

# The Central Provident Fund: More Than Retirement

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The Central Provident Fund (CPF) was originally designed to provide post-retirement security through a compulsory savings system in which individuals receive benefits based on their own contributions. Over the years, CPF's role has widened to include other social objectives such as housing, healthcare and education. To increase the rate of return, the CPF Board also allowed funds to be invested. In addition, adjustments to CPF rates have been used as a macro-economic tool to improve competitiveness by reducing labour costs. In 2003, the Economic Review Committee suggested changes to the CPF system. This article summarizes some of the major developments in the history of the CPF. The views reflected are those of the author.

## Part 1: CPF and Social Safety Nets

**T**he Central Provident Fund is a cornerstone of social and economic policy in Singapore and affects the life of almost every citizen. Legislated in 1955, the CPF system was originally designed only to provide post-retirement security. The model chosen was a fully-funded compulsory savings scheme in which individuals receive benefits directly related to their contributions.

The system is built on the country's fundamental socio-economic philosophy of promoting self-reliance, a traditional family support system, thrift and positive incentive to work, and non-inflationary economic growth. This contrasts with the welfare state model which guarantees cradle-to-grave security with financial provisions from the state.

Singapore's CPF also differs from the pay-as-you-go (PAYG) redistributive model adopted by most Western, developed countries which pays today's

retirees from the contributions of today's working population. With ageing populations and economic downturns, many advanced European countries with the PAYG system are increasingly locked in a vicious cycle of reduced contributions, reduced benefits, increased tax burdens and budget deficits, and a drain on savings available for investment.

Over the years, CPF's domain has extended to cater to other social, economic and political imperatives such as home-ownership, healthcare, education and investment. With each new scheme it has been necessary to weigh and balance policy trade-offs between social and economic goals. The Government has also had to ensure that changes to CPF policies are politically acceptable and understood by the electorate.

The role of the CPF has thus evolved in response to changing demographics, economic conditions and Singaporeans' rising aspirations and expectations. Looking forward, what are the future challenges facing the CPF system? Should CPF's role within the context of Singapore's governance expand or diminish? Should the CPF be refocused to a more purist model specializing in retirement issues? Does the CPF system need incremental change or a complete overhaul?

### Housing as Part of Retirement?

Singapore's housing policy, with its remarkable achievement of 90% home-ownership, has been a bed-rock for social stability and has helped to cultivate a sense of rootedness among Singaporeans. This key pillar in nation-building must be attributed to the Public Housing Scheme in 1968 which marked the first liberalization in the use of CPF funds. The scheme helped working class families buy subsidized public housing by letting them pay their mortgages with CPF funds. This meant they did not have to dig into their take-home pay. It was a significant step designed

to give the largely migrant population a stake in the country. In 1981, the scheme was extended to allow funds to be used for private residential property. In 1986, funds could be used for investing in non-residential property and in the 1990s, CPF could also be used for upgrading costs.

CPF funds in the Ordinary Account (OA) are used mainly for housing. From 1968 to 1977, almost two thirds of total withdrawals were used for various home-ownership schemes.<sup>1</sup> The magnitude of these withdrawals prompted the CPF to reaffirm its primary objective of providing for old age. Thus, in 1977, the Special Account (SA) was introduced alongside the OA to provide savings for retirement.

CPF-funded home-ownership has had wide ramifications, especially for the property market. Several anomalies have surfaced. For instance, there is some concern about the “asset-rich, cash-poor” situation of many Singaporeans. The downward trend in property prices has also eroded the usefulness of property as a hedge against inflation and thus affected CPF’s retirement objectives.

The social objective of home-ownership may also change over time. Young adults, many of whom may be working abroad, might be content to rent and not see an immediate need to own a flat. For them, owning a flat may not be a relevant or crucial determinant for stake-ownership in Singapore. What might matter more are the less tangible, non-physical emotional anchors.

The challenge for the Government is to determine what limit there should be to the use of CPF funds for housing. A delicate balance between social and economic considerations must be attained to safeguard social cohesion without creating too much distortion or instability in the property market, especially given that property prices signal the level of confidence in the Singapore economy.

### Healthcare for Old Age

CPF provides healthcare coverage through its Medisave and MediShield insurance schemes. Medisave was introduced as part of the National Health Plan in 1984 by then 2<sup>nd</sup> Health Minister Goh Chok Tong. A new Medisave Account (MA) was set up to help CPF members save for their

own hospitalisation expenses and those of their family members, especially in old age. Medisave is in alignment with fundamental principles such as self-reliance and filial piety, rather than reliance on the state for health subsidies financed by taxes. The initial MA contribution was 6% of the monthly salary. MediShield was implemented in 1990 as a catastrophic medical insurance scheme financed by premiums paid out of the MA to help CPF members and their dependants meet the costs of treatment for serious illnesses or prolonged hospitalisation.

Medisave and MediShield have evolved over the years as a result of many factors. The adequacy of MA savings is influenced by a variety of forces, such as the rise in healthcare costs; advances in medical technology; an ageing population; a higher risk of lifestyle and chronic diseases and epidemics. Singaporeans are also living longer and are developing higher expectations of preventive care and specialised healthcare services. This will affect the overall demand for healthcare and add pressure on the utilisation of CPF funds.

So there have been revisions to align the MA contribution rate to usage and cost trends. Changes include permitting the use of Medisave funds for a wider range of diseases and the gradual raising of maximum coverage age for MediShield insurance from 65 in 1990 to 80 in 2001. To cope with rising medical costs and life expectancy, there had also been increases in claimable limits per lifetime and per policy year within MediShield.

To safeguard savings for old age medical needs, the Government has to prevent a premature exhaustion of funds from the MA. This has been done through Medisave withdrawal limits. In addition, the Medisave Minimum Sum ensures adequacy of funds for old age. This is a fixed amount that has to be retained in the MA when a member makes his withdrawal at age 55. The Medisave MS increased from \$16,000 in 1998 to \$25,000 in 2003. The Medisave contribution ceiling allows additional MA contributions above the ceiling to flow over to the OA. This ceiling has been raised from \$21,000 in 1998 to \$30,000 in 2003.

Developments within the healthcare industry will inevitably affect individuals’ choices and needs for healthcare coverage. The Government’s task will

<sup>1</sup> K Kalirajan and Paitoon Wiboonchutikula, “The Social Security System in Singapore”, *ASEAN Economic Bulletin*, July 1986. The figures were based on the authors’ computation using the various CPF annual reports.

be to align the use of MA funds and to calibrate the level of MediShield coverage to provide adequate healthcare for the majority of CPF members. At the same time this must be done without whetting the appetite for non-essential healthcare services or increasing the demand for more expensive wards beyond the individual's means.

### Investment to Grow Nest Egg

Another major shift in CPF policy took place in 1978, when CPF members were allowed to use their CPF funds to invest in Singapore Bus Service shares. In 1986, the policy was extended to allow members to invest in commercial property. In the 1990s, the investment schemes were further liberalized, culminating in the CPF Investment Scheme (CPFIS) in 1997 which allowed investments in gold, stocks, shares and approved unit trusts.

The intent of such policies was to enable members to grow their retirement nest egg with the possibility of earning a greater return to their CPF savings than guaranteed CPF rates. The investment schemes also allowed individuals to take greater personal responsibility for their old age financial security. However, to protect members from risking their retirement savings, limits were set on the amount of investible funds and the type of financial instruments in which they could invest.

CPF funds kept with the Government and not used for investment earned a floor rate of 2.5% p.a. for the OA. Till 30 June 1995, this rate applied to the OA, MA and SA and the Retirement Account (RA).<sup>2</sup> From 1 July 1995, the SA and RA earned 1.25% above the OA and MA, since they are considered longer term savings. From 1 July 1998, the rate of return was 2.5% p.a. for the OA and MA and 4% p.a. for the SA and RA. From 1 October 2001, the MA rate of return was also pegged to that of the SA to reflect that they are longer term savings mainly for old age hospitalisation expenses.

In the post dot-com investment environment, a 4% p.a. return might be higher than what a balanced bond and equity portfolio could yield. Ideally, the Government should lower the floor OA rate. However, this might be construed as going back on the government's promise during bad economic times, when the floor rate was most

needed. Policy changes in this area remain an issue that the government must address for the future.

### Is Retirement Truly Secure?

With the array of schemes, is retirement truly secure? While the overall CPF rate affects the size of CPF balances, the allocation to the various accounts, especially the MA and SA, determines how much funds will be ultimately available for old age medical and retirement needs. The amount available for these needs also depends on CPF policies governing withdrawal rules, minimum sum and retirement monthly payout system.

When the CPF system began in 1955, members were able to withdraw a lump sum on reaching the age of 55 which was then the retirement age at most private companies. In 1984, the Committee on the Problems of the Aged chaired by then-Health Minister Howe Yoon Chong suggested linking the CPF withdrawal age with retirement. The committee also suggested raising the retirement age which was then 60 in the public sector and generally 55 in the private sector. The main argument was to safeguard retirement savings from being used up after age 55 before actual retirement.

The idea caused a public outcry with many protesting against the move. It was viewed as encroaching upon their right to their own savings and upsetting their plans to use the lump sum for purposes such as travel, investment and making a pilgrimage to Mecca. On hindsight, Howe's policy recommendation was clearly ahead of its time and unfeasible before the legislation of retirement age. The incident was a reminder of the political sensitivity and inevitably emotive nature of CPF policies.

What resulted from the adverse public reaction and parliamentary debate over the Howe report was the birth of the Minimum Sum (MS) concept and the 50% withdrawal rule. In essence, the MS scheme introduced in 1987 set a target of \$30,000 as the minimum sum that had to be retained in one's CPF account before any withdrawal was allowed. This sum would provide post-retirement payments. Those with savings beyond the MS could withdraw the excess at age 55.

<sup>2</sup> The Retirement Account was set up when the Minimum Sum was introduced in 1987. Details of the MS are in the next section. CPF members can either leave their MS in the RA with CPF Board or use it to buy a life annuity with a participating bank.

For members with less than \$5,000, they can withdraw all their savings. For those with more than \$5,000 and less than or equal to \$10,000, they can withdraw up to \$5,000 and set aside the remainder in the RA. For those with more than \$10,000 in their Ordinary and Special Account, the 50% withdrawal rule would apply. However, if they have balances which are more than twice the MS, they will be required to set aside the full MS before they can withdraw the balance in their Ordinary and Special Accounts.

The MS of \$30,000 when introduced in 1987 was based on an estimate of subsistence living for retirees. To preserve the real value of this MS with regard to inflation, the MS and monthly payout were revised accordingly over the years. In 1995, it was decided that the MS would increase by \$5,000 each year until it reached \$80,000 in 2003. This took into account the rising life expectancy and standard of living. The monthly payouts were computed in relation to the amount of MS set aside. Monthly payouts from the MS were also pegged to prevailing retirement age, in line with the MS objective of catering to post-retirement needs.

In the meantime, legislation raised the retirement age from 55 to 60 in 1993, and subsequently to 62 in Jan 1999. To avoid a similar backlash from Howe's proposal back in 1984, the withdrawal rule at 55 was left untouched.

## Part 2: CPF as a Macro-Economic Tool

The CPF's role in meeting social objectives is just one side of the coin. On the flip side, the CPF has evolved to impinge upon the nation's broader economic and employment concerns. This was evident first during the 1985

recession when CPF was first used as a macro-economic tool.

The 1985 recession marked a turning point for the role of CPF. When the CPF system was originally developed, cost competitiveness was not an issue. Prior to 1985, Singapore enjoyed two decades of high growth rates of an average of 9% per annum. As wages rose, CPF contribution rates were increased steadily until they peaked at 50% in 1985, with a 25% contribution rate by both employers and employees.

While studying Singapore's economic strategies to face the recession, the Economic Committee (EC), chaired by then MOS (Trade and Industry) BG Lee Hsien Loong, identified the loss of competitiveness as a result of total wage costs outstripping average productivity growth rates. Singapore's competitiveness had weakened 50% against Hong Kong, 15% against Taiwan and 35% against Korea. CPF contributions were identified as an overhead and a burden on operating business costs in Singapore. As a result, the Government accepted the EC recommendation to slash the employers' CPF contribution rate from 25% to 10%. With the employees' rate unchanged, the total rate thus dropped from 50% to 35%. This measure helped the economy to recover.

This shift prompted a reconsideration of the long term sustainability of the CPF contribution rate. Sustainability has to take into account adequate provisions for old age needs as well as CPF's new role as a macro-economic tool in adverse economic times. The CPF rate was again cut in the aftermath of the Asian financial crisis. In Jan 1999, the employers' CPF rate was cut by 10 percentage points as part of a \$10 billion cost reduction package to lower business costs and help companies cope with the regional economic crisis.

## ■ CUT IN CPF CONTRIBUTION RATE



The CPF rate thus became an economic lever for wage flexibility and cost competitiveness in good and bad times. As the economy recovered from 1988 to 1994, restoration of employer's contribution rate was made in stages of 2% in 1988 and 3% in 1989, followed by smaller quantum increases in subsequent years. Employees' contribution rates were also reduced by 1% in 1988 and 1989. The long-term contribution rate of 40% was achieved in July 1991 and remained at this level till 1 January 1999 when the contribution rate was lowered to 30%. In April 2000, the CPF rate was restored by 2% to 32%. This was based on projected economic growth rate and wage pressures.

Policy changes to the CPF were therefore made not just through the lens of providing for old age, but within a broader context of wage adjustment, job protection and competitiveness. The quantum and timing for the restoration of the CPF rates were decided within this complex paradigm. To take care of the long-term health of the economy, the Government has to ensure that social objectives are not attained at the expense of economic competitiveness and jobs.

### Part 3: Refocusing CPF

The Economic Review Committee (ERC) was set up in December 2001 to recommend strategies for Singapore's economy. It released recommendations in 2002, including proposals to reform the CPF model. The main objective was to optimize the usage of CPF while seeking to minimize the statutory burden of high contribution rates.

The ERC aimed to focus the CPF on the basic needs of retirement, healthcare and home-ownership. Some of the significant changes suggested were:

- Delay the original intention to restore the total CPF rate to 40% for two years.  
Aim: to effect the restoration when the economy recovers.
- Lower the employee contribution rate from 20% to 16% for older workers, 50-55 years of age.  
Aim: to ease structural unemployment and enhance the employability of older workers.
- Limit CPF withdrawals from the OA for housing to 150% of the value of the property starting from 2002, and bring this Valuation Limit down to 120% over 5 years.

Aim: to tighten OA withdrawals for housing so that they are not excessive in relation to property value.

- Increase the income floor and reduce income ceiling for CPF contributions.  
Aim: to focus the CPF system on income earners between the 10<sup>th</sup> and 80<sup>th</sup> percentile. The rationale is that the lower end of spectrum will include people who cannot rely on their CPF savings alone but need other forms of support. The top 20 percent will be able to take care of their own financial affairs, including planning for their own retirement needs, beyond relying on their CPF savings.
- Increase the MS and MA and SA rates.  
Aim: to build up retirement savings more quickly.
- Facilitate low cost, privately managed pension plans.
- Peg the interest rate paid on SA balances to an appropriate long-term interest rate, such as the yield on long-term government bonds.  
Aim: to encourage long-term investment and enhance rates of returns to build up retirement savings.

In the National Day Rally of 2003, Prime Minister Goh Chok Tong announced a complete overhaul of the CPF system, which built on and went beyond the ERC recommendations. Most significantly, he announced that the 40% long-term target contribution rate would be replaced by a flexible range of 30%-36%. There would also be an immediate cut, from 36% to 33%, which reflected a considered balance to address cost competitiveness without severely dampening domestic demand. A more drastic cut would have been to reduce the rate to 30%.

The most major and politically sensitive change was to increase the MS and Medisave MS and to phase out the 50% withdrawal rule. The CPF MS will be steadily increased annually to reach \$120,000 (in 2003 dollars) in 10 years; the amount that can be withdrawn at 55 will be reduced gradually from 2009 by 10% each year. From 2013, CPF members at age 55 will only be able to withdraw surpluses over the CPF MS and Medisave MS.

## "Should the CPF be constantly fine-tuned to accommodate new needs and aspirations or should it instead return to a 'basic needs' model?"

In order to cushion the impact on CPF members, the Government also released a set of measures such as the restructuring of mortgage loans; moderating the increase in SA and MA rates (earlier proposed by the ERC); easing rules related to the monetizing of HDB flats i.e. allowing HDB homeowners to sublet their flats more easily to earn rent that would supplement retirement income. Incentives would also be provided for employers to retrain older workers.

### Future Role and Challenges

The CPF model has evolved into an institution that takes care of many important facets of a Singaporean's life. It has become a central component of the complex social contract between the government and the people it serves. The CPF reflects how the Government juggles social, economic and political imperatives to meet citizens' needs and aspirations without weakening the economy's capacity and fundamental basis for future growth.

A policy analysis paper by the International Monetary Fund in Dec 1995 lauded the CPF for its many advantages:

"Singapore's CPF is a mandatory saving scheme of the kind operated by a number of other Asian, Latin American, and African countries. However, it exhibits advantages over other schemes used elsewhere in the world. In particular, the returns on members' balances reflect market interest rates and there is a direct link between contributions and benefits. Both employees and employers are required to contribute, which discourages any notion that benefits are a free good.

The Minimum Sum scheme ensures that at least part of the retirement benefit is taken in the form of a pension and cannot be consumed rapidly. Finally, because the plan is mandatory, pressures for budgetary social security outlays are largely avoided, and broad coverage of the population is achieved at low administrative cost."<sup>3</sup>

The future will see pressures from an ageing society, rising healthcare costs, a greater risk of unemployment, higher life expectancy and more intense economic competition from lower cost countries. Against this backdrop, should the CPF be constantly fine-tuned to accommodate new needs and aspirations or should it instead return to a "basic needs" model? The greater or lesser role of the state in the CPF system can be reflected in various permutations with varying weights on the different objectives. Below are some suggestions of thought paradigms for the future direction of the CPF.

**"Basic-Needs Model":** The state ensures a basic safety net that caters to basic living expenses, medical and housing needs in old age. Beyond this basic level, every individual should take charge and plan early to make independent provision for his or her own desired retirement lifestyle. Whether this becomes reality depends largely upon the individual's attitudes towards saving and investment. Public education for financial planning and prudent investment must be put in place to encourage this new mindset. This is crucial since the forced savings regime of the CPF might have dulled the capability, incentive and initiative of Singaporeans to plan for their own future. This model will also be resistant to demands of more liberalised usage of funds such as unemployment benefits.

<sup>3</sup> Robert Carling and Geoffrey Oestreicher, "Singapore Central Provident Fund", Paper on Policy Analysis and assessment, Southeast Asia and Pacific Department, IMF, December 1995.

**“Retirement-centric Model”:** Here the Government plays a larger role in helping Singaporeans grow their nest egg for retirement. It continues to review the CPF model to realign or rationalise schemes towards the main objective of catering to post-retirement security. In this scenario, it might be necessary to limit funds from being soaked up for housing, and to channel more savings towards the SA, MA and RA. It would also entail the CPF imposing tighter discipline to avoid premature leakage of retirement savings, in order to stretch the CPF dollar for a longer period of retirement. To grow retirement funds, the Government could allow greater flexibility for investing CPF savings in other financial instruments and private pensions, with some check on risks.

**“Competitiveness Model”:** The CPF emphasises its role as a macro-economic tool, especially in tough economic times. CPF rates and contributions are primarily driven by concerns about cost competitiveness and other economic challenges, with some social cost or spillover effects. This will lead to injecting greater flexibility into the CPF model to enhance responsiveness to external factors and to promote economic growth. Firms and workers are able to adjust rapidly to market realities. As for social objectives, there will be a more laissez-faire attitude from the government, necessitating a greater role for the private sector to provide affordable healthcare, housing and retirement services.

Undergirding the allocation of funds among the three objectives of retirement, housing and

healthcare lies the determination of the optimal CPF rate. The 1986 cut slaughtered one sacred cow. The more recent cuts and new floating range for the long-term rate represent one approach to ensure that we stay nimble and are not subjected to rigid unrealistic targets.

Another approach would be to reduce uncertainty for foreign investors, companies and employers by making a permanent cut, say at the overall rate of 30%. This could also help curb Government mandated wage cost increases through higher CPF rates, and entrench the principle that real wage increase must come from real productivity gains. Ultimately, there is no magic number for the optimal CPF rate or sure strategy for determining the rate. The Government must make a judgment call, as it did in 2003.

## Conclusion

Our CPF system has grown to be a robust institution and a key pillar of our governance structure. It is very much a part of ordinary Singaporeans’ lives and has contributed to the nation’s resilience in economically challenging times. For Singapore to withstand future storms and prosper, the CPF has an important role to play in influencing the behaviour of workers, employers and companies. Amidst the vicissitudes of economic and social change, the challenge is for CPF to safeguard Singaporeans’ security for old age. This objective should never change. ■