Chapter 3 Pensions

3.1 History of pension in Japan

Like other advanced countries, the Japanese pension system was first introduced by the Army, the Navy, and the authority for the civil servants. At the end of the 19th century, the Imperial Army's Pension was started in April 5th 1875, followed by the Imperial Navy's Pension in Aug. 24th 1875, which were united in 1890 and abolished in 1945. The pension of white color workers started later in 1884, and the pension of blue color workers' in public fields started in 1919. The military pensions required no individual contributions and was completely financed by general revenue of the national government. The scheme was then expanded to civil servants. In those days, the pension (the old-age benefit 恩給) for military and civil workers was based on the salary just before the retirement, and its level was generous. The disparity between the civil workers' pension and private sector workers' pension had been large, and this will be completely corrected only when the private sector workers' pension (EPI: Employees' Pension Insurance) and civil workers' pension (Mutual Fund) will be united in Oct. 2015.

The private sector's employee's pension started in 1942. In those days, the pension premium and benefit was in proportion to the wages. In the beginning, the name of the private sector's employee's pension was Labour's Pension Insurance（労働者年金保険） which covered only male blue collar workers. However, after only one year, the name changed to the Employees' Pension Insurance （厚生年金保険） which covered female and white collar workers too. In those days, the contribution rate was 11% based on the perfect funding system. The contribution rate was then reduced from 11% to 3% after WWII as poverty prevailed.

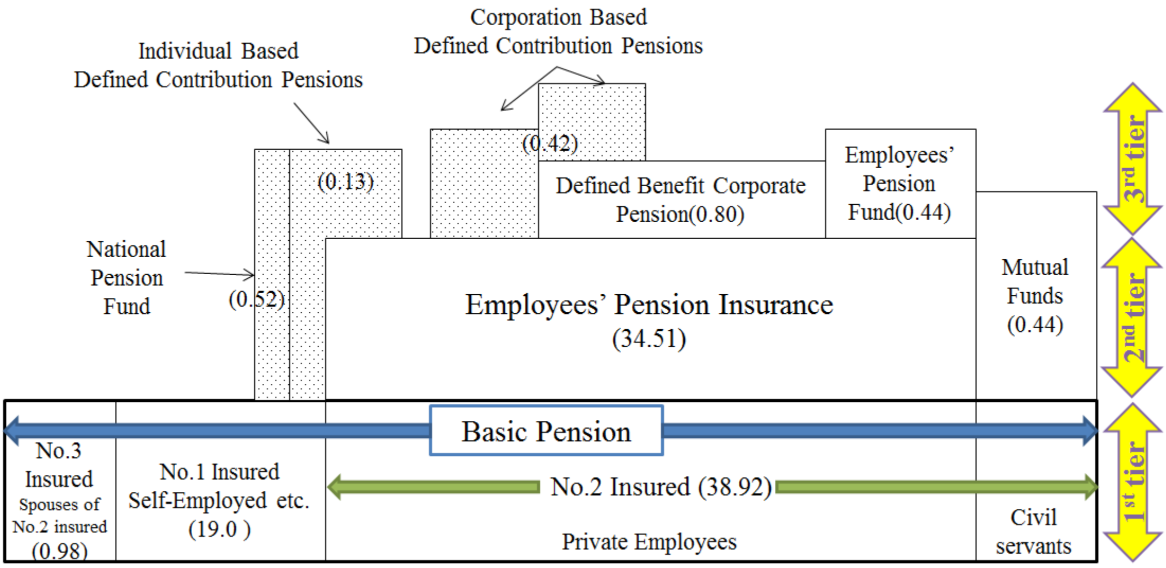
Why did the Japanese Government introduce the pension system for private sector's workers during wartime? The reason is clear. During wartime, the government needed controlled and stable manpower to maintain steady production and to control inflation by reducing the household purchasing power through imposing pension premium. The EPI was reformed in 1954 shifting from an earnings-related pension to a two-tier benefits system including flat-rate benefits. As for the rest of the population, in 1961, National Pension was introduced for the self-employed, fishermen/farmers, unemployed, house wives, and so on, thus the Japanese pension system achieved Universal Coverage. In terms of the payment of contribution and the receipt of the benefit, National Pension has not changed from how it was started.

3.2 Pension system overview

Nowadays, the Japanese pension system is multi-tiered, consisting of public and private pension schemes (Figure.3.1). In this booklet, the distinction between public and private pension is whether the insurer of the pension is the government or not. The first tier is the *Basic Pension* (基礎年金), which provides the flat rate basic pension of a universal coverage. As a non-income-related pension, it aims to provide a basic income guarantee for old age, and the participation is mandatory to all residents of Japan. The second tier, the *Employees' Pension Insurance* (厚生年金保険) covers most employees and is income-related in both premium and the benefit structure. Its provision is mandatory to all corporations over a certain size, and the premium is shared by employers and employees. The first and the second tier pensions are both operated by the government and thus are public.

The third tier is an optional scheme. It is provided either by private corporations (employers) for their employees (Employees' Pension Funds), or by the National Pension Fund for the self-employed, for which the government is the insurer. The Employees' Pension Funds are operated by employers, but has a large portion of financial resources from the Employees' Pension Insurance and thus has a quasi-public character. There are also personal pensions operated by organizations such as private insurance corporations and trust banks, but these are not covered here, as they do not fall under the category of a social security system.

Figure 3.1 Pension System in Japan



Note: 1) Shaded boxes indicate optional Defined-Contribution pensions.
2) Numbers in ( ) are the number of subscribers in millions. All numbers are as of March 2012.
Source: Web-site of Ministry of Health, Labour and Welfare (MHLW)
(http://www.mhlw.go.jp/topics/nenkin/zaisei/01/01-01.html in Japanese Access Aug. 25th 2013)

Similarly, the Basic Pension for the self-employed, farmers, and other non-employed (Category No.1 Insurer) is called the National Pension (国民年金), which is now operated by the Japan Pension Service (日本年金機構) under the responsibility of the government. The pension system for civil servants is called Mutual Aid Pensions (共済年金), which covers both the Basic Pension portion and the income-related portion. Thus, the entire adult population, in principle, is insured either by the Employees' Pension Insurance, the National Pension, or the Mutual Aid Pensions.

The coverage of the Basic Pension is universal, i.e. it is intended to cover all residents 20 years old or above in Japan including foreigners. For the National Pension, the eligibility to receive pension benefit requires a minimum of 10 years of premium payment, and the maximum enrollment period is 40 years.

3.3 Pension system financing

There are three resources for financing pension; the premium, the government subsidy, and the reserve.

Concerning the premium, in case of the *Employee's Pension Insurance*, the premium is paid by both employees and employers, and is set at a fixed rate of the salary (see the table on pp. 20-21). The premium also covers the dependent spouse who earns less than 1.3 million yen per year (called No.3 insured). In case of the National Pension, the premium is paid by the insured only, and is a flat rate for all. Both husband and wife have to pay the premium if he/she is not working as employees.

As for the government subsidy, for the first tier (Basic Pension), 50% of the benefits and all of administrative costs are paid from the general budget of the government. For the second tier (Employees' Pension Insurance and Mutual Aid Pensions for central and local civil servants), the administrative costs are paid by the central government. For the third tier, there is no subsidy from the government.

3.4 Pension system by scheme

3.4.1 The National Pension

As described above, all residents in Japan between ages of 20 to 60 are eligible and required to become a subscriber of the Basic Pension. The amount of pension payment varies depending on the enrollment period and can be calculated as follows.

$$\yen 792{,}100 \times \left((\text{insured months} + 1/2 \times \text{exempt months}) / 480 \right)$$

Whereas employees who are covered by the Employees' Pension Insurance are automatically enrolled in the Basic Pension, those who are not employees are covered by the National Pension. A fixed amount (¥15,040 per month in 2012) is levied on each subscriber to the National Pension as a premium (41.4% of Category 1 subscribers are fully exempted and 2.6% are partially exempt from paying premiums as Japan Pension Service Statistics). Current benefits are paid out of currently collected premiums (pay-as-you-go system), but as much as one half of the benefits are subsidized from the general budget of the government. The benefit is flat rate to all, and the scheme is a defined-benefit scheme.

Due to the impact of the recent economic downturn, the National Pension is facing an issue of contribution evasion, especially among younger people. However, with the introduction of a multi-level premium exemption system in 2002, some subscribers can prepare for future pensions by using a partial waiver program. As a result, the average monthly pension benefit by the National Pension amounts to ¥54,612 in 2011, which is around 83% of the full amount. As the system becomes more mature, this amount may increase.

3.4.2 The Employees' Pension Insurance

The Employees' Pension Insurance forms the core of the income security for retirees. All workplaces with more than five employees and their employers are required to participate in this scheme. Both employers and employees contribute 7.5%[1] of employee's monthly salary as premiums (including a premium for the National Basic Pension), and the pension benefit is income-related. There is no discount system for low-income persons/household (or his/her employer), but employers of those who are on maternity leave (up to 1 year) are exempted from paying premiums[2].

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[1] The premium rate applies to monthly salary as well as bonus.
[2] Employees who are on maternity leave typically do not receive salary, except unemployment benefits (40% of their pay), and thus do not

The average monthly pension benefit by the Employees' Pension Insurance is about ¥149,334, which amounts to 49.0% of the average monthly salary of subscribers (2011).

3.4.3 National Pension Fund

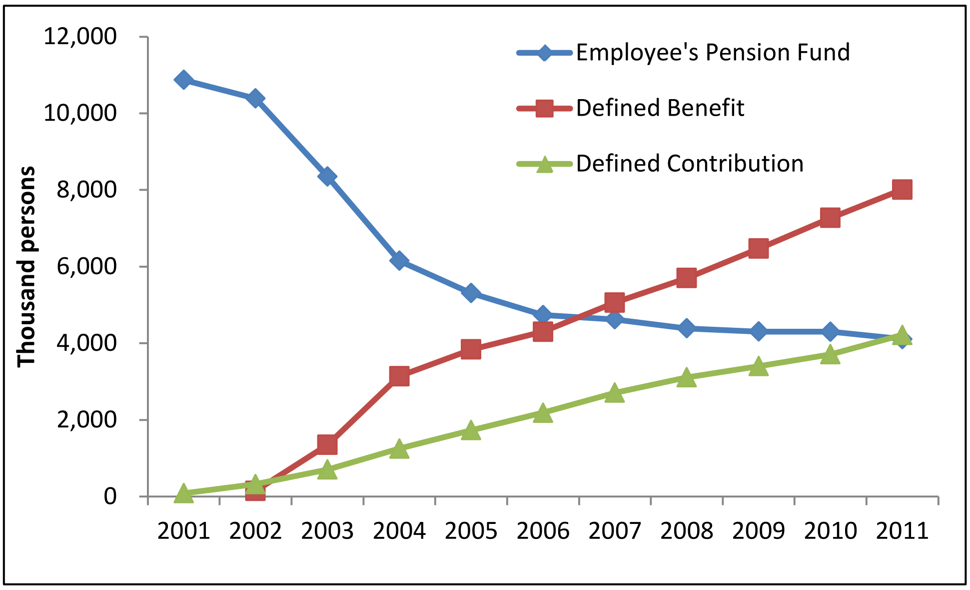
The National Pension Fund is an optional pension for the self-employed (Category No.1), and is designed to give additional pension coverage to the self-employed who do not have the third-tier pension (Employees' Pension Insurance). However, only about 3% (0.61 million) of Category No.1 subscribers (20 million) are currently subscribing to the Fund.

3.5 Pension system reforms

3.5.1 Change of third-tier pension schemes since 2000

In line with the introduction of international accounting standards in 2000, the third-tier pension schemes underwent a major reform. The Employees' Pension Fund was streamlined, and instead, the Defined-Benefit Corporate Pension (2001) and Defined Contribution Plan (2002) were newly established. The principal reason for the introduction of these schemes was to accurately reflect a firm's outstanding pension liabilities in the financial statements. The Defined Contribution Plan, in particular, facilitates the portability when changing jobs and responds to changes in the employment situation.

Figure 3.2 The transition of Employee's Pension Fund, Defined Benefit and Defined Contribution member



Source: The Data on Corporate Pensions (企業年金に関する資料), Pension Fund Association, 2012

As shown in Figure 3.2, the number of subscribers to the Defined-Benefit Corporate Pension and Defined Contribution Plan (corporate type) are on the increase, while that of the Employees' Pension Fund

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need to pay a premium. The duration of maternity leave is counted as insured months in calculating a benefit level.

has steadily been decreasing.

The defined-contribution (DC) pension schemes have two types: individual-based and corporation-based. The individual-based defined-contribution scheme is for self-employed persons (Category 1 subscribers) and is designed to give optional pension coverage to the self-employed. It is operated by the National Pension Fund Association, and its premium is paid by the subscribers themselves. The second type of the defined-contribution pension schemes, the corporation-based DC pension, is a type of corporate pensions. Corporations may provide this type of pensions to its employees. The premium is entirely borne by the employer.

Corporations welcomed the introduction of DC schemes and many have shifted from the Defined-benefit (DB) corporation pension to the DC corporate pension. This is because corporations are realizing a huge burden of future pension payments, which is now labeled as liabilities under the new accounting system. Suffering from low-returns on their funds, corporations are eager to convert their DB pension schemes to DC schemes, in which future payments are related to the investment performance of funds, as opposed to the current system in which future payments are fixed at the beginning.

However, in the UK, there was a noticeable trend to convert to DC schemes in recent years, by closing the DB plan and providing the DC plan to new subscribers. But because a DB scheme is of value to the employees, and could serve a firm to differentiate itself from others when hiring new employees, business owners are shifting to a stance to maintain the DB scheme while also pursuing a more economical approach. As shown in Table 3.1, the DB and DC schemes both have their advantages and disadvantages, and it is desirable for both management and labor to consider which to adopt.

Table 3.1 Comparison of Defined-Benefit (DB) and Defined-Contribution (DC) Plan Characteristics

	DB Plan	DC Plan	Dominant Plan
Investment Choices	Participants have no control over the investment of pension money.	Usually participants make their investment decisions	DC
Investment Risk	Participants do not need to bear investment risk.	Participants have to bear all investment risk.	DB
Investment Returns	Participants can only collect the benefits defined in the DB formula even if the investment has favorable returns.	Participants are entitled investment returns.	Not Clear
Termination Portability	Participants leaving their job forfeit future indexation of benefits already accrued.	Participants could rollover and keep investing investment savings.	DC
Incentives	Participants have greater incentive to sustain a high level of effort over the entire career in order to achieve high career-end salary.	Participants have less incentive over their entire life than in the DB plan since their DC benefits depend upon the wage trajectory over their entire life.	DB
Wage-Path Risk	Benefits tied to wage used in the formula, mostly the final wage.	Benefits tied to career average earnings.	Not Clear
Life Annuity	Usually offers life annuity with favorable mortality rates	Most DC plans' distribution is lump sum. Participants might face unfavorable mortality rate when purchasing annuity in market due to adverse selection problem.	DB

Source: Tongxuan (Stella) Yang(2005), "Understanding the Defined Benefit versus Defined Contribution Choice," Pension Research Council Working Paper, Pension Research Council

3.5.2　Consecutive pension reforms

Aggravated by rapid aging, a low rate of economic growth, and near-zero interest rates, the National Pension and the Employees' Pension Insurance are facing difficulty in securing enough funds to meet the future burden of pension benefits. Various reforms to guarantee the sustainability, including the cutting back of future benefits, raising of premiums, or raising the pensionable age had taken place in order not to put too much burden on the future generations.

Recent reforms were made in 2004, 2009, and 2012. The reform of 2004 was as follows,

〇Reviewing the benefit payment and contribution

(Introducing the insurance premium level fixation method and the macro-economy indexation, utilizing the pension reserve as resource funds, and raising the proportion funded by the national subsidy for the Basic Pension to 1/2. (* This will be implemented gradually as specified in the law.)

〇Reviewing the system of the Old-Age Pension for Active Workers

(Reviewing the system of the Old-Age Pension for Active Workers who are in their early 60s, introducing the system of delaying pensionable age for those who are 65 years or over, and adjusting the amount of benefit payment of the Old-Age Employees' Pension for those insured employees who are 70 years and older.)

〇Enhancing measures for the insured who engage in childcare

(Exempting premium payment for those who are on child-care leave and adjust the standard monthly remuneration during the childcare period)

〇Reviewing the Survivors' Pension system

〇Introducing the division of benefit payment and of the duration to be No.3 insured category in cases such as divorce.

Due to the political confusion, the reform of 2009 remained minimal and only the national subsidy proportion of the basic pension is raised to 1/2. Instead, the reform of 2012 was a major one and the contents were as follows,

Reform details	Implementation from
〇The minimum requirement period for the premium payment is reduced from 25 years to 10 years	Oct.. 2014
〇The national subsidy ratio is set permanently 1/2 for the basic pension	Apr. 2014
〇Expanding the application of Employees' Pension Insurance to part-time workers	Oct. 2016
〇Premiums are exempted during maternity leave	Apr. 2014
〇The survivor's basic pension is paid to the motherless family	Apr. 2014
〇The employee pensions(EPI, Mutual Aid Pensions) is made to be uniform one	Apr. 2015
〇The pensioner support benefit is paied to the lower pensioner	Apr. 2015

3.6 Current issues of pension system

3.6.1 Non-compliance and difficulties of the National Pension

As noted before, one of the biggest problems of the *National Pension* is that there are a growing number of eligible and required persons who have not paid the premium in full. According to the survey in 2009, as much as 0.33 million persons have not subscribed to the National (Basic) Pension at all. In addition, in 2009, the ratio of persons who fully paid the monthly premiums was only 60.0%. The unpaid premium is especially found among the younger generation. To raise the compliance, the government had put in place a mechanism to exempt paying premiums for low-income persons. In 2006, the four-level exemption status was introduced, where previously there were only two levels. However, the number of people fully exempted from premium payment reached 5.21 million, and partially exempted was 0.52 million people. Of these people, if we exclude students (1.65 million people) and the legally exempted such as the disabled (1.14 million people), about 11.9% of persons required to pay a premium are exempted, which is placing a heavy burden on National Pension finances. Every effort is being made at central, prefectural, and municipal government levels to increase the premium payment rate.

3.6.2 Financial pressure on corporations

At the same time, corporate pension schemes are also facing a number of problems. The first problem is financial. Not only did the continuing recession of the Japanese economy and a very low interest rate make it difficult for corporations to keep defined-benefit corporate pensions, but it has also made it difficult for some corporation to keep paying the employers' contribution for the Employees' Pension. It is required by law to participate in the Employees' Pension Insurance for corporations of certain sizes and over, but some corporations have taken a drastic measure to dissolve their Employees' Pension Insurance, and make their employees subscribe to the National Pension, which does not require employers to share a part of the premium.

3.6.3 Accommodating various employment arrangements and life-styles

As mentioned before, the traditional Japanese working pattern of life-long employment with a single employer has been gradually diminishing. Many people now switch jobs and thus their pension status; therefore, change over the life-course. The pattern is more evident among women who tend to leave and re-enter labor force during raising children. Thus, it is becoming increasing harder to put in the required payment period for pension premiums. For the National Pension, to get the full benefit, one has to pay the premium for 40 years, and the Employees' Pension Funds also have, albeit shorter, required premium paying periods. Many people, especially women, are unable to put in the required duration, and are not qualified to get the full amount.

There has been also a big shift of employment arrangements from full-time to part-time, especially among women workers. However, the Employees' Pension does not include part-time workers, and many women adjust their working style in order to remain as Category No.3 (dependent spouse of subscribers of Employees' Pension). The 2004 Reform did not actually implement measures to correct this, but it has mandated the government to review and take necessary action within five years.

The 2004 Reform implemented the following changes to accommodate the changing life-styles: 1) extending the period of premium exemption for those taking maternity or paternity leave from one year to three years, 2) making it possible to divide the pension benefit of the Employees' Pension between husband and wife if they divorce, and 3) putting a time limit of five years for survivor's pension benefit for widows (widowers) younger than 30 years old and with no children.

Currently, 83.9% of all Japanese corporations offer retirement packages for their employees. A retirement package can be either a one-time lump-sum retirement allowance, or a life-long or limited duration pension, or both. The breakdown shows 26.8% of corporations combine lump-sum payment and pension, 10.7% offer pension only, and 46.4% offer lump-sum payment only. Even though the pension is gradually spreading its share, the traditional style of the lump-sum allowance is still the mainstream, and most employees choose to take a part or the entire amount of the retirement money as the lump-sum payment. In any case, it will be important for the private and public sectors to work together to offer pension and retirement benefit schemes that respond to increasingly diverse lifestyles.

3.6.4 Pension system adaptation to the globalized world

Due to the increasing number of foreigners living and working in Japan, or Japanese abroad, the internationalization of the pension system is required. The minimum requirement period for the premium payment was shortened from 25 years to 10 years in August 2012. Also, Japan had concluded social security agreements with other countries with an aim to resolve issues related to dual-enrollment in social security systems and international calculation methods of pension enrollment period. Currently in 2013, Japan has signed the social security agreement with 17 countries and is under negotiation or preparing to begin negotiation with 8 countries, as listed in Table 3.2. The number of countries entering the agreement is expected to increase in line with developments in the economy, globalization, and implementation of social security systems in developing countries.

Table 3.2 Status of International Social Security Agreements

Implemented	Germany, U.K., Republic of Korea, U.S.A., Belgium, France, Canada, Australia, Netherlands, Czech Republic, Spain, Ireland, Brazil, Switzerland
Signed	Italy, India, Hungary
Under negotiation	Luxembourg, Sweden, China, Philippines
Under preparatory negotiation	Austria, Turkey, Slovakia, Finland

Source: Ministry of Health, Labour and Welfare website at;
http://www.mhlw.go.jp/topics/bukyoku/nenkin/nenkin/image-shakaihoshou-gaiyou4.html accessed 25 Nov.2013

Source for Table 3.3 (next page)
The Data on Corporate Pensions (企業年金に関する資料), Pension Fund Association, 2012
Web-site of Ministry of Health, Labour and Welfare (MHLW)
http://www.mhlw.go.jp/topics/nenkin/zaisei/01/01-01.html in Japanese Access Aug. 25th 2013

Table 3.3 Outline of the public pension system in Japan

(All numbers are as of 2011, unless otherwise noted)

	Note	Public Pension: Basic Pension	Public Pension: Employees' Pension Insurance	Public Pension: Mutual Aid Pension	Semi-Private Pension: Employees' Pension Funds	Semi-Private Pension: National Pension Funds
Type of Insurance		Basic 1st Tier Mandatory	Supplemental 2nd Tier Mandatory	Supplemental 1/2/3 Tier Combined Mandatory	Supplemental 3rd Tier Optional	Supplemental 3rd Tier Optional
Insurer		Government	Government	Mutual Aid Associations	Employers of more than 500 employees	Government
Eligible persons	①	All residents (categories 1-3)	Category 2 private-sector workers under 65 who work at workplaces with more than 5 employees	National and local civil servants, teachers, etc.	Employees of above	Category 1
Number of subscribers (millions)	②	72.72	34.41	4.44	4.11	0.61
% to all residents(20-59years)	②/pop	90%	43%	6%	6%	1%
Number of current pension recipients	③	69.43	31.98	4.29	2.68	0.42
% to all subscribers	③/②	95%	93%	97%	65%	69%
Premium Type		Flat rate	Fixed % of salary	Fixed % of salary	Fixed % of salary	Subscriber's choice
Average contribution (% to total salary) Employee		--	7.50%	6.04～7.754%	1.2 ～ 2.5%	--
Employer		None	7.50%	6.04～7.754%	1.2 ～ 2.5%	None
Average contribtion (¥)	⑤	¥15,020(for Category 1 & 2),¥0 (Cat.3)	(including premium for National Pension)	(including premium for National Pension)		¥5,500～¥16,910
Average monthly salary of subscribers	⑥	Not Available	¥304,589	¥415,227		Not Available
Tax exemption Employee		Exempt	Exempt	Exempt	Exempt	Exempt up to ¥68,000
Employer		Exempt	Exempt	Exempt	Exempt	
% of subscribers exempt from paying premium		16.8%	0%	0%		
Benefit (Old Age) Type		Flat rate	Income-related	Income-related	Income-related	Premium-related
Calculation method		\792,100 x ((insured months + 1/2 x exempt months)/480)	(Monthly income * 0.55% * insured months * slide rate)+ dependants allowance	(Monthly income * 0.55% * insured months* slide rate)+ dependants allowance	Average monthly salary during insured months * fixed rate + alpha	Depending on premium & age at the time of entry
Average monthly benefits	⑦	¥54,612	¥149,334	¥264,011	¥40,658	
Replacement ratio (average)	⑦/⑥	Not available	49.0%	64%	Not available	Not available
Starting age	years	65	65	65	65	65
Benefits (Disability) Type		Flat rate	Income-related	Income-related		
Calculation method		¥990,100 (1st degree) or ¥792,100 (2nd degree) + dependents allowance	1st degree old age pension * 1.25 + dependents allowance, 2nd degree: old age pension + dependents allowance, 3rd degree: old age pension	1st degree old age pension * 1.25 + dependents allowance, 2nd degree: old age pension + dependents allowance, 3rd degree: old age pension		
Average monthly benefits		¥73,882	¥100,139			
Benefits (Widow/Widower) Type		Flat rate	Income-related	Income-related		
Calculation method		¥792,100+ children allowance for wives w/children	3/4 of old age pension for spouse or close family	3/4 of old age pension for spouse or close family		
Average monthly benefits		¥64,927	¥73,490			