



Social security: Japan

Abstract

Japan has the oldest population in the world. The ratio of Japanese aged 65 and older to the working age population is 35 percent, compared with 25 percent for the EU15 and 20 percent for the United States. These demographics affect social security and public finances and are a drag on rates of economic growth. What is Japan doing, and what can aging countries learn? First, an aging society is a big fiscal burden, but it can be looked after by adjusting the system. Public pension spending in Japan is 10 percent of GDP, nearly 3 percentage points higher than the OECD average. But Japan still spends less than younger countries: for example, the ratios are much higher in France (13 percent), Greece (12 percent), and Germany (11 percent). The government has sought to modulate benefits to address its rising demographic burden, and the structure of the Japanese pension system has been adjusted several times: in 2004, for example, the government cut benefits for new retirees by 0.9 percent a year. Second, people need to work longer. Japan's system punishes early retirement with lower benefits, and encourages later retirement with the lowest implicit tax on working beyond retirement age. Third, the elderly can be protected by making public pensions progressive, with lower replacement ratios for high-income retirees. Growing social and health care spending will become even a greater burden with time, and the country already has large amounts of public debt, well exceeding 200 percent of GDP. Japan may need to do even more: female work participation could be much higher and Japan may need more immigrants.

Japan is the fastest aging nation in the world. It has a median age of 44 years, and life expectancy at birth close to 83 years. The ratio of Japanese aged 65 and older to the working age population is 36 percent, compared to about 25 percent for the EU15 and 21 for the United States. These demographics affect social security, public finances, and may be a drag on economic growth.

Growth and demographics

There are significant changes in Japan's GDP growth trajectory, especially after 2000, when accounting for demographics (figure 68). Basing on imputed growth rates net of a "demographic drag" in the 1990s, Japanese economic growth was less than US growth despite the correction. However, in the 2000s the imputed rates of growth are essentially the same (HSBC 2011).

Figure 68: GDP growth in Japan and the US, accounting for demographics, 1990–2009



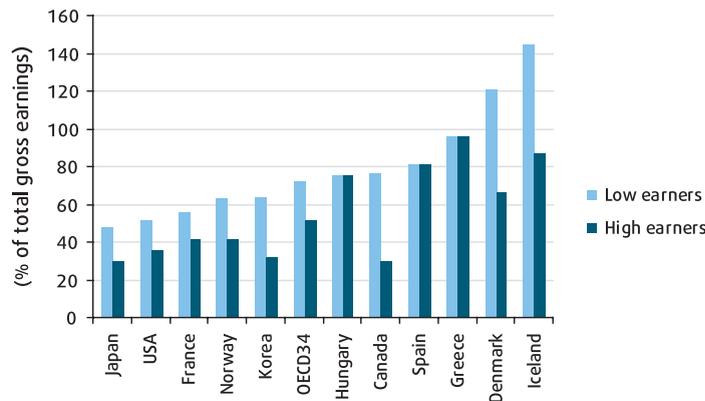
Source: HSBC (2011).

Japan is coping with the demographic drag partly by raising productivity and partly by increased labor force participation. In 2000–05, productivity grew on average by 1.3 percent. According to McKinsey (2011), an increase in productivity growth of 80 percent is needed just to sustain past GDP growth rates. The participation of Japanese women in the labor force has also gone up and amounted to 62.9 percent in 2009 (compared to the OECD weighted average of 61.3 percent). The pensionable age, currently set at 64 for men and 62 for women, will be raised gradually to 65 years for both sexes. But Japanese already work longer: the average effective age of labor market exit is 69.7 years for men and 67.3 for women, one of the highest in the world. The OECD estimates that around 75 percent of Japanese between 60 and 64 years are still working. By comparison, the ratio for US men is about 60 percent and around 20 percent for French men.

Pension problems

An aging society puts a substantial burden on pension system expenditures. Public pension spending in Japan amounted to 9.8 percent of GDP, nearly 3 percentage points higher than the OECD average and less than in some younger countries: for example, France (12.5 percent), Germany (11.4 percent), and Greece (11.9 percent). Limited public spending together with large amount of retirees has led to one of the lowest wage replacement rates in the industrialized world (figure 69). Moreover, the system is highly progressive, with lower the replacement ratios for high-income retirees.

Figure 69: Gross pension replacement rates for high and low earners, selected OECD countries¹



Source: OECD (2011).

Due to a rising demographic burden, the structure of the Japanese pension system has been adjusted several times. Currently, it consists of two principal elements: a basic, flat-rate scheme and an employee pension scheme. In order to be eligible for the basic pension plan, one has to contribute to the system for at least 25 years, and the full basic coverage is received after 40 years of contributions. The second element includes a flat-rate and earnings-related component; however, the flat-rate element for men will be withdrawn by 2013. Enterprises having 1,000 employees or more can partially contract out the earnings-related pension if they set up an employee's pension fund. These funds are obliged by law to meet minimum yield requirements every year. From 2001, the government has also been advocating defined-contribution pension



schemes as well as defined-benefit occupational pension schemes. In order to tame growing public expenditures, in 2004 the government cut benefits for new retirees by 0.9 percent a year.² The system punishes early retirement with lower benefits. Later retirement is encouraged with the lowest implicit tax on working beyond retirement age.

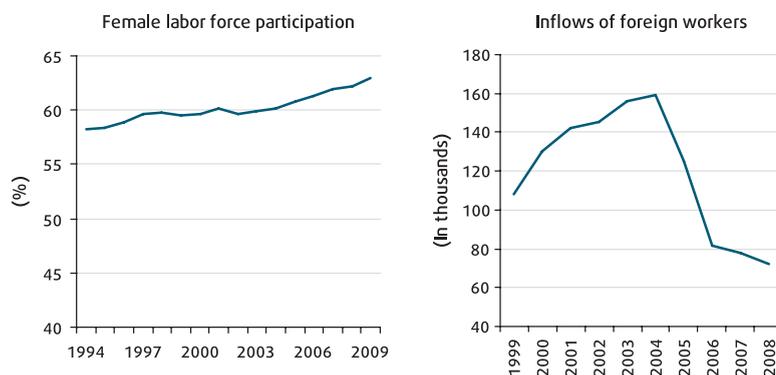
With ever longer life expectancies, expenditure on pensions will increase. The already high gross public debt was mainly accumulated due to stimulus spending during the past two decades and rose again because of countercyclical measures during the recession of 2008. In 2010 the debt amounted to around 220 percent of GDP, and the IMF forecasts that it will reach 250 percent of GDP by 2016. Growing social and health care spending will become even a greater burden with time. Ihuri et al. (2006) estimate that public health insurance benefits to GDP will grow by 1 percent every 10 years, reaching nearly 10 percent of GDP in 2050.

Dealing with the shortage

As the working population is forecasted to shrink further, Japan's pension system will rely on a smaller base of contributors. The dependency ratio of 2.6 remains much lower than anywhere else (OECD average: 4.0). According to the United Nations World Population Prospects, the share of the working-age population will fall in 2050 to around 50 percent, considerably below its 1950 level of 59 percent. Japan needs more workers and production to support the pensioners. Observers believe that this can best be achieved by a combination of three measures: raising productivity, increasing the participation of women in the labor force, and greater immigration.

From 2000 to 2005, annual average productivity rose by 1.3 percent, but it was insufficient to make up for workforce shortages. Women's participation in the workforce increased from 58.3 percent in 1994 to 62.9 percent in 2009 (figure 70). Although the participation of women in the workforce in Japan is higher than in other Asian countries, e.g., South Korea (53.9 percent), the gender wage gap of 31 percent remains the biggest among high-income countries.³ The differences are diminishing slowly; the gap in earnings has closed by only 4 percentage points since 1998.

Figure 70: Female labor participation, 1994–2009, and inflow of foreign workers to Japan, 1999–2008



Source: OECD.

The absolute number of foreign nationals entering Japan has been rising, amounting to around 8 million in 2008. Most of them seem to be tourists, as the actual stock of foreign workers has

declined substantially in the recent years (figure 70). In 2008, foreigners accounted for only 1.9 percent of population. Hayakawa (2010) estimates that around 900,000 foreigners were employed in Japan in 2010, 755 000 legally. Manabu and Oguro (2009) find that an inflow of 150,000 immigrants per year would be needed to improve the welfare of current and future pensioners.⁴ In 2009, legislation was adopted that allows the government to pay unemployed immigrants specified sums if they agree to go back to their country of origin after working for contracted periods. But the condition was that once they left, they would not be able to work in Japan again. Consequently, many stay in Japan illegally. For foreigners, the Japanese labor market remains one of the most difficult to enter. Workers are obliged to pass a language test that in 2010 only 3 out of 254 immigrants passed.

Japan is in a difficult position, with the combination of an aging society, sluggish growth, high public debt, and natural disasters. But it has managed to keep its expenditure on pensions relatively low. Karam et al. (2011) find the most effective solutions for aging societies involve raising the retirement age, and the Japanese already work much longer than their OECD counterparts. If recent developments are a reliable indicator of the reforms ahead, the country is more likely to focus on productivity growth and greater work participation among women. In the long run, however, the problems of aging will require more radical solutions than are currently being contemplated. Reforming social security systems will be more difficult as pensioners become even more politically influential. But if Japan tackles the problem of its aging population successfully, its experience will provide valuable lessons for other parts of the world.



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Notes

- 1 OECD34 consists of Australia, Austria, Belgium, Canada, Chile, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Mexico, Netherland, New Zealand, Norway, Poland, Portugal, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, United Kingdom, and United States.
- 2 The process will continue until 2023.
- 3 According to OECD methodology, the wage gap is unadjusted and calculated as the difference between median earnings of men and women relative to median earnings of men.
- 4 The estimation is based on an overlapping generations simulation model of 16 countries and regions.