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Pension Reform in Japan at the Turn of the Century

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1. Introduction

Changes in the social security pension system have thus far been made at least every five years in Japan. Such frequent changes are considered to be fine tunings resulting from the rapidly changing socio-economic circumstances. Because a major overhaul was proposed in 1994, the chances were that 1999 would become another year of pension reform.

In December 1998, the Japanese government decided to temporarily freeze increases in social security contribution rates for pensions for some years from fiscal year 1999 (beginning 1 April). This freeze was mainly due to the ongoing downturn of the Japanese economy. 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, which it passed in March 2000. The aim of this article is to explain the main content of the 1999 pension reform, with some discussion of it.

There has been a growing emphasis on the area of private pensions in Japan. The Japanese government recently proposed a newly defined contribution plan, along with amending the existing defined benefit plans of occupational pensions. The reform bills concerned were passed by the parliament in June 2001. This article also explains the main points of these reforms in private pensions.

2. The 1999 pension reform

The main content of the 1999 pension reform for social security is as follows.

2.1. Reductions in benefits

Aggregate pension benefits will be reduced by 20 per cent by 2025 for the system to have a healthier financing basis. The following four measures have been adopted to achieve this.

Reductions in the benefit level

Japan has a two-tier system: flat-rate basic benefits and earnings-related benefits.[1] Under the 1999 reform, earnings-related benefits were to be reduced by 5 per cent; more specifically,

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[1] Takayama (1996a, 1998) gives a detailed explanation of Japan's social security and occupational pension system.

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the former annual accrual rate of 0.75 per cent was to be reduced to 0.7125 per cent from fiscal year 2000.

Shift to CPI-indexation

Both flat-rate basic benefits and earnings-related benefits once paid were to be CPI-indexed after age 65 from fiscal year 2000. In the past, the benefits were wage-indexed every five years.

In Japan, the gap in future increases between wages and CPI is assumed to be 1 per cent annually. A shift from wage-indexation to CPI-indexation will bring a considerable effect on reducing aggregate pension benefits as years go. The relative level of pensions over wages will continue to decline after receiving benefits. At age 87 the relative level of benefits will be reduced by 20 per cent.

New earnings test introduced

An earnings test for those aged 65 to 69 is to be newly introduced from fiscal year 2002. Note that Japan currently has no such test. The test is quite generous, however, as shown in Figure 1. The first-tier, basic benefits are fully paid regardless of salary and wage earnings. There are no reductions in earnings-related benefits until the total monthly sum of the benefits and earnings reaches 370,000 yen.[2] If the total exceeds that level, the earnings-related benefits are reduced by 10,000 yen for each 20,000 yen increment in wages.

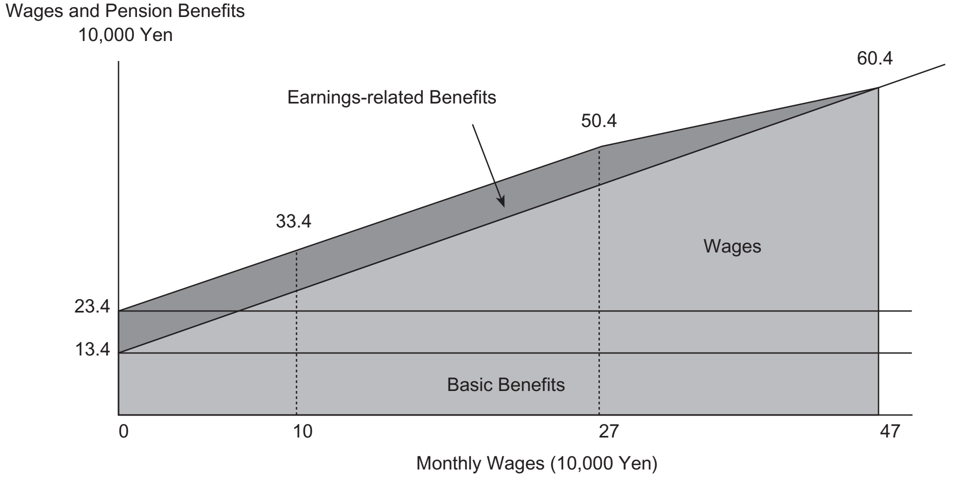

Figure 1: Earnings Test for Those in Their Late Sixties

Notes: Monthly basic benefits and full earnings-related benefits are assumed to equal 134,000 yen (for a couple) and 100,000 yen, respectively.

[2] 10,000 yen = US\$84.2 = €99.3 = £59.2 = DM194.2 as at 31 May 2001.

The newly introduced earnings test may induce earlier retirement, more or less, for those currently working in their late 60s.

Pensionable age increased to 65

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 0.5 per cent by month (6 per cent by year). If a person begins to receive the advance payment from age 60, his or her benefit level will be 70 per cent of the normal amount.

Note that the normal pensionable age for the first-tier, basic old age benefit increases step by step from 60 to 65 for men between fiscal year 2001 and 2013. This was decided by the 1994 pension reform. The 1999 Pension Reform Act raises the normal pensionable age for the second-tier benefit from 2013, just after the end of the shift of the normal pensionable age of the first-tier benefit (see Table 1).

The size of reduction for advance payment of the first-tier benefit was to be reviewed in 2000 using the latest data on life expectancy. The new rates for reductions/increases, as shown in Figure 2, are to be applied for those born after 2 April 1941. The new rates of reduction for advance payment could still be said to be too high, since the actuarially neutral rate of reduction for those starting to receive their old-age benefit at age 60 should currently be 73 or 75 per cent of the normal amount.

There was considerable debate about whether to increase the normal pensionable age in Japan. It seemed to be universal to all employees, at first sight. It turns out, however, to be virtually selective. It will be more damaging to those who have had fewer years in education and come earlier to the labor market. They are apt to be burnt out or to have a sense of

Table 1:
Start age of full old-age benefits for male employees

Date of birth	**Basic benefits**	**Earnings-related benefits**
Before 1 April 1941	60	60
Between 2 April 1941 and 1 April 1943	61	60
Between 2 April 1943 and 1 April 1945	62	60
Between 2 April 1945 and 1 April 1947	63	60
Between 2 April 1947 and 1 April 1949	64	60
Between 2 April 1949 and 1 April 1953	65	60
Between 2 April 1953 and 1 April 1955	65	61
Between 2 April 1955 and 1 April 1957	65	62
Between 2 April 1957 and 1 April 1959	65	63
Between 2 April 1959 and 1 April 1961	65	64
After 2 April 1961	65	65

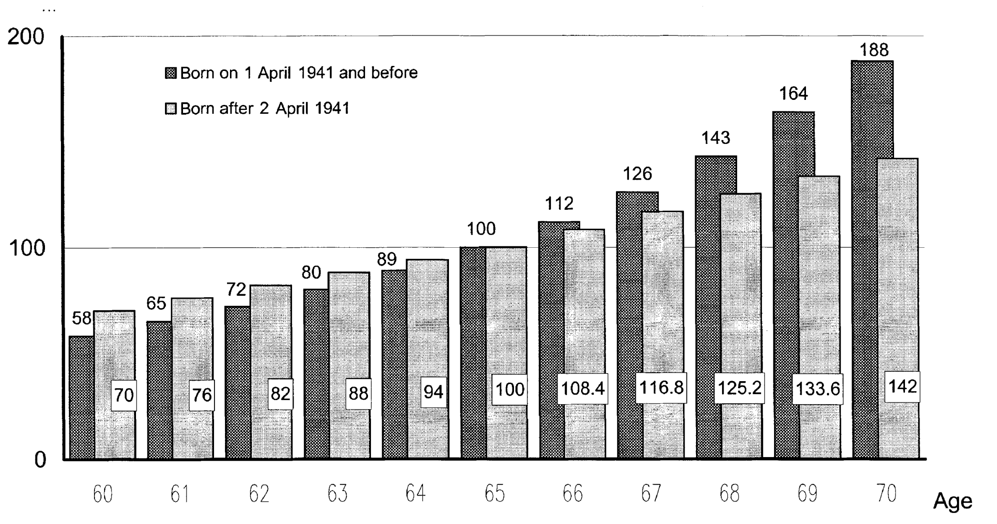

Figure 2: Flat-rate basic benefits for early and delayed retirement

fulfillment after 40 or 45 years' working experience. Most of them are weary and ready for retirement by the time they reach the age of 60. They will be most likely to receive reduced benefits from age 60.

Compare this increase with an extension of the normal contribution period from the current 40 to 45 years. The latter alternative will mostly damage those with longer schooling experience, say, university graduates or those with post-graduate degrees. Usually they are competent, and they face a very advantageous labor market even after age 60. It is easy for them to stay in an excellent job up to age 65. This means that they will suffer least if the normal pensionable age is to be increased to 65. They will, however, be disadvantaged, if the normal years covered are to be extended to 45. Their level of benefits will be reduced due to fewer years of contributions.

Some people proposed extending the normal years covered to 45 first. The government turned down this proposal, however.

Encouraging later retirement is advisable, but there have been few signs of any increases in the male labor force participation rate after age 60 in Japan. In promoting later retirement, it is crucial for older workers to have higher productivity. Training incentives to this end should be more freely available. Redesigning jobs for greater productivity through part-time or flexitime work is also required.[3]

By the four measures listed above, the contribution rate of the principal scheme for private-sector employees will peak by 2025 at 27.8 percentage points,[4] instead of 34.5 percentage points which had been anticipated without the 1999 reform.

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[3] See Takayama (1996b) for more details.

[4] This rate is split equally between employees and their employers.

2.2. *Several changes in contributions*

Covered earnings upgraded

The monthly standard earnings base for social security pensions was upgraded to the 98,000–620,000-yen range from October 2000. Previously it covered the range from 92,000 to 590,000 yen. This upgrading just reflects increases in average earnings over the past five years.

No contributions during childcare leave

Employers became exempt from paying their share of social security pension contributions for their employees on childcare leave from fiscal year 2000. Employees on childcare leave had already been exempt from their share of contributions since April 1995.

Yet no special transfers from general revenue have been arranged to make up for the loss arising from this exemption. Compensation comes from contributions from those not on childcare leave.

Needless to say, the aim of the above exemption is to give support to parents having children in a period of declining fertility.

Shifting to the annual earnings base

The benefit/contribution base is to be shifted from current, monthly standard earnings to annual earnings, including half-yearly bonuses, from fiscal year 2003. The shift is to be adjusted so that there are no changes in aggregate income from contributions in the starting year. The current contribution rate of 17.35 per cent over monthly standard earnings for the principal scheme for private-sector employees will be changed to 13. 58 per cent over annual earnings from April 2003. At the same time, the new accrual rate of 0.5481 per cent will be applied.

Note that special contributions of 1 per cent for social security pensions have been payable on half-yearly bonuses. These special contributions will be abolished from April 2003 and, instead, the same percentage of 13.58 will be levied on half-yearly bonuses as contributions for social security pensions.

This shift is expected to induce more equitable contributions among different levels of wage and salary earners. One serious problem is that there is a ceiling for the bonuses covered: 1.5 million yen at a time. This ceiling will encourage people to pay bonuses not half-yearly but on an annual basis, especially for high-income earners. For them the current pay system of basic monthly salaries with half-yearly bonuses will no longer look attractive. An alternative system on the basis of annual salary (with no bonuses) may even help avoid paying in some of the contributions for social security pensions.

New arrangements for low-income groups

A 50 per cent discounted flat-rate contribution for non-employees is to be introduced from fiscal year 2002. This is mainly for low-income groups. Their basic benefit will be two-thirds of the full amount. Note that one-third of the full benefit is financed by transfers from general revenue.

The new arrangement is like a bargain sale of the basic benefit for non-employees, though its main purpose is to reduce the drop-out rate. It is quite uncertain, however, whether young people's growing distrust of the government in charge of social security pensions will disappear through this arrangement; the government is still asking for further increases in the contribution rate of social security pensions in the future, which will intensify the problem of "incentive compatibility" (see section 2.3 below).

Another arrangement was that, from April 2000, students aged 20 and over were allowed to postpone paying in their flat-rate contributions for ten years at the most. They are, however, to be eligible for full basic disability benefits during years of non-payment.

The majority of students are currently postponing that payment, with little hope of paying it back after graduation. Absence of being back payments will lead to a reduction in their level of basic old-age benefits.

2.3. Partial funding shift to general revenue

In December 1998, the ruling coalition parties announced that they would introduce a partial funding shift to general revenue from the current one-third to one-half in financing basic benefits from fiscal year 2004 at the latest, although no legal arrangements have been specified yet. The funding shift will enable the contribution rate for social security pensions to decrease simultaneously by 1 per cent for the principal scheme for private-sector employees, and by 3,000 yen per month for each non-employee. If increased general revenue is to be financed by a consumption-based tax (earmarked to pay pension benefits, though not legislated yet), a 0.9 per cent increase in the consumption tax rate (currently 5 per cent) will be necessary in 2004.

While the above-mentioned funding shift will not on the whole lead to additional pension burdens current pensioners will also be forced to share the cost of social security pensions. Actively working generations and their employers will get some advantages through this kind of shift in funding. Most Japanese think of it as equitable from an intergenerational point of view. Whether or not the funding shift will actually take place in 2004 depends on political will, and especially on the political ability to persuade the pensioners.

It is said that the funding shift to one-half is not enough for the system to free itself from the problem of incentive compatibility. The contributions of social security pensions for the principal scheme are estimated to be 25.4 per cent at their peak (if calculated on the monthly standard earnings base) even if the above-mentioned funding shift is adopted. Consequently, further increases in the contribution rate from the current 17.35 per cent are inevitable, which will be sure to do more harm to the Japanese economy, together with making younger generations more inclined to think that their participation in the social security pension system does not pay.[5]

3. New legislation on private pensions

A long-awaited defined contribution (DC) plan is to be introduced in Japan from 1 October 2001. The Defined Benefit (DB) Corporate Pension Act will take effect on 1 April

[5] The present author is proposing a freeze in any further increases in the contribution rate for social security pensions to avoid this incentive compatibility problem. The full funding shift to assuring a universal, tax-financed basic pension will be required to do so. At the same time, he is proposing a 4 per cent personal retirement account, a defined contribution plan, to promote private initiatives, as well. For more details, see Takayama (2000), available on the website (*http://www.ier.hit-u.ac.jp/~takayama/index.html*).

2002, as well. This section explains the main points of these developments in private pension schemes in Japan.

3.1. New DC (defined contribution) plans

Eligibility

There are two types of new DC pension plans: the employer-sponsored type and the individual type. Under the former, the employer pays contributions of the pension plan for his or her employees (of age 60 or younger), but the employees are not permitted to pay matching contributions. This is similar to money purchase plans in the U.S. Participants will be fully vested with three years of service.

Non-salaried workers can contribute to a DC individual pension plan, if they are paying flat-rate contributions to social security pensions. In the case of a company that does not have a contracted-out DB plan (an employee pension fund), a tax-qualified DB pension plan or a DC employer-sponsored pension plan, employees can contribute to a DC individual pension plan at their discretion, provided they are 60 years of age or younger. The individual type is similar to the U.S. 401(k) plans or IRA, but employers cannot make matching contributions to it.

Civil servants and full-time housewives are not eligible to contribute to either of the DC pension plans.

Procedures for participation

In the case of a DC employer-sponsored pension plan, the employer and the employees have to work out a set of rules agreeable to both parties, and get the approval of the minister concerned. On the other hand, subscription to a DC individual pension plan must be filed through the National Pension Fund Association.

Limits to contributions

The annual amount a person can contribute is limited to the amounts set forth below. Any amount in excess of these is not accepted.

Employer-sponsored type
If the employer has no contracted-out DB plan nor a DB tax-qualified pension plan: 432,000 yen.
If the employer has a contracted-out DB plan or a DB tax-qualified pension plan: 216,000 yen.

Individual type
Self-employed person (together with the contribution to the DB national pension fund): 816,000 yen.
An employee in a private company: 180,000 yen.

Tax treatment

Contributions are fully tax-deductible, and investment earnings are tax-deferred. However, the special corporate tax of 1.173 per cent applies on pension assets annually, as is the case for the existing DB corporate pension plans, though it is suspended until 31 March 2003 in the current adverse investment environment in Japan. Benefits are taxable as a rule.

But the generous deduction of income from social security pension benefits and from a lump-sum retirement benefit is applied to benefits paid. Rollovers are tax-free.

Benefits available and rollover

There are three types of benefits payable in a lump sum: old-age benefits, disability benefits and death benefits. In principle, people 60 years of age or older will be eligible to receive old-age benefits with over ten years of participation. This means that at termination of employment, employees cannot receive benefits unless they are 60 years old or more. They are forced to just rollover their account balance to the new employer's DC plan or an individual DC plan before they reach age 60. This is completely different from the U.S. DC plans.

Participants can start receiving old-age benefits any time between the ages of 60 and 70. When they reach age 70, they must receive it.

Asset management

Plan administrators will give planholders instructions as to how to invest their pension assets. There should be more than three options, ranging from a capital guaranteed product to bank deposits, bonds, stocks, mutual funds and insurance products. Pension assets can also be invested in individual stocks and shares of the company the policyholder is employed by. Planholders can reshuffle the portfolio at least every three months.

Market outlook in the future

Japanese DC plans will grow in the long run, but the short-term prospects for market growth are not expected to be so remarkable. According to the estimates by Nippon Life Insurance Company, the largest one in Japan, the DC assets for both types combined will be 16.5 trillion yen and their participants will number 8.6 million within ten years.

There are several reasons for this. First, contribution limits are fairly low. Second, no matching contributions are allowed at all. Third, a transfer of accumulated assets from existing DB plans or book-reserve retirement plans will face tight restrictions, though the detailed requirements of that transfer have not yet been made public. Fourth, benefit events are severely limited, coupled with mandatory rollover. Fifth, participation is limited, not open to all Japanese. Sixth, the special corporate tax is applied. All these are very user-unfriendly.

With the current, quite low rate of interest and the sluggish stock market in Japan, it does not seem attractive for anyone to start on a DC plan. What is missing for DC plans to develop is economic recovery in Japan.

3.2. DB corporate pension reform

Contracted-out plans

The benefits of the existing contracted-out plans through the Employees' Pension Fund consist of two components: the benefit equivalent to the earnings-related portion of social security pensions (excluding the benefit resulting from indexing) and the supplementary benefit. Due to bad investment performance for the past ten years, most contracted-out plans are seriously suffering from underfunding. They have been forced to pay a considerable amount of additional money to compensate for the underfunded portion for the social security equivalent benefit.

Company managers and trade unions were strongly asking to abolish the contracted-out plans or to drastically relax requirements for contracting into them by lowering the legislated rate of return from investment used in calculating the assets to be transferred to social security. The DB Occupational Pension Reform Act allows a new DB corporate scheme (the Fund Type) which excludes the benefit equivalent to the earnings-related portion of social security, by relaxing requirements mentioned above. A separate pension entity from the employer is to be set up, as is the case in existing contracted-out plans.

Tax-qualified plans

Many tax-qualified pension plans have been terminated recently without enough assets to pay benefits. To enhance the protection of rights of the participants and beneficiaries, some measures are necessary to strengthen the operational rules. The new Act creates another new DB scheme (the Contract Type DB Plan) to replace existing tax-qualified plans. The new scheme does not require a separate pension entity from the employer to be set up. This is the same as the existing tax-qualified plan. The existing plans have to be terminated by March 2012. Under the new plan, minimum funding rules are to be introduced, with fiduciary duties defined. Disclosure of plan operations to participants will also be required.

No insurance for policy termination

Policy termination insurance is not introduced. This is mainly because most employers are reluctant to pay extra money to save unhealthy companies' pension plans.

Hybrid plans permitted

Designing of benefits is to be liberalized. Hybrid plans are now allowed.

Future prospects

Almost all occupational retirement plans are currently of the DB type in Japan. Not a few companies are considering replacing part or all of their existing DB plans with hybrid or DC plans. In this context, the newly established DB plans (the Fund Type and the Contract Type) do not seem promising. Instead, increased termination of the existing contracted-out plan without any move to new Fund Type DB plans will be more likely to take place.

The new legislation brings more regulations in the operation of the switched DB plans (the Contract Type), forcing increases in costs of maintaining them, though employees' rights to benefits are strengthened. More rules and more regulations will naturally lead to more terminations of tax-qualified plans.

The new DB Occupational Pension Act may be another driving force for DC plans to grow in Japan.

4. Concluding remarks

Japan drastically reformed its social security and occupational pensions at the turn of the century. The pension system in Japan is in a never-ending process of revision. Considerable efforts to slim down the social security and DB occupational pension benefits, together with replacing them with a private DC plan, will still be expected to continue. All these are to mitigate the difficulties arising from declining population and a downturn in the Japanese economy. There will be a political conclusion, sooner or later, as to whether contributions are to be increased in the social security pension arena or in the private-sector initiative.

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