Retirement Systems in Japan

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CHAPTER 1

Introduction

The Japanese system of retirement programs consists of a network of public and private income plans for older persons. These programs include a two-part social security system, the traditional payment of a lump-sum severance benefit by the company to retiring workers, and the recently established system of private pension plans. Retirement decisions are made within the framework of company personnel policies requiring retirement at designated ages. Public and private retirement policies in Japan have evolved during the past 50 years as the economy developed and the population aged. This report examines current retirement policies in Japan and contrasts them to similar policies in the United States. By understanding these Japanese programs and their implications, we will be better able to respond to problems arising in U.S. retirement policies.

OVERVIEW OF RETIREMENT PROGRAMS

Along with the United States, Japan introduced its social security program in the middle of the 20th century, much later than other developed countries did. The initial social security program in Japan was established in the 1940s and covered only certain types of employees. Over time, a series of public pension schemes were developed to cover other categories of workers. By 1960, most workers were covered by one of these government retirement programs. The largest of these social security programs were Employees' Pension Insurance, covering most employees in the private sector, and the National Pension Plan, covering self-employed workers.

As these social security programs matured and the population aged, expenditures on retirement programs rose rapidly. In 1985, the social security system was substantially modified. Prior to 1985, the National Pension Plan covered only self-employed workers and, on a voluntary basis, their spouses. The 1985 amendments restructured the National Pension Plan into a universal plan providing a flat benefit per year of credited service for all persons. The Employees' Pension Insurance program now provides an earnings-related benefit to covered employees. Thus, self-employed workers are covered only by the National Pension Plan, while employees are covered by the National Pension Plan and the Employees' Pension Insurance program.

In addition to social security, most retiring workers receive some form of retirement payment from their employers. Historically, most firms gave workers a lump-sum payment at retirement. In the 1960s, legislation was enacted that excluded employer contributions to pension plans paying retirement annuities from being taxed as current income to employees. Tax-qualified pension plans were introduced in 1962. These plans may be established by firms with as few as 15 workers. Although they offer a pension annuity, most plans have a lump-sum option, and most retirees select this option.

In 1966, legislation was enacted that permitted firms to adopt employees' pension funds. Companies that institute employees' pension funds assume the responsibility for payment of the earnings-related component of social security (the Employees' Pension Insurance benefit) and provide an added benefit equal to at least 30 percent of this "contracted out" part of social security. Over half of the employees covered by the Employees' Pension Insurance component of the social security system are participants in either a tax-qualified pension or an employees' pension fund. Since the 1960s, pensions have spread throughout the economy, especially among large firms, and pensions are beginning to replace lump-sum payment plans as the primary form of retirement benefit.

An outline of coverage by retirement plans in Japan is shown in Figure 1–1. All public workers are covered by either a statutory plan covering national public workers or a plan covering local public workers. In the private sector, all workers are covered by the National Pension Plan. For self-employed workers, this is the only form of retirement plan except for individual savings. In addition to the National Pension Plan, employees are covered by one of three statutory pension plans. Most employees are covered by the Employees' Pension Insurance program.

On top of these statutory plans, most private employees are also covered by private pensions, either tax-qualified plans or employees'

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FIGURE 1–1 Coverage by Retirement Income Plans

	Private-Sector Workers		*Public-Sector Workers*
	Employees	*Self-Employed*	
Statutory pension schemes: Mandatory coverage	National Pension plus earnings-related plan 1. Employees' Pension Insurance 2. Private school teachers and employees' M.A.A. or 3. Agricultural, forestry and fishery institutions employees' M.A.A.	National Pension	National Pension plus earnings-related plan 1. National public service M.A.A. or 2. Local public service M.A.A.
Private retirement income plan	Virtually all firms offer either 1. Lump-sum severance plan 2. Tax-qualified pension plan 3. Employees' pension fund 4. Lump-sum plan plus one of the two types of pensions		Most public workers are covered by a lump-sum severance plan

Note: M.A.A. indicates Mutual Aid Association.

pension funds, or a lump-sum severance payment plan. A married retired employee who had earned the average wage will receive a total social security benefit equal to 69 percent of his final earnings, excluding bonuses. If covered by an employees' pension fund paying the minimum required supplemental benefit, this replacement rate increases to 78 percent. Self-employed workers will have a much lower retirement benefit unless they have engaged in substantial savings during their work life.

The Japanese system of industrial relations is characterized by long-term employment for regular workers coupled with mandatory retirement at a relatively young age. Earnings tend to rise with seniority, and retirement benefits are based on final pay. Retirees are often rehired but at lower wages and with the loss of seniority rights. Despite these policies, the labor force participation rates of older Japanese are the highest in the developed world.

As the population and the labor force have aged, the Japanese labor market has adjusted to the rising cost of retirement programs and

the increased labor costs associated with an older work force. The close linkage among compensation, firm retirement policies, and pensions requires an understanding of each prior to an assessment of retirement systems in Japan. The primary objective of this study is to examine the retirement programs and policies in Japan and to determine how they are changing in response to an aging population.

The remainder of this chapter provides the framework for our analysis by examining the recent aging of the Japanese population and assessing the response of retirement programs to population aging. The next chapter examines the Japanese system of industrial relations and how it affects the labor force participation of older persons. Chapter 2 also reviews recent government employment policies for older workers. Subsequent chapters examine the social security system and the system of private retirement benefit programs. Throughout the analysis, the evolution of these programs is reviewed, and their responsiveness to population aging is highlighted. Specific attention is paid to differences between the Japanese retirement system and that prevailing in the United States.

POPULATION AGING IN JAPAN

Throughout the course of world economic development, the real incomes and living standards of nations have increased. In response to these conditions, birthrates have fallen, health conditions have improved, and life expectancy has risen. These changes have produced an aging of populations in most countries. Work rates of older workers tend to decline with economic development.[1] The typical pattern of development is for countries to experience aging populations along with declines in the work rates of older persons. These changes increase the ratio of retired older persons to active workers, thus increasing the cost of public and private retirement plans.

In the second half of the 20th century, all developed countries have faced the economic and political problems of providing for their aging populations. National retirement systems have been instituted in most countries, and the costs of these programs have risen sharply. The projected continued population aging will further increase the cost of public and private retirement programs.

The Japanese experience is similar to that of the other developed countries, except its population aging and the development of retirement programs have occurred later than in the other developed countries. However, the Japanese population is now rapidly aging. The public and private pension systems instituted after 1940 are now attempting to adjust to this changing demographic environment.

Japan is one of the most rapidly aging countries in the world.[2] Table 1–1 shows that the proportion of the population age 65 and over rose from 4.9 percent in 1950 to 9.1 percent in 1980. By 1990, the proportion of the population age 65 and over is expected to be 11.9 percent. It is projected to increase to 20.5 percent in 2010 before rising to almost 25 percent by 2020. Figure 1–2 compares the increase in the proportion of the population age 65 and over in Japan to several other developed countries. The figure indicates that in the 1950s, the elderly population in Japan was a much smaller proportion of the total population than it was in the other developed countries. The rapid aging of the Japanese population is expected to produce one of the oldest populations in the world within the next 20 years.

This aging of the population occurred in response to sharp declines in the birthrate following a postwar baby boom. Figure 1–3 indicates a relatively stable birthrate over the first third of the 20th century, followed by a gradual decline until World War II. During the war, birthrates dropped sharply. After the end of World War II, Japan experienced a postwar baby boom, as did most other countries. However, in Japan this boom lasted for only three years, from 1947 to 1949, before birthrates again began to fall. By contrast, birthrates in the United States remained relatively high until the early 1960s.

Accompanying the decline in births has been a rapid decline in death rates. Reduced mortality has substantially increased life expectancy in Japan (see Figure 1–4). At present, life expectancy at birth in Japan is among the highest for any nation.[3] In 1987, life expectancy at birth for women was 82.1 years and for men was 75.9 years. This means life expectancy has increased by 33 years for women and 29 years for men since 1935. This rapid aging of the Japanese population since 1950 is contrasted in Table 1–1 to the more gradual aging of the U.S. population. Between 1950 and 2020, the proportion of the population age 65 and over is expected to increase by fivefold in Japan but only double in the U.S.

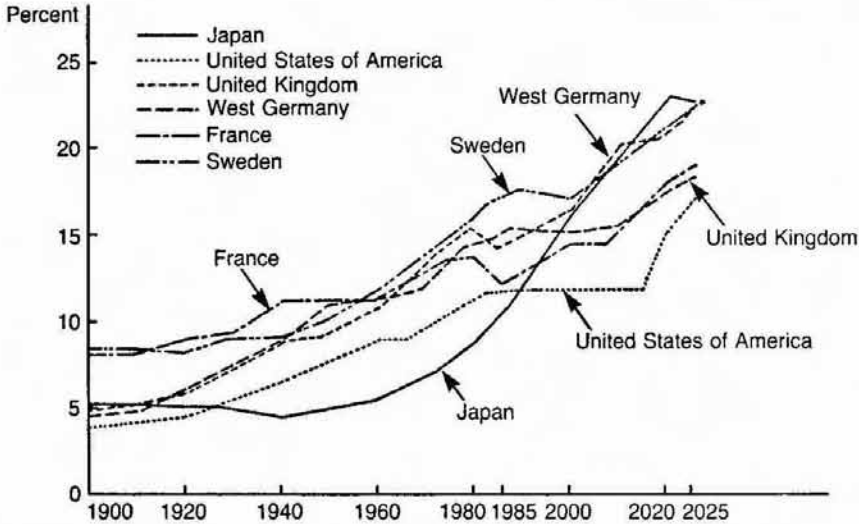
The rapid pace of population aging in Japan is illustrated by comparing the time it will take for the population age 65 and over to increase from 7 percent to 14 percent of the total population to the time required for similar demographic changes in other developed countries. In Japan, this doubling of the older population will require only 25 years and is expected to occur between 1970 and 1995. By contrast, similar population aging required 45 years in the United Kingdom and West Germany (1930–1975); in the United States, it will take 70 years to occur (1945–2015). In France, this doubling of the proportion of the population age 65 and older evolved over 115 years (1865–1980).[4]

TABLE 1–1 Population Ratios: Japan and United States

	Japan			*United States*		
Year	*Age 65 and over / Total population*	*Age 65 and over / Ages 20–64*	*Ages 20–24 / Ages 20–64*	*Age 65 and over / Total population*	*Age 65 and over / Ages 20–64*	*Ages 20–24 / Ages 20–64*
1950	4.9%	10.0%	18.8%	8.1%	14.1%	13.2%
1960	5.7	10.6	16.4	9.2	17.7	11.8
1970	7.1	11.7	17.0	9.8	18.7	16.0
1980	9.1	15.1	11.1	11.3	19.8	16.7
1990	11.9	19.4	11.8	12.6	21.4	12.7
2000	16.3	26.7	10.8	13.0	21.8	11.0
2010	20.5	35.7	9.0	13.9	22.8	11.3
2020	24.6	44.8	10.9	17.7	30.2	10.4

SOURCE: Japanese data were provided by Naohiro Ogawa, Nihon University Population Research Institute. Data for 1950 to 1980 are derived from the Japanese Census. Data for 1990 to 2020 are based on Ogawa's projections. U.S. data are from U.S. Bureau of Census, "Projections of Population of the United States by Age, Sex, and Race: 1988 to 2080," *Current Population Reports*, Series P-25, no. 1018 (Washington, D.C.: U.S. Government Printing Office, 1989). Projections are from the middle series.

FIGURE 1–2 Ratio of Persons Age 65 and Older to Total Population, Various Countries



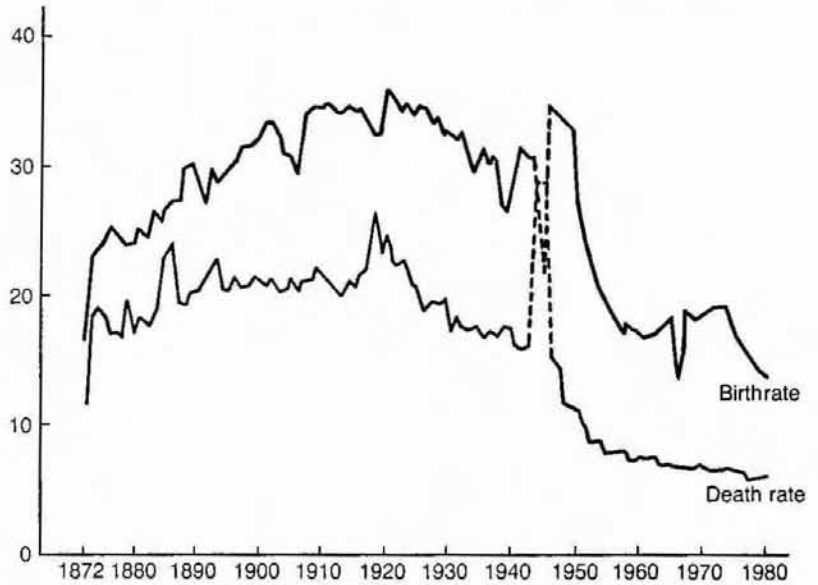
SOURCE: Social Insurance Agency, *Outline of Social Insurance in Japan*, 1988, p. 9.

Postwar fertility patterns have had a dramatic effect on the age structure of the labor force. During the early 1970s, a large number of young workers entered the labor force. Fertility declines after 1950 resulted in a sharp drop in the number of persons entering the labor force after 1975. This is reflected in the decline in the ratio of persons age 20 to 24 to persons age 20 to 64 from 17 percent in 1970 to an estimated 11.8 percent in 1990 (see Table 1–1). As a result, the average age of the labor force increased, and the number of older workers increased rapidly. The average age of employed persons rose slightly from 31 years in 1962 to 33.1 years in 1970. However, by 1988 the mean age of workers had increased to 38 years.[5]

IMPLICATIONS OF POPULATION AGING

The aging of the population and the labor force has confronted Japan with a series of economic and public policy challenges. Given the seniority-based pay system that prevails in many sectors of the Japanese economy, the aging of the labor force has direct implications for firm labor cost. The widespread use of lump-sum retirement allowances means firms face the prospect of large cash payments associ-

FIGURE 1–3 Birth and Death Rates in Japan

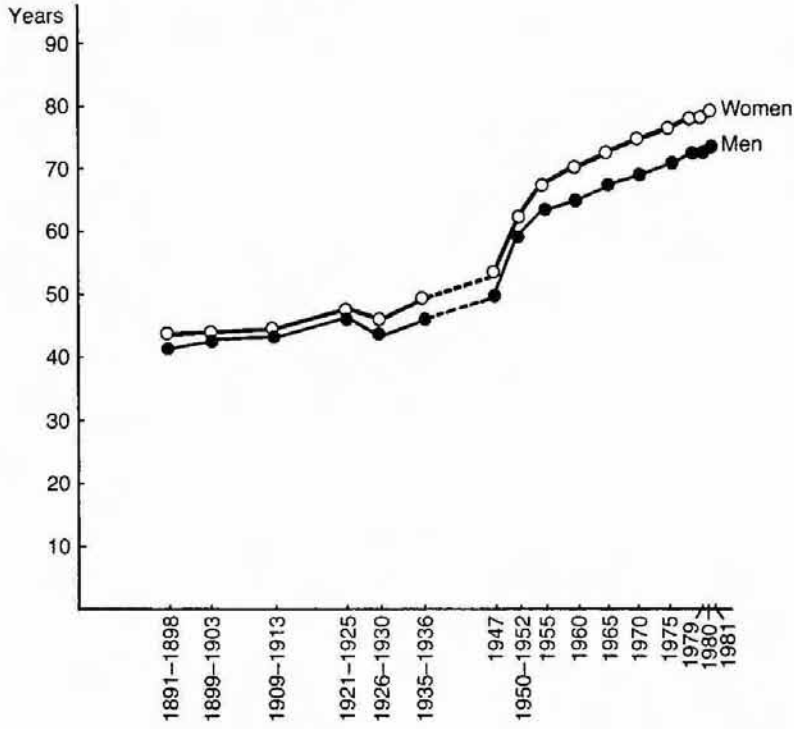


SOURCE: Policy Office for the Aged, Prime Minister's Secretariat, *Aging in Japan* (Tokyo: Japanese Government, 1983), p. 2.

ated with the increasing number of retirees. Firms have responded by attempting to reduce the generosity of these retirement plans and by shifting to a greater reliance on pensions, which offer annuitized benefits and, therefore, spread the expenditures for retirement benefits over a number of years. Pension benefit formulas have been lowered in an effort to reduce labor costs.

The changing demography also has implications for retirement age policies and the financing of the social security system. Indicative of the increasing cost of financing the social security program is the increasing number of persons age 65 and over relative to persons of working ages 20 to 64. This ratio has risen from 10 percent in 1950 to a projected 44.8 percent in 2020. As illustrated in Table 1–1, the aging of the Japanese population has been very rapid. While the United States and other developed countries had many years to respond to the aging of their populations, Japan must adapt to an aging population in a matter of only a few decades. The pace of aging may intensify the economic reactions to population aging.[6]

FIGURE 1–4 Trend in Life Expectancy at Birth in Japan



SOURCE: Policy Office for the Aged, Prime Minister's Secretariat, *Aging in Japan* (Tokyo: Japanese Government, 1983), p. 2.

The impact of population aging on public pension systems is reflected in the increased costs of real and relative pension expenditures throughout the developed world. However, the expected increase in Japan is much greater than it is in the other developed countries. Table 1–2 shows that the real pension expenditures in Japan are expected to increase from an index of 100 in 1980 to 1,314 in 2025. Increases in the United Kingdom, the United States, and France are expected to reach only 290 to 325. As a percentage of gross domestic product (GDP), pension expenditures are expected to more than triple in Japan while rising by less than 75 percent in these other developed countries. The primary factor driving these increases in expenditures is the aging of the population, which leads to a projected annual increase in pension expenditures of 5.9 percent in Japan.[7]

TABLE 1–2 Projection of Pension Expenditures: Developed Countries

Country	*1980*	*2000*	*2010*	*2025*
		Index of Real Pension Expenditures		
Canada	100	154	189	317
France	100	175	230	325
West Germany	100	180	218	300
Italy	100	198	285	498
Japan	100	430	787	1,314
United Kingdom	100	159	199	290
United States	100	145	178	306
		Index of Ratio of Pension Expenditure to GDP		
Canada	100	89	89	123
France	100	110	115	130
West Germany	100	129	140	154
Italy	100	121	138	171
Japan	100	229	307	319
United Kingdom	100	115	124	144
United States	100	92	90	110

SOURCE: Peter Heller, Richard Hemming, and Peter Kohnert, *Aging and Social Expenditures in the Major Industrial Countries, 1980–2025* (Washington, D.C.: International Monetary Fund, 1986), p. 31.

FRAMEWORK FOR ANALYSIS

The Japanese retirement system differs substantially from that developed in the United States. Although it was developed more recently, this retirement system is now being subjected to the stress of an aging population that will confront the United States only after 2010. This analysis will provide a detailed discussion of the public and private retirement programs in Japan and examine how they are responding to the aging of the population.

Throughout this analysis, differences between the Japanese system and that of the United States are highlighted. Each system is closely linked to prevailing industrial relations practices and government policies concerning the employment of older workers. This study indicates that two different retirement systems have arisen in these highly developed economies. Both countries have faced the rising costs of providing retirement income, and both have responded by modifying their social security systems. In direct contrast to the European countries, both the United States and Japan have raised pensionable ages and are attempting to maintain high rates of labor force participation by older persons. Successful programs in one country may provide guidance for policy reforms in the other. Thus, it is important for policymakers and researchers in the United States to be familiar with the Japanese experience.

ENDNOTES

1. See John Durand, *The Labor Force in Economic Development* (Princeton, N.J.: Princeton University Press, 1975); and Robert Clark and Richard Anker, "Labour Force Participation of Older Persons: An International Comparison," International Labour Office, World Employment Programme Research, Working Paper No. 171, December 1989.
2. For a detailed review of Japanese population aging and its causes, see Linda Martin, "The Graying of Japan," *Population Bulletin* 44, no. 2 (July 1989).
3. Prime Minister's Secretariat, *Aging in Japan* (Tokyo: Japanese Government, 1983). For an analysis of the causes of mortality declines in Japan, see Machiko Yanagishita and Jack Guralnik, "Changing Mortality Patterns that Led Life Expectancy in Japan to Surpass Sweden's: 1972–1982," *Demography*, November 1988, pp. 611–24.
4. Ishi Hiromitsu, "Why Tax Reform Now?" *Japan Echo*, Summer 1988. p. 37.
5. Unpublished data compiled by Professor Naohiro Ogawa, College of Economics, Nihon University, Tokyo. Data are from the Basic Survey of Wage Structure, various years.
6. The aging of the population is viewed as an important factor determining future government fiscal policy. In reviewing the current debate over tax reform, Professor Hiromitsu, "Why Tax Reform Now?" p. 38, concludes that "preparing for the graying of Japanese society is the most important goal of tax reform." For a general discussion of the economic effects of population aging, see Robert Clark and Joseph Spengler, *The Economics of Individual and Population Aging* (New York: Cambridge University Press, 1980).
7. Peter Heller, Richard Hemming, and Peter Kohnert, *Aging and Social Expenditures in the Major Industrial Countries, 1980–2025* (Washington, D.C.; International Monetary Fund, 1986), pp. 30–33.