Japan's Pension System in Peril

By Satoru Harada

The pension system is the foundation of Japan's welfare system. But now two huge waves threaten to sweep it away: a declining birthrate and stagnant stock prices.

Japan's birthrate has been declining steadily and, coupled with a rise in life expectancy, is leading to an acceleration in the already rapid graying of Japanese society. There is growing concern about whether society will be able to support the elderly in the future under the existing pension system. The chaos in the stock market has only made matters worse, since the earnings from pension funds have fallen far short of projections and are threatening to disrupt the nation's pension financial program itself.

Need for revision

The governmental National Pension Council routinely reviews the public pension system every five years. But the current review, launched in the summer of 1992, is not likely to stop with minor revisions. It comes at a time when the government is being urged to take drastic steps, from raising the age at which pension payments begin to consolidating the present nine types of pensions into one. The government is determined to settle both issues, already pending for 10 years, when the existing laws are revised in spring 1994.

The Employees' Pension Insurance targeted on ordinary salary earners starts when the recipient turns 60. The government first proposed raising that to 65 in 1980, but the idea was dropped without ever reaching the Diet. A review five years later put another proposal for raising the starting age on the back burner in the face of angry opposition, and instead proposed gradually lowering payment levels, an idea which easily won approval.

The government tried again when the pension system was revised in 1989. This time a draft plan made it to the Diet, only to be killed by hesitant legislators. The National Pension Council decided then to address the issue at the next review in 1994.

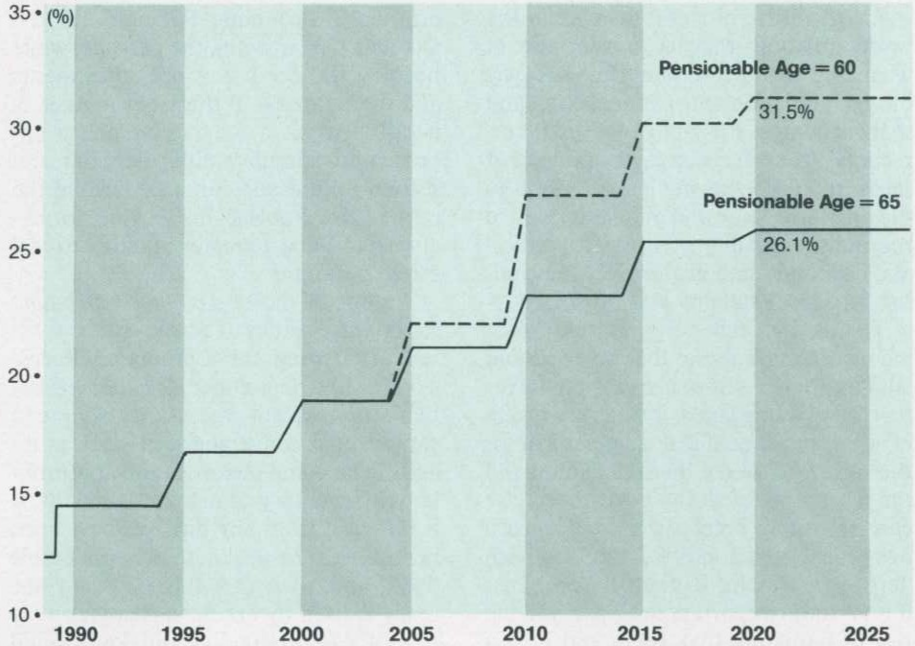
It is hardly necessary to explain why the government has tried so persistently to change the starting age for pensions. If the number of pension recipients continues to increase while the number of working age people supporting them declines proportionally, then the only way to sustain the pension scheme into the future is to lessen the load today. Thus emerged the government proposal, which is partly based on the fact that pension payments start at 65 in most industrialized countries.

How serious is the problem? Fig. 1, published by the government in 1989 as a source of reference when it proposed the delaying of the starting age to 65, projects future trends if the starting age were kept at 60. By 2020, when the graying of Japanese society is expected to peak, salary earners could see 31.5% of their salary going into their Employees' Pension, more than double the current rate. Since the insurance is shouldered fifty-fifty by employers and employees, the actual deduction would be less than 16% of their take-home salary. But that is still considered beyond the capability of the average worker, who will also have to pay taxes and premiums for medical and other social insurance.

If the starting age is raised to 65, the peak burden could be held to around 26.1%, still substantial but an improvement over 31.5%.

The government is not proposing shock therapy. Under the 1989 proposal, the starting age would be raised by one year in 1998, with further one-year increases every two years until 2020. Those born on or after April 2, 1946, would be

Fig. 1 Estimates of Future Contribution Rate for Employees' Pension Insurance (1989 actuarial revaluation)



Note: Assuming the pensionable age is raised gradually from 61 to 65 in the 1998–2010 period for males and in the 2003–2015 period for females.
Source: *Annual Report on Health and Welfare 1990–1991*, Japan International Corporation of Welfare Services

the first generation to get pensions at 65. The graying of Japanese society is projected to peak around 2020, when the postwar baby boomers born between 1947 and 1949 reach 65. By then, a quarter of all Japanese should be 65 or older.

The pension crisis obviously did not occur in a vacuum. It is the product of demographic shifts that are remaking the nation.

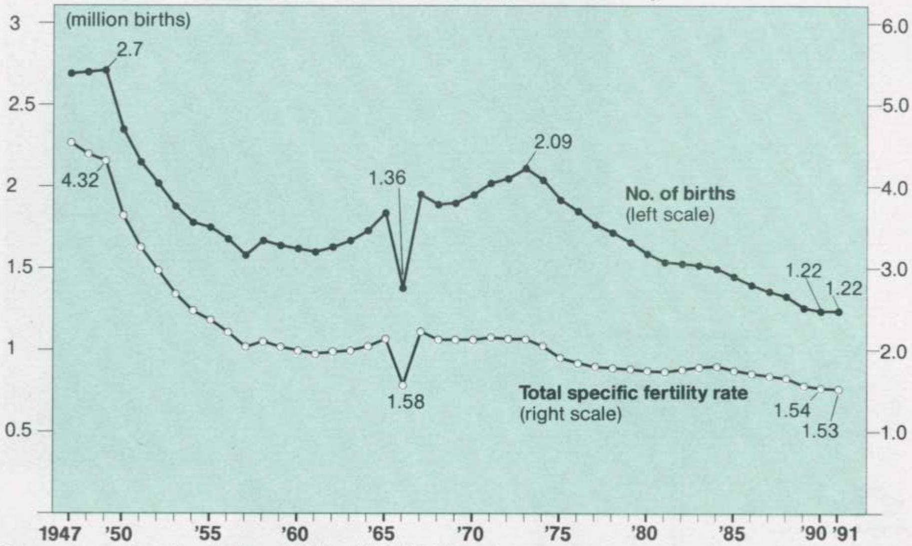
Focus on birthrate

The "1.53 shock" is how some describe it. That number is the total specific fertility rate, or the average number of children born to each Japanese woman in her lifetime as it stood in 1991. The rate was as high as 4.32 at the peak of the postwar baby boom (Fig. 2). Since then, the birthrate has traced a slow decline. For several years it hovered around 2.0. An unusual plunge in 1966 was an anomaly, reflecting a lingering superstition that girls born in that year in the Chinese calendar would someday kill their husbands. Few people would ever believe the superstition, yet many couples dared not have a child in that particular year, which comes around once every 60 years. The birthrate sagged below 2, the population replacement level, for the first time in 1975, and there has been no turning back since then. Today Japan's birthrate is among the lowest of all industrial societies.

Demographers classify industrial countries into four groups according to their population trends: 1) countries where the birthrate is on the upturn or recovery path, such as Sweden and the United States; 2) countries where the rate has remained at 1970s levels such as Britain and France; 3) countries where the rate has remained low, such as the former West Germany and Japan, and 4) countries where the rate has continued to fall, such as Italy and Spain. Demographers are keenly watching whether Japan will shift from the third group to the fourth.

The declining birthrate will inevitably have a direct impact on the future of Japan's pension system, as it will on every aspect of society. But the effects of a continuing rise in life expectancy cannot be ignored either. For the past several years

Fig. 2 Changes in Number of Births and Total Specific Fertility Rate



Source: *Annual Report on Health and Welfare 1990–1991*, Japan International Corporation of Welfare Services

Japanese have led the world in longevity, with the average life span in 1991 statistics reaching 82.11 for women and 76.11 for men.

For pension system planners, that translates into two critical numbers. According to the latest statistics, the average remaining life expectancy for a Japanese man aged 60 is 20.10 years, rising to 24.57 for a woman. Someone who quits work and starts receiving a public pension at age 60 will continue to receive it for at least two decades.

Present pension system

At present, pension funds come from the insurance premiums that the recipient paid while working, from interest earned through the management of those premiums, and from the pension premiums and taxes paid by people in work below 60. Pension specialists say that in the future virtually all pension funds will have to be shouldered by people in work. If births decline while life expectancy rises, the outcome is obvious. The whole world is watching this bellwether experiment in engineering pensions for a country where people live longer than anywhere else on the planet.

How does Japan's present pension system work? Basically, there are two categories of pensions: one for those who earn salaries and one for those who do not. Pensions in the first category are further subdivided into the Employees' Pension for private-sector workers and the Mutual Aid Association Pension for public workers. Complicated enough as it is, the latter category is divided yet again into seven types, such as those for central government officials, local government officials and public corporation officials. Each of these schemes for public workers has its own origins, and until just a few years ago they were all managed independently.

Historically, there have been three main currents in pensions in Japan. The first had its origin in the Soldiers' Pension, started in 1875, which was later extended to government officials. This grew into the Mutual Aid Association Pension after World War II. The second was launched in 1942 during the war to bring stability into people's lives and boost worker morale. This scheme evolved into today's Employees' Pension. The third is the National Pension, introduced in 1961 to meet the growing demand for social security for the elderly as the collapse of the extended family system in postwar Japan left them without support.

The postwar National Pension completed a system under which all Japanese are

Photo: Nihon Keizai Shimbun

Japanese lead the world in longevity, but the pension system is under strain and the number of pension plan consulting offices is increasing nationwide.

eligible for some form of public pension.

The world's pension systems are generally classified by experts into the continental European system, practiced in the former West Germany and France, and the Northern European system found in Britain and Sweden.

While the continental European model is a "vertical" system under which workers, the self-employed and public officials receive different pensions, the Northern European system is a "lateral," two-tier system under which basic pensions are paid to all people, and additional pensions are paid out depending on how much they earned.

The Japanese system was originally modeled on the continental European system. But it was revised with the introduction of the common basic pension system in 1986. The revision in a sense was the first step toward a fundamental realignment from a vertical to a lateral system. Additional adjustment followed in 1990 to rescue the financially ailing Railway Nippon Mutual Aid Association and other public pensions.

Under the rescue plan, funds from the amply funded Employees' Pension and Local Public Workers Mutual Aid Association were used to cover shortfalls in the Railway Nippon Mutual Aid Association (belonging to the defunct Japanese National Railways) and the Tobacco Industry Mutual Aid Association of the defunct Japan Tobacco and Salt Public Corporation. This was a stopgap measure, and the government is now committed to consolidating all the various public pension systems into one by the target year of 1995.

There is ample reason to make the change. Take, for example, the degree of maturity, that is, the ratio between pension fund contributors and pensioners. In the case of the Employees' Pension, the ratio is 6.5 to 1. In the case of the Railway Nippon Mutual Aid Association, the ratio is 1 to 1.7, a sure formula for disaster. In the case of the Tobacco Industry Mutual Aid Association, pensioners actually outnumber pension contributors. Both pension systems typically carry the brunt of changes in the country's industrial structure and social conditions.

Another symbol of the pension crisis is to be found in how long the accumulated pension funds would last if new inflows ceased. The Private School Teachers and Employees Mutual Aid Association has enough funds to pay pensions for more than 12 years, whereas the remaining funds in the Railway Nippon Mutual Aid Association would not last a single year. The Employees' Pension, largest of all the systems, has enough funds to last 5.6 years.

Test of consolidation

Given this great disparity in the degree of maturity and accumulated funds, it is impossible to sustain a stable pension structure if each system is left to its own devices. Yet it remains to be seen whether consolidation can be accomplished by 1995 as planned.

Of all the factors imperiling Japan's pensions today, however, none has caught the public imagination as much as the stock market crisis. Pension fund managers dismiss such concerns, saying that, in the long run, stock investment is still the most profitable way to manage pension funds.

But it may not be so clear-cut as that. As of the end of March 1992, public pension funds (the Employees' Pension for private-sector salary earners and the National Pension for non-salaried citizens) totaled some ¥88.1 trillion, and the corporate pensions (Employees' Pension Funds to be used for an additional payment to the Employees' Pension and individual companies' retirement pensions qualifying for tax incentives) another ¥42.8 trillion. Earlier statistics show that the various mutual aid associations had accumulated funds totaling ¥26.5 trillion by the end of March 1990. Together, pension funds now total some ¥157 trillion, which is close to the balance of Japan's public bonds outstanding at some ¥172 trillion as of the end of March 1992.

The management of these enormous pension funds impacts not just the little man's pension but Japan's state finances and the economy as a whole. The funds in the Employees' Pension and National Pension are first put on deposit with the Fund Management Department of the Ministry of Finance. Combined with postal savings and other public funds, they are the main source of fiscal investment by the national government.

As of now, pension contributors far outnumber pension recipients, leaving a surplus of around ¥5 trillion in the pension account. The surplus is now held in reserve by the Fund Management Department, which keeps interest artificially low. The Health and Welfare Ministry, which is in charge of pension management and related advisory councils, had been openly wondering if there might be a better way to manage these funds. Higher interest, it argued, would make it easier in the long run to finance the pension system.

Independent operation

A reluctant Ministry of Finance finally agreed to allow the Pension Welfare Service Public Corporation, an affiliate of the Health and Welfare Ministry, to partially operate pension funds on its own starting in 1986. This "independent operation," as the measure was called, started with ¥500 billion, and by its seventh year was up to ¥16.1 trillion, increasing at a rate of about ¥3 trillion a year. Trust banks and insurance companies are in heavy competition for the right to manage these pension funds.

The independent operation turned a profit of some ¥230 billion in its first five years. But the abrupt plunge in and the lingering stagnation of stock prices has remorselessly battered pension fund operations. Operating earnings in fiscal 1991 fell short of borrowing costs, resulting in an unprecedented ¥54 billion loss for the year. Some pension operators were also caught by stock scandals in 1991, and were identified as having received compensation from securities companies for their stock market losses. The pension fund operation offices of the Health and Welfare Ministry as well as the Pension Welfare Service Public Corporation have been scrambling from the summer of 1992 to respond to the changing business environment.

Corporate pensions, which form an additional layer on top of public pensions, are seen as playing an increasingly important role in the pension system as a whole.

The Employees' Pension Funds, which are typical of corporate pensions, had 1,600 funds and a membership of more than 10 million as of April 1992. They accounted for one-third of the nation's Employees' Pensions in terms of numbers. Each Employees' Pension Fund is duty-bound to bank its assets with trust banks or life insurance companies. In April 1990, eight years after their establishment, those funds meeting certain government mandated criteria have also been allowed to entrust some of their assets to investment advisory companies. At present only some 10% or so of corporate pension funds fall into this category. But pension managers are watching closely to see how this small step toward deregulation will work in today's stricken financial market.

Japan's pension system today is on a par with that of the advanced countries of the West. An average pensioner who was a member of an Employees' Pension for 35 years and his wife together now receive some ¥213,000 a month, equivalent to about 70% of the average salary earner's monthly income. The pension is automatically raised each April in proportion to inflation.

As long as this mechanism can be maintained without significantly increasing the burden on pension contributors, people will remain content. Yet as things stand now, the system is in serious danger of going bust. Not only the delaying of the pension starting age but also a review of the pension level itself may have to be considered when the next revision of the system takes place. The ability of government and all concerned to revitalize the system in line with the evolving needs of society will determine the future of this vital link in Japan's social safety net.

Photo: Kyodo News Service

The continued decline in Japan's birthrate will have a direct impact on the pension system.

Satoru Harada is a commentator on social security issues and also serves as a member of the governmental National Pension Council.