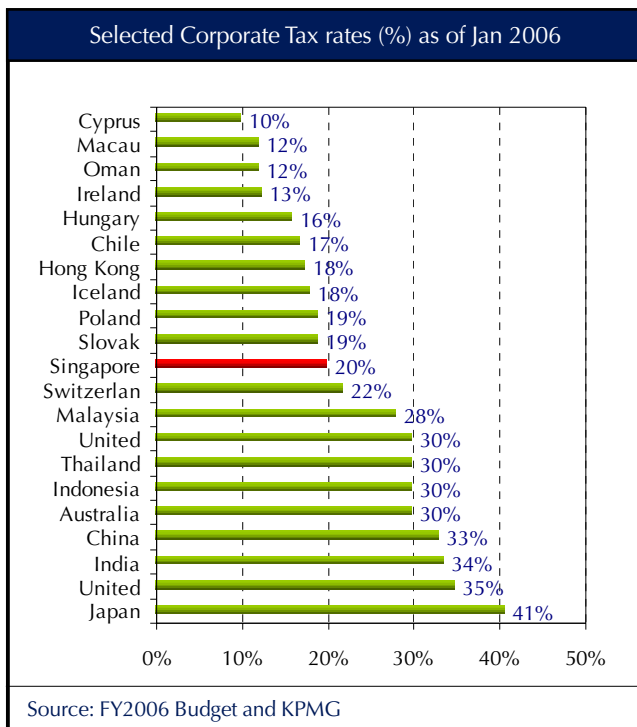
Impending Corporate Tax Cut

On 20 Jan, MM Lee gave the clearest indication of a business-friendly Budget this year, disclosing an impending corporate tax rate cut (of at least 1%). According to MM Lee, the cut would cost the Singapore government S\$400-500mn in lost tax revenue. Corporate taxes in Singapore have been progressively lowered over the years, most recently to 20% in 2005 and had remained unchanged in last year's Budget. With the upcoming announcement of a GST hike to 7% (from the 5% currently) in this year's Budget, markets have expected a corresponding cut in corporate (and even personal) tax rates, a move similar to FY2003 Budget when GST increased from 3% to 5%. We expect the highest corporate income tax to be lowered by 2%age points to 18%, staggered over 2 years (i.e. 19% in FY2007, 18% in FY2008).

GST Hiked to 7% and Unlikely to Stop There

Many countries have been gradually shifting their tax revenue base from direct towards indirect taxes over recent years. The increase indirect taxation has allowed the government to reduce the overall tax burden on income and capital while maintaining tax revenue largely unchanged. Both personal income tax and corporate tax rates have been lowered in many countries (such as Hong Kong, Ireland and Hungary) to attract investments and economic theory also tells us that indirect taxes are preferable to direct taxes because they create less of a disincentive to work since employees retain more of what they earn. By shifting to a lower marginal tax rate, workers will have the incentive to work longer and raise productivity. The long run impact of the tax regime shift would be to increase the potential output of the economy in the long term and actually bring about decline in the CPI as aggregate supply expands.

The current GST rate in Singapore is comparatively lower compared to other countries when matched against the corporate income tax structures. (Please refer to the charts) Thus, looking at the competitive environment, it is conceivable that there is still room for GST to be adjusted upwards beyond 7% while corporate tax rate is furthered lowered towards the league of sub-20%.



As hinted by PM Lee in the recent Singapore Tripartism Forum (24 Jan) and given that the government fees would be frozen for one year only when the GST hike kicks in, we expect the hike would be a one-time 2% increase in 2008 instead of the staggered 2-stage GST hike during 2003-04. We believe that the likely timeframe of implementation will be only in Jan 2008 instead of earlier for two reasons: 1) Hong Kong, one of Singapore's key competitors, just pulled the plug on their GST plan, and this probably gave Singapore some breathing space to implement her GST hike while trying to lower corporate and personal taxes in order to remain competitive with Hong Kong, and 2) With the first IR expected to be ready in 2009, the Jan 2008 implementation date will still allow the tax revenue to benefit from the significant increase in tourist arrivals (due to the IR) and their consumption spending here.

Although we do not expect consumption patterns to be affected in 2007, a key worry about raising the GST is the likely negative impact on domestic demand when implemented in 2008. However, the evidence against the GST increase discouraging spending is not clear. When the GST was first implemented in April 1994 at 3%, there was a visible increase in spending prior to the GST implementation and a subsequent contraction in spending for the few months after its implementation. However, during the 2% increase in GST to 5% in 2003-2004, the impact on spending was less clear, in part due to the spread of SARS in 2003 and the subsequent recovery.

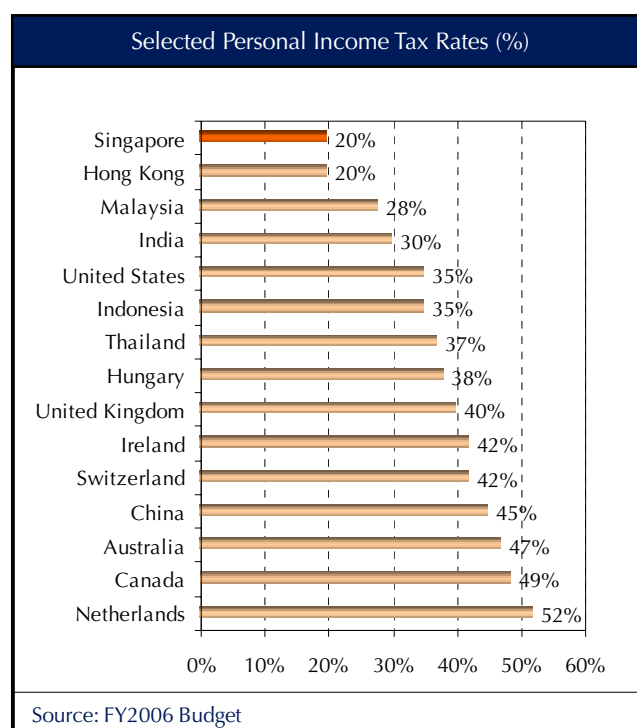
Personal Income Tax Cuts on the Cards as well?

While no indication has been given so far about possible cuts in personal income tax rates, we can apply the same comparison against other countries and we note that Singapore's rates are already very competitive. Nonetheless, as the sourcing and retaining of foreign talent intensify, we do not discount the possibility of further cuts to personal income tax rates to entice top entrepreneurs/specialists to our shores, especially when there is still room for GST increases to make up for the tax revenue shortfall. However, the degree of the cuts will be limited for now, probably capped at 2 percentage points to 18% from the current 20% to 2010.

Adjusting the Employer's CPF Contribution

The government has given clear signals that the employer's CPF contribution rate would be raised from the current 13% in the upcoming budget. Back in 1999, the government slashed the contribution by employers from 20% to 10% on grounds of deteriorating competitiveness before restoring 3 percentage points to the rate in subsequent years. We do not envisage the rate to return to the 20% level in the near future but instead we expect the employer's contribution rate to be increased by 2 percentage points to 15% in FY2007. This restoration of the CPF rates has been long awaited as Singapore has experienced 3 years of above potential output growth. (Potential output growth for Singapore tends to hover between 3-5% historically)

The CPF hike is expected to have positive impact on property (as affordability is enhanced) and to insurance and CPF-approved unit trust funds. While the CPF increase will certainly bring cheer to low and mid-income employees, some electronics manufacturers may face increased cost pressure as the global demand for electronics continues to remain soft in 1H07. Nonetheless, overall wage increase for 2007 remains well within expectations even with the 2 percentage rate increase, and is unlikely to lead to excessive wage cost pressures for the overall economy. Interestingly, the government is also mulling over a variable employer CPF rate component, which we think will be able to restore the employer's contribution rate to 20% in good years, and to cut the rates below the [expected] 15% in recession years.



Singapore Budget Statistics

\$Sbn	FY2002	FY2003	FY2004	FY2005	FY2006 (Budget)	FY2006 (Forecast)	FY2007 (Forecast)
Operating Revenue	25.47	25.31	27.47	27.48	28.96	31.0	30.6
Total Expenditure	27.15	28.50	28.96	28.85	30.62	30.6	30.0
Primary Budget Balance	-1.68	-3.19	-1.49	-1.37	-1.66	0.4	0.6
% of GDP	-1.1	-2.0	-0.9	-0.7	-0.8	0.2	0.3
Less: Special Transfers	1.80	0.60	1.66	0.87	3.59	1.9	2.5
Add: NII Contribution	3.68	1.90	3.04	2.67	2.39	2.3	3.5
Overall Budget Balance	0.20	-1.89	-0.11	0.43	-2.86	0.8	1.6
% of GDP	0.1	-1.2	-0.1	0.2	-1.4	0.4	0.7

Source: MoF, UOB Estimates