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THE Central Provident Fund (CPF) has been in existence since 1955, and plays an important role in the lives of millions of Singaporeans. But this does not mean there is nothing to be learnt from asking some fundamental questions about its usefulness.

Why, for example, do practically all developed economies have social security systems? Why is the CPF fully funded by contributors?

In this article, I seek to answer such questions. I also try to explain why, in the current circumstances, CPF-style social security systems generally work better than systems that are fully funded by the government.

Social security systems, also known as national pension plans, have their roots in Europe in the 19th century. In the 20th century, they grew in scale. The United States social security system was introduced in 1935 as the economy emerged from the debilitating effects of the Great Depression.

If people possessed perfect foresight and saved rationally, there would be no need for a social security system. But there are two important reasons people do not behave like this.

The first is that life is fraught with risk, and private insurance companies are not always able to provide insurance cover at a reasonable price.

The second is that there is strong empirical evidence that people are influenced by both long-term rational concerns and short-term emotional factors.

The result is that, in the absence of a social security system, society will always have a significant number of destitute people among its elderly population. Once a country has crossed the subsistence threshold, it is probably in the interest of all members of society that a social security system is introduced.

Should citizens be allowed to opt out if they want to?

If people really do attach undue importance to immediate gratification, forcing them to make contributions to a mandatory social security system is a good way to ensure they have money set aside for the future. Enrolling everyone may also be seen as a way of ensuring taxes will not have to be raised to finance the cost of taking care of the elderly who have opted out of the scheme, and thus do not have adequate assets to finance their retirement needs.

Such a social security system, with its universal coverage, therefore helps people save for the future.

Most national pension plans in Western economies, however, operate on a pay-as-you-go basis. In other words, social security taxes collected from working young people are used to finance the retirement benefits of the old.

There is also a social equity element in these public pension plans. A person who is born into a less well-to-do family, lacking the resources to get a head start in life, gets a boost in his retirement income. This is because there is typically a degree of progressivity in retirement benefits, so that a low-wage worker receives more in benefits in percentage terms compared with his wage earnings.

Recipients also collect benefits for as long as they are alive. This means that the system absorbs the cost of increased longevity.

How does the CPF system compare on this score?

With the Workfare Income Supplement scheme, low-wage workers who are employed receive payouts that augment their CPF balances and contribute to their retirement incomes.

High-wage earners do not enjoy this benefit. Instead, CPF members with adequate balances are obliged to participate in CPF Life, a national annuity scheme that allows older members to receive a monthly income for life. The only exceptions are for those with private annuities or pension plans that pay higher benefits.

The scheme allows risk pooling and avoids the problem of adverse selection. CPF Life also goes some way towards providing insurance for increased longevity.

The CPF system has important macroeconomic effects. In 2012, CPF balances due to members (net of withdrawals) stood at $230 billion, making up close to 28 per cent of total financial assets of the household sector, not including residential property assets.

Together with a generally prudent fiscal policy over the years, Singapore has built up a net creditor position relative to the rest of the world. Its strong reserves position gives it an advantage during international financial crises.

Many Western economies introduced a pay-as-you-go social security system at a time when their economies were growing rapidly and their populations were relatively young. With ageing populations, these pension plans are placing a strain on national budgets.

Although a move to introduce a CPF-style contribution system has been debated in these countries, there is still the problem of how to finance the needs of the transitional generation of elderly people. That generation paid taxes to help finance the social security system when they were young. But no money was set aside by the authorities to finance social security benefits during the transition to a CPF-style system of individual accounts.

As the population ages, Singapore also faces the challenge of providing retirement adequacy for CPF members. But the problems facing the CPF system are not as serious because they do not have as much impact on the national budget.

If the CPF is to serve as a means of helping its members save for their retirement years, no more flexibility in the way the funds are now being used should be given. Moreover, if the CPF is also needed to provide medical insurance cover, then mandatory participation in the national annuity scheme is justified.

The Government can absorb the risk of investing CPF funds because of its greater financial depth and capacity to tax. But the provision of adequate funds to finance an ageing population of Singaporeans depends more fundamentally on the ability of the country to maintain its economic dynamism, as the economy transits from an era of catch-up growth to being a mature economy.

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