(Reprinted from HKCER Letters, Vol. 22, September 1993)

Lessons of the Singapore Central Provident Fund

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The Legislative Council has voted in favor of the establishment of a Central Provident Fund (CPF) in Hong Kong as a means of providing old-age retirement support for residents. The administration is expected to address this issue shortly. The pros and cons of having an old-age retirement scheme has been debated for many years in Hong Kong. The debate has recently become more politicized. It is therefore useful to take another look at the evidence on CPFs from other countries which have operated such schemes. The most obvious choice is Singapore whose CPF was established in 1955.

In introducing the Singapore CPF scheme, we will emphasize its historical development, examine the consequences for Singapore, and discuss issues that are of great relevance to Hong Kong.

CPF and the Role of the State

The Singapore CPF system was adopted in 1953 and became operative in 1955 under the British colonial government. Self-employed individuals and employers were not obliged to join the scheme. The original goal was to provide a simple savings-withdrawal plan for old-age security. The basic principle that an individual's total benefits are equal to his total contribution plus interests credited to his account was explicitly endorsed, and the idea of a pension scheme that would violate this principle was rejected. Initial contribution levels to the CPF were set at 5 percent each for employee and employer. This level was maintained until 1968, after which it began to rise significantly (see Table).

It was clear from the very outset that the CPF would make available to government a cheap source of credit for social and economic development. For many years, CPF funds were invested almost exclusively in Singapore government bonds. This provided the state with vast resources to pursue its developmental and social goals. The Singapore state was far more involved in social and economic affairs than the Hong Kong government ever was, and the CPF provided the means for it to be so.

More Contributions, Less Restrictions on Withdrawals

The rapid rise of contribution rates after 1968 was partly due to government policy to increase homeownership among the population. The goal was to provide Singaporeans with a stake in their country and to foster social stability. The Homeownership Scheme was initiated in 1964 by the Housing and Development Board (HDB) and provided low-interest housing loans and long repayment periods for the purchase of low-cost HDB housing. The response was, however, poor, and the scheme did not produce the expected results.

To make the Homeownership Scheme more attractive, the CPF was amended to allow members to use their accumulated CPF savings to finance downpayments and to amortize housing loans on HDB housing. The scheme was subsequently expanded with some restrictions to include housing units constructed by the Jurong Town Corporation in 1970, the Housing and Urban Development Company in 1975, the Ministry of Defense in 1977, and private residential properties in 1981.

The Homeownership Scheme had many important consequences. First, the CPF started to withhold from individuals an increasingly large portion of their own financial wealth. The result was, according to the Report of the Central Provident Fund Study Group (1985) chaired by Professor Lim Chong-Yah: "to emasculate their sense of economic initiative and enterprise".

Second, the CPF ceased to be a simple old-age security savings-withdrawal scheme, but became the vehicle for massive state intervention into the housing and capital markets with profound effects. The principle that an individual's benefit would equal what he contributed was effectively abandoned since the gains and losses from home purchase decisions were heavily influenced by the terms and conditions of the financing schemes and housing allocation rules that have unavoidable distributional effects. The timing of the purchase was, for example, often an important determinant of capital gains. Since the terms and conditions have evolved over time, the redistribution may be very complex, but there can be little doubt that the allocative distortions must have been enormous.

Third, the public felt increasingly constrained in its savings and investment decisions as CPF contributions rose. There was a growing popular demand for allowing withdrawals from the CPF for specific purposes. Members were eventually permitted, with certain restrictions, to make withdrawals to purchase Singapore Bus Service shares in 1978, to invest in approved non-residential properties and in a variety of financial assets and funds in 1986, to finance tuition fees for themselves and their children in 1989, and to purchase protection insurance for dependents in 1989. The Medisave Account was established in 1986 to pay for medical expenses and the MediShield Scheme was implemented in 1992 to purchase a medical insurance plan. In another major policy shift, the Singapore government in 1993 changed the rules to allow CPF members more discretion in the management and investment of their funds. The over-subscription of shares in the recently privatized Singapore Telecom is one of the effects of this more liberalized policy.

This sequence of liberalization measures contradicted the original aims of the CPF as a compulsory savings scheme. Why compel in the first place if you were going to allow for so many types of withdrawals later on? What it does reveal is the enormous unpopularity of the mandatory savings scheme so that its most unappealing constraints on personal choice have to be mitigated.

The advisability of putting large sums of money in the hands of the government was questioned in the highly influential Report (1985) by Lim. It states: "[T]he large sums of money vested with the fund are in effect held `hostage' to governmental decision-making: ipso facto, this would be acceptable if there is a guarantee that future governments would be as honourable and as capable as the present one, but can such a guarantee ever be forthcoming?" (p. 23).

Inflation, Exchange Rate, and the CPF

One of the critical issues in any evaluation of the long-term merits of the CPF scheme is an assessment of the extent to which the real value of the contributions is or can be protected against inflationary erosion. The figures in the Table show that with the exception of the two oil shocks in 1973-74 and 1980-81, the real interest rates paid on CPF Balances have been positive for the years 1961-92. The Singapore inflation rate has averaged 3.3 percent between 1961-92, and the resulting real interest rate paid on CPF accounts has averaged 2.0 percent. This is on the whole a reasonable but not spectacular achievement.

Maintaining domestic price stability is the foundation of this achievement. In Singapore the monetary system is based on the currency board arrangement that is in essence identical to the Hong Kong arrangement under the linked exchange rate system. As a consequence, monetary expansion and contraction is essentially accommodative and is not an independent cause of long-term inflation. Under the currency board arrangement, inflation occurs primarily from two sources: (1) imported inflation, and (2) the rise in the relative price of non-tradeables to tradeables as a result of the pressure of demand on the limited supply of domestic land and labor.

During the 1960s, worldwide inflation was quite low so that imported inflation was not an important problem for Singapore. The situation was drastically changed in the 1970s as the world entered a period of high inflation. In 1972, the Singapore Monetary Authority abandoned the policy of maintaining exchange-rate stability but retained the currency board arrangement. The nominal effective exchange rate was allowed to appreciate over time. This ensured that the rate of increase in the domestic prices of tradeables would be considerably lower than the corresponding rate of increase in their foreign prices.

Another factor that has been important in generating inflationary pressure is the rapid economic growth in Singapore. This has precipitated a gradual increase over time in the relative price of non-tradeables owing to the scarcity of land and labor in Singapore, which translates into an increase in absolute prices to the extent that the prices of tradeables are inflexible downwards. The Singapore government has sought to offset these pressures on scarce domestic resources by pursuing a relatively liberal scheme of importing workers. Foreign imported workers are reported to be as high as 20 percent of the labor force.

The exchange rate and imported labor policies in Singapore have important lessons for Hong Kong policy makers in deciding whether to adopt a CPF. Since the CPF is government-operated, it becomes a government responsibility to ensure that it earns a positive real rate of return on its investments. Given the current political commitment to maintaining the linked exchange rate and the hostility of organized labor to allowing imported workers, achieving a positive real rate of return on CPF contributions appears to be an unrealistic goal. It seems obvious that the establishment of the CPF in Hong Kong would set in motion powerful forces that would erode over time the political commitment to the linked exchange rate system. If this is indeed the case, Hong Kong will have to pay a very high price for the CPF.

What Are the Lessons?

What can Hong Kong learn from the Singapore experience? First, it is doubtful that the vast CPF machinery has resulted in a more efficient allocation of resources. Second, one can argue, at least in principle, that the Singapore CPF has probably resulted in a society where most people are more equal, except for the gap between the rulers and the ruled. But this has been achieved by forcing everyone to earn a 2 percent real rate of return on some 40 percent of their savings. Is this acceptable to a Hong Kong population that is accustomed to taking its chances in a more mobile, but perhaps less egalitarian society? Third, to achieve a 2 percent real rate of return, Hong Kong may have to risk abandoning the linked exchange rate.

Perhaps Singapore's Senior Minister Mr Lee Kuan Yew provided the best summary of the lessons of the Singapore model for Hong Kong in a recent interview he gave in Hong

Kong (see South China Morning Post, 27 November 1993):

"I think Singapore has to learn from Hong Kong. What Hong Kong has is nimbleness, a willingness to drop the unsuccessful and change tack, while not making an issue of any differences between the bosses and the unions. If Hong Kong learns from Singapore, you'll lose your competitiveness.

"Singapore had no choice. We must have a defence capability. That means man must have something to fight for. He's not going to fight for somebody else's Rolls-Royce or Mercedes 600. He's got to fight for what he or his family owns.

"So we had to devise a system which gave everybody a home, which he owns. Everyone has something substantial in property. Everyone has a retirement account and medical-cost account. It's not as cosseted a society as say Britain. But it's a lot more cosseted than Hong Kong -- so you don't want to learn from Singapore."

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Table

Year	Ratio of contribution (Percentage of Monthly Wage Income)				Nominal Interest	Real Interest
	Employee	Employer	Total	Inflation Rate	Rate	Rate
1955	5.0	5.0	10.0	-	-	-
1961	5.0	5.0	10.0	0.4	2.5	2.1
1968	6.5	6.5	13.0	0.7	5.5	4.8
1969	6.5	6.5	13.0	-0.3	5.5	5.8
1970	8.0	8.0	16.0	0.4	5.8	5.4
1971	10.0	10.0	20.0	1.8	5.8	4.0
1972	10.0	14.0	24.0	2.2	5.8	3.6
1973	11.0	15.0	26.0	19.6	5.8	-13.9
1974	15.0	15.0	30.0	22.3	6.5	-15.8
1975	15.0	15.0	30.0	2.6	6.5	3.9
1976	15.0	15.0	30.0	-1.9	6.5	8.4
1977	15.5	15.5	31.0	3.2	6.5	3.3
1978	16.5	16.5	33.0	4.8	6.5	1.7
1979	16.5	20.5	37.0	4.0	6.5	2.5
1980	18.0	20.5	38.5	8.5	6.5	-2.0
1981	22.0	20.5	42.5	8.2	6.5	-1.7
1982	23.0	22.0	46.0	3.9	6.5	2.6
1983	23.0	23.0	50.0	1.1	6.5	5.4
1984	25.0	25.0	50.0	2.6	6.5	3.9
1985	25.0	25.0	35.0	0.5	6.5	6.0
1986	25.0	10.0	35.0	-1.4	5.7	7.1
1987	25.0	10.0	36.0	0.5	3.8	3.3
1988	24.0	12.0	38.0	1.5	3.1	1.6
1989	23.0	15.0	38.0	2.4	3.2	0.8
1990	23.0	16.5	38.5	3.4	3.8	0.4
1991	22.5	17.5	40.0	3.5	4.7	1.2
1992	22.0	18.0	40.0	2.3	4.6	2.3
Goal	20.0	20.0	40.0	-	-	-
Average 1961-92				3.3	5.4	2.1
Average 1961-92 (exclude oil shock years)				1.7	5.2	3.5