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Preparing Public Pensions for an Old-Aged Society

Takayama Noriyuki

Pension reform has been placed on the political agenda. It was one of five basic policy items agreed to when, on July 29, 1993, the leaders of eight parties decided to form the new coalition government led by Prime Minister Hosokawa Morihiro.

Nowadays people take public pensions for granted. It has become hard to imagine living in old age without receiving pension benefits. But concerns are being voiced about the future of the pension system, and some are openly expressing misgivings about its viability. When moves to revamp the system begin—and 1994 is set to be a year of a sweeping pension reform—this unease will have to be addressed. But just what should we do to make the system politically and economically sound enough to serve Japan's needs in the twenty-first century?

Germany's new pension plan

Japan is by no means the only country faced with a need for pension reform to cope with a graying society. The industrial countries of the West are also struggling with this problem. As Germany has recently succeeded in overhauling its pension system, let me begin with a review of this achievement.

On November 9, 1989, the West German Bundestag enacted a pension reform bill. By coincidence, the Berlin Wall came tumbling down that very night, thus ending the division between East and West Germany on the same day that the new pension system got its start. Of special note is the painstaking effort that was made beforehand to avoid a political squabble. The goal from the beginning was to work out a reform agreeable to labor and management as well as the government and opposition parties, and this meant that compromises had to be thrashed out for many of the points in contention. Only the Greens failed to endorse the resulting legislative package.

Pension systems have often been presented to the public in a fashion confused by the excessive use of technical concepts. As a result, many people have hazy or erroneous views of their system's basic nature, and debates about pension reform have tended to become complicated. The German reform dealt with this problem by working out some unusually clear and simple rules governing how the economic pie is to be sliced up between currently active workers and those who have retired.

In redistributing income from workers to retirees, a pension system must permit retirees to maintain their dignity in their old age, and it must also allow active workers to receive a respectable share of the economic pie. The problem here is one of coming up with rules that meet both objectives. There rules need to be politically and economically viable over the long run, and they should not be set arbitrarily, as has tended to happen in the past. It was precisely on this question of rules that the German debate focused. To put the conclusion of the

Takayama Noriyuki Born in 1946. Received his Ph.D. in economics from the University of Tokyo. Is a professor at Hitotsubashi University's Institute of Economic Research. Author of The Greying of Japan, Nenkin kaikaku no kōsō *(A Design for Reforming Public Pensions), and other works.*

debate in a nutshell, the main rule is that standard pension benefits should be set at 70% of the average take-home pay of currently active workers. And a secondary rule is that there should be no basic change in the real level of these benefits from the first payments to the time of death.

Under the West German system introduced in 1957, benefit levels had been based on *gross* wages (before tax and social security payments). After benefit disbursements began, moreover, their size was adjusted up in line with growth of gross wages. But this arrangement caused problems. Specifically, as active workers came to shoulder a heavier tax and social security burden, their disposable income failed to grow as fast as that of people in retirement. In the case of a standard pension recipient with 45 years of enrollment, benefits amounted to 60% of workers' wages on an after-tax basis in 1963, but they rose to 65% in 1969 and 70% in 1981. Under this sort of system, as the share of senior citizens in the population increases, placing a growing burden on the workers responsible for their support, retirees' living standards improve faster than those of workers. In effect workers are forced to bear all the costs of a graying society.

Among the legislators in the Bundestag, a consensus emerged in favor of having retirees share part of the burden. This was accomplished by switching the benefit basis from gross to net wages. Under the new system, it will still be possible for pensioners to enjoy the fruits of economic growth. That is, when an expanding economy substantially boosts net wages, pension benefits will also move up. But when, despite a considerable rise in gross wage levels, take-home pay grows slowly or not at all because of hikes in tax and social security charges, the growth of pension benefits will be similarly limited. Under this arrangement, both gains and pains will be distributed more equitably, and all Germans, young and old, should sense that they are riding in the same boat.

When the new system went into effect in July 1992, a mechanism governing funding was installed to ensure that no matter how far the graying process goes, no change will occur in the balance between the income of pensioners and that of active workers. Automatic adjustments made in line with increases in net wages should guarantee that the pension system never runs out of funds. And thanks to the shift from gross to net wages in setting benefit levels, the total cost of the pension system in 2030 should be about 16% lower than it would have been otherwise.

Paying pensioners as much as workers

Turning now to Japan, I will focus my comments on Employees' Pension Insurance (Kōsei Nenkin Hoken), the principal public pension program for private-sector employees. The plans for civil servants, the self-employed, and others have similar benefit structures, though some of their particulars are different. In the case of the Employees' Pension system, the standard benefits around 1975 amounted to 60% of workers' monthly wages before taxes. (Note that this figure excludes the semiannual bonuses, which as I discuss below, have thus far been excluded from pension calculations.) In those days national and local income taxes and social security contributions took about 10% out of wage earners' monthly pay, leaving them with take-home pay equal to about 90% of gross wages, while the tax burden on retirees was tiny. Comparing 60% to 90%, we find that the ratio of benefits to net wages came to 2:3. Thereafter the figures shifted in a direction favoring pensioners. By 1986 their benefits had reached some 68% of monthly pretax wages, while the tax and social security burden on workers had risen to 16%, reducing their net wages to 84% of the gross amount. There was, in other words, a 4:5 ratio between old-age benefits and net wages.

Henceforth the share of older Japanese in the population will be expanding rapidly, and the bill for their support will become far more costly. The chances are that eventually a 25% or 30% bite will have to be taken out of paychecks, and at that point the after-tax pay of workers will be on the same level as old-age benefits. Clearly that would be going too far toward the pension system's goal of having one generation give a helping hand to another.

To preserve a constant balance between the income of the two groups, we should switch to the net-wage basis for setting benefit levels. Thus far the pension debate in Japan has focused on benefits as a percentage of workers' gross wages, but this must be corrected. If the current after-tax ratio is indeed in the vicinity of 4:5, and if people judge this balance to be acceptable, we need merely reach agreement on maintaining it. If we are hoping for a politically smooth transition to a new pension system, preserving this ratio may be our best bet.

Presuming that the new system sets the benefit level as a percentage of after-tax wages, long-term increases in the same net wages must be used for any benefit adjustments. We would also be well advised to hold benefits at the same level until the pensioner's death, since this will assure the system's stability.

What savings will the finance authorities realize as a result of the switch from gross to net wages in pension calculations? Assuming that the share of senior citizens (aged 65 and over) in the total population increases annually by 0.5 percentage points over the next 20 years or so, and assuming also that net wages grow more slowly than gross wages by a margin of 0.5 points per year, I estimate that total government expenditures will be roughly 10% lower than they would have been at a point 20 years after the change begins. And after 40 years, the expenditures should be more than 20% lower. As in Germany, the reform is sure to be a boon for public pension finance.

When should benefits commence?

One other major reform issue is that of raising the commencement age for pension benefits from 60 to 65. The laws under which Japan's pension plans are being operated already set the commencement age at 65 in their basic provisions, but they contain supplementary provisions stating that for the time being full payment will continue to be offered from age 60 on. When the system was reformed in 1989, the administration sought to phase out benefits for those younger than 65, though they would still be entitled to apply for advance payments at reduced rates, but resistance from labor unions and the opposition parties caused this proposal to be scrapped.

In West Germany an agreement was reached beforehand with labor and the political opposition on rolling back the commencement age. The German system is moving the age to 65 by stages, but it left room for partial benefits at an earlier age as well as for a fairly generous scheme that begins with reduced payments at 62 for some people. Still, the authorities reckon that these changes will not reduce disbursements by much more than 2% by 2030.

If the commencement age for Japan's Employees' Pension were raised from 60 to 65, a fair amount of money could be saved, since more than 60% of the eligible participants are currently starting to collect their pensions at age 60, and a certain number of others start collecting at ages 61–64. Raising the commencement age would cut out these payments. But if this were done without first ascertaining whether the enrollees between 60 and 64 had access to good jobs, the effect might be to swell the ranks of the jobless. That is, those who reach the


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Pause that refreshes: Japan's current generation of senior citizens enjoy relatively generous pensions after retirement.

age of 60 might be unable to find suitable employment, and they would have to apply for unemployment compensation. In effect, the bill for their support would simply be shifted from the pension system to the unemployment system. We must also bear in mind that while some people would not be harmed by the change—about one-fifth of all Employees' Pension recipients do not collect their first benefits until they reach 65 even today—there are many others who would suffer seriously if they did not receive benefits from 60 to 64.

The 1989 reform plan sought to impose a commencement age of 65 on one group: workers who were born after April 1, 1946. Insofar as that was when the postwar baby boom began, it seems that this generation was being targeted for special treatment, and this has no doubt offended quite a few of its members. Needless to say, measures that discriminate against one group or another are hardly desirable in administrative reforms. In any event, the majority of the Japanese do not favor a rigid commencement age of 65. According to a March 1993 poll of informed Japanese, 71.5% want the government to be flexible in extending benefits to those between 60 and 64.

Making 65 a dividing line

If a flexible system is to be applied to enrollees in their early 60s, it might take one of two approaches. First, the current practice of permitting full payments to start from the age of 60 might be replaced with a system of reduced benefits that participants can collect before the age of 65. This is basically what the administration proposed in 1989. While that plan went down to defeat, conceivably it could be resurrected by setting the reduced rates at a higher level. But because the labor movement remains firmly opposed to the elimination of full pensions for those in the 60–64 age bracket, there seems to be little possibility of forging a consensus in favor of this approach.

The other approach is to retain the pensions for those under 65 while modifying their content. Above all, the revisions should be designed to encourage people eligible for benefits to continue to work. As suggested by Yamazaki Yasuhiko, an associate professor at Sophia University, the first step in this reform should be to separate the financial accounts for those in the 60–64 bracket from those who are 65 or over. The funding for the former benefits should come from a special incentive system whereby the contribution level would be lower for businesses that actively employ older people.

For people in the 60–64 bracket who are not fully retired and therefore cannot claim full benefits, the design of the partial benefits they are entitled to (if their wage income is not above a certain level) should be arranged so that wage hikes do not lead to equivalent or larger benefit cuts. Another idea would be to remove the cap on the flat-rate component of the benefits, as distinguished from the earnings-related component. Currently these flat-rate benefits hit a ceiling at 35 years of enrollment, giving no advantage to those who work longer than that. In addition, the practice of permitting people to collect both unemployment compensation and old-age benefits should be brought to a stop.

Naturally an overhaul of the benefit standards should be part of the second approach. Specifically, the payments to those under 65 should be lowered in order to curb swelling pension costs in the future, but care must be taken to ensure a smooth transition to the new payment levels. The benefits must be left at a level high enough so that retired couples can make ends meet. According to a 1989 Management and Coordination Agency survey, households with couples aged 60 or over most frequently spent a monthly sum somewhat in excess of ¥140,000. Apparently only a few found this to be an insufficient amount to get by on; most reported that it met at least their basic needs. With the inflation since then in mind, we might set the standard payment for long-term enrollees in the 60–64 bracket at ¥150,000 in 1994 prices. (For comparison, as of 1993 the "model" pension for a new retiree with 35 years of service and a dependent spouse came to ¥216,000 per month.)

In any event, my proposal is that the benefit schedule be set so that over a period of years, with no abrupt changes, a gap emerges between the payments before and after 65. Pensioners in their early 60s would receive reduced amounts, and when they reach 65, their benefits would jump upward. In this way, my system would differ from one that applies reduced benefits to the end of the pensioner's life. Of course, there may be some people who would prefer to receive more generous payments in their early 60s, and this could be arranged by allowing them to withdraw beforehand some of the funds they would be entitled to after they reached 65. We might also see calls for arrangements under the corporate pension plans of the private sector to allow retirees to receive relatively higher benefits in the years before age 65.

The important point is to guarantee the "freedom to retire" at 60, ascertaining that those who want to withdraw from the labor force can support themselves until they reach 65, while simultaneously motivating all workers to remain employed until a more advanced age, thereby meeting the needs of the coming century's old-aged society.*

Securing funds with the consumption tax

Given the social and economic changes now underway, we can no longer design pensions with no

*Author's postscript: On December 20, 1993, a pension reform team made up of representatives of the ruling coalition parties reached agreement on the principle of switching to net wages as the basis for setting benefit levels. It also decided that while the current earnings-related component of the Employees' Pension will continue to be paid from age 60, the normal commencement age for the flat-rate component will be gradually raised starting in the year 2001 so as to reach 65 by the year 2013. According to the team's plan, participants will continue to have the option of receiving the flat-rate component from age 60, but at a reduced level.

Good thinking: One major electronics company has tapped the pool of job-seeking seniors to staff an engineering office.

relation to other public policies. Leaving behind the thinking that pension plans can stand in isolation, we should formulate an innovative pension philosophy. Above all, the plans must be structured to encourage older Japanese to work, but there are also many other issues to address. Benefits should be tailored to the needs of participants at each stage of life, with the introduction, for example, of a special disability allowance for aged pensioners who have come to require long-term care; deductions in the calculation of contributions should be provided to those who are bearing and raising children; survivors' annuities should be reformed; and working women should be given more support.

At the same time, sources of pension funds should be reconsidered. At present contributions are not taken out of the portion of the salaried worker's wages paid in the form of semiannual bonuses, but this is a cause of unfairness in the distribution of pension burdens. The exemption is advantageous for high-wage workers, since they generally have the largest bonuses, and it sends a message to labor and management to raise the share of bonuses in annual income, since this lowers the overall contribution rate. In addition, workers in their early 60s can maximize their benefits by having their employers pay them only a minimal monthly wage, making up for this with extra large bonuses. All such distortions could be reduced or eliminated by assessing contributions on bonuses as well as monthly salaries.

The single most essential condition for the health of the pension system is sustained economic growth. If growth were to come to a standstill, younger Japanese would despair of achieving a higher standard of living than their parents, and it would become difficult to continue the present level of intergenerational transfers from workers to retirees. Growth is also an important consideration for corporate managers, since it encourages them to continue operating in Japan. From management's point of view, the portion of pension contributions paid by employers is an integral component of personnel costs, and hikes in these contributions increase the pressure to shift production to low-wage countries. Thus, for the sake of the domestic economy as well as for the future of the pension system, it is best not to set contribution rates too high.

From the perspective of minimizing the constraints on growth, the best medium for raising public revenues is actually the consumption tax, since it does not apply to the saving and investment that serve to power growth. This means that as pension disbursements swell in the years to come, we should use the consumption tax as a supplementary funding source, raising its 3% rate in order to secure more funds. This money will also make it possible to lighten the pension load on young and middle-aged workers, spreading the costs of the system more evenly across the various stages of life. Surely the vast majority of Japan's wage earners would benefit from this sort of funding reform. At the same time, though, it cannot be said that the current consumption tax is a neutral levy, since smaller businesses enjoy special breaks. This and other defects in its design need to be corrected.

Now that the opposition forces have moved into power under Prime Minister Hosokawa, they must assume far more political responsibility for the pension system than they have been accustomed to. Among their numbers are Japan's labor leaders as well as the Socialists, formerly the loudest voice in the opposition, and this should make it easier to forge a consensus on reform. At this time of intensifying expectations in the political arena, it is my fervent hope that a cool and wise debate on the pension system will unfold, paving the way for a reform program that labor, management, and all the political parties can endorse. (Courtesy of Tōyō Keizai Shinpōsha)

Translated from "Seidoku ni narai tedori bēsu no dōnyū o," in Shūkan Tōyō Keizai, *August 28, 1993, pp. 54–59.*