

# **Closing the Gap between the Retirement Age and the Normal Pensionable Age in Japan**

by

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## **1. Introduction**

One of the top priority policy issues in Japan has been to ensure that the elderly can make a smooth transition from employment to a comfortable retirement with adequate income. Much of the debate regarding pension policies in recent years has focused on how to close the gap that exists between the time that many retire in practice (due to the enforcement of a mandatory retirement age at most companies and government offices) and the time when they reach the legally stipulated normal pensionable age (NPA) of the social security pension system.

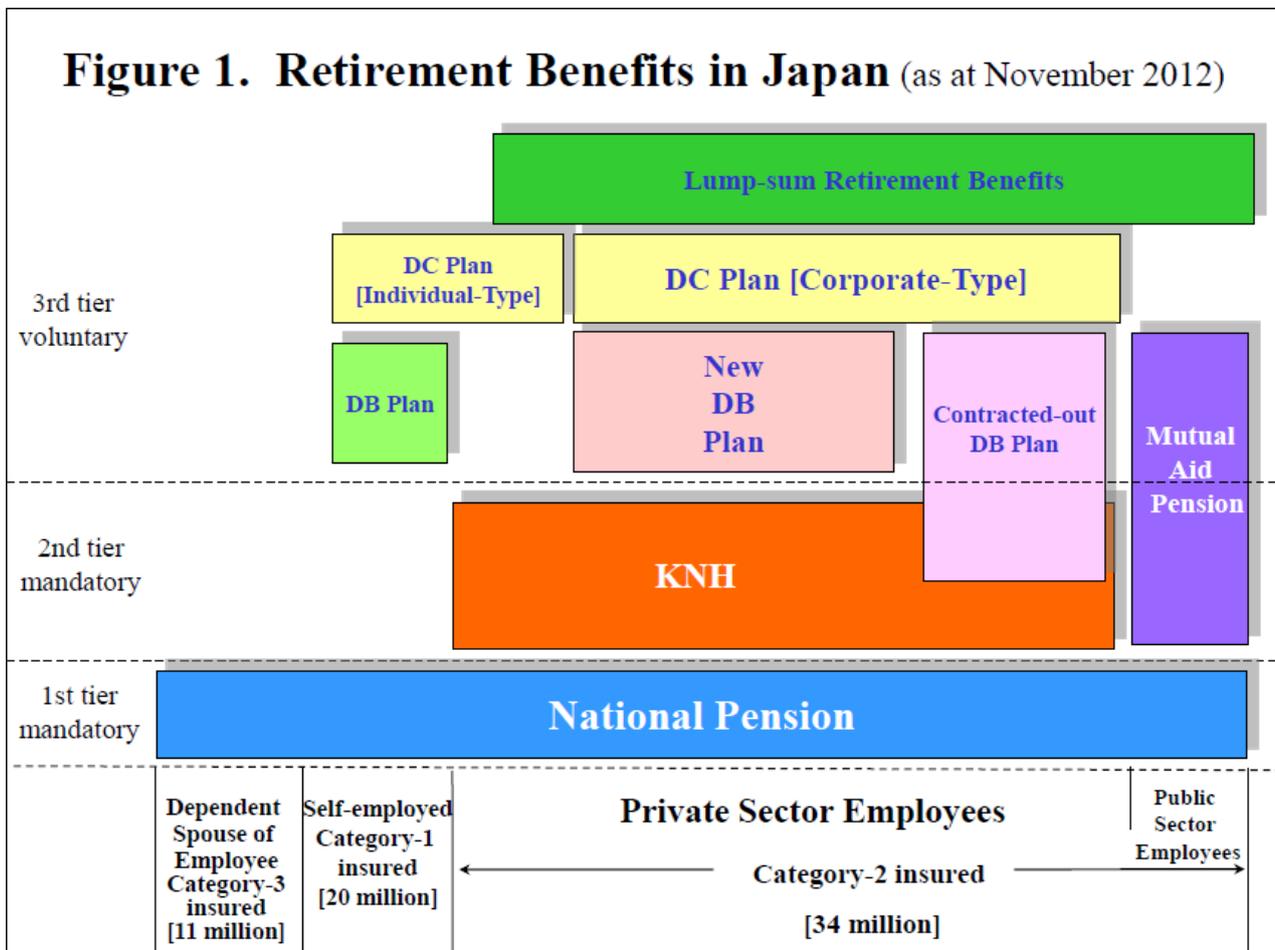
Against the background of a rapidly aging population, Japan has been making strong efforts to close this gap during which individuals potentially receive neither a salary nor a pension. The purpose of this paper is to examine the historical background to this gap, policy efforts to close it, and the various mechanisms that have been or could be applied to do so.

The paper starts by presenting a brief outline of Japan's current social security pension programs. Next, Section 3 looks at how the NPA has changed over time, while Section 4 present the latest statistical figures on employment for the elderly in Japan. Section 5 then discusses how the gap period can be closed by focusing on seven alternative mechanisms. Finally, Section 6 argues that further increases in the NPA will be required.

The author hopes that Japan's experience in dealing with its pension challenges will hold some lessons for other countries in the world.

## 2. Brief Outline of Japan’s Current Social Security Pension Programs

Japan has a two-tier defined benefit system of social security pensions. The first tier provides a flat-rate basic benefit and the second tier an earnings-related benefit (see Figure 1). The present system is based on the 1986 reform. Eligibility for the first tier is universal for all residents of Japan, covering not only employees, but also the self-employed as well as unemployed and non-employed adults, including full-time housewives. The only persons eligible for the second tier earnings-related pensions are regular full-time employees who have worked for 30 hours or more per week. The system also provides a pension benefit to dependent spouses of regular employees.



Although each system has its own contribution and benefit structure, all systems are similar, operating largely like pay-as-you-go defined benefit systems. This

section will mainly focus on the principal program for private sector workers, the Kosei Nenkin Hoken (KNH).

Only those contributing to the pension scheme for 25 or more years are eligible to receive old-age benefits. The full basic old-age pension is payable after 40 years of contributions. Its maximum monthly benefit for those with 40 years coverage as of 2012 is JPY66,000 (about USD825). The benefit is indexed automatically each fiscal year (from 1 April) to reflect changes in the consumer price index (CPI) of the previous calendar year.

In principle, benefit payments begin at the age of 65, but there has been a special legal provision allowing employees to receive the full amount of first tier basic benefits before age 65. However, this special provision has gradually been phased out in stages, starting in 2001 and due to be completed in 2013 for men. For women, the phasing out was delayed by five years and started in 2006. This means that, by 2018, no-one under 65 will receive basic benefits at the full rate. In exchange, employees between 60 and 64 will become eligible for advance payments of basic benefits at a reduced rate.

If a person opts for advance payments, monthly benefits are reduced pro rate for each month that such payments commence before the 65<sup>th</sup> birthday. Specifically, the rate of reduction is 0.5 percent for each month (6 percent for each year), so that a person that begins to receive the advance payment from age 60 pension benefits will be 70 percent of the normal amount.

The annual accrual rate for the earnings-related portion is 0.5481 percent of lifetime average real earnings per year. For a typical male retiree (with an average salary earned during 40 years of coverage) and a dependent spouse, the current replacement rate (including basic benefits) is around 60 percent of lifetime average salary. This average benefit level, however, is set to decrease to 50 percent in the near future.

The full earnings-related portion is currently payable from age 60 to an employee who is fully retired. On reaching age 60, an individual who has not fully retired can receive a pension subject to an earnings test.

The earnings test is based on the individual's current average monthly earnings (including semi-annual bonuses). If the total of the average monthly pay and his/her pension benefit is under JPY280,000 (USD3,500), the worker receives a pension with no reductions. If the total exceeds that level, the benefits are reduced by JPY10,000 for each JPY20,000 increment in wages. After monthly wages reach JPY460,000 (USD5,750; a level more or less in line with the average pay of male

employees), benefits are reduced by the same amount that wages exceed JPY460,000.

The earnings test changes upon reaching the age of 65 and becomes more generous. Specifically, first-tier, basic benefits are paid fully regardless of salary and wage earnings. There are no reductions in earnings-related benefits until the total monthly sum of benefits and earnings reaches JPY460,000 (USD5,750). If the total exceeds that level, earnings-related benefits are reduced by JPY10,000 for each JPY20,000 increment in wages.

The current legislation guarantees that the tier 2 earnings-related benefits for retired employees between 60 and 64 are paid without any reduction. 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 sixties will be delayed by five years and will start only in 2018. In exchange, those between 60 and 64 will become eligible for advance payment at a reduced rate out of the earnings-related benefits.

The 2000 pension reform act raised the NPA for *second-tier* benefits from 2013, just after the adjustment of the NPA for first-tier benefits has been completed (see Table 1).

**Table 1. Normal Pensionable Age for Old-age Benefits for Male Employees**

Date of Birth	Basic Benefits	Earnings-related Benefits
Before 2 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

The contribution rate of the KNH, as of October 2012, was around 16.8 percent of an individual's salary (including bonuses), with contributions divided equally

between employees and employers.<sup>1</sup> The monthly per person amount of contributions for those covered solely by the flat-rate benefit as of April 2012 was about JPY15,000 (equivalent to around US\$200). The financing is basically pay-as-you-go, with partial prefunding. The government subsidizes half of the total cost of the flat-rate basic benefit. There is no subsidy for the earnings-related part of the KNH. The government covers all of the administrative expenses as well.<sup>2</sup>

### **3. History of Changes in the Normal Pensionable Age in Japan**

The NPA for old-age benefits was set at 55 for men<sup>3</sup> when the KNH was inaugurated in 1942. At that time, life expectancy at age zero for males was around 55 years.

The first change took place in 1954, when it was decided that, from 1957 onward, the NPA for male employees covered by the KNH should rise by one year every four years up to the age of 60. The NPA for female employees remained unchanged at 55, however.

In 1954, the public showed little interest in increases in the NPA, since at that time the level of the KNH old-age benefit was quite small and instead lump-sum occupational retirement benefits made up the major part of income sources for retired employees.

In the 1950s, a growing number of companies introduced a mandatory retirement age of 55, which subsequently became widespread. From about 1960 onward, labor unions began to ask employers to increase the mandatory retirement age to 60. Employers were quite reluctant to accept this, however, since this would have brought about an increase in labor costs due to a higher share of older, higher-paid workers, and would have slowed down the replacement of older with younger workers within companies.

In 1961, the national pension (NP) was introduced for self-employed persons and

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<sup>1</sup> The contribution rate of the KNH is to be raised gradually to 18.3 percent by 2017 and thereafter is no longer scheduled to rise. The KNH will become virtually equivalent to defined contribution plans with pay-as-you-go financing.

<sup>2</sup> More detailed explanations of Japan's social security pension system can be found in Takayama (2003, 2004, 2006).

<sup>3</sup> Female employees have been included in the KNH since 1944 and their NPA was first set at 55.

employees not covered by the KNH or by pension schemes for civil servants. The NPA for NP old-age benefits was set at 65 from the beginning.

In 1973, the KNH completed the transition of the NPA for male employees to age 60. At the same time, a drastic increase in KNH old-age benefits was legislated, with automatic CPI-indexation. The typical replacement rate was hiked to 60 percent. As a result, the KNH old-age benefit became a major income source after retirement.

With the mandatory retirement age set by companies at 55, but the NPA for the KNH set at age 60, employees thus faced a gap period of five years between retirement and the start of pension benefit payments. Against this background, labor unions stepped up their demands to employers to close this gap by raising the mandatory retirement age to 60 or higher. Employers started to heed these demands through a variety of means, such as transferring employees aged 50-59 to affiliated or related smaller companies, flattening the seniority wage curve, and re-employing those that had reached the retirement age as non-regular employees based on one-year contracts with shorter working hours per week (resulting in a salary decrease of 20-40 percent). Employers also began to provide an increased lump-sum retirement payment for early retirees between ages 50 and 54.

In 1980, the Ministry of Health and Welfare proposed to further increase the NPA of the KNH for male employees to 65, but the Ministry of Labour opposed this increase at the time. Consequently, no bill to increase the NPA was submitted to parliament.

A drastic reform of social security pensions was carried out in 1986, which included the establishment of common flat-rate basic benefits throughout all the pension programs. The reform legislated an increase in the NPA of the KNH to 65 for men, but did not mention the exact transition period, thus allowing retirees in their early sixties to receive full-amount pension benefits for a while.

Regarding the NPA for female employees covered by the KNH, the 1986 reform decided to increase this by one year every three years from 55 to 60 from 1987 up to 1998. The background to this move were calls for equal treatment between men and women.

In 1989, the government submitted another pension reform bill to increase the NPA of the KNH to 65, but it was rejected by parliament. Politicians lacked the stamina to pass the bill, since any further increases in the NPA were quite unpopular at the time.

Therefore, it was not until 1994 that it was decided to increase the NPA of the first-tier flat-rate basic benefits of the KNH step by step from 60 to 65 for men from

2001 to 2013. Later, in 2000, it was decided to gradually raise the NPA for the second-tier earnings-related benefits from 60 to 65 for men from 2013 to 2025, just after the adjustment of the NPA for first-tier benefits has been completed. The phasing-out of old-age pension benefits for female employees in their early sixties was to be delayed by five years and start only in 2006, with its completion scheduled for 2030.<sup>4</sup>

In the meantime, the government formally legislated the mandatory retirement age (which had hitherto been set by companies themselves) in 1994, setting it to 60 or over from 1998 on. In any case, the mandatory retirement regime, in which companies had set the mandatory retirement age at 55, had been hollowed out by the changes described above and employers dropped their opposition to raising the mandatory retirement age to 60 (see Saguchi 2000).

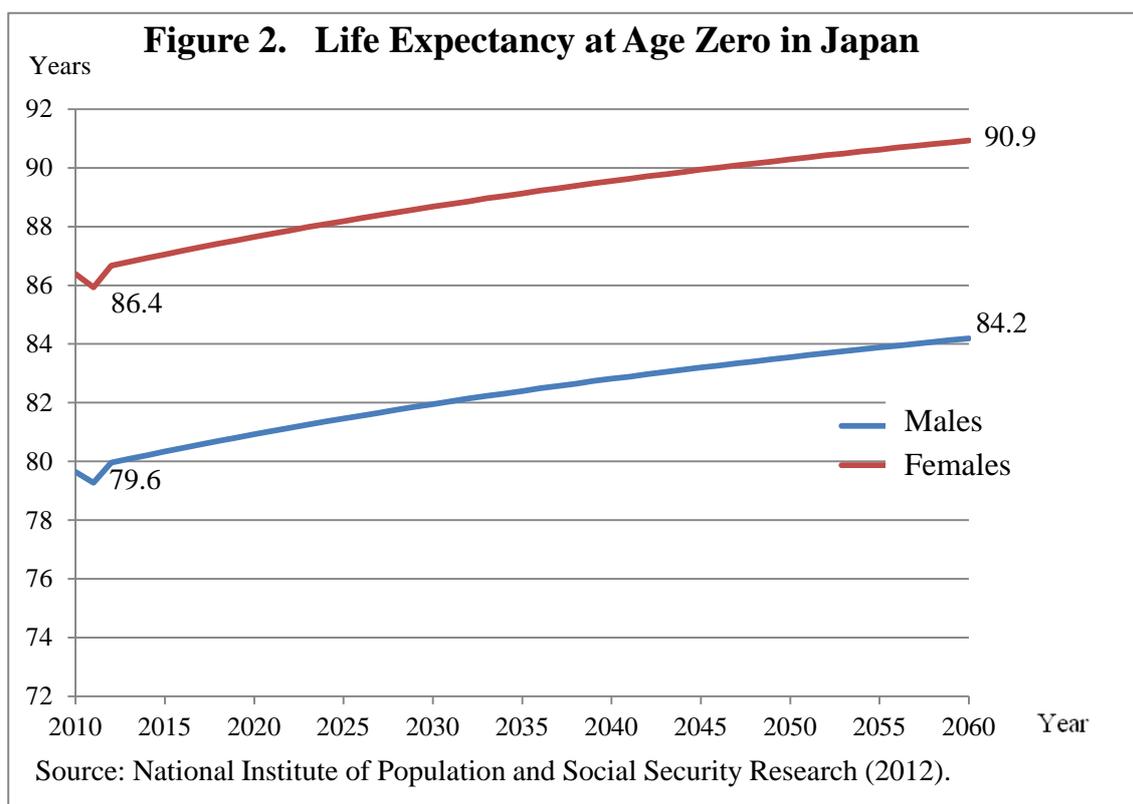
Furthermore in 2006, it was legislated that employers were to be forced to keep employing workers up to the age of 65 from 2013, if employees want to continue working. However, in a compromise with employers, no requirements were set regarding the working hours per week or salary levels after age 60.

In 2011, the government began to reconsider the NPA of the KNH by shortening the transition period and further increasing it to 68. This reconsideration faced strong oppositions by all stakeholders, and the Minister in charge of pensions was forced to announce that the government would make no concrete proposals during the next two years.

The driving force underlying the successive increases in the NPA has been to maintain the financial sustainability of the social security pension system against the backdrop of a continuous aging of Japan's population since the early 1960s. Japan's population has enjoyed increasing longevity, with a growing proportion of healthy persons in their sixties (see Figure 2). As a result, "active aging" and "ageless working" have become the new norm. However, many employees have been unable to find a new job just after the mandatory retirement age, thus experiencing a gap between retirement and the NPA, in which they receive no income. For this reason, proposals to raise the NPA since the early 1980s have been unpopular and attempts by the government to do so have met with stiff resistance, resulting in repeated failures to implement an increase in the NPA. As a consequence, it took the government a long time to succeed in raising the NPA from 60 to 65.

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<sup>4</sup> The [Government Actuary](#) expected the future aggregate amount of pension benefits to reduce by around 15 percent with the increase in the NPA from 60 to 65.



#### 4. Latest Statistical Figures on Employment of the Elderly

According to the Ministry of Health, Labour and Welfare (2012), by 2012, 97.3 percent of employers had already set up schemes to provide employment to elderly workers to completely close the gap until they reach the NPA. However, only 14.7 of employers had done so by raising the mandatory retirement age to 65 or over, while the overwhelming majority had adopted some kind of continuing employment after the mandatory retirement age of 60. 48.8 percent of employers promised employees that they could continue working until age 65, if they wished to do so. Incidentally, 75.2 percent of employees who reach the mandatory retirement age currently want to continue working.

The number of employees in their early sixties increased from 3.17 million in 2005 to 4.08 million in 2009, while the number in their latter sixties rose from 2.28 million in 2005 to 3.05 million in 2009.

Labor force participation rates for males and females in their sixties are shown in Table 2. These rate are quite high in international perspective, suggesting that there is considerable room in Japan for further increasing the NPA.

**Table 2. Labor Force Participation Rates of the Elderly in Japan**

## A: Males

Year	Age		
	60-64	65-69	70+
1975	79.4%	63.9%	31.6%
1980	77.8	60.1	28.4
1985	72.5	55.6	26.8
1990	72.9	54.1	26.3
1995	74.9	54.2	26.1
2000	72.6	51.1	24.3
2005	70.3	46.7	21.1
2010	76.0	48.9	19.6

## B: Females

Year	Age		
	60-64	65-69	70+
1975	38.0%	27.7%	9.3%
1980	38.8	25.8	9.6
1985	38.5	26.8	10.0
1990	39.5	27.6	10.4
1995	39.7	27.2	10.3
2000	39.5	25.4	9.8
2005	40.1	24.0	8.7
2010	45.7	27.4	8.4

Source: Statistics Bureau, Ministry of Internal Affairs and Communications, Japan, *Labour Force Survey*.

## 5. How to Close the Income Gap

Although the changes in government legislation, various reforms of the pension system, and changes by employers to the mandatory retirement age and the employment of elderly workers have gone a long way in closing the gap between the retirement age and the NPA, many employees nevertheless still face such a gap. The following considers the various ways or mechanisms that provide individuals with a means to bridge that gap.

### *Later Retirement*

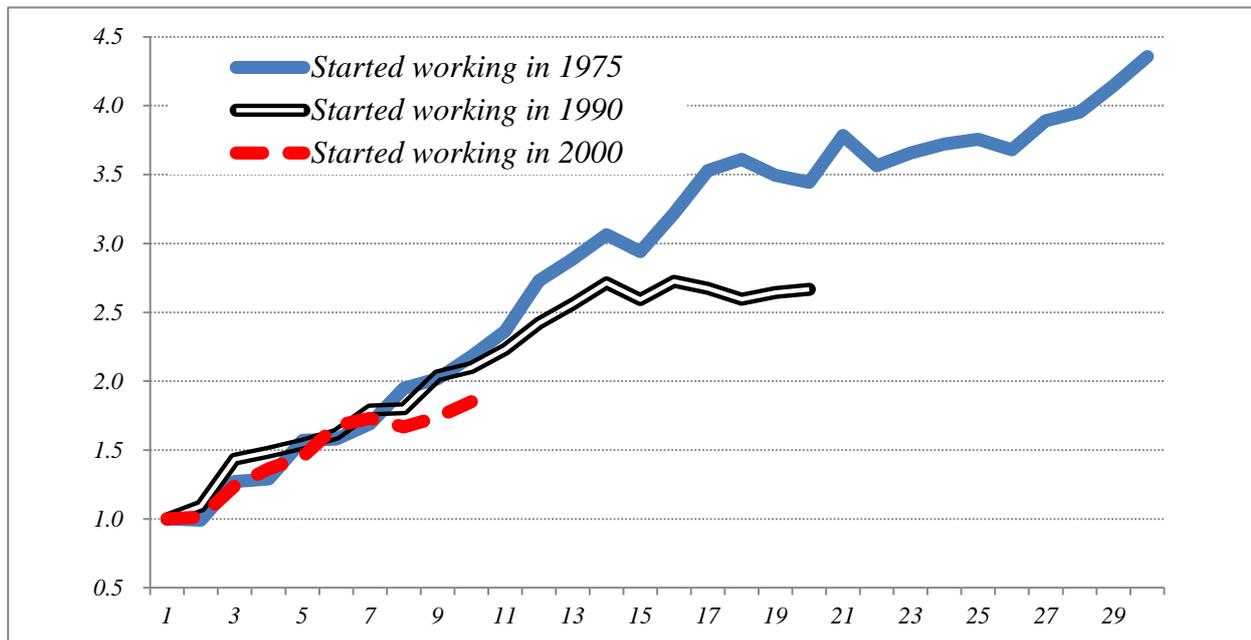
The most obvious solution to closing the retirement gap would be to raise the legally stipulated mandatory retirement age to 65 or higher. This, however, would raise personnel costs for employers, who are therefore reluctant to accept such a change. That being said, employers have devised several means to contain an increase in labor costs. One of these has been to strictly limit the number of employees who continue working full-time with them until the NPA. Moreover, the wage/salary profile of such employees is most likely to be fixed at a certain level after age 50 (or 55).<sup>5</sup> Further, the wage/salary profile for younger generations has been flattened at the same time, so that the lifetime wages for younger generations will be about 30 percent lower in real terms than those for the current older generation (see Figures 3 and 4).

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<sup>5</sup> However, there are exceptions. Mayekawa Manufacturing Company, for instance, is very famous for allowing its employees to continue working full-time in their sixties (or even seventies). See the following website for more details:

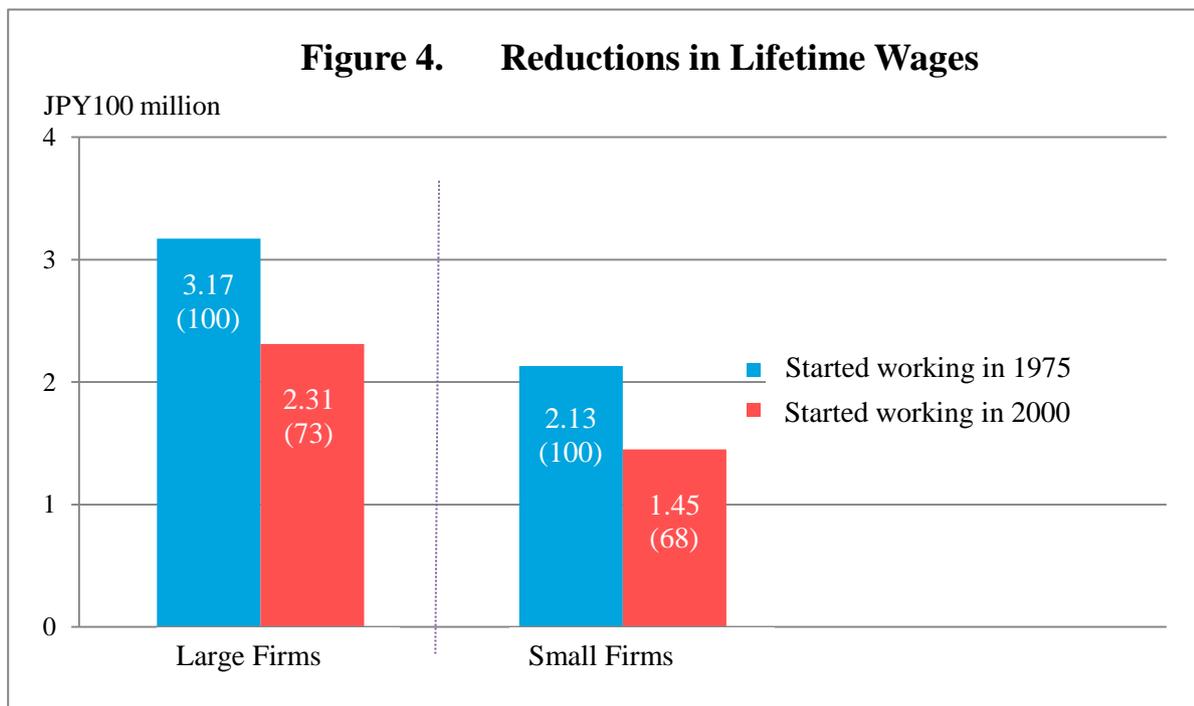
[http://www.wdaforum.org/images/stories/120524\\_1035\\_4\\_Maekawa\\_Masao\\_e\\_ps.pdf](http://www.wdaforum.org/images/stories/120524_1035_4_Maekawa_Masao_e_ps.pdf).

**Figure 3. Lifetime Wage Profiles for Workers in Manufacturing Industry**



Note: Large manufacturing firms; college-educated white-collar workers.

Source: Hori and Iwamoto (2012).



Note: College-educated white collar workers in manufacturing industry, in terms of 2005 wages, assuming a zero discount rate.

Source: Hori and Iwamoto (2012).

The majority of male employees in Japan currently continue working after the mandatory retirement age in other companies than before as transferred staff and/or temporary workers at wages that are typically up to 40 percent lower than their previous wages. Moreover, in general, they work for less than 30 hours per week and their employment status is non-regular and on a one-year contract basis. They are eligible to receive the full amount of earnings-related old-age pension benefits from social security.<sup>6</sup> As a result, their monthly income often remains little changed just after the mandatory retirement age, if old-age pension benefits and their reduced wages are combined.

In promoting later retirement, it is crucial to raise the productivity of older workers. This means that more free training programs should be made available and jobs should be re-designed so as to increase the productivity of part-time or flextime workers.

Note that later retirement to some extent has a negative effect on employment opportunities for younger persons or middle-aged females. If the economy is sluggish, then encouraging later retirement will crowd out the young and female workers in the labor market. However, priorities in employment policy should be placed on young persons.<sup>7</sup>

#### *Occupational Pensions and/or Lump-sum Retirement Benefits*

According to National Personnel Authority (2011), 85 percent of employees currently pay occupational retirement benefits to their employees, usually in the form of a lump-sum payment. On average, the present value of such retirement benefits is quite large at JPY25 million (equivalent to USD312,500) for private-sector employees with 20 or more years of service in a single company. The amount is equivalent to 10-12 times of annual old-age pension benefits from social security. Thus, such retirement benefits work as a bridge between the mandatory retirement age and the NPA.

Around 50 percent of employers in Japan have occupational pension plans and

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<sup>6</sup> The requirement for employees to be covered by the KNH is that they work for 30 hours or more per week in a single company. Older employees working for less than 30 hours per week are not regarded as KNH enrollees and are treated in the pension system as if they were completely retired.

<sup>7</sup> Japan currently faces the “Bad Start, Bad Finish” problem. Many young persons are forced to start their working career as atypical employees. See Takayama and Shiraishi (2012) for more details.

pay annuities to their retired employees. The annuities come from the earned entitlements to retirement benefits that employees accumulate while working for their employer. Thus, a more widespread use of occupational pension annuities would be another option to allow employees to receive retirement benefits before they reach the NPA.

### *Wage Subsidy*

An earnings test applies for employees working 30 hours or more per week in their sixties. As mentioned above, they usually receive full or reduced earnings-related pension benefits from social security while earning wages/salaries. Full or reduced pension benefits operate as a subsidy to older employees, which increases the labor demand for them. The earnings test is often criticized as, it is argued, it provides a disincentive for older persons to work and thus reduces labor supply. However, it is important to bear this wage subsidy effect in mind, which helps to increase the labor demand for elderly workers.

### *Advance Payment of Old-age Pension Benefits*

Further, as mentioned above, another way to bridge the gap between actual retirement and the NPA is to receive an advance payment of reduced old-age pension benefits from age 60, with the reduction continuing after age 65. However, fewer and fewer people are receiving this advance payment and the majority of the elderly begin receiving their social security old-age pension benefits at their NPA.<sup>8</sup>

### *Unemployment Benefits*

If employees in their early sixties are not employed immediately after the mandatory retirement age and are looking for a job, they are eligible to receive unemployment benefit for up to 150 days. The amount of unemployment benefit varies from 45 to 80 percent of the average monthly salary during the preceding six months. As of 2012, unemployment benefits are capped at around JPY200,000 (USD2,500) per month, while the minimum is JPY55,680 (USD700).

Many unemployed in their early sixties first receive unemployment benefit and then start taking advance payments from the social security old-age pension. Pensioners are not allowed to receive unemployment benefit in their early sixties,

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<sup>8</sup> The eligibility for receiving disability benefits in Japan is severely restricted, with detailed health checks. The number of pensioners receiving disability benefits changes little before and after the age of 60.

but are able to receive old-age pension and unemployment benefits simultaneously if they become unemployed after age 65.

### *Dissaving*

Another way in which individuals can potentially bridge the pension gap is to decumulate their assets. Currently, it remains rather rare in Japan for retirees in their early sixties to do so.

### *Relying on Financial Support from One's Children*

Until around the mid-1970s, it was common in Japan that elderly parents were supported by their family members. However, in recent decades, only a minority of the elderly have been relying on their children or other family members for financial support.

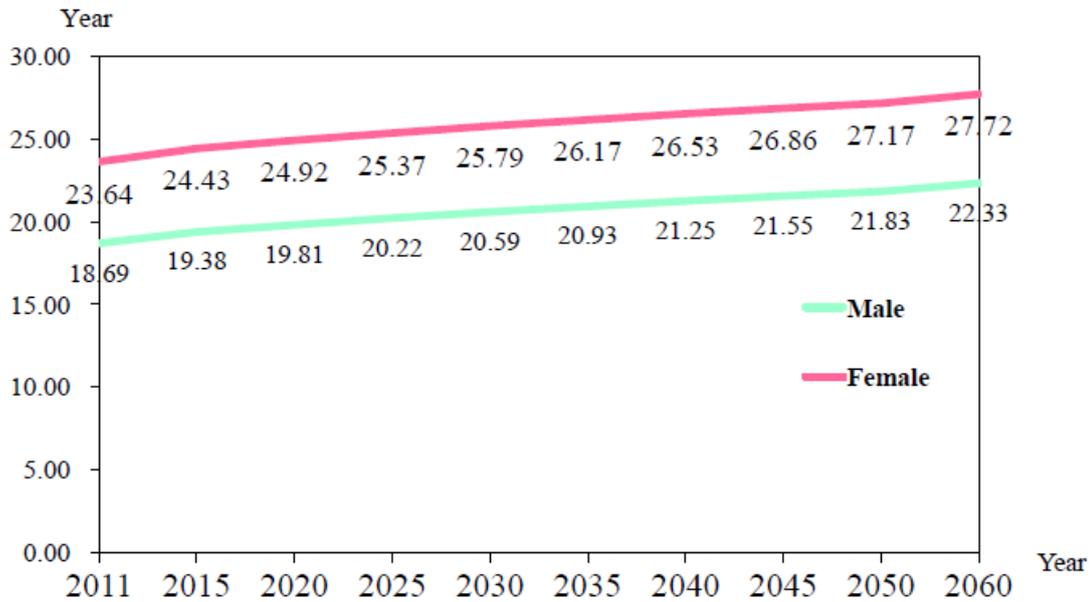
## **6. Further Increases in the NPA Required**

Japan already has one of the oldest populations in the world, and despite the various reforms its social security pensions still face future financial challenges. The contribution rate will be increased to the maximum (18.3 percent for the KNH) by 2017. It is already legislated to be fixed at that level for the next 85 years thereafter. Transfers from general revenue make up half of the aggregate amount of basic pension benefits, and there seems little room for any further increases in the future. The typical replacement rate of the KNH is to be reduced from around 60 percent to 50 percent in the near future. If social security pension benefits are to provide an adequate level of income, there seems little room for the replacement rate to decrease any further.

Against this background, the only remaining policy option to maintain the financial sustainability of Japan's pension system is to further raise the NPA, given the ongoing and persistent increase in life expectancy at age 65, which is depicted in Figure 5. The most relevant reference case in this context is that of Denmark. In 2006, Denmark introduced the automatic indexation of the NPA to longevity. This step is based on the realization that indexation to longevity is quite a wise move in order to avoid political risks while ensuring equity between generations, since the average period that individuals will receive social security old-age pension benefits will be the same for all generations. Denmark's Ministry of Social Welfare expects

that the NPA will reach 70 around 2040,<sup>9</sup> as is shown in Figure 6.

**Figure 5. Expected Increase in Life Expectancy at Age 65 in Japan**



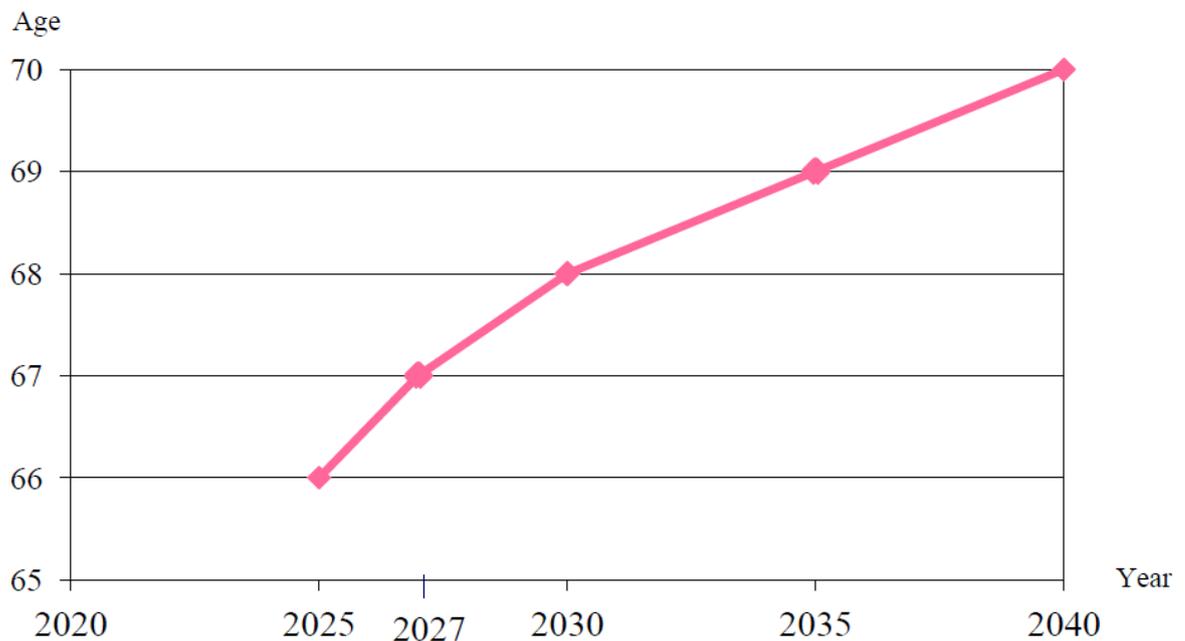
Source: National Institute of Population and Social Security Research (2012).

In 2011, the Netherlands reached an agreement among stakeholders (labor unions, business, and the government) to follow Denmark’s indexation to longevity in quite a similar way. Later in the same year, Italy also decided to introduce indexation to longevity after 2018, when the NPA will reach 67 (see Mazzaferro, 2012).

Another issue for debate in Japan in the future will be whether or not the current 40-year coverage should be extended to 45 years or more for people to receive the full amount of old-age pension benefits if indexation to longevity takes place.

<sup>9</sup> See Ministry of Social Welfare, Denmark (2008, pp.53-55).

**Figure 6. Expected Normal Pensionable Age in Denmark**



Source: Ministry of Social Welfare, Denmark (2008).

Extending the minimum number of contribution years for eligibility for the full amount, however, would affect different segments of the population differently and disadvantage those coming later to the labor market such as university graduates, especially Ph.D. holders. Adverse effects can also be anticipated for female workers, who leave the labor market to raise children or care for their parents at home, and, potentially for atypical workers.<sup>10</sup>

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<sup>10</sup> A discussion of future challenges in Japan’s social security pensions from a broader perspective, along with the latest 2012 pension reform, is provided in Takayama (2012).

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