

# 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. So frequent changes are considered as fine tunings to the rapidly changing socio-economic circumstances. Because the great 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 1999 (from April 1). 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 was passed in March 2000. The aim of this article is to explain the main content of the 1999 pension reform, with some discussions.

There have been growing stresses in private pensions of Japan. The Japanese government recently proposed a newly defined contribution plan,

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along with amending the existing defined benefit plans of occupational pensions. The reform bills concerned passed the parliament in June 2001. This article explains the main points of these reforms in private pensions, as well.

## 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 percent by 2025 for the system to have a healthier financing basis. Following four measures are adopted to attain this purpose.

#### *Reductions in the Benefit Level*

Japan has a two-tier system; the flat-rate basic benefits and the earnings-related benefits<sup>2</sup>. Through the 1999 reform, the earnings-related benefits were to be reduced by five percent; more specifically, the former annual accrual rate of 0.75 percent was to be decreased to 0.7125 percent from fiscal year 2000.

#### *Shift to CPI-indexation*

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

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<sup>2</sup> Takayama (1996a, 1998) gives a detailed explanation of Japan's social security and occupational pension system.

In Japan, the gap in future increases between wages and CPI is assumed to be 1.0 percent 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 percent.

#### *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 for them. The test is quite generous, however, as is depicted 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 that benefits and earnings come up to 370,000 yen<sup>3</sup>. If the total exceeds that level, the earnings related benefits are reduced by 10,000 yen for each 20,000 yen increment in wages.

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

Figure 1 about here

#### *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

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<sup>3</sup> 10,000 yen = US\$84.2 = EURO99.3 = £59.2 = DM194.2 as at 31 May 2001.

employees in their early sixties 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 percent 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 percent of the normal amount.

Note that the normal pensionable age for the first-tier, basic old-age benefit is increased step by step from 60 to 65 for men from fiscal year 2001 to 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 shift's end of the normal pensionable age of the first-tier benefit (see Table 1).

[Table 1 about here](#)

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. One can say the new rates of reduction for advance payment is still too severe, since the actuarially neutral rate of reduction for those starting to receive their old age benefit at age 60 should be currently 73 or 75 percent of the normal amount.

[Figure 2 about here](#)

There were so much debates for and against increasing the normal pensionable age in Japan. It seemed to be universal to all employees, at first sight. It will turn out, however, to be virtually selective. It will more damage

those with shorter schooling experience, coming earlier to the labor market. They are apt 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 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 current 40 to 45 years. The latter alternative will most damage those with longer schooling experience, say, the university graduates or MA/PHD holders. Usually they are competent, facing 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 have least sufferings if the normal pensionable age is to be increased to 65. Their disadvantage will be not a little, however, if the normal covered years are to be extended to 45. Their level of benefits will be reduced due to shorter contributing years.

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

Encouraging later retirement is advisable, but there have been little signs for 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. Job re-designing for greater productivity in part-time or flexitime is also required.<sup>4</sup>

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<sup>4</sup> See Takayama (1996b) for more details.

By the four measures listed above, the contribution rate of the principal scheme for the private-sector employees will peak by 2025 at 27.8 percentage point<sup>5</sup>, instead of 34.5 percentage point anticipated without the 1999 reform.

## 2.2 Several Changes in Contributions

### *Covered Earnings Upgraded*

The monthly standard earnings base for social security pensions was upgraded to the 98,000 to 620,000 yen range from October 2000. It had been the 92,000 to 590,000 yen range, before. This upgrading just reflects the increases in average earnings for the past five years.

### *No Contributions during Child-care Leave*

Employers became exempted from paying their share of social security pension contributions for their employees on child-care leave from fiscal year 2000. Employees on child-care leave have already been exempted from their share of contributions since April 1995.

Yet, no special transfers from general revenue have been arranged to make up for the loss from this exemption. Compensations virtually come from contributions from those not on child-care leave.

Needless to say, the aim of the above exemption is to give support to child-bearing in the age of the fertility decline.

### *Shifting to the Annual Earnings Base*

The benefit/contribution base is to be shifted from current, monthly standard earnings to annual earnings including semi-annual bonuses from fiscal

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<sup>5</sup> This rate is split equally by employees and their employers.

year 2003. The shift is to be adjusted to induce no changes in aggregate income from contributions in the starting year. The current contribution rate of 17.35 percentage point over monthly standard earnings for the principal scheme for the private-sector employees will be changed to 13.58 percentage point over annual earnings from April 2003. At the same time, the new accrual rate of 0.5481 percent will be applied.

Note that a special 1.0 percentage point contributions for social security pensions have been done from semi-annual bonuses. These special contributions will be abolished from April 2003 and instead, the same percentage point of 13.58 will be levied on semi-annual 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 covered bonuses; 1.5 million yen, one time. This ceiling will encourage people to pay bonuses not semi-annually but once annually, especially for high-income earners. For them, the current pay system of basic monthly salaries with semi-annual bonuses will no longer look charming. An alternative system on an annual salaries base (with no bonuses) may even help avoid to pay in some of contributions for social security pensions.

#### *New Arrangements for Low-income Groups*

A 50 percent discounted flat-rate contributions 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. 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 the non-employees, though its main purpose is to lessen the drop-out. It is quite uncertain, however, that growing distrust among young people against the government in charge of social security pensions will disappear through this arrangement; the government is still asking further increases in the contribution rate of social security pensions in the future, which will intensify the problem of “incentive compatibility” (see discussions below in section 2.3).

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 the students are currently postponing that payment, with little hope of back paying-in after graduation. No back-payment 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 will introduce a partial funding shift to general revenue from 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 one percentage point for the principal scheme for the private-sector employees, and by 3,000 yen per month per each non-employee person. 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 percentage point increase

in the consumption tax rate (currently 5 percent) will be necessary in 2004.

While the funding shift above mentioned will induce no additional pension burdens as a whole, current pensioners will be also forced to share the cost of social security pensions. Actively working generations and their employers will get some advantages through this kind of the funding shift. 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 is decisively depending on the political will, especially on its ability to persuade the pensioners.

It is said that the funding shift to one-half is not enough for the system to get free from the problem of incentive compatibility. The contributions of social security pensions for the principal scheme are estimated to be 25.4 percentage point at their peak (if calculated on the monthly standard earnings base) even if the funding shift above mentioned is adopted. Consequently further increases in the contribution rate from current 17.35 percentage point is inevitable, which will be sure to do more harms 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<sup>6</sup>.

### 3 New Legislations on Private Pensions

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<sup>6</sup> The present author is proposing to freeze any further increases forever 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 percent personal retirement account, a defined contribution plan, to promote private initiatives, as well. For more details, see Takayama (2000) which is available on the website (<http://www.ier.hit-u.ac.jp/~takayama/index.html>).

A long awaited defined contribution (DC) plan is to be introduced in Japan from 1 October 2001. The Defined Benefit (DB) Occupational Pension Act will take effect on 1 April 2002, as well. This section explains the main points of these developments in private pension schemes in Japan.

### 3.1 New DC 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 its 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 US. 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 US 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 Involved to Participate*

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 amounts 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 percentage point applies on pension assets annually, as is the case for the existing DB corporate pension plans, though it is suspended until March 31, 2003 under the current adverse

investment environments 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 10 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 completely differs from the US DC plans.

Participants can start receiving old-age benefits any time between 60 and 70 years old. When they reach age 70, they have to 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 planholder 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 time prospects for the market growth is 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 be 8.6 million in 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 been made public, yet. Fourth, benefit events are severely limited coupled with mandatory rollover. Fifth, the participants are limited, not open to all Japanese. Sixth, the special corporate tax is applied. All these are very user-unfriendly.

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

### 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 equivalent benefit of the earnings-related portion of social security pensions (excluding the benefit resulting from indexing) and the supplementary benefit. Due to the bad investment performance for the past ten years, most contracted-out plans are seriously suffering from under-funding. They have been forced to pay considerable money additionally to compensate for the under-funded portion for the social security equivalent benefit.

Managements and trade unions were strongly asking to abolish the contracted-out or to drastically relax requirements for contracting-in from contracted-out plans 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 equivalent benefit of 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 protection of rights of 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 is not asked to set up a separate pension entity from the employer. 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 be required, as well.

#### *No Insurance for Plan Termination*

Plan termination insurance is not introduced. It is mainly because most employers are reluctant to pay extra money to save unhealthy company's

pension plans.

### *Hybrid Plans Permitted*

Designing of benefits is to be liberalized. Hybrid plans are newly allowed to be set up.

### *Future Prospects*

Almost all occupational retirement plans are currently of the DB type in Japan. Not a few companies are considering to replace part of or whole of existing DB plans with hybrid or DC plans. In this context, the newly established DB plans (the Fund Type and the Contract Type) seem not 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 operating the switched DB plans (the Contract Type), forcing increases in costs of maintaining them, though employees' rights for benefits are strengthened. More rules and more regulations will naturally induce 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 her social security and occupational pensions at the turn of the century. The pension system in Japan is under a never-ending process of revisions. 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 populations with a downturn of the Japanese economy. There will be a political conclusion, sooner or later, as to whether the contributions are to be increased in the social security pension arena or in the private-sector initiative.

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