Aftermath of the Social Security & Tax Reform: Minor or Comprehensive Change?

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Introduction

Japan is aging faster than any other developed country. Japanese people aged 65 and older accounted for 23.2% of the total population in 2010. This figure is expected to rise to 41.1% in 2100. You can see that Japan is an outlier when you consider that the 2100 forecasts for the 65-and-older population in the major developed countries are clustered around 30%, such as Germany at 28.4%. Nobody is surprised at this anymore since it has become common knowledge.

The government has taken a variety of measures to counter the decreasing birthrate and aging population. A recent major undertaking was the Comprehensive Reform of Social Security and Tax launched by the administration led by the Democratic Party of Japan (DPJ), which took over in the summer of 2009. Legislation was passed in the summer of 2012 to raise the consumption tax from the current 5% to 8% as of April 2014 and 10% as of October 2015 in order to finance various social security programs. The Liberal Democratic Party (LDP) and the New Komeito party, then in the opposition, also voted for the measure.

The National Council on Social Security System Reform was established during the legislative deliberation process on the tax hike in order to consider the substance of the reform of the social security system. The National Council is an official organization established according to the Act on Promotion of Reform of the Social Security System. Its members consist of nongovernmental persons of wisdom; its objective is to deliberate necessary matters concerning the reform of the social security system in order to "promote the establishment of a sustainable social security system in which the benefits and burdens are balanced while securing stable financial sources."

The National Council issued a report on Aug. 6, 2013 after holding 20 meetings between November 2012 and August 2013. During this period, a general election of the House of Representatives was held in December 2012, returning the LDP-New Komeito coalition to power under Prime Minister Shinzo Abe. On Oct. 15, 2013, the Abe administration adopted by cabinet decision and submitted to the Diet, currently in an extraordinary session, the Act on the Program for the Reform of the Social Security System, which presents the overall picture and process of the reform of the social security system in concomitance with the consumption tax hike, based on the report.

It would appear that thoroughgoing reform of the social security system has finally begun in Japan. However, a closer look at the details reveals that this is not necessarily true. The National Council held hearings with a wide range of organizations and saw a massive amount of documents distributed. However, there was not much by way of fundamental discussions on how the overall social security system would be reviewed against the background of the interests of the taxpayer, who would bear the burden of the consumption tax hike and of the rapidly progressing effects of the decreasing birthrate and aging population. The reason for this was the existence of deep divisions concerning a minimum guaranteed pension and the late-stage medical care system for the elderly between the three parties — the DPJ, LDP, and New Komeito — that had passed the consumption tax hike and related legislation. The basic position of the LDP and New Komeito is one of minor alterations based on the current system, while the DPJ seeks fundamental reform to establish a minimum guaranteed pension and abolish the late-stage elderly medical care system.

Missing in the debate within the National Council is a thoroughgoing analysis and extraction of the problems of the social security and taxation systems. An appropriate prescription cannot be written without grasping the true cause of the problems, and the discussions regarding the reform of the social security system will not reach a conclusion. This is unfortunate for the Japanese public. If the burden of the consumption tax hike is assumed while putting off necessary reforms, it is the Japanese public that will wind up footing the bill. That is no way to solve the problem.

How did this happen? This article will analyze the fundamental problems in the current social security system and offer a prescription for reform.

Rapid Increase of Social Security Costs

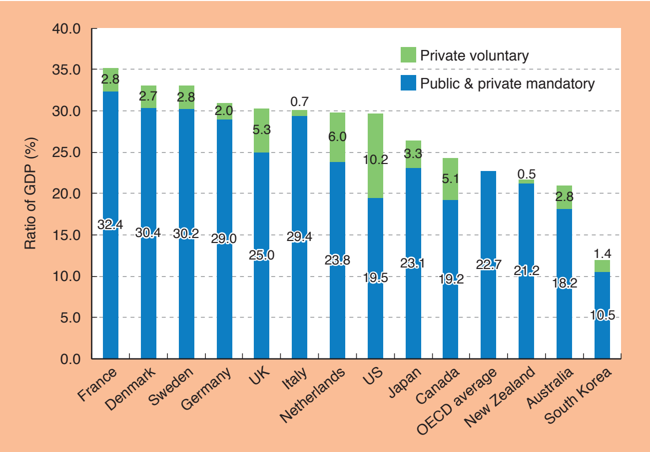
Conventional wisdom has been that Japan has a "small government". However, Japan is no longer a small-government state in comparison to other OECD countries.

Chart 1 is a comparison of social security-related expenditures relative to GDP. This "social expenditure" is comprised of social security expenditures broadly defined, including obligatory private expenditures and voluntary expenditures. Japan's social expenditure (public and obligatory private) now exceeds that of Canada and is approaching Dutch levels. Moreover, Japan's social expenditure has more than doubled in three decades from 10.2% in 1980, a significantly higher rate than in the other countries. Although Japanese expenditures as a proportion of GDP for families, occupational training, unemployment, and the like are small, expenditures for pensions and healthcare have reached levels roughly equal to Sweden's.

Let's take a look at the size of social security through domestic statistics (National Institute of Population and Social Security Research). The total amount of social security benefits paid out in fiscal year 2010 reached approximately 104 trillion yen, of which pensions and medical care accounted for approximately one-half and three-tenths respectively. Between FY 1990 and 2010, the total

CHART 1

Social expenditure in major OECD countries (2009)



Source: Created using the OECD Social Expenditure Database

amount of benefits increased by 129%. Of this, the National Pension, public assistance, and Social Pension payments grew more quickly, by 296%, 158%, and 128% respectively.

A look at the financial sources of the benefit payments (FY 2010) shows that social insurance premiums accounted for 51.6% while general tax revenues at the national and local levels accounted for 35.7%, demonstrating that social insurance comprises the core of the Japanese social security system. However, there are major differences in the relative weight of social insurance premiums and general tax revenues depending on the type of the benefits. *Chart 2* shows in what proportion general tax revenues have been allocated to the various systems over the years. The proportion of general tax revenues has decreased for many benefits, but the shares of the Social Pension and the Elderly Healthcare (renamed from Late-term Elderly Medical Care) systems have been growing, to 21.1% and 14.9% respectively in FY 2010. The aging of the population is behind these changes. Nevertheless, the increase in the general tax revenues allocated to the Social Pension system (and the mutual aid pension system for national public service personnel), whose members are employed and relatively well-off, must not escape scrutiny.

Problems of the Pension System

The basic purpose of a pension system is to avoid poverty in old age. Let's take a look at the income distribution and social welfare of the elderly by OECD statistics.

A comparison of the ratio of the per capita income of people aged 65 or older to the per capita income of the population as a whole shows that while the disposable income of the elderly in the mid-2000s was about 70-90% of that of the younger population, the Japanese figure was 86.6% - higher than the United Kingdom at 72.9%, Sweden at 82.0%, and the OECD average at 82.6%. In other words, the elderly in Japan are relatively rich.

At the same time, a comparison of the proportion of the poor among people aged 65 or older using OECD statistics shows that Japan at 22% is on a par with the United States at 22.4 and significantly higher than the UK and Canada at 10.3% and 5.9% respectively. Comparing Gini coefficients, which indicate the level of inequality, for the elderly, it is high in Japan and the US, at 0.34 and 0.39 respectively, and low in Denmark, Sweden, and the Netherlands, at around 0.2 each, with Canada, France, Germany, and the UK in between.

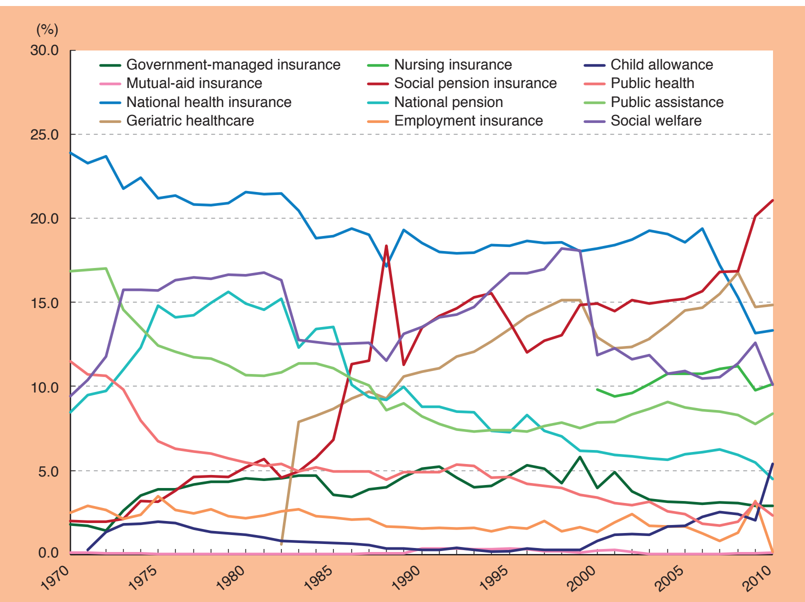
Let's clarify the relationship between these outcomes and pension expenditures. *Chart 3* shows the levels of public and private pension expenditures in OECD countries. The sums of public and private pension expenditures in Japan, France, Germany, and the US are each in the 10-13% range, but the poverty rates in Japan and the US are more than twice as high as that of either of the other two. The poverty rates in New Zealand, Canada, and Sweden are lower than 10% but pension expenditures are small. Although expenditures in the Japanese pension system are high, the poverty rate and Gini coefficient are high; from a poverty prevention perspective, the cost, relative to the benefits, is high. We will now consider why.

The Japanese public pension system has two fundamental problems. The first is the design of the basic pension system and its financial sources. The second is the relationship in the income-proportional part of the Social Pension system between the benefits and the burdens. Here, I will address the first problem in view of its particular urgency. The issues can be consolidated into the following three points.

First is the existence of multiple systems. The general perception of the Japanese public pension system is that it is a two-tier system with the National Pension as the first tier and a second-tier consisting of the Social Pension and mutual aid pension, with the private corporate pension as a third

CHART 2

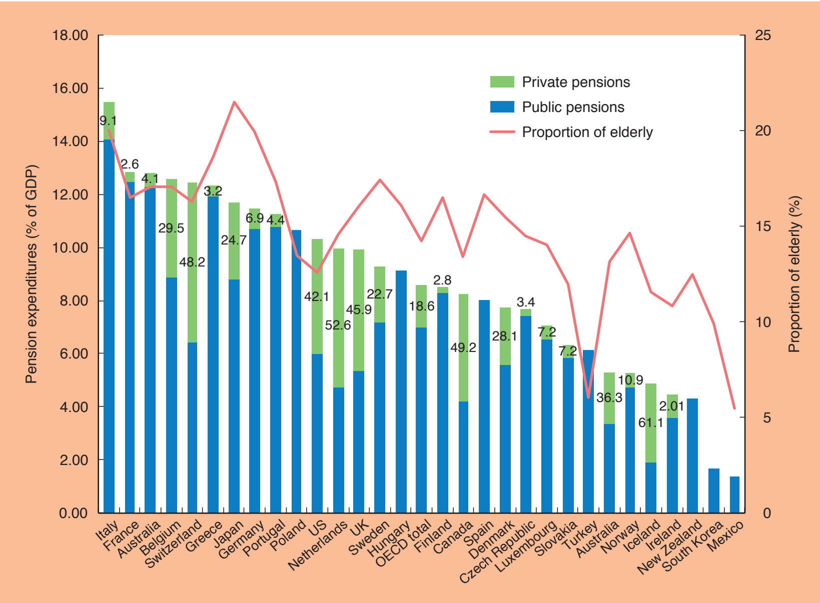
History of distribution of general tax revenues (national & local) to respective systems



Source: Created using annual editions of Shakai Hoshou Hiyou Toukei (The Cost of Social Security in Japan), National Institute of Population and Social Security Research

CHART 3

Pension expenditures & proportion of elderly in OECD countries (2007)



Note: Numbers in chart represent proportion of private pension expenditures (%).
Source: Created using Pension at a Glance (OECD, 2011)

tier. In reality, the three pension systems exist in parallel. The first tier is called a basic pension common to all the people. However, this system is not a "pension" but a fiscal adjustment system introduced in 1985 to avoid the financial collapse of the National Pension system, as it is a form of "insurance" where the insurance discipline of the link between premiums and benefits fails to operate, even lacking clarity about the premiums.

I stated that the basic pension is a fiscal adjustment system. The problem is in the calculation method. The cost of paying benefits under the basic pension is calculated by dividing the total amount of the benefits by the number of people covered by all the pension systems. However, for Item 1 insurees — i.e. people who are self-employed and part-time workers — the number of people who actually make payments is used for the calculation. Thus, as the number of people who fail to pay premiums under the National Pension system or to sign up in the first place rises, it is the salaried employees, who are the Social Pension and mutual aid pension members, who must bear the burden. As a result, the burden of salaried employees is about 20% higher than it would be if the costs were to be borne equally based on the total number of people covered. The problem is not with the fiscal adjustment *per se* but the fact that the basic pension is not one in which all the people share the burden according to their abilities, but is one in which the burden is borne unfairly.

Second, the basic pension is not a "universal pension". Specifically, this is an issue of the failure to pay and failure to enroll. As of March 31, 2012, some 3.29 million people, or 16.5% of the 19.04 million people eligible for the National Pension, had failed to join the system or pay premiums. Moreover, 5.68 million people were exempted from payment of all or part of their premiums, bringing the number of eligible people who paid none or only a part of the premiums to almost half (46.9%) of all the eligible people.

The dramatic changes in the employment structure are the backdrop to these problems. More than one-third of all workers are irregular staff and employees. The problem is that their incomes are low. Failure to pay premiums occurs because low-income people are also required in principle to pay a fixed premium of 15,000 yen per month (FY 2012). Although premium reduction/exemption has been introduced for low-income people, the fact that someone with an annual income of 3 million yen must still pay the same amount as someone with an annual income of 100 million is the cause of extreme regressivity *(Chart 4)*. Moreover, benefits will be reduced if premiums cannot be paid, but that is not the end of it; more people will just wind up receiving public assistance.

The third problem is the appropriation of general tax revenues and the unfairness of the burden-sharing. The general tax revenues being appropriated to meet basic pension benefits were raised from one-third of the benefits to half in FY 2009. The Ministry of Health, Labour and Welfare (MHLW) explains this by saying that it is necessary to raise the burden on the national treasury to half in order to contain the burden on the public and make the pension system sustainable. However, the "burden on the national treasury" is ultimately borne not by the state but by the public. Tax, premiums — regardless of the name, the people are the only ones who are there to bear the burden.

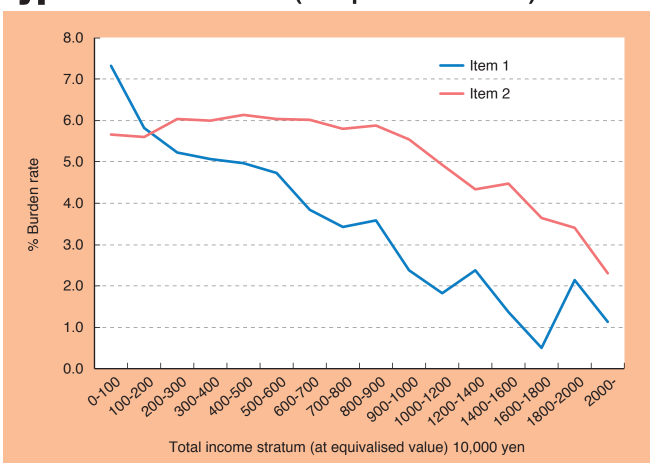
The problem is that the appropriation of general tax revenues is resulting in inefficiency and unfairness. For example, irregular workers have their benefits reduced or eliminated if they fail to pay Item 1 premiums but the consumption tax that they paid will be used among other things to pay basic pension benefits to high-income people.

Directions for Reform

Although "social insurance" is deemed to be at the heart of the Japanese social security system, this social insurance system itself is

CHART 4

Pension premium burden rates by type of insurees (at equivalised value)



Source: Calculated using the Comprehensive Survey of Living Conditions (2007) the cause of a variety of contradictions and unfairness against the background of a decreasing birthrate and aging population. The fundamental problem here is the fact that the social insurance system has drifted away from the original premise of being financed with premiums and has become an ambiguous system that sees a large amount of general tax revenues being appropriated to it.

This is not to deny the appropriation of any general tax revenues to the social insurance system. Some redistribution is admissible since it is a public insurance system.

Pensions have two functions; security for the kind of income earned while working (insurance principle), and security that is appropriate from an overall social perspective (redistribution principle). The former is "social insurance" and the latter is a "universal pension". The important thing here is that if the objective is a universal pension system, then the source of funds must be general tax revenues as a matter of logic; it cannot be achieved through a social insurance system.

So the question is how the basic pension system ought to be, with the unification of the multiple systems being the foremost challenge. As the mobility of employment rapidly increases and disparities grow, the basic pension system should have these socio-economic changes taken into consideration and be positioned as a social safety net, emphasizing its redistribution function.

However, there is the question of whether it is appropriate to finance basic pensions for high-income people with general tax revenues when public finances are in such dire straits. Means testing is one way to deal with this issue, but it is more efficient to raise taxes. The basic pension by itself does not ensure that old age is provided for; some self-help is required. Moreover, excepting the handicapped and others, it is normal to work during one's prime years and pay taxes, so this is not a mechanism that allows the collection of pension benefits free of charge. There is merely no specific link between the burden and the benefits. Canada has this kind of pension system.

In Canada, the first tier is the basic pension funded by tax revenues, the second tier is a public pension proportionate to income, and the third tier is the corporate or private pension. The basic pension is the equivalent of a little less than 50,000 yen and can be received by any resident of Canada. However, since people without the public pension proportionate to income cannot survive on the basic pension alone, there is a supplementary benefit paid to the elderly, the equivalent of the Japanese public aid. If the elderly have an income of more than approximately 6 million yen, a "recovery tax" reduces the basic pension, which for all practical purposes is cancelled as annual income rises over 10 million yen. Since middle- and high-income people cannot cover previous income through the first two tiers, the third tier is of importance to them. However, transitional measures are necessary to maintain fairness between the people who had faithfully paid the premiums, so the transition will take several dozen years.

On the other hand, if social insurance is to be considered appropriate from a self-help perspective, the first answer to unification is a social insurance system in which the basic pension is abolished and everyone joins the same system and bears a burden proportionate to their income. In this case, there will be no universal pension. The second answer is the Swedish system. Sweden used to have a two-tier — basic and income-proportional — pension. However, covering the first tier with general tax revenues was inefficient and there was an understanding that what was essentially a defined-benefit mechanism increased intergenerational unfairness. Thus, the two-tier system was abolished and replaced with an innovative defined-contribution method that directly links burden and benefits. A minimum guaranteed pension for low-income people that requires Swedish residency was introduced in order to maintain the universal pension.

Both proposals are attractive but have little feasibility given the current situation in Japan. The challenge is to consolidate the National Pension and other systems and collect premiums from salaried workers and the self-employed alike effectively under the same standards. The DPJ's minimum guaranteed pension follows the example of Sweden. However, there is little justification for a large pension system proportional to income in which everyone including the self-employed pays when pension finances are facing increasing difficulties. The number of people receiving the minimum guaranteed pension is expected to decrease in Sweden, but it will increase rapidly in Japan if it is introduced here.

Conclusion

The DPJ administration, with the cooperation of the LDP and New Komeito, implemented as part of the Comprehensive Reform of Social Security and Tax a consumption tax hike that will raise the rate to 10%. Although the DPJ failed to fully explain the tax hike, which had not been part of its 2009 election manifesto, it does deserve credit for undertaking a tax hike that previous administrations had kicked down the road. However, this merely goes to fill the revenue gap that is being created by the increase in social security expenditures. This was not truly a "Comprehensive Reform of Social Security and Tax", as it failed to address issues such as improving the efficiency of social security expenditures and reviewing the respective roles of taxes and premiums.

Japanese social security is a highly inefficient amalgam of insurance and tax. As a result, the social safety net is full of holes. This report deals with the pension system, but healthcare faces essentially the same challenges.

A correct prescription cannot be written unless the issues are understood properly. The fundamental basis of social security reform is to have the well-to-do bear a greater share of the burden. It is necessary to clarify the respective roles of the government and the private sector, with the government having responsibility for the social safety net while middle- and high-income people demonstrate self-help. Unless this kind of reform is undertaken, raising the consumption tax will end up being little more than spilling water on desert sands. The government emphasizes the intergenerational issue in the current reform, but it should provide us with data that shows whether or not the intergenerational unfairness will truly be mitigated. We must immediately stop passing the buck to future generations, for that is our responsibility, the responsibility of the current generation.

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