Demographic Changes, Economic Downturn and the Pension Reform Debate in Japan

1 Demographic Changes and Economic Downturn

The total fertility rate of Japan has been declining sharply since 1974 and the current level in 1998 was 1.38 (see Figure 1). There is still little sign that the TFR will stabilize or return to a higher level. The total number of the population for Japan will peak out at about 127 millions around 2007 and then begin to fall sharply, reaching 54 percent (medium projections) or even 40 percent (pessimistic ones) of the current number in 2100. The proportion of the elderly (65 years and above) was about 16 percent in 1998 and will be one third by 2040. Japan will then have one of the oldest populations in the world.

Following the medium projections, the total labor force of Japan will fall sharply in the 21st century as is depicted in Figure 2. Its probable consequence is a sharp decline in young labor, a decrease in the savings rate, and a decrease in capital formation. All these factors will contribute to the shrinking of the Japanese economy.

There is a need for setting different priorities in policy issues. Missing is a shift in priorities of social support from the elderly to child-bearing and child-raising. Alternatively Japan's immigration policy should be changed drastically.

Due to these demographic and economic changes, Japan will probably be involved in difficulties in managing its social security. Are there any solutions for containing the social security costs? Are public pension benefits still too generous? Is privatization of social security pensions a good idea? Is it possible for Japan to freeze any increases in the contribution rate of social security pensions to avoid any more damages to the economy? Should an earmarked consumption-based tax be introduced as a new income source of pension benefits? Is it inevitable to increase the normal pensionable age to 65? Are there any alternatives for it? How to arrange the pension provisions for women? Should the existing contracting-out option be deleted? These are examples of topics in the pension debate in current Japan.

This paper examines these issues one by one. Main problems in the pension debate are discussed through Section 2 to Section 4. The present author's proposals will be given in Sections 5 and 6, where several devices to freeze any increases in the contribution rate will be presented along with a proposal of 4 percent personal retirement accounts. Section 7 gives a brief explanation of the latest government proposals for reforming public pensions.

2 Pension Debate in Japan

Pros and Cons for a Pay-as-you-go Defined Benefit Plan

Japan has a pay-as-you-go defined-benefit (PAYG DB) system for public pensions[1). Japanese have once had a successful story of this system when the economy enjoyed a relatively high speed of growth with relatively young populations. It has been effective in reducing poverty among the elderly and also in providing people with a stable living standard after retirement. Further, administrative costs of this system have been quite low, showing quite an efficient system-operation[2).

For the past 20 years, however, the PAYG DB plan for public pensions have been facing severe and growing criticisms in Japan. Criticisms are so many. Among others, financial stresses are becoming so severe under a declining rate of economic growth with the population aging. The system is now quite unpopular among younger people.

It becomes quite difficult for Japan to increase the contribution rate for social security pensions. In fiscal 1999, its contribution amounts to 30 trillion yen[3)], while personal income tax is 15.7 trillion yen and corporate income tax is 10.4 trillion yen respectively in the same year. Hikes in the contribution rate will bitterly damage domestic companies which have been facing the “mega-competition” on a global scale, thereby exerting adverse effects on the economy, inducing a higher unemployment rate, lower economic growth, lower saving rates and so on.

Hikes in the contribution rate will induce an incentive compatibility problem, too. The internal rate of return in the public pension system will be quite low or will become negative for the younger cohorts, and younger generations will find that their participation in the public pension system does not pay.

There is another criticism on the current PAYG DB plan. It exerts perverse redistribution. Through a massive transfer of income by public pensions, the rich elderly are becoming richer, while other elderly people still are suffering from low income.

Political resistances to cutting the benefits level or to increasing the normal pensionable age have been so strong. Indeed, many people in Japan are feeling that the government is breaking its promise with them. There has been a growing concern on an incredibility problem. Namely, distrust against the government commitment is growing.

With a better understanding of the PAYG DB system, however, some of the criticisms will disappear. Moreover, we can rectify some of deficiencies and inequities in the existing system.

We can draw some lessons from the experiences in other OECD countries for the past 20 years, where they have had so painstaking reforms of public pensions. The important lessons are as follows.

First, the PAYG DB system has been working not as a pure insurance system but rather as a tax-and-transfer system involving huge amounts of income transfers between generations. It is possibly a problem between managers and trade unions, but mainly is a problem between generations.

We have a political difficulty in this sense. Seniors are strong voters while the younger people and future generations currently have so weak or no political powers. The interest of future generations is likely to be neglected.

Second, the nature of the intergenerational contract is difficult for many people to understand. Maintaining a fixed rate of replacement in gross income terms is by no means “a contract.” It is found to be quite risky, pushing its costs entirely to actively working generations or future generations.

In a PAYG system, pension benefits don’t come from the heaven. Pension benefits for the aged parents are financed mainly by contributions of their children and grandchildren. It is a socialized system of intergenerational transfers between parents and their children. Without a socialized system, ordinary parents and their children would have responded quite flexibly to a changing circumstance. The retired parents are expected to maintain their dignity, while actively working children should be adequately rewarded for their labours. There should be little difference in the design of a PAYG DB public pension plan and the privately based income transfers between aged parents and their children. The PAYG DB system should prescribe the rules for satisfying two needs for the aged parents and their children just stated.

The benefits and contributions in PAYG DB plan should be changed flexibly to respond to changing circumstances. As

Diamond (1996) explained, it partly comes from the incompleteness of planning for different possible outcomes in the future. Consequently we have found that the replacement rate embedded in the law is not a “promise” in a strict sense, but it is just the “starting place” of an ongoing process of adaptation to a changing and unpredictable world. Everlasting reforms are required to keep the system viable, while they can be viewed as “political risks.” Japan succeeded twice in reducing a part of “earned entitlements” to nil in 1985 and 1994[4]. These efforts are to continue in the future.

The third lesson is that continued economic growth is definitely in need to maintain the PAYG finance healthy. Were the economy to fail to expand when the share of senior citizens in the population increased, the real after-tax pay of workers would decline. Younger people would despair of achieving a higher standard of living than their parents, and the present level of intergenerational transfers from workers to the retired would become hard to maintain.

In this light, we need to approach the question of funding from the perspective of circumventing constraints on economic growth. We must ask which revenue sources will slow down growth the least. The answer is not a wage tax nor an income tax, but a consumption-based tax. The consumption tax does not function as a direct levy on the saving and investment that powers the economy. In this respect, social security contributions (wage tax) are highly problematic. It will make sense in Japan to fund part of the increased costs of our greying society by raising the rate of consumption-based tax. Current reforms in Spain, Portugal, Switzerland and Germany followed this approach by reducing the contribution rate for public pensions, with increasing the rate of VAT, instead[5]. Through these reforms, as well, pension burdens will be shared more evenly over the whole life cycle of each person.

Advantages and Disadvantages of the Funded Defined Contribution Plan

Due to a reduction of benefit levels in a PAYG DB plan, there has been a move, passive or active, toward a funded scheme of pensions in many OECD countries. A funded DC scheme has a potential advantage over the PAYG DB plan. It is mainly because the rate of return from the financial market could now become much higher than the internal rate of return in PAYG systems, on average.

All economists in Japan agree with an opinion that we should not ignore or make light of the current move toward a funded scheme. Partial prefunding by mandating or encouraging private pensions is inevitable. It has due reasons. We have to accept it as a matter of fact.

Obviously the funded DC scheme has some other advantages such as possible increase in the saving rate, possible higher rates of economic growth, understandability or transparency, and flexible response to increasing diversity of a life-course of ours (increasing heterogeneity, increasing freedom to choose a working place, working hours, and working periods, widening choices of no-kids, divorce, and remarriage, etc.). It also encourages people to make responsible for themselves and to support themselves on self-reliance, not allowing to behave irresponsibly to impose cost on others, especially on future generations who have no political influence today.

The funded DC plan will have several difficulties, however. First, the market rate of return is quite volatile in the short-term, as is known as “the NIKKEI effect.” Its differentials are quite large. The rate of return from the financial market will decline with an ongoing population aging, and with ample supply of funded money. It is not inflation-proof.

Consequently the insured people will face the investment risk. The income disparity after retirement will get widened, and the increasing proportion of the elderly will suffer from low income. Some of the current retirees, namely, asset-holders will also have some damages from a possible decline in the market rate of return on their assets.

Second, we have to have relevant regulations on the funded scheme. We can learn something from experiences of the Anglo-Saxon countries. But, so far we have had insufficient knowledge about them. Missing are institutions against investment risks.

Third, there exists an administrative cost problem. Take the Chilean case, for example. Chilean pension funds earned a real rate of return about 11 percent per annum on average between 1981 to 1998, but it went down at 4.2 percent in net terms after deducting administrative costs. If we look at the period after 1990, the real rate return turned minus on average in net terms. This problem will be quite serious especially for the low-income earners. They are forced to have a relatively low rate of return.

We have other problems here in shifting from a PAYG to a funded system. Among others, a “twice-burden” problem should not be ignored. It is still an open question whether people can politically accept the heavier burdens on the middle-aged generations at the start-up of the transitional period. The Singaporean case is another example. Its contribution rate for pensions still remains at 4 percent. More than 40 years have passed since Singapore introduced the provident fund. It is said that not a few aged people in Singapore still depend on their children to maintain their standard of living.

Feldstein-Samwick (1998) proposed 2 percent personal retirement accounts (PRA) to combine reduced social security pension benefits in the US, thereby freezing any increases in the contribution rate of social security from current 12.4 percent. Three fourths of equivalent benefits from the PRA are to be reduced from social security benefits. Their idea is to assure old-age income security given by the current PAYG DB system at least on the one hand, and to avoid the twice-burden problem by making tax credit for the proposed 2 percent DC plan on the other hand. The essence of Feldstein proposal is a combination of the existing PAYG DB plan with a funded DC plan. Privatization of social security will remain partial.

We have also had an important intellectual innovation from recent reforms in Sweden. The "notional" rate of return is to be introduced in shifting to a PAYG DC plan from a PAYG DB plan. With this shift, we can entirely escape from the "twice-burden" problem. As James(1996) observed, unfunded DC schemes can produce a close transparent relationship between contributions and benefits, thereby deterring evasion and other distortionary behavior, as well. They can eliminate undesirable redistribution within the same cohort of individuals, too. On the other hand, the real level of pension benefits will decrease step by step in the future.

A Diversified Multi-pillar System

Some emphasized advantages of the PAYG DB plan more than its disadvantages, alerting risks involved in the funded DC plan, while others did the opposite, calling for a "paradigm shift" to a funded scheme. Nonetheless, they all seemed to agree that a diversified multi-pillar system is most advisable. Differences would be in the magnitude of reforms and in the speed of adjustments.

For Japan, increased costs are still required to prevent poverty with securing stable income after retirement. We have no painless solutions for the future. No reforms without tears.

Partial prefunding, mandatory or voluntary, is inevitable[6)]. Missing are better instruments to minimize risks involved on the funded system. Missing as well are better understandings in the induced individual behaviors, the macro economic impacts, and the distributional outcomes from increased prefunding.

Different objectives are often competing. Promoting later retirement may induce higher unemployment for younger people. Encouraging occupational and individual pensions can lead to early retirement. Tax smoothing or advance increases in the contribution rate for the long-term sound financing will cause higher unemployment in the short-term. Solutions will be different depending on which objective is more important.

What we want to have is not a society with so small a cradle with so many graves. We are moving to a society of compassion with a harder edge. Time is now not to deliver generous benefits, but rather to manage to share the increased costs. Who shares them and when? How are they shared? These are the imminent questions before us. More specifically, are the costs to be shared by increasing social security contributions? By increasing taxes? By increased individual savings? By later retirement? Or by reducing benefits? Who is to bear basic living costs arising from longer life expectancy? Are there any differences in responding to this question when longer life expectancy is expected in well advance to take place and when unexpected? How much is increased freedom to choose accompanied by self-reliance in old age? How much is the exchange of income resources between generations allowed through a public program? Is there any room for a universal or differential cut of benefits for the elderly? Can it be accepted at once or gradually? What devices (other than cutting benefits) can we have in making part of increased costs shared by current pensioners? What economic differences will come from all of the alternative solutions? The answers will be different individual by individual.

In the end, life is still risky. We have to realize that we cannot eliminate all of risks in our long life completely. But we have been making great efforts to control these risks at a minimum level. I eagerly hope that Japanese will be wise enough to manage them.

3 Financing the Basic Benefit by Contributions or Taxes

Drop-out

The first-tier, basic benefit in Japan's public pension system is not universal, yet. Nearly 100 percent of typical employees are currently covered by the social security pension programmes, but non-employees are not necessarily covered, though their enrolment is legally mandatory. In 1998, more than 40 percent of independent workers, the self-employed and persons with no occupations dropped out from the basic level of protection, owing to exemption (17.5 percent), delinquency in paying contributions (18.8 percent) or non-application (7.7 percent). This dropout rate increased from 28 percent in 1990 and will probably continue to grow further with future rises in flat-rate contributions, since they intensify a so-called incentive compatibility problem.

In principle, the full basic benefit is payable for a person with 40 years of contributions. Those who have dropped out of paying contributions will receive a smaller amount of pension or none at all in old age. They would then most likely be dependent on means-tested public assistance programmes. The principal idea for a public pension should have been old-age income security without depending on means-tested support. A social insurance system has its own drawbacks in promising old-age security to all members of the community[7]. The current legislation on a basic pension is virtually becoming hollow for the non-employees.

Universal Benefits: Yes or No?

Many have proposed a change in Japan from the current, contribution-based basic benefit to a tax-based one, universal to all residents, to accomplish the long-cherished aim of old-age income security.

What tax should be implemented to attain a universal pension benefit? This is a long-disputed topic in Japan. Some advocated an increase in income tax, others advised introducing an earmarked consumption-based tax, both replacing the current flat-rate contributions and (part of) wage-proportional pension contributions. There will be different impacts on labour supply, savings and income redistribution between the two funding sources, though public understanding of them still has to be deepened before an eventual political conclusion in Japan.

4 Pensions for Women and Atypical Employees

Treatment of Full-time Housewives

The most controversial problem in Japan is how to treat full-time housewives in social security. The current public pension system assumes that a full-time housewife is still quite typical. Currently, dual-income couples and single women are steadily increasing in number and full-time housewives are no longer in the majority.

Under the current system, dependent wives of employees are automatically entitled to the flat-rate basic benefits, and the wife is not required to make any individual payments to the public pension system. This treatment is often attacked as too generous and unfair by single women and dual-income couples. It can be said, however, that it is quite fair as far as the old-age benefits are concerned, since benefit/contribution relations are essentially neutral to couples' combined earnings under the current provisions.

But one can say that the survivor's benefits are unfair between dependent wives and wives within dual-income couples. Both can receive three-fourths of the earnings-related old-age benefits of their husband. The level of wages and salaries for men with a dependent wife is by and large higher than the level for husbands within dual-income couples. Consequently, it is often the case that survivor's benefits are less for wives within dual-income couples, provided the level of their combined earnings is the same.

Either benefits or contributions can be adjusted for the system to get fairer. One idea comes from adjusting from the contribution side, asking the couple with a full-time dependent wife to contribute more. One can proceed further to change the benefit/contribution unit wholly from a current household basis to an individual one, asking the full-time dependent wife to contribute directly to social security. The other idea is to adjust the system from the benefit side, changing the survivor's benefit to equal three-fourths of the combined earnings-related old-age benefits of the couple (not the husband). The point at issue is whether the principle is purely individualistic or earnings-split. While a purely individualistic principle is simple and understandable to everybody, it has some drawbacks: the survivor's benefit would consequently be abolished and a majority of women would seriously suffer from a decrease in pension benefits after the death of their husband, since the level of salaries for women is still considerably lower than for men, in general. Besides, the individualistic approach would force the couple that includes a full-time housewife to contribute more to social security in spite of a downturn in the Japanese economy, which seems unrealistic. A majority of people in Japan are likely to prefer an earnings-split principle, but no conclusions have yet been reached.

Exemption from Contributions for Child Care

As of April 1995, the social security system exempts people on child-care leave[8] from paying their share of pension contributions as well as health and unemployment contributions[9]. They are regarded in their benefit calculation as if they have paid their contributions. Employers, however, still have to continue to pay contributions as in the past. This operates as a disincentive to hiring female employees, since mothers are most likely to take the child-care leave. Removing this disincentive would require the system to exempt employers, as well, from paying their share of pension contributions for people on child-care leave[10].

Note that Japan's system assures all of the full-time housewives in employees' households to enjoy a full basic flat-rate benefit of their own, whether raising a child or not.

Some people advocate use of a child-support deduction when public pension contributions are calculated, in order to support both childbirth and the raising of children.

Others prefer supporting both childbirth and child rearing not by decreasing pension contributions but by increasing benefits (including childbirth benefits, child benefits and pension benefits for parents) through a special funding from general revenue. This group regards the possible amount of the child-support deduction in calculating pension contributions as remaining at quite a minor level. We would need more evidence before reaching a conclusion on this matter.

Other Problems for Women

Four other problematic points involving pensions for women have also been raised. First, a full-time housewife who divorces has no right to claim part of the earnings-related benefits her husband accumulated while she was married. It has been suggested that the right to these benefits be divided between the two.

Second, payments of survivor's pensions terminate upon remarriage, but critics say they should continue. The current provision is inducing cohabitation among pensioners without remarriage, causing an inheritance problem.

Third, critics also find it strange that a spouse who marries after beginning to receive an old-age pension becomes entitled to claim a survivor's pension. If a woman is identified as being virtually a spouse of a retired man without formal marriage, she is entitled to claim a survivor's pension. This route is often fictitiously misused.

Fourth, while a fatherless family has the right to a survivor's annuity, a motherless family does not. This, it is said, violates gender equality.

Pensions for Part-time Employees

Turning now to the debate over providing pension coverage for part-timers (mostly females), we find that the current system does not directly apply to those who work fewer than 30 hours (or three-fourths of the normal working hours) a week. In principle, these part-timers are treated like full-time homemakers. But if their annual pay exceeds 1,300,000 yen, they lose the right to be treated as a dependent spouse. They then become obliged to participate in the system and are forced to pay the flat-rate pension contributions like unemployed persons.

This arrangement often tends to encourage part-time jobs that pay less than 1,300,000 yen a year. Critics say this is the main reason that part-timers remain low-income earners.

One solution would be a reduction in the higher earnings limit of 1,300,000 yen to a negligible level, as is the case in the United States, where any amount of earnings is covered by social security, in principle. Employers, however, are strongly against this kind of change, since they prefer continuing avoid higher handling costs of social security.

The Japanese pension system involves a massive transfer of income from higher-earning groups to lower-earning ones, because the benefits include the flat-rate component (irrespective of earnings levels), while contributions are proportional to earnings. A reduction in the higher earnings limit for part-timers would intensify this transfer element. This is a second reason for employers to oppose a reduction.

The element of income transfers mentioned-above could be partly diminished, however, if the flat-rate pension benefit were changed into a universal benefit financed by an earmarked, consumption-based tax. The social security handling cost involved for employers could be decreased by integrating social security administration offices with inland revenue offices. The two are currently separated owing to bureaucratic sectionalism.

If these two reforms are made, employers will no longer oppose a reduction in the higher earnings limit for part-timers. In turn, they may begin to lower their demand price (rates of wages) for part-time workers, since the non-wage costs including their share of social security contributions, will be somewhat increased after such a reduction.

Growing Numbers of Quasi-employees

The Japanese economy is now in recession. Employers are currently trying to slim down the number of their core employees. Outsourcing, replacement of workers by contracts with outside staffing agencies, and increasing dependence on part-time, temporary and seasonal, workers are all now common occurrences.

The social security coverage of earnings-related pension benefits is currently decreasing, since the existing system only covers the core employees. Not covered is temporary staff with labour 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. These labour contracts are often made fictitiously to evade paying social security contributions, in collusion with employees who want to have higher take-home pay on the spot. Critics say that second-tier pension provision is beginning to be reduced to mere form.

Essentially the same problem seen with part-timers arises if it is wished to expand the coverage of earnings-related pension benefits to these non-core employees. The two drastic reforms mentioned above will then be required.

In addition, extending social security coverage to atypical employees, including those engaged in multi-jobs, requires an integrated single social security number for each person, which has already been introduced in Japan since 1997.

5 Can Japan Manage to Contain the Increasing Cost of Social Security Pensions?

This section will propose a set of policy options to freeze the contribution rate of social security pensions at the current 17.35 percentage point or below its level.

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 be 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 basic and earnings-related pensions. They are virtually 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, with spreading pension burdens to entire life stages. In the short-term, the funding shift will enable the contribution rate to decrease. It can be pulled down by 4.0 percentage point in 1998, with an introduction of the earmarked consumption-based tax (its tax rate: 3.3 percentage point). The monthly flat-rate contributions (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 6.1 percentage point in 2025. It substantially decreases the contributions.

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.

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

Social security pension benefits, once received, are currently wage-indexed in net terms in Japan. 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 and Japan are major countries 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.

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 3). 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 in 2025[11)].

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 contribution rate (see Figure 4).

6 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 be reduced through a partial shift of funding to a consumption-based tax. 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 401k are in fever. It will become effective from 2000.

How about creating personal retirement accounts (PRA) in which each individual would deposit 4 percent of monthly earnings from 2000? 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.

Then, the combined benefits with a slightly slimmed-down social security pensions which follow reforms just explained in Section 5, will enable the standard of living after retirement to stabilize at or even increase from the current level (see Table 5).

7 The 1999 government plan for Pension Reform

In December 1998, the Japanese government decided to 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 principal programme for private-sector employees, and by 3,000 yen a month for each non-employee person. If increased general revenue is to be financed by the earmarked consumption-based tax, a 0.8 percentage point increase in the consumption tax rate (currently 5 per cent) will be necessary, though the type of tax increase 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 March 1999, the government proposed the 1999 pension reform plan. 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. The rate of reduction will be newly fixed just before fiscal year 2013.

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[12)].

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.

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 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[13)].

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.

In proposing these measures, the government is aiming at reducing aggregate pension benefits by 20 per cent by 2025. As a result, the anticipated contribution rate for private-sector employees will peak by 2025 at 25.2 per cent, instead of 34.5 per cent without the 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. In July 1999, the pension reform bill was submitted to parliament.

Endnotes

1) Takayama (1998) gives a detailed explanation of the Japan's public pension system.

2) See Beattie-McGillvray (1995) for defending the PAYG DB public pension system.

3) 10,000 yen = AD 130.5 = USD 89.2 = ECU 84.6 = UKL 55.6 = DM 165.5 as at 18 August 1999.

4) See Takayama (1996, 1998) for more details.

5) The generalized social contribution (the so-called "CSG") introduced in France can be viewed as the same line of this argument.

6) In a funded public system, the so-called "political risks" in managing the funded reserve will be inevitable. Politicians and bureaucrats often misuse the reserve, with a quite inefficient allocation of the funded money. A typical example is given by the recent performance of the Japanese fiscal investment and loan program. More prefunding, therefore, should be done not in the

public, but in the private scheme.

7) The administrative cost of the basic flat-rate pension for non-employees in Japan is currently equivalent to about 10% of their aggregate amount of contributions.

8) Under the current law in Japan, an employee can take up to 12 month's maternity/paternity leave until the child's first birthday; generally, the employer does not pay salary during the leave period, but the employer must allow the employee to return to the same job when the leave ends. From April 1995, a benefit for child care was introduced in the unemployment insurance system. The benefit is 25 per cent of the monthly salary just before the child-care leave.

9) No special funding, say, from general revenue, has yet been arranged to make up for the loss in contributions.

10) No exemption from contributions for social security pensions has yet been allowed for long-term care.

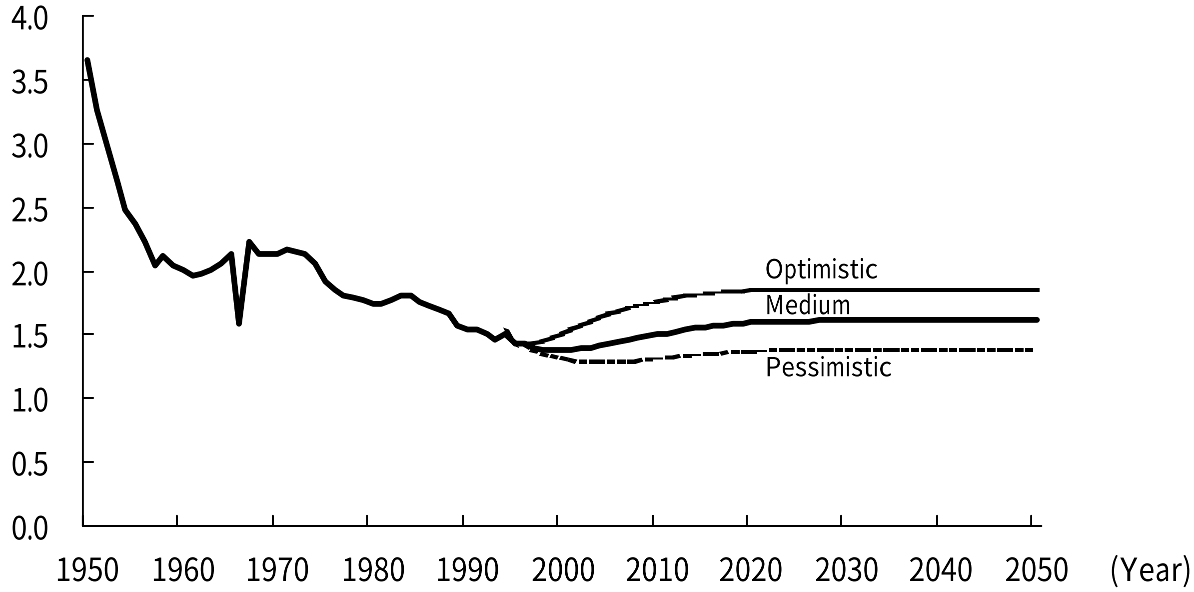
11) Compare an extension of the contributing period with increasing the normal retirement age. The latter will damage those with shorter schooling experience, coming earlier to the labor market. They are likely to be burnt out or to have a sense of fulfillment after 40 or 45 years working experience. 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.

12) The existing earnings test for those aged 60 to 64 will be abolished along with increasing the normal retirement age. It will considerably reduce the labor force demand for those in their early sixties. Combined effects with the increased labor force supply will be a reduction of employment for them, since income elasticity of their supply is not so high. The market wage rate for them will eventually go down, too. The government proposals will be against promoting later retirement.

13) It should be born in mind that voluntary opting-out from

the state 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). 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.

Figure 1 Changes in the Total Fertility Rate



Source: The 1997 Population Projections.

Figure 2 The Total Number of the Labor Force in Japan (The Medium Projection)

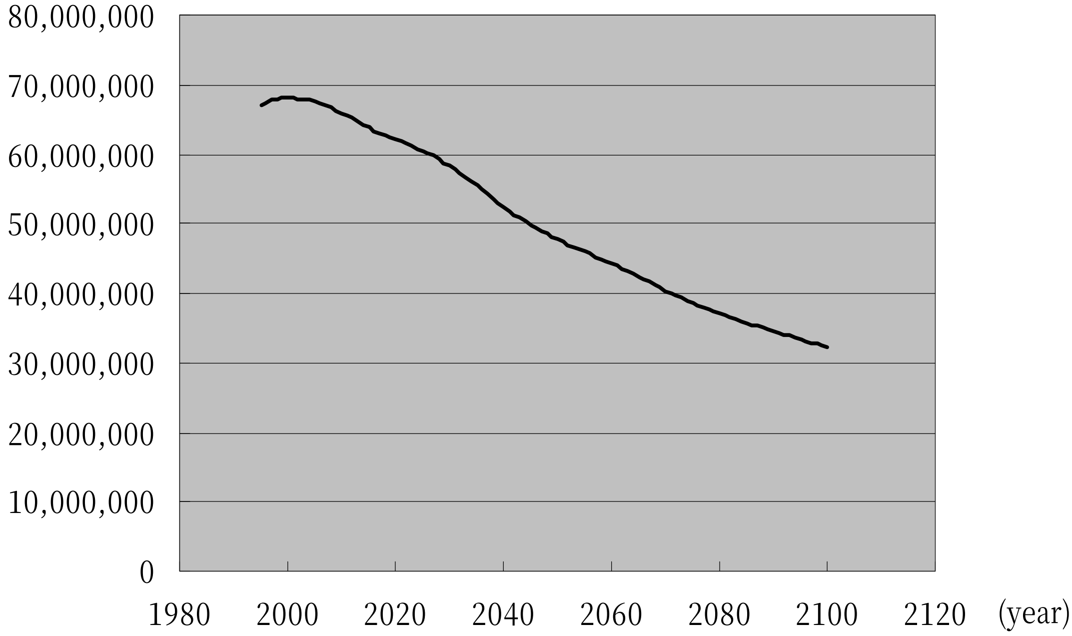
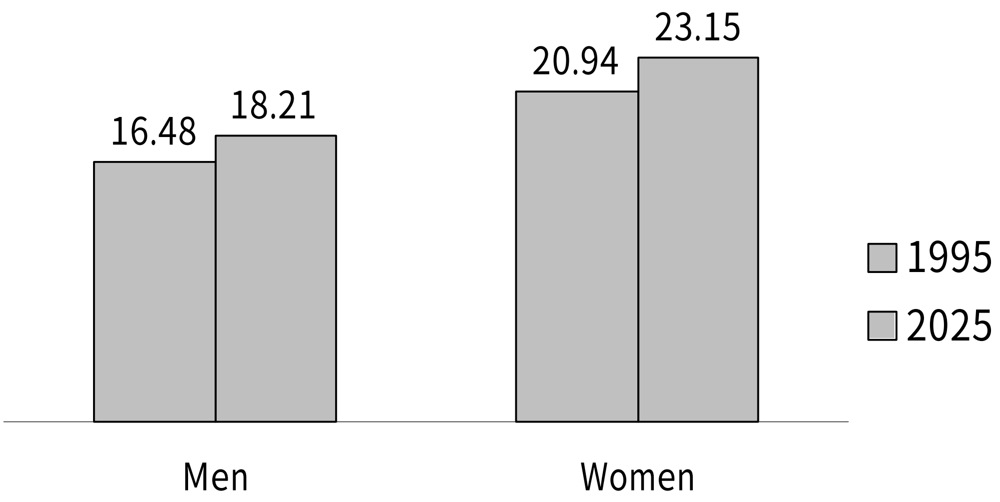


Figure 3 Life Expectancy at Age 65 (Years)



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

Figure 4 Future Contribution Rates by Alternative Policy Options

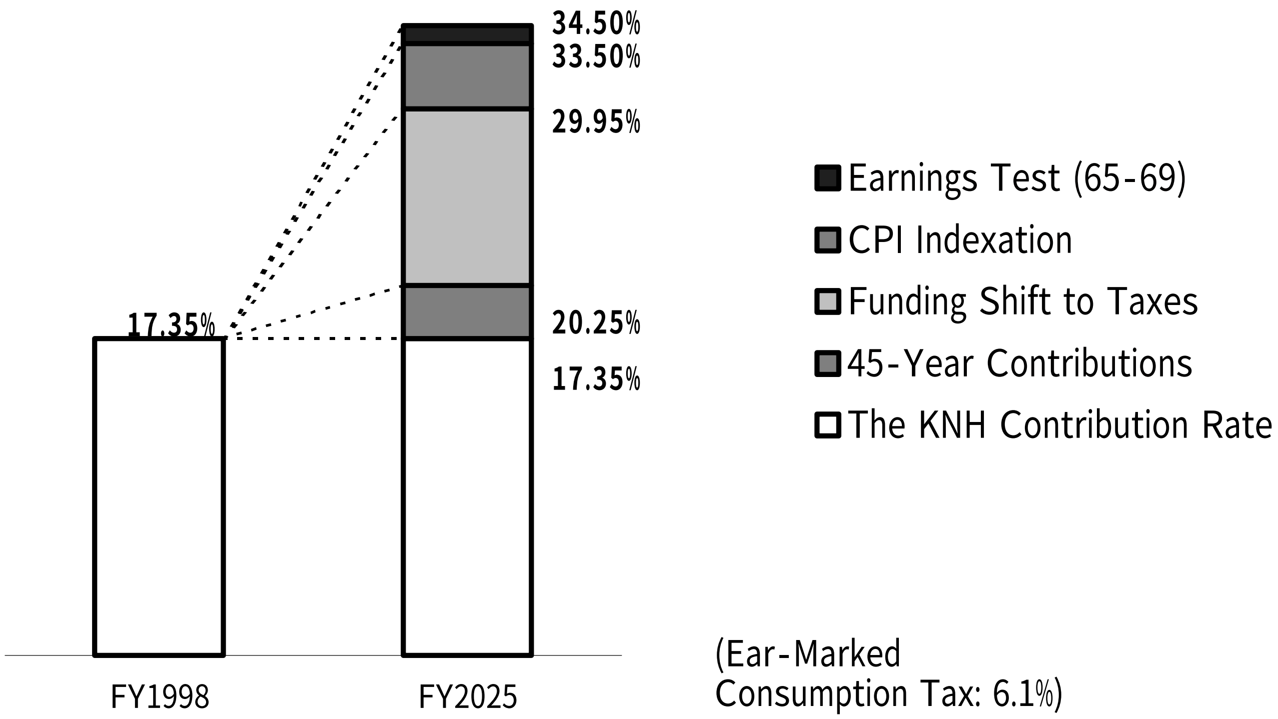
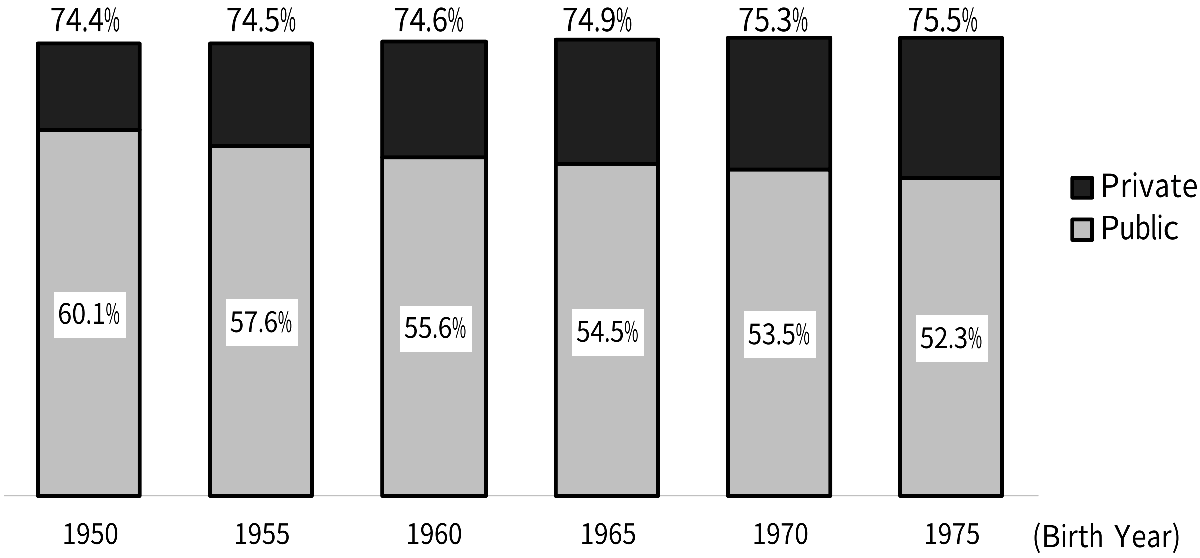


Figure 5 Replacement Rates Combined by Cohorts



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