HOW ABOUT THE FUTURE PICTURE OF PENSION PROGRAMS IN JAPAN?

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Summary

This chapter proposes policy options for freezing any increases in Japan's social security contributions for pensions in the 21st century. A partial replacement by 4 percent personal retirement accounts, a defined-contribution plan, is also examined. The main objective of this replacement is to avoid the so-called twice-burden problem. Japan's government is seeking, however, for the different options (as shown in the 1999 pension reform bill) requiring further increases in social security contributions, which is briefly explained, as well.

I Introduction

Japan's declining population with a rapid aging will impose greater stresses on the current pay-as-you-go defined-benefit public pension system. A partial replacement by some defined-contribution plan is advisable, also in Japan. The main objective

of this replacement is to avoid the so-called twice-burden problem.

This chapter proposes policy options for freezing any increases in the social security contribution rate in the 21st century, along with 4 percent personal retirement accounts, a private defined-contribution plan.

Before going into the proposals above stated, a brief outline of the current public pension system in Japan is given. Finally, the 1999 pension reform bill is explained.

Ⅱ A Brief Outline of Japan's Public Pension Program

Japan currently has six public pension programs covering different sectors of the population. The earliest plan was established in 1890; the most recent, in 1960. All programs has been managed independently until April 1986. There had been no revenue sharing among them.

Owing to rapid economic growth in the 1960s, urbanization took place, inducing a rapid decline in the absolute number of the self-employed. The pension scheme for these workers faced large deficits. A revenue sharing scheme became necessary. Moreover, the onset of slower economic growth in the mid 1970s forced a scaling down of all the public pension programs in Japan.

Legislation enacted in 1985 introduced substantial changes in the country's entire old-age, disability and survivors' benefits under the social security system. The present system is based on the 1985 reform. Under the new system, which become effective on 1 April 1986, all sectors of the population receive a common, flat-rate basic benefit. The other five systems for employees provide a supplement on the top of it related to the contributions. Although each system has its own contribution and benefit

structure, all systems are similar, operating largely like pay-as-you-go defined-benefit systems.

The principal program for private sector employees is the Kosei-Nenkin-Hoken (KNH). This chapter will focus on this KNH[1].

The maximum basic benefit is 65,000 yen[2] per month at 1994 prices. The benefit is indexed automatically each fiscal year (from 1 April) to reflect changes in the consumer price index (CPI) of the previous calendar year. The current maximum basic benefit for 1999 fiscal year is 67,017 yen per month. In principle, benefit payments begin at the age of 65, but there was a special legal provision allowing employees to receive the full amount of the basic benefit from age 60. The tier-1 basic benefits are to be phased out by stages between 2001 and 2013 for men in their early 60s. The phasing out for female employees will be delayed by five years starting in 2006. Eventually nobody under 65 will receive full basic benefits. In exchange, employees between 60 and 64 will become eligible for advance payments at a reduced rate from the basic benefit.

Under the KNH, the accrual rate for the 2nd-tier, earnings-related component of old-age benefits was 0.75 percent per year (before the 1999 reform). Thus, 40-year contributions would earn 30 percent of the career average monthly real earnings. 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 net earnings level. These conversions are curried out at least every five years; after each conversion, benefits are indexed automatically every fiscal year to reflect changes in the CPI.

The full earnings-related portion is payable from age 60 to an

employee who is fully retired. On reaching the age 60, an individual who has not fully retired can receive a reduced pension with the earnings test.

The KNH old-age benefits for the male "model" retiree (with an average salary earned for 40 years of coverage) with his dependent wife was about 231,000 yen per month in 1994, replacing 68 percent of average gross monthly earnings of currently active male workers.

Under the KNH, equal percentage contributions are required of employees and their employers. The contributions are based on the monthly standard earnings. The total percentage in effect from October 1996 was 17.35 percent.

Since April 1995, contributions have been deducted from bonuses. The rate is 1 percent of the bonuses, with employees and their employers each contributing half this amount. These contributions are not used for benefit calculation purposes.

The total annual cost of the flat-rate basic benefits is shared by all the programs on a fully pay-as-you-go basis. This cost sharing is in proportion to the number of persons covered.

The government covers one-third of the total cost of the flat-rate basic benefits. There is no subsidy for the earnings-related part of the KNH. The government pays administrative expenses, as well.

III Containing the Increasing Social Security Cost

The total number of the actively working population in Japan has been decreasing since 1998 and this decrease will be lasting for many years in the 21st century, due to the ongoing sharp fertility decline. A long term decline will take place in the

Japanese economy, and there can be little hope for future Japan to enjoy any substantial wage/salary increases in the aggregate level.

Consequently any increases in the wage tax have become quite difficult for Japan to implement. These increases are not advisable from a policy point of view, as well.

Can Japan manage to contain the social security pension cost, avoiding any increases in the contribution rate from the current 17.35 percentage point? The answer is "Yes." We can freeze it at the current level until 2025 by adopting the following four measures.

1) Partial Funding Shift from Wage-Based Contributions to an Ear-Marked Consumption-Based Tax

The first-tier, flat-rate basic benefit is currently financed partly by general revenue. The share of general revenue is currently one third. The remaining two-thirds are financed by contributions.

For self-employed and jobless persons together with those of no-occupation, the flat-rate contributions are levied for basic pensions. They are virtually poll taxes. The current dropout rate is over 40 percent and a cherished dream for a universal pension is getting far- and far-reaching. For employed persons, 17.35 percentage contributions are currently levied for combined basic and earnings-related pensions. They are virtually earmarked wage taxes, doing harms to employees as well as their employers.

A universal pension can be attained by financing basic pensions not through contributions but through taxes. One alternative is

an earmarked consumption-based tax. Earmarking will be required for a majority of people to accept its introduction as plausible. A consumption-based tax is less harmful than a wage tax, since it taxes nothing on investment and savings which generate economic growth. It also spreads pension burdens to entire life stages. In the short-term, the funding shift will enable the contribution rate to decrease. It could be pulled down by 4.0 percentage points in 1998, with an introduction of the earmarked consumption-based tax (its tax rate: 3.3 percentage point). The monthly flat-rate contributions (currently 13,300 yen per person) for non-employees are entirely replaced by the above consumption-based tax. Through this change, almost all enrollees will lessen their pension burdens in net terms, while pensioners are forced to begin to bear some part of pension burdens.

The rate of consumption-based tax for basic pensions is estimated to be 5.9 percentage points in 2025. Its replacement substantially decreases the required hike of the existing contributions.

2) Introducing an Earnings-Test for Those Aged 65-69

Currently, the earnings-test is applied for those employees aged 60-64, but workers aged 65-69 enjoy full social security pension benefits even if they earn considerably high income. Another earnings-test can be applied to these workers aged 65-69.

3) Changing Benefit-Increases from Wage-Indexation to CPI-Indexation

Social security pension benefits, once received, are currently wage-indexed in net terms in Japan (before the 1999 reform).

They can be CPI-indexed, however. Benefit indexation is quite crucial for public pensions, but if wage-indexation is found to be too expensive and harmful to actively working generations, CPI-indexation will be an alternative. The UK, the US, France and many other countries are currently adopting CPI-indexation. Germany is a country with wage-indexation.

Changing benefit increases from wage-indexation to CPI-indexation will be estimated to decrease aggregate pension costs for social security by 11 percent by 2025.

4) Extending the Contribution Period for Full Benefits from 40 to 45 Years

In the current legislation, the normal contribution period for full benefits is assumed to be 40 years. It can be extended to 45 years.

According to the latest population projections, the life expectancy at age 65 will get longer (see Figure 1). In 1995, it was 16.48 years for men and 20.94 years for women. In 2025, it is estimated to be 18.21 years for men and 23.15 years for women. A little more than 10 percent increases will be expected. Consequently, the period for receiving pension benefits would get longer in the future.

One can say that the contribution period should be extended proportionately for the pension system to be sustainable. The idea is that the contribution period for full pensions has to be changed step by step from 40 to 45 years. Note that this change will virtually pull down the benefit level in real terms for late comers into the labor market, while preserving the normal pensionable age. This change can save the aggregate pension costs by about 10 percent by 2025[3)].

Combined with a funding shift to a consumption based-tax, together with other measures listed above, this can decrease the contribution rate of social security pensions to 17.35 percentage point in 2025. Through these measures, we can freeze any further increases in the KNH contribution rate (see Figure 2).

IV Promoting Private Initiatives: A Proposal of 4 Percent PRA

Overly generous public pension benefits in Japan should be further reduced, while the contribution rate can be frozen forever at the current level or even be reduced. At the same time, we should encourage private initiatives including a private, personal saving account for retirement, through the use of powerful tax-incentives. Recently, discussions on a Japanese version of the 401(k) are in fever. It may become effective from January 2001.

How about creating personal retirement accounts (PRA, a defined-contribution plan) in which each individual would deposit 4 percent[4)] of monthly earnings from 2001? In examining the PRA effect, we assume that the expected rate of return on investment is 4 percent per annum and that the increases in CPI and wages are 1.5 percent and 2.5 percent per annum, respectively. All these figures are in nominal terms. Administrative costs will be assumed to amount to 1 percent of the funded reserve each year, and consequently the net rate of return on investment will be just 3 percent annually. The PRA contributions are assumed to be tax-deducible and no tax is levied on the earned income during accumulation. The participation will be from age 25. The contribution to the PRA will continue to age 65. At age 65, the PRA is converted to buy a constant benefit of lifetime annuity. It is payable from age 65[5)].

Then, the combined benefits with a slightly slimmed-down social security pensions, which are just explained in Section III, will enable the standard of living after retirement to stabilize at or even increase from the current level (see Figure 3).

The Japanese government holds a different scenario. Its officials still believe that step-by-step increases in public pension contributions have to be done in the future for the system to become sustainable. They have been ignoring the adverse effect of the payroll tax. As depicted in Figure 4, however, the social security pension contributions (payroll taxes) have become the No.1 income source for the central government. Employees and their employers will continue to strongly resist to any increases in payroll taxes.

The government officials of Japan played a leading role in implementing the 1999 pension reform, as was the case for the past 25 years. Main contents are as follows.

V The 1999 Pension Reform Bill

In December 1998, the Japanese government decided to temporarily freeze increases in social security contribution rates for pensions from fiscal year 1999, with a partial funding shift to general revenue from one-third to one-half in financing basic benefits from fiscal year 2004 at the latest. The funding shift will enable the contribution rate for social security pensions to decrease by one percentage point for the KNH, and by 3,000 yen per month for each non-employee person. If increased general revenue is to be financed by the earmarked consumption-based tax, a 0.9 percentage point increase in the consumption tax rate

(currently 5 per cent) will be necessary, though the type of tax increases has not yet been specified. It is still quite uncertain, as well, whether or not the funding shift is on the way to assuring a universal, tax-financed basic pension for all members of the community.

Also, in December 1998, the government decided to increase existing pension benefits in fiscal year 1999 to reflect only changes in the CPI over the previous calendar year, though fiscal year 1999 was previously anticipated as seeing net-wage indexation of existing pension benefits after a five-year interval.

In July 1999, the government submitted the 1999 pension reform bill to the parliament and the bill was passed through it in March 2000. Its main points are as follows:

a) Earnings-related benefits are to be reduced by 5 per cent; specifically, the current annual accrual rate of 0.75 per cent is to be decreased to 0.7125 per cent from fiscal year 2000.

b) Both the flat-rate basic benefits and the earnings-related pension benefits once paid are to be CPI-indexed after age 65 from fiscal year 2000.

c) The normal pensionable age for earnings-related old-age benefits is to be increased step by step from age 60 to 65 for men from fiscal year 2013 to 2025. The phasing out of earnings-related old-age benefits for female employees in their early 60s will be delayed by five years starting only in 2018. In exchange, those between 60 and 64 will become eligible for newly provided advance payment, at a reduced rate, out of the earnings-related benefits[6)]. The rate of reduction will be 0.5 per cent by one month (6 percent by one year). If a person begins to receive the advance payment from age 60, his/her benefit level will be 70 per cent of

the normal amount.

d) An earnings test for those aged 65 to 69 is to be introduced from fiscal year 2002 (currently Japan has no such test for them). Increases in earnings-related old-age benefits for delayed retirement between ages 65 and 69 are to be abolished accordingly.

e) Employers are to be exempted from paying their share of social security pension contributions for their employees on child-care leave from fiscal year 2000[7)].

f) The monthly standard earnings base for social security pensions is upgraded to the 98,000 to 620,000 yen range from October 2000.

g) The benefit/contribution base is to be shifted from monthly standard earnings to annual earnings including semi-annual bonuses from fiscal year 2003. The shift is to be adjusted to induce no changes in aggregate income from contributions in 2003.

h) The rebates on contributions for contracted-out schemes are to be frozen from fiscal year 1999[8)].

i) A 50 per cent flat-rate contribution for the non-employees is to be newly introduced from fiscal year 2002. This is mainly for low-income groups. Their basic benefit will be two-thirds of the full amount. Students aged 20 and over are to be able to postpone paying in their flat-rate contributions for ten years at the most. They are, however, to be eligible for the full basic disability benefit during years of non-payment.

By these measures, aggregate pension benefits will be reduced by 20 per cent by 2025. As a result, the contribution rate for the KNH will peak by 2025 at 25.2 per cent, instead of 34.5 per cent

anticipated without any reforms (the rate estimated on the basis of monthly standard earnings). The flat-rate monthly contributions for non-employee people will peak by 2021 at 18,200 yen (instead of 26,400 yen) at 1999 prices.

Notes

[1] See Takayama (1996) (1998, chapter 2) for more details of Japan's pension system.

[2] 10,000 yen = US$ 95.8 = EURO 100.9 = £60.7 = DM 197.4 = Skr 833.6 as at 18 April 2000.

[3] Compare an extension of the contributing period with increasing the normal retirement age. The latter will damage those with shorter schooling experience, coming earlier to the labor market. They are likely to be burnt out or to have a sense of fulfillment after 40 or 45 years working experience. Most of them are weary and ready for retirement by the time of age 60. If they begin to receive the reduced pension benefits from age 60, their benefit level is currently 58 percent of the normal amount. The current reduction rate is too severe. Their benefit level should be 73 percent or 75 percent of the normal amount, if calculated on a current, actuarially neutral basis.

[4] Why 4 percent? It is assumed that the partial funding shift to an earmarked consumption-based tax will be introduced at the same time. Then 4 percentage points decreases in public pension contributions will follow. The combined net burden for the current, actively working generations will not increase, since the PRA is expected to induce a massive substitution effect on private savings. The twice-burden problem can be avoided, then. The philosophy behind this proposal seems to be basically the

same as that of Feldstein-Samwick (1999).

[5] The assumptions of the PRA are of the present author's. They are slightly different from the government proposal of Japan's version of the 401(k). For more details, see Takayama (2000), which can be also found at http://www.ier.hit-u.ac.jp/~takayama/index.html.

[6] Increasing the normal retirement age will considerably reduce the labor demand for those in their early sixties, since advance payments with the earnings-test (which virtually mean "wage subsidies") will be decreased, then. With combined effects of the increased labor supply, the market wage rate for them will eventually go down.

[7] Employees on child-care leave have already been exempted from their share of contributions.

[8] It should be born in mind that voluntary opting-out from the state earnings-related scheme induces a cream-skimming problem. Losers are those contracted in the state scheme. According to the estimates made by National Audit Agency in the UK, the loss of the state scheme caused by opting out through individual pensions would be 5.9 billion sterling pounds. The loss in Japan by voluntary contracting-out through occupational pensions would be around 2 trillion yen (see Murakami, 1997). Nevertheless, the contracting-out schemes have been badly suffering from huge unfunded liabilities due to too low a rate of return on investment after the bubble burst. Many of them are asking contracting-in, again. The Japan's contracting-out turns to be a failure.

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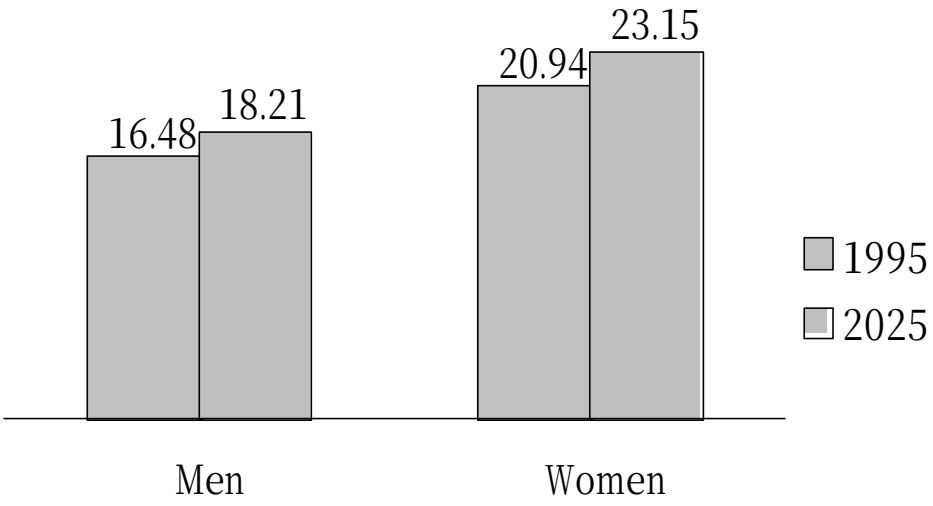
Figure 1 Life Expectancy at Age 65
(Years)



Source) National Institute of Population and Social Security Research, Japan (1997), *Population Projections for Japan: 1996-2100*

Figure 2 Future Contribution Rates by Alternative Policy Options

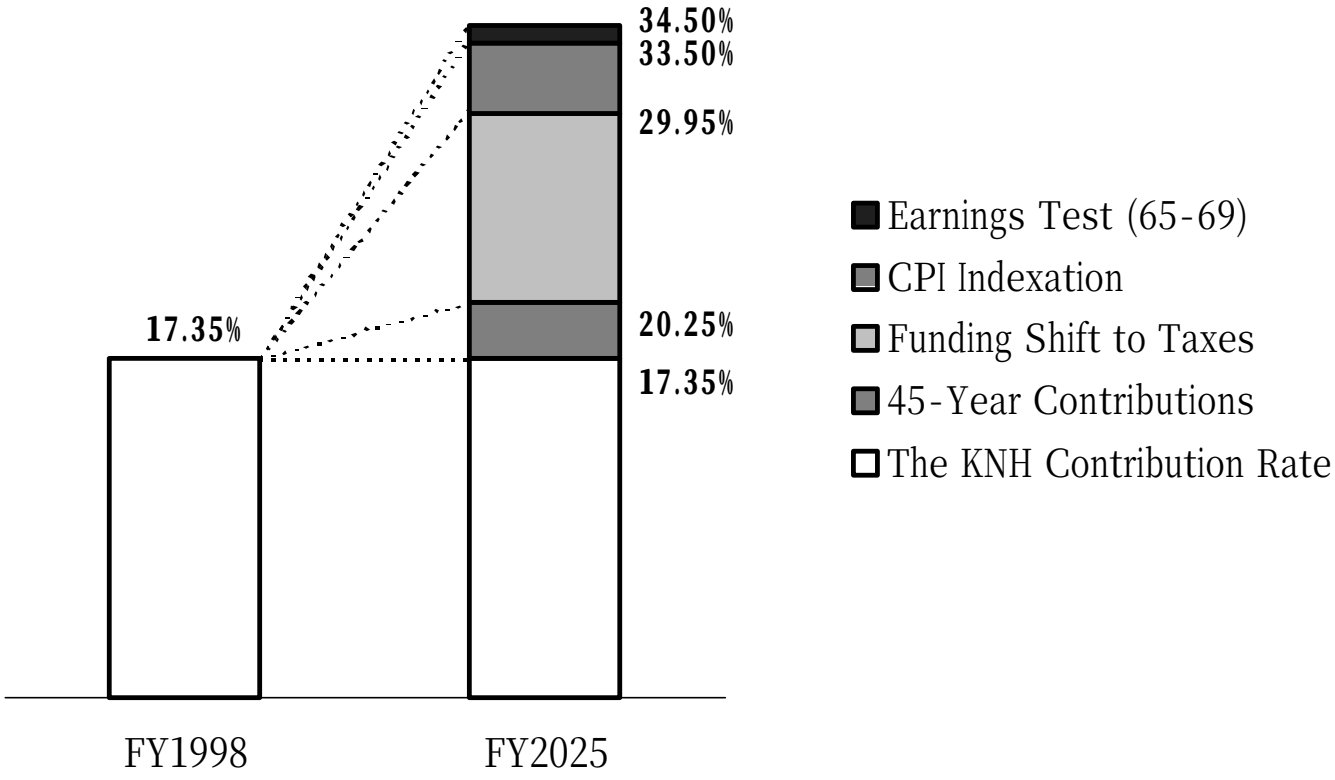


Figure 3 Replacement Rates Combined by Cohorts

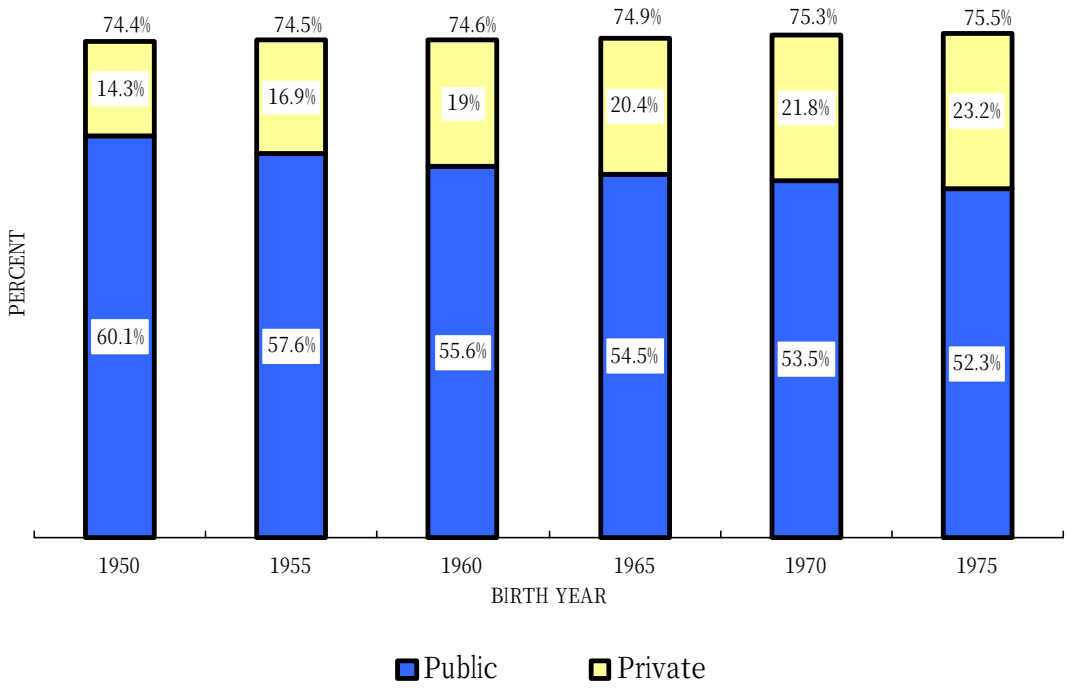


Figure 4 Main Income Sources of Japan's Central Government
(Fiscal Year 1999)