

Global Horizons Seminar: Pensions and Lifetime Savings

Washington, D.C., May 24, 2002

## **Taste of Pie: What Matter in Japanese Public Pensions?**

By Noriyuki Takayama

Professor of Economics

Institute of Economic Research, Hitotsubashi University

2-1 Naka, Kunitachi, Tokyo 186-8603

E-mail: [takayama@ier.hit-u.ac.jp](mailto:takayama@ier.hit-u.ac.jp)

URL: <http://www.ier.hit-u.ac.jp/~takayama/index.html>

### 1 Declining Population with Rapid Aging

Currently in 2002, the proportion of the elderly (65 years and above) to the total population of Japan is 18.5%. It will steadily continue to rise to more than 30% in 40 years (see Figure 1).

On the other hand, the total fertility rate (TFR) showed an unexpected sharp decline from 1975 and the current level in 2000 is 1.35. There is still little sign that the TFR will stabilize or return to a higher level. In 5 years, Japan's total population will begin to fall sharply to be less than 50% of its current level by 2100 (see Figure 2). This trend will soon be reflected in a sharp decline in young labor, in a falling savings rate and in a decrease in capital formation, all of which will contribute to a further shrinking of the country's economy. Consequently,

Japan will be left with a population in decline, a disproportionately large cohort of pensioners, and an ailing economy with which to support them.

And yet, in spite of the currently ailing state of the economy, the older population of Japan are still receiving massive income transfers from younger generations through social security pensions (see Figure 3). One may say that the elderly in Japan are currently better off than the young or the middle aged in terms of living conditions (see Figure 4).

## 2 Social Security: Incentive- compatible?

The social security contributions (payroll taxes) have become the No.1 income source for the central government (see Figure 5). Yet, latest estimates show that the current 17.35% contribution rate is to be hiked to around 30% by 2025 to finance currently legislated pension benefits.

Further increases in payroll taxes will be sure to do even more harms to the Japanese economy, while making younger generations more inclined to think that their participation in the social security pension system does not pay.

Indeed, in 1999 nearly 50% of independent workers, the self-employed and persons with no occupations dropped out from the basic level of old-age income protection, due to exemption, delinquency in paying contributions or non-application. Employers also are seriously considering how to avoid social security pension contributions.

## 3 Taste of Pie

Growing concerns are now observed in Japan on the “taste of pie” and not on the “size of pie”. The basic design of the pension program should be incentive-compatible. Contributions should be much more directly linked with old-age pension benefits, while elements of social adequacy be incorporated in a separate tier of pension benefits financed by other sources including a consumption-based tax.

Shifting to a new regime mentioned above will cause considerable reductions in social security pension benefits in the future. Current older generations still enjoy too generous pension benefits at the cost of their children and/or grandchildren (i.e., actively working generations) who are currently suffering from reductions in their nominal amount of salaries/ bonuses and from increased unemployment, as well.

Next year, the current account for the principal pension scheme of social security in Japan will turn into a deficit, making its structural reform inevitable.

#### 4 Strengthening Private Initiatives

Majority of people in Japan are quite reluctant to accept further increases in taxes and/or social security contributions. Under such circumstances, people are to be much more encouraged to go on self-reliance after retirement. A new defined-contribution plan was established last year and from April 2002, a hybrid similar to U.S. cash balance plans started. With stronger tax incentives, private initiatives will grow in due course. The future picture on distribution of old-age income in Japan can be quite different.