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Pension Coverage in Japan

Noriyuki Takayama

Introduction

Japan has mandated social insurance pensions for all residents. Its principal objective is to secure adequate income in old age.

A contribution-based social insurance pension incur some difficulties, however. Those people in financial difficulties are not likely to pay contributions. Its application to small-size companies, atypical employees and informal sectors is not easy, since its administration and compliance costs are relatively expensive.

Taking those difficulties into consideration, Japan provides several social pensions, as well, to virtually attain a higher coverage.

This chapter deals with coverage issues of social insurance pensions in Japan and also explains her social pensions. Covering the informal sector is still a big challenge in Japan and there have been hot discussions on introducing a universal or minimum guaranteed pension. Experiences in Japan will give interesting lessons on what worked and did not work in extending pension coverage.


Japan already has the oldest population in the world. The proportion of the elderly of age 65 and above was more than 20% in 2005 (see Table 1) and will go up rapidly to more than 40% by around 2050.

= Table 1 about here =

Japan has a relatively long history of social insurance pensions dating back to 1884. The basic statistics of current pension programs is given in Table 2. Benefits consist of two tiers. While the first-tier, flat-rate basic benefit is paid to all participants of social
insurance pensions, the second-tier, earnings-related benefit applies only to employees.\(^1\)
The system operates largely like a pay-as-you-go defined benefit program.

\[\text{= Table 2 about here =}\]

A person is required to contribute for no less than 25 years to receive basic old-age benefits. The full basic old-age pension is payable after 40 years of contributions. The maximum monthly pension of 66,000 yen\(^2\) at 2008 prices (with maximum 40 years of coverage) is payable from age 65. The benefit was indexed automatically each fiscal year (from 1 April) to reflect changes in the consumer price index (CPI) from the previous calendar year. Since 2004 this indexation formula has been provisionally suspended and instead, a new indexation taking demographic factors into account has been introduced (see Takayama (2004, 2006)). The pension may be claimed at any age between 60 and 70 years with actuarial reduction or increase.

Earnings-related benefits are given to all employees. The accrual rate for the earnings-related component of old-age benefits is 0.5481 per cent per year. Thus, 40 years’ contributions will earn 28.5 per cent of career average monthly real earnings.\(^3\)

As a transitional measure, the full earnings-related pension is payable from age 60 (normally from 65) to an employee who is fully retired. An individual who has reached 60 but has not fully retired can receive a reduced pension. The current replacement rate (including basic benefits) is near 60 per cent for a typical male retiree (with an average salary earned during 40 years of coverage) and his dependent wife\(^4\). It will decrease to 50 per cent by 2023 through a provisional indexation formula.

Equal percentage contributions are required of employees and their employers. The contributions are based on earnings (which include semi-annual bonuses). The total percentage in effect from September 2008 is around 15 per cent for the principal program

\[\begin{align*}
1 & \text{A detailed explanation of the Japanese public pension system is given by Takayama (1998, 2003).} \\
2 & \text{1,000 yen} = \text{US$ 9.28 = UK £ 4.68 = Euro 5.96 as at 1 August 2008.} \\
3 & \text{A semi-annual bonus equivalent to 3.6 months salary is typically assumed.} \\
4 & \text{Their monthly amount of old-age benefits is 233,000 yen in 2008.}
\end{align*}\]
for private-sector employees (Kosei-Nenkin-Hoken, KNH). Non-employed people between the age of 20 to 60 years pay flat-rate individual contributions as Category-1 persons under the Kokumin-Nenkin (KN) program. The current rate since April 2008 is 14,410 yen per month. For those who cannot afford it, exemptions will be permitted. The flat-rate basic benefits for the period of exemption will be one-half of the normal amount from fiscal 2009.

The government subsidizes one-half of the total cost of the flat-rate basic benefits from fiscal 2009. There is no subsidy for the earnings-related part. The government pays administrative expenses as well.

Social Pensions

Japan currently has the following six types of social pensions, which are paid without individuals’ contributions.

*flat-rate basic pensions for full-time housewives*

Under the current system, dependent spouses of regular employees, typically full-time housewives are *automatically* entitled to the flat-rate basic benefits, without being required to make any direct individual payments to the social insurance pension system. They were about 10.8 million in number in 2007, equivalent to around 15per cent of the total number of insured persons.\(^5\)

\(^5\) The treatment of housewives is now controversial. Dual-income couples and single women have been steadily increasing in number and currently full-time housewives are no longer in the majority. The current provisions of full-time housewives in social insurance programs above stated have been often attacked as too generous and unfair by single women and dual-income couples. The point at policy issue is whether the principle is purely individualistic or earnings-split. While a purely individualistic principle is simple and understandable to everybody, it has some drawbacks: the survivor’s benefit for widows would consequently be abolished and a majority of women would seriously suffer from a decrease in pension benefits after the death of their husbands, since the level of salaries for women is still considerably lower than for men, in general. An alternative solution is an earnings-split scheme. The amount of earnings before splitting is assumed to be zero for full-time housewives.
basic disability pensions for those who are qualified as mentally or physically disabled before age 20

Those who are mentally or physically disabled before age 20 can receive the basic disability pensions from age 20, with a generous income-test. A thorough medical checkup is run before the qualification. The budget is fully financed by transfers from general revenue.

basic old-age pensions for lower-income groups

Those among lower-income groups can be exempted from paying a part or whole of KN flat-rate pension contributions.\(^6\) 5.84 million people were exempted in 2007. Once exempted, they are still qualified to receive one half of full basic old-age pensions, which are financed by transfers from general revenue.

two-tier old-age benefits for those under parental leave

Japanese parents can enjoy a parental leave of one year (husband and wife combined) each time they have a baby. During the parental leave, they are exempted from paying KNH pension contributions but still entitled to receive old-age pensions as if they would have continued to earn the same amount of salaries just before the parental leave. In 2007, 111 thousand employees were exempted through this scheme. No special funding arrangement has been made, and consequently their old-age pension benefits during the parental leave are shouldered by contributions made by other participants.

pension entitlements due to the contribution-gap

Employers withdraw their employees’ pension contributions from their monthly salary.

\(^6\) The upper limit of annual income for full and/or partial exemption varies depending on different sizes of each household. Taking a single household for example, the 2008 amount for partial exemption is 1.89 million yen or less.
In spite of the withdrawal, a small number of employers fail to transfer their contributions to Social Insurance Agency (the government body of collecting contributions), due to financial difficulties or bankruptcy. The recovery rate at Social Insurance Agency is usually not 100 per cent, and the “contribution-gap” remains. This gap is compensated by transfers from general revenue, which enables the full payment of KNH pension benefits once the withdrawal of contributions is certified. This arrangement generates moral hazard among employers, however.

*welfare pensions for aged low-income groups at the start-up*

The flat-rate basic old-age pension is normally payable to those who have contributed for no less than 25 years. However, at the start-up of the KN, those aged between 36 and 49 as at year 1961 were specially entitled to receive a smaller amount of basic pensions with a shorter period of contributions of 10 to 24 years. Those of age 50 and over in year 1961 were not entitled to receive basic pensions. Instead, “welfare pensions” were provided to them when they reached the age of 70, with an income-test. Welfare pensions have been financed wholly by transfers from general revenue, and their current monthly benefit is around 34,000 Japanese yen. Welfare pensions are a transitory sunset scheme, and their recipients are currently very small in number, around 20,000 persons in March 2007.

**Increasing Rate of Drop-out**

The descriptions given above are just half a story. Japan still has several coverage, implementation and social adequacy problems in social insurance pensions.

The first-tier, basic benefit is not universal, yet. Nearly 100 per cent of the *regular* employees are currently covered by the social insurance pension programs, but atypical- and non-employees are not necessarily covered, though their enrolment is *legally*
mandatory. In March 2007, around 54 per cent\(^7\) of Category-1 persons of the KN (independent workers, atypical workers, the self-employed and persons with no occupations) dropped out from the basic level of protection, owing to exemption (5.84 million persons), delinquency in paying contributions (5.19 million persons) or non-application (363,000 persons). This drop-out rate increased from 35 per cent in 1992.

Those who have dropped out will receive a smaller amount of pension or none at all in old age, which makes them likely to be dependent on the means-tested public assistance program. The principal idea of a social insurance pension should be old-age income security without having to depend on means-tested support. A social insurance system that promises old-age security to all members of the community has its own drawbacks. The current legislation of a basic pension is becoming virtually hollow for atypical- and non-employed people.

**Growing Numbers of Atypical Employees**

In 2007 there were 32 million male and 23 million female employees in Japan, and proportions of regular employees were 82 per cent (males) and 47 per cent (females) respectively. These proportions have gradually been decreasing. Instead, outsourcing, replacement of workers by contracts with outside staffing agencies, and increasing dependence on part-time, temporary and seasonal workers are all now common. Table 3 presents the 2007 shares of different types of employees, indicating that around one third were not regular employees. A majority of female employees are now of non-regular type, most of them engaging in part-time jobs.

\[\text{Table 3 about here}\]

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\(^7\) This figure was equivalent to around 19 per cent of all the mandatory contributors. The administrative cost of the KN was equivalent to about 7.7 per cent of the aggregate amount of contributions in 2006, mainly due to the high rate of drop-out.
The current KNH system does not directly apply to those employees who work fewer than 30 hours (or three-fourths of the normal working hours) per week. These part-time employees are obliged to participate in the KN, instead. If they are the spouses of regular employees and their annual pay is less than 1.3 million Japanese yen (USD 12,000 equivalent), they are treated like full-time homemakers. But if their annual pay exceeds 1.3 million yen, they lose the right to be treated as a dependent spouse. They are then forced to pay the flat-rate pension contributions as Category-1 persons.

This arrangement often tends to encourage part-time jobs that pay less than 1.3 million yen per year. Critics say that this is the main reason that part-timers remain low-income earners.\(^8\)

The social insurance coverage of earnings-related pension benefits has been decreasing as a trend, since the existing KNH system only covers regular employees. Not covered are temporary staffs with labour contracts of no more than two months, seasonal employees working no more than four continuous months or those engaged on contract work for no more than six months, in addition to part-timers as stated above. These labour contracts are often made fictitiously to evade paying social insurance contributions, in collusion with employees who want to have higher take-home pay on the spot.

In addition, employers of small-size business establishments are often reluctant to participate in the compulsory KNH. Typical examples are those of restaurant, lodging, cleaning, barber, beauty-salon, amusement and construction businesses. The KNH

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\(^8\) One solution would be to reduce the upper earnings limit of 1.3 million yen to a negligible level as is typical in the United States and Germany. Employers in Japan, however, are strongly against this kind of program changes, since they prefer continuing to avoid higher compliance costs of social security. If the solution above stated is implemented, employers may begin to lower their demand price (rate of wages) for part-time workers, in turn, since the non-wage costs including employers’ share of social insurance contributions, will be somewhat increased after such a change.
coverage in these industries is currently around 50 per cent,\(^9\) and the rest of the employees there including regular ones are obliged to participate in the KN.

At first, the KN was supposed to mainly cover the self-employed and non-employed people, but today it also covers around 9 million employees. The share of employees in the Category-1 insured persons of the KN was 37 per cent in 2005, being the highest (shares of non-employed and self-employed persons were 31 per cent and 18 per cent, respectively). Critics say that the KNH for employees is beginning to be reduced to mere form.

Distrust against government pension commitments built up in 2007, mainly due to a surprising announcement of 50 million “floating” pension records. The word “floating” means not being integrated to the unified personal pension numbers which were introduced in 1997. Implementations of the social insurance pension system proved to be still weak in Japan, inducing a higher drop-out rate in the future (see Takayama (2009) for more details).

**Non-beneficiaries of Social Security Pensions**

In April 2007, around 420,000 persons (1.6 per cent) of those aged 65 and over received no social security old-age pension benefits, and a total of 1.18 million persons including those less than 65 years old are estimated to be non-beneficiaries in the near future. These are mainly due to no application or shorter years of contributions.

In 2005, 556,000 persons (2.2 per cent) among the elderly of age 65 and over received means-tested public assistance. Around 65 per cent of the elderly with no social insurance pension benefits were forced to receive public assistance. There were other elderly who received both social insurance pension benefits and public assistance, mainly due to their lower amount of pension benefits.

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\(^9\) The enforcement abilities of Social Insurance Agency still remain relatively poor, compared with those of tax authorities.
Discussion on Introducing a Universal or Minimum Guaranteed Pension

Many have proposed a change in Japan from the current, contribution-based basic benefit to a tax-based one, universal to all residents, to accomplish the long-cherished aim of old-age income security.\(^{10}\) The most politically probable funding source for this change in Japan is an earmarked consumption-based tax, replacing the current flat-rate contributions and (part of) wage-proportional pension contributions.\(^{11}\) If this change takes place in 2009, an additional increase of the consumption-tax rate by 3.5 percentage points will be required, while the KNH contribution rate can be reduced by 4.0 percentage points, in turn (see National Council on Social Security, Japan (2008)).

Overall, this can almost be a zero-sum change in funding sources. Current pensioners will be forced to bear additional pension burdens, however. They will be losers. Employers can be winners, on the other hand, if their portion of KNH contributions is cut down. But if the cut-down in KNH contributions is to be wholly on the employees’ portion, then the employers’ portion will remain unchanged. In this case, the winners will be current actively working generations (see Takayama-Miyake (2008)).\(^{12}\)

In order to mitigate the controversial issues on winners/losers, other experts are now recommending to alternatively introduce a minimum guaranteed pension. The required additional financing sources are estimated to equal around 1.0 trillion Japanese yen in 2009, equivalent to only 0.4 percentage point increases in the consumption-tax rate. It remains to be argued however, which is best among means-test, income-test, pension-test, claw-back or tax-credit schemes.

Conclusion

Japan has tried strenuously to cover all people with social insurance pension systems.

\(^{10}\) Typical are opinions of Democratic Party, Management Federation, trade union (Rengo), and the Nikkei Newspaper Group.

\(^{11}\) The rate of Japanese consumption-based tax is 5.0 per cent in 2008. There may be much room for the Japanese consumption-tax rate to be raised up to the minimum 15 per cent, which is the norm in EU countries.

\(^{12}\) There is another problem on how to make out the necessary transitions. Some experts assert a 40-year transition period, while others propose a 20-year period, since all people in Japan have been paying consumption-based taxes for nearly 20 years since 1989.
The coverage, overall, is among the highest in the world, with only 1.6 per cent of the elderly currently not receiving social security old-age pension benefits.

Due to a rapid aging of the population, Japan has been hiking contributions to finance social insurance pensions, which have induced an increasing rate of drop-out from basic protection. Weak implementations aggravated lower coverage. Furthermore, a growing number of atypical non-regular employees are losing entitlements of an earning-related pension in social insurance programs.

Incentives, compliance and accountability are basic prerequisites for maintaining good coverage or expanding coverage. A trustworthy government with its competent and neat implementation is required for broader coverage, as well. Heavy work still lies ahead.

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