Retirement Systems in Japan

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CHAPTER 4

Tax Policy, Private Retirement Plans, and Lump-Sum Payments

Prior to the 1940s, the retirement income system in Japan consisted primarily of lump-sum retirement allowances. These retirement plans were payments by employers to employees leaving the firm for any of a variety of reasons, provided the worker had met certain minimum standards. They are more appropriately defined as severance pay plans. The first old-age pension programs were introduced in 1875; however, coverage was limited to military personnel. For the most part, the private pension system in Japan has developed in the last 25 years.

This chapter explores the coverage of Japanese workers by some type of private retirement program and examines the lump-sum severance plans in detail. The challenge of adjusting these programs to an aging population is shown to be one of the factors stimulating the shift to annuity pensions. Tax policy directly affects the choice of a retirement program by altering the cost of savings for retirement. Therefore, the first section of this chapter examines the Japanese system of taxation. The analysis concentrates on the effect of personal and corporate income tax on pension plans and other forms of savings for retirement.

TAX POLICY AND RETIREMENT INCOME

Individual retirement savings plans, along with company-sponsored and statutory pension programs, are structured within the framework of national tax policies. In many countries, governments have encouraged the establishment of formal retirement plans through the use of preferential tax treatment for pension plans. This section briefly describes Japanese tax policy and how it relates to the development of pensions and other retirement savings plans.

Japan and the United States have the lowest overall tax burden as a percent of gross domestic product (GDP) among the major OECD (Organization for Economic Cooperation and Development) countries. In 1985, tax revenues were 28 percent of GDP in Japan, compared to 29 percent in the United States.[1] The lower tax burdens in the United States and Japan were primarily due to lower social security costs stemming from their relatively young populations compared to the other developed countries. As examined earlier, population aging in Japan and the United States will increase these costs over the next three decades.

In Japan, taxes are levied by the national government, prefecture or state governments, and municipal governments. At the national level, most revenues are raised through personal and corporate income taxes. In fiscal 1988, 37.6 percent of tax revenues are estimated to be derived from the personal income tax and 30 percent from the corporate income tax.[2] Most of the other revenues are derived from a series of sales and excise taxes. The prefecture and local governments depend mostly on income and property taxes along with sales and excise taxes. The following analysis focuses on personal and corporate income taxes because these taxes most directly influence retirement savings plans.[3]

Personal Income Taxation

For taxation purposes, personal income is divided into 10 categories: interest income; dividends; real estate income; business income; employment income; retirement income; timber income; capital gains; occasional income, which includes gifts and prizes; and miscellaneous income, which includes royalties and fees for lectures. Retirement income includes only lump-sum severance payments and lump-sum payments from pension plans. Annuity income from a pension is included under miscellaneous income.[4]

Individual taxpayers determine their tax liability by first calculating their adjusted gross income. This is done within each income category. The first step is to subtract from gross receipts the allowable expenses of earning the income. Some of the income categories have special deductions for various types of income.

For most persons, earnings from employment will be their primary source of income. Employment income includes salaries, wages, allowances, and bonuses. Expenses cannot be deducted in an itemized manner; however, a special deduction is allowed for employment income. This deduction equals 40 percent of the first 1.65 million yen in earnings plus 30 percent of earnings between 1.65 and 3.3 million yen plus 20 percent of earnings between 3.3 and 6 million yen plus 10 percent of earnings between 6 and 10 million yen plus 5 percent of earnings over 10 million yen. There is a minimum employment income deduction of 570,000 yen.

In addition to these deductions, specific exemptions are allowed for loss on assets, medical expenses, losses from fire, and some donations. Of particular interest to this study is the deductibility of social insurance premiums paid by the taxpayer for himself, his spouse, or other relatives living with him. Since 1962, firm contributions to tax-qualified pension plans have not been counted as current income to employees and, since 1966, firm contributions to employees' pension funds have not been counted as current income to the taxpayer.

Also, premiums on life insurance policies or contributions to tax-qualified pensions are deductible in accordance with the following formula: for premiums less than 25,000 yen, the entire premium is deductible; for premiums between 25,000 and 50,000 yen, the deduction equals one half of the premium plus 12,500; for premiums between 50,000 and 100,000 yen, the deduction is one fourth of the premium plus 25,000; and for premiums in excess of 100,000 yen, the deduction is 50,000. All employee contributions to employees' pension funds are tax deductible.

Capital gains and savings receive special tax treatment in Japan. A variety of deductions and exemptions result in low effective tax rates on capital gains earned by individual taxpayers. Until 1987, individuals were permitted to establish savings plans in which the earnings were tax exempt. Four types of savings plans were available to taxpayers. First, interest accruing from postal savings plans when the principal did not exceed 3 million yen were tax exempt. Second, interest or distributions of profits from deposits, bonds, open-end bond investment trusts, or specific stock investment trusts if the principal did not exceed 3 million yen were tax exempt. These accounts were referred to as the Small Saving Tax Exemption. Third, interest on central government and local government bonds not exceeding 3 million yen in total face value was tax exempt. Fourth, the System for Savings for the Formation of Employees' Assets allows for tax-exempt interest income or distribution of profits received from accounts set up by employers for workers to accumulate assets particularly for housing and pensions. Employees must establish savings contracts and have contributions withheld from their earnings. The earnings from these funds are only tax exempt when the principal does not exceed 5 million yen.

If an individual made maximum use of these four savings plans, he could have held up to 14 million yen in nontaxable forms. These maximums apply to individuals, so a family of four could have four times this amount in nontaxable investments.[5] Nagono estimated that over 70 percent of all personal savings in Japan were in one of these tax-exempt savings plans.[6] For most taxpayers, this tax-exempt savings system was abolished in 1987 and replaced with a flat tax of 20 percent of all interest income. All of the tax-exempt savings plans are still available to persons age 65 and older, fatherless families, and physically handicapped persons. The System for Savings for the Formation of Employees' Assets remains as a form of tax-exempt savings for employees.

Lump-sum retirement allowances are an important, one-time source of income to newly retired persons. Prior to 1989, retirees with 20 years or less of service with their employer could deduct from retirement income 250,000 yen per year of service. The minimum deduction from retirement income was 500,000 yen. If the length of service was more than 20 years, the deduction was 5 million yen plus 500,000 per year of service in excess of 20 years. Thus, a person with 30 years of service could receive a lump-sum severance payment of up to 10 million yen without incurring any tax liability.

These exemptions from retirement income have recently been raised. Currently, the exemption is 400,000 yen per year of service for the first 20 years plus 700,000 per year of service for job tenure in excess of 20 years. Thus, a retiree with 30 years of service could receive a lump-sum payment of 15 million yen tax free. In early 1989, this represented $116,000 at an exchange rate of 129.6 yen per dollar. For payments exceeding these values, 50 percent of the lump-sum payment in excess of the exempt amount is tax free, while the balance of the retirement benefit is taxed at regular income tax rates. Any benefits attributable to past employee contributions are not taxed.

Pension annuities from both social security and company pension plans are part of miscellaneous income and also subject to a special income tax deduction. In 1988, the deduction was composed of a flat amount plus a deduction that varies with the size of the annuity. To calculate the total deduction, first subtract 800,000 yen as a flat deduction. If the amount of the pension annuities after the flat deduction has been subtracted does not exceed 3.6 million yen, there is an additional, fixed-rate deduction equal to 25 percent of that amount. If the amount of the annuities after the fixed deduction exceeds 3.6 million yen but not 7.2 million yen, the fixed-rate deduction is 360,000 yen plus 15 percent of that amount. Finally, if the amount of the annuities after the flat deduction exceeds 7.2 million yen, the fixed-rate deduction is 1.08 million yen plus 5 percent of that amount. The minimum total deduction is 1.2 million yen for a taxpayer age 65 and older or 600,000 for a taxpayer under age 65. Benefits from tax-qualified pension plans attributable to employee contributions are not included in taxable income; however, all benefits from employees' pension funds are part of taxable income.

After these and similar adjustments have been made to each source of income, all of the types of income except retirement and timber incomes are added together. At this point, personal exemptions and deductions for specified expenditures are made. A taxpayer may subtract 330,000 yen as a basic deduction from his income for himself, his spouse, and dependents. In addition, a special exemption of 500,000 yen is allowed for persons age 65 and older; however, if annual income of an aged person exceeds 10 million yen, he is not entitled to this exemption.

After determining taxable income, the tax liability is calculated by using a progressive tax schedule. Marginal tax rates in 1988 ranged from 10.5 percent for income of less than 1.5 million yen to 60 percent on income in excess of 50 million yen. Prefectural and local income tax rates are then added to these rates. The maximum prefectural rate is 4 percent, and the maximum municipal rate is 14 percent. By statute, the total maximum income tax rate that anyone can be required to pay for these combined income taxes is 78 percent.

Tax legislation enacted in 1987 reduced marginal rates for most income levels and lowered the maximum marginal national income tax rate from 70 to 60 percent. Proposals by the Ministry of Finance made in 1988 would further reduce the marginal tax rates. These proposals would reduce the number of tax brackets from 12 to 5 and lower the tax rates to between 10 and 50 percent.[7]

While these marginal rates may seem high, relatively few people actually pay such high tax rates because of the many exemptions and deductions used in determining taxable income. Shoven examined the income tax threshold for a family of four composed of an employee, his spouse, and two children, one of whom is between 16 and 22 years old. The taxpayer receives a basic exemption (330,000 yen), an exemption for the spouse and each child (330,000 each), and deductions for employment income and social insurance premiums. Together, these deductions mean the individual could earn up to 2.6 million yen without incurring a tax liability. At the time of Shoven's analysis, average annual earnings in Japan were approximately 4 million yen. In 1987, this represented twice the tax threshold prevailing in the United States.[8]

Examining tax information for 1970, Pechman and Kaizuka found that 32 percent of the total income was not reported on tax returns in Japan or was reported by persons who were not taxable; the corresponding figure for the United States was 10 percent. As a result of the exemptions and deductions, the tax base in Japan amounted to only 33 percent of total income, compared to 59 percent in the United States.[9]

The tax liability for most types of income is determined by a taxpayer declaration. Taxes are then withheld from the payment of income. Due to this sophisticated withholding system, many individuals do not even have to file a tax return. There is no formal indexing for inflation, but tax cuts are typically made to compensate for the effects of inflation.

Corporate Income Taxes

The corporate tax on the income for firms is computed by multiplying taxable income of the corporation by the appropriate marginal tax rates. The corporate income tax in Japan is similar to that of the United States. The tax base is gross income minus gross expenses. Gross income includes revenue from sales of commodities and manufactured products, sales of fixed assets, interest, and other income. The tax rate is essentially flat except for differential treatment for very small firms. The primary difference between the Japanese and the U.S. corporate income tax is the Japanese treatment of dividends distributed to shareholders.

For companies with capital of more than 100 million yen, the tax rate on retained profits is 42 percent, and the tax rate of profits distributed as dividends is 32 percent. For companies with capital of 100 million yen or less, the tax on income of less than 8 million yen is 30 percent for retained profits and 24 percent for profits distributed as dividends. For income in excess of 8 million yen, the tax rates rise to 42 and 30 percent, respectively.

Prefectural governments also employ an enterprise, or corporate, income tax. The standard tax rates for corporations on ordinary taxable income are 6 percent if annual income is not more than 3.5 million yen, 9 percent if annual income is between 3.5 and 7 million yen, and 12 percent if annual income is in excess of 7 million yen. The reduced rates of 6 and 9 percent are not applicable to corporations with offices in more than three prefectures and capital of 10 million or more yen. The Ministry of Finance estimated that the overall marginal corporate income tax rate on equity income, including national and local taxes, was 51.6 percent in 1988.[10]

Since 1962, companies have been able to make tax-deductible contributions into tax-qualified pension plans, which are not counted as current income to their workers. Before the 1962 amendments to the Corporation Tax and Income Tax Laws, any pension contributions by a company to a trust bank or life insurance company were treated as an expense of the corporation but were subject to income tax as employee compensation at the time of the transfer. A similar tax status was awarded to employees' pension funds in 1966. A trust must be established for these pension funds.

The rules and regulations for both types of pension plans are examined in Chapter 5. Trust revenues and expenses are not counted as revenues or expenses of the pension plan sponsor. In addition, the revenues and expenses of the pension funds are not counted as revenues and expenses of the trust companies managing the pension plan. The taxable income of the trust company consists only of the amount received as trust fees. A tax of 1.173 percent per year is levied on the tax-qualified pension funds held by trust banks or life insurance companies; 1 percent is a national tax, and 0.173 percent is a local tax. This tax is considered interest on income tax not paid during the period of tax deferral. The accumulated sum of assets held by a company for its employees as part of an Employees' Assets Formation Plan also is subject to this 1 percent national tax. Assets in employees' pension funds are also subject to these taxes; however, there is a substantial deduction for these pension funds. This deduction is sufficiently large that relatively few employees' pension funds pay any tax.

Firms are not allowed to establish a tax-exempt reserve fund for their lump-sum severance pay systems. No special tax advantage is given to firms if they make contributions into a trusteed fund. Instead, a partial tax deduction is given when liabilities in these plans are accrued and noted in the form of a book reserve.

Tax Policy and the Growth of Pension Plans

This description of the Japanese tax structure indicates that there are considerable tax incentives for private savings in the tax code. Most individuals could have earned a tax-exempt return on most of their savings prior to 1987. These incentives represent a partial explanation for the high savings rate in Japan.

Since 1962, companies have been able to establish trusteed pension plans on behalf of their workers with contributions that are tax

TABLE 4–1 Coverage by Retirement Benefit Plans

Size of Firm (number of employees)	*Percent of Firms with Retirement System*	*Percent of Firms with Retirement System Offering*		
		Lump Sum Only	*Annuity Only*	*Both*
Total				
1975	90.7%	67.1%	13.2%	19.7%
1981	92.1	55.4	18.5	26.2
1985	89.0	51.9	14.3	33.8
1,000 or more				
1975	97.8	40.2	4.3	56.5
1981	99.6	24.6	11.5	63.9
1985	99.9	18.1	10.1	71.8
300–999				
1975	97.4	50.3	9.1	40.6
1981	99.4	36.2	20.6	43.2
1985	98.5	32.0	16.8	51.1
100–299				
1975	96.6	63.0	11.3	25.3
1981	95.9	49.2	22.2	28.6
1985	94.9	40.4	17.0	42.5
30–99				
1975	87.7	71.3	14.6	14.1
1981	90.0	60.3	17.3	22.4
1985	86.1	58.8	13.3	27.8

SOURCE: Ministry of Labor, *Taishoku-Kin Seido Sogo Chosa Hokoku*, as reported in Kiyoshi Murakami, "Retirement Benefits and Pension Plans in Japan," Sophia University Business Series Bulletin no. 118, 1988, p. 13.

deductible to the firm and not counted as current income to their workers. The same tax treatment is not given to the traditional lump-sum severance plans. This differential tax treatment is one of the major factors driving the current movement toward greater reliance on pension plans. For the most part, the current tax treatment of pension plans in Japan is similar to that in the United States. The primary exception is that in Japan the assets in pension funds are taxed.

COVERAGE BY RETIREMENT PLANS

In Japan, private retirement plans are either lump-sum severance payment plans or pension plans that provide annuity benefits. The pension plans often include options for lump-sum distributions instead of an annuity. One or both of these types of retirement plans are offered by 90 percent of all firms in Japan. Table 4–1 shows that virtually all employers with 300 or more workers provide some type of retirement plan for their regular workers. Smaller firms are less likely to offer retirement benefits; however, even among firms with between 30 and 99 workers, over 85 percent have at least one of these plans. These total coverage rates by some type of retirement plan are much higher than the pension coverage rate in the United States, which is estimated to be just over 50 percent.[11]

The coverage rates based on percent of firms with retirement plans in Japan probably overestimate the percentage of all workers covered by a retirement plan. This follows from the exclusion of part-time workers from participation in many company benefits, including pensions and lump-sum plans. In addition, the Japanese estimates are based on a survey limited to firms with at least 30 workers. This omission of very small firms, which are less likely to offer retirement plans, will tend to overestimate the proportion of workers actually covered by a retirement plan.

During the past decade, there does not appear to have been any trend in coverage by some type of retirement plan. However, an increasing proportion of firms now offer an annuity pension, and there has been a decline in the proportion of firms offering only a lump-sum plan. The average expenditure on retirement benefits by large firms in 1982 represented 4.9 percent of total labor costs.[12]

The traditional method of providing retirement income has been to grant lump-sum payments to retiring workers. Table 4–1 shows that the proportion of firms with some type of retirement plan offering only lump-sum severance payments has fallen from 67 percent in 1975 to 52 percent in 1985. This decline in firms with only lump-sum plans is especially prevalent among larger employers. Paralleling this trend is the increase in the proportion of firms with a pension annuity system. The percentage of firms with pension plans rose from 33 percent in 1975 to 48.1 percent in 1985. Among firms with 1,000 or more employees, 82 percent now have pension plans. Pensions are either tax-qualified pension plans, employees' pension funds, or non-qualified pension plans. The growth and development of pension plans is examined in the next chapter.

LUMP–SUM SEVERANCE PAY

Most Japanese companies provide severance pay in the form of a lump-sum benefit to workers leaving the firm. These payments are awarded to departing workers whether termination is employee or employer initiated. Benefits may be denied if the worker is fired for misconduct. The severance pay system was introduced in the 19th century and covered civil servants and employees in large firms. In 1935, 53 percent of all manufacturing firms with 100 or more employ-

TABLE 4–2 Average Voluntary Lump-Sum Benefits as Percent of Involuntary Benefits

Years of Service	*Large Firms*		*Small Firms*	
	1975	*1985*	*1974*	*1986*
1			52%	72%
3	50%		62	70
5	56	50%	66	72
10	67	60	74	78
15	75	69	79	81
20	84	78	83	84
25	89	82	86	87
30	91	87	88	87

SOURCE: Large-firm data is based on Central Labor Relations Commission, *Taishoku-Kin Teinen-Sei oyobi Nenkin Jijo Chosa*. Small-firm data is based on Tokyo Municipal Government, Labor Department, *Taishoku-Kin Jijo*. Data are reported in Kiyoshi Murakami, "Retirement Benefits and Pension Plans in Japan," Sophia University Business Series no. 118, 1988, p. 6.

ees offered a lump-sum severance plan. The government made these severance pay plans mandatory in 1936 as a substitute for introducing an unemployment insurance system. Mandatory lump-sum plans were abolished in the 1940s when the Employees' Pension Insurance system was introduced.[13] After World War II, lump-sum disbursements at the end of work life became an important retirement benefit for many workers.[14]

Qualifying for Benefits

While payments are made for both voluntary (worker-initiated) and involuntary (firm-initiated) retirement, the amount of the retirement allowance is lower for voluntary departures. The objective of penalties for early departure is to limit worker turnover. Table 4–2 shows that among large firms, the average ratio of voluntary retirement benefits to involuntary retirement benefits is only 50 percent if retirement (or quitting) occurs after only five years of service. This ratio rises to 87 percent for retirement after 30 years of service. The penalties for early departure from a large firm increased between 1975 and 1985. Smaller firms have less severe penalties on voluntary earlier departure, and these penalties have declined slightly.

A worker becomes eligible for a severance benefit from involuntary retirement within the first two years of service. Somewhat longer service is needed to qualify for a benefit if the departure is worker initiated. Smaller firms require a longer period of service to qualify for severance pay than do larger firms.[15] For example, Table 4–3 shows that 87 percent of large firms provide a lump-sum payment to

TABLE 4–3 Minimum Service Requirements for Eligibility for Lump-Sum Severance Payment (percent of companies)

Years of Required Service	Large Companies (1985)		Small Companies (1986)	
	Voluntary	Involuntary	Voluntary	Involuntary
0–1	3.1%	48.7%	1.6%	17.3%
1–2	29.3	38.1	20.1	30.1
2–3	18.1	4.7	17.2	11.7
3 or more	49.5	8.5	50.6	23.8
Not available			10.6	17.1

SOURCE: Large-firm data is based on Central Labor Relations Commission, *Taishoku-Kin Teinen-Sei oyobi Nenkin Jijo Chosa.* Small-firm data is based on Tokyo Municipal Government, Labor Department, *Taishoku-Kin Jijo.* Data are reported in Kiyoshi Murakami, "Retirement Benefits and Pension Plans in Japan," Sophia University Business Series no. 118, 1988, p. 7.

workers who leave involuntarily after only two years of employment, while half of these firms require three or more years of service to qualify for a worker-initiated termination. Even among small firms, almost half provide benefits to workers who were involuntarily terminated after as little as two years of service.

These very short employment requirements to qualify for a lump-sum benefit differ substantially from the rather long vesting periods required for pension plans in Japan (see Chapter 5). Similar long vesting periods prevailed in the United States prior to the passage of the Employee Retirement Income Security Act (ERISA) in 1974. This legislation required U.S. firms to adopt one of several vesting standards, with most plans adopting a 10-year vesting rule. Recent legislation in the United States has lowered vesting to five years of service.

Calculation of Benefits

Lump-sum payments are calculated without regard to the departing employee's age, although reaching the age of mandatory retirement may be a factor in involuntary job termination. In general, the benefit formula is a function of the final month's basic salary and the number of years of service.[16] The formula usually increases with years of service, and benefits average about one month's final salary for each year of service. Within a company, the benefit formula is typically the same for all types of workers. Lump-sum retirement payments are a larger proportion of final salary among large employers.

In 1988, average lump-sum payments to male college graduates leaving at age 60 were equal to 3.5 years of annual salary. For a male high school graduate, lump-sum payments averaged 3.7 years of annual earnings.[17] The greater relative benefits paid to those with lower ed-

TABLE 4–4 Lump-Sum Retirement Allowance for Involuntary Termination, Large Firms

	College Graduate		*High School Graduate*	
Years of Service	*Benefit (millions of yen)*	*Months of Final Pay*	*Benefit (millions of yen)*	*Months of Final Pay*
5	0.6	3.1	0.5	3.3
10	2.0	7.2	1.5	7.1
15	4.3	12.4	3.2	12.4
20	8.2	19.1	5.9	19.4
25	13.7	27.2	9.7	27.1
30	20.2	35.4	14.4	35.0

SOURCE: Nippon Dantai Life Insurance Company, "Recent Studies on Severance and Retirement Benefit Plans," August 1988, pp. 6–7. The data is based on a survey by the Central Labor Relations Board in 1987 that covered firms with at least 1,000 employees.

ucational attainment is due to their greater job tenure at retirement.[18] Those with higher education will receive larger absolute benefits due to their higher average earnings.

The value of the retirement allowance paid by large firms is shown in Table 4–4. Although the table indicates benefits separately by educational attainment, there will be no differential treatment within any particular plan. The data indicate that the average college graduate who remains with a firm for 30 years would receive a lump-sum payment of 20.2 million yen ($140,000 at an exchange rate in 1987 of 144.6 yen per dollar), or approximately 3 years' salary. The payment for a high school graduate is about 30 percent lower. Higher benefits are achieved with longer service.

Reserve Funding

Firms establishing a reserve fund to pay lump-sum benefits can do so within the firm or with a public or financial institution outside the firm.

Typically, most employees establish a reserve fund that is, in effect, a book reserve. Rather than making contributions into an investment account from which future benefits are paid, most firms retain these funds in the company and create a liability on their books. As of March 31, 1989, tax-exempt book reserves totaled 10.9 trillion yen. The total amount of book reserves is considerably greater as only 40 percent of total reserves are tax deductible.[19]

These funds have been an important source of capital to many firms. In principle, the retirement allowance funds are used for investment in the company—making the employees partial owners of the company or, alternatively, creditors of the company by holding this implied debt.[20] In general, future payment of the lump sum is conditional on the continued survival of the firm. In most cases, workers whose employer goes bankrupt will not collect on the promised lump-sum benefit; however, a portion of the severance payment may be paid as part of Japan's system of workman's compensation insurance. This program insures workers against the nonpayment of compensation by firms in bankruptcy.

If an employer creates a book reserve account for these plans to provide for future benefits, the company receives a tax deduction equal to the least of:

1. 40 percent of the amount that would be payable at the end of the year if all employees voluntarily terminated, less the deduction allowed up to the end of the previous year.
2. The full amount payable at the end of the year if all employees voluntarily terminated, less the amount payable at the beginning of the year if all employees had voluntarily terminated.
3. 6 percent of total payroll.

However, no additional tax deduction is permitted if the company creates a fund for these retirement systems and invests those funds in assets outside the company. As a result of this tax treatment, most lump-sum plans are based solely on book reserves.

Lump-sum retirement payments are very popular in Japan. These benefits are used by retirees for a variety of purposes. A 1980 survey by the Ministry of Labor indicated that of persons retiring between 1972 and 1978 who received a lump-sum payment, 49 percent indicated some of these funds would be used for paying off housing loans or buying real estate. Thirty percent of retirees responded that the money would be used for the marriage of their children, and 11 percent stated that the funds would go to the education of their children. Sixty-one percent of the retirees indicated they would save some of the money for their remaining retirement years.[21]

Small Enterprise Retirement Allowance Mutual Aid Plan

Small firms sometimes entrust their severance pay plan to the Special Retirement Allowance Mutual Aid Scheme, which is administered by the local municipality, or to the Smaller Enterprise Retirement Allowance Mutual Aid Plan, which is managed by the government. The latter program was established in 1959 to encourage small firms to adopt retirement allowance plans. The government provides financial assistance to cover administrative costs and some funds to subsidize the retirement allowance.[22] The plan pays lump-sum retirement allowances to workers when they retire.

Firms with less than 300 regular employees may participate in this program. Employers make regular contributions of up to 20,000 yen per month.[23] There are no employee contributions. Contributions may be the same for all employees or vary with salary and length of service. One third of these contributions are subsidized by the government for two years for new participants. Employer contributions are tax deductible.

A lump-sum benefit is payable upon the termination of employment. The amount of the lump sum is determined by employer contributions and length of participation. On March 31, 1989, there were 343,257 employers participating in the Small Enterprise Retirement Allowance Plan covering 2.3 million employees. In fiscal 1987, average monthly contributions per employee were 5,368 yen and average payments were 523,305 yen. In March 1988, total assets in these plans were 1.3 trillion yen.

The benefits of workers who change jobs among employers participating in the Small Enterprise Retirement Allowance Plan are portable. Benefit credits accumulated with the new employer are simply added to those from the old employer. In practice, relatively few persons take advantage of this portability, choosing instead to accept a lump-sum distribution at the termination of employment. Only 2.8 percent of the 243,833 terminated employees in fiscal 1987 elected to retain their credits in the plan with the rest accepting lump-sum payments.[24]

CHANGING NATURE OF LUMP–SUM PLANS

The expenditures on severance pay plans have risen rapidly over the past 20 years due to wage increases and the increased number of workers at retirement age. Since these plans typically are not funded, firms faced the prospects of large annual payouts to support this system of retirement income. During this period, firms began to shift from lump-sum severance pay systems to pension plans (see Chapter 5). An important factor stimulating this trend was the establishment of favorable tax treatment accorded pensions beginning in 1962. More than 80 percent of firms with 1,000 or more employees have transformed their traditional retirement plans, partially or fully, into funded pensions. Since most retirees select lump-sum options offered by the pension plan, these changes may be more apparent than real.

A related development has been the tendency to slow down the rate of growth of basic salary for older workers. The Ministry of Labor has encouraged firms to limit the rising cost of retirement benefits by stopping automatic increases of basic salary after age 45 or 50. Firms have also attempted to slow down the rising cost of lump-sum payments by not counting years of service after age 55 in the calculation of the lump-sum payment.

Some firms have attempted to reduce the cost of an aging labor force by encouraging early retirement. In 1986, just over 4 percent of all firms with 30 or more employees offered early retirement with favorable treatment. Early retirement plans are much more prevalent among large firms, as over 50 percent of companies with 5,000 or more workers and 40 percent of companies with 1,000 to 4,999 employees offered early retirement incentives. By comparison, only 17 percent of firms with 300 to 999 employees have early retirement plans, and less than 6 percent of smaller firms offer these incentives.[25] These early retirement plans have been established even as the government has strongly encouraged firms to hire more older workers.

A final response to the rising cost of lump-sum retirement allowances has been to reduce the benefit formulas used to determine the lump-sum payment. Shamada summarizes this development by concluding that "in years when the number of workers who are old enough to receive retirement allowances was small, employers paid them relatively lavishly partly to encourage long-term commitments of workers, but in the years in which the number of eligible workers is large and increasing, employers begin to cut down the payment."[26] Formulas for lump-sum severance plans can be reduced by the firm. Thus, the security of these benefits to workers is limited by the lack of funding and by the potential downgrading of these benefits prior to retirement.

ENDNOTES

1. John Shoven, "The Japanese Tax Reform and the Effective Rate of Tax on Japanese Corporate Investments," National Bureau of Economic Research Working Paper no. 2791, December 1988, p. 3.
2. Ministry of Finance, *An Outline of Japanese Taxes, 1988* (Tokyo: Japanese Government, 1988), p. 17.
3. This discussion is based on information from Ministry of Finance, *Outline of Japanese Taxes, 1988.*

4. For a detailed description of the items included in each of these types of income, see H. Homma, T. Maeda, and K. Hashimoto, "Japan," in *Comparative Tax Systems*, ed. Joseph Pechman (Arlington, Va.: Tax Analysts, 1987). This paper also examines the process of determining tax liability in Japan.
5. Shoven, "Japanese Tax Reform," pp. 8–10.
6. Atushi Nagono, "Japan," in *World Tax Reform: A Progress Report*, ed. Joseph Pechman (Washington, D.C.: The Brookings Institution, 1988), pp. 155–61.
7. Shoven, "Japanese Tax Reform."
8. Ibid., pp. 6–7.
9. Joseph Pechman and Keimei Kaizuka, "Taxation," in *Asia's New Giant: How the Japanese Economy Works*, ed. Hugh Patrick and Henry Rosovsky (Washington, D.C.: The Brookings Institution, 1976).
10. Shoven, "Japanese Tax Reform," p. 12.
11. Emily Andrews, *The Changing Profile of Pensions in America* (Washington, D.C.: Employee Benefit Research Institute, 1985).
12. Yoshitaka Fujita, *Employee Benefits and Industrial Relations* (Tokyo: Japan Institute of Labor), p. 30.
13. Kiyoshi Murakami, "Severance and Retirement Benefits in Japan," in *Pension Policy: An International Perspective*, ed. John Turner and Lorna Dailey (Washington, D.C.: U.S. Government Printing Office, forthcoming).
14. Yoshitaka Fujita, *Employee Benefits and Industrial Relations*.
15. Kiyoshi Murakami, "Retirement Benefits and Pension Plans in Japan," Sophia University Business Series no. 118, 1988, p. 7.
16. In Japan, employee compensation consists of a basic salary and various allowances. In some companies, the final monthly basic salary used to calculate retirement benefits is nearly 100 percent of total compensation or regular salary, while in other companies, it is much lower. Bonuses are always excluded from earnings used to calculate lump-sum severance payments. A recent study by the Central Labor Relations Commission found that the base salary is, on average, 55.5 percent of the regular salary. See Murakami, "Retirement Benefits and Pension Plans in Japan," p. 10.
17. International Benefit Information Service, April 1989, p. 14.

18. This follows from those with less education being hired at an earlier age. Thus, if they remain with the same company until retirement, they will have more years of service than college graduates.
19. Murakami, "Severance and Retirement Benefits in Japan," p. 26.
20. Fujita, *Employee Benefits and Industrial Relations*, pp. 35–36.
21. Survey conducted by Ministry of Labor, 1980. Data provided to me by Junichi Sakamoto, senior actuary, Pension Bureau, Ministry of Health and Welfare.
22. Japan Institute of Labor, *Wages and Hours of Work*, Japanese Industrial Relations Series no. 3, p. 18.
23. For firms in the wholesale sector, the maximum firm size is 100 and for the retail and service sectors, the maximum is 50 employees.
24. Murakami, "Severance and Retirement Benefits in Japan," pp. 22–23, 25.
25. Ministry of Labor, *Yearbook of Labour Statistics: 1986* (Tokyo: Japanese Government, 1987), p. 50.
26. Haruo Shimada, *The Japanese Employment System* (Tokyo: The Japan Institute of Labor, 1980), p. 17.