Rise and Fall of the Opting-out Plan in Japanese Pensions: A Brief Note

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1. Introduction

In February 2005, President G. Bush proposed a reform package of social security in the United States. It included an opting-out plan from social security.

The United Kingdom and Japan have already had opting-out plans for social security pensions. People in the US currently seem to be getting more and more familiar with the UK experience of opting-out plans in pensions. Little have yet been known about the Japanese experience, however.

This short note gives a brief sketch of the rise and fall of the opting-out plan in Japanese pensions, providing some lessons from Japanese experiences.

2. Brief Outline of Japan's Opting-out Plan

The opting-out plan in Japan was established in 1966. It is called the *Kosei Nenkin Kikin* (KNK, Employees' Pension Fund). The benefits of the KNK consist of two components: the equivalent benefit of the earnings-related portion of the social security (excluding the benefit resulting from indexing), and the supplementary benefit (see Figure 1). The latter is primarily financed by the employer. The supplementary benefit can be received in a lump sum at the discretion of the employee, although in principle it should be in the form of a life annuity. The plan must be funded through a trust fund or an insurance contract. The employers' contributions to the KNK are 100% tax deductible as a business expense. A special 1.173% corporate tax is levied annually on fund assets, though the KNK does not pay special taxes on accrued benefit liabilities up to 2.7 times the equivalent benefit of the earnings-related portion of the State scheme (with only the undynamized benefit). Incidentally this special tax has been provisionally suspended since 1999.

The KNK enjoys the contribution rebate (the payroll tax rebate) between 3.2 and 5.0 percentage point from social security pensions, depending on each KNK's average age of their participants (employees). A 5.5% rate of return from investment in nominal terms is assumed in setting the rebate.

3. Changes in the Number of Opting-out Plans

The KNK started in 1966. Its number was 142 at the outset. It has once steadily increased up to 1883 in 1996, but recently it has been sharply decreasing to 746 in August 2005 (see Figure 2). The proportion of the participants in the KNKs over total number of the private sector employees was near 40% in 1996, but it fell down to around 18% in 2004. The requirements for the contracted-in to social security were relaxed considerably in April 2002, inducing a sharp decrease of the KNKs in number. This decrease is called a rash to "Daikou-Henjou".

(Figure 2 about here)

4. Why the KNKs Were Falling?

There have been several factors governing the KNKs since the bubble burst in the 1990s. Among others, the market rate of return from investment turned quite miserable, falling below the nominal rate of 5.5% per year. The annual rate of 5.5% return has been one of the basic assumptions for the KNKs. The assumption has been crucial in determining the contribution rebate. In the 1990s in Japan the 5.5% assumption seemed to force the KNKs to "walk on water". Consequently the majority of KNKs began to suffer from huge amounts of unfunded liabilities, giving a serious impact on the mother company's rating in the capital market.

Many mother companies were forced to pay considerable additional money to compensate for the under-funded portion for the social security equivalent benefit, which in turn induced a considerable downsizing of employment and curtailed new investments.

A downward change of the 5.5% assumption into, say, 3.0% will mitigate the future funding problem for KNKs, while their net pension liabilities accrued from contributions made in the past automatically jump up fairly.

Thus, managements and trade unions were strongly demanding to abolish the opting-out or to drastically relax requirements for the contracted-in from opting-out plans by lowering the set rate of return used in calculating the asset amount to be transferred to social security. The DB Occupational Pension Reform Act which took effect on 1 April 2002 relaxed requirements mentioned above.

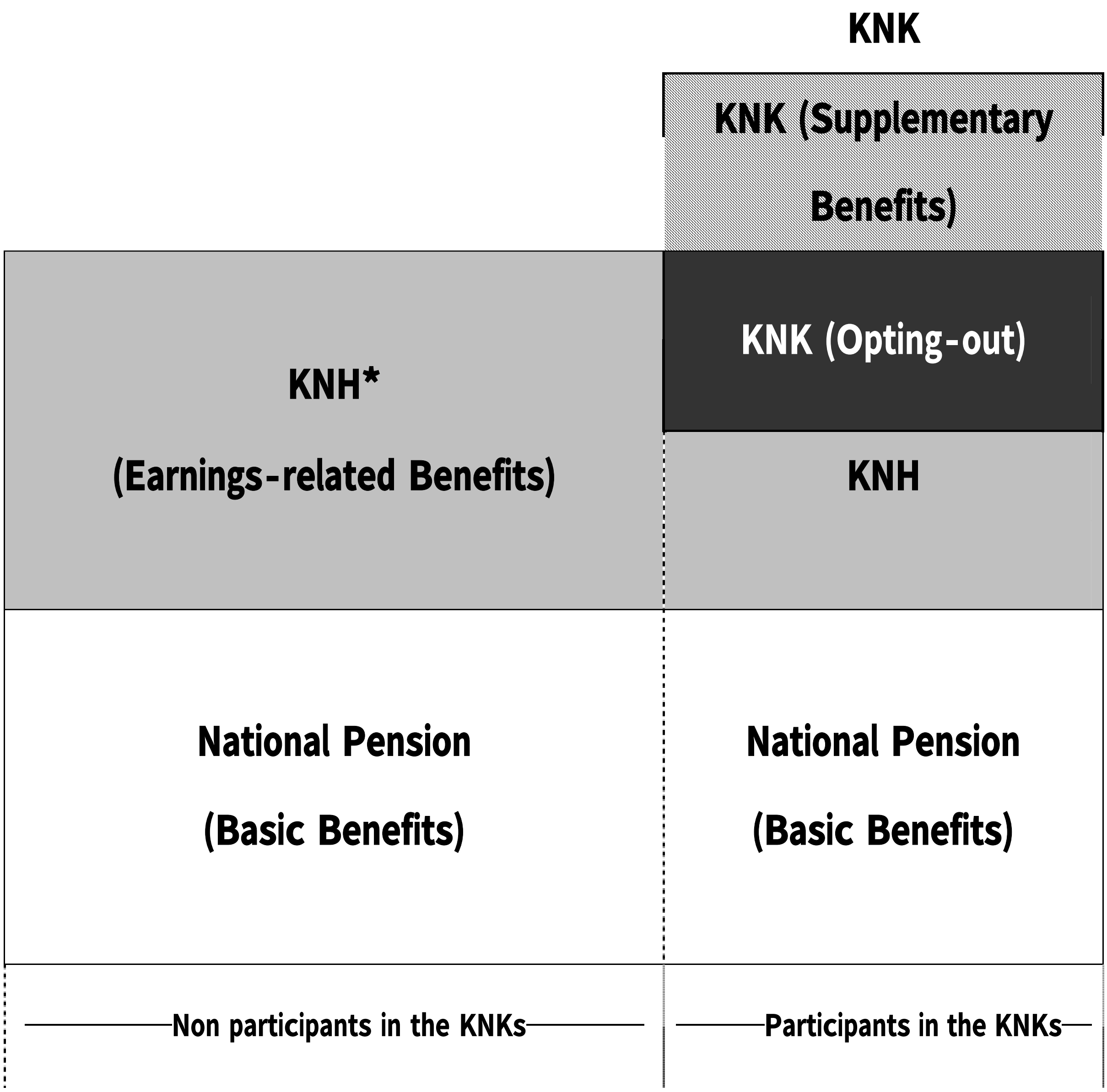
5. Structural Difficulties in the Opting-out Plan

A proposal of the opting-out plan is like saying that one of three sons who have been sending money to support their parents would begin to save for his own, by partly stopping sending money to his parents. The two remaining sons will be adversely affected or the income level of their parents will be reduced accordingly, by his change of mind.

The PAYG supporting is based on a principle of mutual help, but the prefunded savings are essentially for his/their own interest. Their underlying philosophies are totally different, and thus the opting-out does not seem simple when it comes to technical matters. Indeed, the current opting-out plans in the UK and Japan are very much complicated and consequently very hard for most people to understand. Moreover their handling costs are quite expensive.

The most symbolic and shocking event in this field is that the group of security companies of Japan dismissed their KNK in March 2005, implying that the Japanese opting-out plan was not promising at all in the end even for the experts of asset management.

Figure 1 Opting-out System in Japan



* KNH is the principal social security program for the private sector employees (the Kosei Nenkin Hoken).

Figure 2 The Number of the KNKs