Gradual retirement in the OECD countries

Macro and micro issues and policies

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8 Gradual retirement in Japan: macro issues and policies

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It is well known that Japan's population is aging very rapidly. By 1994 about 14 per cent of the population were elderly (65 years or older). Projections suggest large increases in the number of the elderly over the next fifty years, so that by 2040 more than 30 per cent of the population will probably be 65 or above. Japan will then have one of the oldest populations in the world.

Meanwhile, around 2000, the working population will begin to diminish. Growth in productivity will to some extent offset the decline in the size of the working population, but if people work more after 60 years, Japan is more likely to maintain her economic vitality into the twenty-first century. This, in turn, will make it easier for Japan to support its growing elderly population.

In this chapter we attempt to describe the current labour market situation of the elderly in Japan, and to explain why a move towards early retirement has been taking place. We also examine what kind of policy measures have been adopted to encourage later retirement and whether or not they are effective in achieving this. Finally, we consider what kind of policies will be needed to promote gradual retirement and to reduce the future financial burden of social expenditure.

8.1 Recent trends

Labour market position of older workers

The labour market positions of older workers in Japan have been very severe. The mandatory[1] retirement age used to be 55. As of April 1998, a mandatory age for retirement under 60 will no longer be permitted by law. In 1994, most companies in Japan (84 per cent) were mandating their employees to retire at 60 years or above.

Currently only 20 per cent of companies in Japan re-employ all employees wishing to continue to work until the age of 65. Those employees mandated to retire when they reach the age of 60, if they are highly skilled or possess some special expertise, are usually given an opportunity to be re-employed by their former company or a closely related one. However, their salaries are very likely to decline sharply after the age of 60. The effective demand/supply ratio for those re-entering the external labour market in their early sixties was just 0.08 in November 1994. The likelihood of their securing a new job in the external labour market after mandatory retirement is negligeable.

On the other hand, a fair proportion of retired employees become self employed after the age of 60. Among highly industrialised countries Japan is perhaps rather special in this respect.

In 1992 nearly 60 per cent of Japanese workers said they wished to continue working in labour market employment over the age of 65, the majority of them wishing to be in part-time jobs after the age of 60. Their main reasons for wishing to continue working after 60 were in order to maintain good health and to remain active in society, but not primarily in order to get money.

Pensions and social security

Currently Japan has a *first pillar* system comprising six public pension programmes covering different sectors of the population. The earliest plan was established in 1890; the most recent, in 1961. All sectors of the population receive a basic minimum benefit. Five employee systems provide a contributions-related supplement on top of the minimum. Although each system has its own particular contribution and benefit structure, all systems are similar, for the most part operating on a pay-as-you-go basis (see Takayama, 1992).

The monthly minimum benefit was 65,000 yen[2] per person in 1994 while monthly earnings-related benefits are typically about 30 per cent of average past monthly real earnings. Equal percentage contributions are required of employers and their employees. The total percentage currently in effect from November 1994 is 16.5 for the principal programme for private sector employees (the Kosei Nenkin Hoken; KNH). This contribution rate is applied to monthly earnings. From April 1995 contributions are for the first time to be taken out of bonuses, which are usually paid twice each year and account for a substantial portion of many employees' income. A special 1 per cent contribution rate split equally between employees and employers will apply to bonuses without any ceiling.

At present, KNH old age benefits for a new 'model' retiree (based on average earnings over 37 contribution years) and his dependent spouse (full-time housewife) were about 231,000 yen per month in 1994, replacing 68 per cent of the average monthly earnings of currently active male workers.

In Japan, employees usually receive semi-annual bonuses which typically amount to from four to five months salary, although in small companies they are often more modest. Since they are not included in the earnings base for public pension benefits, the replacement rate for the above-mentioned 'model' retiree will be considerably lower, about 50 per cent of the average annual earnings.

To put it another way, the 68 per cent replacement is the rate for gross salary. Active workers pay income tax and make social security contributions, and their deductions currently average 16 per cent of their monthly earnings. For retirees the deduction from their pension benefits is zero or quite small. Consequently the current replacement rate to monthly take-home pay or net income is about 80 per cent.

As for the *second pillar*, Japan has occupational pensions and/or lump sum retirement benefits. Currently the coverage of occupational retirement benefits is close on 90 per cent, although the coverage of occupational pension plans is nearer 50 per cent.

The average lump sum retirement benefits paid to mandated career male retirees were 20 to 24 million yen in large firms and 10 to 13 million yen in smaller firms in 1989. For employers, the main attraction of their type of occupational pension plan is that instead of paying out annuities, they can accumulate funds on favourable tax terms. In actual fact, more often than not, almost all retiring employees choose their retirement benefits as a lump sum, although their employers operate annuity-based formal pension plans.

There are three major schemes whereby employers can prepare provision for retirement benefits. One is to fund plans on a pay-as-you-go-basis with book-reserve accounting (started in 1952, and similar to West Germany's). Book reserves are tax deductible within certain limits: namely 40 per cent of the benefit liability can be deducted from income tax-calculations as a corporate expense. Originally a deduction was permitted on 100 per cent of the liability. Another scheme is a tax-qualified plan (TQP started in 1962). Plans of this kind must be funded externally through a group-annuity contract or a trust agreement. An employer's contributions to a tax-qualified plan are 100 per cent tax deductible as a business expense. A special 1.173 per cent corporate tax is levied annually on fund assets. Such plans must contain provision for annuity payments, though a lump sum option is permitted. The third scheme is for contracted-out plans (started in 1966) through the Kosei-Nenkin-Kikin (KNK, Employees' Pension Fund). KNK benefits comprise two components: an equivalent benefit of the earnings-related portion of social security (excluding the benefit resulting from indexing), and a supplementary benefit. The latter is financed primarily by the employer. It can be received in a lump sum at the discretion of the employee, although in principle it should be in the form of a life annuity. The plan must be funded through a trust fund or an insurance contract. Tax treatment of the contracted-out plan is substantially the same as that of the tax-qualified plan, except that the KNK does not pay taxes on accrued benefit liabilities equal to 2.7 times the benefit equivalent of the fixed earnings-related portion of the state scheme.

By the end of March 1993 the number of persons insured under company pension schemes (KNK and TQP) was 11.57 million for the KNK and 10.4 million for the TQP. In spite of the fact that some companies have adopted both systems, overall about one third of employees is covered by KNK and another third by TQP. The number of companies with a TQP pension age of 60 years has increased steadily and by 1992 60 had been adopted by 57.2 per cent of those offering TQP schemes (JILI, 1993, p. 122).

Book reserves are not funded outside, but are in fact retained as profits inside, contributing to the further investment of firms. The funded reserves of tax-qualified and contracted-out plans have been growing rapidly and are helping to augment national savings in Japan.

And what of the *third pillar* in Japan? The accumulation of private savings is among the highest in the world. But the distribution of monetary asset holding is very skewed. Those elderly, whose monetary asset holdings remain small, are not a few even in Japan today.[3] In the past, the role of individual pension plans was not so great. But more recently it has been growing fast, so the household coverage of individual pension plans stood at about 35 per cent in 1994.

In April 1991 a special type of individual pension account, called the Kokumin-Nenkin-Kikin, became available for non-employees and their spouses (ages 20 to 59). A contribution up to 68,000 yen per month per person is now tax exempt, which is very generous compared with only 50,000 yen per year for all individual 'pension' insurance policy premiums in respect of salaried workers together with their dependent spouses.

The recent move towards early retirement

Since the early 1970s, early retirement has become very popular in OECD member countries, and Japan is no exception.[4] Recently a growing number of males in younger cohorts has been earning wages and salaries, with the proportion of salaried men in their late forties, for example, reaching nearly 80 per cent of the work force. Meanwhile, the proportion of salaried men in their early sixties has been gradually decreasing. It was less than 40 per cent in 1988.

And what of the average retirement age of salaried men in Japan recently? Figure 8.1 presents the employment status in 1986 for men aged 59-64 years who had once been, or continued to be, wage and salary earners. By the time they were 61, a majority of these people were moving into full retirement or had become self employed. In Japan, then, the average age of exit from employment for salaried men would have been just before 61 years.

Figure 8.1 Employment status of men by age in Japan in 1986

Source: The 1986 Basic Survey of Japanese Living Conditions.

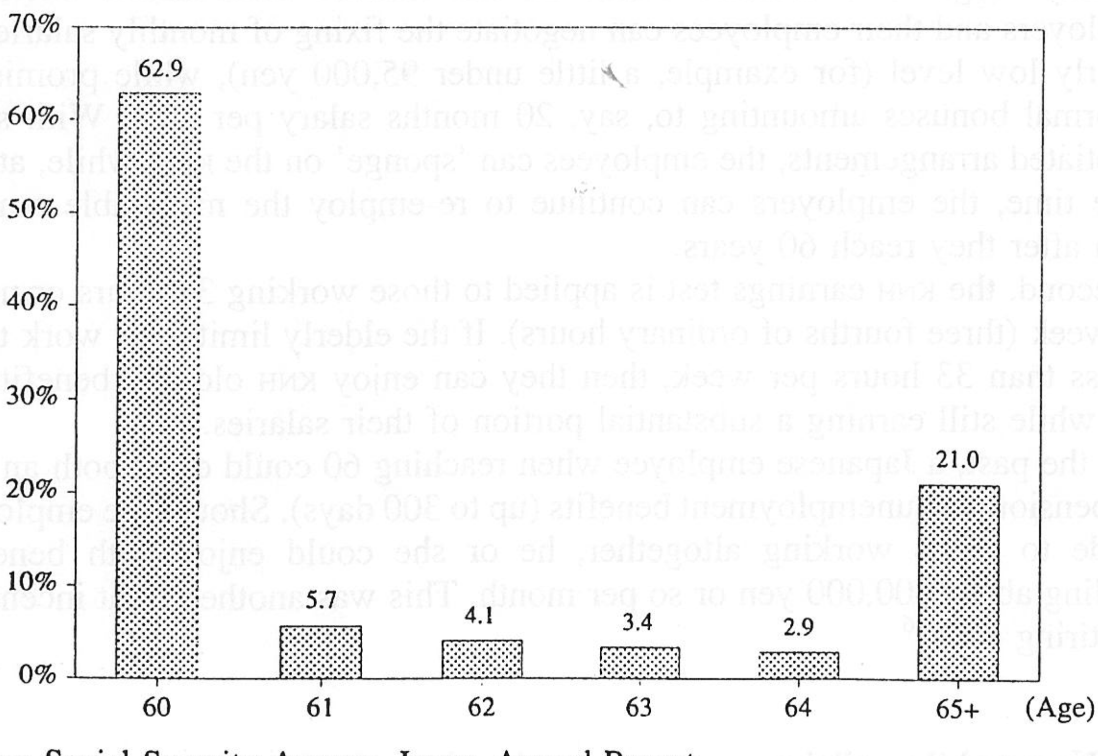
Why, then, do the majority of salaried men in Japan today cease to be salary and wage earners around the age of 60? The main reason is, undoubtedly, that at that age they begin to draw public pension benefits. The normal pensionable age for men in the KNH is still 60 years, and currently their average amount of public pension benefits is 200,000 yen per month, fairly high by international standards. Indeed, the above amount is currently a little more than the average monthly salary initially paid to college and university graduates in Japan.

Moreover, by the time they are 60 the majority of wage earners in Japan today have 35 years or more of work experience. At this stage in their professional life, in a Japan where firms are competing fiercely for rapid, refined and innovative technological advantage, it is very understandable that many elderly workers, especially non-office workers, are 'burnt-out', that some have a sense of fulfillment, but that most are weary and ready for retirement.

Furthermore, the mandatory retirement age for most of firms in Japan is currently 60 years.[5] Employers are more likely to dismiss their employees at the age of 60 or even earlier. As going concerns, firms must struggle to survive. Productivity growth is the top priority, and new technologies will be built into corporate practice by younger, and not by elderly, workers. Promotions are as a general rule useful incentives to harder work, so that ordinary managers and directors in Japan are generally asked to retire when they reach 55.

Figure 8.2 shows the age distribution for men who started drawing KNH old age benefits in fiscal 1990. It reveals that nearly two thirds of them began receiving their old age benefits as of 60 years, although their average starting age was 62.1.

Figure 8.2 Age distribution of men in Japan who started to receive old age pensions of the KNH in fiscal 1990



Source: Social Security Agency, Japan, Annual Report.

Why exactly did a majority of them start receiving KNH old age benefits at 60? First, prior to 65 years postponing the start of KNH old age benefits increases the sum of the benefits to a very limited extent only; the first-tier flat-rate benefits of the KNH have a 37-year ceiling in the benefit formula, so that postponing start-up before the age of 65 produces no actuarial increment in the level of the monthly benefit.

Second, employers in general have little or no incentive to hire elderly people. Supporting retired workers aged 60 years or more has been socialised by the KNH, meaning that all employers have to contribute to the KNH in support of retired workers regardless of their efforts to continue to employ the latter. On the other hand, hiring workers including elderly ones is essentially on a private basis, so that employers who *continue* to employ workers aged 60 years or more are effectively paying the wages out of their own pocket. A 'free rider' problem arises, and employers are thereby more inclined to dismiss their employees by the time they reach 60.

In short, the KNH has its own built-in inducement causing people to start drawing old age benefits as soon as they reach 60.

There are other incentives, too. It was often said that the past earnings test of the KNH was inducing early retirement around the age of 60. It was indeed the case that the marginal 'tax' rate through the KNH earnings test would be about 100 per cent, but that was only half the story. In point of fact the KNH had, and continues to have, loopholes. First, the earnings test depends on monthly wages and salaries which do not include semi-annual bonuses. Employers and their employees can negotiate the fixing of monthly salaries at a fairly low level (for example, a little under 95,000 yen), while promising abnormal bonuses amounting to, say, 20 months salary per year. With such negotiated arrangements, the employees can 'sponge' on the KNH, while, at the same time, the employers can continue to re-employ the more able among them after they reach 60 years.

Second, the KNH earnings test is applied to those working 33 hours or more per week (three fourths of ordinary hours). If the elderly limit their work time to less than 33 hours per week, then they can enjoy KNH old age benefits in full, while still earning a substantial portion of their salaries.

In the past, a Japanese employee when reaching 60 could draw both an old age pension and unemployment benefits (up to 300 days). Should the employee decide to cease working altogether, he or she could enjoy both benefits totalling about 400,000 yen or so per month. This was another great incentive to retiring early.[6]

8.2 New public policies

In 1994 the Japanese public pension and employment insurance systems were reformed with a view to promoting later retirement. In this section we indicate what those reforms were and attempt to assess to what extent they have been effective in generating jobs for the elderly.

Incentives in public pension schemes

The 1994 reform in public pension schemes includes a raising of the pension age and a change in the earnings test. Both measures were adopted so as to promote employment of the elderly.

Two pension ages will be applied to salaried workers. While the start of basic benefits will be gradually shifted to the age of 65, earnings-related benefits will continue to be available at 60 years. This arrangement corresponds basically to a system once envisaged in Britain.[7]

Figure 8.3 shows the new payout configuration for men both in 2001, the first year of their shift, and in 2013, at the shift's end. From 2001 through 2003, men will have to wait until they are 61 before they can receive the full amounts of basic benefits. This will affect those males born between 2 April 1941 and 1 April 1943 (see table 8.1). The phasing out of basic benefits for female employees will be delayed five years behind the schedule for male employees, starting only in 2006. Eventually, retired workers under the age of 65 will not receive any of the special benefits now available for enrollees in the 60-64 age bracket, though they will still be eligible for full amounts of the earnings-related 1st pillar benefits (tier 1).

Figure 8.3 Adjustment in the commencement age of pension benefits for men in Japan

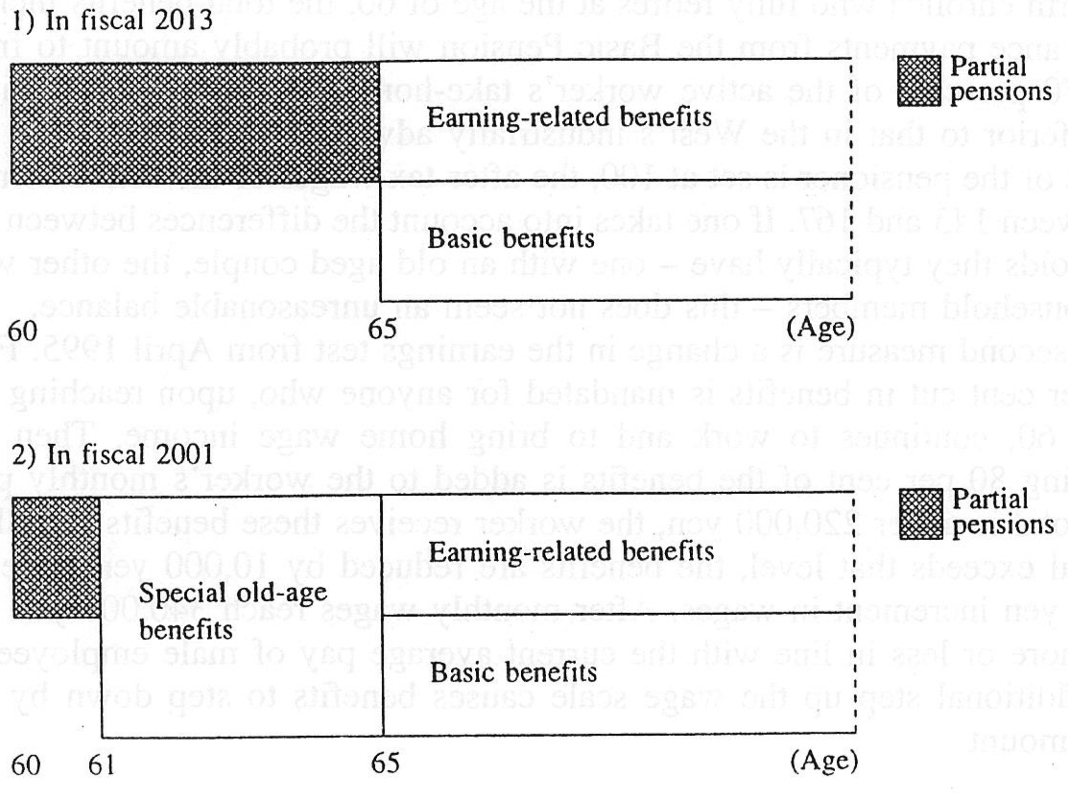


Table 8.1
Start of full basic benefits for male employees in Japan

Date of birth	Age
Before 1 April 1941	60
Between 2 April 1941 and 1 April 1943	61
Between 2 April 1943 and 1 April 1945	62
Between 2 April 1945 and 1 April 1947	63
Between 2 April 1947 and 1 April 1949	64
After 2 April 1949	65

Those in this age bracket can also receive advance payments at a reduced rate from the Basic Pension on tier 1 (1st pillar). At present non-salaried workers can already take advantage of this system, and at the start of the twenty-first century salaried workers will gain the same right. Advance payments are to be handled by paying out Basic Pension benefits at a reduced rate until the end of the pensioner's life. The size of the reduction now being applied rises from 11 per cent for one year of advance payments to 20 per cent for two years, 28 per cent for three years, 35 per cent for four years, and 42 per cent for five years. As some people feel that the current rates of reduction are too steep, their appropriateness is to be reviewed in 2001 using the latest data on life expectancy. Meanwhile, 60-year-old retired wage earners will continue to receive earnings-related benefits without any reduction in their amounts.

When we add these factors together, we find that in the standard case of a long-term enrollee who fully retires at the age of 60, the total benefits including advance payments from the Basic Pension will probably amount to from 60 to 70 per cent of the active worker's take-home pay. This level is in no way inferior to that in the West's industrially advanced countries. When the income of the pensioner is set at 100, the after-tax wages of the active worker lie between 143 and 167. If one takes into account the differences between the households they typically have – one with an old aged couple, the other with four household members – this does not seem an unreasonable balance.

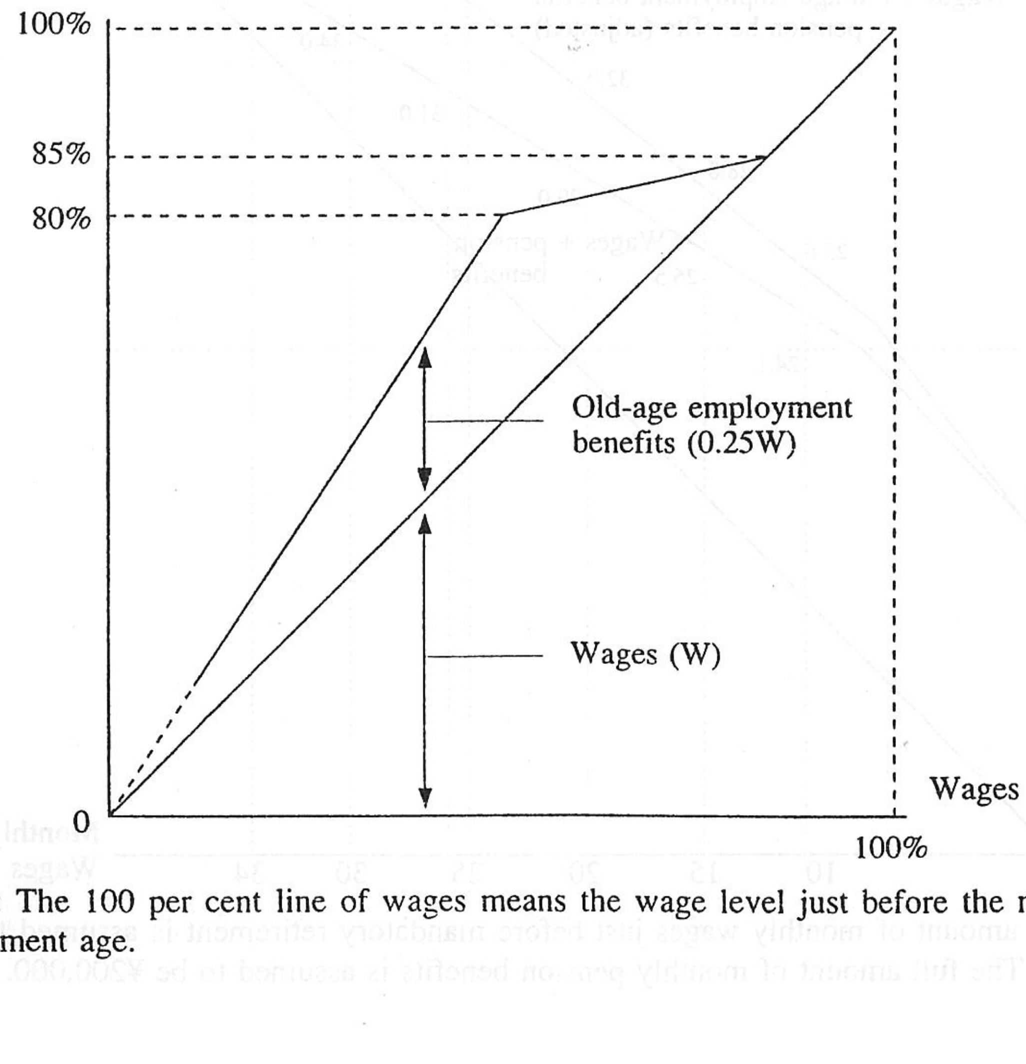
The second measure is a change in the earnings test from April 1995. First a 20 per cent cut in benefits is mandated for anyone who, upon reaching the age of 60, continues to work and to bring home wage income. Then the remaining 80 per cent of the benefits is added to the worker's monthly pay. If the total is under 220,000 yen, the worker receives these benefits in full. If the total exceeds that level, the benefits are reduced by 10,000 yen for each 20,000 yen increment in wages. After monthly wages reach 340,000 yen – a level more or less in line with the current average pay of male employees – each additional step up the wage scale causes benefits to step down by the same amount.

What sets this arrangement apart from the existing system, making it an incentive to later retirement, is that salaried workers can increase their total income by earning more money. With each hike in wages, the combined sum of their benefits and wages moves up. The 2:1 ratio between wage increments and benefit reductions happens to be one that used to be employed by the United States.

Incentives in employment insurance schemes

In the employment insurance system, old age employment benefits are to be introduced for those who continue to work from April 1995. The purpose of this measure is to plug a hole in unemployment compensation, which in some cases gives people who have passed the retirement age more money if they stop working than if they stay employed. The measure is designed to motivate those with the will and the ability to work to remain employed during their early 60s.

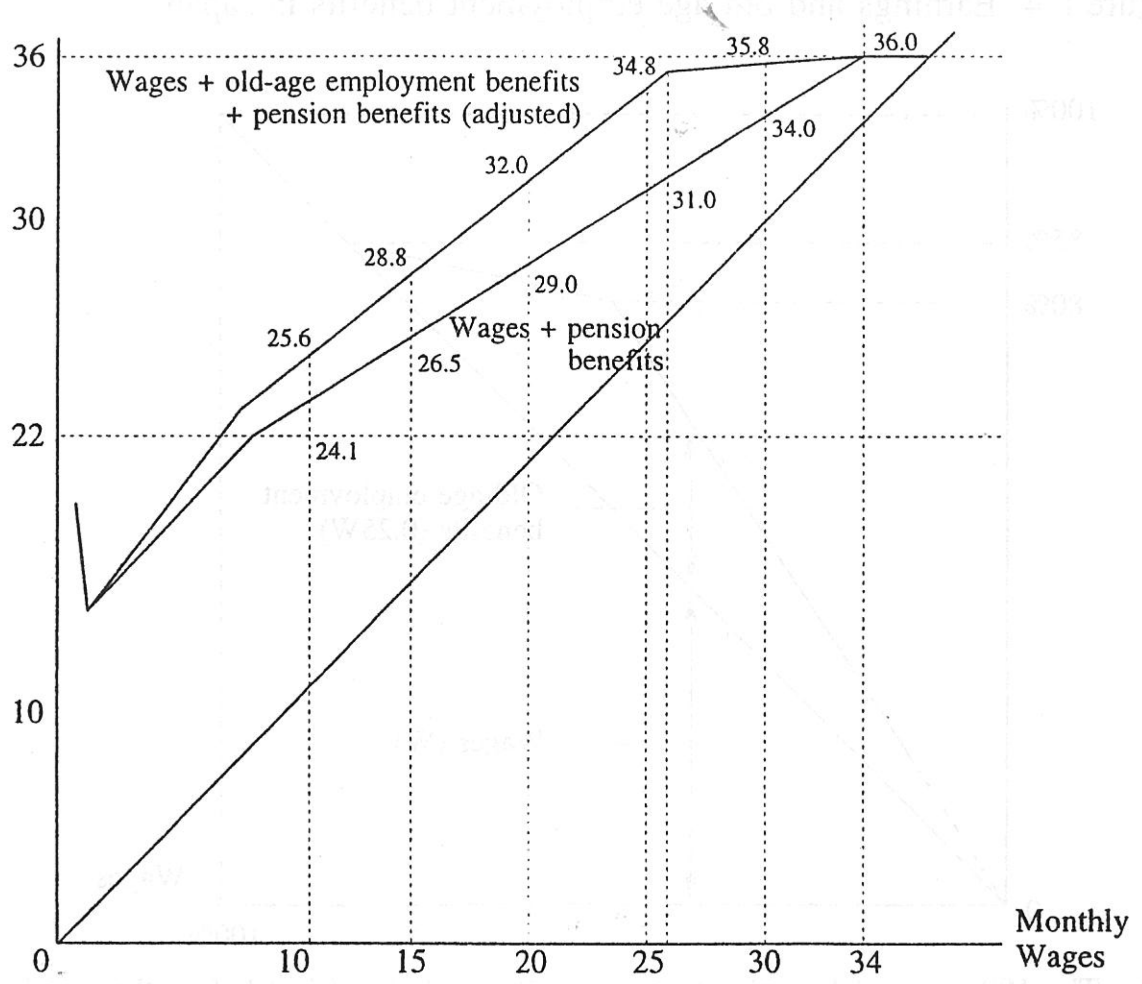
Figure 8.4 Earnings and old age employment benefits in Japan



Note: The 100 per cent line of wages means the wage level just before the mandatory retirement age.

In the normal Japanese company, employees reach the mandatory retirement age at or around 60. Some people do indeed retire then, but many go on working, at least for a while. What, instead, generally happens at 60 is that employees, whether they stay with the same employer or switch jobs, suffer a large salary cut, and at that point the unemployment compensation they are entitled to may be larger than their new wages. The newly introduced measure rectifies this problem by hereafter treating those who have a sharp decline in wages as quasi-unemployed; specifically, these people are to be provided benefits amounting to 25 per cent of their new wages. These benefits, when combined with wage income, will give many of those in the 60-64 age-group more money than they could receive from employment insurance alone. The 25 per cent benefit rate begins to drop at the point where workers are still receiving 64 per cent of their former salary, and for those who receive 85 per cent or more, the rate reaches zero and no benefits are provided (see figure 8.4).

Figure 8.5 Wages and benefits for employees in their early sixties in Japan (Unit: yen 10,000)



Note: The amount of monthly wages just before mandatory retirement is assumed to be ¥400,000. The full amount of monthly pension benefits is assumed to be ¥200,000.

Shown in figure 8.5 is the net income of a worker receiving both these old age employment benefits and the old age benefits paid by the pension system. To balance the employment benefits, the pensions of such workers are to be cut by an amount equivalent to 10 per cent of their new monthly salary.

Moreover, from April 1998 people will no longer be able to draw both unemployment compensation and old age pension benefits.

Future prospects

Stated above are the new policies the Japanese Government has introduced recently. Will they be really effective in promoting later retirement?

As has already been demonstrated in other OECD countries, legislation on increasing the normal age of retirement alone is not enough to reverse the trend towards early retirement. Indeed, on reaching the age of 60, a long-term enrollee can still enjoy very generous pension benefits if he or she receives advance payments from the Basic Pension even after 2013. The elasticity of employment with respect to pension benefits is rather limited in Japan (see Takayama, 1992). The labour market situation for those in their early 60s will not be much different from the current situation. Rather, increasing the normal retirement age will be effective in cutting down the amount of pension benefits for those who begin to draw them before the age of 65.

Turning to the new incentives created by the change in the earnings test and the introduction of old age employment benefits; they seem, at first sight, to be effective. But on closer examination, our findings turn out to be rather different. The absolute sum of pension and old age employment benefits paid to employees in their early sixties will be highest if monthly wages and salaries are kept at a level slightly below 95,000 yen. Introduction of the new measures described above will not alter this situation. Employers and their employees are likely to make a joint decision to seek from the Government the highest level of benefits (subsidies) available. In this sense, no significant changes will occur on the labour market to affect the elderly.

A number of issues have yet to be dealt with. For instance, thus far bonuses have not been considered in the earnings test. Again, the reform will not affect the practice of awarding full benefits to those who continue to receive wage income but work fewer than 33 hours per week, as in the case of part-time advisors and people working on commission. Furthermore, once a private-sector wage earner reaches the age of 65, the full pension becomes payable regardless of whether he or she is earning a high salary.

If we really want the elderly to be employed more, we should have incentives directly influencing the demand side of the labour force, rather than the supply side. As already stated, current legislation is not cost-neutral as to the decision of employers to employ people in their early sixties. If employment neutrality of public pensions for those in their early sixties is desirable, public pension benefits paid to those in the 60-64 age bracket should come from their former employers (and/or employees). The so-called merit system in contribution rates will require them to be set lower for those businesses that actively employ older people.

If later retirement is to be promoted, it is essential that older workers achieve higher productivity. Increased incentives for higher productivity training must be created. Job re-designing to include more part- and flexible-time work patterns is also required.

As far as reducing the future financial burden of social security is concerned, a switch from a gross- to a net-wage basis for setting benefit levels will yield substantial results, as is shown in table 8.2. It is true that the primary purpose of the switch is to preserve a stable balance between the net income of the two groups (actively working generations and retired ones), bringing about a much fairer distribution of income between generations, but it will also prove effective in reducing the future cost of public pensions (see Takayama, 1994; 1995). Japan made this switch in 1994.[8]

Table 8.2
Net income of actively working generations in Japan under population aging

Year	Annual growth rate of gross salary	Actively working generations Gross salary[a]	T&SSC[b]	Net salary	Retired generations Public pension benefits[c]
1995	–	100	16	84	68
	2.0%	200	64	136	110
2030	1.0%	142	45	97	78
	0.6%	123	39	84	68

a The amount of gross salary in 1995 is assumed to be 100.
b Tax burdens and social security contributions (T&SSC) are assumed to equal 16 per cent in 1995 and they will double in 2030.
c Public pension benefits in net terms are set to equal 80 per cent of net salary of actively working generations.

Continued growth of the economy will be necessary if net indexation is to function successfully.[9] Table 8.2 tells us that more than 0.6 per cent real annual growth of gross wages and salaries may be required for members of the active population to be richer than their parents.

The issue of funding becomes important, therefore, if only from the standpoint of avoiding constraints on economic growth. If we ask, as we must, which of the three main revenue sources available – income tax, social security contributions, and consumption tax – is least likely to slow down growth, the answer is consumption tax. Over the long term, accordingly, it will make sense to fund part of the increased cost of our society's 'greying' by raising the rate of consumption tax, which will have the effect of obviating an increase in social security contribution rates.

A shift from a pay-as-you-go to a funded system is often proposed as a way of encouraging savings and, thereby, of stimulating the economy to higher growth. It should be borne in mind, however, that the transition from a pay-as-you-go to a funded system is a rather delicate matter, since the transitional generation has to participate in both systems, paying for pensions twice. This is likely to constitute a political hot-potato especially in societies where population aging continues. Besides, in the Japan of today, it is by no means clear that the public sector will be more effective than the private in stimulating economic growth through investing the funded reserve. For Japan at least, then, a continued lowering of the generous level of the old age benefits operating on a pay-as-you-go basis together with giving much more incentives to private pensions on a funded basis seems to be the advisable course.

Notes

1 It is neither the official/legal age, nor the age at which one is entitled to draw a state pension. Mandatory retirement age is the age at which retirement is compulsory for anyone who has benefitted from lifetime employment. In some cases there is an option to be re-employed by the same company after that age. The mandatory age is set within each company by management-union negociation or by the employer.
2 ¥10,000 = US$112.0 = £70.10 = DM157.7 as at 27 March 1995.
3 See Takayama-Kitamura (1994).
4 The labour force participation rate for those in their early sixties stopped declining in 1989 and began to increase thereafter. This change might be due to favourable labour market conditions in the asset price 'bubble'.
5 Actually, the majority of employees in large firms are leaving long before age 60. However, in these firms, the monthly salaries of non-executive workers are often forced downwards after the age of 55, and, as a general rule, the mandatory retirement age for executive workers is 55. In other words, the spirit of the earlier mandatory age of 55 is still preserved in large firms. Outplacement of employment after the age of 45 is quite popular in these firms. Substantial lump sum retirement benefits are paid to those mandated to retire.
6 The eligibility requirements for disability pensions in Japan are very severe, causing the latter to be a route seldom used by early retirees.
7 See Takayama (1995) and Secretary of State for Social Security, UK (1991).
8 Other ways of reducing the cost of social security pensions would be to raise the normal retirement age from 65 to 67 and to increase the number of contribution years required for full benefit from 40 to 45.
9 Continued growth of the economy will be also necessary if the elderly are to be employed more.

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