

## Japanese public pension reform from international perspectives

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### Abstract

The Japanese public pension system is still being pressed to reestablish long-term financial stability and regain public support. This paper reveals the characteristics and actual roles of the Japanese public pension system, although mainly focusing on the Employees' Pension Insurance (EPI), taking an international perspective and discussing various options useful for Japanese public pension reform. The Japanese public pension system was reviewed in comparison with the systems in France, Germany, Sweden, United Kingdom (UK) and United States of America (USA). Based on this review, lessons are drawn from reform efforts in other countries on intergenerational equity, fairness of the system, income-smoothing function, share of the public pension, and neutrality of the system.

### 1. Introduction

Population aging due to a low birth rate and increasing longevity has had a strong impact on public pension system in Japan. The entire working population has been covered by the public pension system since 1961. Historically, employees and non-employees, such as self-employed or farmers, have been treated differently in the social insurance system in Japan, with the latter being supported through favorable government subsidies. Most employees in the private sector are covered by the Employees' Pension Insurance (EPI), and non-employees are covered by the National Pension. Expenditure on public pension was 8.1 percent of GDP in 2001. According to a national household survey, the share of public pension benefit in the income of elderly households (elderly singles or couples aged 65 and over) was 66 percent in 2000.

The Japanese public pension system is statutorily required to review its financial stability at least every 5 years, and public pension reforms have been implemented together with these financial reviews. The Basic Pension was introduced in 1985 reform to provide a flat rate benefit for every elderly person (Note 1). Benefit reduction in various forms as well as the improvement in efficiency and fairness of the system has been the main focus of the recent reforms. An increase in normal pension age from 60 to 65 years of age (gradual implementation) was decided in the 1994 and 2000 reforms. A reform package including a reduction of the benefit accrual factor of the earnings related part of the EPI was passed in March 2000 in order

to maintain a contribution rate that would be acceptable to the working population in future years.

The Japanese pension system is still being pressed to reestablish its long-term financial stability and regain public support. Based on the latest population projection in January 2002, the Japanese Ministry of Health, Labor and Welfare submitted a reform bill to the Diet in February 2004 (Note 2). The contribution rate of the EPI would increase from the present 13.6 percent to 23 percent in 2025 without further reform. According to the bill, the contribution rate to the EPI will be increased gradually but will be fixed at 18.3 percent in 2017 and afterwards, and pension benefits need to be lowered accordingly. However, it was explained by the Ministry that the model replacement rate (Note 3) would not fall below 50 percent when beneficiaries start receiving benefits at age 65. One way of controlling pension expenditure is to apply a lower benefit increase through "macro economy slide" (Note 4), but there are concerns as to whether setting a ceiling on the contribution rate is compatible with the guarantee of the benefit level.

The reform of the public pension system has been high on the agenda of most developed countries, with the need to establish mid- and long-term stability of the system against aging of the population. In France, an important reform bill of the public sector was passed in 2003. The latest German pension reform legislation passed in 2000 and implemented in 2001 and 2002 invented a new formula to offset the reduction of public pension benefits by introducing a tax-supported voluntary corporate/private funded pension program. The new Notional DC system has been implemented in Sweden since 2001. The UK began a shift to a new system from 2001. There have been no major changes in the US system since 1983. However, in 2001, the Bush Commission proposed three models based on the introduction of the personal retirement account.

This paper identifies the characteristics and actual roles of the Japanese public pension system, although mainly focusing on the EPI, taking an international perspective and discussing various options useful for Japanese public pension reform. The Japanese public pension system was reviewed in comparison with the systems in France, Germany, Sweden, UK and USA. Based on this review, five points are drawn as lessons learned from reform efforts in other countries.

## 2. Public pension systems in six countries

Developed countries are experiencing aging of the population, and birthrates are especially low in Japan and Germany. Japan enjoys the highest life expectancy at birth among the six countries shown in Table 1, and life expectancy at age 65 in Japan is higher by 3 years than that

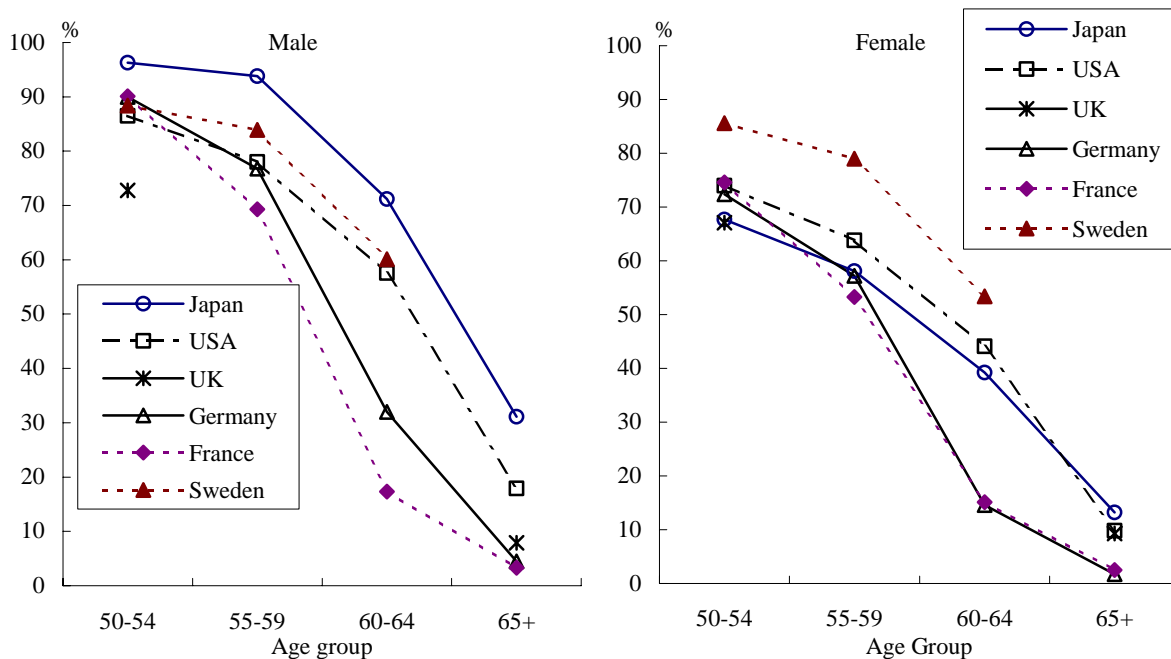
in Germany, for example. Fig. 1 shows the labor force participation rate of those aged 50+ by gender and age group. Early retirement prevails in France and Germany, where less than 20 percent of those who have passed beyond 60 years of age remain in the labor market in France.

Table 1 Basic Background Data in 6 Countries

			France	Germany	Japan	Sweden	UK	USA
GDP	Trillion Dollars	2001	1.3	1.8	4.2	0.2	1.4	10.0
Per capita GDP	1000 Dollars (PPPs)	2001	27	26	27	26	26	35
Population	million	2002	60	82	127	9	60	288
65+	% of total population	2002	16.2	17.3	18.2	17.2	15.6	12.4
General government expenditure	% of GDP	2002	54.0	48.6	38.6	58.3	40.9	35.6
Gross public debt	% of GDP	2001	63.6	57.8	118.6	48.6	50.7	54.6
Social protection expenditure	f	1998	28.8	27.4	14.6	29.9	24.8	14.4
Total Fertility Rate		2002	1.86	1.36	1.32	1.65	1.66	2.06
Life expectancy at birth	Year	2000/01	79.3	77.7	81.5	79.8	78.1	76.8
Labor force	% of total population	2001	45.3	48.7	53.1	50.2	50.1	50.4
Unemployment rate	%	2002	8.7	8.2	5.4	4.9	5.1	5.8

Sources: OECD (2003), OECD Health Data 2003. Statistical Abstract of the United States 2003.

Fig.1 Labor force participation rate by sex and age group



ILO (2003). Yearbook of Labour Statistics 2003.

Public pension spending was 7.1 percent of GDP in Japan in 1998, which was higher than that in the US (6.8 percent), but considerably lower than the 12.0 percent in Germany and 13.1 percent in France (Table 2). Concerning old age benefits, the UK and the US are lower than Japan, but Japanese disability benefits are quite low. Moreover,

Japanese public pension expenditure is expected to increase rapidly in future. The ways to reevaluate previous earnings as well as to adjust benefits after retirement are shown in Table 2, which are also important factors influencing the size of public pension expenditure. In many cases, the former is in line with wage increases (gross or

net), and the latter is in line with consumer price increases. There is a program with flat rate benefits in Japan and the UK, and the Japanese Employees' Pension Insurance (EPI) has a flat rate benefit part. The contribution rate is lower in the US and Japan, and the highest in France. In the US, there are no tax revenues allocated to the pension system. The contribution rate in Sweden is 18.5 percent of pensionable earnings (earnings minus employee contribution), which means that the actual contribution rate is 17.21 percent (Note 5).

Part-time employees are covered by the pension program for employees with the exception of Japan. Where pension benefits are closely linked to premium payments during working life, women receive on average much lower

old-age pensions than men, because of interrupted working careers due to child-rearing. Therefore, the level of survivors' pension is closely linked with the issue of the improvement of individual pension entitlements for women. In Germany and Sweden, there is a notion to reduce and eventually eliminate widow's pensions. The German pension system places more weight on supporting child care and long-term care, and it suffers more from early retirement and high unemployment than the Japanese system (OECD, 1999b; Schmahl, 2002a). The share of public pension benefits among all pension benefits is high in France and Germany, and the share of corporate pension is high in Sweden, the UK and the US.

**Table2 Public Pension Systems in 6 Countries**

	France	Germany	Japan	Sweden	UK	USA
<b>Benefit</b>						
Pension expenditure 1998 a) % of GDP	13.1	12.0	7.1	10.2	7.9	6.8
Old-age	10.6	10.5	5.7	7.2	4.3 b)	5.1
Survivor	1.6	0.5	1.1	0.7	1.0	0.9
Disability	0.9	1.0	0.3	2.0	2.6	0.8
Type of benefit	DB	DB+	DB	NDC +DC	DB	DB
Program for employees						
Normal pension age	60	65	(65)	61-	65	(67)
Net replacement rate (%)	40ys	62	59			
Average retirement age	58.1	60.2	62			
Revaluation of previous earnings	P	gW	nW			gW
Indexation of benefit	P	g'W	P	gW	P	P
Flat-rate pension						
Normal pension age	-	-	65	-	65	-
Benefit level	-	-		-		-
Financing : Program for employees						
Financing method	PAYG	PAYG	PAYG	PA+F	PAYG	PAYG
Financing structure 2000 %		(2002)				
Contribution		74	71	74	77	85
Tax		25	13	17	22	-
Others		1	16	9	1	15
Contribution rate 2003 %	25.5	19.5	13.6	17.21		12.4
Ceiling of contribution % of av. earnings	135	190	195	160		240
<b>Characteristics and Issues</b>						
Coverage of part-time workers	Yes	Yes	No		Yes	Yes
Level of survivors' pension	54%	55%	61%	-		2/3
Consideration to child raising	Yes	Yes	Y	Yes		excl.
Consideration to long-term care giving	Yes	Yes	No	No		No
Weight of various pension benefits (%)						
public	98	95		85		84
corporate	1	5		13		
individual	1	...		2		

a) OECD (2003), OECD Health Data 2003.

b) Excluding occupational pensions.

### 3. Detailed comparison of Germany, Japan and the United States

The main characteristics of the Japanese Employees' Pension Insurance (EPI) are summarized as follows: a) earned benefits depending on former contributions; b) combination of flat rate benefit (Basic Pension) and earnings-related benefit; c) income redistribution based on lifetime earnings; d) Pay-As-You-Go (PAYG) financing method with accumulated fund payable for pension benefits for 6 years; and e) protection against inflation through adjusting benefits in line with price increase (Fukawa and Yamamoto, 2003). The public pension systems for employees in the private sectors in Germany, Japan and the US have much in common: PAYG financing method; earnings-related contributions and benefits; defined benefits; etc. However, there are some remarkable differences among the three systems. The EPI and the Old-age, Survivor and Disability Insurance (OASDI) have some accumulated funds, which can be used to modify the

degree of inter-generational inequality in the contribution-benefit relation due to the PAYG financing system. In Germany, the situation is completely different, and there is only a small amount of money to avoid default. The EPI covers only about half of the working population because part-time employees and the self-employed are excluded from the EPI (Table 3). In contrast, a single OASDI system covers virtually all the working population in the US. Benefit expenditure of the EPI was 4.1 percent of GDP in 2000, which is the same as the OASDI.

One-third of the Basic Pension expenditure is financed by government subsidy in Japan. About one sixth of the EPI revenue comes from the interest on the accumulated fund which is payable for pension benefits for six years. In Germany, the share of national subsidy including tax revenue earmarked for the pension system was enlarged in order to avoid an increase in the contribution rate. Income redistribution is considered in Germany to be done not by contributions but by tax revenues, and the share of national subsidy has increased accordingly.

**Table3 Some key indices of public pension systems for employees in Germany, Japan and the US**

	Germany GRV 2000	Japan EPI 2000	USA OASDI 2000
Coverage of working population (%)	85	49	96
Expenditure/GDP(%)	9.6	4.1	4.1
Old-age	7.0	3.3	3.0
Survivor	1.8	0.7	0.5
Disability	0.8	0.1	0.6
Revenue/GDP(%)	11.5	5.5	5.7
Contribution	8.1	3.9	5.0
National Subsidy	2.7	0.7	-
Interest/Others	0.7	0.9	0.6
Contribution rate(%) a			
Present	19 (26)	13.6 (16)	12.4
Final	22 (31)	18.3 (22)	
Earnings-related Benefit			
Share (%)	100	b	100
Benefit accrual rate (%)	1.07 <sup>c</sup>	0.548 <sup>d</sup> (1.37, 1.04, 0.77) <sup>e</sup>	
Gross replacement rate for 40 years of participation according to lifetime earnings level (1.0 = average) f			35 years
0.5	42.8	50.0 (78.1)	48.0 (72.0)
1.0	42.8	36.0 (50.0)	36.5 (54.8)
2.0	40.7	28.4 (35.4)	27.1 (40.7)

a) Effective contribution rate in parenthesis, which is calculated as if tax revenues allocated to the pension system were also covered by contribution.

b) The proportion of earnings-related part in the average EPI pension is 61 percent for those without dependent spouse and 44 percent for those with dependent spouse.

c)  $(48.1/45) = 1.07$

d)  $(0.75 \times 0.95)/1.3 = 0.548$

e) Gross replacement rate / 35 years

f) figures for those with dependent spouse in parenthesis

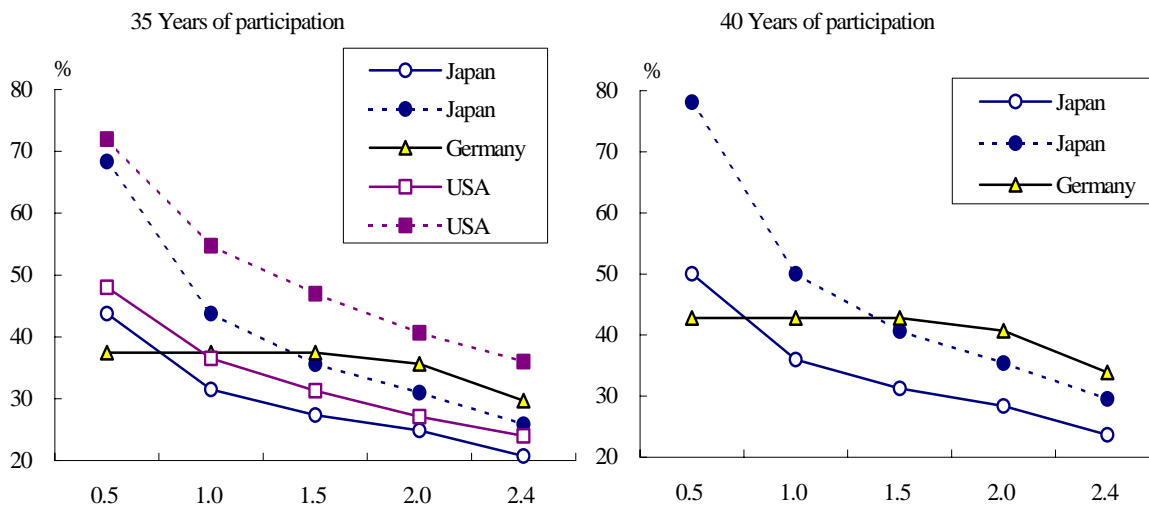
The contribution rate now is about 19 percent, and the ceiling of contribution is set at 20 percent until 2020 and 22 percent until 2030 in Germany. However, if tax revenues allocated to the pension system were also covered by contribution, this effective contribution rate is about 26 percent now and will eventually be 31 percent in Germany. The situation is the same in Japan. The planned final contribution rate is 18.3 percent, which means that the effective contribution rate would be 22 percent in Japan, compared to 12.4 percent in the US (Note 6) where no tax revenues are allocated to the pension system.

In order to control the premium increase, it is necessary to reduce the rate at which pension benefits accrue. As the weight of the Basic Pension is about half of the benefit (40 percent for a single beneficiary and 55 percent for a beneficiary with dependent spouse, on

average), the benefit accrual rate for the earnings-related part of the EPI is almost half of the German system (Note 7).

Fig. 2 shows the gross replacement rate of pension benefit according to the lifetime wage level. Old age pension in Germany provides rather a flat replacement rate regardless of lifetime wage level. On the other hand, the OSADI and the EPI clearly treat low-income persons favorably, and the replacement rate of those with dependent spouses is somewhat higher than single beneficiaries with the same lifetime wage level in both systems. It is worthwhile noting here that the replacement rate is proportional to the contribution periods in Germany and Japan, whereas benefit amount is based on the wages of highest 35 years in the US.

Fig.2 Gross replacement rate according to lifetime wage level (1.0 = average)



(Note) : Without dependent spouse  
: With dependent spouse

#### 4. Three indices for comparison

##### (1) Role of public pension benefits viewed from income quintile of the elderly

Public pension benefits are important as retirement income in all developed countries, and they are especially dominant for the low-income elderly households. Table 4 shows the share of different income sources of the elderly households aged 65 and above by income quintile. In France and Germany, the share of corporate / individual pensions is lower than that in the UK and the USA, and the public pension benefits are dominant for the most elderly households (Schwarze and Frick, 2000). Whereas in the UK,

private corporate pensions have become the norm in most regular reasonably paid jobs (Glennerster, 2003). The role of private pension in Sweden is larger than one would expect in a country with such a strong welfare state provision (Palme, Note 8).

In Japan, for the bottom 80 percent of the elderly, the share of public pension benefits is more than 80 percent, and the top quintile receive 40 percent of their income from public pension benefits. Earnings and public pension benefits are two dominant sources of income for the elderly in Japan, and corporate pensions or income from assets have not yet played a major role in terms of benefits.

**Table4 Shares of Different Income Sources of the Elderly (65+) by Income Quintile (In percent)**

Income Sources	France 2000						Germany 1996					
	1	2	3	4	5	T	1	2	3	4	5	T
Earnings	5	7	9	8	8	8	2	6	10	14	19	8
Public Pension Benefits	72	76	73	71	62	82	87	80	72	64	55	76
Private Pension Benefits	0	0	0	0	1	0	3	3	3	5	8	3
Income from Assets	10	12	15	20	29	7	6	10	14	16	18	12
Others	13	5	2	1	0	3	2	1	1	1	0	1
Income Sources	Japan 1997						Sweden 1987					
	1	2	3	4	5	T	1	2	3	4	5	T
Earnings	4	7	8	10	46	26	0	1	1	2	12	
Public Retirement Benefit	87	83	87	86	40	64	84	63	73	72	48	
Private Pension Benefits	-	-	-	-	-	-	8	28	15	18	24	
Income from Assets	2	1	3	2	11	6	8	8	11	7	17	
Others	8	9	3	2	3	4	-	-	-	-	-	
Income Sources	UK 1987						USA 2000					
	1	2	3	4	5	T	1	2	3	4	5	T
Earnings	0	1	2	4	13		1	3	7	14	35	23
Public Retirement Benefit	90	87	78	65	25		83	85	71	57	29	47
Private Pension Benefits	3	7	13	20	31		2	4	10	13	9	9
Income from Assets	6	6	8	12	31		3	5	9	13	24	18
Others	-	-	-	-	-		11	3	3	3	3	3

Note. In this table, Public Pension Benefits in the UK include all social security benefits.

Sources : INSEE(2003), Schwarze and Frick(1999), Fukawa (2003), Kangas and Palme (1993), Johnson (1992), SSA (2002)

**(2) Scale of public pension benefits**

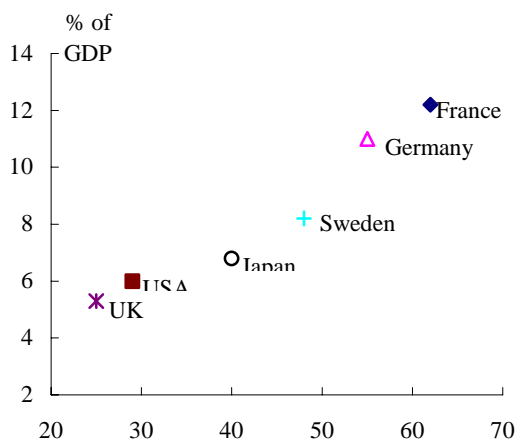
Fig. 3a) shows the relation between a) the share of public pension benefits in the income of the elderly households of the top income quintile and b) the public old-age & survivor pension expenditures as percentage of GDP. It is important to note that not only the size of public pension

expenditures as a percentage of GDP, but also how they are distributed differs from country to country. Both Japan and the US use about 7 percent of GDP for public pension (Table 2). However, the distribution of them differs in the two countries.

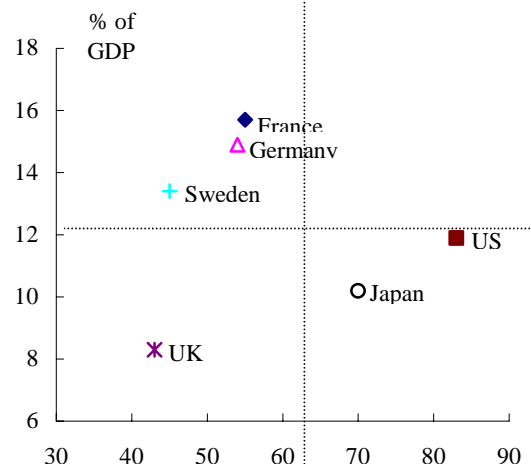
**Fig.3 Characterization of 6 countries**

(a) Relation between the share of public pension benefits in the income of the elderly households of the top income quintile (X Axis) and the public old-age & survivor pension expenditures as percent of

(b) Relation between the cost of public programs for the elderly as percent of GDP (Y Axis) and the proportion of the cost to the social expenditure (X Axis)



Share of public pension benefits in the income of the elderly households of the top income quintile (%)



Cost of public programs for the elderly/ social expenditure (%)

### (3) Cost of public programs for the elderly (65+)

Social expenditure in Japan and the US is quite low compared to France, Germany, Sweden and the UK (Table 5). If employer-sponsored health insurance is included in social expenditure, the US figure would be more than 20 percent. Not only "old age and survivors" but also "family cash and services" are low in Japan and the US. If we assume that the Japanese pension benefit is similar to the German level, then the Japanese figure would be around 20 percent. The Japanese public pension system is not yet fully

matured. However, the structural benefit level of the EPI, which is the benefit level promised by the law, might still be high for the upper income elderly.

Table 5 also shows the cost of the public programs on pension, health and long-term care for the elderly (65+). The cost is low in the UK and Japan, and the proportion of the cost to the social expenditure is low in the US and Japan (Fig. 3b). One interpretation of Fig.3b is that social protection in those countries located in II is greater than the countries located in IV of the Fig. 3b.

**Table5 Social expenditure and cost of public programs for the elderly (65+) : 1998**

		France	Germany	Japan	Sweden	UK	USA
Social expenditure % of GDP	A	28.8	27.4	14.6	29.9	19.3	14.4
Old age and Survivors	B	12.2	11.0	6.8	7.9	5.3 d)	6.0
Disability cash benefits		0.9	1.0	0.3	2.0	2.6	0.8
Health		7.3	7.8	5.6	6.4	5.6	5.8
Services for elderly and disabled		0.7	0.7	0.3	3.6	0.8	0.1
Family cash and Services		2.7	2.7	0.5	3.2	2.2	0.5
Unemployment		1.8	1.3	0.5	1.9	0.3	0.2
Others		3.2	2.9	0.6	4.9	2.5	1.0
Total expenditure on health % of GDP		9.3	10.6	7.1	8.3	6.9	13.0
Public expenditure on health	C	7.1	7.9	5.5	7.1	5.5	5.8
Private expenditure on health		2.2	2.7	1.6	1.2	1.4	7.2
Cost of public programs for the elderly % of GDP							
Pension a)		12.2	11.0	6.8	7.9	5.3	6.0
Health b)		2.8	2.6	2.6	2.8	2.0	5.2
Long-term care c)		0.7	1.3	0.8	2.7	1.0	0.7
Total	D	15.7	14.9	10.2	13.4	8.3	11.9
D / A (%)		55	54	70	45	43	83

a) Same as B

b) = C times elderly share. The following figures are used for the elderly share : France 40%, Germany 33%, Japan 48%, Sweden 40%, UK 37%, USA 90%.

c) Based on Scheil-Adlung (2003) for France, Germany and Japan ; based on OECD (1999a) for Sweden, UK and USA.

d) Excluding occupational pensions.

Sources: OECD Health Data 2003.

## 5. Discussion

### (1) Paradigm shift: sustainability of the system

The contribution rate for the US pension system has been 12.4 percent, and it is fixed to 18.5 percent of pensionable earnings (namely 17.21 percent of earnings) in Sweden. Recently in Germany, the paradigm has been shifted from a system where contributions have been adjusted to finance an agreed-upon level of benefits to a system where benefits will be adjusted so that a maximum premium level of 22 percent of gross income will not be exceeded until 2030 (Conrad and Fukawa, 2003).

A similar paradigm shift from benefit-first to contribution-first is occurring also in Japan. Driving forces behind this shift are the concern about the long-term sustainability of the public pension system and general

distrust in the pension system. Low expectations about future pension benefits together with a perception of intergenerational inequality on lifetime contribution-benefit relation leads to an increasing unwillingness to pay contributions to the public pension system in Japan.

### (2) Consistency between benefits and contributions

Establishing or at least improving "generational equity" has become a major concern of policy makers in Germany. Quite contrary to previous reforms (where benefit levels were at the center of the public debate), the contribution rate has now become the central issue of recent German pension policies (Conrad and Fukawa, 2003). Via changes in the adjustment formula, the replacement rate of the standard pension in Germany (45 earnings points) has been lowered from about 70 percent to 64 percent in 2030.

Generational equity is also a big concern in Japan. There

are several ways to improve the contribution-benefit relation. The Japanese Ministry has chosen the way of adjusting benefit more slowly through "macro economy slide" and placing a ceiling on the contribution rate, although the contribution rate to the EPI will increase from the present level of 13.6 percent to 18.3 percent over about 15 years. Previous earnings will be revalued in line with total net wages of all insured, instead of the present average net wage increase, and benefit after retirement will be adjusted slightly less than price increase, in order to take the reduction of the working population into consideration. However, it would be more transparent to reduce the accrual rate directly, keeping the price indexation as it is.

### **(3) Incentives to work and to retire later**

Reform discussions should take into account the consistency of pension programs with work incentives. The public pension system would become more sustainable if labor force participation of the elderly were to increase. The normal pension age has decided to be delayed from 65 to 67 years of age in reforms in 1983, and actual implementation has begun since 2003 in the US. In Sweden, there is no normal pension age, and it is completely up to individual when to start receiving public pension after 61 years of age. Although there are several ways to control expenditure, a further increase in the normal pension age has not been seriously discussed yet in Japan. The public pension benefits are so dominant in the retirement income in Germany that more radical reform would be quite difficult. Nevertheless, the issue of increasing the normal pension age from 65 to 67 has already been raised in Germany.

The issue of an earnings test is related to providing incentives for older persons to continue to work. EU countries are trying to alter the paradigm from early retirement to later retirement. The impact of the earnings test in the US will be relatively small in the future, since the earnings test only applies to beneficiaries below the normal retirement age and for these persons the delayed benefit credit increases future benefits by an actuarially fair amount (Clark, 2003).

### **(4) Gender-neutral pension system**

There is a growing recognition that pension programs need to reflect the profound changes that have occurred in society such as higher labor force participation of women, smaller family size and so on. The social security system would become more sustainable if the labor force participation of women and the elderly were to increase and if the birth rate were to rise (OECD, 1997a). To accomplish this, social policy should be more oriented to helping

families and reducing the cost to women of working and having families (OECD, 1997a). Child-rearing periods will usually result in higher future pension entitlements in order to improve old-age provisions for women.

Reforming women's pensions has become a major issue in most industrialized countries over the last 10 to 20 years. In Germany, pension entitlements of married couples are split evenly in case of divorce. A next step towards splitting pension entitlements would be a system, where contributions of the working spouse are split every year, regardless of whether a marriage continues or not (Conrad and Fukawa, 2003).

After improving intergenerational equity and financial stability in the Japanese public pension system, the next important issue is the responsiveness of the system to the needs of individuals. This implies taking more explicitly into account a life-cycle perspective that will permit people to opt more readily for non-traditional work patterns, for family care periods, for lifelong learning and for gradual retirement (Hoskins, 1998). Dependent spouses of employees are entitled to the Basic Pension benefit without paying contributions in Japan, dealing to views that the system is favoring single-income families. It is interesting to note in this regard, that dependent spouses are entitled to 50 percent of old age benefit of the insured in the US, and there are no benefits for them in the German system.

### **(5) Coordination between public and private arrangements**

The latest German pension reform measures highlight a shift in strategy with regard to the evolving public-private pension mix. The core reform element is the partial substitution of public pensions by personal and corporate pension provisions. It is not an option in most developed countries to increase the contribution rate of the public pension system, and solutions in private arrangements are inevitably sought. Along this line, a personal retirement account approach has been introduced or discussed in Germany, Sweden and the United States. However, the share of such an approach is around 10 to 30 percent of total public pension benefits.

Corporate pension reforms in 2001 and 2002 greatly increased the options of Japanese companies to restructure their pension systems. It is hoped that the reduction in public pensions will be compensated by an increase in corporate or individual provisions. However, the current tax environment in Japan does not exactly favor such additional pension provisions, and lower income earners who work predominately in smaller and middle-sized companies cannot easily compensate the reductions in public pension by additional private provisions (Conrad and Fukawa, 2003).



## 6. Concluding remarks

Japan is trying to redefine the role of the public pension system and to make the system less vulnerable to economic and demographic changes. Financing of the welfare state is still one of the key issues in Japan, and currently new options are being reviewed, including new ways of approaching the issues of the elderly, broadening the financing basis of social benefits, and greater reliance on private arrangements. In considering a new approach, it is worth keeping in mind that cutting social expenditures will not necessarily lead to a reduction in the total resources which a society devotes to such ends, though it will change the distribution of burden (OECD, 1997b).

The most important factors for the sustainability of the public pension system are fairness of the system and public trust in the system. It is important to provide meaningful benefits to the elderly within an affordable level of contribution for the working population. To this end, it is indispensable that burden will be shared by everybody. For beneficiaries, it means that benefit expenditure will be reduced through lower post-retirement indexation and lower benefit accrual rate. The issue here is an optimum scale of the EPI for the Japanese working population in order to provide meaningful retirement income within an affordable level of contribution (Fukawa and Yamamoto, 2003). Intergenerational inequality is perceived as a serious problem and effects of population ageing are quite serious in Japan. We summarize the following 5 points, among others, as lessons we can learn from reform efforts in other countries:

- Intergenerational equity is an important factor for the public pension system in every country, and it is often used for this purpose to fix contribution rates for many years. In order to mitigate intergenerational inequality caused by the PAYG financing method, a personal retirement account approach has been introduced or discussed in Germany, Sweden and the United States. However, the share of such an approach is around 10 to 30 percent of total public pension benefits.

- Fairness of the system is prerequisite for public trust in the system, and it is clearly useful to treat employees and the self-employed equally. In fact, a single OASDI system covers virtually all the working population in the US.

- There is wide support for making public pension benefits related to contributions, although not necessarily in direct proportion. The main function of public pension systems in France, Germany, Sweden and the US is to cope with the loss of earnings after retirement, and there is a broad consensus in these countries that public pension has an income-smoothing function. In this respect, it is interesting to note that the third model of the Bush Commission proposed to reduce the replacement rate of higher income above the second bend point.

- The share of public pension benefits in retirement income reflects the situation of each country. The public pension benefits have a commanding share in France and Germany, whereas the UK government is trying to further reduce the role of public pension. The share of public pension benefits also differs according to income level. It also requires cost to offset the reduction of public pension benefits through introducing a tax-supported corporate / private pension system, as seen in Germany.

- The public pension system needs to be neutral from individuals' decisions about their life course. EU countries are trying to alter the paradigm from early retirement to later retirement. A typical example of neutrality is that an individual chooses when he or she wishes to retire in Sweden.

## Notes

<sup>1</sup> Basic Pension benefit is proportional to the contribution period. The National Pension provides only the Basic Pension.

<sup>2</sup> The bill passed the Diet in June 2004, without major changes.

<sup>3</sup> Model benefit level refers to the old age pension benefit for those male employees with dependent spouse, who earned average earnings for 40 years. Model replacement rate is the proportion of model benefit level to the average net earnings of male employees.

<sup>4</sup> If we denote total net wage increase minus average net wage increase as  $d$ , pension benefit will be increased each year in line with price increase minus  $d$ , instead of the present price increase. This is what it termed a "macro economy slide" in Japan.

<sup>5</sup> Employee pays 7.0 percent of earnings with an upper ceiling and employer pays 10.21 percent of earnings without an upper ceiling. The total contribution rate of 17.21 percent is equivalent to 18.5 percent of pensionable earnings.

<sup>6</sup> The contribution rate needs to be raised by about 2 percentage points immediately, in order to gain 75 years financial stability.

<sup>7</sup> The benefit accrual factor for the earnings-related part was 0.7125 percent of earnings without bonuses per year of contribution until March 2003, but it is 0.548 percent of annual earnings since April 2003, as shown in Table 3. It is important to remember that this change of accrual rate does not accompany any benefit reduction.

<sup>8</sup> Prof. Joakim Palme sent the following message to the author on June 29, 2004. The private pension benefits are important in Sweden because the occupational collectively bargained schemes have an extraordinary wide coverage, partly due to the strong trade-unions and the high union density. This explains why low income pensioners also have

substantial income from private pensions.

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