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SYMPOSIUM ON CENTRAL PROVIDENT FUND

Editor's Note: The Hong Kong Economic Association sponsored a symposium on Central Provident Fund on February 13, 1987. The speakers were: Dr. L.C. Chau, Senior Lecturer in Economics, University of Hong Kong; Dr. L.S. Ho; Lecturer in Economics. The Chinese University of Hong Kong; Mr. John Greenwood, Chairman, G.T. Management (Asia) Ltd.; Mr. D.K. Patel, Manager, International Department, The Hongkong and Shanghai Banking Corporation; and Dr. Y.C. Wong, Senior Lecturer in Economics, The Chinese University of Hong Kong. The symposium was chaired by Mr. Edward Leung, Chief Economist of the Bank of Asia Ltd. We publish their presentations below with only slight abridgement, as well as a paper jointly authored by a group of economists from Hong Kong Baptist College and City Polytechnic of Hong Kong.

RICHARD YUE-CHIM WONG

To make provisions for those threatened by the extremes of disability and incapacity due to circumstances beyond their control is an accepted duty of society. It is, however, not evident that such provisions are invariably done most effectively through the public sector than the market and the family. There is evidence that extensive state activity in providing social security tends to drive out private efforts. Recent debates over the proposal to establish a Central Provident Fund (CPF) suggest that there is much confusion about the purposes and merits of such a Fund in particular, and of social security provision in general.

There are only two economic reasons for establishing a CPF. We either have to assume that individuals are myopic or there are significant capital market imperfections that justify state intervention. There are also two economic reasons why there should be reservations about setting up such a scheme. First, the state has to compete against the family in providing for social security. They almost inevitably get in each other's way and often to the detriment of the welfare of society. Second, state provision of social security is costly, not only in terms of direct administrative outlays, but also in term of utility costs that individuals with different risk-averse attitudes must bear by being coerced to accept a common degree of risk exposure as determined by the state over which they have little control.

The CPF is simply a forced savings scheme. It is neither a proposal to redistribute income or wealth among individuals nor a proposal to tax firms or workers. As such the issue of the relative amount of employer's contributed share versus employee's contributed share is totally irrelevant to the discussion. All forced savings must come out of each individual's income. Nominal wages would simply adjust accordingly. For those who believe that there is downward rigidity of money wages then there will be a period for wages to adjust. It is, however, unlikely to be very long given our highly competitive and flexible labour markets. Furthermore, it may actually be fully anticipated so that no adjustment may be necessary when the scheme is introduced.

Imperfect Capital Markets

In principle, a force savings scheme like the CPF will have no effect on those whose planned savings will be more than the stipulated amount, because the additional savings will be held in private accounts. Hence, only individuals whose planned savings are less than that stipulated by the scheme will be affected. It should be emphasized, however, that even those who are so constrained by the scheme can circumvent it by borrowing in the market to realize immediate consumption plans. They would be able to do so because their credit rating is guaranteed by a government backed institution – the Central Provident Fund. As a consequence, the true effect of the scheme depends on the differential between the rate of return from the CPF and the interest rate in the capital market. If the latter rate is higher, an individual will end up with a reduced level of life time wealth and also of consumption. Therefore, an individual will have less incentive to borrow as much to finance current consumption and his savings will therefore increase. Notice that a higher level of savings is necessary even though retirement consumption is reduced, because the rate of return on savings is now lower. Conversely, if the former rate is higher then wealth and consumption levels will increase and savings will by lower. In practice, the rates are unlikely to differ significantly if the CPF is allowed to invest with little restrictions and is efficiently managed. In which case it is doubtful why the CPF should be introduced in the first place.

The capital market imperfections case for setting up a CPF rests on its ability to provide individuals with a means of savings that can yield a higher rate of return than what is available on the market, after adjusting for risk factors. Since the CPF is a fully funded social security scheme rather than a pay-as-you-go scheme, it does not correct for intergenerational market failures in a way that the latter type of scheme may do. Therefore, the CPF's ability to generate social gains rest on its ability to pool risks among small investors whom existing market financial institutions fail to service. How significant are these social gains are anyone's guess. The market economist would probably argue that if there were indeed significant gains then profit-oriented financial institutions would have exploited it. If these institutions have not done it so far then perhaps there is not all that much to gain. In reality, the reason why small investors may not have been well served in most countries is not a result of market failure, but because of government failure. The state has often over-regulated financial institutions so that they have no incentive to cater to these potential clients. In this respect Hong Kong is much more fortunate than most countries, and for this reason the case for having a CPF is all that much weaker.

To conclude, capital market imperfections do not by itself justify the establishment of a CPF as a means to redistribute spendable income over an individual's life cycle. The imperfections must give rise to social losses of sufficient magnitude to justify the establishment of such an institution which is costly to administer and whose efficiency in performing such a task need not be better than the market or the family.

Incentive Effects

Whether people are myopic is neither self-evident nor easily ascertained. The only significant insight that the study of economics has to offer is that if individuals are not myopic they will have an incentive to be if they are so subsidized, and those who are already myopic will be even more so. In supporting a social security scheme we should not take lightly the adverse incentive effects that are often present in such schemes.

This brings me to the effect of the CPF on work incentives. If the CPF enhances lifetime wealth, which is why it should be introduced, then it would encourage individuals to take more leisure. This reduces lifetime labour supply. This occurs by reducing hours worked each period and by taking earlier retirement. This is the major effect on the labour market and it is in this sense that it will raise labour costs and the real wage rate.

The effect on labour mobility is negligible to the extent that CPF benefits are fully transferable when a worker changes job. It may have an effect, however, if the structure of private provident funds and pension schemes will be altered as a result of the introduction of the CPF. It is important to note that unlike the CPF, private schemes reduce labour mobility and encourage firm-specific human capital investments through the sharing of firm and worker contributed shares. Hence, if private schemes are adversely affected by the CPF then it could reduce worker productivity and lead to excess labour mobility.

The Ricardian Equivalence Theorem

"The essence of the Ricardian Equivalence argument is that even if there are imperfect capital markets it does not matter because there is altruism in the family which can unravel what the state does."

The idea that a CPF cannot force individuals to save beyond what they desire because they can borrow back that same amount through the market is derived from a well known proposition in the literature, the Ricardian Equivalence Theorem. It was first noted by Ricardo and has been revived by Barro (1974) using an intergenerational model with altruistic preferences. Indeed a very general proof has been given by Bernheim (1986) which demonstrates that all government transfer schemes, both lump sum and distortionary ones, can have no real effects, i.e., everything is neutral. While such results may appear counter-intuitive the basic idea is not outrageous. Individuals who are coerced into unpreferred positions would try to get away from those positions. The market provides one such means of getting around artificially contrived restrictions. It may or may not be costly to do so. At zero costs, Ricardian Equivalence will hold perfectly, otherwise such constraints may have some real effect.

There are economicsts who tend to believe in the Ricardian Equivalence result (Barro 1974) and those who do not (Buchanan 1976). All would, however, agree that it would be both naive and incorrect to expect that individuals would save ten more dollars simply because it has been legislated.

Is Ricardian Equivalence inconsistent with observable experience? The fact that we do not observe individuals borrowing explicitly against their retirement entitlements, does not mean there is no implicit borrowing. The latter occurs because in the presence of a CPF guaranteed by government, the credit rating of these individuals improve. Hence, they can get more favourable terms from financial institutions than were previously available. This in turn prompts them to borrow more. Let me emphasize that they may or may not be able borrow back the full amount of their forced savings. I may also add that the reason why we do not observe individuals pledging their retirement to take loans is not because they do not wish to do so, but because they are prevented from doing so by law. Most if not all, schemes explicitly disallow individuals from using it as collateral in loans. This is true of the Staff Terminal Benefits Scheme at both the Chinese University of Hong Kong and the University of Hong Kong. These schemes disallow such activity because they realize that if it were allowed people would indeed pledge them and thereby defeat the whole purpose of having the scheme in the first place.

Besides the market individuals often borrow from relatives. A daughter may be more willing to "lend" or "give" money to her father who indulges in race track betting, if she knows that he can collect retirement entitlements, because she can then reduce her contributions to his indulgences in the future. A significant amount of the intertemporal transfer of resources occurs within the family. Nowadays, the role of the family as a social security institution is often underrated.

Furthermore, individuals can also affect intertemporal resource transfer through the political process. I have in mind the CPF in Singapore, which forced individuals to save a huge share of their income. Deferred consumption was, however, partly restored through increased government spending that provided immediate consumption benefits to the population, which also had the side effect of increasing the size of the government. Similarly, the decision to allow borrowing against the CPF for home purchases was of course a reflection of the preferences expressed by individuals collectively through the political process. Unfortunately this very roundabout mechanism of imposing restrictions and then circumventing them is extremely costly for society. In many ways the true social cost of introducing any form of force savings scheme is the resource cost spent to circumvent it and the utility cost associated with the uncertainty of whether circumvention will be successful.

The Strategic Bequest Motive

"The essence of the strategic bequest argument is that parents use intergenerational transfers to induce children to attend to them and state interference in this process can have destabilizing effects on the family."

The Barro (1974) and Bernheim (1986) Ricardian Equivalence results depend on the assumption of intergenerational altruism. Bernheim, Shleifer, and Summers (1985) have proposed an alternative motive affecting intergenerational transfers. They argue that parents save to accumulate bequeathable wealth so that they can threaten to disinherit those children who do not attend to them. In their model forced savings offsets private savings by less than one for one so that total savings is increased and Ricardian Equivalence no longer holds.

The important point is, however, that a strategic bequest motive implies that forced savings schemes may lead to other potentially undesirable consequences when it alters the ratio of bequeathable to non-bequeathable wealth among the population. If total bequeathable wealth actually declines then the hold parents have over their children also declines. Some economists believe that the introduction of social security and the spread of annuitized pension schemes has contributed to the decline in attentiveness of children to parents in the United States.

Bernheim, Shleifer, and Summers (1985) suggest that the much higher savings rate in Japan as compared with United States is certainly related to the fact that 80% of elderly Japanese live with their children, but only 10% do so in the United States. In Hong Kong, the growth of nuclear households and the reduction in fertility rates may have contributed to the decline in the savings rate, because there is less incentive to purchase attention. On the other hand, rising life expectations and a longer span of retirement years have the opposite effect. Changes in national savings rates may have a great deal to do with the family structure. The adverse effects of a CPF on the family should be seriously considered when assessing its desirability. In my view, the recent proposal by the Government to introduce interest-free loans to finance down payments on home purchases is probably a better way to help individuals save. The expected returns are likely to be high over the long run and it is in the form of bequeathable wealth with well defined property rights vested in the homeowner. CPFs have poorly defined property rights, because the regulation governing it can be changed by government policy over time.

Final Word

Many people have supported the introduction of a Central Provident Fund on the grounds that it represents a far-sighted solution to the problem of an aging society. The solution is to force shortsighted individuals to save for old age. The arguments I have presented seeks to demonstrate that such coercive measures are unlikely to be effective. And if they do there are many other costs that would have to be taken into account before the desirability of a CPF can be evaluated.

Finally, let me note the assumption that individuals are necessarily and systemmatically myopic needs to be substantiated. If mankind were indeed so myopic and tended to underprovide for the future, then how are we to explain the enormous wealth which has been bequeathed to us by our forefathers in the absence of such state administered schemes? The answer I think lies in the fact that the twin institutions of market and family have been unusually successful at this task. The state is a latecomer in the provision of social security. Its track record as evidenced by the performance of existing schemes in so many countries is dismal indeed. Indeed savings have tend to decline in countries where state social security schemes have been introduced. Do we really want to risk weakening the market and the family as the first line social security institutions and make way for the state?

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