PENSION PLAN REVISION AND FISCAL CONSOLIDATION OF JAPAN

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Introduction

Japanese fiscal position is the worst among developed countries. One of the main reasons is the expansion of social security expenditure due to rapid aging. Social security expenditure accounts for almost half of the general expenditure of Japanese budget, and is growing very rapidly every year.

Therefore both Japanese social security reform and fiscal reform are indispensable to maintain sustainable social security and fiscal policy.

In this standpoint I want to discuss following issues:

1) first point is to show that Japanese fiscal position is very bad and aging progresses very rapidly. These two points are big constraints in terms of maintaining Japanese fiscal as well as social security sustainability;
2) second point is to explain the Pension Revision of 2004. The basic idea consists of following three points:
   (1) fixing future premium level legally to avoid putting too much burden on the future working age people,
   (2) introducing the system to adjust indexation to respond the aging society as well as decrease of the population of working age people,
   (3) raising the ratio of state subsidy for Basic Pension from about 1/3 to half to maintain the level of the pension. This costs extra 2.5 trillion yen (around 2.5 billion US Dollars);[1]
3) last point is to explain Japanese effort towards fiscal consolidation. Since Japan had to deal with the raise of the ratio of state subsidy to the Basic Pension, as well as stimulus package, Japan needed fiscal reform including obtaining stable revenue resources. Thus last year Japanese government decided "The Medium-term Program" concerning tax reform and social security.

1 Japanese aging society and current fiscal position

1.1 Japanese aging society

Figure 1 shows that Japanese aging is progressing faster than any other developed countries. The ratio of population older than 65 is already above 20 per cent in 2005, expected to go up to 30.5 per cent in 2025 and 39.6 per cent in 2050.

The main causes of the aging are:

1) continuous decline of the *total fertility rate*. Total fertility rate is 1.34 in 2008, it was 4.57 in 1947 and it became less than 2 in 1975.[2] 2008 figure was slightly recovered from previous year's 1.32;

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This paper is a compilation of the author's presentation at the workshop held in Perugia, Italy on March 25-27, 2009.

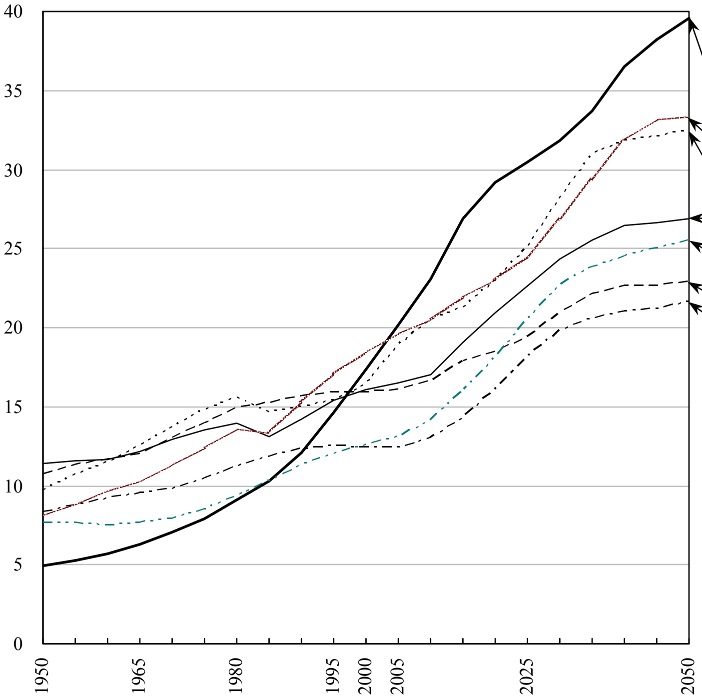
The article is based on the author's personal view and should not be regarded as reflecting official stance of the Japanese government.

[1] Calculate with exchange rate 100 yen per dollar.

Figure 1

Aging in Japan

(percent)



(%)

(CY)	1965	1980	1995	2000	2005	2025	2050	1965 ↓ 1995	1995 ↓ 2025	2025 ↓ 2050
Japan	6.3	9.1	14.6	17.4	20.2	30.5	39.6	8.3	15.9	9.1
Italy	10.2	13.5	17.0	18.4	19.6	24.4	33.3	6.8	7.4	8.9
Germany	12.5	15.6	15.4	16.4	18.9	25.1	32.5	2.9	9.7	7.4
France	12.2	14.0	15.4	16.1	16.5	22.6	26.9	3.2	7.2	4.3
Canada	7.7	9.4	12.0	12.6	13.1	20.5	25.5	4.3	8.5	5.0
G.B.	12.0	14.9	15.9	15.9	16.1	19.4	22.9	3.9	3.5	3.5
U.S.	9.5	11.2	12.5	12.4	12.4	18.1	21.6	3.0	5.6	3.5

Note:
Figures for Japan from Ministry of Internal Affairs and Communications, *National Census*, and National Institute of Population and Social Security Research (December 2006), *Population Projections for Japan: 2006-2055.*
Figures for other countries are based on UN projections.

2) continuous longevity. Average life expectancy in Japan was 79 years for male and 85.81 years for female in 2006.[3] In 1947 it was 50 years for male and 54 years for female, so both have become almost 30 years longer in 60 years. Main cause of recent longevity is medical improvement such as treatment with cancer, heart disease, cerebrovascular.

Figure 2 shows the Japanese Population Pyramid. As like other countries, there exist two baby-boomers generations.

The first one is the first baby boomers, 6.73 million people in 2007,[4] born just after WW2 (1947-1949). They are shown in red poles, and beginning to reach retiring age. By 2011 the first baby boomers will begin to reach 65 years and receive formal pension. By 2015 all the first baby boomers receive pension, and they are beginning to be eligible for the late-stage medical care system for the elderly, which covers people more than 75 years old and is financed by tax revenue as well as contribution from other generations.[5]

The first baby-boomers are now in the supporting side of the Japanese social security, but by 2011 or mid-2010s, they are to become being supported by younger generations. This explains why Japanese Government fiscal consolidation targets were Year 2011 or mid 2010s. That is, Japan has to prepare for the first baby-boomers social security expenditure.

2 Registration of vital statistic in 2008, Ministry of Health, Labor and Welfare.

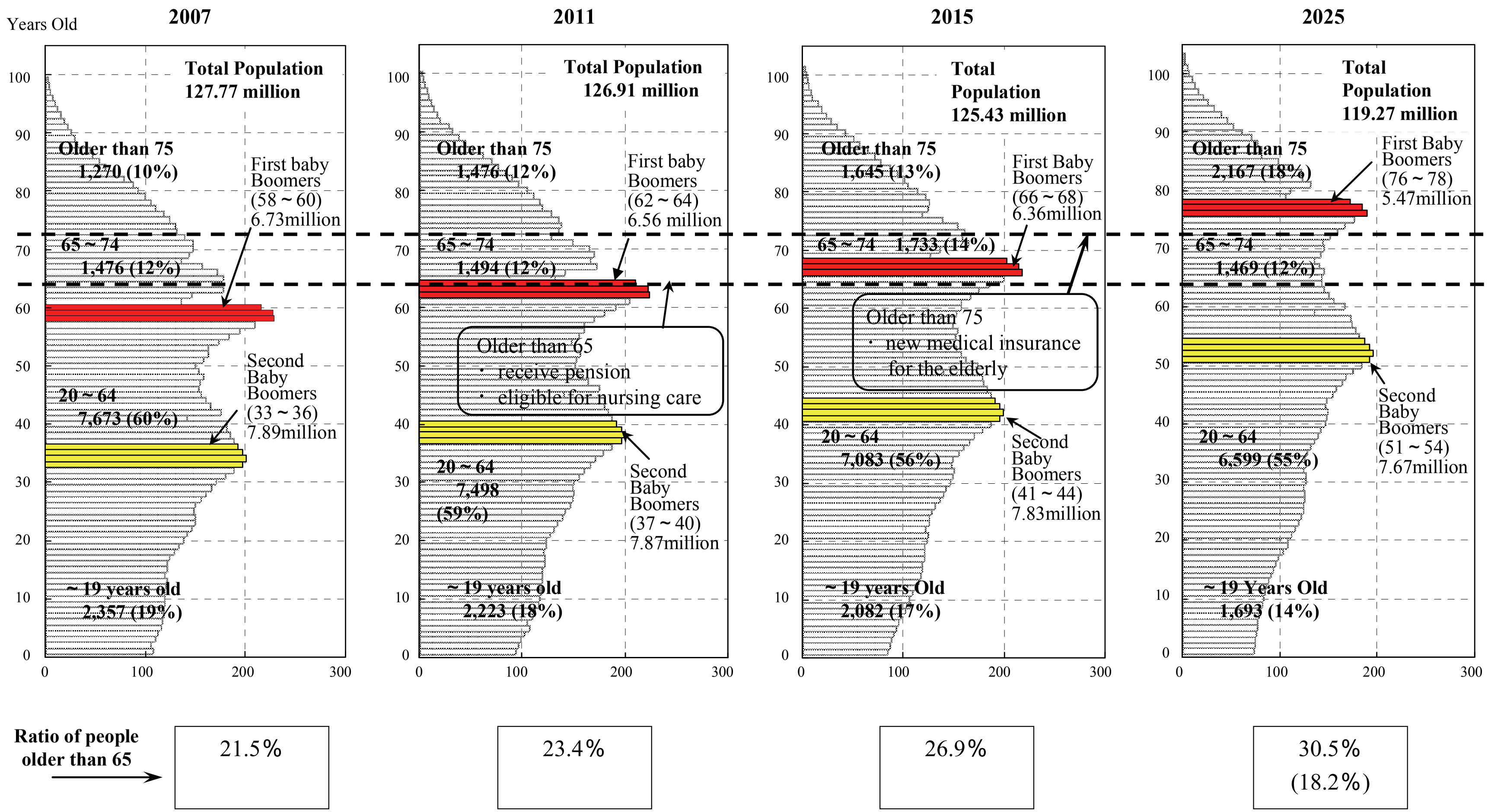
3 Life table in 2006, Ministry of Health, Labor and Welfare.

4 Figures from "National Census" (the Ministry of Internal Affairs and Communications) and "Population Projections for Japan: 2006-2055" (National Institute of Population and Social Security Research, December 2006).

5 For the late-stage medical care system for the elderly, the co-payment is 10 per cent, and the rest is financed by; 10 per cent from insurance fee of elderly, 40 per cent from younger generation's insurance fee, and 50 per cent is from tax.

Figure 2

Japanese Population Pyramid, 2007-25



Note: Figures for Japan from Ministry of Internal Affairs and Communications, *National Census*, and National Institute of Population and Social Security Research (December 2006), *Population Projections for Japan: 2006-2055.*

Figure 3 shows Japanese economy and population of the past and the future.

In 1961 Japan had implemented universal pension coverage and universal medical care coverage system. Those reforms were done during so-called high-growth period, the economy was catching up with other developed countries and growth rate was above 10 per cent. The ratio of working age people (20-64 years old) against elder people (65 years old~) was very high (in 1965 9.1 times). High growth rate combined with young population meant plenty room for social security improvements at that time.

Since then growth rate has dropped, the ratio of elder people has increased dramatically, and the ratio of working age people decreased. In 2025 every 2 working age persons will have to support one elder person and in 2050 almost every single working age person will have to support one elder person.

Take a look at this figure from political side. At the bottom of the figure is the elderly people's share among Japanese voters.

Generally speaking, the bigger the ratio of elderly population is, the more difficult to implement policy change which put burden on, or cut benefit from, elderly people. In 2007 the elder people's ratio among voters is 26 per cent, and already more than a quarter of the voters are more than 65 years old. In 2025 the ratio will go up to more than one-third, and in 2050 the ratio will be 45 per cent.

It is said that elderly people tends to have high election turnout. In 2005 general election, election turnout of elderly people (more than 65 years old) is 73.5 per cent, on the other hand that of working age people (20-64 years old) is 66.4 per cent.[6] If you use these numbers automatically, the voting power of elderly people in 2007 was now 28.4 per cent,[7] slightly less than three-tenth. Since people begin to think about their post-retirement life when their age is close to 65 years old,[8] the potential voting power of elderly people might be even bigger than the figures above.

This political point of view also justifies the fact that Japanese fiscal reform targets were 2011 or mid 2010s, before First Baby-boomers become supported side.

1.2 Japanese fiscal position

Figure 4 is the international comparison of fiscal balance to GDP. In 1990s developed countries other than Japan succeeded in fiscal consolidation. On the other hand, Japanese fiscal balance worsened, suffering from the largest fiscal deficit among the major advanced economies, as a result of economic slump and aging society.

Now the fiscal balance is becoming more and more devastating because of the world economic turmoil caused by sub-prime problem.

The debt was accumulated in the 1990s, which is often called "lost decade" after Japanese bubble economy collapsed.

Figure 5 shows that the ratio of general bonds to GDP has increased from 37 per cent (FY1990) to 120 per cent[9] (FY2009), the increase is astounding 83 per cent, and a total of

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6 2005 general election for lower house, figures from the association of promoting fair elections.

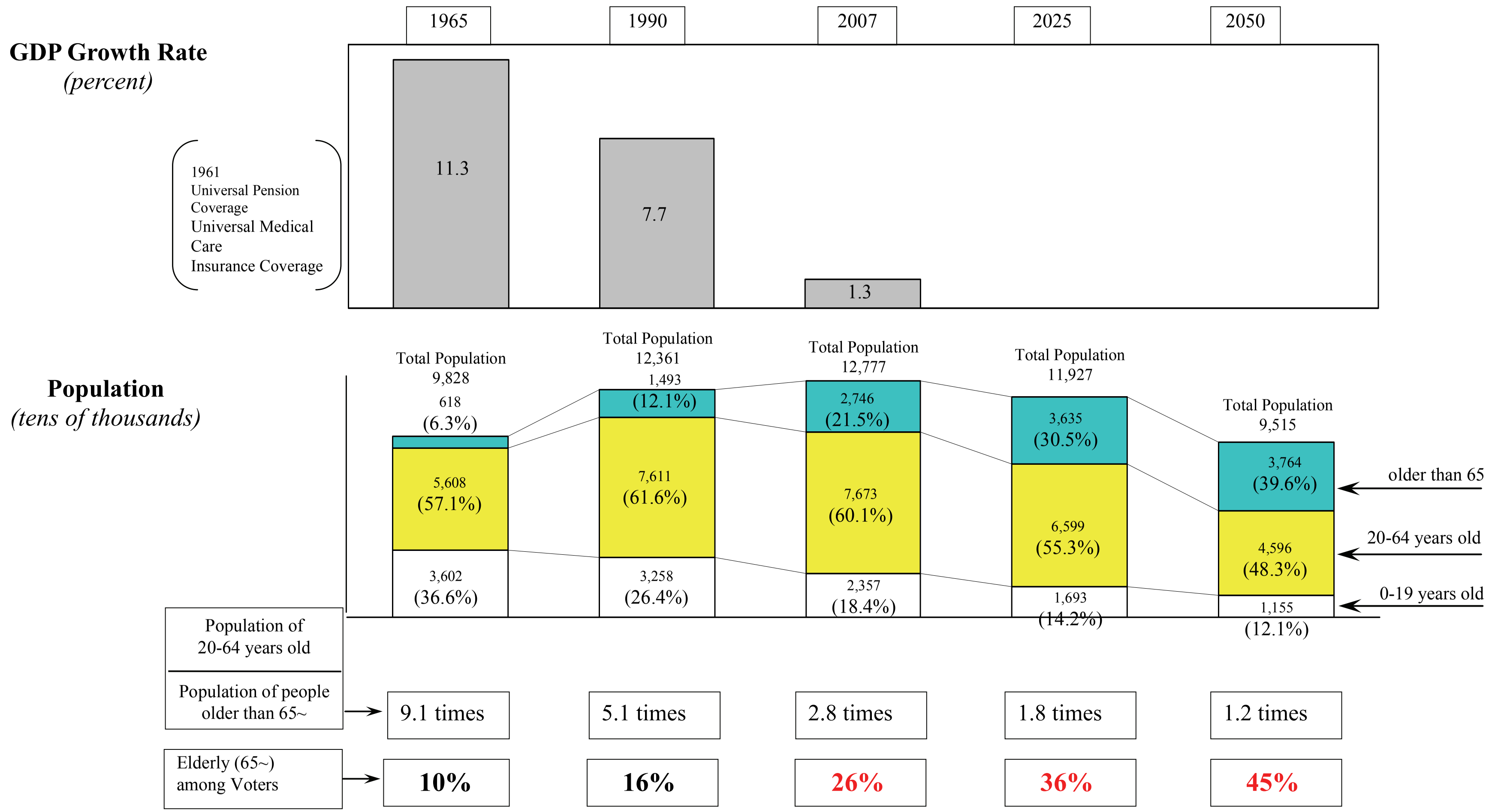
7 The ratio of elderly people (2007) × elderly election turnout (2005) against elderly people (2007) × elderly turnout (2005) + working age people (2007) × working age turnout (2005).

8 According to the questionnaire, 83.3 per cent of 50-59 years old male and 92.5 per cent of 50-59 female think about their old age. (Poll about public pension system, Cabinet Office, April 2003).

9 The ratio drastically worsened from 2008 (105 per cent).

Figure 3

The Economy and Population of Japan, Past and Future

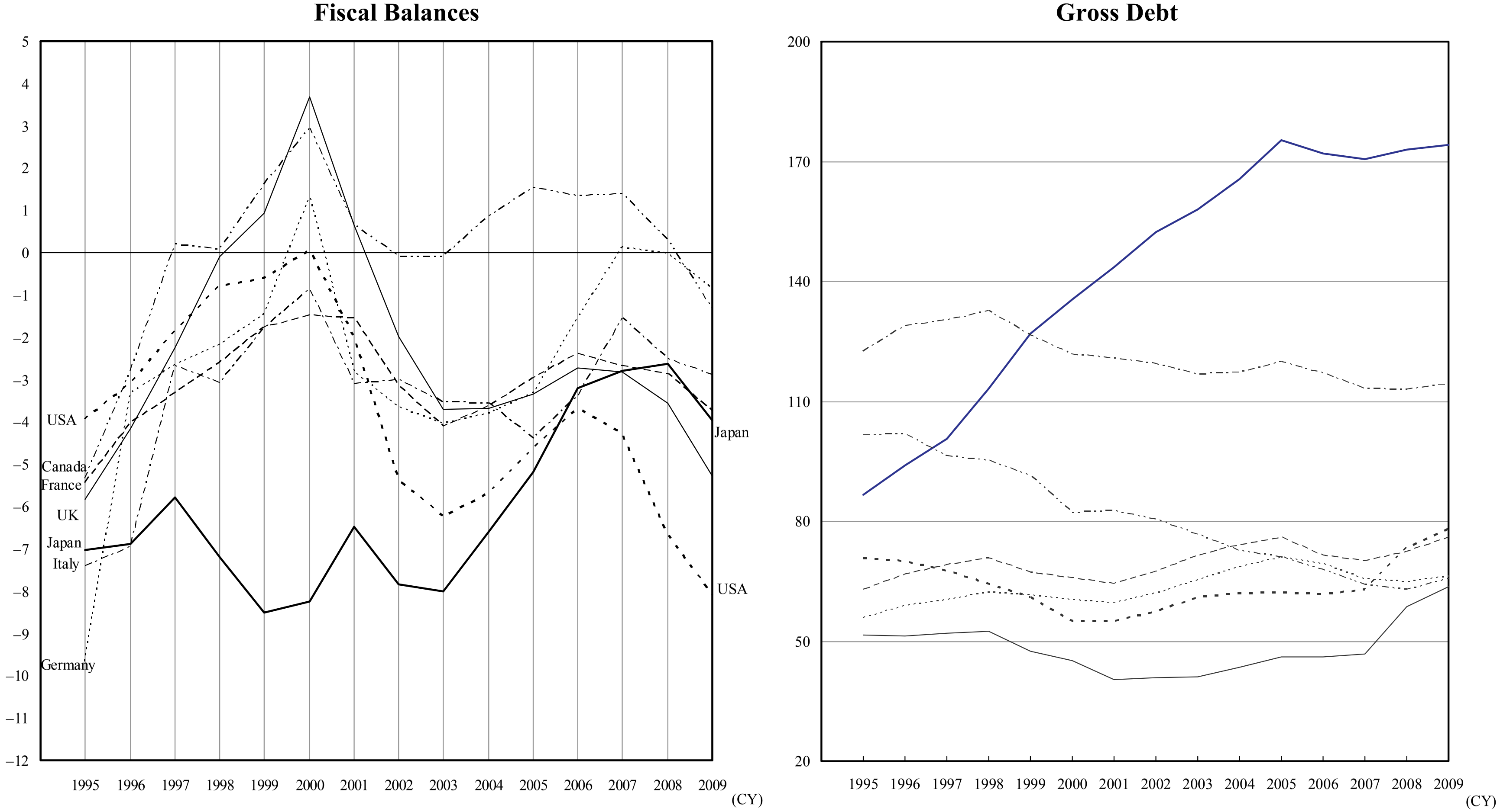


Note: Figures from Ministry of Internal Affairs and Communications, *National Census*, and National Institute of Population and Social Security Research (December 2006), *Population Projections for Japan: 2006-2055*.

Figure 4

General Government Fiscal Balances and Gross Debt – International Comparison

(percent)



FY2009 budget is not reflected in the above data.
Japanese figures in FY1998 and FY2005-FY2009 are adjusted in order to exclude special factors.

FY2009 budget is not reflected in the above data.

Figure 5

Factors for Increase in General Bonds Outstanding

Increase in General Bonds Outstanding from FY1990 to FY2009: 415 trillion yen (Ratio to GDP: FY1990: 37.0% → FY2009: 120.0% (+83 percentage points)

(component percentages)

Contribution of Expenditures: 165 trillion yen (40%)

Social Security related expenditures:	127 trillion yen (31%)
Public works related expenditures:	62 trillion yen (15%)
Other expenditures excluding debt redemption:	–24 trillion yen (–6%)

Effect of decline in tax revenues: 154 trillion yen (37%)

Other Factors (e.g. succession of debt from JNR, bad-loan disposal): 46 trillion yen (11%)

Difference in revenue and expenditure in FY1990: 50 trillion yen (12%)

415 trillion yen, mainly because Japan had to deal with tax revenue decrease, stimulus measures and aging society at the same time.

1) 40 per cent of this increase is due to an increase in expenditures including social security.
   - Among them, social security expenditure accounts for 31 per cent, almost one-third of the deficit making. So pension reform, health care reform and nursing reform were indispensable.
   - 15 per cent of the increase is from public works, which was accumulated during successive stimulus fiscal measures to boost economy.
2) 37 per cent, the biggest single cause, is the decline in tax revenues due to the economic downturn. Corporate tax revenue dropped sharply, and tax cuts were implemented to boost economy.
3) Other factors such as succession of debt from privatized companies and bad-loan disposal occupy 11 per cent of the increase. The drastic drop of the asset prices brought about bad loans of the banks, and taxpayer funds were then used.
4) The difference in revenue and expenditure that already existed in FY1990 shares 12 per cent as well.

Figure 6 shows international comparison of benefit and burden. Upper figure shows social security benefit level of each country. You can describe Japanese social security level as Medium-size if you compare with U.S. (rather small) and Germany, France (rather big).

Lower figure shows national burden plus fiscal deficit. If you deduct social security benefit from national burden and deficit, the result is ranged from 16.5 per cent (Germany) – to 24.3 per cent (Sweden), around 20 per cent. That is, around 20 per cent of NI is used to expenditures other than social security benefit. So roughly speaking, social security benefit plus 20 per cent becomes the size of national burden (and deficit). The level of national burden is

Figure 6

Benefit and Burden – International Comparison
(percent)

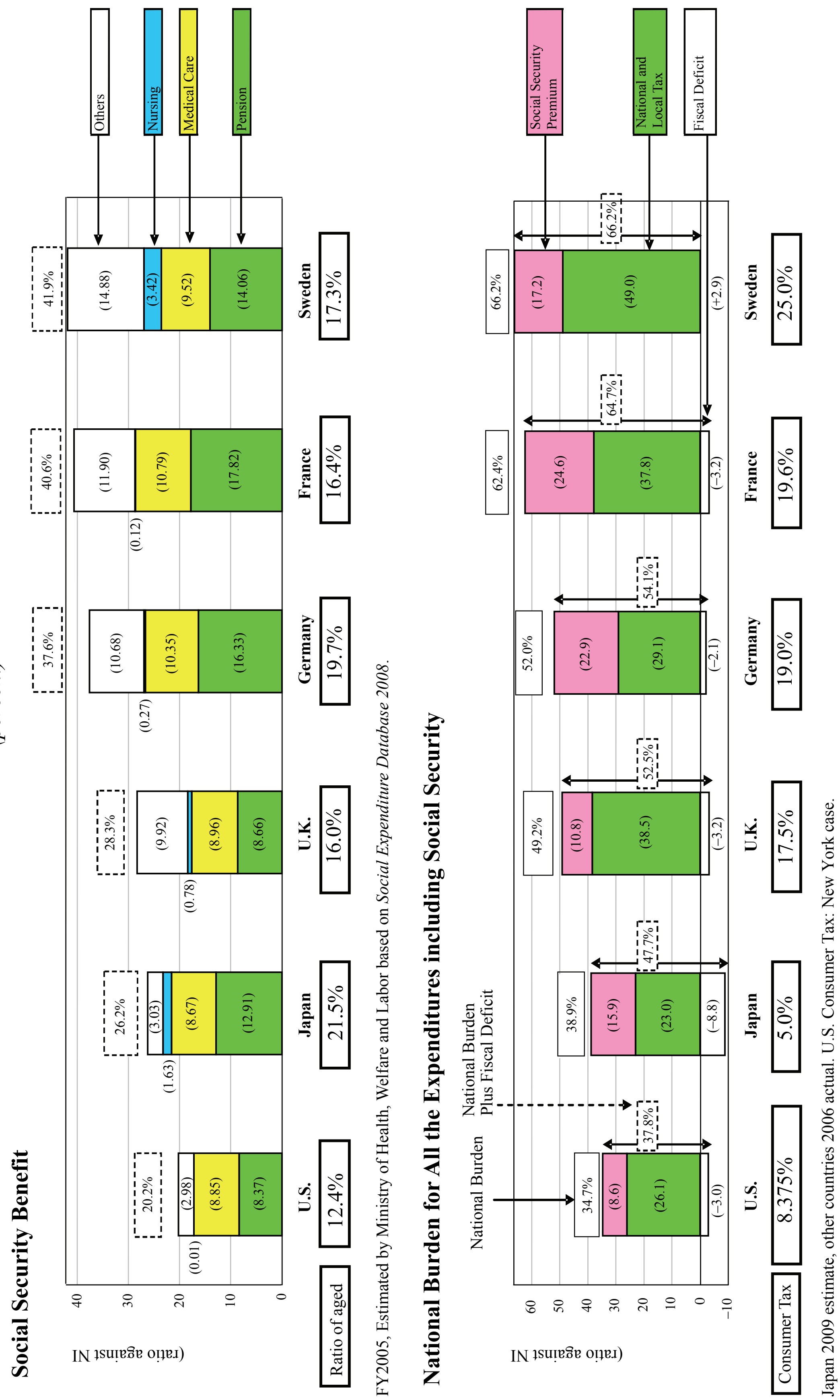
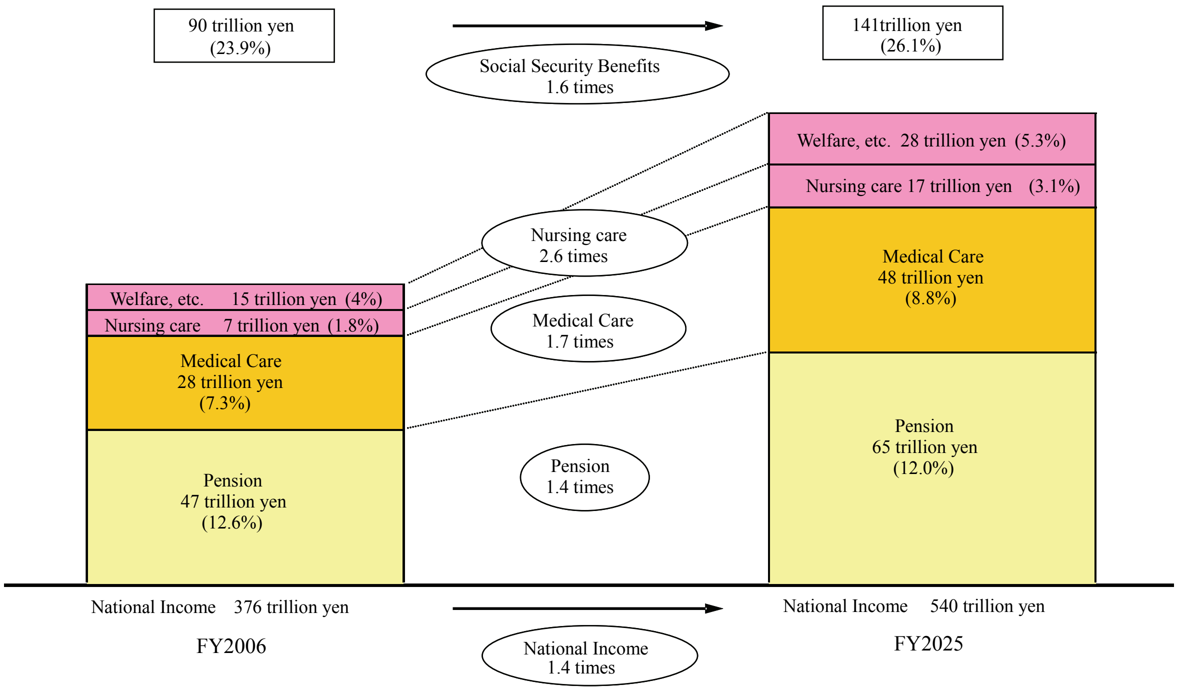


Figure 7

Forecasts for Social Security Benefits



Source: Health, Labour and Welfare Ministry (2006), *Projection of Social Security Benefits and Burdens* (May).

decided by democratic procedure, thus if you have big national burden, you can have good social security benefit.

In Japanese case, national burden plus fiscal deficit is 47.7 per cent, and 26.2 per cent goes to social security benefit, 21.5 per cent goes to other expenditures. Unlike other countries, Japan has 8.8 per cent deficit. Other countries' deficit is less than half of Japanese one. In this respect it can be said that Japan has medium-size social security, but small-size national burden.

Since social security accounts for biggest part of expenditure, continues to increase every year, and since Japan already have huge deficit, if Japan wants to strengthen social security benefit, Japan has to raise national burden either by raising tax or raising premium.

Figure 7 shows that in line with the rapid aging of the population, social security benefits in total are estimated to increase by 60 per cent from FY2006 to FY2025. Especially medical care and long-term care (nursing) shows great increases.

2 Japanese Pension Reform 2004

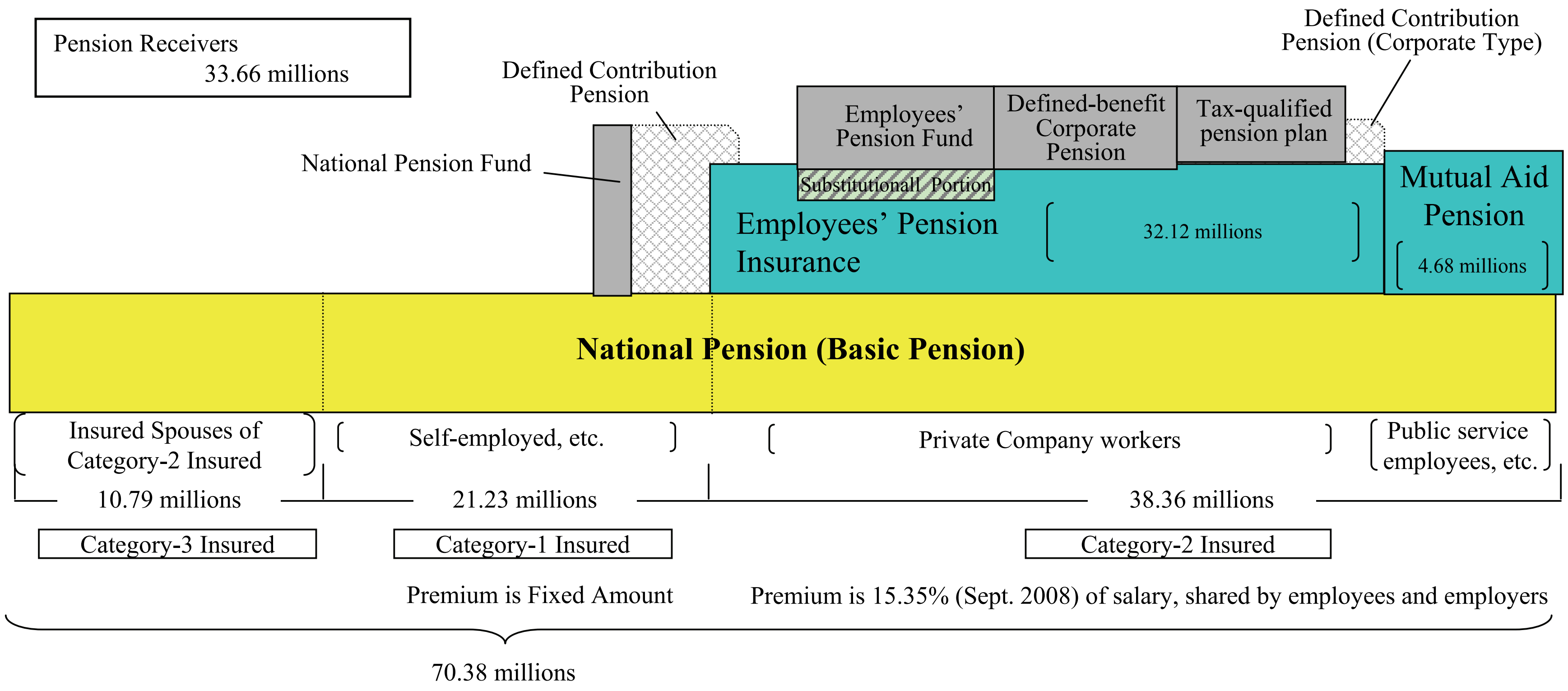
2.1 Japanese Pension System

Figure 8 shows current Japanese pension system. Japanese public pension system is a combination of inter-generation supporting efforts as well as self-relief efforts made by each individual.

There are three pillars of pension, like many other countries.

Figure 8

Overview of the Japanese Pension System
(March 2007 figures)



- Public Pension System is a social insurance System, combination of reserve funds of premium payments and subsidy from tax revenues.
- Basic Pension is provided through mandatory participation of the working generation. 1/3(after 2009 1/2) of the payment is financed by the state subsidy.
- Employees (including public service employees) participate in Employees' pension plan. They receive Remuneration-related pension.
- There are also Corporate Pension Fund etc.

The brown part is Basic Pension (National Pension), the 1st Pillar, in which all of Japanese above 20 compulsory join. For the cost of this pillar, half (after 2009) is financed by state subsidy, the rest is paid by each insurer according to the number of the insured people (according to the ability to pay).

There are three types of insured people for the National Pension:

1) category 1 covers self-employed, farmers, not employed etc. The premium is fixed amount, mainly because it is hard to grasp their incomes. There are 21 million people in this category;
2) category 2 covers private company employees and public service employees. These people have Second-pillar, Employees' Pension, and their premiums are paid half by employers, half by employees themselves. The premium is certain percentage of the wages. There are 38 million people in this category;
3) category 3 covers spouses of category-2 insured. They don't pay premium by themselves, the cost of this category is shared by Employees' Pension. There are 11 million people in this category.

There are also Third-pillar for the employees', not compulsory, financed by premium.

2.2 Basic points of the 2004 pension revision

The basic idea of the revision is to make Japanese pension system sustainable for the next 100 years, at the same time not putting too much burden on the working age people, and maintain certain benefit level.

Point 1) Fixing premium level in order not to put too much burden on working-age people. Before revision, premium level was 13.6 per cent, and we set legal premium ceiling of 18.3 per cent (as mentioned above, premium is divided equally by employer and employee).

Point 2) Taking a balance between burdens and benefits by introducing the system to adjust price indexation.

Point 3) Securing the benefit level to support the basic part of aged people. It is aimed that the benefit level is maintained above 50 per cent of average income of the employees.

Point 4) In order to achieve points above, the ratio of state subsidy for Basic Pension is to be raised from about 1/3 to half.

Figure 9 shows the basic idea of how the revision tried to take balance of burdens and benefits.

The upper figure shows pension without reform. Because of the rapidly aging society, for the burden side we suffered decrease in the work force, and for the benefit side we had to deal with increase in the life expectancy. Japanese pension system used to make pension projection every 5 years, and the total fertility rate drops beyond estimation.

In order to maintain balance, the lower part of the figure shows, for the burden side, that the future premium level is to be fixed, the ratio of state subsidy is to be raised, and the pension reserve fund is to be utilized. For the benefit side, the benefit level is to be adjusted, to be deducted A (estimated approximately 0.3-1.7 from 2012 to 2030) per cent plus B (fixed 0.3) per cent.

Japanese pension system is mainly adjusted by CPI, thus for example, if CPI goes up 1 per cent and A is 0.6 per cent, pension payment rises $1 - 0.9 = 0.1$ per cent.

Figure 10 shows the premium level. Upper graph shows premium for Employees' Pension Insurance, and the lower graph shows premium for Basic Pension.

Figure 9

Outline of the Review of Pension Benefits and Burdens

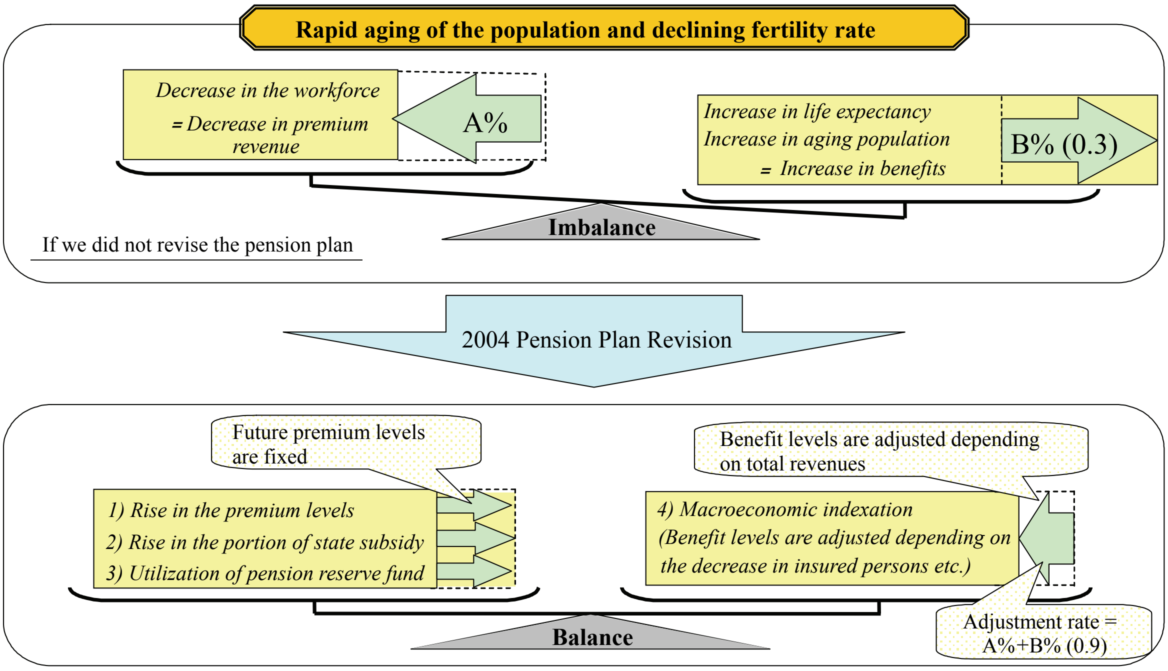


Figure 10

Estimation of the Premium Rate with/without Reform

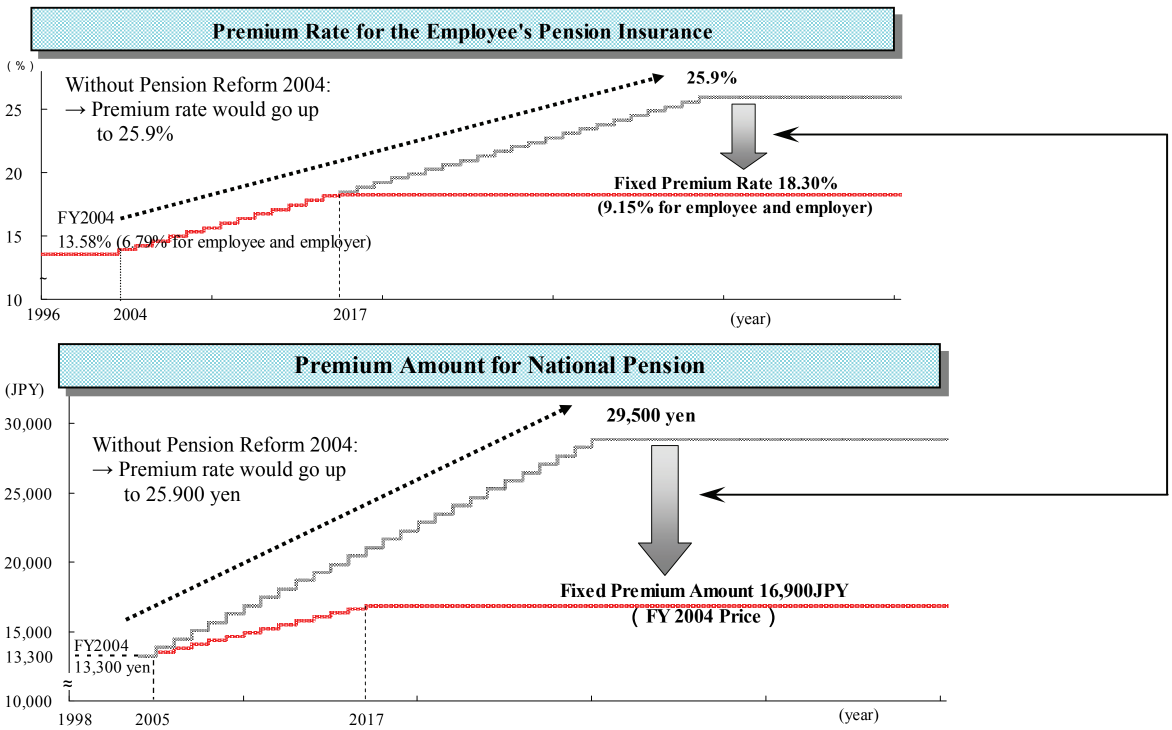
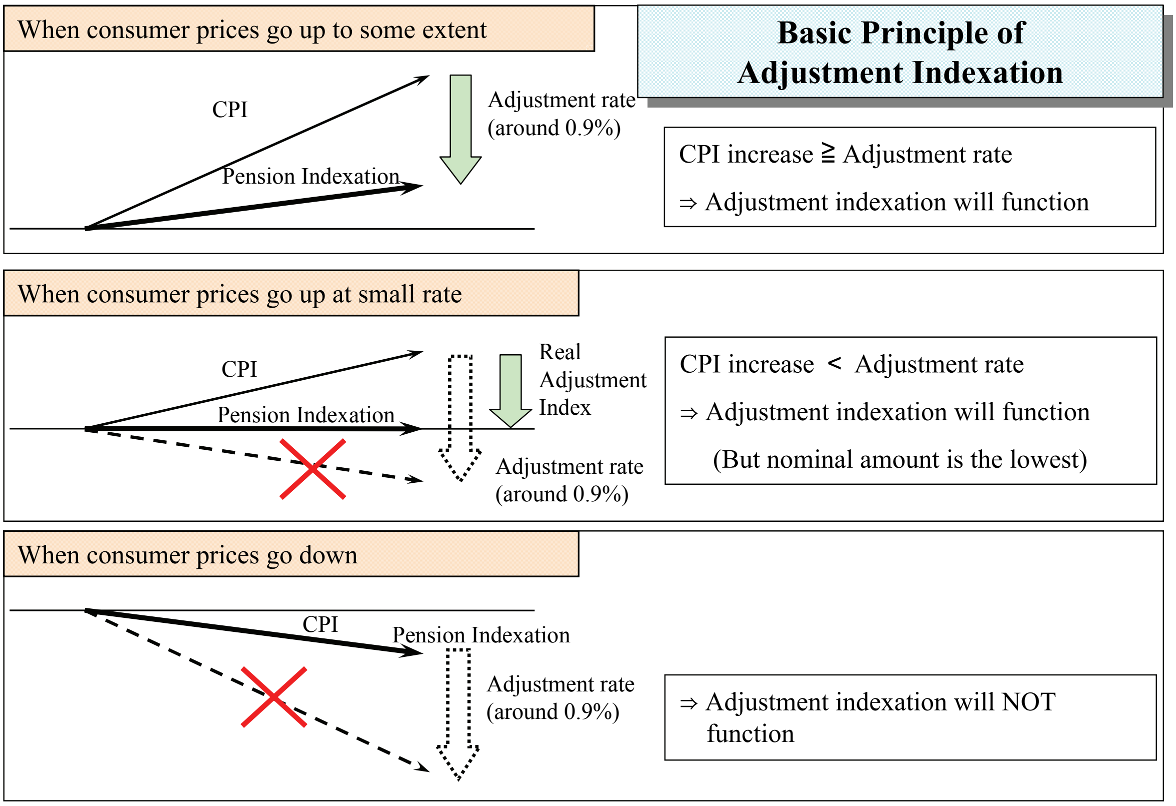


Figure 11

Rules of Adjustment Indexation



In the upper graph, without revision case, the premium goes as high as 25.9 per cent. In the revision process, avoiding too much future premium rise was put high priority so that future generation can maintain vitality.

Figure 11 is the basic rule of index adjustment.

For the most beneficiaries, the benefit is adjusted by price indexation. The upper graph shows ordinary case. When CPI goes up, pension indexation adjustment rate (decrease of the labor force (A, 0.3-1.7 per cent) plus growth of average life expectancy (B, 0.3 per cent)) will be deducted.

The middle graph shows when CPI goes up small percentage. In this case, adjustment rate is deducted, but if the result is minus, pension indexation adjustment will work until the result will be zero, so that nominal amount of the pension benefit is maintained.

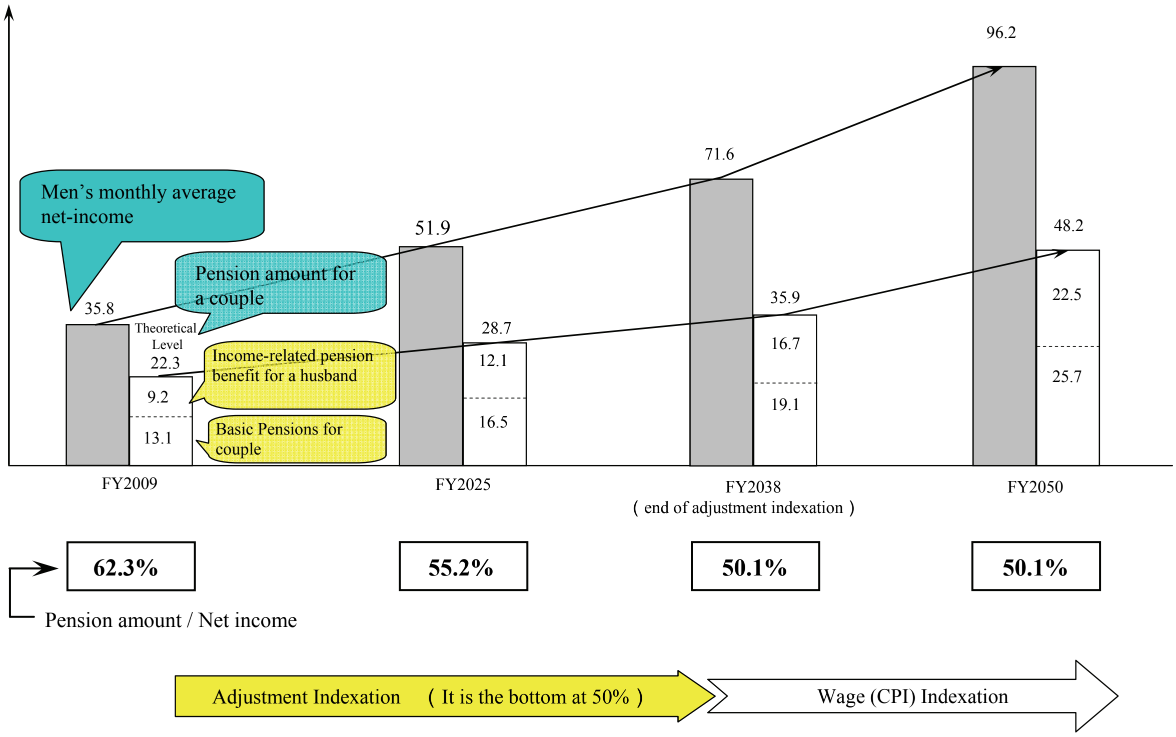
The lower part shows when the CPI goes down, they don't deduct adjustment indexation so that in this case pension indexation equals the decline of the CPI.

Figure 12 shows the projection of benefit level against working people's average income. The ratio of 1st pillar pension for husband and wife plus the 2nd pillar pension for husband against average net-income for active generation has to be more than 50 per cent[10] for the next 100 years, Macro-economic adjustment will be applied until taking a balance burdens and benefits.

[10] 2004 Pension Reform Act (2004.6.11 Law No.104), Supplementary provision, Article 2.

Figure 12

Benefit Level against Average Working Salary
Adjustment Indexation and Development of Benefit Level – Employees' Pension
2009 Projection
(nominal amount, tens of thousands of yen)



The Pension Law obliges that we re-calculate pension projection for every 5 years.

- The latest projection was done in 2009, and the premises of this projection are different from 2004 original projection, Future total fertility rate 1.39(2004 projection)→1.26(2009 projection)
- CPI 1% → 1%(unchanged)
- Wage Increase 2.1% → 2.5%
- Investment Return 3.2% → 4.1%

According to the projection, benefit level slightly drops from 50.2 to 50.1 per cent, and managed to maintain 50 per cent requirement. Adjustment indexation was originally forecasted to effective from 2007 to 2023, but under new projection, adjustment indexation will be effective from 2012 to 2038.

There are other points of the 2004 pension revision:

- establishing pension plan to meet diversification of lifestyle and working style. In this category Japan introduced system to encourage working of the people older than 65 years;
- introducing the system which allows division of employees' pension upon divorce for the first time;
- trying to make insured people understand how much benefit they can receive after reaching the age of 65.

3 Japanese fiscal consolidation

3.1 Roadmap and targets for fiscal consolidation in 2006

The government had launched the basic policy action on integral reform of expenditure and revenues in the *Basic Policies for Economic and Fiscal Management and Structural Reform in 2006*, as endorsed by the cabinet in July 2006 (Figure 13).

In the Basic Policy, the target horizon is divided into three phases, each around 5 years:

- phase 1 is from FY2002 to 2006,
- phase 2 is from FY2007 to early 2010s,
- phase 3 is to mid-2010s. The government tried to gradual fiscal consolidation with surplus in the primary balance of the central and local governments combined in phase 2, and decrease in the debt-GDP in phase 3.

In this time schedule, the social security expenditure played important role. In 2009 pension subsidy ratio was to be raised, and tax reform was planned to take place, so the deadline of phase 2 was decided to be FY2007 to early 2010s.

First baby-Boomers will reach 65 years old and receive formal pension in the mid 2010s and eligible for the late-stage medical care system for the elderly, so the phase 3 deadline is mid-2010s.

As mentioned above, by synchronizing the timing of social security reform and revenue reform, the Government tries to maintain fiscal discipline.

Figure 13

Roadmap and Targets for Fiscal Consolidation
(basic policies for economic and fiscal management and structural reform 2006, endorsed at the Cabinet meeting in July 2006)

<u>Phase I (FY2001-FY2006): Reforms by the Koizumi Cabinet – "No growth without reform"</u>

- Make efforts to advance fiscal consolidation under the concept of the integrated reform of the economy and public finance
- Make steady improvement in the primary balance

<u>Phase II (FY2007-**early 2010**)</u>

- Achieve a surplus in the primary balance as a first step toward fiscal consolidation
  - Continue fiscal consolidation as in Phase I and ensure a surplus in the primary balance of the central and local governments combined by FY2011
  - Aim to achieve a primary balance for the central government as much as possible

<u>Phase III (early 2010-**mid-2010s**)</u>

- Decrease the debt-to-GDP ratio at a steady pace
  - Ensure surplus in the primary balance of the central and local governments
  - Aim at a steady reduction of the central government's debt-GDP ratio

The government sets the target of achieving a primary surplus in FY2011 and calculates the required adjustment from a baseline projection of expenditures and revenues for each category of expenditure.

This plan progressed rather smoothly until last year, but economic turmoil devastated the progress. January projection forecasted, even the world economy recovers moderately, we have 2.9 per cent deficit in FY 2011.

3.2 Medium-term program for establishing a suitable social security system and its stable revenue sources

Japan had to deal with the economic crisis, and took measures necessary.

But on the other hand, Japan have to recognize and make preparation for the next fiscal consolidation, especially because ratio of state subsidy for Basic Pension was to be raised to 50 per cent in 2009 (needs extra 2.5 trillion yen, around 2.5 billion US dollars). Furthermore, Japan has to strengthen social security system, such as acute medical care, securing nursing labor force.

Thus in December 2008, the cabinet decided "The Medium-term Program for Establishing a Sustainable Social Security System and its Stable Revenue Sources".

Basic points of tax reform and social security are as follows:

1) Tax Reform

- In order to implement the fundamental reform of the tax system including that of consumption tax from FY2011, necessary legislative action is to be taken in advance so as to establish a sustainable fiscal structure in a stepwise manner by the mid-2010s on the premise that an upturn in the Japanese economy will be achieved within next three years starting from FY2008.
- Specifically, consumption tax revenues are to be allocated in full to social security benefits relating to the pension, medical and nursing care programs, and the expense for falling birthrate countermeasures that have been established and instituted, thus in effect all being returned to the people; not being used for an expansion of government bureaucracy.[11]

2) The rise of Government's ratio of state subsidy for Basic Pension to half

The rise of the ratio of state subsidy for Basic Pension to 50 per cent is to be made permanent after securing the required stable revenue sources under the aforementioned fundamental tax reform.

For the fiscal year of 2009 and 2010, the Government's ratio of state subsidy for Basic Pension is to be 50 per cent by allocating temporary revenue sources.

In the case with the "unexpected economic developments", the ratio should also be kept to 50 per cent by allocating temporary revenue sources.

3.3 New targets for fiscal consolidation

After January's projection, the economic situation had worsened, and new target was just implemented in order to fit in recent developments.

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[11] "If Japan tried to revise tax including consumption tax, for the Japanese people the most convincing and understandable way is to have money collected by tax go back to people, by using for pension, medical care and nursing, falling birthrate countermeasures. Without this philosophy it's hard to deal with consumer tax problem" (Upper House Budget Committee, 2009.1.26 Minister of State for Financial Services, Economic and Fiscal Policy Yosano).

On June 24th 2009, the new target was just decided[12] in this new economic environment.

The basic concepts of this new target are as follows:

- in order to maintain fiscal sustainability, as a basic target for fiscal consolidation, the ratio of national and local governments' debt against GDP is to be at least stabilized towards mid-2010s, and stably decreased by early-2020s;
- in this respect, national and local governments' primary balance is to be in surplus within 10 years;
- national and local governments' primary balance (except for balance from stimulus measures) against GDP is to be decreased at least half within 5 years. For this target, considering recent world economy's uncertainty, timely verification should be conducted.

[12] Basic policies 2009, 2009.6.24 cabinet decision.