

# C omprehensive Reform Bill — Insufficient Discussion on Redressing Inter-generational Disparities & Intra-generational Redistribution

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## Social Security System Falling Victim to Institutional Fatigue: Most Important Element in Reform Is Redressing Inter-generational Disparities.

Legislation relating to the comprehensive reform of social security and taxation systems, including a consumption tax hike, was approved and passed by majority vote with support from the ruling Democratic Party of Japan and the opposition Liberal Democratic Party and New Komeito at a plenary session of the House of Councillors on Aug. 10, 2012. The consumption tax rate is now likely to rise to 8% on April 1, 2014 and 10% on Oct. 1, 2015. However, the reform cannot yet be deemed sufficient, with one estimate showing that the ultimate consumption tax rate necessary to achieve fiscal sustainability will be more than 25% unless social security costs, which are growing by more than 1 trillion yen per year, are brought under control.

The most important perspectives in this regard are (1) “redressing inter-generational disparities” and (2) “appropriate intra-generational equity”. With regard to the former, the provisional results of inter-generational accounting in the Cabinet Office “Annual Report on the Japanese Economy and Public Finance 2005” showed that a person in the generation aged 60 and older (born in or before 1943) would enjoy a net benefit of 48.75 million yen over his or her lifetime, while a person in the younger generation (born in or before 1982) including those under 20 would suffer a net loss of 45.85 million yen.

This kind of inter-generational disparity is caused by the pay-as-you-go social security system (pension, medical care, and nursing care) and the structural fiscal deficit. The main reason for this is that the current system, unable to meet the demands of a low-birth rate and rapidly aging demographics, is suffering from institutional fatigue. This reality can be confirmed by looking at [Chart 1](#).

### Inversion in Redistributed Income

[Chart 1](#) plots the “initial income” before redistribution (before paying taxes and premiums and receiving social security benefits) and “redistributed income” (after paying taxes and premiums and receiving social security benefits) according to age group. First, when we look at “initial income” before redistribution, the working-age generations (20-59) earn average incomes between 3 million and 4.2 million yen per year, while the retirement-age generations (60 and older) only earn average incomes between 1.4 million and 2.9 million yen. The initial income of the generation aged 65 and older is 1.7 million yen or less, but this is natural because the generation above 60 mainly leads life in retirement.

However, it is interesting to note that when it comes to “redistributed income” those of the 30-39 year-olds and of the 60 and over generation are reversed. Although we cannot say for certain due to the limitations of the available data, the “redistributed income” of the 30-39 year-olds, who must bear the costs of raising children and paying down mortgages, is 3.06 million yen, while that of the 60 and over generation, who receive public pensions and the like, is 3.08-3.80 million yen (3.08 million yen is the “redistributed income” for 70-74 year-olds). In short, it is possible that there is an income reversal between one segment of the working-age generation and the retirement-age generation. If this is indeed true, is it an acceptable phenomenon?

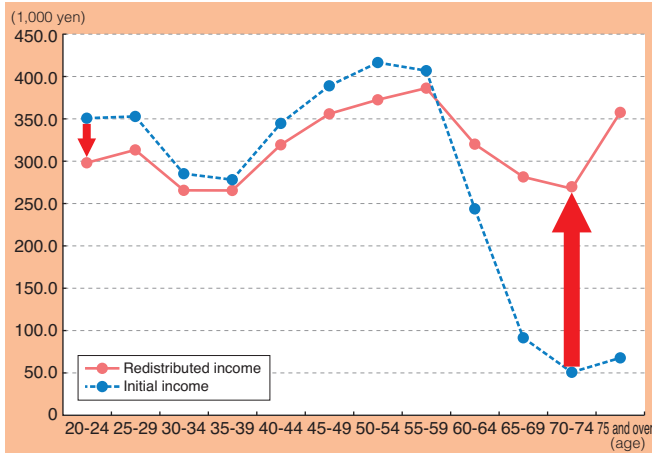
These phenomena (inter-generational disparities and redistributed income reversal) are caused by defects in both the philosophy and sequence of reform. A philosophy of “inter-generational support” is at the foundation of the current pay-as-you-go system of social security, but this only functions when the retirement-age generation is small and the working-age generation is large, and it is inappropriate for a rapidly aging, low-birth society like Japan today. It will be highly impractical to manage the social security system on the basis of this philosophy, since the retirement generation will increase rapidly from now on while the working-age generation will decrease. In fact, it will be necessary to suppress as much as possible this philosophy of “inter-generational support” and establish “intra-generational support” as the basic philosophy of social security. In this respect, the sequence of reform should be (1) redressing inter-generational disparities, then (2) consideration of intra-generational redistribution. If the discussion on reform proceeds in reverse order, it will be difficult to redress inter-generational disparities. Although intra-generational disparities among the young with regard to the “lost generation” and the like do receive a certain amount of attention, there is a tendency for the reform debate to focus on the paucity or lack of pensions and other issues relating mainly to the retirement-age generation because of the difference in political influence between generations. The result is an increase in redistribution to the retirement-age generation, as seen in [Chart 1](#). When redressing inter-generational disparities is discussed, it is forgotten that inter-generational transfer is essentially a zero-sum game and the upshot is that the resources for expanding redistribution to the retirement-age generation are procured from the young and future generations.

### Sequencing Reform & 3 Options

Because of this, it is desirable to begin reform by redressing inter-generational disparities. In this regard, it is absolutely necessary to attempt it by abandoning the current pay-as-you-go social security

CHART 1

## Income by age group before & after redistribution (equivalent income)



Source: Ministry of Health, Labour and Welfare, "Income Redistribution Survey" 2008

system and by "hardcapping the social security budget" and "pre-funding", as I explain in my book *The Year 2020: The Day Japan Faces Bankruptcy* (Nikkei Premier Series) and elsewhere. If the inter-generational disparities are redressed and the costs and benefits for each generation are more or less balanced by these efforts, the reform should have one of three outcomes for the level of benefits (= level of burden): (1) "high-cost, high-welfare" (maintaining current levels of social security benefits while expeditiously securing the required revenue source); (2) "low-cost, low-welfare" (significantly reducing social security while refraining from seeking any more additional burdens); and (3) "medium-cost, medium-welfare" (somewhere between (1) and (2)).

Choosing from these three options (or any other) would be a "political decision" and discussions concerning future directions are urgently needed. In any case, if the costs and benefits are more or less balanced within each generation and one of the three options is chosen, then the framework of the mid- to long-term social security budget will be determined and consequently the framework for the social security budget for each generation will be clarified.

It is then desirable to proceed to the next step by considering intra-generational redistribution within the social security budget framework for each generation, based on the fundamental philosophy of "redressing disparities within each generation".

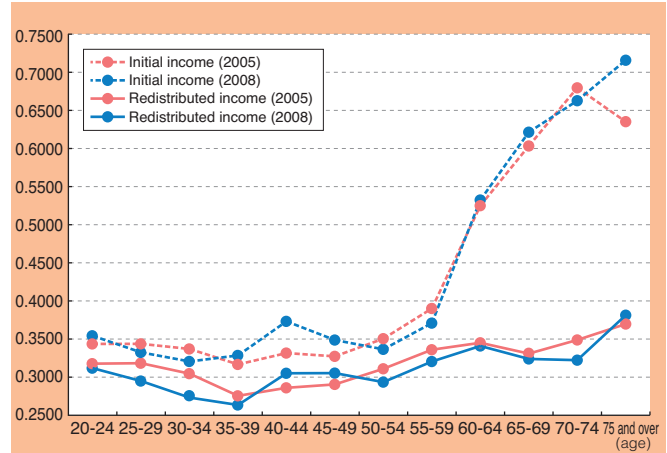
If "high-cost, high-welfare" is chosen there will be plenty of resources required for intra-generational redistribution, while if "low-cost, low-welfare" is chosen the resources will be small. Either way, it is essential to understand how intra-generational disparities change as a result of redistribution.

### Importance of Inter-generational Equity

Changes under the current system can be seen in *Chart 2*. In this chart, the Gini coefficient for "initial income" before redistribution and the Gini coefficient for "redistributed income" are plotted for each generational category. The chart clearly shows the tendency for

CHART 2

## Gini coefficients (equivalent income) by age category before & after redistribution



Source: Ministry of Health, Labour and Welfare, "Income Redistribution Survey" 2005, 2008

the Gini coefficient for initial income to have a positive correlation with age. The rise of the Gini coefficient is particularly dramatic in the 60 and over retirement-age generation.

However, the Gini coefficient for redistributed income does not rise as steeply as the Gini coefficient for initial income and instead shows a nearly flat trend line.

Attention usually tends to focus on measures to deal with the problem of the paucity or lack of pensions. However, if the Gini coefficient (redistributed income) is lowered for the 60 and over generation by increasing redistribution within the retirement-age group using intra-generational redistribution as the guiding philosophy, it is obvious that the issue of what to do with the Gini coefficient (redistributed income) of the working-age generation will also arise. A calm and measured deliberation including this and other perspectives is necessary.

In any case, the "philosophy of reform" and the "sequence of reform" are key concepts in moving forward with fundamental fiscal and social security reforms. It is expected that the National Council for Social Security System Reform will be the forum for substantive discussion, but so far, there is no indication that redressing inter-generational disparities will be given real consideration. If the political will exists to undertake truly fundamental reform, the most important perspectives are "redressing inter-generational disparities" and "intra-generational fairness." In this regard, it is desirable to suppress as much as possible the philosophy of "inter-generational support" and instead adopt "intra-generational support" as the fundamental philosophy of social security, and to examine the substance of reform for "(1) redressing inter-generational disparities and (2) intra-generational redistribution" in that order. JS

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