Japan's 2012 Social Security Pension Reform

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1. Introduction

On 10 August 2012, Japan's parliament passed a package of social security and tax reform bills after the ruling party, the Democratic Party, had succeeded in reaching an agreement with the two major opposition parties, the Liberal Democratic Party and New Komeito. The core of the bills is that the consumption tax rate is to be raised from the current 5 percent to 8 percent in April 2014 and further to 10 percent in October 2015. Moreover, consumption tax revenue is to be earmarked exclusively for financing social security expenditures, i.e., for pensions, healthcare for the elderly, long-term care, and childcare.

The aim of this short note is to provide a brief outline of the reforms of the pension system that form part of the package of social security and tax reform bills and highlights some remaining challenges in Japan's pension system.

2. Outline of the Pension Reform

Transfers from General Revenue

In the past, one-third of the flat-rate basic pension used to be financed through general government revenues. In 2009, this share was raised to one half, but no specific source for the required funds had been designated. With the passage of the reforms, it was finally decided that from April 2014 the additional funds would come solely from the increase in consumption tax

revenues.

Inclusion of Civil Servants in the General Pension Scheme

So far, civil servants have been covered by a special pension system of their own, which is independent of the general pension system for private-sector employees. From October 2015, civil servants in the central and local governments are to be included in the general pension program. Further, when the two pension systems are integrated, the third-tier pension for civil servants, which has been a component of their social security provisions, will be abolished. Their earned third-tier pension entitlements, however, are assured as they are paid from a separate part of the existing reserve fund. The remaining part of the reserve fund will be absorbed into the general pension scheme. The first- and second-tier (earnings-related) pensions for current public-sector retirees are to be paid from the general system.

The current government plans to establish a new occupational pension program for civil servants to supplement their social security. In order to finance this new program, the government has proposed reducing the lump-sum retirement payment for civil servants. Thus, the new occupational pension program still remains to be designed.[1]

Reducing the Required Years of Coverage for Old-age Pensions

From October 2015 on, the required years of coverage to be entitled to an old-age pension will be reduced from the current 25 years to only 10 years. This change will lead to an increase in the number of retirees with smaller old-age pensions due to their shorter contribution periods.

A danger of this change is that many of the self-employed and atypical workers may decide to stop paying contributions after completing the minimum of 10 years, turning this originally mandatory pension scheme into a virtually optional (voluntary) one. This kind of situation might arise if implementation is weak and be exacerbated by the introduction of a supplementary benefit for low-income pensions (see below).

Introduction of a Supplementary Benefit for Low-income Pensioners

From October 2015 onward, low-income pensioners with annual pension benefits of less than JPY780,000 will be entitled to a supplementary monthly benefit of up to JPY50,000. The scheme is to be established as a welfare program outside the pension system and will be financed from the

[1] While old-old retirees from the public sector were not required to pay pension contributions during their active working days, they have been assured to receive their pensions (*onkyu*) after retirement. However, the 2012 pension reform will, in principle, drastically reduce the *onkyu* benefit for each pensioner by 27 percent.

increase in consumption tax revenues. Details of the supplementary benefit will be set down in another bill, which the government is currently preparing to submit.

Extending the Coverage of the Employees' Pension Insurance to Employees with Shorter Working Hours

The general Employees' Pension Insurance (*Kosei-Nenkin-Hoken*: KNH) currently covers employees with 30 working hours or more per week. From October 2016 on, coverage will be extended to employees working between 20 and 30 hours a week. Although there are estimated to be about 4 million employees in Japan who work between 20 and 30 hours a week, the expected increase in covered employees is only around 250,000, since the following four conditions will also be put in place. Only employees (1) with a monthly salary of JPY88,000 or more, (2) with an employment contract for at least one year, and (3) working for a company with more than 500 employees (i.e., a large company) will qualify. Further, (4) students are excluded. These conditions were incorporated to placate strong opposition from employers.

Survivor Benefits for Single Fathers

Currently, only mothers whose husband has deceased or children whose parents have deceased are entitled to survivor benefits. From April 2014, fathers whose wife has deceased will also be entitled to survivor benefits, unless the wife was a full-time housewife.

Contribution Exemption during Maternity Leave

Within the next two years, the system will be changed to exempt the employer and the employee herself from pension contributions when an employee takes maternity leave. The employee will continue to accrue pension entitlements as though both she and her employer had continued contributing. The pension entitlements accruing during this period will be financed through contributions by other employees and their employers.

3. Major Challenges Ahead

The changes introduced in the social security and tax reform bills go some way toward putting the pension system on a sounder financial footing and creating a more equitable pension system overall. Nevertheless, challenges remain. Four of the major challenges ahead are the following.

First, in 2004, Japan introduced an "automatic balancing mechanism," according to which pension benefits were to be adjusted upward below the rate of inflation. However, Japan has been

suffering from deflation for more than a decade now, so that the automatic balancing mechanism has not taken effect. This means that the mechanism needs to be redesigned to apply also in times of deflation (with benefits falling faster than the price level).

Second, the proportion of atypical employees has been increasing, reaching 40% in 2010. A growing number of young employees are forced to enter the job market as irregulars and are given few opportunities thereafter to obtain a position as a regular status employee with a higher and more stable salary. In addition, Japan is seriously affected by the "Bad Start, Bad Finish" problem identified by Takayama and Shiraishi (2012).[2]

Third, the normal pensionable age in Japan is still 65. Its automatic indexation to longevity is essential to the long-term financial sustainability of the pension system.

Fourth, under the current system, full-time housewives married to regular employees are automatically entitled to the flat-rate basic pension without making any contributions of their own. This system is being viewed as grossly unfair by dual-income couples and single women.[3] A solution to this problem would be to introduce an equal income split between an income-earning husband and his dependent wife in determining their pension entitlements (while keeping the husband's pension contributions unchanged).

[2] See Takayama, N. and Shiraishi, K. (2012) "Does a Bad Start Lead to a Bad Finish in Japan?" PIE/CIS DP-547, available online at: http://takayama-online.net/pie/stage3/Japanese/d_p/dp2011/dp547/text.pdf. The problem was first highlighted by Italian pension experts. See, for example, Galasso, V. and Boeri, T. (2012) "Is Social Security Secure with NDC?" in Holzmann, R., Palmer, E. and Robalino, D., eds., *NDC Pension Schemes in a Changing Pension World: Volume 2*, Washington, D.C.: World Bank.

[3] See Takayama, N. (2009) "Pension Coverage in Japan," in Holzmann, R., Robalino, D.A. and Takayama, N., eds., *Closing the Coverage Gap: The Role of Social Pensions and Other Retirement Income Transfers*, Washington, D.C.: World Bank, pp.111-118.