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Changes in the Japanese Pension System

Takayama Noriyuki

The administration of Prime Minister Koizumi Jun’ichirō submitted a set of pension reform bills to the National Diet on February 10, 2004, and they were enacted on June 5. This article will describe the gist of the approved reforms and explore issues that remain to be addressed.

Salaried workers are, as a rule, enrolled in the Employees’ Pension plan, which is part of the public pension system. Contributions under this plan have since October 1996 been set at 13.58% of annual income, paid half by the worker and half by the employer, but the newly enacted reforms will raise this rate by 0.354 percentage point per year starting in October 2004. The rate will rise every September thereafter until 2017, after which it will remain fixed at 18.30%. The portion paid by workers will accordingly rise from the current 6.79% of annual income to 9.15%.

For an “average” male company employee earning ¥360,000 a month plus annual bonuses equivalent to 3.6 months’ pay, contributions will increase by nearly ¥20,000 a year starting this October 2004, and by the time they stop rising in September 2017, they will have reached just under ¥1.03 million a year, and the share paid by the worker will be just over ¥514,000. This comes to 35% more than the current level of contributions.

Those who are not enrolled in the Employees’ Pension plan or another public pension scheme are required to participate in the National Pension plan, which provides just the so-called basic pension. (The basic pension also forms the first tier of benefits under the Employees’ Pension and other public pension system.) Contributions under this plan will rise by ¥280 each April from the current ¥13,300 per month until they plateau at ¥16,900 (at 2004 prices) in April 2017. The actual rise in National Pension contribution will be adjusted according to increases in general wage levels.

In addition, the government will increase its subsidies for the basic pension. One-third of the cost of basic pension benefits is paid from the national treasury; this share is to be raised in stages until it reaches one-half in 2009.

Lower Benefits Despite Higher Contributions

Benefits under the Employees’ Pension plan consist of two tires; the flat-rate basic pension, which is paid to all public pension plan participants, and a separate earnings-related component. The latter is calculated on the basis of the worker’s average preretirement income, converted to current values. Until now, the index used to convert past income to current values was the rate of increase in take-home pay. Under the recently enacted reforms, though, this index will be subject to a negative adjustment over the course of an “exceptional period” based on changes in two demographic factors, namely, the decline in the number of participants and the increase in life expectancy. This period of adjustment is expected to last through 2023.

The application of the first demographic factor will mean that benefit levels will be cut to
reflect the fact that fewer people are supporting the pension system. The actual number of people enrolled in all public pension schemes will be ascertained each year, and the rate of decline will be calculated based on this figure. The average annual decline is projected to be around 0.6 point.

Introducing the second demographic factor, meanwhile, will adjust for the fact that people are living longer and thus collecting their pensions for more years; the aim is to slow the pace of increase in the total amount of benefits paid as a result of increased longevity. This factor will not be calculated by tracking future movements in life expectancy; instead, it has been set at an annual rate of about 0.3 percentage point on the basis of current demographic projections for the period through 2025. Together, the two demographic factors are thus expected to mean a negative adjustment of about 0.9 point a year during the period in question.

How will these changes affect people’s benefits in concrete terms? Let us consider the case of a pair of “model” Employees’ Pension beneficiaries as defined by the Ministry of Health, Labor, and Welfare: a 65-year-old man who earned the average wage throughout his 40-year career and his 65-year-old wife who was a full-time homemaker for 40 years from her twentieth birthday. In fiscal 2004 (April 2004 to March 2005), this model couple would receive ¥233,000 a month.

How does this amount compare to what employees are currently taking home? The average monthly income of a salaried worker in 2004 is projected to be around ¥360,000, before taxes and social insurance deductions. Assuming that this is supplemented by bonuses totaling an equivalent of 3.6 months’ pay, the average annual income is roughly ¥5.6 million. Deducting 16% of this figure for taxes and social insurance payments leaves a figure for annual take-home pay of about ¥4.7 million, or ¥393,000 a month.

The ¥233,000 provided to the model pensioners is 59.3% of ¥393,000. But this percentage, which pension specialists call the “income replacement ratio,” will gradually decline to an estimated figure of 50.2% as of fiscal 2023 (assuming that consumer prices and nominal wages rise according to government projections by 1% and 2.1% a year, respectively). Over the next two decades, then, benefit levels will decline by roughly 15% by comparison with wage levels.

The revised pension legislation stipulates that the income replacement ratio is not to fall below 50% for the model case described above, and so the exceptional period of negative adjustment will come to an end once the ratio declines to 50%. This provision was included to alleviate fears that benefits would continue to shrink without limit.

How will the reforms affect those who are already receiving their pensions? Until now, benefits for those 65 years old and over were adjusted for fluctuations in the consumer price index. This ensured that pensioners’ real purchasing power remained unchanged and helped ease postretirement worries. But this cost-of-living link will effectively be severed during the exceptional period, since the application of the demographic factors will pull down real benefits by around 0.9 point a year. In principle, however, nominal benefits are not to be cut unless there has also been a drop in consumer prices. Once the exceptional period is over, the link to the consumer price index is to be restored.
Provisions for Working Seniors and Divorcees

People aged 60-64 who are receiving pensions and also have wage income have up to now had their benefits reduced by a flat 20%, regardless of how much or little they earn. This rule has been abolished so as not to discourage older people from working. But these people will still be subject to the current rule that if the sum of wages and pension benefits exceeds ¥280,000 a month (after factoring in annual bonuses), the pension benefits are to be cut by 50% of the amount in excess of this level.

Workers aged 70 and over, meanwhile, have been exempt from paying into the Employees’ Pension system, even if they are still on a company’s payroll. And they have not had their benefits reduced no matter how much they earn. Beginning in April 2007, though, their benefits will be reduced if they are high-income earners. Those receiving more than an equivalent of ¥480,000 a month in wages and pension benefits will have their benefits cut by 50% of the amount in excess of this level. This is a rule that currently applies to those aged 65 to 69, and it will be maintained for this age group. The over-70 group will still be entitled to the full amount of the basic pension, and they will continue to be exempt from paying contributions.

Divorced wives are now not legally entitled to any portion of their former husbands’ earnings-related pension benefits, but this will change under the revised legislation. Couples who divorce after April 2007 will be able to split the rights to the earnings-related portion of the husband’s pension that accrued during their marriage. The wife will be able to receive a share of up to 50% of these rights; the actual share is to be determined by agreement between the two. For rights accruing after April 2008, moreover, a full-time homemaker will be able to automatically receive half of her husband’s benefits in case of divorce by filing a claim at a social insurance office. Underlying this rule is the assumption that even though the contributions are paid in the husband’s name, the wife has provided half of the couple’s livelihood through her work as a homemaker. (Note that the provisions for working husbands and dependent homemaker wives apply conversely in cases where a home-maker husband is dependent on the wife.)

Widowed spouses younger than 30 and without children under the age of 18 have been entitled to lifelong benefits under the survivor’s pension scheme (based on the earnings of the deceased spouse). After April 2007, however, they will receive benefits for no longer than five years.

Workers taking child-care leave are exempt from making pension contributions, and to prevent a decrease in their future benefits due to this period of nonpayment, they are treated as having continued their full payments, even when they have no income. This special exemption can now be claimed for up to one year after childbirth, but starting in April 2005 the period will be extended until the child reaches age three.

Also from April 2005, parents who change their working arrangements to put in shorter hours so as to care for children under age three and who take a corresponding cut in pay will be treated as having worked full time and earned a full salary. Actual contributions during this three-year period, though, will be based on the lower earnings.
Additional Adjustments

As a rule, a person cannot simultaneously receive more than one public pension. But the recent reforms have created an exception. People with disabilities who had gainful employment and paid pension contributions will, from April 2006, be entitled to not only their basic disability pension but also the earnings-related component of the old-age pension or survivor’s pension. This measure is designed to encourage employment among people with handicaps.

Participants in the National Pension plan who have low incomes currently pay either half of the regular contributions or none at all. There will be a finer tuning of payment exemptions starting in July 2006, when low-income earners may also be exempt from paying one-quarter or three-quarters of the regular contributions.

Under the current setup, pension plan participants can find out how much they will receive in benefits only by going to a social insurance office with their pension pass-books after they have reached age 55. From April 2008, though, such information will be disclosed to all contributors each year, along with their payment records.

The reform cover private pension plans as well. The upper limit of the amount that can be put aside each month under company-funded defined-contribution pension plans will be raised from ¥36,000 to ¥46,000 in cases where there is no other corporate pension plan and from ¥18,000 to ¥23,000 in cases where there is another plan in effect. The ceiling on monthly installments under individually funded defined-contribution plans for salaried workers will be raised from ¥15,000 to ¥18,000 where there is no corporate pension coverage, while the cap for the self-employed will remain unchanged at ¥68,000. The higher ceilings for private plans are designed to make up for the anticipated smaller benefits of public old-age schemes.

Future Issues

Social insurance payments in Japan already exceed the amount collected in national taxes, and contributions to the pension system are by far the biggest social insurance item. If this already huge sum is increased by more than ¥1 trillion a year, as the government plans, both individuals and companies are bound to change their behavior. Government projections of revenues and expenditures, though, completely ignore the prospect of such changes.

Companies will likely revamp their hiring plans and wage scales to sidestep the higher social insurance burden. They will cut back on recruitment of new graduates and become more selective about midcareer hiring as well. Many young people will be stripped of employment opportunities and driven out of the labor market, instead of being enlisted to support the pension system with a percentage of their income. And most of the employment options for middle-aged women who wish to reenter the work force will be low-paying ones. Only a few older workers will be able to continue commanding high wages; there is likely to be a dramatic rise in the number of aging workers who will be forced to choose between remaining on the payroll with a cut in pay or settling for retirement. Many more companies will either choose or be forced to leave the Employees’ Pension scheme, causing the number of subscribers to fall far below the
government’s projections and pushing the system closer to bankruptcy.

The jobless rate on the whole will rise. The Ministry of Economy, Trade, and Industry has estimated that higher pension contributions will lead to the loss of 1 million jobs and boost the unemployment rate by 1.3 points. The government plan to increase pension contributions annually for the next 15 years will exert ongoing deflationary pressure on the Japanese economy. For the worker, a rise in contribution levels means less take-home pay; as a result, consumer spending is likely to fall, and this will surely hinder prospects for a self-sustaining recovery and return to steady growth.

Another problem with increasing pension contributions is that they are regressive, since there is a ceiling for the earnings on which payment calculations are based and unearned income is not included in the calculations at all.

One major objective of the reforms is to eventually eliminate the huge excess liabilities of ¥500 trillion in the balance sheet of the Employees’ Pension plan. The plan is to generate a surplus equal to this amount by (1) hiking contributions, (2) increasing payments from the national treasury, and (3) reducing benefits. But the combination of higher contributions and lower benefits will mean the future participants will end up getting back less than they pay into the system. It is estimated that their benefits will amount to only about 80% of their contributions. This is hardly likely to encourage people to participate. Higher contributions will further alienate younger workers from the pension system and deepen their distrust of politics.

As noted above, those who are already receiving their pensions will see their benefits decline in real terms by an average 0.9% per year. The government scenario sees consumer prices eventually rising 1% a year and take-home pay 2.1% a year. This means that the model beneficiary who begins receiving ¥233,000 a month at age 65 in 2004 will get roughly ¥240,000 at age 84 in 2023; nominal benefits, in other words, will remain virtually unchanged for two decades, despite the fact that average take-home pay of the working population will have risen by over 40%. The income replacement ratio, which stood at nearly 60% at age 65, will dwindle to 43% by the time the model recipient turns 84. The promise of benefits in excess of 50% of take-home pay does not apply, therefore, to those who are already on old-age pensions.

A Lack of Foresight

The so-called demographic factors are likely to continue changing for the foreseeable future. The government itself foresees the number of participants in public pension plans declining over the coming century: The estimated figure of 69.4 million participants as of 2005 is expected to fall to 61.0 million in 2025, 45.3 million in 2050, and 29.2 million in 2100. This corresponds to an average annual decline of 0.6% through 2025, 1.2% of the quarter century from 2025, and 0.9% for the half century from 2050. In other words, the decline in the number of workers who are financially supporting the public pension system is not likely to stop after just two decades.

The recently enacted reforms, though, adjust benefit levels in keeping with the decline in the contribution paying population for the next 20 years only; the government’s “standard case” does not foresee any further downward revisions, even if the number of participants continues to
fall. If the government really anticipates an ongoing decline, there is no good reason to abruptly stop adjusting benefit levels after a certain period of time. Sweden and Germany, for instance, have adopted permanent mechanisms whereby benefit levels are automatically adjusted for fluctuations in demographic factors.

The decision to keep the model income replacement ratio at 50% at the point when pension payments commence represents, in effect, the adoption of a defined benefit formula. Maintaining both fixed contributions on the one hand and defined benefit levels on the other is not an easy task, for there is no room to deal flexibly with unforeseen developments. The government will be confronted with a fiscal emergency should its projections for growth in contributions and a reversal in the falling birthrate veer widely from the mark.

The government bases its population figures on the January 2002 projections of the National Institute of Population and Social Security Research. Under these projections, the medium variant for the total fertility rate (the average number of childbirths per woman) falls to 1.31 in 2007, after which it begins climbing, reaching 1.39 in 2050 and 1.73 in 2100. Actual figures since the projections were released have been slightly lower than this variant, and there are no signs whatsoever that the fertility rate will stop declining in 2007.

If the government is to keep its promise on an upper limit for contributions and a lower limit for benefits, the only policy option it will have in the event of a financial shortfall will be to raise the age at which people begin receiving benefits. The reform package makes no mention of such a possibility; the drafters of the bills no doubt chose to simply put this task off to a future date.

By fiscal 2009 the share of the basic pension benefits funded by the national treasury will be raised from one-third to one-half. This means that more taxes will be used to cover the cost of benefits. Taxes are by nature different from contributions paid by participants in specific pension plans, and there is a need to reconsider the benefits that are to be funded by tax revenues.

The leaders of Japanese industry tend to be quite advanced in years. For the most part, they are over the age of 65, which means that they are qualified to receive the flat-rate basic pension. Even though they are among the wealthiest people in the country, they are entitled to the same basic pension as other older people hovering around the poverty line. Using tax revenues to finance a bigger share of the basic pension essentially means asking taxpayers to foot a bigger bill for the benefits of wealthy households as well. For an elderly couple, the tax-financed portion of the basic pension will rise from ¥530,000 a year to ¥800,000. If a need arises to raise taxes at a future date, who will then actually agree to pay more? Few people will be willing to tolerate such wasteful uses of tax money.