A Balance Sheet Approach to Reforming Social Security Pensions in Japan

by

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Joint PBC-IMF Seminar on China's Monetary Policy Transmission Mechanism
Beijing, April 12-13, 2004
Organization

- Demography
- Basic Facts:
  - Identifying Main JPN Problems
- Future Policy Options
- The 2004 Reform Bill
- Concluding Remarks

- 2-tier Benefits
- Contributions
- The Biggest Business
Two-tier Benefits (DB)

- **Basic Flat-rate Benefits (PM, PP)**
  
  66,200 yen = USD 630

- **Earnings-related Benefits (40Yrs)**
  
  28.5% of Career Average Monthly Real Earnings

- **Replacement Rate (One-earner Couple)**
  
  Around 60% Net (230,000 yen = USD 2,200)

- **CPI Indexation**

- **The NRA: 65**
Contributions/Transfer from GR

- Contributions
  - 13.58% of Annual Wages
  - 13,300 yen = USD 125 (PM, PP)

- Subsidy from General Revenue
  - 1/3 of Flat-rate Basic Benefits

- Mainly PAYG, but
  - with Partial Prefunding
The Biggest Business in Japan

- **Aggregate SS Pension Benefits**
  
  44 tr. Yen = USD 415 billion in 2003
  
  (9% of Japanese GDP)

  cf. The Automobile Industry

  40 tr. Yen (Domestic Output in 2000)

- **Rapidly Growing**
Demography

- TFR
- Total No. of Populations
- Proportion of 65+
Trends in the Total Fertility Rate of Japan

Actual and Projected Population of Japan

Proportion of the Elderly (+65) in Japan

Basic Facts

- Deficit in Current Account
- Balance Sheet:
  - Huge Excess Liabilities
- SS Pension Contributions:
  - Heavy Burdens Outstanding
- Too Much Income Transfers between Generations
- Increasing Drop-out
Current Account of the KNH

<table>
<thead>
<tr>
<th>Year</th>
<th>Value (trillion yen)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>3.95</td>
</tr>
<tr>
<td>2000</td>
<td>2.08</td>
</tr>
<tr>
<td>2001</td>
<td>-0.70</td>
</tr>
<tr>
<td>2002</td>
<td>-4.10</td>
</tr>
<tr>
<td>2003</td>
<td>-2.84</td>
</tr>
</tbody>
</table>
Balance Sheet of the KNH
(as at the 31st MAR 2000)

Assets

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount (trillion yen)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contributions</td>
<td>1170</td>
</tr>
<tr>
<td>Transfers (GR)</td>
<td>2150</td>
</tr>
<tr>
<td>F. Reserve</td>
<td>500</td>
</tr>
</tbody>
</table>

Liabilities

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount (trillion yen)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contributions</td>
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</tr>
<tr>
<td>F. Reserve</td>
<td>0</td>
</tr>
</tbody>
</table>

Excess Liabilities: 530 tr. yen
Balance Sheet of the KNH (Part 1)
(as at the 31st MAR 2000)

Pension Liabilities Accrued from FUTURE Contributions

Excess Liabilities: 80 tr. yen

Assets

Contributions: 1170

Liabilities

Transfers (GR): 180

Total Liabilities: 1430

Total Assets: 1610
Balance Sheet of the KNH  (Part 2 )

(as at the 31st MAR 2000)

Pension Liabilities Accrued from PAST Contributions

Excess Liabilities: 450 tr. yen

Assets Liabilities
(trillion yen)

100 Transfers (GR)
170 F. Reserve

720

0 100 200 300 400 500 600 700 800
Assets Liabilities
Which Is More, SS Contributions or Tax Revenues?
FY 2003 National Budget, Japan

SS Contributions vs Tax (Central Gov.t)

<table>
<thead>
<tr>
<th></th>
<th>(trillion yen)</th>
</tr>
</thead>
<tbody>
<tr>
<td>SS Contributions</td>
<td>55.6</td>
</tr>
<tr>
<td>Tax (Central Gov.t)</td>
<td>43.9</td>
</tr>
</tbody>
</table>
Main Income Sources of Japan’s Central Government
FY 2003 National Budget, Japan

(trillion yen)

Consumption Tax: 11.9
Personal Income Tax: 13.8
SS Pension Contributions: 29.0
SS Health Care Contributions: 17.5
Corporate Income Tax: 9.1
Per-capita Income by Age in Japan

SS pension benefits are the major source of retirement income

Source: The 1989 NSFIE (elderly couples: median income group)
Drop-out from SS Pensions (Non-employees)
Delinquency in Paying Pension Contributions

% 40
35
30
25
20
15


37.2
Future Policy Options

- Strengthening Incentive-Compatibility
  Shift to NDC
- Handling Legacy Pensions
  Diminishing Excess Liabilities
Strengthening Incentive-Compatibility
Shift to NDC

- Direct Link between Contributions and Pension Benefits
  “Every Yen Counts”
- Increased Credibility
Handling Legacy Pensions
Three Options

- Reducing Benefits
- Increasing Contributions
- Increasing Subsidies
Option 1: Reducing Benefits

- Deflation-Indexing
- A Clawback System
- Benefits Indexation Reflecting Macroeconomic Conditions
- Increasing the NRA to 67
- Deducting Contributions for Health Care
- More Taxes on Benefits
Option 2: Increasing Contributions

- Incentive-compatible?
  - What Matters is **Taste of Pie**
- Penalties on Employment
  - Non-neutral & Regressive
- Income Tax Revenues
Option 3: Increasing Subsidies

- **Where to Go:**
  
  Flat-rate Basic Benefits (1/3 or 1/2) or Guaranteed Pensions or Legacy Pensions?

- **What Funding Source:**
  
  Consumption Tax or Income Tax or Cutting Other Public Expenditure?
The 2004 Reform Bill (1)

- **Increasing Contributions**
  - by 0.354 point Every Year
  - 18.30% from 2017 onwards
  - by 280 yen Every Year
  - 16,900 yen from 2017 onwards

- **Increasing Subsidies**
  - Flat-rate Basic Benefits (1/3 → 1/2)
Changes in Balance Sheet of KNH after the 2004 Reform Bill

(as at 31st MAR 2000)

<table>
<thead>
<tr>
<th>(Tr Yen)</th>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>2,000</td>
<td>PAST</td>
<td></td>
</tr>
<tr>
<td>1,500</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>500</td>
<td></td>
<td></td>
</tr>
<tr>
<td>0</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

- **Excess A**: 480 Tr. Yen
- **Excess L**: 390 Tr. Yen

- Transfers (GR)
  - 120
  - F. R. 170

- Pension Liabilities
  - 680

- Contributions
  - 1500

- Pension Liabilities
  - 1290

Changes in Balance Sheet of KNH after the 2004 Reform Bill (as at 31st MAR 2000)
The 2004 Reform Bill (2)

- Reducing Benefits by Considering “Demographic Factors” in Indexing Benefits between 2005 and 2023

Replacement Rate for a “Model” Couple

Benefits at Age 65:

- 60% (2004) → 50% (2023)

Current Pensioners:

- 60% (Age 65) → 43% (Age 84)
Benefits for Current Pensioners

(1,000 yen)

Take-home Pay  Pension Benefits

1999 (Age 61)
- Take-home Pay: 401 (100.0)
- Pension: 238 (59.4)

2022 (Age 84)
- Take-home Pay: 562 (140.1)
- Pension: 240 (60.1)

1999: $1,000 yen
2022: $2,100 yen
The 2004 Reform Bill (3)

- Relaxing the Earnings-test
- Earnings-split between Husband & Wife
- Non-Employees:
  Shift to Income-related Contributions
- Strengthening Private Initiatives
Concluding Remarks

- Balance Sheet: So Informative Tools
- Greater Significance on Incentives and Compliance
- Burden-Sharing: How It Will Be
  - Separating Legacy Pensions from Newly Qualified Pensions Recommended
  - Minimize Adverse Effects on the JPN Economy
- Automatic Stabilizers Still Lacking