

Pension Issues in Japan: How Can We Cope with the Declining Population?

by
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Abstract

This chapter begins with a brief sketch of the Japanese demography and its impact on financing social security. It then explains the Japanese social security pension program and summarizes Japan's major pension problems. It further examines the 2004 pension reform and uses the balance sheet approach to analyze its economic implications. The chapter discusses future policy options on pensions, as well.

Financial sustainability of social security pensions is not often attained even if its income statement enjoys a surplus. The balance sheet approach is an indispensable tool for people to understand the long run financial sustainability of social security pensions and to evaluate varying financial impacts of different reform alternatives.

When it comes to social security pensions, the most important question is whether or not they are worth buying. Contributions are required to be much more directly linked with old-age pension benefits, while an element of social adequacy has to be incorporated in a separate tier of pension benefits financed by other sources than contributions.

It is also shown that a shift to a consumption-based tax to finance the basic pension in Japan will induce smoother increases in pension burdens among different cohorts.

1 Introduction¹

Japan already has the oldest population in the world. It has built generous social security programs. In 2002 the income statement of the principal program of social security pensions moved into deficit and its balance sheet has continued

¹ This is a revised and extended version of (Takayama 2008a). The present author is grateful to Takatoshi Ito, Worawan Chandoevmit, Hyungpyo Moon, Ronald Lee, Naohiro Ogawa, and Francis Lui for their valuable comments and advices at the 19th EASE meeting, Seoul, June, 2008.

to suffer from huge excess liabilities. This has been accompanied by a growing distrust of the government's commitment on public pensions and increased concern with the incentive-compatibility problem. The 2004 pension reforms went some way towards addressing these issues.

This chapter uses a balance sheet approach to describe the current financial performance of social security pensions in Japan, and analyses the impact of the recent reform measures.

The balance sheet approach was first used about 700 years ago in Italy and since then has become one of the two major accounting tools. However, it has been underutilized for public policy analyses.

Benefits of the balance sheet approach include: first, that it describes the current financial status in stock terms by presenting assets and liabilities with their compositions; second, it implies how smoothly future financing will be carried out; and third, it makes clear the impacts of alternative policy measures on future financing.

Before going into discussion on the design flaws of Japanese pensions, some remarks have to be made on their implementation issues, since there arose a serious pension record-keeping problem in Japan from May 2007. Namely around 50 million pension records of social security are found to be floating, not being integrated to the unified specific pension numbers. The pending records are due to human errors made by enrollees, their employers and agencies. There has been no integrated collection of taxes and social security contributions in Japan, and additionally no monitoring organizations have been effectively implemented in the field of pension administration. Government officials in Japan used to be regarded as the best and brightest, and thus too much reliance on bureaucracy was observed in the past. The general public were under the illusion that government officials were able to do and did everything correctly without committing any errors. However, human errors are inevitable anywhere. Regular and prompt examinations over possible errors are required for proper record-keeping of pensions. Upon any no-match identified, a two-way notification and confirmation with correction should follow in due course. The trustworthy government with its competent and neat implementation is, thus, the basis for any pension system.

This chapter begins with a brief sketch of the Japanese demography and its impact on financing social security. It then explains the Japanese social security pension program and summarizes Japan's major pension problems. It further

examines the 2004 pension reform and uses the balance sheet approach to analyze its economic implications. The chapter discusses future policy options on pensions, as well.

2 Demography and Its Impact on Financing Social Security

In December 2006, the Japanese National Institute of Population and Social Security Research (NIPSSR) released its latest population projections. These indicated that the total population peaked at 128 million in 2004 and then began to fall steadily, decreasing to about 50 per cent of the current number by 2080.

The total fertility rate (TFR) was 1.26 in 2005 and there is little sign that it will stabilize or return to a higher level. The 2006 *medium variant* projections assume that it will record the historical low of 1.21 in 2013 and will gradually rise to 1.26 around 2050, remaining unchanged at 1.26 thereafter. The number of births in 2005 was about 1.06 million and will continue to decrease to less than 1.0 million by 2008, falling further to 0.49 million in 2050.

Because it has the world's longest life expectancy,² Japan is now experiencing a very rapid aging of its population. The number of the elderly (65 years and above) was 25.8 million in 2005. This will increase sharply to reach 36 million by 2020, remaining around 36-39 million thereafter until around 2060. Consequently the proportion of the elderly (65 years and above) will go up very rapidly from 20.2 per cent in 2005 to 30 per cent by 2023, rising further to more than 40 per cent by 2052. Japan already has one of the oldest populations in the world.

In Japan, around 70 per cent of social security benefits are currently distributed to the elderly. Along with the ailing domestic economy, the rapid population aging will certainly put increased stresses on the financing of social security.

In May 2006 the Ministry of Health, Labor and Welfare published the latest estimates of the cost of social security just after the 2006 health care reform, using the 2002 population projections of the NIPSSR. According to these estimates, the aggregate cost of social security was 17.5 per cent of GDP in 2006. This is expected to steadily increase to 19.0 per cent by 2025.³

² Further declining mortality is almost ignored by the NIPSSR projections. Things will be much worse than imagined here.

³ Of the various social security costs, that of pensions is predominant, amounting to 9.2 per cent of GDP in 2006, with an expected decrease to 8.7 per cent by 2025 after the 2004

3. Japanese Pension Provisions before the 2004 Reform

Since 1980, Japan has undertaken piecemeal pension reforms every 5 years, mainly due to great stresses caused by anticipated demographic and economic factors. This has resulted in a step by step reduction in the generous pension benefits, an increase of the normal pensionable age from 60 to 65, and an increase in the pension contribution rate. Yet, in 2004, the pension provisions still remained generous and the system seemed likely to face serious financial difficulties in the future.

Japan currently has a two-tier benefit system. All sectors of the population receive the first-tier, flat-rate basic benefit. The second-tier earnings-related benefit applies only to employees.⁴ The system operates largely like a pay-as-you-go defined benefit program.

The flat-rate basic pension covers all residents aged 20 to 60. A minimum 25-year contribution is required to receive an old-age benefit. The full old-age pension is payable after 40 years of contributions, provided the contributions were made before 60 years of age. The maximum *monthly* pension of 66,000 yen (in 2008 prices) per person is payable from age 65.⁵ This benefit was indexed annually to reflect changes in the consumer price index (CPI). The pension may be claimed at any age between 60 and 70 years and is subject to actuarial reduction if claimed before age 65, or actuarial increase if claimed after 65 years.

Earnings-related benefits are given to all employees. The accrual rate for the earnings-related component of old-age benefits was 0.5481 per cent per year; 40 years' contributions would thus earn 28.5 per cent of career average monthly real earnings.⁶

The career-average monthly earnings are calculated over the employee's entire period of coverage, adjusted by a net-wage index factor, and converted to the current earnings level. The full earnings-related pension is normally payable from age 65 to an employee who is fully retired.⁷ An earnings test is applied to

reform. The cost for health care is 5.4 per cent in 2006, but is projected to steadily rise to 6.4 per cent by 2025.

⁴ A detailed explanation of the Japanese social security pension system is given by (Takayama 1998, 2003b).

⁵ 1,000 yen = US\$9.16 = Euro6.15 = UK £ 4.83 as at 13 August 2008.

⁶ A semi-annual bonus equivalent to 3.6 months salary is typically assumed.

⁷ The normal pensionable age of the KNH is 65, though Japan has special arrangements

those who are not fully retired. The current replacement rate (including basic benefits) for take-home pay or net income is about 60 per cent for a typical male retiree (with an average salary earned during 40 years of coverage) and his dependent wife. This translates to a *monthly* benefit of about 233,000 yen in 2008.

Equal per centage contributions are required from employees and their employers. The contributions are based on annual standard earnings including bonuses. Before the 2004 reforms, the total contribution rate for the principal program for private-sector employees (Kosei-Nenkin-Hoken, KNH), was 13.58 per cent. Non-employed persons between the ages of 20 to 60 years paid flat-rate individual contributions. The 2004 rate since April 1998 was 13,300 yen per month. And those who cannot pay for financial reasons are exempt. The flat-rate basic benefits for the period of exemption will be one-third of the normal amount.

As well, if the husband has the pension contribution for social security deducted from his salary, his dependent wife is automatically entitled to the flat-rate basic benefits, and she is not required to make any individual payments to the public pension system.

The government subsidizes one-third of the total cost of the flat-rate basic benefits plus administrative expenses. There is however no subsidy for the earnings-related part. All social security pension contributions are tax-deductible, while the overwhelming parts of their benefits are virtually tax-exempt.

For 2004 the aggregate amount of social security pension benefits is estimated at around 46 trillion yen, or about 9 per cent of GDP.⁸

4 Some Basic Facts on Pensions

Any pension reform proposal must take into account the current basic facts on social security pensions. Of these, the following five are especially crucial.

A Persistent Deficit in the Income Statement

Since 2002, the pension scheme for private sector employees (KNH) has

for a transition period between 2000 and 2025. See (Takayama 2003b) for more details.

⁸ Almost all Japanese employees receive occupational pensions and/or lump-sum retirement benefits, as well. See (Takayama 2003b) for more information.

been facing an income statement deficit. It recorded a deficit of 1.3 trillion yen in 2002, increasing to 9.8 trillion yen in 2005. It is estimated that this deficit will persist for a long time, unless radical remedies are made in the KNH financing.

Huge Excess Liabilities in the Balance Sheet

The KNH balance sheet is shown in Table 1. In calculating the balance sheet, it was assumed that: the annual increases in wages and the CPI were 2.1 per cent and 1.0 per cent respectively, nominal, while the discount rate is 3.2 per cent annually; and the 2003 contribution rate of the KNH of 13.58 per centage points, would remain unchanged over the projection period (to the year 2100).

Table 1 indicates that as at the end of March 2005, excess liabilities of the KNH are estimated at 550 trillion yen, which is a quarter of the total liabilities.⁹

(Table 1 about here)

The balance sheet set out in Table 1 has two parts. Part One illustrates the assets and liabilities accrued from past contributions, while Part Two refers to assets and liabilities accrued from future contributions.¹⁰ It can be seen that as far as Part Two is concerned, any excess liabilities are almost eliminated. That is, the funding sources of the current provisions will be sufficient to finance future benefits. Here the only task left is to slim down future benefits by 4.5 per cent.

But if we look at Part One of the balance sheet, things appear quite different. The remaining pension liabilities are estimated to be 800 trillion yen, while pension assets are only 300 trillion yen (comprising a funded reserve of 170 trillion yen plus transfers from general revenue of 130 trillion yen). The difference is quite large, about 500 trillion yen,¹¹ which accounts for most of the excess liabilities in the KNH and is equivalent to about 100 per cent of GDP of Japan in 2004.

⁹ Excess liabilities of all social security pension programs in Japan as at the end of March 2005 amounted to around 650 trillion yen, which is equivalent to 1.3 times the year 2004 GDP of Japan.

¹⁰ The balance sheet approach is slightly different from the generational accounting one which is initiated by L. Kotlikoff.

¹¹ The amount of excess liabilities (EL) will vary depending on alternative discount rates. For example, a 2.1 per cent discount rate induces EL of 650 trillion yen, while another 4.0 per cent discount rate produces EL of 420 trillion yen. Part One excess liabilities can be termed as “accrued-to-date net liabilities” or “net termination liabilities”. See (Franco 1995) and (Holzmann et al. 2004).

In the past, too many pension promises were made, while sufficient funding sources had not been arranged. As a result, the Japanese have enjoyed a long history of generous social security pensions. However, contributions made in the past were relatively small, resulting in a fairly small funded reserve. Consequently, the focus of the true crisis in Japanese social security pensions is how to handle the excess liabilities of 500 trillion yen representing entitlements from contributions made in the past.

The Heavy Burden of Pension Contributions

In Japanese public policy debates, one of the principal issues has been how to cut down personal and corporate income tax. But recently the situation has changed drastically. Social security contributions (for pensions, health care, unemployment, work injury and long-term care) were 55.6 trillion yen (11.2 per cent of GDP) for FY2003, more than all tax revenues (43.9 trillion yen) of the central government for the same year. Since 1998, the central government has received more revenue from social security contributions than from tax on incomes; FY2003 revenue from personal income tax was 13.8 trillion yen and from corporate income tax 9.1 trillion yen, while revenue from social security pension contributions stood at 29.0 trillion yen. As a result many Japanese now feel that the burden of social security pension contributions is far too heavy and employers have begun to express serious concerns about any further increases in social security contributions.

Overshooting the Income Transfer between Generations

Currently in Japan the elderly are better-off than those aged 30 to 44 in terms of per-capita income after redistribution (see (Takayama 1998, 126) for more details). This amazing fact suggests that current pension benefits may be too generous and there is still room for reduction in benefits provided to the current retired population (which would address the excess liabilities indicated by the balance sheet).

An Increasing Drop-out Rate

In the past 30 years, the Japanese government has made repeated changes to the pension program, increasing social security pension contributions and reducing benefits through raising the normal pensionable age while reducing the accrual rate. Similar piece-meal reforms are likely continue into the future.

Many Japanese feel that the government is breaking its promise. As distrust of the government's pension commitment builds up, non-participation is growing.

In 2007, 54 per cent of non-salaried workers and persons with no occupations dropped out from the basic level of old-age income protection, owing to exemption or failure to pay contributions (see Figure 1). Any further escalation in the social security contribution rate will surely induce a higher drop-out rate.¹²

(Figure 1 about here)

5 The 2004 Pension Reform: Main Features and Remaining Difficulties¹³

The administration of Prime Minister Koizumi Jun'ichirō submitted a set of pension reform bills to the National Diet on February 10, 2004. These were enacted on June 5. This section will describe the gist of the approved reforms and explore issues that remain to be addressed.

Increases in Contributions

Salaried workers are, as a rule, enrolled in the KNH, which is part of the public pension system. Contributions under this plan had since October 1996 been set at 13.58 per cent of annual income, paid half by the worker and half by the employer. The newly enacted reforms raised this rate by 0.354 percentage points in October 2004. The rate will rise every September thereafter by the same amount until 2017, after which it will remain fixed at 18.30 per cent of annual income. The portion paid by workers will accordingly rise to 9.15 per cent of annual income.

For an "average" male company employee earning 360,000 yen a month plus an annual bonus equivalent to 3.6 months' pay, total contributions will increase by nearly 20,000 yen a year starting from October 2004, and by the time they stop rising in September 2017, they will have reached just under 1.03 million yen a year (of which the share paid by the worker will be just over 514,000 yen or 35 per cent more than the 2004 level of contributions).

Those who are not enrolled in the KNH or other public pension schemes for

¹² Integrated collection of social security pension and healthcare contributions can reduce drop-out rates.

¹³ This section draws heavily on (Takayama 2004).

civil servants are required to participate in the National Pension plan (Kokumin-Nenkin, KN), which provides the so-called basic pension *only* (the basic pension also forms the first tier of benefits under the KNH and other public pension systems for civil servants). Contributions under this plan will rise by 280 yen each April from 13,300 yen per month in 2004 until they plateau at 16,900 yen (at 2004 prices) in April 2017. The actual rise in National Pension contributions will be adjusted according to increases in general wage levels.

In addition, the government will increase its subsidies for the basic pension. Currently one-third of the cost of basic pension benefits is paid from the national treasury; this share is to be raised in stages until it reaches one-half in 2009.

Reductions in Benefits

Benefits under the KNH consist of two tiers; the flat-rate basic pension, which is paid to all public pension plan participants, and a separate earnings-related component. The latter is calculated on the basis of the worker's average preretirement income, converted to current values. Until now, the index used to convert past income to current values was the rate of increase in take-home pay. Under the recently enacted reforms, however, this index is subject to a negative adjustment over a transition period based on changes in two demographic factors - the decline in the number of participants and the increase in life expectancy. This period of adjustment is expected to last through to 2023.

The application of the first demographic factor means that benefit levels will be cut to reflect the fact that fewer people are supporting the pension system. The actual number of people enrolled in all public pension schemes will be ascertained each year, and the rate of decline will be calculated based on this figure. The average annual decline is projected to be around 0.6 points.

The second demographic factor will adjust for the fact that people are living longer and thus collecting their pensions for more years; the aim is to slow the pace of increase in the total amount of benefits paid as a result of increased longevity. This factor will not be calculated by tracking future movements in life expectancy; instead, it has been set at an annual rate of about 0.3 per centage points on the basis of current demographic projections for the period through 2025. Together, the two demographic factors are thus expected to lead to a negative adjustment of about 0.9 points a year during the period in question.

How will these changes affect people's actual retirement benefits? Let us consider the case of a pair of "typical" KNH beneficiaries as defined by the

Ministry of Health, Labor, and Welfare: a 65-year-old man who earned the average wage throughout his 40-year career and his 65-year-old wife who was a full-time homemaker for 40 years from her twentieth birthday. In FY 2004, this typical couple would receive 233,000 yen a month.

How does this amount compare to what employees are currently taking home? The average monthly income of a salaried worker in 2004 was around 360,000 yen, before taxes and social insurance deductions. Assuming that this is supplemented by bonuses totaling an equivalent of 3.6 months' pay, the average annual income is roughly 5.6 million yen. Deducting 16 per cent of this figure for taxes and social insurance payments leaves a figure for annual take-home pay of about 4.7 million yen, or 393,000 yen a month.

The 233,000 yen provided to the typical pensioners is 59.3 per cent of 393,000 yen. However, under the 2004 reforms this per centage, or replacement rate, will gradually decline to an estimated figure of 50.2 per cent by FY 2023 (assuming that consumer prices and nominal wages rise according to government projections by 1.0 per cent and 2.1 per cent a year, respectively). Over the next two decades, then, benefit levels are projected to decline by roughly 15 per cent by comparison with wage levels.

The revised pension legislation stipulates that the income replacement rate is not to fall below 50 per cent for the typical case described above, so the transition period of negative adjustment will come to an end once the replacement rate declines to 50 per cent. This provision was included to alleviate fears that retirement benefits would continue to shrink without limit.

How will the reforms affect those who are already receiving their pensions? Until now, benefits for those 65 years old and over were adjusted for fluctuations in the consumer price index. This ensured that pensioners' real purchasing power remained unchanged and helped ease postretirement worries. But this cost-of-living link will effectively be severed during the transition period, since the application of the demographic factors will pull down real benefits by around 0.9 points a year. In principle, however, nominal benefits are not to be cut unless there has also been a drop in consumer prices. Once the transition period is over, the link to the consumer price index is to be restored.

Changes to Provisions for Working Seniors and Divorcees

People aged 60-64 who were receiving pensions and also had wage income had their benefits reduced by a flat 20 per cent, regardless of how much or little

they earned. This rule was abolished in the 2004 reforms so as not to discourage older people from working. However these older workers will still be subject to the previous rule that if the sum of wages and pension benefits exceeds 280,000 yen a month (after factoring in annual bonuses), the pension benefits are to be cut by 50 per cent of the amount in excess of this level.

Workers aged 70 and over, meanwhile, have been exempt from paying into the KNH, even if they are still on a company's payroll. And they didn't have their benefits reduced no matter how much they earned. Beginning in April 2007, however, their benefits are reduced if they are high-income earners. Those receiving more than an equivalent of 480,000 yen a month in wages and pension benefits will have their benefits cut by 50 per cent of the amount in excess of this level. This is a rule that currently applies to those aged 65 to 69, as well. The over-70s group will still be entitled to the full amount of the basic pension, and they will continue to be exempt from paying contributions.

Divorced wives were not legally entitled to any portion of their former husbands' earnings-related pension benefits, but this changed under the 2004 reforms. Couples who divorce after April 2007 are able to split the rights to the earnings-related portion of the husband's pension that accrued during their marriage. The wife is able to receive a share of up to 50 per cent of these rights with the actual share to be determined by agreement between the two. For rights accruing after April 2008, moreover, a full-time homemaker is able to automatically receive half of her husband's benefits in case of divorce by filing a claim at a social insurance office. Underlying this rule is the assumption that even though the contributions are paid in the husband's name, the wife has provided half of the couple's livelihood through her work as a homemaker.¹⁴

Improved Survivors' Benefits and Child-raising Concessions

Until now widowed spouses younger than 30 and without children under the age of 18 have been entitled to lifelong benefits under the survivor's pension scheme (based on the earnings of the deceased spouse). After April 2007, however, they receive benefits for no longer than five years.

Workers taking child-care leave are exempt from making pension contributions, and to prevent a decrease in their future benefits due to this period of nonpayment, they are treated as having continued their full payments, even

¹⁴ The provisions for working husbands and dependent homemaker wives apply conversely in cases where a home-maker husband is dependent on the wife.

when they have no income. This special exemption can now be claimed for up to one year after childbirth, but starting in April 2005 the period is extended until the child reaches age three.

Also from April 2005, parents who change their working arrangements to put in shorter hours so as to care for children under age three and who take a corresponding cut in pay are treated as having worked full time and earned a full salary. Actual contributions during this three-year period, though, are based on the lower earnings.

Other Public and Private Pension Reforms

As a rule, a person cannot simultaneously receive more than one public pension. But the recent reforms have created an exception. People with disabilities who had gainful employment and paid pension contributions are, from April 2006, entitled to not only their basic disability pension but also the earnings-related component of the old-age pension or survivor's pension. This measure is designed to encourage greater employment among these people.

Participants in the National Pension plan who had low incomes paid either half of the regular contributions or none at all. There is a finer tuning of payment exemptions starting in July 2006, when low-income earners may also be exempt from paying one-quarter or three-quarters of the regular contributions.

As well, the administrative processes are improved and streamlined. In the past, pension plan participants found out how much they would receive in benefits only by going to a social insurance office with their pension pass-books after they had reached age 55. From April 2008, however, such information is disclosed to all contributors each year, along with their payment records.

The reforms cover private pension plans as well. From October 2004, the upper limit of the amount that can be put aside each month under company-funded defined-contribution pension plans was raised from 36,000 yen to 46,000 yen in cases where there is no other corporate pension plan and from 18,000 yen to 23,000 yen where there is another plan in effect. The ceiling on monthly installments under individually funded defined-contribution plans for salaried workers was raised from 15,000 yen to 18,000 yen where there is no corporate pension coverage, while the cap for the self-employed remained unchanged at 68,000 yen. The higher ceilings for private plans are designed to make up for the anticipated smaller benefits of public old-age schemes.

Is the 2004 Reform Incentive-compatible?

Social insurance contributions in Japan already exceed the amount collected in national taxes, and contributions to the pension system are by far the biggest social insurance item. If this already huge sum is increased by more than 1 trillion yen a year, as the government plans, both individuals and companies are very likely to change their behavior. Government projections of revenues and expenditures, though, completely ignore the prospect of such change.

It is possible that companies will reconsider their hiring plans and wage scales to avoid the higher social insurance burden. They may cut back on recruitment of new graduates and become more selective about midcareer hiring as well. Many young people will be stripped of employment opportunities and driven out of the labor market, instead of being enlisted to support the pension system with a percentage of their income. As well, the employment options for middle-aged women who wish to reenter the work force will be reduced and as only a few older workers will be able to continue commanding high wages; there is likely to be a dramatic rise in the number of aging workers who will be forced to choose between remaining on the payroll with a cut in pay or settling for retirement. It is possible that many more companies will either choose or be forced to leave the KNH, causing the number of subscribers to fall far below the government's projections and pushing the system closer to bankruptcy.

If these event come to fruition, the jobless rate on the whole could rise. The Japan Ministry of Economy, Trade, and Industry has estimated that higher pension contributions could lead to the loss of 1 million jobs and boost the unemployment rate by 1.3 per centage points.

The government plan to increase pension contributions annually for the next 10 years will therefore exert ongoing deflationary pressure on the Japanese economy. For the worker, a rise in contribution levels means less take-home pay; as a result, consumer spending is likely to fall, and this will surely hinder prospects for an economic recovery and return to steady growth, which is one of the most important factors for Japan to make social security sustainable.

Another problem with increasing pension contributions is that they are regressive, since there is a ceiling for the earnings on which payment calculations are based and unearned income is not included in the calculations at all.

One major objective of the 2004 reforms is to eventually eliminate the huge excess liabilities in the balance sheet of the KNH. The plan is to generate a

surplus by (1) increasing contributions, (2) increasing payments from the national treasury, and (3) reducing benefits. The policy measures adopted in the 2004 pension reform bill will induce huge *excess assets* of 420 trillion yen in Part Two of the balance sheet while offsetting excess liabilities of the same amount in Part One, as shown in Table 2.¹⁵ Huge excess assets of Part Two of the balance sheet imply that future generations will be forced to pay more in contributions than the anticipated benefits they will receive. That is, it is estimated that in aggregate the present value of future benefits will be around 80 per cent of the present value of future contributions.

(Table 2 about here)

It is as if the Japanese government is cutting paper not with scissors but with a saw. Younger generations are most likely to intensify their distrust against Government and the incentive-compatibility issue or drop-out problem will intensify. The management lobby (Nippon Keidanren) and trade unions (Rengo) both oppose any further increases of more than 15 per centage point in the KNH contribution rate.

A Declining Replacement Rate

As noted above, those who are already receiving their pensions will see their benefits decline in real terms by an average 0.9 per centage points per year. The government scenario sees consumer prices eventually rising 1.0 per cent a year and take-home pay by 2.1 per cent a year. This means that the typical beneficiary who begins receiving 233,000 yen a month at age 65 in 2004 will get roughly 240,000 yen at age 84 in 2023., in other words, nominal benefits will remain virtually unchanged for two decades, despite the fact that average take-home pay of the working population is projected to have risen by over 40 per cent. The income replacement rate, which stood at nearly 60 per cent at age 65, will dwindle to 43 per cent by the time the typical recipient turns 84. The promise of benefits in excess of 50 per cent of take-home pay does not apply, therefore, to those who are already on old-age pensions.

Automatic Balance Mechanism: Still Incomplete

¹⁵ Assumptions in Table 2 are same as those described in Section 4 in this chapter. Annual productivity growth of 0.7 per cent is incorporated.

The so-called demographic factors are likely to continue changing for the foreseeable future. The government itself foresees the number of participants in public pension plans declining over the coming century: The estimated figure of 69.4 million participants in 2005 is expected to fall to 61.0 million in 2025, 45.3 million in 2050, and 29.2 million in 2100. This corresponds to an average annual decline of 0.6 per cent through 2025, 1.2 per cent of the quarter century from 2025, and 0.9 per cent for the half century from 2050. In other words, the decline in the number of workers who are financially supporting the public pension system will continue for many decades.

The 2004 reforms, however, adjust benefit levels in line with the decline in the contribution paying population for the next 20 years only; the government's "standard case" does not foresee any further downward revisions, even if the number of participants continues to fall. If the government really anticipates an ongoing decline in participation, there is no good reason to abruptly stop adjusting benefit levels after a certain period of time.¹⁶

The decision to keep the typical income replacement rate at 50 per cent at the point when pension payments commence represents, in effect, the adoption of a defined benefit formula. Maintaining both fixed contributions on the one hand and defined benefit levels on the other is not an easy task, as there is little room to deal with unforeseen developments. The government will be confronted with a fiscal emergency should its projections for growth in contributions and a reversal in the falling birthrate veer widely from the underlying assumptions.

For example, the government has based its population figures on the January 2002 projections of the NIPSSR. Under these projections, the medium variant for the total fertility rate (the average number of childbirths per woman) falls to 1.31 in 2007, after which it begins climbing, reaching 1.39 in 2050 and 1.73 in 2100. Actual figures since the projections were released have been slightly lower than this variant, and there are no signs whatsoever that the fertility rate will stop declining in 2007.

The Normal Pensionable Age

If the government is to keep its promise on an upper limit for contributions and a lower limit for benefits, the only policy option it will have in the event of a financial shortfall will be to raise the age at which people begin receiving benefits.

¹⁶ The replacement rate at 50 per cent can be regarded as still too high, since many people will also receive occupational pensions.

The reform package makes no mention of such a possibility; policymakers no doubt chose to simply put this task off to a future date.¹⁷

Increasing Transfers from General Revenue, Why?

By FY 2009 the share of the basic pension benefits funded by the national treasury will be raised from one-third to one-half. This means that more taxes will be used to cover the cost of benefits. Taxes are by nature different from contributions paid by participants in specific pension plans, and there is a need to reconsider the benefits that are to be funded by tax revenues.

The leaders of Japanese industry tend to be quite advanced in years. For the most part, they are over the age of 65, which means that they are qualified to receive the flat-rate basic pension. Even though they are among the wealthiest people in the country, they are entitled to the same basic pension as other older people hovering around the poverty line. Using tax revenues to finance a bigger share of the basic pension essentially means asking taxpayers to foot a bigger bill for the benefits of wealthy households as well. For an elderly couple, the tax-financed portion of the basic pension will rise from 530,000 yen a year to 800,000 yen. If a need arises to raise taxes at a future date, who will then actually agree to pay more? Few people will be willing to tolerate such wasteful uses of tax revenue.

6 Future Policy Options in Social Security Pensions

There are five major policy options discussed in Japan, as follows.

Option 1: Privatizing the 2nd-tier Earnings-related Pension

The background for privatization is that too many promises have been made on social security pensions and their down-sizing is required. Japan Association of Corporate Executives (Keizai-Doyu-Kai) proposes a privatization of the earnings-related portion, with paying off the reduced earned entitlement by around 30-40 per cent. The proportion of this reduction is to be decided by the remaining funded reserve of the KNH.

The proposed pay-off scheme is unpopular, however. It is still an open question how to make the privatization politically feasible.

¹⁷ Raising the normal pensionable age will be implemented for financial reasons as in the US, the UK and Germany, even though it might not be socially acceptable.

Option 2: A Move to a Fully-funded Plan

Many economists in Japan believe that any pay-as-you-go pension program is financially vulnerable to an aging population with declining fertility. They recommend a move to a mandated fully-funded pension plan to avoid the demographic risks (see (Hatta-Oguchi 1992) for example).

Others say, however, that it is *not* the pay-as-you-go program *but* the defined benefit (DB) plan that is financially fragile under demographic changes. The KNK (Kosei-Nenkin-Kikin), a typical occupational DB pension plan, which enables a contracted-out from social security pensions in Japan, faced a huge financial risk after the bubble burst in 1990s. It turned quite unpopular and a majority of them have been abolished since then. Any move to a fully-funded DB plan can no longer promise sound financing.

Option 3: A Switch to Universal Pensions

The drop-out problem is getting more and more serious in recent Japan. The elderly receiving no social security pension benefits were 420,000 persons in January 2007, and the number will increase to 1.18 million in the near future. Those elderly with a smaller monthly amount of pension benefits of less than 30,000 Japanese yen amounted to 1.03 million in number, and 90 per cent of them were female (see (Takayama 2008b) for more details) .

In order to overcome these difficulties, Democratic Party, Nippon Keidanren, Rengo, Members from the private sector of the National Council on Economic and Fiscal Policy, Japan, and Nikkei newspaper group have proposed to shift from the current contribution-based basic pension to a universal pension which is wholly financed by taxes.

Figure 2 illustrates changes in net burdens among different cohorts through this shift. In estimating these changes, it is assumed¹⁸ that a) a universal pension is to be introduced in 2007, b) its benefit level is the same as that of the current flat-rate basic pension, c) the flat-rate monthly contributions of 14,100 Japanese yen per person for non-employees are abolished and the employees' portion of the KNH contributions (around 7.5 per cent of their annual salaries) is reduced by 5.0 per centage points, while the employers' portion of the KNH

¹⁸ See (Takayama-Miyake 2008) for more details on the assumptions and estimating procedures here. (The National Council on Social Security, Japan 2008) made a different estimate, assuming that both employees' and their employers' portions of the KNH contributions are reduced by the same percentage points.

contributions remains unchanged, d) instead, an ear-marked consumption-based tax of around 4.3 per cent is newly introduced to finance the universal pension on a fully pay-as-you-go basis, and e) the tax-base is 90 per cent of the total consumption expenditure. A typical life course is assumed, as well. That is, a man starts working as an employee at age 20, continuing working until age 65 when he begins to receive pension benefits, and dies at age 80. At age 30, he marries a woman, 4 years younger, who becomes a full-time housewife, without divorcing until his death. His wife lives longer, dying at age 85.

(Figure 2 about here)

Unless the shift of financing sources above stated takes place, the contribution rate of the KNH will gradually rise from around 15 per cent in 2007 to 18.3 per cent by 2017. With these increases in pension contributions, the younger the cohort, the heavier his/her lifetime burdens after 2007. Needless to say, current elderly people of age 65 and over will not incur any additional pension burdens in this setting.

The alternative financing shift to a universal pension brings a varying effect on pension burdens among different cohorts. Current pensioners will be forced to cover additional burdens of the newly introduced ear-marked consumption-based tax, whereas the younger cohorts born after around 1955 can enjoy some net decreases in pension burdens through the switch of financing sources from contributions to consumption-based tax. The overall net lifetime impact will be increased burdens for everybody, as is shown in Figure 2, although the financing shift to a consumption-based tax will induce smoother increases in pension burdens among different cohorts.

Any increases in social security burdens on the current elderly look still politically hard in Japan. Without these changes, however, their children and grand-children will surely be forced to bear much heavier burdens for social security.

If we want to minimize increases in the consumption-based tax, it is worth considering a Canadian type of the claw back scheme which is applied to pension beneficiaries with a higher income.

Option 4: A Move to NDC

The Japan Ministry of Health, Labor and Welfare has shown a great interest

in switching the pension system to an NDC (notional defined contribution) arrangement. It has indicated, however, that it does not consider such a switch to be realistic until the KNH contribution rate reaches its peak level in 2017.

However, switching to an NDC arrangement can be introduced in Japan sooner, if we *separate* the “legacy pension” problem from the issue of re-building a sustainable pension system for the future.

The legacy pension problem is equivalent to *sunk costs* in the economic perspective. It can be solved not by increasing the KNH contribution rate but by introducing a new tax – for example a 3.2 per cent earmarked consumption-based tax and intensive interjection of the increased transfers from general revenue.¹⁹ Needless to say, the current generous benefits can also be reduced more or less by the same per centage in the aggregate level as implemented in the 2004 pension reform.

As far as Part Two of the balance sheet which relates to future contributions and promised pension benefits entitled by future contributions, is concerned, a switch to the NDC is possible. The KNH contribution rate can be kept unchanged at around current 15 per centage points. As well, the notional rate of return may be endogenous, following a Swedish-type automatic balance mechanism.

Importantly, with the NDC plan, the incentive-compatibility problem can be avoided. Indeed, every dollar counts in the NDC, and this would be the most important element of a switch to an NDC plan. It will be demonstrated to the public that everybody gets a pension equivalent to his/her own contribution payments.²⁰

Further, an NDC plan is expected to be rather neutral to the retirement decision. The labor force participation rate for Japanese elderly males still remains at a considerably high level (70.9 per cent in 2006 for those of age 60 to 64) as compared with other developed countries. The shift to NDC arrangements can induce later retirement also in Japan, but its effect may not be so significant.

A move to NDC may lead to lower replacement rates at age 65. However, this can be compensated by working longer to age 67 or so, or by more voluntary saving.

While not explicitly considering NDC arrangements, the Japanese

¹⁹ Alternatively, a 2 per cent earmarked consumption tax might be all right, since the remaining excess liabilities of 90 trillion yen may be acceptable as a “hidden” national debt.

²⁰ See (Könberg 2002), (Palmer 2003) and (Settergren 2001) for more details. The NDC is still a pay-as-you-go scheme, but it is no longer financially vulnerable.

government has signaled increased support of financial defined contributions (FDC) arrangements by deciding to give more tax incentives to the existing defined contribution plan from October 2004 onward.²¹

Option 5: Introducing a Minimum Guaranteed Pension

The NDC does not suffice, however, when we also need to take account of *social adequacy*.

One way to resolve this problem is to introduce a minimum guaranteed pension, as Yomiuri newspaper group suggests. The National Council of Social Security, Japan (2008) estimated the cost of introducing such a pension with income-testing. According to the estimate, the cost will be around 1.0 trillion yen, looking politically more feasible than other options. It remains a future task to specify the provision of income-testing and tax sources, ear-marking or general revenue.²²

An evidence-based policy decision is recommended. There remain a lot of empirical researches before the Japanese adopt wise and appropriate policy measures for the future.

7. Concluding Remarks

The December 2006 release of future population projections by the NIPSSR made social security financing more serious. The majority of the population have recognized the gravity of the problem. The Japanese can forgive and forget.

Socioeconomic conditions will change very rapidly. The changes that take place will often be beyond our expectations. Never-ending reforms of social security are inevitable in Japan, where only fine-tuning of programs even in the face of changing circumstances is acceptable in the political arena.

The Japanese are increasingly concerned with the “taste of pie” rather than the “size of pie” or the “distribution of pie.” When it comes to social security pensions, the most important question is whether or not they are worth buying. It has become a secondary concern how big or how fair they are. Despite the comprehensive 2004 reforms, many issues remain. In particular, the basic

²¹ Mandating a partial FDC can be an option, when the KNH benefit level is further reduced.

²² Another option is to raise the returns on the Government pension investment fund (GPIF). Deregulations will bring higher returns.

design of the pension program has to be incentive-compatible. Contributions must be much more directly linked with old-age pension benefits, while an element of social adequacy should be incorporated in a separate tier of pension benefits financed by sources other than contributions.

Traditionally the current (and projected future) income statement has been the major tool for describing the financial performance of social security pensions all over the world. It can only give half the story, however. Financial sustainability of social security pensions is often unattained even if its income statement enjoys a surplus. The balance sheet approach is now an indispensable tool for people to understand the long run financial sustainability of social security pensions and to evaluate varying financial impacts of different reform alternatives. This chapter provides a typical example of applying the balance sheet approach to analyzing social security pensions.

Balance sheet of social security pensions in the US, Sweden, Germany, Korea, Singapore and China have also been available for some time. It is essential that the approach be used for future policy developments anywhere in the world.

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Table 1 Balance Sheet of the KNH before Reform as at the 31st March 2005

| | | (trillion yen) |
|--------------------------------------|--|----------------|
| 1. Part One | | |
| Assets | | |
| Financial reserves | | 170 |
| Transfers from general revenue | | 130 |
| | | |
| Liabilities | | |
| Pensions due to past contributions | | 800 |
| <hr/> | | |
| Excess liabilities | | 500 |
| <hr/> | | |
| 2. Part Two | | |
| Assets | | |
| Contributions | | 920 |
| Transfers from general revenue | | 130 |
| | | |
| Liabilities | | |
| Pensions due to future contributions | | 1,100 |
| <hr/> | | |
| Excess liabilities | | 50 |

Note) The present author's own calculation

**Table 2 Balance Sheet of the KNH after Reform as at
the 31st March 2005**

| | | (trillion yen) |
|--------------------------------------|--|----------------|
| 1. Part One | | |
| Assets | | |
| Financial reserves | | 170 |
| Transfers from general revenue | | 150 |
| Liabilities | | |
| Pensions due to past contributions | | 740 |
| Excess liabilities | | 420 |
| 2. Part Two | | |
| Assets | | |
| Contributions | | 1,200 |
| Transfers from general revenue | | 190 |
| Liabilities | | |
| Pensions due to future contributions | | 970 |
| Excess assets | | 420 |

Source) Ministry of Health, Labor and Welfare Japan,
The 2005 Financial Recalculation of the KNH, 2004 (in Japanese)

Figure 1 Drop-out from Social Security Pensions (Category 1 Non-employees) Delinquency in Paying Pension Contributions

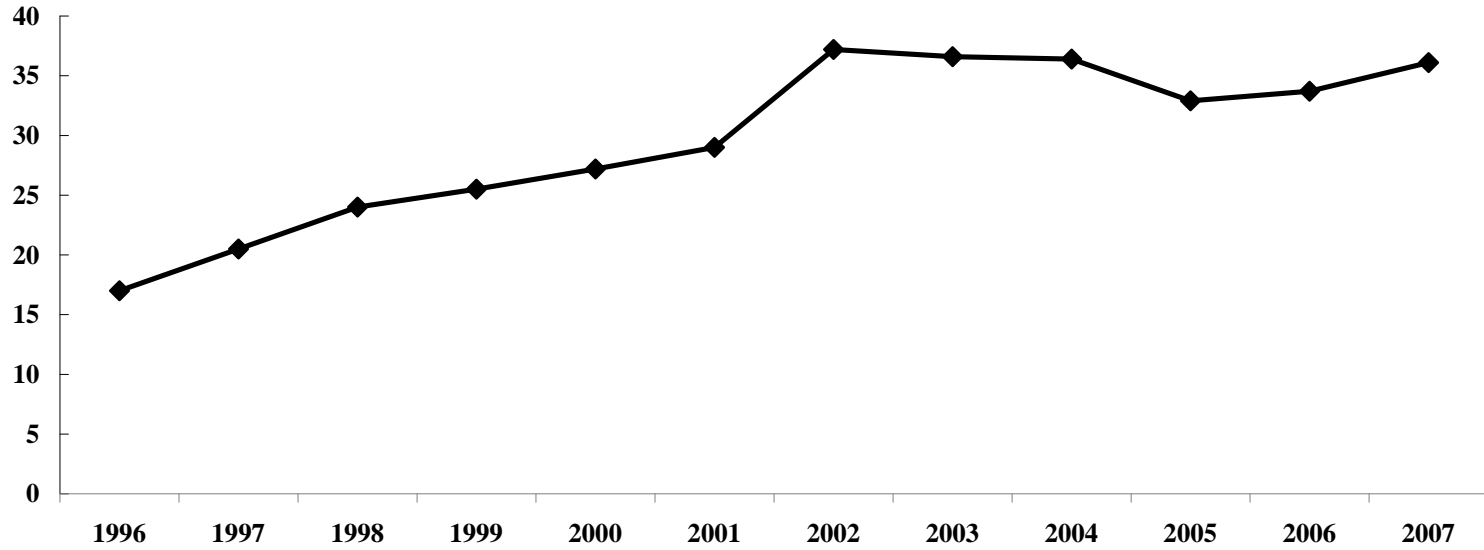
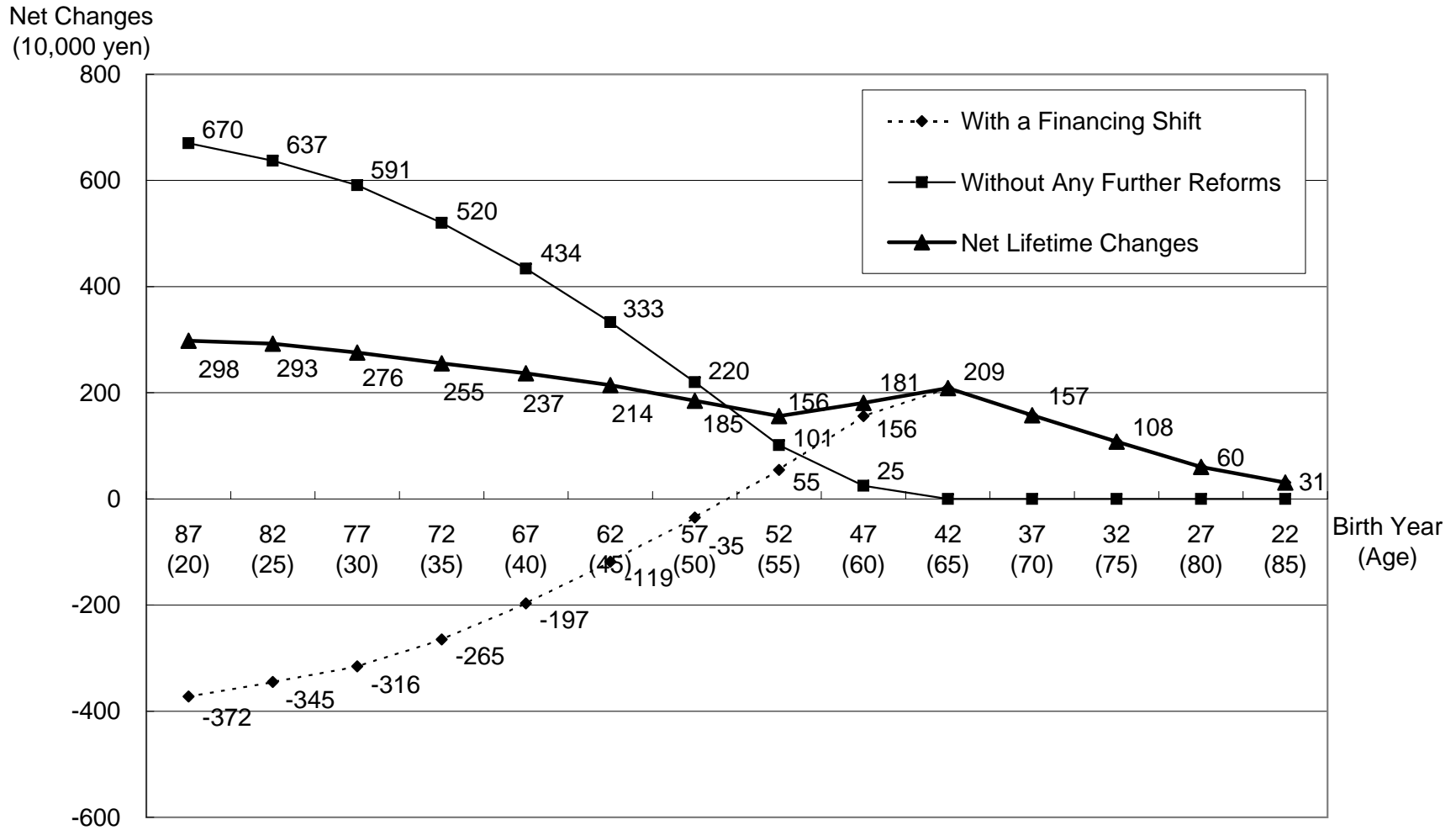


Figure 2 Net Changes in Lifetime Burdens of Social Security Pensions



Note: Ages are in 2007. Source: The present author's own calculation.