Retirement Systems in Japan

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CHAPTER 6

Lessons from the Japanese Experience for U.S. Pension Policy

The Japanese system of retirement plans includes both public and private systems. The social security system includes both the National Pension flat benefit with universal coverage and a system of earnings-related plans, of which Employees' Pension Insurance covers most workers. These plans were significantly amended in 1985 by altering the benefit formulas to lower projected costs. Even with these changes, contribution rates will rise sharply due to the aging of the population. As a result, the government is considering raising the age of eligibility for benefits and is encouraging firms to retain older workers.

The private pension system has grown substantially in the last two decades. Legislation in the 1960s established the framework for employees' pension funds and tax-qualified pension plans. These two types of pension plans have developed rapidly within the limits of government regulations. These plans, in conjunction with lump-sum retirement payments, form the basis of the private retirement system.

The retirement plans are integral parts of the Japanese industrial relations system, which includes seniority pay, long-term employment, and relatively young mandatory retirement. The aging of the labor force increases firm labor costs due to the seniority-based pay structure. Having more older workers also increases labor costs through increases in pension costs due to the link between pension benefits, years of service, and final earnings.

The problems raised by an aging population represent one of the major challenges facing the Japanese government and its social insurance programs. In addition, private firms must adjust to the shift from the young labor force of the 1970s and early 1980s to the rapidly aging labor force of the future. This report has outlined the evolution of retirement systems to date and identified the responses to population aging. Since the United States is confronting similar demographic changes, the Japanese experience provides useful insights into the effectiveness of alternative pension policies.

This study has yielded several important findings concerning Japanese retirement systems. First, the population of Japan is rapidly aging, and this is changing Japan from a relatively young nation to one of the oldest in the world in the span of three decades. These demographic changes have required the government and private industry to respond to an aging labor force. Although the United States faced the early stages of population aging a decade before Japan did, in the future Japan will confront the challenges of a mature, older population before the United States will. Thus, policymakers in the United States should examine the Japanese reaction to further population aging for insights into possible changes in public policies.

Second, one of the first challenges of population aging to confront developed countries has been the increase in cost of social security systems due to increases in the ratio of retirees to workers and a maturing pension system. Just as did the United States, Japan recently amended its social security system to reduce projected cost increases. The 1985 social security reforms sharply reduced the benefit formula. This action was aimed at maintaining the gross replacement ratio at approximately 70 percent for married workers with nonworking spouses. Without these changes, the gross replacement rate for married retirees with nonworking spouses would have risen to about 83 percent.

The Diet is now considering proposals to raise the age of eligibility for benefits. These actions parallel policy initiatives in the United States enacted in 1977 and 1983. However, these changes are opposite of the European experience, where governments have encouraged early retirements as a policy to counteract relatively high rates of unemployment.[1]

Third, in an effort to provide a greater component of retirement income from private sources, the Japanese government has encouraged the adoption of private pensions. Preferential tax treatment for funded pensions was introduced in the 1960s. In the subsequent two decades, pensions have spread through the private sector.

Coverage rates by private retirement programs approach 90 percent in Japan, compared to around 50 percent in the United States.

Much of this difference is due to coverage by lump-sum severance payments, which are the traditional method of retirement payments in Japan. Annuity pension plans in Japan cover 58 percent of workers who are participating in the employee component of social security, the Employees' Pension Insurance system.

Fourth, several aspects of the employees' pension funds and tax-qualified pension plans provide useful insights for pension policy in the United States. Recently, attention in the United States has focused on whether lump-sum distributions should be permitted. In Japan, most plans have lump-sum options. Virtually all participants in tax-qualified pension plans and half of the employees' pension fund participants select lump-sum options. The popularity of these options may be due to the traditional lump-sum payment systems; however, their widespread use suggests how retirees in the United States may behave if given the option of lump-sum distributions.

Just as in the United States, Japanese private pensions are not required to provide inflation increases, and few—if any—plans automatically award such increases. Available information indicates that few pension plans provide ad hoc increases. This differs from the U.S. experience, where large employers have been found to provide regular ad hoc benefit increases. However, these increases are typically less than the rate of inflation.

Periodically, there have been proposals to privatize part of the U.S. social security system. In Japan, employees' pension funds have contracted out the earnings component of social security. The employees' pension funds are required to create a reserve fund, and the government regulates these investments. Proponents of privatizing social security should study the Japanese system, which has developed over the last two decades. The effect of the employees' pension fund system on national savings is a topic that needs further study and may provide useful information on the differential effects of unfunded social security in comparison to a private, funded system, which takes the place of a portion of social security.

An additional aspect of the employees' pension fund system that merits further attention is the use of the Pension Fund Association as a portability center for workers who move across firms with employees' pension funds. The portability applies only to the contracted-out benefit. Advocates of greater portability among pensions in the United States may wish to examine the performance of the Pension Fund Association in providing benefits to workers who leave an employees' pension fund prior to retirement. This may be a manageable job, because relatively few workers move among employers with employees' pension funds.

Tax-qualified plans are audited at least every five years, and excess funds must be returned to the employer. At no other time can funds be withdrawn. The remaining assets are viewed as belonging to the participants. At the termination of a plan, the assets are divided among the participants. This system, along with strict full-funding limits, precludes the use of plan assets in firm takeovers. Employees' pension funds are also subject to regular governmental review; however, excess assets in these plans must remain in the fund.

Several other differences in pension policy are worth emphasizing. Japan has no system of defined contribution plans. Currently, there is some discussion of permitting the adoption of a voluntary defined contribution plan for self-employed workers, who are covered only by the National Pension component of social security.[2]

In contrast to U.S. policy, pension fund assets are taxed by the Japanese government at the rate of 1 percent per year plus a small local tax. Exemptions to these taxes result in most employees' pension funds having only limited tax liabilities.

In an effort to delay withdrawal from the labor force, the Japanese government is offering subsidies to firms that hire older workers. The Japanese government has outlined goals and objectives for the continuation of work. No statistical studies have attempted to estimate the effectiveness of these policies. It is clear, however, that the labor force participation rates of older men are much higher than they are in other developed countries, and these rates have declined less rapidly than those in the European countries or in the United States.

Another aspect of the Japanese labor market that varies greatly from the United States is the system of reemployment after mandatory retirement. Reemployed workers lose their seniority status, are paid lower wages, and do not receive seniority-based wage increases. Such policies would clearly be illegal under U.S. age discrimination laws.

Sixth, among developed countries, Japan has the highest labor force participation rates for older persons. These high rates prevail despite the widespread use of mandatory retirement policies by many companies. In recent years, firms have raised the age of mandatory retirement from approximately 55 toward age 60. Government policy is to have mandatory retirement at age 60 or higher, but firms are not required to comply.

In summary, several aspects of Japanese pensions are directly related to current pension policy debates in the United States. Changes in government policies concerning the employment of older workers and social security in response to the continuing aging of the population also will be of interest. Greater knowledge concerning these concepts in Japan may provide useful information to U.S. policymakers.

ENDNOTES

1. Barry Mirkin, "Early Retirement as a Labor Force Policy: An International Overview," *Monthly Labor Review*, March 1987, pp. 19–33.
2. Kiyoshi Murakami, "Aging and Pensions in Japan," paper presented at the Employee Benefit Research Institute Policy Forum, "Aging in Japan: Lessons from the U.S.?" p. 5.