

## Pension Reforms in the UK: implications for Japan

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### Abstract

Japanese public pension system confront at least three problems, 1) fiscal imbalance of the system, 2) inequality of pensioner's income distribution and 3) distrust of the public in the system. Although further verification is required for the UK system, there are plenty to be gained in studying reform efforts of the UK system. The UK public pension policy is weighted on improving the low incomes pension and aims to cut its own responsibility for middle and high incomes persons. This policy would lead to low-level pension expenditure in the long run, and succeed to make the public pension system neutral from income distribution. As for Japan, the lack of the special pension scheme for low incomes persons is a problem. If Japan would introduce special schemes or modify the current Basic Pension in order to improve the low income pensioners' condition, the income distribution would be more equal. Fiscal imbalance in the long run is a big issue in Japan. Cutting the government responsibility for the middle and high incomes might be acceptable in Japan. Then, it is necessary to improve financial market stability for the occupational and the private pension. Particularly, educations for investing, governance systems on fiscal market and establishing the pensioner's rights are important. In any case, if long run stability of fiscal balance is to be secured and low incomes pension is to be maintained, the reliance on the public pension system would be recovered in Japan.

### 1. Introduction

In 1998, Green Paper *A new contract for welfare: partnership in pensions* was issued by the Labour Government. This Green Paper is the base of the recent UK pension reform. The new proposals are

- A) help people make better informed choices regarding their retirement;
- B) reaffirm the role and responsibilities of employers in the pensions partnership, improve saving through the workplace, and provide greater protection for members of occupational schemes;
- C) encourage simple and flexible savings products, broadening access to the financial services industry; and

D) introduce measures to extend working lives.

With regard to A) and B), the UK Government replaced the State Earnings-Related Pension Scheme (SERPS) with the State Second Pension (S2P) to provide more generous pensions to those with low and moderate incomes, and for the first time, to provide a second pension to many carers and people with disabilities. Further, with regard to B) and C), the UK Government introduced stakeholder pensions that provide a good value, simple, and flexible vehicle for saving for retirement. The UK Government also reformed the regulatory framework for saving, replacing ten regulators with a single one—the Financial Services Authority (FSA)—enabling consumers to save with more confidence. Finally, with regard to D), the pension age was raised to 65 (In 2015 women's pension age was raised the same age 65). As a result, the UK Government's future pension expenditure understates and is sustainable in terms of cost. In 2050, state spending on pension for UK, Japan, Italy, and the US will be 4.1percent, 16.5percent, 20.3percent, and 7.0percent of GDP, respectively (Disney et al., 2003). However, promoting occupational and private pension scheme has widened the gap between the rich and the poor. In 2003, the richest pensioner's occupational pension benefit was ten times that of the poorest pensioner's benefit in the UK.

Japan also continues to reform its schemes in the public pension field. In Japan, the segment of aged population is growing rapidly and pension cost is becoming very high. In addition, most of the elderly rely on public pension, which uses both price and earnings indexation and the weak financial market cannot raise sufficient occupational and individual annuity. Therefore, Japanese reform style involves slashing the benefit rate and raising the contribution fee, i.e., is called as parametric reform. This type of reform repeats every reform time, hence, many individuals are tired of the system and do not want to pay their pension contribution. A bill has passed in the Japanese Diet in June 2004, with reforms aimed at saving the pension system from collapsing, by gradually increasing contribution rate through the next 13 years (from 13.58percent to 18.3percent of salaries), while reducing the model<sup>1</sup> household's

replacement ratio from 59.3percent to 50.2percent in 2023. In the public pension field, the contribution rate is increasing and the benefit level is decreasing every year to maintain fiscal balance. These reform ideas are not the appropriate solutions for the problems of Japanese public pension schemes.

As for Japanese occupational pension field, on June 22, 2001, the Japanese Diet passed the significant defined contribution (DC) pension legislation. The new laws allow Japanese companies to adopt DC schemes (company schemes) similar to 401(k)<sup>2</sup> schemes in the US. The new law also allows individuals who are either self-employed or employed but not covered by any pension plan at work to make contributions to schemes (individual schemes) similar to those available in the US. The existing corporate pension system in Japan had not sufficiently permeated to small-to-medium-sized enterprises (SMEs) and entrepreneurs. Further, in the event of a job change, the pension assets and transfer of those assets were not sufficiently secured, resulting in an impediment to labor mobility. Therefore, the introduction of the DC type pension scheme was necessary. To be sure, DC type occupational pension is able to ease pension cost typically in corporate account. And, if middle or high income group would prefer to occupational pension, Japanese government could cut their earnings-related part of pension and Japanese pension expenditure would be modest. As Japanese DC schemes are new systems, it is too early to estimate the effects of introducing new DC plan to ease pension expenditure.

The purposes of this paper are to review recent UK pension reforms, to clarify the difference between the UK and Japanese reforms, and finally to make suggestions for the reform discussions of the Japanese Employee's Pension Insurance (EPI<sup>3</sup>).

## **2. Brief framework of the UK pension scheme and reform**

This section briefly outlines the current UK pension system and the reforms made over the last 20 years. A more detailed description can be found in Budd and Campbell (1998), Banks and Emmerson (2000), and Emmerson and Johnson (2001), among others.

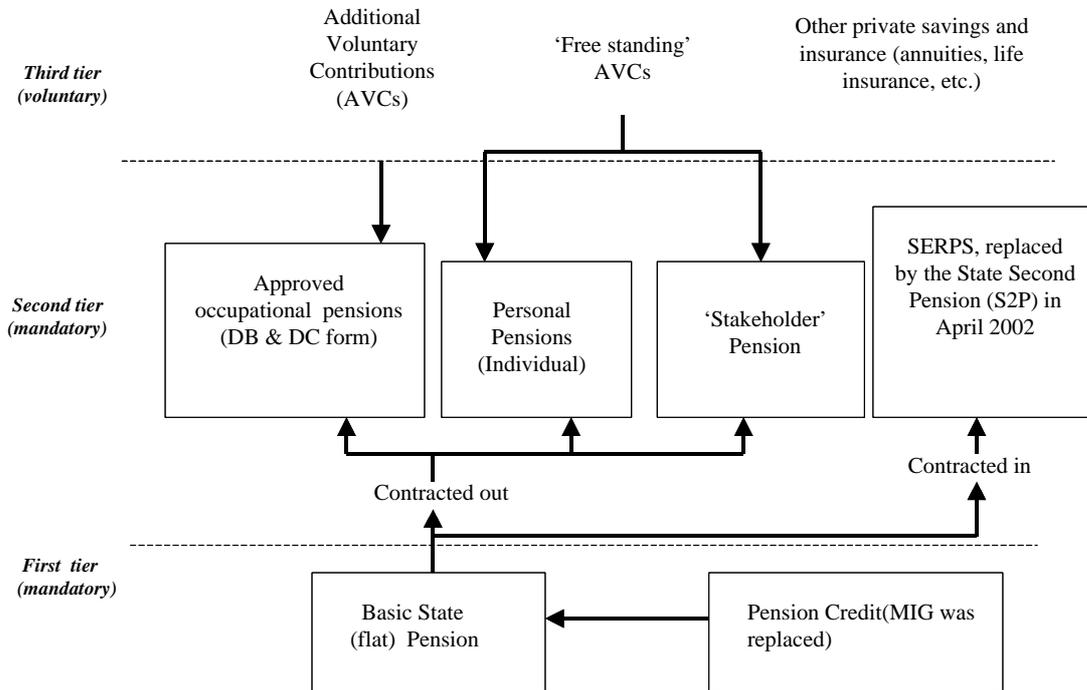
**Figure1** provides a diagrammatic representation of the current UK pension system. The UK pension system is split into three pillars. The first is provided by the state, and consists of the Basic State Pension and a significant means-tested (non-contributory) benefits area. The Basic State Pension is a flat contributory benefit that is financed on social security tax and a

pay-as-you-go (PAYG) basis. The Basic State Pension in 2002-03 will be worth £72.50 a week for a single pensioner<sup>4</sup>, which is about 15percent of average male earnings. This is down from around 20percent of average earnings in the early 1980s, which is a result of the broad increase in the Basic State Pension in line with price inflation since 1981, while average earnings have grown in real terms (GAD, 2002).

Low incomes are eligible for the Minimum Income Guarantee (MIG), which will be worth £92.15 a week for a single pensioner in 2002-03, nearly £20 more than the Basic State Pension<sup>5</sup>. In addition, pensioners with low incomes may be eligible for housing benefit and council tax benefit, which are means-tested benefits designed to provide assistance toward housing costs and local taxes, respectively. In 2002-03, approximately 21percent pensioner couples and 47percent single pensioners were recipients of means-tested benefits<sup>6</sup>. Government policy is to continue increasing the Basic State Pension in line with prices, while increasing the MIG in line with average earnings. Since the MIG is withdrawn at a rate of 100percent, those with small amounts of income are left no better off than those with small amounts of income from savings. Therefore, from April 2003, the government has introduced a new "pension credit" for those with low incomes. The social security system is financed on a PAYG basis. There are no schemes to pre-fund social security, other than through the indirect route of contracting-out. The Basic State Pension and SERPS are financed from an earmarked payroll tax, the National Insurance Contribution, notionally levied on employees up to an earnings ceiling, and on employers without an earnings ceiling. In addition, income-tested benefits are funded by general tax.

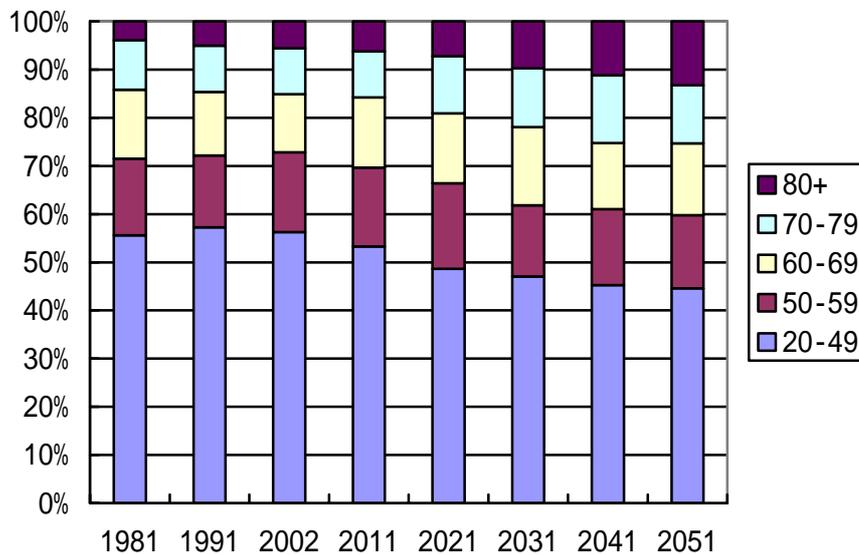
In the second pillar of mandatory pension, provision is split between state provision in the form of SERPS and private pension provision in the form of occupational or personal pensions. The original SERPS scheme was introduced in 1978. This scheme paid individuals 1/4 of their earnings between a lower and upper limit from the best 20 years of their lifetime. Earnings were to be appraised to retirement age by growth in average earnings, with payments during retirement then being indexed to prices. The Social Security Act of 1986 reduced the generosity of SERPS by lowering the payments to 20percent of individual average earnings, with the average now to be calculated over their entire lifetime, rather than their best 20 years.

Figure 1 Scheme of the UK pension system, 2003.



Source) Disney R., Carl E., and Matthew W. (2001), modified by the author

Figure 2 Population Projections in the UK



Source) <http://www.gad.gov.uk>

Many Individuals were able to contract out of SERPS into an employer's occupational pension scheme as long as it guaranteed a retirement income at least as

high as SERPS. Hence, these schemes had to operate on a defined benefit (DB) basis. In return for "opting-out," both the employee and employer paid a

lower rate of National Insurance Contribution. The 1986 Social Security Act took the principle of “opting out” further by allowing individuals to choose to contract out of SERPS into a defined contribution pension scheme. In return, the government contributed a part of an individual’s National Insurance Contribution into their pension fund. SERPS was replaced by the S2P that is a top up to the Basic State Pension, and hence, more redistributive toward those with lower incomes (see detail in Section 4.1). In addition, the government is introducing a “stakeholder pension,” which is essentially a personal pension with a heavily regulated charging structure, including an overall cap on charges. (Emmerson and Tanner, 2000). It is true the UK government is promoting occupational and private pension system and maintains adequate level of private pension. For promoting occupational and private pension, the UK government sets up financial stability and establish the beneficiary right. On this point, we could learn from the UK pension system. After the Maxwell Scandal,

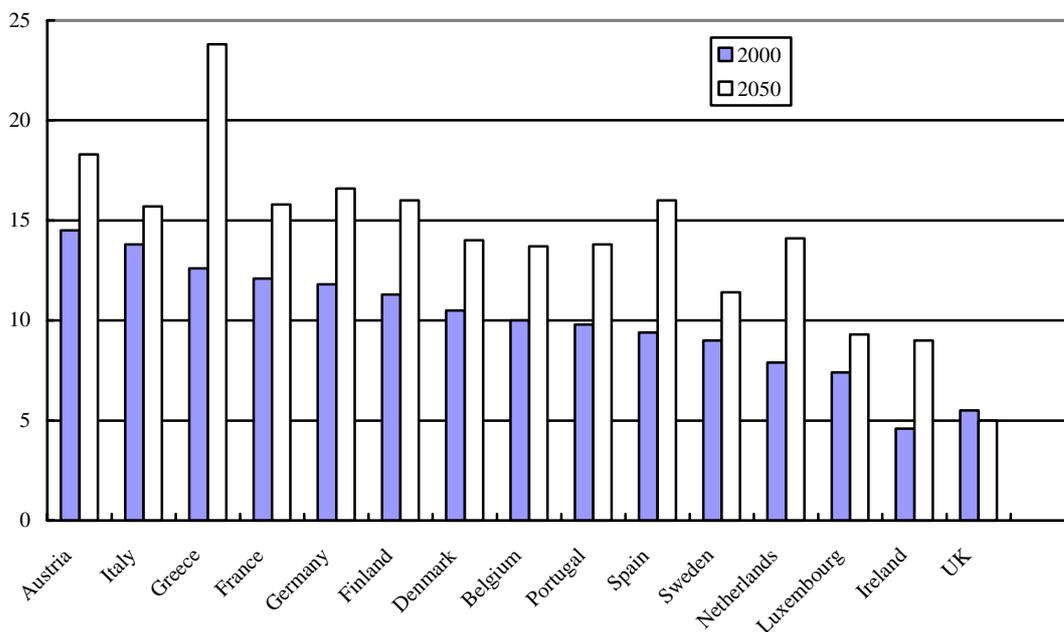
the British may be nervous regarding compensation of the right of pension receipt and payment guarantee schemes. Therefore, in 2002, the UK Government published a Green Paper on pensions (DWP, 2002). The 176-page document proposed a series of reforms to the existing system (detail in section 5).

### 3. Reform impacts

#### 3.1 Impacts on Cost Projection

Many projections point out that the UK exhibits a slower aging rate than most OECD countries. The old-age dependency ratio, i.e., the number of people aged at least 65 relative to the working-age population (defined here as being between 20 and 64), is projected to be slightly more than double over the next half century. The recent projection for the UK old-age dependency ratio<sup>7</sup> is 45.3 (current 26.6) by 2050 in **Figure2**, lower than most OECD countries (e.g., Japan, 27.7 to 64.6; Germany, 26.6 to 53.2; and Italy, 28.8 to 66.8<sup>8</sup>).

Figure 3 Projected public pension costs across Europe in 2000 and 2050



Source) Economic Policy Committee (2001)

The extent to which population aging is “healthy” or “unhealthy” will be a major determinant of the future demands placed on the National Health Service (NHS) and the demand for long-term care. Emmerson, Frayne, and Goodman (2000) suggests

that the increase in demands on the NHS over the next 50 years due to changing demographics may be of approximately the same magnitude as the increase witnessed over the last 50 years. In the future, whether the number of old age is healthy or unhealthy

will also have implications for the number of recipients of disability benefits. In contrast with education spending, the effect of demographics is actually likely to reduce the pressure on the government (HM Treasury, 1999). According to the UK Government's principal state pension projection, pension expenditure as a percentage of GDP was 6.2percent in 2001-02, and as a percentage of

projected GDP, will be 5.1percent in 2040-41, and 5.4percent in 2060-61<sup>9</sup>. In Japan, only the EPI expenditure as a percentage of GDP was 4.4 in 2001, and as a percentage of projected GDP, will be 9.0 in 2040 (Fukawa and Yamamoto, 2003). As shown in **Figure3** the UK state pension is financially sustainable. Therefore, tax increases are not required, in contrast with the rest of the EU.

**Table 1 Forecast of the state expenditures on pensioners: 2000 to 2050**

	2000	2010	2020	2030	2040	2050
Basic State Pension (£ billion)	34.4	38	41.3	49.4	52.8	51.2
SERPS/S2P (£ billion)	4.9	9.5	12.8	17.8	22.5	30.2
Total State Pension (£ billion)	39.3	47.5	54.1	67.2	75.3	81.4
Total National Insurance Expenditure (% of GDP)	5.4	5.5	5.4	5.6	5.3	4.9
Required NIC rate (%) (Employers and employees)	20.2	19	18.2	19.2	18.5	17.7
GDP spending per pensioner (1999-2000 = 100)	98.7	92.2	88.1	78.8	70.7	68.3

Source: Government Actuary's Department (1999; 2000)<sup>10</sup>

**Table 2 Selected benefit expenditures by age-based client group, 2001-03 (in real terms)**

	2001-02		2002-03	
	£bn	%ofGDP	£bn	%ofGDP
Contribution-based	45,635	4.6	46,786	4.5
Minimum Income Guarantee	4,798	0.5	4,633	0.4
Housing Benefit	4,757	0.5	4,939	0.5
Attendance Allowance	3,394	0.3	3,418	0.3
Disability Living Allowance	7,148	0.7	7,416	0.7
Winter Fuel Payments	1,825	0.2	1,788	0.2
Council Tax Benefit	1,272	0.1	1,365	0.1
Over-75 TV License	396	0	405	0
Total Retirement Pension	69,225	7	70,750	6.8
Total G.B. benefit expenditure	115,885	11.7	115,974	11.1
GDP <sup>11</sup>	994,037		1,043,306	

Source) DWP (2004a)<sup>12</sup>

Despite the forecasted population aging, spending as a share of national income is expected to remain relatively stable over the next 40 years, while National Insurance Contribution rates should actually be able to fall. This is shown in **Table1** and is due to the assumed indexing of the Basic State Pension to prices (which rise more slowly than national income), the planned increase in the state pension age of women, and two reforms of SERPS. The reforms

substantially reduced SERP's future generosity, and hence, the expenditure on it. The Basic State Pension, worth £75.50 in 2002-03, would have been worth slightly over £100 a week, had it been indexed to earnings since 1981-82. While the Basic State Pension is forecasted to cost £51.2billion in 2050, this cost would more than double (approximately £108.8bn) if it were continually increased in line with earnings instead of prices.

There are several reasons why the figures

presented in **Table1** understate Government expenditure on future generations of pensioners. First, the National Insurance rebates that are paid to individuals who have chosen to “contract out” of SERPS or the S2P. In the past, these have been more generous than would have been required to provide an incentive for individuals to “contract out” of the state scheme. In part, this reflected the drive to move toward privatization of a part of the second tier of pension coverage. According to Disney et al., 2003,

*“The cost of reduced National Insurance Contributions, after netting off the reduced entitlement to SERPS, was £5.9bn for the period 1988 to 1993. In 1999–2000 National Insurance Contributions were £8.8bn (1.0percent of GDP) lower than they would have been in the absence of the contracting out arrangements. This is equivalent to between a 2½ and 3 percentage point increase in the NI Contribution rate.”*

**Table 3 Comparison of pensioner’s income**

	UK		Japan	
	£ pw	%	10,000py	%
Total income	358	100.0	328.9	100.0
Benefit Income	154	43.0	203.3	61.8
Occupational Pension	111	31.0	4.7	1.4
Investment Income	52	14.5	24	7.3
Earnings	38	10.6	91	27.7
Other Income	3	0.8	5.8	1.8

Source) UK:Pensioners’ Incomes Series 2002–03. Japan:Report on Comprehensive Survey of Living Condition of the People on Health and Welfare, 2000

Second, these estimates have forecasting errors. In the past, these have tended to underestimate future numbers of pensioners due to an underestimation of future improvements in mortality (Disney, 1998) and decreasing TFR. For example, the 1996 population projection published by the Government Actuary’s Department forecasted that there would be 8.2 million people aged over 75 in 2051, while just two years later it forecasted a figure of 8.7 million (Emmerson, Frayne, and Goodman, 2000).

Third, the Government Actuary’s projections, shown in **Table1**, do not include the cost of means-tested benefit and other (non-means-tested) benefits that go to pensioners. **Table2** shows that a total of £69.3bn (7.0percent of GDP) is spent on benefits to those above working age, of which only £45.6bn (4.6percent of GDP) was spent on the retirement pension schemes in 2001–02. Other than these, the biggest items were expenditure on the MIG (£4.8bn) and housing benefit (£4.8bn). How these expenditures change in future will depend on whether the Government’s aspiration to increase the MIG in line with earnings is fulfilled and on the private incomes of future generations of pensioners. The

latter will depend on the amount these individuals save for their retirement and the return that they receive on those funds.

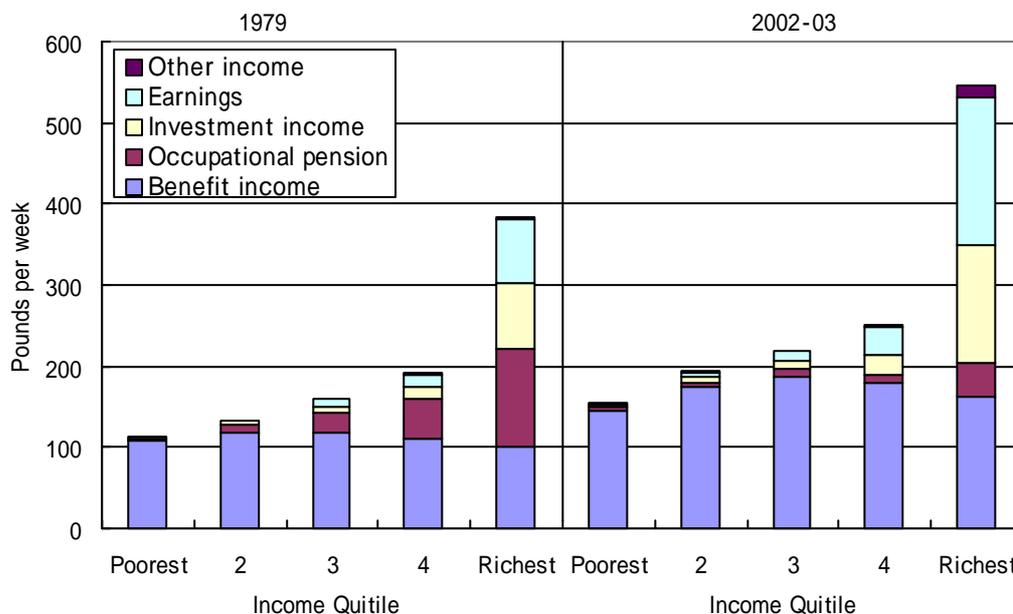
### 3.2 Impacts on Income distribution

Over the last 15 years, UK Government have embarked on a series of pension scheme reforms, privatizing reforms, designed both to reduce the prospective costs of social security and to permit more flexibility and individual choice in secondary pension provision. For this purpose, “contracting-out,” which was originally introduced in 1978 as a means of integrating existing occupational pension schemes into the new SERPS, has been modified. In short, contracting-out means that employers and employees obtain part of their social security pension through a private pension fund instead of the state. In compensation for establishing a private arrangement, employers and employees pay a

lower National Insurance Contribution (similar to a payroll tax). Under the 1978 arrangements, individuals could only opt out of a part of the social security

pension, SERPS, if they worked for an employer who provided an approved DB occupational pension scheme.

Figure 4 Components of gross weekly income of each quintile of the pensioner couples income distribution, 1979 and 2002-03: July 2003 prices



Source) Pensioners' Income Series 1979 and 2002-03, Department of Work and Pension

Table 3 displays the pensioner income of the UK and Japan. As a result of the UK pension reform, the value of the UK occupational pension unit is greater than that of Japan. Further, the UK reform has impacted income distribution, typically that of low incomes. The presence of greater contracting-out might be expected to lead to greater inequality for two reasons. First, private pension incomes may be more volatile than state incomes. Second, in the 1980s and 1990s, average private pensions grew much faster than state pensions, and as can be observed, higher earners are more likely to have contracted out. Despite cutbacks in the basic pension since 1981, pensioner incomes over the last 20 years have, on average, grown more quickly than that of the entire population. The net income, before housing costs, of both pensioner couples and single pensioners was approximately 60 percent higher in real terms in 2002-03 than in 1979, compared with real average earnings growth of 38 percent over this period (Department of Work and Pensions, 2004). This has been due to real increases in incomes from state

pensions (as SERPS gradually matured after its introduction in 1978), means-tested benefits, occupational pensions, and investments (Department of Social Security, 2000).

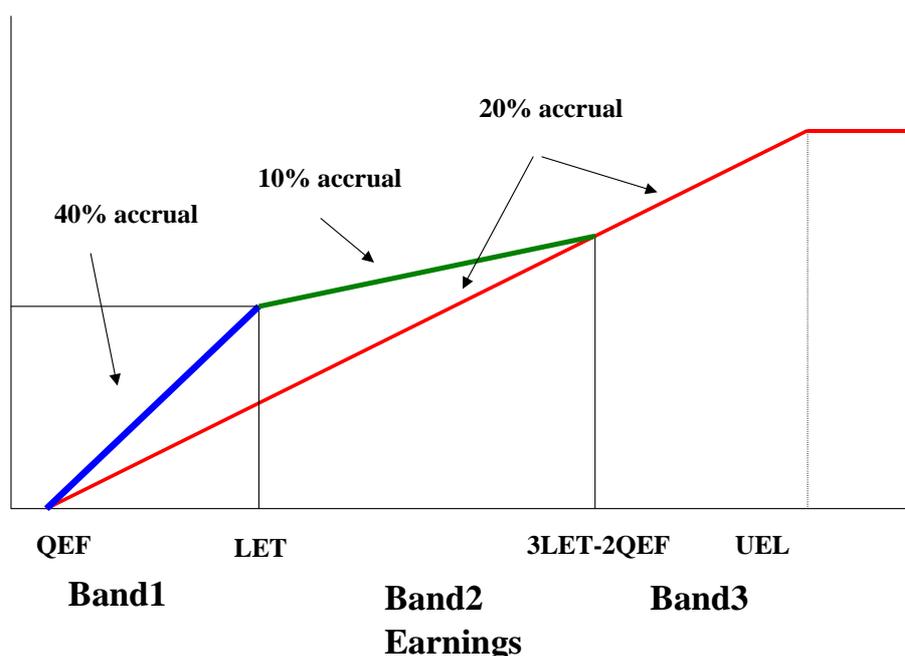
This real increase in pensioner incomes has led to pensioners now being under represented in the poorest 10 percent of the population, which since the start of the 1970s has tended to be occupied by other unwaged groups such as unemployed and single parents (Goodman and Webb, 1994). They are still over represented in the bottom half of the income distribution. These real increases in income have not, however, been evenly spread across pensioner distribution. Johnson and Stears (1995) show that while income inequality among pensioners fell between the early 1960s to the late 1970s, it rose sharply during the 1980s. This was caused by a combination of an increase in the inequality of income from investments and private pensions. Growing inequality and growing average real income are shown in Figure 4 as data updated Johnson and Stears (1995), which provides the gross incomes of pensioner couples in

1979 and 2003–04, by income quintile, at July 2003 prices. Clearly in Figure 4, the earnings and investment income are causes of income distribution inequality within the pensioners as Johnson and Stears (1995) pointed out. As most of all quintiles have the same level of benefit income<sup>13</sup>, public pension schemes are to be neutral for the income distribution. Middle and High incomes are allowed to opt out of public schemes. To sum up, the UK public schemes are carefully to the low incomes as mentioned later.

#### 4. Pensions for those with low incomes

As noted above, contracting-out arrangements have made the UK Government’s expenditure on future pensioners understated (details in Section 3.1) and expanded the gap between wealth and poverty (Figure 5). Therefore, the UK Government introduced two schemes: S2P and pension credit to improve the financial position of those with low incomes at present and in the future.

Figure 5 S2P and SERPS



#### 4.1 State Second Pension

Beginning April 2002, SERPS itself was replaced by S2P. S2P is a career-average revalued earnings plan, similar to SERPS, but it accords more weighted to accrual on the lower earnings. Benefit accrues at the rate of 40percent over the working life of an individual on earnings up to the Low Earnings Threshold (LET), which is £10,800 a year for 2002–03, and at 10percent from the LET up to a level of earning defined as “three times the LET less twice the QEF (qualifying earnings factor)” (the QEF is the annualized LET). This level of earnings has initially been set at £24,600 a year. Above this level, accrual is at 20percent, exactly as with SERPS, up to the Upper Earnings Limit (UEL). S2P has other features to help the poorly paid. Those earning below the LET are credited with S2P as though they were earning at the LET. Some people outside the labor force, because of incapacity or caring responsibilities, will also be credited with S2P at

the level of the LET. The accrual of S2P is diagrammatically shown in Figure 5.

Following the introduction of S2P, the age-related rebates for APP contracting-out are now calculated on the basis of the forgone S2P benefits, that is, at 40percent, 10percent, and 20percent accrual rates. However, for COSRS and COMPS, the rebate is based only on a uniform 20percent accrual rate (as under SERPS) between the LET and the UEL. The rebate for earning below the LET is based on actual earnings, rather than deemed earnings, equivalent to the LET, which apply for S2P purposes. Setting the rebate terms inevitably involves some compromises. Giving more to those who are contracted-out implies charging more to those who are not contracted-out. Increasing the generosity of the terms, particularly for personal and stakeholder pensions, may make the corresponding private sector product more marketable, but will also raise the

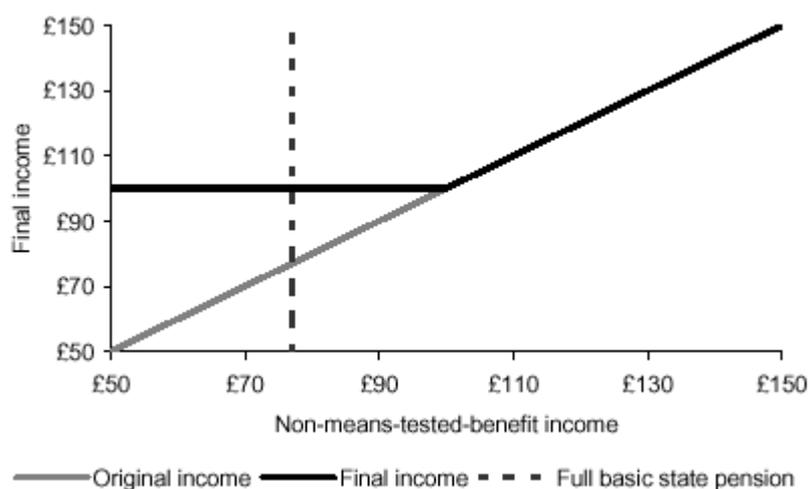
criticism that the government is paying over the odds to transfer liabilities to the private sector. The adequacy (or otherwise) of the rebate is posed in particularly clear terms with money purchase contracting-out, where the provider of a personal pension or stakeholder pension has to demonstrate that the offer is of good value compared with the alternative of remaining in SERPS.

## 4.2 Pension Credit

Pension Credit<sup>14</sup> was introduced in October 2003. It contains two principal elements:

- (i) a *guarantee credit*, which provides a minimum income for pensioners<sup>15</sup> aged 60 and over;
- (ii) a *savings credit*, which “rewards” (UK Government terminology) every pound of extra income for pensioners aged 65 and over with a 60p credit, within a specified range.

Figure 6 Illustrative budget constraint under the MIG, for a single pensioner<sup>16</sup>



Source) Clark (2002)

This Pension Credit is the next stage of S2P for the low incomes pension scheme in the government’s pension reform programs at a cost of approximately £2 billion per year. It will provide a guaranteed income for all pensioners and a “reward” for those with small-scale savings and second incomes. In the UK, about half of low incomes pensioners are single women and as a female life is long, female private pension cost is relatively high. Through this credit, the UK Government aims not only to raise the level of income for the low incomes (a role of guarantee credit part), but also to increase their incentives to save (a role of saving credit part). In addition, the financial service authority (FSA<sup>17</sup>) makes appropriate pension and saving plan for the low incomes. The background of this credit is the 1998 Green Paper *A new contract for welfare: partnership in pensions*, in which the government set out its “plans for radical reform of the whole pension system.”<sup>18</sup>

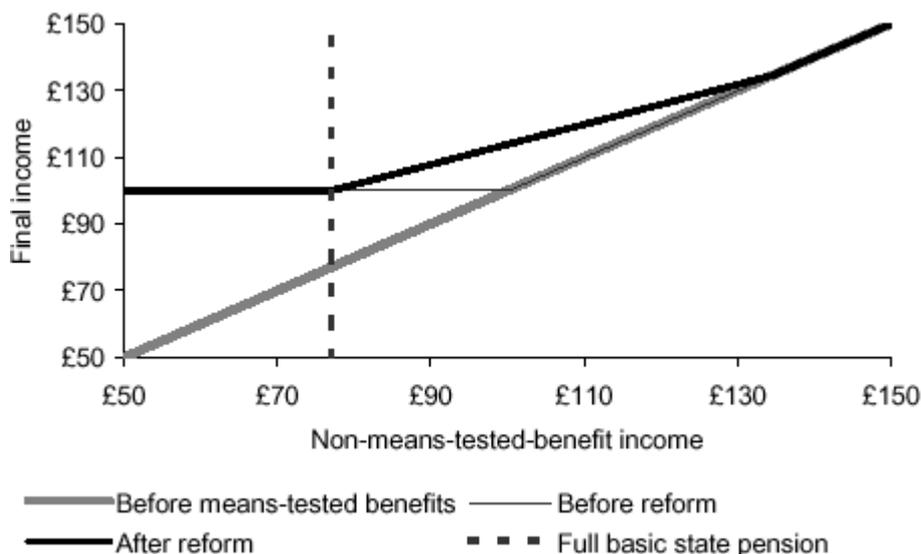
These schemes were based upon the principle outlined by the Prime Minister in the Paper’s foreword, and often restated since: “*We believe that those who can save for their retirement have the*

*responsibility to do so, and the State must provide effective security for those who cannot.*” Toward this goal, the Green Paper outlined how the pension system would be reformed. Only the Basic State Pension is not abolished and others would be altered. For example, Income Support for pensioners became the MIG and Stakeholder Pensions have been introduced to help achieve the government’s aims. **Figure6** shows how a single pensioner’s final income increases as the individual’s pension and savings income increase. As is evident, the MIG brings all pensioner incomes up to the minimum income level of £100. Under this system, however, all pensioners with a small income from savings or a second pension that brings them up to a level below the MIG find themselves no better off than those who have made no provision for their retirement. For example, a pensioner who had a full Basic State Pension of £77 per week plus £10 from an occupational pension would have the same final income (£100) as a pensioner who had made no such saving. The Pension Credit aims to tackle this problem, as illustrated in **Figure7**.

As Pension Credit is a new system, it is too early to estimate the effects of introducing Pension Credit to ease inequality of pensioner’s income

distribution. We had better to watch the income distribution in the near future.

Figure 7 Effect of Pension Credit for a single pensioner<sup>19</sup>



Source) Clark (2002)

## 5. Japanese systems viewed from the UK experience

In the UK public pension reforms processes, there are two important points. The first point is promoting private pension sector by the UK government. The UK government allows those with middle and high incomes to opt out of the schemes, and to take the occupational and private pension scheme as mentioned in section 2. The UK makes many efforts to establish the pensioners right typically on the safeguard schemes for employees. In other word, the promoting the occupational and private pension means to reduce the UK government responsibility for the middle and high incomes' public pension. The second point is the introduction of the measures to the low-income pensioners. The UK government has taken the measure of underpinning the low incomes pension level and has introduced S2P and Pension Credit to the goals, as mentioned in section 4.1 and 4.2. Whether these two options make the British people's sense of reliability over the pension program strong or not remain to be proved. However, there is no doubt that the UK pension "crisis" is not a fiscal crisis of demography but of unequal pension asset distribution and low levels of pension saving.

Japanese pension problems are not only a fiscal crisis, but also inequality of income distribution crisis

and public distrust in the system. It is useful to begin by making a distinction among three problems. First, a fiscal crisis does exist in Japan as mentioned above. The EPI expenditure was 4.4 percent of GDP in 2001, and might be 9.0 percent in 2040. This figure represents a partial cost of the public pension system, and does not include public health insurance or long-term care cost. Without appropriate reforms, younger generation could not endure those large contributions.

Second, inequality of income distribution crisis is emerging in Japan too. In short, the Japanese public pension scheme doesn't have minimum guarantee pension for low incomes. In the EPI scheme, benefit formula has the earnings-related part and the flat rate part, and the earnings-part expands the pensioners' income gap. On this point, according to Yamada (2002) studied trends in income sources, by income group, age 65 and over and suggested " *In Japan, the share of income from work is high in all income groups, but its importance has rapidly decreased among middle-income group in the recent decade. The share of net social transfers tripled in middle-income groups, while the share of income from work decreased by almost half.*" Fukawa (2002) also showed, " *As for the shares of different income sources of the elderly households (single or couple-only aged 65+) by income quintile of equivalised gross income, the share of public pension was about 80 percent or more for the*

*first to fourth quintiles, and it decreased to 40 percent for the fifth quintile. The share of earnings was more than one third for the fifth quintile.*" In these two empirical studies, there is no doubt about Japanese pensioner income distribution is unequal and Japanese public pension schemes are causes of the inequality of distribution. In the other words, income gap among older people in Japan expanding and Japanese public pension schemes would have a major role to expand income gap among pensioners. This point is very important for comparison of the UK schemes and Japanese schemes. The contracting out schemes would cut the public responsibility for middle and high incomes in the UK and the government maintains special pension schemes for the low incomes to shrink the income gap among pensioners. It should be noted that contracting out schemes are not the magic to clean the costs of the old age. For the private pension field, the UK government maintains fiscal market itself and makes many regulations for the market. The middle and high incomes, and the firms pay their fee for the occupational and private pension. It is true that the cost of the old age does not disappear in any case.

Third, the distrust on the schemes is emerging in Japan. Projected high level contribution rate and cutting the benefit level may be causes of such a crisis. In aging society, it is important to save low income's retirement income and to maintain younger generation's incentives for the contribution. However, Japanese reforms repeat parametric reform every time. If we could learn from the UK schemes, contracting-out schemes<sup>20</sup> are useful for Japan. In Japan, it is necessary to cut public responsibility for medium and high incomes, and to downsize the public pension expenditure. Modest contribution level and redistribution effect of pension would cease the losing reliance.

Surely, it is necessary to have some condition in Japan for promoting contracting-out schemes. And for this point, we could learn from the UK experience. In the UK, financial market is mature<sup>21</sup> to return enough level of the investment of private pension fund and the pensioner's right is established. As noted in section 2, Japan has introduced new schemes for occupational pension field and has to provide good financial market condition. In order to make Japanese financial market mature, the following conditions should be met:

1. Safeguards for employees whose company pensions are wound up, "to increase members' confidence that

they will receive the pension they were promised." This includes revising the "priority orders," so that those close to retirement are less affected by scheme wind-ups. Further, forcing employers to consult their workers before making changes to pension schemes.

2. An insurance-style compensation scheme for members of schemes that are wound up when an employer is insolvent. This scheme, which the DWP expects will cost pension funds about £350m a year, will protect up to £20,000 of annual income from a pension that is wound up without sufficient assets in it.

3. Protection for members of schemes whose employers choose to wind up schemes even though the company is solvent. This will include "full buyout," an obligation to fund annuities to the full value of its members' existing pensions up to that point.

Above market conditions are presented in DWP consultation paper issued in June 2003. And those are from a Green Paper on pensions (DWP, 2002). To compare with the UK and Japan, the first condition is the most important for present Japanese situation. As many Japanese people are not familiar with investing, they may be not good at making good portfolio. Good education for the private finance is the key of Japanese new schemes. The third condition is important too, however, new schemes are newly introduced and it is too early to evaluate the schemes.

The UK way of contracting-out schemes would have possibility to shrink the future pension expenditure as mentioned above. Cutting the government responsibility for the middle and high incomes would be acceptable in Japan too. Then, public financial stability would be gained in exchange of improving occupational and private pension. Particularly, educations for investing, governance systems on fiscal market and establishing the pensioner's rights are important. Surely, other options may be available. If set up costs of fiscal market would be too expensive, pension reforms had better to be carried out within public schemes. It depends on the economic condition, the extent of globalizations, culture and so on. The Japanese financial market is globalized and restructuring the bank system is in action. In addition, small investors are emerging in stock market The Japanese market is to be qualified the maturity market in the near future. In any case, long run stability of fiscal balance is to be secured and low incomes pension is to be maintained, the reliance on the public pension system would be recovered in Japan.

## 6. Conclusion

There are three problems, 1) fiscal imbalance of the system, 2) inequality of pensioner's income distribution and 3) distrust of the public in the Japanese public pension system. On these three problems, there are plenty to be gained in studying reform efforts of the UK system. The UK public pension policy is weighted on improving the low incomes pension and aims to cut its own responsibility for middle and high incomes persons pension. This policy would lead to low-level pension expenditure in the long run, and succeed to make the public pension system neutral from income distribution. As for Japan, the lack of the special pension system for low incomes persons is a problem. If Japan would introduce special schemes like S2P and Pension Credit or modify the current Basic Pension in order to improve the low income pensioners' condition, the income distribution would be more equal. Fiscal imbalance in the long run is a big issue in Japan. Cutting the government responsibility for the middle and high incomes might be acceptable in Japan. Then, it is necessary to improve financial market stability for the occupational and the private pension. Particularly, educations for investing, governance systems on fiscal market and establishing the pensioner's rights are important. In any case, long run stability of fiscal balance is to be secured and low incomes pension is to be maintained, the reliance on the public pension system would be recovered in Japan.

### Notes

<sup>1</sup> Model household implies households in which the husbands contribute to the EPI for 40 years and the wife is not a permanent worker (annual earnings below 1.3 million yen).

<sup>2</sup> A 401(k) plan is arrangement that permits an employee to elect to have the employer contribute part of the employee's cash wages to a retirement plan on a pretax basis. These deferred wages are not subject to income tax withholding at the time of deferral. The deferred wages are not reflected on Form 1040 since they were not included in taxable wages. However, they are included as wages subject to social security, Medicare and federal unemployment taxes. The amount an employee can elect to defer is limited. The maximum amount of deferral for tax year 2003 is \$12,000 for all 401 (K) plans in which the employee participates. Employees age 50 or over may be eligible to make additional catch-up contributions of up to \$2,000 in 2003.

<sup>3</sup> The EPI is private sector employees' pension as funded Pay As You Go. In now, it's contribution rate is 13.6percent and the EPI is biggest public pension in Japan. The EPI consists of two tier benefit and benefit formula is below:

Basic Pension = ¥804,200 × insured period / 480 \* CPI (¥804,200 2001price)

Earnings Related = Average Total Earnings × insured period × 5.7 / 1000 (Average Total Earnings has bottom and ceiling)

<sup>4</sup> Department of Work and Pension (2003)

<sup>5</sup> Department of Work and Pension (2003)

<sup>6</sup> Department of Work and Pension (2004b)

<sup>7</sup> Old-age dependency ratio is equal to (persons aged 65+)/ (persons aged 20-64)

<sup>8</sup> Casey et al. (2003), Table 1

<sup>9</sup> GAD (2000), Table 5.5

<sup>10</sup> Total National Insurance cost includes some non-pension expenditure such as Incapacity Benefit and Jobseekers Allowance. Figures exclude expenditure cost on means-tested benefits to pensioners. Cost of the Basic State Pension excludes the cost of the above inflation increases in April 2001 and April 2002 that were announced in the November 2000 Pre-Budget Report. It also excludes the November 2001 Pre-Budget Report commitment to increase the Basic State Pension by a minimum of 2.5percent if inflation falls below this level. Neither of these increases in generosity is sufficient to significantly change the long-run picture.

<sup>11</sup> <http://www.statistics.gov.uk/>

<sup>12</sup> <http://www.dwp.gov.uk/publications/dwp/2004>

<sup>13</sup> It consists of income by public pension and other public allowance.

<sup>14</sup> Pension Credit is a new entitlement for people aged 60 and over living in UK. This could mean extra money for pensioners every week. It guarantees everyone aged 60 and over an income of at least:

1) £105.45 a week if a pensioner is single or

2) £160.95 a week if a pensioner has a partner.

<sup>15</sup> This scheme is mainly for low income and single women.

<sup>16</sup> <http://www.parliament.the-stationery-office.co.uk/pa/cm200102/cmselect/cmworpen/638/63803.htm>

<sup>17</sup> <http://www.fsa.gov.uk/>

<sup>18</sup> Department of Social Security (1998)

<sup>19</sup> <http://www.parliament.the-stationery-office.co.uk/pa/cm200102/cmselect/cmworpen/638/63803.htm>

<sup>20</sup> To be sure, the Employee Pension Fund (Kousei-Nenkin-Kikin), which is imitation of the UK contracting-out scheme, have established since 1967. As this scheme is Defined Benefit, some firms can't

maintain the benefit level and some are abolished. And the EPF is not a pure occupational scheme including the government portion, so firms can't manage the funds in the finance market by some regulations. So, the middle and high incomes in Japan could not mainly rely on occupational pension, and Japanese public pension schemes with earnings-related part still cover middle and high incomes.

In the occupational pension context, maturity of financial market means the market has next four points.

1) Government policies should facilitate the development of suitable infrastructure that will enable pension funds to efficiently allocate retirement savings and risks. 2) It is necessary for those making the risk-return trade-off decisions on behalf of pension beneficiaries to be well informed, to have suitable incentives, and to be adequately supervised. 3) The policy should recognize that financial innovations could improve the functioning of financial markets. 4) A well-functioning funded pension system requires a stable and efficient financial market infrastructure consisting of the legal framework, the financial accounting system, the regulatory and supervisory framework, clearing and settlement systems, and the microstructure for trading securities( Blommestein 2001).

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