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

by

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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

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

Assets

Liabilities

- Contributions: 1170 trillion yen
- Transfers (GR): 280 trillion yen
- F. Reserve: 170 trillion yen
- Total Liabilities: 2150 trillion yen

Net Position: 530 trillion 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

Contributions

1170

Transfers (GR)

180

Assets

Liabilities

1430
Pension Liabilities Accrued from **PAST** Contributions

**Balance Sheet of the KNH (Part 2)**

(as at the 31st MAR 2000)

Excess Liabilities: 450 tr. yen

- **Assets**
  - 100 Transfers (GR)
  - 170 F. Reserve

- **Liabilities**
  - 720

(trillion yen)
Which Is More, SS Contributions or Tax Revenues?
FY 2003 National Budget, Japan

<table>
<thead>
<tr>
<th>(trillion yen)</th>
<th>SS Contributions</th>
<th>Tax (Central Gov.t)</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>55.6</td>
<td>43.9</td>
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</table>
Main Income Sources of Japan’s Central Government

FY 2003 National Budget, Japan

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<tr>
<th>Income Source</th>
<th>Amount (trillion yen)</th>
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<tbody>
<tr>
<td>Consumption Tax</td>
<td>11.9</td>
</tr>
<tr>
<td>Personal Income Tax</td>
<td>13.8</td>
</tr>
<tr>
<td>SS Pension Contributions</td>
<td>29.0</td>
</tr>
<tr>
<td>SS Health Care Contributions</td>
<td>17.5</td>
</tr>
<tr>
<td>Corporate Income Tax</td>
<td>9.1</td>
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Per-capita Income by Age in Japan

SS pension benefits are the major source of retirement income

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**