Key Issues Regarding Japan's Public Pension Reform

Akiko Nomura
Senior Analyst,
Nomura Institute of Capital Markets Research

I. 2009 financial review report released

On 23 February 2009, the Ministry of Health, Labour and Welfare (MHLW) released its 2009 financial review report on the public pension system. As a result of reforms enacted in 2004, Japan's public pension system (1) fixes premiums, after stepped increases, at jpy16,900 for the National Pension (*kokumin nenkin*) and 18.3% for the Employees' Pension Insurance (*kosei nenkin*); (2) adjusts benefits automatically to adapt to the demographic trend of low fertility.; (3) allocates pension reserve funds to benefits and ensures the system will have funding for one year's worth of benefits after 100 years; and (4) raises the portion of the basic pension funded by tax revenues (the national subsidy ratio). It will also conduct a financial review once every five years, and when the replacement rate is projected to drop below 50%[1], that benefit-level adjustment period will be ended, and the system revised.

The key focus of this financial review, the first under the revised framework, was whether a 50% replacement rate could be maintained in light of demographic and economic trends.

The review results were given under three different scenarios -- high, medium, and low -- for fertility rates, death rates, and the long-term economic growth assumption. Under the base scenario (medium fertility and medium economic growth), the report projects a decline in the replacement rate from 62.3% in FY2009 to 55.2% in FY2025, and then to 50.1% in FY2038, at which point it levels off (Figure 1). Based on the latest review, in other words, no system revisions are needed.

II. Recent debate over public pension reform

1. 2004 reforms left to implement: raising the national subsidy ratio for the basic pension

Japan's public pension is a social insurance system in which a person’s benefits are paid based on premiums contributed during his/her working years. Nevertheless, the

1 The replacement rate is the pension benefit as a percentage of the take-home salary of the working population.

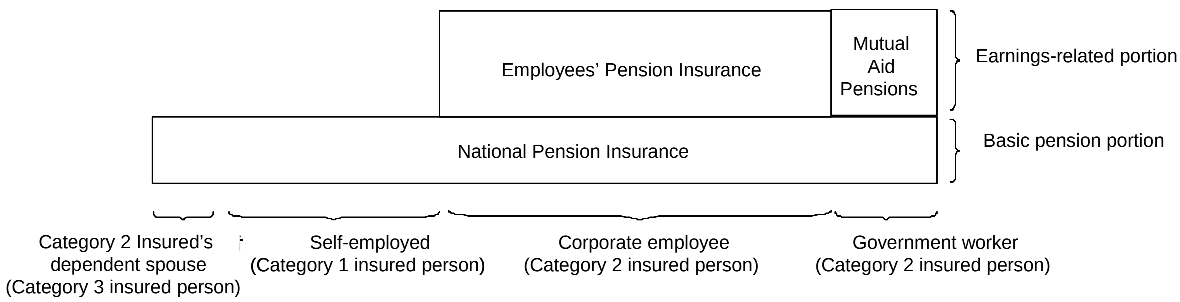
basic pension (Figure 2) relies on a combination of social insurance premiums and general tax revenues (referred to as the national subsidy), and the 2004 pension reforms described above raised the ratio of benefits to be funded by taxes from one third to one half. The specific source of this tax revenue was left for further debate, however.

Figure1: Assumptions and results for 2009 financial review

		2009			(For reference) 2004 financial re-calculation		
Assumptions	Total fertility rate	2005 (actual)		1.26	2000 (actual)		1.36
		2055		1.26	2050		1.39
	Average life span	2005 (actual)	Males:	78.53	2000 (actual)	Males:	77.64
			Females:	85.49		Females:	84.62
		2055	Males:	83.67	2050	Males:	80.95
			Females:	90.34		Females:	89.22
	Long-term economic assumptions	CPI:		1.0%	CPI:		1.0%
		Wage growth	(nominal)	2.5%	Wage growth	(nominal)	2.1%
			(Real = relative to price level)	1.5%		(Real = relative to price level)	1.1%
		Investment returns	(nominal)	4.1%	Investment returns	(nominal)	3.2%
			(Real = relative to price level)	3.1%		(Real = relative to price level)	1.1%
Results	End of period for adjusting benefit levels	FY2038			FY2023		
	Replacement rate from then	50.1%			50.2%		

Note: Only the medium scenario is shown
Source: Ministry of Health, Labour, and Welfare

Figure2: Diagram of Japan's public pension system



Source: Nomura Institute of Capital Markets Research

The supplementary provision to the 2004 Pension Reform Law included a suggested schedule of increases. Specifically, the provision called for "raising the national subsidy ratio to appropriate levels" in FY2005 and FY2006 "after making the necessary changes to tax law," and, upon "thoroughly reforming the tax system to ensure a stable source of the revenue needed" by FY2007, completing the increase of that ratio to half by FY2009. The tax system had yet to be reformed, however, and FY2009 was about to commence.

As an interim measure, the MHLW submitted a draft amendment to the National Pension Act on 30 January, 2009, in which it proposed to use a special transfer of funds from the Fiscal Investment and Loan Program's special account to the general account as a way to fill the gap between the current national subsidy ratio and the 50% target. The proposed amendment also calls for thorough tax reform after that in order to secure the required revenue source and perpetuate the national subsidy ratio at one half. Because the proposal does not indicate where this revenue should come from, it effectively just postponed the needed reform for two years. The current financial review assumes that the national subsidy is raised to one half, however, and unless that increase is actually implemented, a replacement rate of 50% will become unobtainable.

2. Framing of basic pension a cause of funding problem

Some have argued that all, rather than half, of the basic pension should be funded by tax revenue[2]. In that case, the consumption tax, rather than the income tax, would probably be the more appropriate source of funding to lessen the working population's tax burden.

Hidden beneath the funding problem is a dispute over how the basic pension should be framed around the lives of the elderly. If the basic pension is seen as providing the elderly with a fixed payment to guarantee a minimum standard of living, then one could argue that rather than fund benefits with premiums, which would mean those with a low income during their working years would receive a low pension, the pension should be funded with tax revenues, and thus serve as a way to redistribute wealth. Realistically, however, it is not clear that the role of the basic pension is to guarantee a minimum standard of living. Another problem that has often been pointed out is the lack of any clear relationship between the basic pension benefit and the level of welfare payments. This lack of a consensus on the basic pension's role is probably one reason why the funding question has yet to be solved.

It is not as if the government is ignoring the issue. In January 2008, the Prime Minister's Cabinet Office formed a National Commission on Social Security to debate, in terms easily understood by the general populace, the nature of social security and the direction of future reforms, including the question of funding. In addition to issues concerning pensions, health care and nursing care, the Commission also dealt with Japan's declining birth rate. Its final report, issued in November 2008, described its vision of social security and estimated the additional costs that would be needed to

---

2 For more on proposals addressing problems with Japan's public pensions, including full-scale reform of the basic pension system, see Kazuhiko Nishizawa, *Nenkin Seido Wa Dare no Mono ka* (Whose pension system is it?), Nihon Keizai Shimbun-sha, April 2008 (in Japanese).

achieve that vision[3]. In regards to how to fund the basic pension, however, the Commission did not go beyond merely outlining the two sides of the argument.

The Cabinet approved on 23 December 2008 a medium-term program to build and secure funding for a sustainable social security system, within which the consumption tax was identified as the primary source of revenue to fund a social security system with "medium benefits" and "medium costs." The Cabinet noted that one principle of the tax reform to be implemented after the economy starts to recover should be to use consumption tax revenue to fund the costs of social security, thereby benefiting all citizens, and not use it to expand government bureaucracy. This seems to indicate an intention to earmark the consumption tax for social security.

Furthermore, the draft amendment to the National Pension Law submitted to the Diet includes wording to the effect that debate over strengthening the minimum guarantee aspect of the basic pension should proceed, with changes phased in once a stable source of funding can be secured to cover the necessary costs of the system in its new form. Although we think this is meant to address the failure of the current system evidenced by the growing number of people with zero or low pension benefits, the actual wording used referred to guaranteeing a minimum standard of living.

3. Introducing the funded system for the earnings-related component

Closely related to the positioning of the basic pension is the treatment of the component of employee pensions based on earnings. On 25 December 2008, seven Lower House Diet members from the Liberal Democratic Party (LDP) and the Democratic Party of Japan (DPJ) proposed pension reforms. The bipartisan proposal (1) clarified the basic pension's role as a minimum living standard guarantee, with a monthly benefit of about jpy70,000 funded by general tax revenue, (2) recommended shifting the premium-based public pension portion to a funded system in which benefits are paid based on that individual's paid-in premiums, , and (3) called for establishing a low-cost, reliable organization to run the system. In a funded system, each worker's contributions are credited for their benefit, in contrast with a pay-as-you go approach, where premiums from individuals still working fund the benefit payments of retirees. This is envisioned as a defined contribution plan, rather than a defined benefit plan.

A pension reform study group put together by the *Nihon Keizai Shimbun* made a proposal on 8 December 2008, prior to the nonpartisan Diet member proposal, to shift

---

3 It has been estimated that by 2025, the consumption tax rate would have to be raised 6 percentage points if social security is funded by premiums and by 9-13 percentage points if it is funded by taxes. Nippon Keidanren, one of Japan’s largest business federations, estimated that strengthening the social security system and moving the basic pension to a purely tax-based funding scheme would require raising the consumption tax about 12 percentage points by FY 2025. See Nippon Keidanren, *Kokumin Zentai de Sasaeau Keizokukanou na Shakaihoushouseido wo Mezashite* (Aiming for a sustainable social security system that everyone supports), 17 February, 2009 (in Japanese).

a portion of earnings-related premiums to a funded system[4]. That same study group released its first report on funding the basic pension entirely with the consumption tax in January 2008, and followed that with a second report. The reports noted that although shifting solely to a funded system for the earnings-related portion would be ideal, it recommended going with a hybrid system to ameliorate the doubled burden[5] that would result when shifting from a pay-as-you-go approach.

Sweden's public pension is a well-known example of a country that partially implemented a funded system along with a pay-as-you-go pension. The individual retirement savings portion of Sweden's system is a defined contribution pension in which participants can choose from a menu of investment options for the assets in their own account. Denmark's ATP public pension uses a funded system, but it is a defined contribution plan with guaranteed yields, and participants are not allowed to choose investments. There are thus a variety of different ways to implement a funded system. Although it is hard to say which direction the debate over a funded system will take in Japan, a likely area of debate, along with the issue of the doubled burden associated with the transition, is how the assets of the funded portion should be managed.

III. Conclusion

The media appears to have been quite critical of the "overly optimistic" assumptions underlying the financial review, shown in Figure 1[6]. Observers have also noted that a nominal yield of 4.1% may be difficult to achieve, even over the long term, given that the Government Pension Investment Fund (GPIF), which manages public pension savings, reported on 27 February 2009 an investment return on those savings of -9.13% for April-December 2008.

Japan's public pension system has been reformed numerous times in the past (Figure 3). A bill to integrate the employee pensions of private-sector salaried employees (Employees' Pension Insurance) with government worker pensions (Mutual Aid Pensions), submitted to the Diet in April 2007, remains in limbo. If demographics and socio-economic conditions necessitate further reforms, it is essential that those reforms be started without delay.

---

4 See pages 1, 6, 7, and 2 (editorial section) of the *Nihon Keizai Shimbun* dated 8 December 2008.

5 During the transition from pay-as-you-go to a funded system, the currently working generation is forced to contribute both to the retired generation's pension and to the fund for their own pension. The biggest challenge in implementing a funded system is dealing with this cost of the transition.

6 For example, there were articles on this subject in several major newspapers, including the *Nihon Keizai Shimbun*, the *Asahi Shimbun*, the *Mainichi Shimbun*, and the *Tokyo Yomiuri Shimbun*. In addition, during debate in the Diet over the proposed reforms to the National Pension Law in April, there was criticism of the assumption of an 80% premium collection rate for the national pension premium, even though the actual collection rate is 65%.

Figure3: Past reform of Japan's public pensions

1942: Laborers' Pension Insurance established	♦ Covers male factory and mining workers. Renamed Employees' Pension Insurance in 1944.
1961: National Pension system is launched	♦ Covers self-employed and others. Dependent spouses of employees could enroll voluntarily.
1985: Introduction of Basic Pension	♦ System categories based on workplace were revised, and changed to the current two-tier system, the first tier for everyone and the second tier just for employees. Dependent spouses of employees were made eligible for the national pension as a Category 3 insured person.
1989 Reform	♦ Debate over raising the minimum age for receiving retirement benefits to accommodate the increase in average longevity was begun, but no changes were made. Start of full inflation-indexing of benefits and compulsory enrollment in national pension for students aged 20 and older.
1994 Reform	♦ Aging of the population and declining fertility rate recognized as serious problems, minimum age for receiving the flat portion of employee pension benefits is raised, to 65 years from 60 years, phased in for males from FY2001 to FY2013 and for females from FY2006 to FY2018.
2000 Reform	♦ Minimum age for receiving the earnings-related portion of Employees' Pension Insurance benefits is raised to 65 years from 60 years, phased in for males from FY2013 to FY2025 and for females from FY2018 to FY2030.
2004 Reform	♦ Premium level is fixed, benefits adjusted based on demographics, reserve funds put to use, and the national subsidy ratio for the basic pension is raised

Note: This is an extract of the key items
Source: Ministry of Health, Labour, and Welfare