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A Balance Sheet Approach to Reforming Social Security Pensions in Japan: Is NDC the Answer?

by

Noriyuki Takayama

Professor of Economics, Hitotsubashi University
takayama@ier.hit-u.ac.jp
http://www.ier.hit-u.ac.jp/~takayama/

World Bank & RFV Conference on NDC Pension Schemes
Sandhamn, Sweden, 29-30 September 2003
Organization

- Demography
- Basic Facts:
  - Identifying Main JPN Problems
- Is NDC the Answer?
- Conclusion

- 2-tier Benefits
- Contributions
- The Biggest Business
Two-tier Benefits (DB)

- Basic Flat-rate Benefits (PM, PP)
  66,400 yen = USD 580

- Earnings-related Benefits (40Yrs)
  28.5% of Career Average Monthly Real Earnings

- Replacement Rate (One-earner Couple)
  Around 60% Net (230,000 yen = USD 2,000)

- CPI Indexation
Contributions/Transfer from GR

- **Contributions**
  13.58% of *Annual* Wages
  13,300 yen = USD 117 (PM, PP)

- **Subsidy from General Revenue**
  1/3 of Flat-rate Basic Benefits

- **Mainly PAYG, but**
  with Partial Prefunding
The Biggest Business in Japan

- Aggregate SS Pension Benefits
  44 tr. Yen = USD 386 billion in 2003
  (12% of National Income)

  cf. The Automobile Industry
  40 tr. Yen (Domestic Output in 2000)

- Rapidly Growing
Demography

- TFR
- Total No. of Populations
- Proportion of 65+
Trends in the Total Fertility Rate of Japan

1.32 in 2002

Actual and Projected Population of Japan

Proportion of the Elderly (+65) in Japan

Year 2003
19.0% (Japan)

Basic Facts

- Deficit in Current Account
- Balance Sheet:
  Huge Excess Liabilities
- SS Pension Contributions:
  Heavy Burdens Outstanding
- Too Much Income Transfers between Generations
- Increasing Drop-out
Current Account of the KNH

(trillion yen)

1999: 3.95
2000: 2.08
2001: -0.70
2002: -0.61
2003: -2.84

(YEAR)
Balance Sheet of the KNH
(as at the 31st MAR 2000)

Excess Liabilities: 530 tr. yen

- Contributions: 1170 tr. yen
- Transfers (GR): 280 tr. yen
- F. Reserve: 170 tr. yen

Total Assets: 2150 tr. yen
Total Liabilities: 2150 tr. yen
Balance Sheet of the KNH (Part 1)
(as at the 31st MAR 2000)

Pension Liabilities Accrued from FUTURE Contributions

Excess Liabilities: 80 tr. yen

<table>
<thead>
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<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contributions</td>
<td>1170</td>
</tr>
<tr>
<td>Transfers (GR)</td>
<td>180</td>
</tr>
<tr>
<td>Liabilities</td>
<td>1430</td>
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</table>

(trillion yen)
Balance Sheet of the KNH (Part 2)

(as at the 31st MAR 2000)

Pension Liabilities Accrued from PAST Contributions

Excess Liabilities: 450 tr. yen

- 100 Transfers (GR)
- 170 F. Reserve
- 720 Liabilities
Which Is More, SS Contributions or Tax Revenues?
FY 2003 National Budget, Japan

SS Contributions (trillion yen): 55.6
Tax (Central Gov.t) (trillion yen): 43.9
Main Income Sources of Japan’s Central Government
FY 2003 National Budget, Japan

(trillion yen)

- Consumption Tax: 11.9
- Personal Income Tax: 13.8
- SS Pension Contributions: 29.0
- SS Health Care Contributions: 17.5
- Corporate Income Tax: 9.1
Per-capita Income by Age in Japan

SS pension benefits are the major source of retirement income

median income: 3.38 million yen

Source: The 1989 NSFIE (elderly couples: median income group)
Drop-out from SS Pensions (Non-employees)
Delinquency in Paying Pension Contributions

YEAR

% 15 20 25 30 35 40

37.2
Is NDC the Answer?

- How Helpful?
- Any JPN-specific Problems Remaining?
- Politically Feasible?
Strengthening Incentive-Compatibility

- Direct Link between Contributions and Pension Benefits
  “Every Penny Counts”
- Increased Credibility
JPN-specific Problems

- Income Reporting Reliable?
- Legacy Pensions
  - Huge Excess Liabilities
- Reducing EL:
  - Several Options
Option 1: Reducing Benefits

- Deflation-Indexing
- A Clawback System
- “Macroeconomic Indexation”
- Increasing the NRA to 67
- Deducting Contributions for Health Care
- More Taxes on Benefits
Option 2: Increasing Contributions

- Incentive-compatible?
  - What Matters is *Taste of Pie*
- Penalties on Employment
  - Non-neutral & Regressive
- Income Tax Revenues
Option 3: Increasing Subsidies

Where to Go:
Flat-rate Basic Benefits (1/3 or 1/2) or Guaranteed Pensions or Legacy Pensions?

What Funding Source:
Consumption Tax or Income Tax or Cutting Other Public Expenditure?
Politically Feasible?

- Strong Interest Already Shown
- No Concrete Proposals, Yet
- Options Still Vary among Different Ministries
- Gov’t Reform Plan:
  May be Fixed by the End of DEC 2003
Conclusion

- **Switch to NDC:**
  - Very Much Helpful for Strengthening Incentive-Compatibility
- **Handling Legacy Pensions Still Remains**
- **Politically Feasible, but Unclear When to Switch**