

## **Pension Reforms toward an Aging Society**

**Atsushi SEIKE**

### **1. Introduction**

An aging population is, needless to say, a common phenomenon among the world's advanced countries. Among the problems an aging population poses, the financing of public pensions is one of the most difficult with which to cope.

Under the pay-as-you-go system, which is widely employed by most public pension schemes in advanced countries, an increase in the older benefits-receiving population coupled with a decrease in the younger premium-paying population has in itself worsened the financial situation of public pensions. Of course, while a fundamental solution to this problem would be for a country to transform its pension scheme from a pay-as-you-go system to a fully funded system, a complete transformation to a fully funded system would be very difficult to achieve because of serious obstacles including the so-called double burden problem. As advanced countries already have matured pension schemes, there is a need to improve the financial situation of public pensions through the use of the existing pay-as-you-go system, although public pension funds can also be increased to some extent and this system can be partially privatized.

One solution under the pay-as-you-go system to improving the financial situation of public pensions would be to increase premiums. Increasing the premium, however, will decrease the living conditions of the working generations and increase the labor costs of employers.

Another possible solution is to reduce the level of pension benefits, which is what the Japanese government decided when it reduced future benefits in a revision of the public pension law in 2000. A drastic reduction in benefits, however, would lower the living standard of retired people, which would be inconsistent with the basic value in advanced countries of the right to a stable retirement.

It is an undeniable fact that every time population projections have changed in Japan, public pension schemes have also been revised so as to raise premiums

and lower benefits. This has led to public skepticism over the veracity of these schemes, and hence, more positive solutions are now required to ensure the sustainability of public pension schemes.

One noteworthy scenario for coping with the financial situation problem of pensions is to allow older people who are willing and able to work to continue doing so beyond the current retirement age. By working later into life, older people would continue to be both tax and premium payers and this would significantly improve the financial situation of public pension systems. Such a scheme is underpinned by an "age-free active" scenario, whereby many older people contribute to support an aging society.

Based on the tenets of such a concept, Japan, the U.S. and several European countries are now trying to promote the employment of older people. Japan, in particular, has a great advantage in promoting the employment of older people given their intrinsically high motivation to participate in the labor force. With this high level of motivation, Japan is considered to be the most promising country to develop an age-free active society<sup>1</sup>.

The purpose of this paper is to explore the possibility of an age-free active society in connection with pension reform. In the process, it will examine the inherent influences of pension schemes that could pose obstacles to promoting the employment of older people. Finally, this paper will offer some policy proposals on pension reform toward the establishment of an age-free active society.

### **2. Pension Reform and Employment Policy toward Promoting the Employment of Older People**

The pension scheme and employment situation of older people are closely related. In particular, this is because the context in which the government regards the public pension system to have an effect on retirement induce-

ment influences the employment situation of older people.

The directions of pension reform and employment policy for older people have been observed in the U.S. and Europe. In the late 1970s and the 1980s, European countries had policies that discouraged older people from continuing to work in favor of providing more job opportunities for younger people. By increasing early retirement and disability benefits, pension schemes were reformed to encourage the early retirement of older workers during that period. Partly as a result of that policy, however, the ratio of older worker participation in the labor force in Europe has declined to significantly lower levels than in Japan and the U.S.<sup>2</sup>

Yet, even in Europe, there is of late a growing interest in promoting the employment of older people as a means to cope with a substantially aging populations. European pension policies were changed in the 1990s to encourage, not discourage, participation in the labor force by older people, and some European countries are now also considering raising the age of eligibility for pension benefits and reducing these benefits.

Regarding employment policy, the German government has, for example, implemented a new policy package called "Campaign 50 Plus," which provides wage subsidies to employers who employ people over age 50 and assists the retraining of such workers. The Netherlands' employment policy promotes part-time jobs as a means to expand job opportunities, including those for older people. It is apparent from such examples that European countries have begun moving towards the promotion of employment for older people.

The U.S. government, on the other hand, has had a policy to promote the employment of older people for several decades. The policy's most salient aspect was the Age Discrimination in Employment Act, which was first enacted in 1967 and then amended in 1978 and 1986. The law first addressed age discrimination against people up to age 65. The age limit was raised to 70 in the first amendment and then lifted altogether in the second amendment. This has created an employment environment in the U.S. where, with few exceptions, there is no mandatory retirement age nor age limits in hiring.

With regard to public pensions, called social security in the U.S., the U.S. government eliminated one work-d discouraging effect associated with its pension system in January 2001. It did this by ending its "earnings test" scheme for social security eligibility so as to remove the negative effect it had on the labor supply of pension-

eligible people. This earnings test scheme was considered to have discouraged pension-eligible people from working or induced them to reduce their working hours. This problem attracted particular attention in the U.S. where there has been much discussion on the introduction of the so-called negative income tax to avoid the work discouraging effect of income maintenance programs, which have an effect similar to that of the social security earnings test.

In Japan, there has been a higher motivation among older people to work, as shown in the country's labor force participation rate. Government policies have acted to expand job opportunities for older people, making full utilization of their motivation. The main measures taken have been to lift the mandatory retirement age and to promote the rehiring, by the same employer, of workers who were subject to mandatory retirement. The law that has played the central role in this area is the Employment Stabilization Act for the Elderly, which was first enacted in 1986 and has since been amended several times. Mandatory retirement under the age of 60 is illegal under the Act's 1998 amendment, which by lifting the mandatory retirement age and other measures prompts employers to continue employing workers up to age 65.

Thus, the advanced countries of Europe and North America, as well as Japan, are all adopting policies to promote the employment of older people. At least in general terms, a consensus now appears to be forming on the creation of an age-free active society. The problems, however, are in the details, particularly obstacles contained in public pension schemes.

### **3. The Impact of Public Pension on the Labor Supply of Older People**

Public pension benefits act to reduce the labor supply of pension-eligible older people. Table 1 shows the labor supply elasticity of public pensions among Japanese men aged 60 to 69 in the 1980s and 1990s. The coefficients representing elasticity have constantly been estimated as negative to a statistically significant degree.

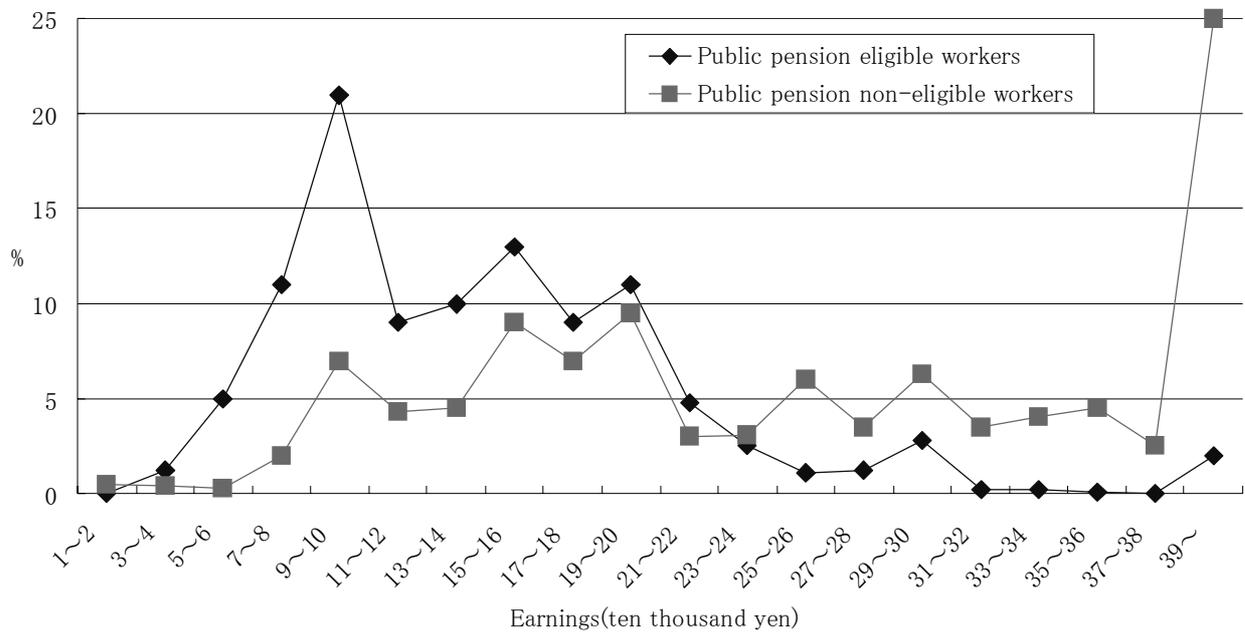
There are two ways that public pension schemes lead to a reduction in labor supply. One is the income effect. Pension-eligible older people are able to retire upon their pension benefit, which they receive as non-earned income. The other is the effect of the earnings test of public pension schemes. Under it, pension benefits may be reduced or stopped according to the level of

Table 1. The Negative Effect of Public Pension Benefits  
on Labor Force Participation  
(Japanese Men aged 60-69 in 1980s and 1990s)

year	elasticity
1980	-0.2580
1983	-0.2800
1988	-0.4348
1992	-0.4240
1996	-0.4364

Source: Seike and Suga (2001)

Figure 1. Earnings Distribution for Public Pension Eligible Workers and Non-eligible Workers



Source: Seike(1995)

earnings by pension-eligible people who continue to work and earn income. Consequently, pension-eligible workers tend to reduce their labor supply to avoid having their benefits reduced or cut. Of these two effects, the income effect has an impact on pension-eligible people irrespective of the type of public pension scheme.

With regard to the earnings test on pension benefits, it poses a problem because it levies a kind of penalty on the work of pension-eligible people. Figure 1 shows the effect of the earnings test on labor supply by observing the earnings distribution of Japanese workers eligible to collect public pension benefits in 1992. Though the earnings test scheme has changed several times, its effect on the labor supply of older people was most clearly

observed in the early 1990s when pension-eligible workers were eligible to receive 80% of their full benefit if their monthly earnings were lower than 95,000 yen.

As seen in the figure, a quarter of pension-eligible people work just to the point where their monthly earnings are about 95,000 yen, while people who are not eligible for public pensions do not show such an earnings distribution. Hence many pension-eligible workers reduce their labor supply so as to not exceed the earnings test ceiling and remain eligible to receive 80% of their pension benefit.

In addition to the negative impact of public pension schemes on the labor supply of pension-eligible

people, these schemes can also obstruct the full utilization of the skills and abilities of these older workers. That is, they may affect whether the person is able to continue working in the same occupation.

Although there is not a single clear index that shows the degree of utilization of human capital, if an older worker continues working in the same occupation as his/her career job, his/her ability would be rightly utilized. Figure 2 shows the ratio of workers aged 60 to 69 working in the same occupation as they had been at age 55, or in other words, in fields that can be regarded as the occupations in which they accumulated their career. Because the possibility of working in the same occupation correlates to mandatory retirement experience and there is high correlation between public pension eligibility and mandatory retirement experience, the observation sample is divided between those with mandatory retirement experience and those without it. In both cases, workers who receive public pension benefits have a statistically lower possibility of being in the same occupation as they were at age 55. This result means that pension eligible workers in their 60s have a lower possibility of being in a workplace where their abilities are fully utilized.

#### 4. Policy Proposals

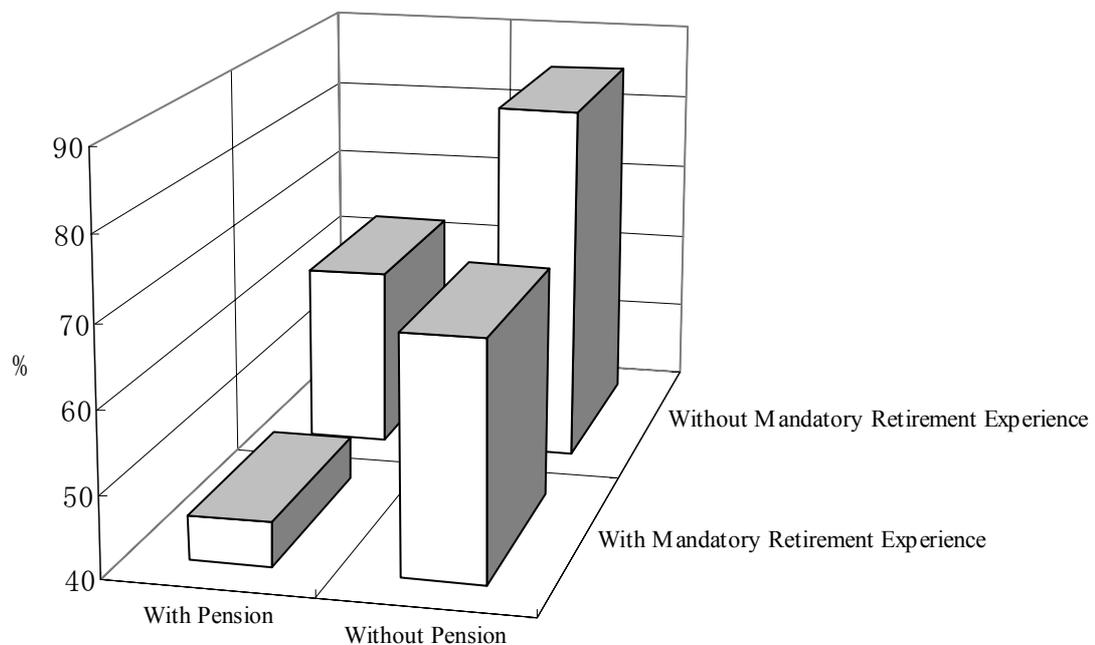
With respect to the above discussion, it is useful to make policy proposals on pension reform in regard to establishing an "age-free active society."

Proposal: "Reform public pension schemes in such a way that they do not discourage older people from continuing to work."

Because public pensions affect income in a way that induces retirement, it is important to raise the pension eligibility age so as to avoid the effect of discouraging continued work. In fact, governments in Europe, the U.S. and Japan have already started in this direction, though it will be necessary for them to accelerate the timing of their reforms and to reconsider their final target age for pension eligibility. Of course, in raising the pension eligibility age on the one hand, it will, on the other, be necessary to guarantee the right to receive an early but reduced pension for those who want to retire before reaching the eligibility age for full benefits.

To avoid the discouraging effect of the earnings

Figure 2. Proportions of Workers Who have the Same Occupations as at the Age 55: by Pension Status and Mandatory Retirement Experience



Source: Seike and Yamada (1998)

test on the labor supply of pension-eligible people, it will be necessary to revise the earnings test on public pensions substantially. While sustaining the public pension system requires promoting the employment of older people, it is inconsistent for the public pension scheme itself to discourage older people's participation in the labor market. As the U.S. government has done, the earnings test should be eventually eliminated, as should the favorable treatment of pension benefits be abolished in the income tax system. Income redistribution from older people with high earnings to others should be done through the taxation system rather than through the pension system.

### Notes

<sup>1</sup> For details, see Seike (2001).

<sup>2</sup> For example, the labor force participation rate in the early 1960s was 75% for Japanese men, 40% for Japanese women; 55% for U.S. men and 39% for U.S. women; 30% for German men, 12% for German women; and 17% for French men, 16% for French women.

### References

- Seike, A. (1995) "The Impact of the Earnings Test," in the Report on the Analysis of Utilization of Human Capital and Structural Change in the Labor Market, Japan Center for Economic Research.
- Seike, A. and Yamada, A. (1998) "The Impact of Mandatory Retirement and the Public Pension System on Human Capital Loss," *The Economic Analysis*, No. 155, Economic Research Institute, Economic Planning Agency.
- Seike, A. (2001) "Beyond Lifetime Employment." *The Geneva Papers*, Vol.26 No.4, October 2001.
- Seike, A. and Suga, M. (2001) "An Analysis of the Impact of the Employees' Public Pension on the Labor Supply of Older Men by the Employment Status Survey of the Elderly in 1988, 1992 and 1996." a paper for the Labor Market Committee of the Statistical Research Institute.

Atsushi SEIKE  
(Keio University)