

# PENSION COVERAGE IN JAPAN

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## [ABSTRACT]

Japan has devoted considerable effort toward the coverage of all people with social insurance pension systems. The coverage is among the highest in the world, with only 1.6% of the elderly currently not receiving social security old-age pension benefits. Due to several reasons however, the drop-out rate from basic protections schemes has recently been increasing. Weak implementations have aggravated lower coverage. Incentives, compliance and accountability are basic prerequisites for maintaining or expanding good coverage. A trustworthy government capable of competent and neat implementation is required for broader coverage, as well.

### Introduction

Japan has mandated social insurance pensions for all residents, the principal objective being to secure adequate income in old age. However, a contribution-based social insurance pension presents some disadvantages. Collecting contributions from small-size companies, atypical employees and informal sector workers is not easy, since administration and enforcement costs are relatively high. This may leave low-income workers, in particular, outside the social insurance umbrella. In view of those difficulties, Japan provides several social pensions, as well, to attain higher coverage and minimize the risks of elderly poverty.

This chapter describes the current social insurance pension system in Japan, giving special emphasis to coverage issues. Covering the informal sector is still a major challenge, and the introduction of a universal or minimum guaranteed pension has been the subject of heated debate. The Japanese experience furnishes a valuable lesson on what to do and what not to do when extending pension coverage.

### 1. Current Provisions of Social Insurance Pensions: A Brief Sketch

Japan already has the oldest population in the world. The proportion of the elderly of age 65 and above was more than 20% in 2005 (see Table 1) and will have risen to more than 40% by 2050.

= Table 1 about here =

Japan has a long history of social insurance pensions dating back to 1884. The basic statistics of current pension programs are given in Table 2. Benefits consist of two tiers. While the first-tier, flat-rate basic benefit is paid to all participants of the social insurance pension system, the second-tier, earnings-related benefit applies only to employees.<sup>1</sup> The system operates largely as a pay-as-you-go defined benefit program.

= Table 2 about here =

A person is required to contribute for no less than 25 years to receive basic old-age benefits. The full basic old-age pension is payable after 40 years of contributions. The maximum monthly pension of 66,000 yen<sup>2</sup> at 2008 prices (with the maximum 40 years of coverage) is payable from age 65. The benefit was previously indexed automatically each fiscal year (from April 1st) to reflect changes in the consumer price index (CPI) from the previous calendar year. Since 2004 this indexation formula has been provisionally suspended and instead a new indexation taking demographic factors into account has been introduced (see Takayama (2004, 2006)). The pension may be claimed at any age between 60 and 70 years with actuarial reduction or increase in benefit.

Earnings-related benefits are given to all employees. The accrual rate for the earnings-related component of old-age benefits is 0.5481% per year. Thus, 40 years' contributions will earn 28.5% of career average monthly real earnings.<sup>3</sup>

As a transitional measure, the full earnings-related pension is payable from age 60 (normally from 65) to a fully-retired employee. An individual who has reached 60 but has not fully retired can receive a reduced pension. The current replacement rate (including basic benefits) is close to 60% for a typical male retiree (with an average salary earned during 40 years of coverage) and his dependent wife<sup>4</sup>. It will decrease to 50% by 2023 through a provisional indexation formula.

Equal percentage contributions are required of employees and their employers. The contributions are based on earnings (which include semi-annual bonuses). The total percentage in effect from September 2008 is around 15% for the principal program for private-sector employees (Kosei-Nenkin-Hoken, KNH). Non-employed persons between the ages of 20 and 60 pay flat-rate individual contributions as Category-1 persons under the Kokumin-Nenkin (KN) program. The current rate since April 2008 is 14,410 yen per month. For those who cannot afford it, exemptions will be permitted. The flat-rate basic benefits for the period of exemption will be one-half of the normal amount in fiscal 2009.

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<sup>1</sup> A detailed explanation of the Japanese public pension system is given by Takayama (1998, 2003).

<sup>2</sup> 1,000 yen = US\$ 9.28 = UK £ 4.68 = Euro 5.96 as of 1 August 2008.

<sup>3</sup> A semi-annual bonus equivalent to 3.6 months salary is typically assumed.

<sup>4</sup> Their monthly amount of old-age benefits is 233,000 yen in 2008.

The government subsidizes one-half of the total cost of the flat-rate basic benefits from fiscal 2009. There is no subsidy for the earnings-related part. The government pays administrative expenses as well.

## 2. Social Pensions

Japan currently has the following six types of social pensions, which are paid without individuals contributions.

### **2.1 Flat-rate Basic Pensions for Full-Time Housewives**

Under the current system, dependent spouses of regular employees, typically full-time housewives, are *automatically* entitled to the flat-rate basic benefits, without being required to make any direct individual payments to the social insurance pension system. There were about 10.8 million such persons in 2007, equivalent to around 15% of the total number of insured persons.

This entitlement raises contentious issues. The number of dual-income couples and single women has been steadily increasing, to such a degree that full-time housewives are no longer a majority of working age women. Single women and dual-income couples have often attacked the current provisions geared toward full-time housewives as unfair. The policy bias is clear, but the issue lies in ideologically contested ground. A purely individualist approach would, for example, logically lead to the abolition of survivors' benefits, even though married women earn far less than their husbands. An alternative solution is to assign some share of husbands' earnings to non-working wives. The implicit income share of full-time housewives is currently assumed to be 50%. But this, in turn, could act as a disincentive for married women to work. .

### **2.2 Basic Disability Pensions for Those who are Qualified as Mentally or Physically Disabled Before Age 20**

Those who are mentally or physically disabled before age 20 can receive the basic disability pensions from age 20, with a generous income-test. A thorough medical checkup is run before the qualification. The budget is fully financed by transfers from general revenue.

### **2.3 Basic Old-age Pensions for Lower-income Groups**

Those in low -income groups can be exempted from paying a part or whole of KN flat-rate pension contributions. The upper annual income limit for full and/or partial exemption varies

depending on household size. Taking a single-member household, for example, the 2008 amount for partial exemption is 1.89 million yen or less. Suffice it to say that 5.84 million people were exempted in 2007. Once exempted, they are still qualified to receive one half of full basic old-age pensions, which are financed by transfers from general revenue.

#### **2.4 Two-tier Old-age Benefits for Those Under Parental Leave**

Japanese parents can enjoy a parental leave of one year (husband and wife combined) each time they have a baby. During parental leave, they are exempted from paying KNH pension contributions but still entitled to receive old-age pensions as if they had continued to earn the same salary as they earned just before taking leave. In 2007, 111,000 employees were exempted through this scheme. No special funding arrangement has been made, and consequently their old-age pension benefits during the parental leave are shouldered by contributions made by other participants.

#### **2.5 Pension Entitlements due to a Contribution-gap**

Employers withdraw their employees' pension contributions from their monthly salary. In spite of the withdrawal, a small number of employers fail to transfer their contributions to the Social Insurance Agency (the government body of collecting contributions), due to financial difficulties or bankruptcy. The recovery rate at the SIA is usually not 100%, and the "contribution-gap" remains. Transfers from general revenue compensate for the gap by enabling the full payment of KNH pension benefits once the withdrawal of contributions is certified. This arrangement generates moral hazard among employers, however.

#### **2.6 Welfare Pensions for Aged Low-income Groups at the Start-up**

The flat-rate basic old-age pension is normally payable to those who have contributed for no fewer than 25 years. However, when the KN was first started, those who were between the ages of 36 and 49 in 1961 were specially entitled to receive a smaller amount of basic pension with a shorter period of contributions by 10 to 24 years. Those of age 50 and over in 1961 were not entitled to receive basic pensions. Instead, "welfare pensions" were provided to them when they reached the age of 70, with an income-test. Welfare pensions have been financed wholly by transfers from general revenue, and their current monthly benefit is around 34,000 Japanese yen. Welfare pensions are a transitory sunset scheme, and their recipients are currently very small in number, around 20,000 persons in March 2007.

### 3. Increasing Drop-out Rate

The descriptions given above are just half the story. Japan still has several coverage, implementation and social adequacy problems facing social insurance pensions.

The first-tier, basic benefit is not yet universal. Nearly 100% of *regular* employees are currently covered by the social insurance pension programs, but atypical employees and the non-employed are not necessarily covered, though their enrolment is *legally* mandatory. In March 2007, around 54%<sup>5</sup> of Category-1 persons under the KN (independent workers, atypical workers, the self-employed and persons with no occupation) dropped out from the basic level of protection, owing to exemption (5.84 million persons), delinquency in paying contributions (5.19 million persons) or non-application (363,000 persons). This drop-out rate increased from 35% in 1992.

Those who have dropped out will receive a smaller pension or none at all in old age, which makes them likely to depend on the means-tested public assistance program. The principal idea of a social insurance pension should be old-age income security without having to depend on means-tested support. A social insurance system that promises old-age security to *all* members of the community has its own drawbacks. The current legislation of a basic pension is becoming virtually hollow for atypical employees and the non-employed.

### 4. Growing Numbers of Atypical Employees

In 2007 there were 32 million male and 23 million female employees in Japan, and proportions of *regular* employees were 82% (males) and 47% (females) respectively. These proportions have gradually been on the decline. Instead, outsourcing, replacement of workers by contracts with outside staffing agencies, and increasing dependency on part-time, temporary and seasonal workers have all become quite common now. Table 3 presents the 2007 shares of different types of employees, indicating that around one third were not regular employees. A majority of female employees are now irregular, most of them engaging in part-time jobs.

=Table 3 about here=

The current KNH system does not directly apply to employees working fewer than 30 hours per week (or three-fourths of the normal work week.) These part-time employees are obliged to participate in the KN, instead. If they are the spouses of regular employees and their annual pay is less than 1.3 million Japanese yen (USD 12,000 equivalent), they are treated like full-time homemakers. But if their annual pay exceeds 1.3 million yen, they lose the right to be treated as a

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<sup>5</sup> This figure was equivalent to around 19% of all the mandatory contributors. The administrative cost of the KN was equivalent to about 7.7% of the aggregate amount of contributions in 2006, mainly due to the high rate of drop-out.

dependent spouse. They are then forced to pay flat-rate pension contributions as Category-1 persons. .

This arrangement tends to encourage part-time jobs that pay less than 1.3 million yen per year. Critics say that this is the main reason why part-timers remain low-income earners. One solution would be to reduce the upper earnings limit of 1.3 million yen to a negligible level (as in the United States and Germany). Employers in Japan, however, are strongly against this kind of program change, since they prefer continuing to avoid the higher compliance costs associated with social security. If this solution were implemented, employers may begin to lower the wages for part-time workers since the non-wage costs including the employers' share of social insurance contributions will be increased.

The social insurance coverage of earnings-related pension benefits has been on the decline, since the existing KNH system only covers regular employees, and does not apply to such workers as temporary staff-members under labor contracts of no more than two months, seasonal employees working no more than four continuous months or those engaged on contract work for no more than six months, in addition to part-timers as stated above. Such labor contracts are often made fictitiously to evade paying social insurance contributions, in collusion with employees who want to have higher take-home pay on the spot.

In addition, employers of small business establishments are often reluctant to participate in the compulsory KNH. Typical examples are those who work in restaurant, lodging, cleaning, barber, beauty-salon, amusement and construction businesses. The KNH coverage in these industries is currently around 50%,<sup>6</sup> and the rest of the employees there including regular ones are obliged to participate only in the KN.

At first, the KN was supposed to mainly cover the self-employed and non-employed people, but today it also covers around 9 million atypical employees. The share categorized as uninsured was 37% in 2005, the highest of all categories (shares of non-employed and self-employed persons were 31% and 18%, respectively). Critics say that the KNH for employees is beginning to drop to mere form.

Distrust of government pension commitments saw an increase in 2007, mainly due to the unexpected announcement of 50 million "floating" pension records. In other words, these pensions had not been integrated into the unified personal pension numbers, which were introduced in 1997. Social insurance pension implementation was proven to still be quite weak in Japan, inducing a higher drop-out rate in the future (see Takayama (2009) for more details).

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<sup>6</sup> The enforcement abilities of Social Insurance Agency still remain relatively poor, compared with those of tax authorities.

## 5. Non-beneficiaries of Social Security Pensions

In April 2007, around 420,000 people (1.6%) aged 65 and over received no social security old-age pension benefits, and a total of 1.18 million including those less than 65 years old are estimated to be non-beneficiaries in the near future. These are mainly due to no application having been filed, and insufficient years of contributions.

In 2005, 556,000 persons (2.2%) among the elderly aged 65 and over received means-tested public assistance. Around 65% of the elderly with no social insurance pension benefits were forced to receive public assistance. There were others among the elderly who received both social insurance pension benefits and public assistance, mainly due to their lower benefit level.

## 6. Discussion on Introducing a Universal or Minimum Guaranteed Pension

Many in Japan have proposed a change from the current, contribution-based basic benefit to a tax-based one, universal to all residents, with a view toward accomplishing the long-cherished aim of old-age income security for all residents.<sup>7</sup> The most politically probable funding source for this change in Japan is an earmarked consumption-based tax, replacing the current flat-rate contributions and (part of) wage-proportional pension contributions.<sup>8</sup> If this change takes place in 2009, an additional increase in the consumption-tax rate by 3.5% will be required, while the KNH contribution rate can be reduced by 4%, in turn (see National Council on Social Security, Japan (2008)).

Overall, this can almost be seen a zero-sum change in funding sources. Current pensioners will be forced to bear additional pension burdens, however. Employers stand to gain, on the other hand, if their portion of KNH contributions is cut down. However, if the cut-down in KNH contributions is to be wholly on the employees' portion, then the employers' portion will remain unchanged. In this case, the current actively working generations stand to benefit (see Takayama-Miyake (2008)).<sup>9</sup>

In order to mitigate the controversial issues of intergenerational loss and gain, other experts are now recommending, as an alternative, the introduction of a minimum guaranteed pension. The required additional financing sources are estimated to equal around 1.0 trillion Japanese yen in 2009, equivalent to a mere 0.4% increase in the consumption-tax rate. It remains to be argued however, which among means-test, income-test, pension-test, claw-back or tax-credit schemes is preferable.

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<sup>7</sup> Typical are opinions of Democratic Party, Management Federation, trade union (Rengo), and the Nikkei Newspaper Group.

<sup>8</sup> The rate of Japanese consumption-based tax is 5.0% in 2008. There may be much room for the Japanese consumption-tax rate to be raised up to the minimum 15%, which is the norm in EU countries.

<sup>9</sup> There are other problems. One is how to make out the necessary transitions. Some experts assert a 40-year transition period, while others propose a 20-year period, since all people in Japan have been paying consumption-based taxes for nearly 20 years since 1989. Another problem is the trade-off between reducing labor distortions and affecting the integrity of the budget. Moving to consumption-taxes will increase capital-labor ratio, but little empirical studies on this issue have been done in Japan.

## Conclusion

Japan has devoted considerable effort toward the coverage of all people with social insurance pension systems. The coverage, overall, is among the highest in the world, with only 1.6% of the elderly currently not receiving social security old-age pension benefits.

Due to a rapidly aging population, Japan has been hiking contributions to finance social insurance pensions, which have induced an increased drop-out rate from basic protections schemes. Weak implementations have aggravated lower coverage. Furthermore, a growing number of atypical and irregular employees are losing their entitlement to an earning-related pension in social insurance programs.

Incentives, compliance and accountability are basic prerequisites for maintaining or expanding good coverage. A trustworthy government capable of competent and neat implementation is required for broader coverage, as well. Heavy work still lies ahead.

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Table 1 The 2005 Japan at a Glance

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Population	127.8 million
Population 65+	25.7 million (20.1%)
TFR	1.26
GDP	JPY 504 trillion (USD 4.6 trillion)
GDP per capita	USD 36,000
SS Pension Benefits	JPY 46.3 trillion (9.2% of GDP)
No. of SS Pension Enrollees	70.45 million (55%)
No. of SS Pension Beneficiaries	32.87 million (26%)
Normal Pensionable Age	65
Life Expectancy at Age 65	
Males (Females)	18.11 years (23.16 years)
Labor Force Participation Rate for the Elderly Males	
60–64 (65+)	70.3% (29.4%)

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Source: Social Insurance Agency, Japan, *Annual Reports (in Japanese)*, Japan Statistical Association, *Statistical Handbook of Japan*

Table 2 Basic Statistics of Social Insurance Programs in Japan

program name	as at the 31st March 2007			
	Kokumin Nenkin (KN)	Kosei-Nenkin-Hoken (KNH)	Kyo-Sai-Nenkin (KSN)	Total
covered people	non-employed persons and full-time housewives	employees in the private sector	civil servants and others	
set up year	1961	1942	1884	
no. of insured persons (mil.)	32.03	33.79	4.60	70.42
no. of old-age pensioners (mil.)	9.03	11.98	2.34	26.19
contributors/pensioners	1.74	2.82	1.96	2.05
contributions	13,860 yen (per month per person)	14.642%	14.767%	
current account surplus/deficit (tril. yen)	-0.55	-5.26	0.91	-4.90
funded reserves (FR) (tril. Yen)	9.15	132.4	50.88	193.16
FR/(annual benefits)	2.0	3.8	10.46	5.7

Table 3 Proportion of Employees in 2007

(%)

Type	Males	Females	Total
Employees	100.0	100.0	100.0
Regular	81.7	46.5	66.5
Non-regular	18.3	53.5	33.5
Non-regular	100.0	100.0	100.0
part-time	47.4	76.1	67.2
temporary	9.9	6.7	7.7
contract	29.9	11.5	17.2
others	12.8	5.7	7.9

Source) Ministry of Internal Affairs and Communications, *The 2007 Labor Force Survey* (in Japanese)