Executive Summary

In some ways, the Japanese system is not unlike that of other industrialized countries. This is not surprising in so far as Japan, once it opened to the west in the nineteenth century, made a point of learning from the western countries. Moreover, although a full public pension system was not properly established until after the Second World War — no later than in many western European countries — it was established under the American occupation. Therefore, similar to other industrial countries, the state has an important role in providing pensions, and the public system is based upon a pay-as-you-go principle with a partially proportional benefit formula. Company benefit systems supplement the public system and, in some cases, predate it.

Despite the similarities with other countries, however, the retirement income system in Japan does have a number of special characteristics. First, unlike in many other countries, people in Japan keep working well after the “normal” retirement age. Second, older people in Japan are much more likely to be living with their adult children than are older people elsewhere. Thus, incomes in old age comprise a considerable element of intra-familial transfers. In these respects, Japan is “a special case.”

Like most industrialized countries, Japan is confronted with the challenge of supporting a rapidly aging population. Indeed, Japan is aging faster than almost any other in the industrialized world (see Figure 1). In this respect, Japan is not “a special case.” Moreover, the employment and social structure of Japan is also changing. Working in older age may be a less viable option in the
future. And families are becoming less willing and less able to provide homes and care services for their parents. Accordingly, the way that Japan has been “a special case” may be fading over time, which could undermine retirement income security. In short, the challenges that Japan faces are more profound than those faced by many other societies.

Figure 1. Number of People 65 and Older per 100 People of Working Age (Aged 15-64), 2000 and 2050


The Early Period

Japan developed its pension system relatively late. Although there had been provisions for specialized groups such as the military (1875) and civil servants (1890), a national pension system for private sector workers was not established until the 1940s. The current earnings-related pension system dates to legislation in 1954 and 1961.

The absence of a public pension system had much to do with notions of familial responsibility. Care of the aged parent was considered an important task for the eldest son and his wife. Those who had no resources were assumed to be cared for by the wider family and by their neighbors, a social unit that the Japanese call one’s “home.” By the early 20th century, some politicians favored the introduction of a Bismarckian social insurance system, if for no other reason than that it might reduce social unrest. However, most industrialists preferred to rely upon a paternalist approach and were not willing to countenance increases in labor costs.

The war effort in the 1940s, rather than concern for the well-being of the elderly, motivated the introduction of public pensions for industrial workers. The first mandatory scheme was established in 1940 for the strategically important shipping industry. In 1942, schemes were opened for workers in the mining, manufacturing and transport sectors. In 1944, the Employees Pension Insurance program extended coverage to all sectors of private industry and commerce.

Consistent with the objective of supporting the war effort, the pension system was a funded, not a pay-as-you-go, system. Thus, the state received tax income but faced no immediate costs. The new system set contributions at 11 percent, and was designed to pay benefits to individuals aged 55 and older who had contributed for a minimum of 20 years. Twenty-five years of contributions were required for a full benefit.

Post-war hyperinflation, however, rendered the assets built up in the funded system worthless. Japan was forced to reconstruct its pension system. The resulting 1954 reform occurred under the auspices of the post-war occupying powers, and it fundamentally rebuilt pension provisions. A new

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1 Because of the importance of this sector, proposals for the establishment of a mandatory pension system for its workers had been made since the end of the 19th century.

2 Even that system excluded workers in establishments with fewer than five employees. It also excluded agricultural workers, domestic workers and the self-employed.

3 For miners and seafarers, the eligibility requirement was somewhat lower – 15 years of contributions and an age of 50.
civil code narrowed the traditional concept of who held responsibility for supporting the elderly, replacing the notion of the “home” with a “family” unit presumed to consist of a married man with a dependent wife and possibly children. Rather than being funded, a PAYGO element became dominant in the new public system — although a fund was still built in. The system had a Beveridgian principle. It collected flat rate contributions and paid out modest flat rate benefits, with supplements for any dependent spouse or child. Half of the costs were met by transfers from general revenue and half from a 3 percent levy on earnings. The pension age was set at 55 for women and 60 for men, at a time when life expectancy of those reaching these ages was some 21 and 14 years respectively. Nevertheless, only a fraction of the active workforce reached pension age — of the cohorts starting to retire in the mid 1950s, life expectancy was only around 66 for men and 69 for women. In 1959, a special means-tested benefit, financed out of general revenue, was introduced for those 70 and over who had failed, or would fail, to meet the full contribution requirement.

The pension set up in 1954 covered only 40 percent of the population aged 20-59 — that age group for whom membership was compulsory. This reflected the importance of the agricultural workforce — which was excluded — and the economic situation of women — most of whom were not working and who derived benefits only through their husbands.

In 1961, legislation made coverage essentially universal for all workers and set up the basis of the current pension system. Dependent, non-working wives could join on a voluntary basis until 1985; thereafter, their membership has been compulsory.

The Essential Features of the Current System

The public pension system since 1961 has had two tiers, a flat-rate basic pension — “the national pension” (NP) — and an earnings-related “employees pension” — (EPI). The former is, effectively, a continuation of the system that had been built up since the 1940s. The latter was intended to substantially increase the generosity of the pension and change it to one that related retirement income to income in working life.

Over and above these two public tiers are third and even fourth private tiers. The third tier consists of company-sponsored pensions, the fourth of personal pensions. The four tiers will be described in turn.

The Public Pension

The NP remains a universal flat rate benefit. For dependent employees covered by the EPI, the two are, to all intents and purposes, integrated as a single program.

The public system has three categories of membership — referred to as the No.1, No. 2 and No. 3 insured. The No. 2 insured consists of employees working in firms with more than five employees, so long as they are not on part-time or temporary contracts — here, contracts lasting under three years. Employees of central and local government are covered by schemes that are similar to the EPI, known as Mutual Aid Association pensions (MAA). The No. 1 insured consists of those who are either self-employed, agricultural workers who are not employees, or employees in small businesses, part-time workers, and workers on temporary contracts. The No. 3 insured are the dependent spouses of the No. 1 and No. 2 insured. Contributions for the No. 2 insured are deducted through the employer. The No. 1 insured have to arrange their own contributions; the No. 3 insured pay no contributions.

Benefits payable under the NP and EPI take the form of annuities. However, the retirement ages have not always been the same. The NP age of eligibility is 65; that of the EPI was 60 until 2001 (for men) and 2006 (for women) when it began increasing in steps to 65, reaching this level by 2013 (for men) and 2018 (for women). Those who reach the age of entitlement to an EPI pension and cease to work are entitled to a special bridging benefit that effectively equals the NP benefit.

Company Pensions

Lump-sum, tax-privileged benefits, sponsored by the employer, can be traced back to before the Second World War when paternalist employers established “book reserve” schemes not unlike those that are still found in Germany. These schemes paid a leaving allowance in the form of a lump sum, the level of which was dependent upon age and length of service. Strictly speaking, this leaving allowance cannot be labelled a pension, since even younger leavers might be entitled to something.

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4 This measure is for people who had already survived into their late teens, so it excludes those who died in infancy or childhood.
In 1962, legislation permitted firms employing more than 15 workers to set up separate tax-qualified retirement plans (TQRPs) that built up assets and paid out lump sums on retirement or, if chosen, an annuity. Since 1966, it has been possible for large employers — those employing over 500 workers — or those who acting together employ this number — to “contract out” of a part of the state earnings-related EPI, subject to their offering superior levels of benefits and establishing their own employer pension funds (EPFs) to finance these benefits. That part of the EPF that exceeds the level payable under an EPI can be taken as an annuity but, more often, it is taken as a lump sum.

Further revisions of corporate pension provisions were made at the end of the twentieth century. In part as a response to the parlous state of many corporate pension funds, and in part as an attempt to improve scheme governance, no new TQRPs were to be established and those in existence were to be closed by 2012. At the same time, the framework for a new form of defined benefit corporate pension fund (DBC PF) and, for the first time, for corporate defined contribution plans (DCC PF) was established. The aspiration was that TQRPs would be shifted into DBCPFs or DCCPFs, while this opportunity was also open to EPFs.

The large majority of private sector firms with at least 30 employees offer some form of private retirement/separation benefit. As shown in Figure 2, firm size determines whether a benefit is offered at all and what form that benefit takes. Book reserve retirement allowances predominate in small enterprises, funded pension systems in larger ones. By definition, EPFs are almost exclusively found in large enterprises, while TQRPs are more common in small enterprises. As the figure also shows, firms can have more than one plan. Indeed, of enterprises with an EPF, about half also have a TQRP.

Personal Pensions

The fourth tier of voluntary insurance, itself, involves many forms of savings plans. Since 1991, self-employed people have had the opportunity to make supplementary contributions into one of a series of 70 or so occupational or regional pension funds. These funds, together referred to as the National Pension Funds (NPF) operate on a defined benefit basis and pay out as an annuity. Moreover, relative to life insurance plans, NPF pensions have considerable tax advantages. Take-up is, however, low. Under 2001 legislation, self-employed people are also able to join one of the new, open defined contribution schemes offered by insurance companies, trust companies or banks. This option is also open to employees whose employers are not sponsoring any supplementary pension plan.

Life insurance-type personal savings plans are open to the population as a whole. These pay out lump sums on termination, although these lump sums can, theoretically, be annuitized. Between a quarter and a third of employees appear to contribute to such plans.

Table 1 shows overall pension coverage by tier and the extent to which many in the workforce have more than statutory coverage. Figure 3 shows a breakdown of pension participants in the public system.


Table 1. Participants in the Public Pension System by Type of Plan, in Millions of People, 2002

<table>
<thead>
<tr>
<th>Tier of Pension System</th>
<th>Full-time</th>
<th>Self-employed and Agricultural</th>
<th>Dependent Spouses</th>
<th>All</th>
</tr>
</thead>
<tbody>
<tr>
<td>First Tier - National Pension (NP)</td>
<td>37.2</td>
<td>19.3</td>
<td>11.6</td>
<td>68.1</td>
</tr>
<tr>
<td>Second Tier - Earnings-Related Pension</td>
<td>37.2</td>
<td>0</td>
<td>0</td>
<td>37.2</td>
</tr>
<tr>
<td>Public Sector Employees (MAA)</td>
<td>5.3</td>
<td>0</td>
<td>0</td>
<td>5.3</td>
</tr>
<tr>
<td>Private Sector Employees (EPI)</td>
<td>31.9</td>
<td>0</td>
<td>0</td>
<td>31.9</td>
</tr>
<tr>
<td>Third Tier - Supplementary Plans</td>
<td>21.2</td>
<td>0.9</td>
<td>0</td>
<td>22.0</td>
</tr>
<tr>
<td>EPF</td>
<td>10.6</td>
<td>0</td>
<td>0</td>
<td>10.6</td>
</tr>
<tr>
<td>TQRP</td>
<td>8.6</td>
<td>0</td>
<td>0</td>
<td>8.6</td>
</tr>
<tr>
<td>DBCPF c</td>
<td>1.4</td>
<td>0</td>
<td>0</td>
<td>1.4</td>
</tr>
<tr>
<td>DCCPF d</td>
<td>0.6</td>
<td>0</td>
<td>0</td>
<td>0.6</td>
</tr>
<tr>
<td>NPF</td>
<td>0</td>
<td>0.8</td>
<td>0</td>
<td>0.8</td>
</tr>
<tr>
<td>New defined contribution plan</td>
<td>0</td>
<td>0.1 a, b</td>
<td>0</td>
<td>0.1</td>
</tr>
<tr>
<td>Fourth Tier - Individual Retirement Plan</td>
<td>10.2</td>
<td>3.3</td>
<td>2.6</td>
<td>16.1</td>
</tr>
</tbody>
</table>


a Data refer to end of 2003.
b Less than 0.1
c Includes those who are also members of a DCCPF.
d Includes those who are also members of an EPF or DBCPF.

Contributions, Benefits, and Tax Treatment

The public pension system operates in a conventional fashion in so far as employer and employee contributions are taken from income before tax. Currently, contribution rates are 13.58 percent of annual earnings, split evenly between employers and employees. Annual and semi-annual bonuses are taken into account, although subject to a cap. For those in the NP only, the flat rate contribution is the equivalent of about 3.5 percent of the average wage (or about 20 percent of the full NP pension). EPFs and TQPRs are funded by the employer.7 Where an EPF operates, the employer makes lower contributions to the EPI.8

Figure 4 shows a breakdown of revenue sources for the public pension system. Transfers from general revenue cover the administrative costs of both the NP and the EPI and, since 1985, one-third of the costs of NP benefits. In addition, the public pension system receives income from the assets of its fund. In this respect, the system can be described as partly funded. In the year 2000, income from fund investments was about one-eighth of total income, and the fund had reserves equal to about six years of payments.

Public pensions for employees were never particularly generous. Legislation in 1973 substantially enhanced benefits and regularized indexing. By the mid-1980s, it was intended that employees may make additional, voluntary contributions. This is much more frequent in larger enterprises, where EPFs are to be found, than in medium-sized enterprises where TQPRs predominate.

7 However, employees may make additional, voluntary contributions. This is much more frequent in larger enterprises, where EPFs are to be found, than in medium-sized enterprises where TQPRs predominate.

8 The rebate lay between 3.2 and 3.8 percent of annual earnings in the 1990s, with its size depending on the assessed ability of the fund to meet its liabilities, although this has now been changed to a single 3.5 percent rebate.
The public pension system provides a survivors benefit, which is worth three-quarters of the pension of the deceased person. Alternatives, which involve taking all or part of the survivor’s own pension are also available, and in some cases these might be more favourable. Employer-sponsored schemes do not, in general, offer survivors benefits, which is consistent with their lump-sum nature.

Early and Late Retirement
The difference in retirement ages of the EPI (60) and the NP (65) is, to an outsider, an anomaly of the public pension system of Japan. The retirement age in the EPI and in company-sponsored plans reflects the retirement practices of employers in both the private and public sectors. Seniority-related payment systems, at least in large firms and in the public sector, mean that employers have an interest in employees leaving as soon as their wages exceed their productivity. However, a culture that respects age acts as a counter-imperative. In practice, employers seek to effect some sort of demotion once the employee has passed a critical age. This critical age might be lower than the age of EPI eligibility and is normally no later than that. The demotion can take the form of an internal transfer to a non-mainstream position or of an external transfer to a subsidiary or a sub-contractor. It can even involve assistance to set up a worker in self-employment. Demoted and transferred workers might well continue to work beyond the normal retirement age of 65; indeed, Japan has one of the highest rates of employment of older people in industrial countries (see Figure 5).

The public pension system appears to provide clear incentives to retire at the earliest possible age. In the EPI, neither years of contributions above 40 nor claiming at a later age brings additional benefits. Under the rules operating until 2000, those retiring at 60 were entitled to a special bridging benefit paid by the EPI scheme, which made up the equivalent of the NP benefit that would have been drawn at 65. Part-time work from age 60, combined with a public pension, was also possible. However, a relatively complex earnings

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9 Since 2001, they have to be only 10 percent more generous.
10 In fact, a survivor has one of three choices. She can take three-quarters of the pension of the deceased person, half her own EPI pension plus half of the pension of the deceased person (i.e. two-thirds of a survivor’s benefit), or her own.
11 Any increase in the EPI age of eligibility requires corresponding changes by employers. In the past, these changes tended to occur, albeit sometimes with some lag.
12 The practices of larger and public sector employers are not the sole reason for this high employment rate. Many of the oldest workers in Japan are engaged in agriculture or retailing. They leave employment in industry and commerce and find refuge in work in family-run plots and micro-businesses (Casey, 2001).
The Income of the Older Population

Understanding the income of older people in Japan is a complex task for two reasons. First, as noted above, a substantial share of people who are “above retirement age” still work. In this respect, income from labor is much more important for older people — particularly the younger old — than it is in many other countries. Second, the living arrangements of older people in Japan differ substantially from those in most western industrialized countries. Multi-generational families are much more important (see Table 2a). One in four older Japanese persons lives in such a family. The importance of multi-generational arrangements is reflected in the low number of elderly Japanese women who live alone — traditionally, the group most at risk of poverty (see Table 2b).

Table 2a. Percent of the Population Aged 65 and Above Living in Intergenerational Households, by Age and Marital Status

<table>
<thead>
<tr>
<th></th>
<th>Single People</th>
<th>Couples</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Aged 65-74</td>
<td>Aged 75+</td>
</tr>
<tr>
<td>Japan</td>
<td>10</td>
<td>35</td>
</tr>
<tr>
<td>USA</td>
<td>5</td>
<td>9</td>
</tr>
</tbody>
</table>

Source: Derived from Yamada and Casey (2002).

Table 2b. Percent of the Female Population Aged 65 and Above Living Alone

<table>
<thead>
<tr>
<th></th>
<th>Aged 65-74</th>
<th>Aged 75+</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single Women Living Alone</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Japan</td>
<td>9</td>
<td>11</td>
</tr>
<tr>
<td>USA</td>
<td>18</td>
<td>33</td>
</tr>
</tbody>
</table>

Source: Derived from Yamada and Casey (2002).

The multi-generational arrangements make it difficult to identify what constitutes an “elderly household.” Household income data are normally organized according to the age of the head of household, but, in some multi-generational households, the head is the adult child (or child-in-law). In other words, the elderly person has moved in with the children and is in a subordinate position. Second, even when such a household has been identified, its income will contain the labor income of any adult children (or children-in-law) living with the elderly person. Therefore, taken

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14 For a full comparison of incomes of older people that covers a number of OECD countries, see Yamada and Casey (2002) and Casey and Yamada (2004).
together, any statement of the household income of elderly people in Japan may include substantial income from the adult children. Moreover, since both the adult child and the older person are likely to be working, household income will contain a considerable amount of labor income (as shown in Figure 7). And, in so far as multigenerational households are larger than conventional households, they enjoy greater scale economies.

Figure 7. Composition of Household Income, Households Headed by a Person Aged 65 or Over, Mid-1990s

![Composition of Household Income](image)

Source: Derived from Casey and Yamada (2004).

After adjusting for these complications, older people in Japan appear to enjoy a relatively high living standard. Incomes that account for scale economies and intra-household transfers do not fall as substantially with age as in many other countries (see Figure 8).

![Adjusted Median Incomes for Selected Age Groups](image)

Source: Derived from Yamada and Casey (2002).

* As a percentage of adjusted median disposable income of the working age population (aged 18-64) in the mid-1990s.

Perhaps not surprisingly, living in a multigenerational household has beneficial consequences for elderly incomes, particularly for elderly women — the group that in almost all countries makes up the poorest of the old. While four-fifths of very old women living alone have an income that places them in the bottom fifth of overall distribution, less than one-fifth of very old people who are widowed or otherwise single but who are living in a multigenerational family are in this position.

The Reforms of 2000 and 2004

The public pension system is subject to reappraisal on a five-year basis. Major legislation on pensions occurred in 2000, affecting not only the public but also corporate pension schemes. Further legislation, affecting the public pension system was completed in summer 2004 to take effect in 2005.

Reforms to the Public Pension System

The retirement age under the EPI is currently being raised to 65 under legislation dating from 2000. For men, the new age will be valid as of 2013; for women, as of 2018. The legislation also introduced, for the first time, the opportunity to take benefits early on a reduced basis. The rate of reduction is set at six percent per annum, so that at 60 — the

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15 Statements of individual income are equally fraught, since these are derived from household income sources. Account has to be taken not only of assumed transfers between spouses — normally from the male to the female — but also from the adult children to the parents.
earliest age of eligibility — an EPI pension would be worth 70 percent of its normal value. Along with the increase in the EPI retirement age, the rules for combining part-time work and benefits are due to change. When the transition is complete, a system similar to the one that currently applies to 60-64 year-olds will operate.

The accrual rate for EPI benefits had stood at 0.75 percent of wages per year worked since 1985. Before 1985 it had been one percent. The 2000 reform cut it further to 0.7125 percent. Thus, after 40 years of contributing, the pension would be worth only 28.5 percent of measured wages rather than 30 percent. Rather than index pensions to prices and, every five years, to wages, price rises alone would determine pension increases. In fact, since 1999, and as a result of deflation, there had been no increase in pensions at all. Indeed, special legislation had to be passed to prevent pensions from being cut. Nevertheless, the adjustment in the accrual rate and the indexation procedures are projected to cut pension benefits by some 20 percent when they take full effect. In order to smooth acceptability of the reform, the 2000 legislation contained a provision for pension levels to be re-examined should wage and price increases move too far apart.

In early 2002, a new set of projections was made, suggesting yet higher dependency rates than had been envisaged earlier. As Figure 9 shows, by 2025, the public pension contribution rate would have to rise to 24.8 percent rather than the 21.6 percent foreseen earlier.

Figure 9. Projections of Age Dependency Rate and Planned Contribution Levels, 2000-2050

In order to hold down contributions, a number of further reform proposals were considered. Radical solutions, including a switch to funding and the introduction of some form of notional defined contribution system, were rejected. Instead, the 2004 reform legislation placed a cap on contributions so that they stabilize at 18.3 percent by 2017, and it increased general revenue contributions from one-third of the NP costs to one-half.

The raising of the contribution rate even to this level has brought expected protests from the business community. At the same time, capping contributions and fixing limits to revenue transfers, coupled with further changes in the indexing arrangements that, in effect, introduce a demographic coefficient, also means that projected pensions will fall. The replacement rate for a “model” employee with a dependent spouse, which had been targeted at 60 percent in the 1973 legislation, will fall by 2020 to around 50 percent. This has led to protests from labor unions and parties of the left.

Recasting the Reserve Fund

Although the public pension system could be described as partly funded, in reality it has scarcely been so. The reserves that were built up, along with savings in post office accounts, were passed to the Trust Fund Bureau (TFB) of the Ministry of Finance where they were used, “in the public interest,” to support infrastructure projects and housing loan schemes. The actual rate of return was extremely low. It was not until 1986 that this practice changed with the establishment of a Project to Secure the Financing for Future Pension Benefit Payment. The purpose of this initiative was to strengthen the financial resources of the EPI and NP by making use of external fund managers who would invest in domestic and foreign equities and bonds. However, even by the late 1990s, only about five percent of the reserve fund was allocated in this fashion.

The 2000 legislation also made substantial administrative changes in the management of the reserve fund. Responsibility was handed to the Ministry of Health, Labour and Welfare, and the ministry was instructed to invest not in any “public interest,” but rather in “the interests of the insured population” — to maximize returns to the fund. A new Government Pension Insurance Fund (GPIF) started to operate in 2001 and over the following eight years it is to take charge of the entire reserve.

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The index will increase pensions in line with prices minus 0.9 percentage points. The 0.9 is the sum of the projected annual decline in the size of the labor force — 0.6 percent — and the projected annual increase in longevity — 0.3 percent.
Even in its early days, the fund was enormous — roughly twice the size of the California Public Employee Retirement System. By 2009, the fund is projected to equal the GDP of Canada.

The reforms gave a predominant role in GPIF management to investment specialists, rather than ministerial officials. The reforms also strengthened terms of disclosure and introduced external audits. And they set a target investment portfolio for the end of the eight-year transition period (see Table 3).

Table 3. Portfolio of the Government Pension Insurance Fund

<table>
<thead>
<tr>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic bonds</td>
<td>58%</td>
</tr>
<tr>
<td>Foreign bonds</td>
<td>4%</td>
</tr>
<tr>
<td>Domestic shares</td>
<td>22%</td>
</tr>
<tr>
<td>Foreign shares</td>
<td>11%</td>
</tr>
<tr>
<td>Cash, etc.</td>
<td>5%</td>
</tr>
</tbody>
</table>


The GPIF management has argued for passive management on the grounds of superior performance and lower cost. More than 70 percent of its investments in domestic shares are now managed this way, nearly three times as many as in 2000, as are nearly 80 percent of the investments in foreign shares and bonds. Only investment in domestic bonds is retained in house by the fund.

Fund performance after such a short period is difficult to assess. Yields on domestic government bonds are low, while the domestic stock market took a major fall in the first two years of the GPIF’s existence. Overall, the fund lost close to one-eighth of its value in this period. Prospects for the coming years in both the stock and bond markets are not universally regarded as good. Therefore, the target rate of return of 4.5 percent that has been set for the fund might prove overly optimistic.

Reforming Corporate Schemes

During the 1990s, company pension schemes found themselves in increasing difficulties. The value of investments in domestic equities plummeted as the stock market lost three-quarters of its value. Yields on long-term government bonds fell through most of the 1990s, reaching under two percent by 1998. Foreign holdings were adversely affected by Yen appreciation. Real estate prices had crashed when the “bubble economy” burst. The condition of retirement allowance plans, which operated as book reserves, was less obvious. Nevertheless, by the mid-1990s concerns were being expressed about the extent to which the assets of funded pension plans matched their liabilities. By 1998, some 70 percent of EPFs were reported as underfunded, and by 2003 the overall shortfall among EPFs was some 17 percent. The problems became more evident in the late 1990s, first due to a requirement that pension funds be valued at market rather than book value, and then due to a change in accounting rules that deducted claims from reserves and reported the results in enterprise balance sheets.

The shortfall, by some estimates, reached the equivalent of 15 percent of GDP by early 2002. A rough comparison of the situation of the top 300 companies in Japan and the S&P 500 companies of the United States shows a shortfall of some $196 billion at the end of 2002 in the former case and of some $220 billion at the end of 2003 in the latter case — while the GDP of Japan is only about half that of the United States.

Some enterprises responded to the problem of fund shortfalls by taking steps to reduce the benefits paid. They were constrained both by a legal obligation, albeit one that was not absolute, to meet a 5.5 percent return on pension savings, and by a moral obligation to provide for their workforce. Nevertheless, by 2003, over one in four EPFs had cut benefits. Some companies went so far as to close their schemes down completely. Figure 10 shows the decline in the number of EPFs and TQRPs.

Figure 10. Number of EPFs and TQRPs, 1995-2002


17 It is reported that, as a result, the fund cut the amount of management fees it paid by 57 percent, to $153 million, in just two years.

18 Until 1999, funds were required to follow a “5-3-2 rule” whereby not more than 50 percent of assets were to be held in equities, not more than 30 percent in foreign equities or bonds, and not more than 20 percent in property.
TQRPs — either through closure (as was the case of most EPFs) or as a consequence of the sponsoring employer going bankrupt (as was the case of many of the TQRPs).

As discussed earlier, the government response to the crisis of employer-provided pensions was to legislate the establishment of Defined Benefit Corporate Pension Funds (DBCPFs). Such plans have to be funded and the funds must be external to the company. They are subject to new rules governing trustee responsibility and information disclosure, and they must undergo actuarial review every five years with an obligation to meet reported shortfalls. By 2012, all existing TQRPs are to be transferred to new accounts or closed down.\(^{19}\)

Shortly after the passage of the law establishing DBCPFs, the long awaited legislation permitting the establishment of defined contribution schemes (DCCPFs) cleared parliament.

By spring 2004, over 500 DBCPFs had been established with 1.44 million active members. Moreover, and largely as a result, the number of EPFs had fallen to just over 1,200 by the end of 2003 — over 400 below the end of 2001 total shown in Figure 4. The take-up of DC schemes has not been large. Employees have seen little merit in these plans, especially when the new schemes absorbed part of their employer’s contributions to an EPF. The experience of recent years would have suggested to most employees that investments in securities were producing nothing like the returns that were to be expected from an EPF plan.

Long-term Prospects

The 2004 pension reform law by no means marked the end of a process. Many politicians and academic analysts share the view that the current system is unsustainable and further five-year reviews and legislation will follow. A number of issues have yet to be resolved. These concern not only pension finances or private pension security — issues that attract a lot of attention — but also more fundamental matters — in which direction is Japanese society moving — something that is much less openly addressed but that is at least as pertinent.

Improving the Financial Base of the Public Pension System

The ability of the government to raise taxes to meet the increased general revenue commitment is less than certain. Were the additional revenue raised by the income tax, the burden would fall heavily on the working age population since pensioners pay very little income tax. This has led some commentators to suggest relying more heavily on a consumption tax. In this case, older persons would also bear a share of the burden of societal aging. However, experience with trying to introduce a form of value-added tax (VAT) in Japan has not been a happy one. In the mid-1980s, the announcement of plans to introduce a sales tax contributed to the Liberal Democrat Party losing its parliamentary majority for the first time since the war. Although a form of VAT was introduced shortly after, its rate was very low and small traders were exempted. Currently the VAT stands at only five percent compared to the 15-25 percent common in Europe.

Another way to improve the financial base is to extend coverage to those who are not making contributions. These non-payers fall into three groups: 1) low income workers, who are exempted (nearly 60 percent); 2) those who are not paying but should be (about 40 percent); and 3) a few who are not even registered in the system at all.\(^{20}\) Complete or partial non-compliance is also prevalent among the self-employed.\(^{21}\) Finally, many unemployed people and students — groups that are normally required to make contributions into the NP system — are failing to do so. Overall, contribution

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19 EPFs can transfer themselves into DBCPFs but they are not obliged to do so. If they do this, they are required to make good any shortfall with respect to EPI entitlements in advance — something that could put further pressure upon the sponsor. They can also switch all or part of what they offer in excess of an EPI into a DCCPF. Because the law allows for EPF closures, it also allows enterprises with such plans to hand the responsibility for their schemes back to the NPF system. However, when a transfer takes place, any securities holdings have to be liquidated, either by the fund as the transferor or by the state as recipient — something that could further depress stock markets. An even tougher requirement to make up any shortfall applies when an EPF is converted to an EPI plus a DCCPF. In such cases, the entire value of accumulated entitlements has to be transferred to the new plan.

20 Those who are on very low incomes are exempted from the NP system. However, among this group are many young people, including those who are described as having “dropped out” of the employment system or who choose to work on a casual or part-time basis — the group sometimes referred to as “freeters.”

21 According to some statistics, the proportion of “delinquent” self-employed rose from one in six in 1996 to nearly four in ten by 2002. As the 2004 reform bill was passing through parliament, non-compliance became a particularly sensitive issue. Parliamentarians are, technically, counted as “self-employed” and it was revealed that many leading members, including the prime minister, had at some time been non-compliant.
income to the NP is said to be only about three-quarters of what it would be if all of the covered age groups were fully compliant.\textsuperscript{22}

Safeguarding Corporate Pension Members Rights

One of the reasons for introducing corporate defined contribution schemes was that existing employer provisions disadvantaged mobile labor — a shortcoming of the “lifetime employment system.” By definition, retirement allowance schemes paid out on departure — accrued rights were not transferable. Neither were accrued rights under TQRPs. Moreover, TQRPs paid out only once retirement had been reached and were lost if the insured person changed employers. It was only in 1997 that vesting was introduced for that component of the EPF that exceeded the EPI entitlement. Those who had at least 20 years membership in a plan were henceforth entitled to a deferred pension. Those with shorter membership (in excess of one month) were henceforth entitled to a minimum preserved benefit based on that which they had accrued. This preserved benefit generated a lump sum that could be taken as cash or transferred to a special Pension Fund Association. That body takes responsibility for the assets, invests them further, and pays out an annuity once retirement age has been reached. It does not arrange transfers into the EPF of any successor employer.\textsuperscript{23} Only when TQRPs are switched into DBCPFs or DCCPFs will they be vested.

Retirement allowances under the book reserve system are especially poorly protected. Employees of bankrupt companies are likely to lose their retirement allowances, since the status of their claims is no higher than that of any other creditor. Funded systems offer some protections. TQRPs and EPFs are now subject to stricter actuarial valuation. However, only EPFs are required to make contributions to a plan termination insurance programme — the Pension Guarantee Programme that was inaugurated in 1989. The contribution rate is supposed to be experience-rated, although the proxy for financial soundness appears to be size — the required contribution per participant declines gradually as the number of insured employees increases. After the number of plan terminations started to rise in the mid-1990s, the contribution rate was quadrupled.

The legislation governing DBCPFs applied the same protection rules to the new plans as applied to EPFs. These include the minimum funding requirement of 90 percent, and, where this target is not met, an employer must set out a timetable for reaching it. However, the law imposes no sanction if circumstances later prove that the sponsoring corporation cannot meet the schedule set down. Extension of existing guarantee provisions is under consideration but does not seem to be a high priority.

Coping with the Changing Situation of the Older People

The challenges facing the Japanese pension system are not only the consequences of the way in which the system is constructed or the generosity of the benefits it offers; they are more fundamental. To date, Japan has supported older people in two ways. First, it has managed to maintain a high rate of employment in old age. The ability to do this is being reduced. Enterprises are finding both that they can no longer retain what they consider to be costly or less productive workers in special positions and, where relevant, that their sub-contractors are no longer able to take them on — the latter are facing the same pressures as the large firms. Similarly, the decline of the agricultural sector and the retailing sector — in part a consequence of external pressure through the World Trade Organization — will reduce the number of external opportunities for people leaving jobs with their long-term employers or their sub-contractors. On top of this, Japanese enterprises are resorting to early retirement to manage workforce reduction and restructuring. As unemployment was rising in the 1990s, enterprises made increasing use both of layoffs and of early retirement (see Figure 11). If this tendency continues, the differences between Japanese and American or European employment practices might become less obvious.

\textsuperscript{22} Non-compliance appears to be motivated, in part, by a lack of confidence in the public pension system — a concern that is said to be strongest among the young. The 2001-2 Report of the Health, Labour and Welfare Ministry devoted a page to appealing for compliance in the interests of maintaining intergenerational solidarity, but also pointed out the longer-term consequences for individuals who have no contribution record. In 2003, the social security agency, which is responsible for premium collection, mounted well-publicized raids on some 10,000 self-employed people whom it had identified as persistent defaulters and sought to seize assets to make up the shortfall.

\textsuperscript{23} The NPF system acts as the recipient of assets where a participant in a DCCPF moves to an employer without its own DC plan.
Second, Japan has been able to rely upon the family to support the elderly. Even now it is common for elderly people — especially those who have become widowed — to move back in with their adult children. These provide them with both financial and physical support. However, the incidence of multi-generational families fell rapidly over the last quarter century, as Figure 12 shows.

The falling share of older people living in multi-generational families reflects increased mobility, as adult children move away from the place of their birth, and preferences of elderly people themselves, who thanks to pension benefits have been able to live independently. A gradual erosion of the level of pension benefits might slow down the trend towards independent living. However, if fewer of the younger old stay in work, the ability of adult children to maintain their elderly parents will also decline.

**Conclusion**

Is Japan a special case? Many observers and commentators like to claim it is. In practice, Japan has a pension system much like that of many other countries and faces, if in a more intense fashion, the same demographic challenges. In this respect, it is not so much a special case. On the other hand, the social system is different from those of most of the western industrialized countries. The nature of employment practices and of living conditions makes it important to consider sources of support in old age beyond simply individual pension entitlements. Yet these employment practices and living conditions are themselves not necessarily sustainable. To the extent that they are not, Japan will be required to engage in yet more fundamental reforms than those envisaged so far.
References and Further Reading


The Japan Times (Daily). [Available at http://www.japantimes.co.jp].


All of our publications are available on our website:
www.bc.edu/crr
About the Center
The Center for Retirement Research at Boston College, part of a consortium that includes parallel centers at the University of Michigan and the National Bureau of Economic Research, was established in 1998 through a 5-year grant from the Social Security Administration. The goals of the Center are to promote research on retirement issues, to transmit new findings to the policy community and the public, to help train new scholars, and to broaden access to valuable data sources. Through these initiatives, the Center hopes to forge a strong link between the academic and policy communities around an issue of critical importance to the nation's future.

Affiliated Institutions
American Enterprise Institute
Massachusetts Institute of Technology
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The Brookings Institution
Urban Institute

Contact Information
Center for Retirement Research
Boston College
Fulton Hall 550
Chestnut Hill, MA 02467-3808
Phone: (617) 552-1762
Fax: (617) 552-1750
E-mail: crr@bc.edu
Website: http://www.bc.edu/crr