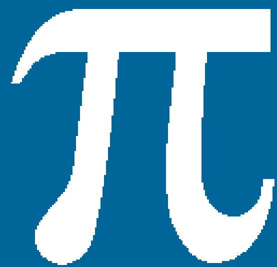

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The Japanese Retirement Income System: a special case?

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The Japanese retirement income system: a special case?

Introduction and summary

Japan is the only non-western country to have a fully developed pension system. However, the nature of that system is little understood. This **Briefing** seeks to explain its basic principles to outsiders.

In some ways, the Japanese system is not unlike that of other industrialised countries. This is not surprising in so far as Japan, once it opened to the west in the nineteenth century, made a point of learning from the western countries. Moreover, although a full public pension system was not properly established until after the second war – no later than in many western European countries – it was established under the American occupation. The relevant authorities, like their counterparts in Germany, were not adverse to borrowing ideas from abroad when it came to establishing a new social and economic infrastructure.

In Japan, the state has an important role in providing pensions, and the public system is based upon a pay as you go principle with a degree of proportionality. Company benefit systems supplement the public system and, in some cases predate it. *Prima facie*, Japan does not appear to be "a special case". On the other hand, little is known about company benefit systems, a deficit that this **Briefing** seeks to remedy.

Retirement income systems in Japan do, however, have a number of special characteristics. First, unlike in many other countries, people in Japan keep working well after "normal" retirement age. Thus, income in old age is made up, to a considerable extent more than elsewhere, of income from paid employment or from self-employment. Second, older people in Japan are much more likely to be living with their adult children than are older people elsewhere. Thus, incomes in old age comprise a considerable element of intra-familial transfers. In these respects, Japan is "a special case".

As do almost all industrialised countries, the population of Japan is confronted with ageing. Indeed, Japan is ageing faster than almost any other in the industrialised world. In this respect, Japan is not "a special case". However, it is not only the fiscal consequences of ageing that places the sustainability of its retirement income system in question. The employment and social structure of Japan is also changing. Working in older age might no longer be possible. Families are becoming less and less willing and less and less able to provide homes and care services for their parents. Accordingly, the way that Japan has been "a special case" constitutes a special weakness in its system of supporting older people. The **Briefing** concludes that the challenges that Japan faces are yet more profound than those faced by many societies to which the epithet "a special case" is less readily applied.

1) The early period

Japan was a relatively late developer with respect to pensions. Although there had been provisions for specialised groups such as the military (1875) and for civil servants (1890), a national pension system for private sector workers was not established until the 1940s. Even this initiative had little to do with pensions and much to do with the peculiarities of the war time situation, so that the system known

today can better be said to have its roots in legislation first of 1954 and then of 1961. It was by the latter legislation that the current earnings-related pension system was established.

The absence of a public pension system had much to do with notions of familial responsibility. Care of the aged parent was considered an important task for the eldest son and his wife. Those who had no resources were assumed to be cared for by the wider family and by their neighbours. A form of income support for the elderly was introduced in the 1870s, but such assistance was discretionary. There was suspicion that establishing any form of assistance undermined traditional arrangements of community support. By the early 20th century there were some politicians who favoured the introduction of a Bismarkian social insurance system, if for no other reason than that it might reduce social unrest. However, most industrialists preferred to rely upon a paternalist approach and were not willing to countenance increases in labour costs.

What motivated the introduction of public pensions for industrial workers was the need to maintain social control, coupled with the opportunity it provided to raise money to finance the war effort, rather than concern for the well-being of the elderly. The first mandatory scheme was established in 1940 for the strategically important shipping industry.[1] In 1942, schemes were opened for workers in the mining, manufacturing and transport sectors. Initially, the Workers Pension Insurance covered only employees in these industries and of them, only those in establishments with at least 10 male employees. It was not until 1944 that the then renamed Employees Pension Insurance extended coverage to all sectors of private industry and commerce. Even that system excluded workers in establishments with fewer than five employees. It also excluded agricultural workers, domestic workers and the self-employed.

Consistent with the objective of supporting the war effort, the pension system was a funded, not a pay-as-you-go, system. Thus, the state had income but it had no immediate costs. Contributions were set at 11 percent and for a pension to be liquidated a minimum of 20 years contributions was required and the age of 55 had to be reached.[2]

Post-war hyperinflation rendered the assets built up in the funded system worthless. Moreover, by 1957 that system would have had to start paying its first benefits. The 1954 reform occurred under the auspices of the post-war occupying powers, and it fundamentally rebuilt pension provision. A new civil code had replaced the notion of the "home", by which was meant the immediate community in which the person lived and particularly his or her relatives, as responsible for supporting the elderly. Instead, the "family" was recognised and the pension system was built upon the presumption that this consisted of a married man with a dependent wife and possibly children. Rather than being funded, a PAYGO element become dominant – although a fund was still built in. The system had Bevridgian principle. It collected flat rate contributions and it paid out modest flat rate benefits. However, there were

[1] Because of the importance of this sector, proposals for the establishment of a mandatory pension system for its workers had been made since the end of the 19th century.
[2] For miners and seafarers, the eligibility requirement was somewhat lower – 15 years contributions and an age of 50.

supplements for any dependent spouse or child. Half of the costs were met by transfers from general revenue and half from a 3 percent levy on earnings. The pension age was set at 55 for women and 60 for men, at a time when life expectancy of those reaching these ages was some 14(m) and 21(w) years. Nevertheless, of those for whom contributions were being paid, only a fraction reached pension age – of the cohorts starting to retire in the early 1950s, life expectancy was only around 66(m) and 69(w).[3] For those 70 and over who had failed, or would fail, to meet the full contribution requirement of 25 years, a special means-tested benefit was established, financed out of general revenue.

The pension set up in 1954 was by no means universal. It covered rather fewer than 30 per cent of the private sector workforce and only 40 per cent of the population aged 20-59 – that age group for whom membership was compulsory. This reflected the importance of the agricultural workforce – which was excluded – and the economic situation of women – most of whom were not working and who derived benefits only through their husbands.

In 1961 legislation took effect that substantially increased coverage and set up the basis of the pension system observable today. All people aged 20-59 were required to contribute. Thus, agricultural workers and the self-employed were brought into the system. Dependent, non-working wives could join on a voluntary basis until 1985; thereafter, their membership has been compulsory.

2) The essential features of the current system

The public pension system since 1961 has two tiers, a flat-rate basic pension – "the national pension" (NP) – and an earnings-related "employees pension" – (EPI). The former is, effectively, a continuation of the system that had been built up since the 1940s. The latter was intended to substantially increase the generosity of the pension and change it to one that related retirement income to income in working life.

Over and above these two public tiers are third and even fourth private tiers. The third tier consists of company-sponsored pensions, the fourth of personal pensions. The four tiers will be described in turn.

a) the public pension

The NP remains a flat rate benefit, but for dependent employees, it is, to all intents and purposes, integrated with the EPI. There are three categories of membership of the public system – referred to as the No.1, No. 2 and No. 3 insured. The No. 2 insured consists of employees working in firms with more than five employees, so long as they are not on part-time or temporary contracts – here, contacts lasting under three years. Employees of central and local government are covered by separate, but similar schemes to the EPI, known as Mutual Aid Association pensions (MAA). The No. 1 insured are those who are self employed, agricultural workers who are not employees, part-time workers and workers on temporary contracts. The No. 3 insured are the dependent spouses of the No. 1 and No. 2 insured. Contributions for the No. 2 insureded are deducted at source. The No.1 insured and the No. 3 insured have to arrange their own contributions.

[3] This is for people who had already survived into their late teens, so it excludes those who died at the start of life or in childhood.

Benefits payable under the NP and EPI take the form of annuities. However, the retirement ages have not always been the same. The NP age of eligibility is 65; that of the EPI was 60 until 1994, when it was raised in steps to 65. The age of 65 has applied for men since 2001 but will not be effective until 2006 for women. Those who reach the age of entitlement to an EPI pension and who ceased to work are entitled to a special bridging benefit that effectively equals the NP benefit.

b) company pensions

The third tier of employer-sponsored pensions can take many forms. Lump-sum, tax-privileged benefits, sponsored by the employer, can be traced back to before the Second World War when paternalist employers established "book reserve" schemes not unlike those then and still found in Germany. These paid a leaving allowance in the form of a lump sum, the level of which was dependent upon age and length of service. Strictly speaking, this leaving allowance cannot be labelled a pension, since even younger leavers might be entitled to something.

In 1962 legislation permitted firms employing more than 15 workers to set up separate tax-qualified retirement plans (TQRPs) that built up assets and paid out lump sums on retirement or, if chosen, an annuity.[4] Since 1966 it has been possible for large employers – those employing over 500 workers – or those who acting together employ this number – to "contract out" of a part of the state earnings-related EPI, subject to their offering superior levels of benefit and to establish their own funds (EPFs) to finance these benefits. That part of the EPI that exceeds the level payable under an EPI can be taken as an annuity but, more often, it is taken as a lump sum.

Further revisions of corporate pension provision were made at the end of the century. In part as a response to the parlous state of many corporate pension funds, and in part as an attempt to improve scheme governance, no new TQRPs were to be established and those in existence were to be closed by 2012. At the same time, the framework for a new form of defined benefit corporate pension fund (DBCPF) and, for the first time of defined contribution plans at corporate level (DCCPF) or as open plans was established. The aspiration was that TQRPs would be shifted into DBCPFs or DCCPFS, whilst this opportunity was also open to EPFs.

The large majority of private sector firms with at least 30 employees offer some form of private retirement/separation benefit. Whether a benefit is offered at all, and what form that benefit takes, is determined by firm size. Book reserve, retirement allowances predominate in small enterprises, funded pension systems in larger ones. By definition, EPFs are almost exclusively found in large enterprises, whilst TQRPs are more common in small enterprises.

Table 1: Combination of corporate pension schemes in 1997 (all private sector enterprises with 30 or more employees)

	lump sum retirement allowance/book reserve only	pension only (EPF and/or TQPR)	both retirement allowance and pension	no retirement benefits
all	42,2	18	28,6	11,1

[4] The minimum number of employees requirement was dropped in the late 1990s.

30-99 employees	48,1	15,6	22,1	14,3
100-299 employees	33,8	22,2	40	4,1
300-999 employees	17,2	30,5	50,1	2,3
1000+ employees	9,6	22,6	67,4	0,5

Source: Ministry of Labour

As the table also suggests, firms can have more than one form of pension. Indeed, of enterprises with an EPF, about half also have a TQRP.

c) personal pensions

The fourth tier of voluntary insurance, itself, involves many form of savings plan. Since 1991 self-employed people have had the opportunity to make supplementary contributions into one of a series of the 70 or so occupational or regional pension funds. These funds, together referred to as the National Pension Funds (NPF) operate on a defined benefit basis and pays out as an annuity. Moreover, relative to life assurance plans, NPF pensions have considerable tax advantages.[5] Take up is, however, low. Under 2001 legislation, self-employed people are also able to join one of the new, open defined contribution schemes offered by insurance companies, trust companies or banks. This option is also open to employees whose employers are not sponsoring any supplementary pension plan.

Life insurance-type personal savings plans are open to the population as a whole. These pay out lump sums on termination, although these lump sums can, theoretically, be annuitised. Between a quarter and a third of employees appear to contribute to such plans.

The following table indicates overall pension coverage by tier and the extent to which many in the work have more than statutory coverage.

Table 2: Participants in the four tiers of the Japanese pension system (millions of people) c2002			
in the public pension system	68,1		
- of which No 1 insured		19,3	
- of which self-employed in NPF			0,8
- of which self-employed in new DC			few*
- of which others with a personal pension			3,3
- of which No 3 insured		11,6	
- of which with a personal pension			2,6
- of which No 2 insured		37,2	
- of which in an MAA (public sector)			5,3
- of which in the EPI (private sector)			31,9
- of which in EPF			10,6
- of which in TQRP			8,6
- of which in DBCPF**			1,4*
- of which in DCCPF***			0,6

[5] An individual could set against tax contributions of up to ¥50,000 per annum to a life assurance policy but of up to ¥68,000 per month (and the same amount, again, for a spouse) to an NPF pension scheme.

- of which with a personal pension		10,2
not in the public system	2,4	
- of which with a personal pension		0,4

source: Ministry of Health, Labour and Welfare annual reports; Social Insurance Agency, Comprehensive Survey of the Living Conditions of People on Health and Welfare.

*data refers to end 2003, ** includes those who are also members of a DCCBF,
*** includes those who are also members of an EPF or DBCPF

reference data (millions of people)	
population aged 20-29	70,9
in labour force aged 20-59	52,0
self-employed aged 20-59	6,0

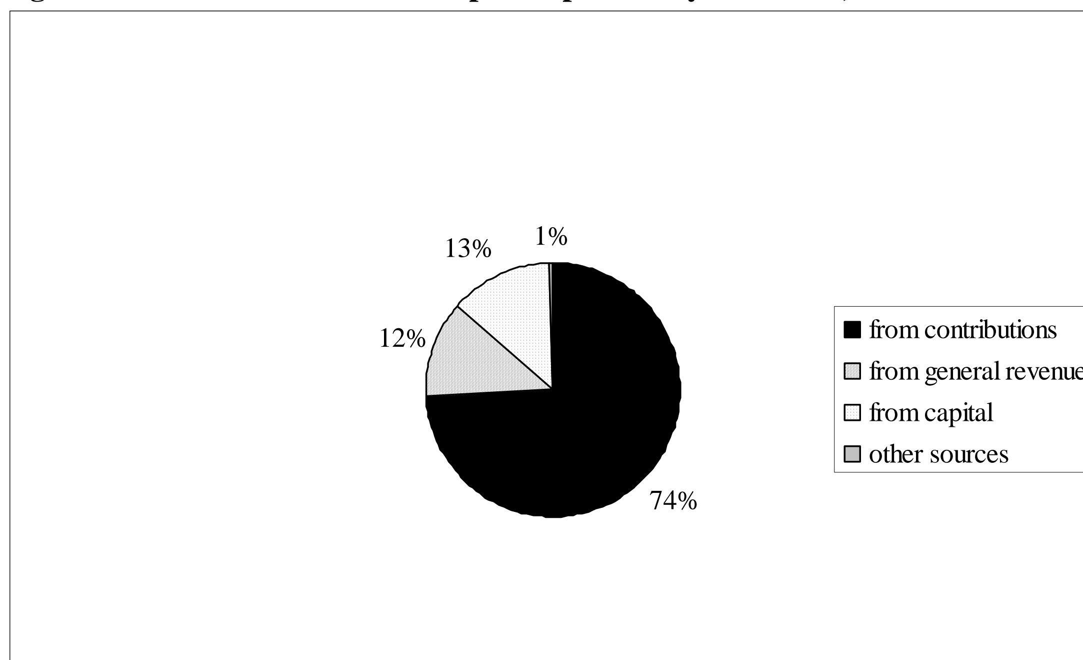
d) contributions, benefits and tax treatment

The public pension system operates in a conventional fashion in so far as employer and employee contributions are taken from income before tax. Currently, contribution rates are 13.58 per cent of annual earnings, split 50:50. Annual and semi-annual bonuses are taken into account, although subject to a cap. For those in the NP only, the flat rate contribution is the equivalent of about 3.5 per cent of the average wage (or about 20 per cent of the full NP pension). EPFs and TQPRs are non-contributory.[6] Where an EPF operates, the employer made lower contributions to the EPI – the rebate lay between 3.2 and 3.8 percent in the 1990s, with its size depending on the assessed ability of the fund to meet its liabilities, although this has now been changed to a single 3.5 per cent. In the case both the contracted out element of the EPF and of the DBCPF, the employer's total contribution to the scheme is supposed to be sufficient to ensure full funding.

Contributions are not the sole source of finance to the public pension system. Transfers from general revenue cover the administrative costs of both the NP and the EPI and, since 1985, one third of the costs of NP benefits. In addition, the public pension system receives income from the assets of its fund. In this respect, the system can be described as a part funded one. Income from returns on fund investments constituted about one eight of total income to the system in the year 2000. At this time the fund had reserves sufficient to meet rather over six years of payments.

[6] However, employees may make additional, voluntary contributions. This is much more frequent in larger enterprises, where EPFs are to be found, than in medium sized enterprises where TQRPs predominate.

Figure 1: Revenue sources for the public pension system – NP, EPI and MAA



source: own calculations from social security accounts

Public pensions for employees were never particularly generous. Legislation in 1973 that made a substantial benefit enhancement and regularised indexing was intended to produce a combined EPI/NP benefit for a " pensioner" with 40 years contributions and a dependent spouse of some 60 per cent of the earning of a "model worker" (one on, effectively, average earnings). In practice, the outcome is rather different. A model worker's earnings exclude bonuses, yet these have been equal to as much as five months salary in larger enterprises. On the other hand, the tax treatment of pensioners is extremely favourable. Although pensions are taxable, people of pension age benefit from larger tax allowances than do people of working age. The table below provides a comparison.

Table 3: income tax provisions for older people

	single aged 65+	couple aged 65+	couple aged 70+	single working age	couple working age
tax-free allowance (¥m)	2,3	3,3	3,5	1,1	2,1
as % APW wage	56	80	84	27	50

source: OECD

Where an EPF pension exists, benefits are required to be at least 30 per cent more generous than those the EPI system would provide.[7] The part of the benefit that corresponds to the full EPI benefit has to be paid as an annuity, but the remainder can be taken as a lump sum. TQRP plan benefits are almost always taken in lump sum form. The preference for commutation reflects a yet more generous tax treatment of lump-sum benefits payments relative to income. Under both EPF and TQRP schemes, benefits are wage- and service-related, but tend to be much higher from EPF

[7] Since 2001, they have to be only 10 per cent more generous.

schemes rather than from TQRP schemes. This reflects the generally superior terms and conditions of employment in the larger firms that operate the former.

The public pension system provides a survivor's benefit. This is worth three quarters of the pension of the deceased person. Alternatives, which involve taking all or part of the survivor's own pension are also available, and in some cases these might be more favourable.[8] Employer-sponsored schemes do not, in general, offer survivors benefits, something that is consistent with their lump-sum nature.

e) early and late retirement

The difference in retirement ages of the EPI (60) and the NP (65) is, to an outsider, an anomaly of the public pension system of Japan. The retirement age in the EPI and in company-sponsored plans reflects the retirement practices of employing organisation in both the private and the public sector. Any raising of the EPI age of eligibility requires corresponding changes by these organisations. In the past, this has tended to occur, albeit sometimes with some lag. Increases were announced well in advance and were always accompanied by extensive exhortation. Seniority-related payments systems, at least in large firms and in the public sector, mean that employers have an interest in employees leaving as soon as their wages exceeds their productivity. However, a culture that respected age acts as a counter imperative. In practice, employers seek to effect some sort of demotion once the employee had passed a critical age. This critical age might be lower than the age of EPI eligibility and is normally no later than that. The demotion can take the form of an internal transfer to a non-mainstream position or of an external transfer to a subsidiary or a sub-contractor. It can even involve assistance to set up as self-employed. Demoted and transferred workers might well continue to work beyond the normal retirement age of 65; indeed, Japan has one of the highest rates of employment of older people in the OECD world.[9]

Table 4: Employment rates for older men, 1999(%s)

age	Canada	Finland	France	Germany	Italy	**Japan**	N'lands	Sweden	U K	U S A
55-59	67	54	61	66	52	**91**	67	79	70	76
60-64	44	23	16	28	29	**66**	24	51	47	53
65+	10	6	2	5	6	**34**	5	13	8	16

source: OECD

Working longer does not enhance the pension that can be accessed from the EPI scheme.[10] Years of contributions above 40 do not bring additional benefits, nor does the shorter expected time in retirement bring any enhancement of benefit. *Prima facie*, there are incentives in the public pension system to retire at the earliest possible age. Under the rules operating until 2000, those retiring at 60 were entitled to a special, bridging benefit, paid by the EPI scheme, that makes up the equivalent of the NP benefit that would be drawn at 65. Part-time working from 60, combined with a

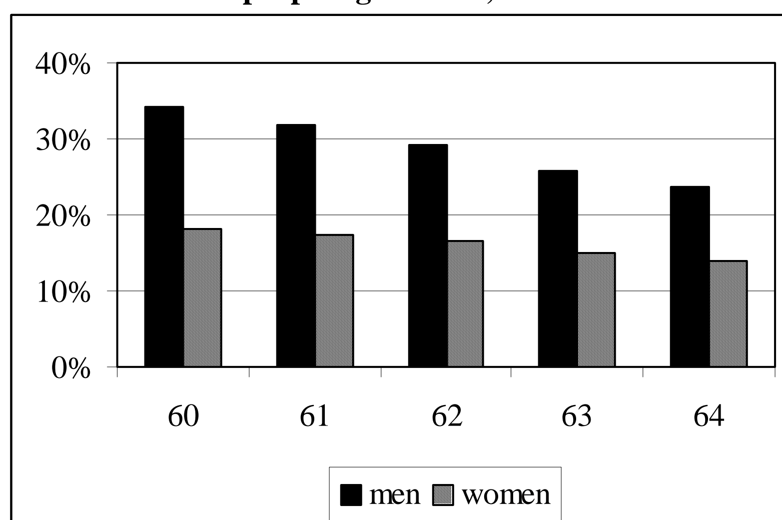
[8] In fact, a survivor has one of three choices. She can take three quarters of the pension of the deceased person, half her own EPI pension plus half of the pension of the deceased person (i.e. two thirds of a survivor's benefit), or her own.

[9] The practices of larger and public sector employers are not the sole explanation for this high rate of employment. Many of the oldest workers in Japan – those aged 65 and above – are engaged in agriculture or retailing. They leave employment in industry and commerce and find refuge in work in family run plots and micro-business (see Casey, 2001).

[10] Reductions and enhancements do, however, apply to the NP.

public pension, was also possible. However, a relatively complex earnings rule applied. All who continue to work had to take a 20 per cent cut in their pension. In addition, a 50 per cent offset against earnings above a certain level was applied and no pension benefit at all was paid if earnings exceeded an amount equal to those of a model worker. Nevertheless, a person might still wish to work to increase contribution years. Rather over a quarter of eligible men, but considerably fewer eligible women, appear to have taken advantage of this form of partial pension. Few seem to have been entirely put of working by the earnings test, although some seem to choose to worker fewer hours as a consequence.

Figure 2: Partial pensioners as a share of those entitled under the EPI, people aged 60-64, 2000



Source: Social Insurance Agency Annual Operational Report FY 2000
Note: Includes people whose pension is totally suspended

3) The income of the older population

Understanding the income of older people in Japan is a complex task.[11] There are two reasons for this. First, as has already been shown, a substantial share of people who are "above retirement age" are still working. In this respect, income from labour is much more important for older people – particularly the younger old – than it is in many other countries. Second, the living arrangements of older people in Japan differ substantially from those in most western industrialised countries. Multi-generational families are much more important. One in four older Japanese person lives in such a family.

Table 5: Living arrangements of the population age 65 and above Japan and the US, percent

	single women living alone		single people with others and not HH head		couples and neither is HH head	
	aged 65-74	aged 75+	aged 65-74	aged 75+	aged 65-74	aged 75+
Japan	9	11	10	35	7	10
USA	18	33	5	9	1	1

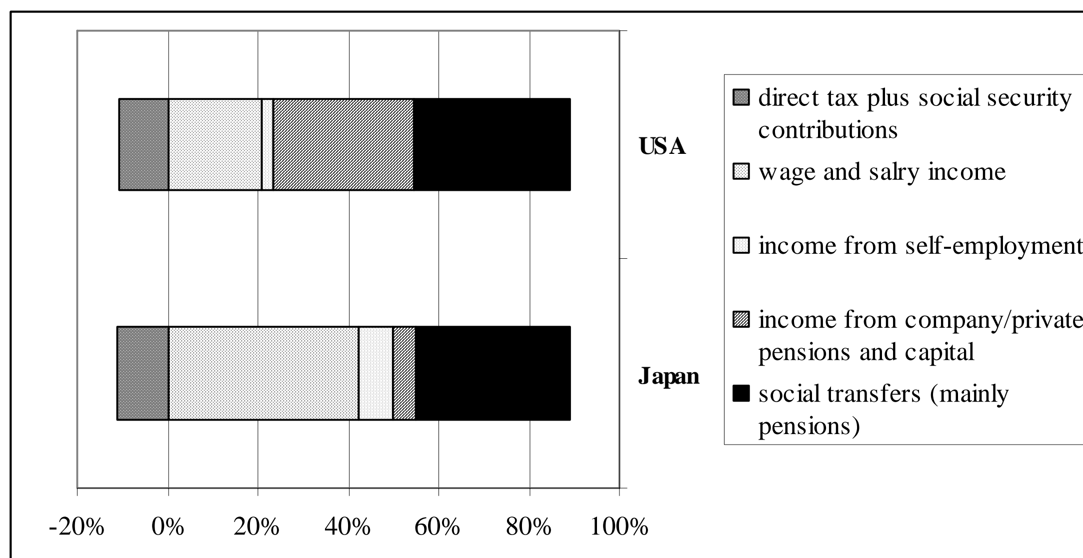
Source: derived from Yamada and Casey, 2002

[11] For a full comparison of incomes of older people that covers a number of OECD countries, see, Yamada and Casey, 2002 and Casey and Yamada, 2004.

Both these differences make understanding household income data difficult. Again, there are two reasons for this. First, it is not always easy to identify what constitutes an "elderly household". Household income data is normally organised according to the age of the head of household, but in some multi-generational household, the head is the adult child (or child in law). In other words, the elderly person has moved in with the children, rather than the children have stayed with the parent, and is in a subordinate position. Second, even when such a household has been identified, its income will contain the labour income of any adult children (or children in law) living with the elderly person.

Taken together, this means that any statement of the household income of elderly people in Japan might well be as much a statement of the income of the adult children as one of the older people themselves. Moreover, since both the adult child and the older person, him/herself, is likely to be working, the statement of household income will contain a considerable amount of labour income. The diagram below shows this.

Figure 3: Make up of household income – households headed by a person aged 65 or over – mid 1990s



Source: derived from Casey and Yamada, 2004
The data refer to percentage of gross income

Statements of individual income are equally fraught, since these are derived from household income sources. Account has to be taken not only of assumed transfers between spouses – normally from the male to the female – but also from the adult children to the parents. Moreover, in so far as multigenerational households are larger than conventional households, they enjoy greater scale economies, and these, too, are picked up when income is "equivalised".

There are indications that older people in Japan enjoy a relatively high living standard. Equivalised incomes, taking account of scale economies and intra-household transfers, do not fall as substantially with age as in many other countries. The table below provides some illustration of this.

Table 6: Adjusted median incomes for selected age groups as a percentage of adjusted median disposable income of the working age population (18-64) – mid 1990s							
	selected age groups				all aged 65 and over		
	45-54	55-64	65-74	75+	all	men	women
Japan	112	101	81	80	80	82	79
USA	121	104	81	66	74	83	69

source: derived from Yamada and Casey, 2002

On the other hand, there is also a considerable dispersion in the incomes of the elderly in Japan. Amongst the younger old, there are more at the bottom of the income distribution than in the USA; amongst the older old, there are more at the top.

Table 7: Income distribution in older age (equivalised incomes), %s				
	aged 65-74		aged 75 and over	
	bottom quintile	top quintile	bottom quintile	top quintile
Japan	27	14	34	17
USA	24	15	35	10

source: derived from Yamada and Casey, 2002

Perhaps not surprisingly, living in a multi-generational household has beneficial consequences for the incomes of the elderly concerned. This is particularly the case for elderly women – the group that in almost all countries make up the poorest of the old.

Table 8: Proportion of people aged 75 and over in bottom income quintile, %s				
	all	single women living alone	women living with spouse only	single, living with others and not household head
Japan	34	79	59	18

source: derived from Yamada and Casey, 2002

Whilst four fifths of very old women living alone have an income that places them in the bottom fifth of overall distribution, less than one fifth of very old people who are widowed or other wise single but who are living in a multigenerational family are in this position.

4) The reforms of 2000 and 2004

Japan is well known both for having one of the fastest aging populations amongst the advanced industrialised countries and for being destined to have one of the highest projected age dependency rates in the coming decades. The public pension system is subject to reappraisal on a five-year basis. Major legislation on pensions occurred in 2000, affecting not only the public but also corporate pension schemes. Further legislation, impacting on the public pension system was completed in summer 2004 to take effect in 2005.

a) reforms to the public pension system

The retirement age under the EPI is currently being raised to 65 under legislation dating from 2000. For men, the new age will be valid as of 2013; for women, as of 2018. This brought forward a rise first announced in 1998 but then set to be completed only by 20025(m) or 2030(w). Another law passed rather later in the same year made mandatory retirement before 60 illegal, but it did not prohibit it before 65. As yet, only about one in three enterprises keep on all their workers until this age, and the government continues to rely on a mixture of moral pressure and special employment assistance programmes.

The law that raised the EPI age to 65 introduced, for the first time, the opportunity to take benefits early on a reduced basis. The rate of reduction is set at six per cent per annum, so that at 60 – the earliest age for liquidation – an EPI pension would be worth 70 per cent of its normal value. Along with the raising of the EPI retirement age, the partial pension system is due to change. When the transition is complete, a system similar to that that had applied to 60-64 year-olds will operate. The immediate impact of this change was perverse – it encouraged immediate exit by those already contemplating exit as they sought to evade its scope.

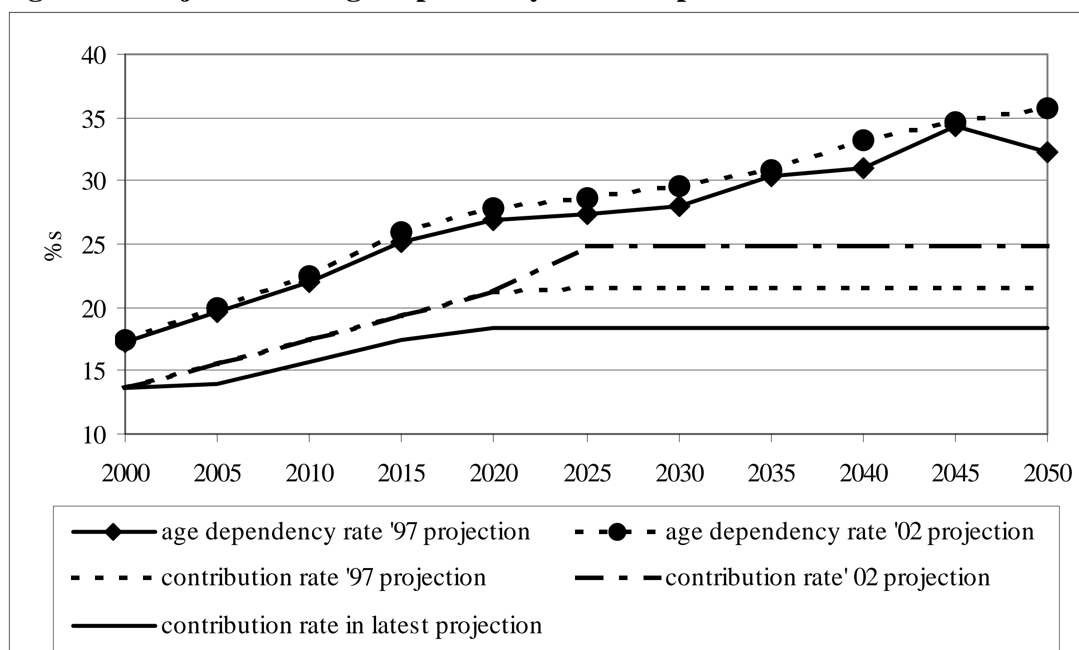
The accrual rate for EPI benefits had stood at 0.75 per cent of wages per year worked since 1985.[12] The 2000 reform cut it further to 0.7125 per cent. Thus, after 40 years of contributing the pension would be worth only 28.5 per cent of measured wages rather than 30 per cent. Rather than index pensions to prices and, every five years, to wages, price rises alone would determine pension increases. In fact, since 1999, and as a result of deflation, there had been no increase in pensions at all. Indeed, special legislation had had to be passed to prevent pensions from being cut. However, taken together, the adjustment in the accrual rate and the indexation procedures were projected to cut pension benefits by some 20 per cent when they had taken full effect. However, in order to smooth acceptability of the reform, the 2000 legislation contained provision for pension levels to be re-examined should wage and price increases move too far apart.

Projections of population ageing prepared in 1997 had formed the basis of a long-term review of the sustainability of the existing system. Rather than there being a need to double the pension contribution rate by 2025, an increase of only 60 per cent seemed necessary.[13] However, when the 2000 reform was being planned, policy makers and analysts were working on the basis of population projections made in 1997. In early 2002, a new set of projections was made, suggesting yet higher dependency rates than had been envisaged earlier. The proposals to raise contribution rates that had already been envisaged appeared inadequate to ensure fiscal sustainability. Yet higher rates were required, as the chart below shows. Thus, by 2025, the EPI contribution rate is suggested to have to rise to 24.8 per cent rather than the 21.6 per cent foreseen earlier.

[12] Before 1985 it had been one per cent.

[13] The increase was expressed with respect to the contribution rate measured in terms of the monthly wage, and so excluding bonuses, rather than the annual wage, which does include these. Thus, it was cast as a prospective rise from 17.35 per cent to one of 34.5 per cent. The rate, after the reform, was projected to be 27.6 per cent.

Figure 5: Projections of age dependency rate and planned contribution levels



source: Ministry of Health, Labour and Welfare

In order to try and hold down contributions yet further, and in the course of the latest five year review, a number of further reform proposal were considered. Radical solutions, including a switch to funding and the introduction of some form of NDC system, were mooted. However, the steps contained in the 2004 reform legislation were gradualist. They involved placing a cap on contributions, such that these stabilised at 18.3 per cent by 2017, and increasing the contribution to the system that comes from general revenues from one third of the NP costs to one half.

The raising of the contribution rate even to this level has brought expected protests from the business community. At the same time, capping contributions and fixing limits to revenue transfers, coupled with the indexing changes of previous legislation, has also meant the projected pensions will fall. The replacement rate for a "model" employee, which had been targeted at 60 per cent in the 1973 legislation, will fall by 2020 to around 50 per cent. This has led to protests from labour unions and parties of the left.

b) recasting the reserve fund

Although the public pension system could be described as partly funded, in reality it was scarcely so. The reserves that were built up, along with savings made into post office accounts, were passed to the Trust Fund Bureau (TFB) of the Ministry of Finance where they were used, "in the public interest", to support infrastructure projects and housing loan schemes. The actual rate of return was extremely low. It was not until 1986 that practice changed with the establishment of a Project to Secure the Financing for Future Pension Benefit Payment. The purpose of this was to strengthen the financial resources of the EPI and NP by making use of external fund managers who would invest in domestic and foreign equities and bonds. However, even by the late 1990s, only about five per cent of the reserve fund was allocated in this fashion.

Substantial administrative change was made in 2000 with the introduction of "self management". Responsibility for the reserve fund was handed to the Ministry of Health, Labour and Welfare as "the insurer". The ministry was mandated to establish arrangements whereby investment decisions would be taken not in any "public interest", as had been the case when the TFB had had responsibility, but, rather, "the interests of the insured population" – to maximise returns to the fund. A new Government Pension Insurance Fund (GPIF) was created for this end and it took over those assets that had been built up under the Project so far. The GPIF started to operate in 2001 and over the following eight years it is to take charge of the entire reserve. Even in its early days, the fund was enormous – acknowledged as the largest in the world. Its assets in the first year (FY 2001/2) were in the order of ¥27trn ($240bn), which in US$ terms was over twice the size of CALPERS. By 2009, on some estimates, assets will have reached ¥97trn ($870bn) – giving the fund a size equivalent to the GDP of Canada.

Investment specialists, rather than ministerial officials, were given a predominant role in the decision-making structure of the GPIF. Terms of disclosure were strengthened and external audit introduced. A target investment portfolio was set, although adjustment to it was not expected to be reached until the eight year transition was complete. That portfolio was as follows:

Inherited portfolio	Target portfolio
Domestic bonds – 58%	Domestic bonds – 68% +/-8
Foreign bonds – 4%	Foreign bonds – 7% +/-5
Domestic shares – 22%	Domestic shares – 12% +/-6
Foreign shares – 11%	Foreign shares – 8%+/-5
Cash, etc – 5%	Cash, etc – 5%

The GPIF management has argued for passive management on the grounds of superior performance and lower cost. More than 70 percent of its investments in domestic shares are now managed this way, nearly three times as many as in 2000, as are nearly 80 percent of the investments in foreign shares and bonds.[14] Only investment in domestic bonds is retained in house by the fund.

Fund performance after such a short period is difficult to assess. Yields on domestic government bonds are low, whilst the domestic stock market took a major fall in the first two years of the GPIF's existence. Overall, the fund lost close to one eighth of its value in this period. Prospects for the coming years are not universally regarded as good – interest rates might well remain low and there is no guarantee that equity markets will improve. The target rate of return of 4.5 per cent that has been set for the fund might be overoptimistic.

c) reforming corporate schemes

During the 1990s, company pension schemes found themselves in increasing difficulties. The value of investments in domestic equities plummeted as the stock market lost three quarters of its value. Yields on long-term government bonds fell through most of the 1990s, reaching under two percent by 1998. Foreign holdings

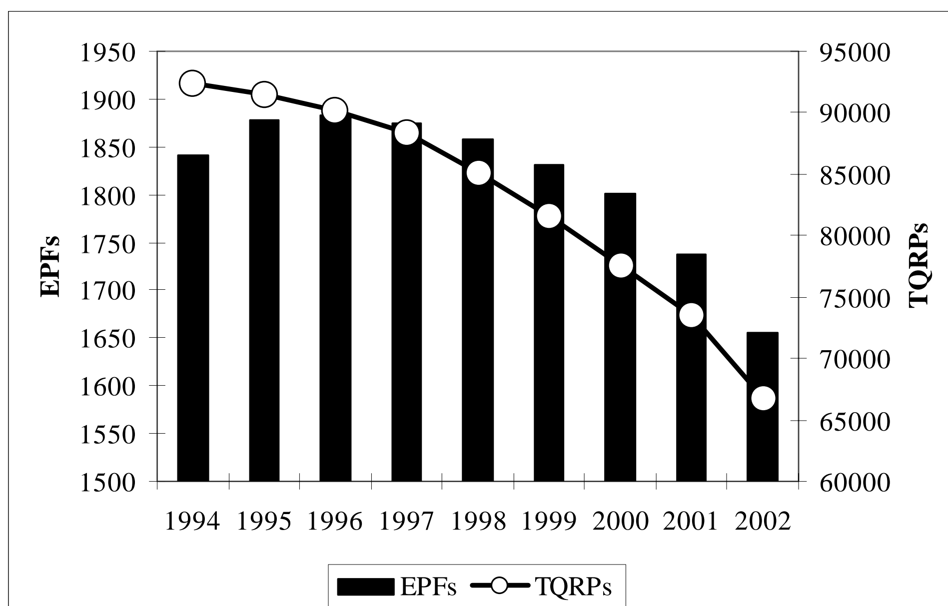
[14] It is reported that, as a result, the fund cut the amount of management fees it paid by 57 percent, to $153 million, in just two years.

were adversely affected by Yen appreciation. Real estate prices had crashed when the "bubble economy" burst.[15] Whilst the condition of retirement allowance plans, because these operated as book reserves, was less obvious, by the mid-1990s concerns were being expresses about the extent to which the assets of funded pension plans matched their liabilities. By 1998, some 70 per cent of EPFs were reported as under-funded, and by 2003 the overall shortfall amongst EPFs was some 17 percent. The difficulties funds were having were exacerbated in the late 1990s, first by a requirement that pension funds be valued at market rather than book value, and then by a change in accounting rules that meant that claims had to be deducted from reserves and the results shown in enterprise balance sheets.

Estimates of the extent of the shortfall vary from commentator to commentator but, according to some, could have reached the equivalent of 15 per cent of GDP by early 2002. A rough comparison of the situation of the top 300 companies in Japan and the S&P 500 companies of the USA shows a shortfall of some $196bn at end 2002 in the former case and of some $220bn at end 2003 in the latter case – whilst the GDP of Japan is only about half that of the USA.

Some enterprises responded to the problem of fund shortfalls by taking steps to reduce the benefits paid. They were constrained both by a legal obligation, albeit one that was not absolute, to meet a 5.5 per cent return on pension savings, and by a moral obligation to provide for their workforces. Nevertheless, by 2003, over one in four EFPs had cut benefits. Some companies went so far as to close their schemes down completely. The diagram below shows the extent to which the number of EPFs and TQRPs fell – either through closure (as was the case of most EPFs) or as a consequence of the sponsoring employer going bankrupt (as was the case of many of the TQPRs).

Figure 4: Number of EPFs and TQRPs



[15] Until 1999, funds were required to follow a "5-3-3-2 rule" whereby not more than 50 per cent of assets were to be held in domestic bonds or cash, not more than 30 per cent in domestic equities, not more than 30 per cent in foreign equities or bonds, and not more than 20 per cent in property.

source: Ministry of Health, Labour and Welfare

The government response to the crisis of the employer-provided pension sub-system was to legislate the establishment of Defined Benefit Corporate Pension Funds (DBCPFs). Such plans have to be funded and must be external to the company. They are subject to new rules governing trustee responsibility and information disclosure, and they must undergo actuarial review every five years with an obligation to meet reported shortfalls. By 2012, all existing TQRPs are to be transferred into DBCPFs, DCCBFs (or EPFs) or closed down. EPFs can transfer themselves into DBCPFs but they are not obliged to do so. If they do this, they are required to make good any shortfall with respect to EPI entitlements in advance – something that could put further pressure upon the sponsor. They can also switch all or part of what they offer in excess of an EPI into a DCCPF. Because the law allows for EPF closures, it also allows enterprises with such plans to hand the responsibility for their schemes back to the NPF system to be run by it as a closed scheme. However, when a transfer takes place, any securities holdings have to be liquidated, either by the fund as the transferor or by the state as recipient – something that could further depress stock markets. An even tougher requirement to make up any shortfall applies when an EPF is converted to an EPI plus a DCCPF. In such cases, the entire value of accumulated entitlements has to be transferred to the new plan.

By spring 2004 over 500 DBCPF had been established. Moreover, and largely as a result, the number of EPF had fallen to just over 1200 by the end of 2003 – over 400 below the end 2001 total shown in Figure 4.

Table 9: number of DCPFS (spring 2004)	
total	510
- from an EPF	297
- from a TQRP	133
- from an EPF and a TQRP	42
- new	38
total number of active members	1.44m

Shortly after the passing of the law establishing DBCPFs, the long awaited legislation permitting the establishment of defined contribution schemes cleared parliament. These schemes also became an acceptable successor of closing TQRPs or of EPFs.

The take up of DC schemes, however, has not been large. Initially, many of the enterprises that introduce DCCPFs were new ones that either did not have corporate pension plans or have only a short history of them. However, major financial services firms established plans at an early stage and their actions, when followed by those of certain large manufacturing corporations, had a domino effect. Employees, on the other hand, were less impressed, especially when the new schemes absorbed part of their employer's contributions to an EPF. The experience of recent years would have suggested to most employees that investments in securities were producing nothing like the returns that were to be expected from an EPF plan.

Table 10: Coverage of defined-contribution pensions (end 2003)		
	plans	members (000s)

corporate DC	632 covering 1768 firms	620
personal DC	665 offered	12 (self-employed) + 3 (employees)

5) Long-term prospects
The 2004 pension reform law by no means marked the end of a process. Many politicians and academic analysts share the view that the current system is unsustainable and that any "fix" made on this occasion was, at best a short term one. There will be further five reviews and further legislation will follow after, at most five yeas. A number of issues have yet to be resolved. These concern not only pension finances or private pension security – issues which attract most attention – but also more fundamental matters – in which direction is Japanese society moving – something that is much less openly addressed but that is alt least as pertinent.

a) improving the financial base of the public pension system
The ability of the government to raise taxes to meet the greater share of expenditure on public pension the system that comes from general revenue is less than certain. Were the additional revenue to be raised by income tax, the burden would fall heavily on the working age population. As has been shown, pensioners, themselves, pay very little income tax. This has led to some commentators to suggest that the tax system needs reform with a greater share of revenues being raised from a consumption tax. In this case, older persons would also bear a share of the burden of societal ageing. However, experience with trying to introduce a form of VAT in Japan has not been a happy one. In the mid-1980s, the announcement of plans to introduce a sales tax contributed to the Liberal Democrat Party losing its parliamentary majority for the first time since the war. Although a form of VAT was introduced shortly after, its rate was very low and small traders were exempted. Currently VAT stands at only five percent compared to the 15-25 per cent common in Europe, but whilst there is scope for reform, the political constraints are large.

On a more ad hoc basis, there have been calls for increases in compliance as a means of enhancing revenue to the system. Although all residents of working age are supposed to be insured, Table 1 has already suggested that there are some people – about 3.5 per cent of the total – who are not making contributions. These non-payers fall into three groups – those who are exempted (nearly 60 per cent), those who are not paying but should be (about 40 percent) and a few who are not even registered in the system at all. Those who are on very low incomes are exempted from the NP system. However, amongst this group are many young people, including those who are described as having "dropped out" of the employment system or who choose to work on a casual or part-time basis – the group sometimes referred to as "freeters". Complete or partial non-compliance is also prevalent amongst the self-employed. According to some statistics, the proportion of "delinquent" self- employed rose from one in six in 1996 to nearly four in ten by 2002.[16] Last, there are suggestions that

[16] As the 2004 reform bill was passing through parliament, non-compliance became a particularly sensitive issue. Parliamentarians are, technically, counted as "self-employed" and it was revealed that, *inter alia*, the prime minister, the finance minister, the economics minister, the minister for health, labour and welfare, the defence minister and the chief secretary of the cabinet, together with the chairman of the lower house committee on health, labour and welfare had all, at some time been non-

many unemployed people and students – groups that are normally required to make contributions into the NP system – are failing to do so. Overall, contribution income to the NP is said to be only some three quarters of what it would be if all the covered age group were fully compliant.[17]

b) safeguarding corporate pension members rights

One of the reasons for introducing corporate defined contribution schemes was that existing employer provision disadvantaged mobile labour. Some of the shortcomings of the "lifetime employment system" were being recognised. By definition, retirement allowance schemes paid out on departure – accrued rights were not transferable. Neither were accrued rights under TQRPs. Moreover, TQRPs paid out only once retirement had been reached and were lost if the insured person changed employer. It was only in 1997 that vesting was introduced for that component of the EPF that exceeded the EPI entitlement. Those who had at least 20 years membership of a plan were henceforth entitled to a deferred pension. Those with shorter membership (in excess of one month) were henceforth entitled to a minimum preserved benefit based on that which they had accrued. This preserved benefit generated a lump sum that could be taken as cash or transferred to a special Pension Fund Association (PFA). That body takes responsibility for the assets, invests them further, and pays out an annuity once retirement age has been reached. It does not arrange transfers into the EPF of any successor employer.[18] Only when TQRPs are switched into DBCPFs or DCCPFs will they be vested.

Retirement allowances under the book reserve system are especially poorly protected. Employees of bankrupt companies are likely to lose their retirement allowances, since the status of their claims is no higher that of any other creditor. Where a funded system operates there are some protections. TQRPs and EPFs are now subject to stricter actuarial valuation. However, only EPFs are required to make contributions to a plan termination insurance programme – the Pension Guarantee Programme (PFGP) that was inaugurated in 1989. This is a mutual aid scheme that is financed through contributions from EPF sponsors. The contribution rate is supposed to be experience-rated, although the proxy for financial soundness appears to be size – the required contribution per participant declines gradually as the number of insured employees increases. After the number of plan terminations started to rise in the mid-1990s, the contribution rate was quadrupled.

The legislation governing DBCPFs applied the same protection rules to the new plans as applied to EPFs. These include the minimum funding requirement of 90 per cent, and, where this is not met, the setting out of a timetable by which this is to be reached.

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compliant. So too, had been leading members of opposition parties, including the leader of the principal opposition party.

[17] Non-compliance appears to be motivated, in part, by a lack of confidence in the public pension system – one that is said to be strongest amongst the young. The 2001-2 Report Health, Labour and Welfare Ministry devoted a page to appealing for compliance in the interests of maintaining intergenerational solidarity, but also points out the longer-term consequences for individuals who have no contribution record. In 2003 the social security agency, responsible for premium collection, mounted well-publicised raids on some 10,000 self-employed people whom it had identified as persistent defaulters and sought to seize assets to make up the shortfall.

[18] The NPF system acts as the recipient of assets where a participant in a DCCPF moves to an employer without its own DC plan.

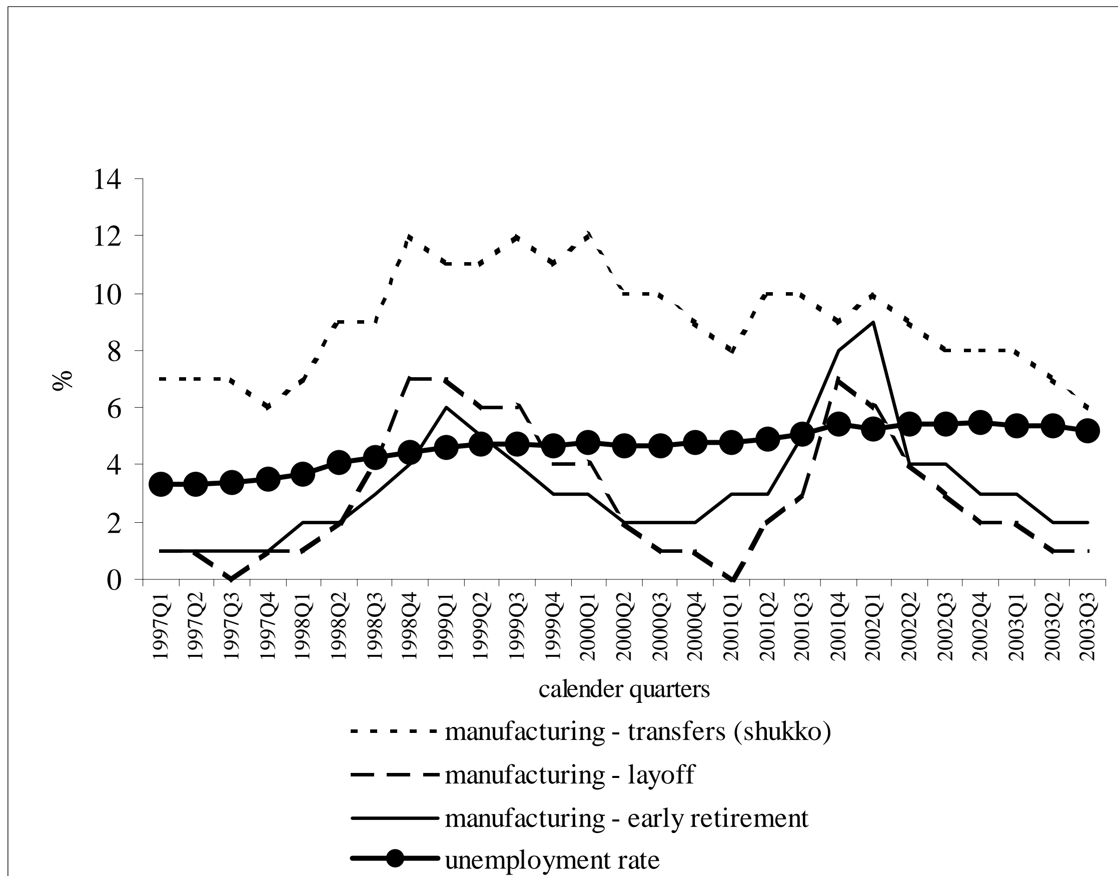
However, there is no sanction if circumstances later prove that the sponsoring corporation cannot meet the schedule set down.

Extension of existing guarantee provisions is under consideration but does not seem to be a high priority.

c) coping with the changing situation of the older people

The challenges facing the Japanese pension system are not only the consequences of the way in which the system is constructed or the generosity of the benefits it offers; they are more fundamental. To date, Japan has supported older people in two ways. First, it has managed to maintain a high rate of employment in old age. The ability to do this is being reduced. Enterprises are finding both that they can no longer retain what they consider to be costly or less productive workers in special positions and, where relevant, that their sub-contractors are no longer able to take them on – the latter are facing the same pressures as the large firms that they work with. Equally, rationalisation of the agricultural sector and of the retailing sector – in part a consequence of external pressure through the WTO – will reduce the number of external opportunities for people leaving jobs with their long-term employers or their sub-contractors. On top of this, there are signs that Japanese enterprises, rather than practicing post-retirement age employment extension schemes, are resorting to early retirement to manage work force reduction and restructuring. The diagram below shows how, as unemployment was rising, in the late 1990s, enterprises made increasing use both of layoffs and of early retirement.

Figure 6: Share of manufacturing firms reporting early retirements, layoffs and external transfers and the overall level of unemployment



source: Quarterly survey of firms' labour adjustment processes

If this tendency continues, the differences between Japanese and American or European employment practices might become less obvious.

Second, Japan has been able to rely, if not upon the traditional "home" to support the elderly, at least upon the family. Even now it is common for elderly people – especially those who have become widowed - to move back in with their adult children. These provide them with both financial and physical support. However, the incidence of multi-generational families fell rapidly over the last quarter century, as the table below shows.

Table 11: The changing structure of pensioner households in Japan, %s

	single	couple only	unmarried child still at home	in any multiple generation household	other
1975	9	13	10	54	14
1980	11	16	11	50	12
1985	12	19	11	46	12
1990	15	21	12	40	12
1995	17	24	13	33	12
2000	14	33	14	26	13

source: Comprehensive Survey of Living Conditions of the People on Health and Welfare (Ministry of Health, Labour and Welfare

The falling share of older people living in multi-generational families reflects increased mobility, as adult children move away from the place of their birth and preferences of elderly people themselves, who thanks to pension benefits were able to live independently. A gradual erosion of the level of pension benefits might slow down the trend towards independent living. However, if fewer of the younger old stay in work, the ability of adult children to maintain their elderly parent will also decline.

Conclusions

This **Briefing** commenced by asking the question whether Japan was a special case. Many observers and commentators like to claim it is. In practice, Japan has a pension system much like that of many other countries and faces, if in a more intense fashion, the same demographic challenges that face these other countries. In this respect, it is not so much a special case. On the other hand, there are elements less of the pension system and more of the social system that are, if not specific to Japan, different from those of most of the western industrialised countries. The nature of employment practices and of living conditions makes it important to consider sources of support in old age beyond simply individual pension entitlements. Yet these employment practices and living conditions are themselves, not necessarily sustainable. To the extent that they are not, Japan will be required to engage in yet more fundamental reforms than those envisaged so far.

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