Tax-Funding of Basic Pensions and the National Minimum Concept

By Kenichiro Naganuma
Social Development Research Group

1. The Welfare-Targeted Consumption Tax

As the result of an agreement reached between the Liberal Democratic Party and Liberal Party, the fiscal 1999 Budget Law stipulates that consumption tax revenue will be used exclusively to fund programs for the basic pension, long-term care, and medical care for the aged. This effectively frames the consumption tax as a welfare tax.

Reaction has been mixed; even those who welcome the new sense of direction criticize the initiative for being an incomplete solution. For instance, the Economic Strategy Council represents a widely accepted viewpoint in calling for a full shift to a tax-funded basic pension program. In this view, targeting consumption tax revenue for welfare programs, while only incrementally increasing the national treasury's burden in the basic pension program from one-third to one-half of the total, would have a limited effect due to the persisting problem of nonpayment and nonparticipation.

On this point, we need to distinguish between taxes that exclusively fund a particular purpose, and the welfare-targeted tax in the present case (Table 1).

Table 1 Comparison of Earmarked Tax and Welfare－Targeted Tax Schemes

Scheme	Description
Earmarked tax funding for basic pension	All tax revenue is allocated to the basic pension program. The basic pension is funded exclusive by the earmarked tax revenue (operated under the extraordinary budget).
Consumption tax funding for welfare purposes	Consumption tax revenue is allocated to welfare purposes (basic pension, long-term care, medical care for aged). Funding source for welfare programs is not limited to consumption tax revenue (operated under the ordinary budget).

If consumption tax revenue is targeted at funding the basic pension program so that the basic pension becomes funded exclusively by the consumption tax (meaning a complete shift to tax funding), we could solve the problem of nonpayment and nonparticipation, as well as the third-party problem (fair treatment of single income and double income households) and applicability to students.

However, under the new scheme, which will apply consumption tax revenue broadly to elderly welfare, while leaving insurance premiums to fund pensions, the only impact will be to reduce the rate of increase in future social security premiums, and the problem of nonparticipation and nonpayment will remain unresolved.

Stated differently, since the welfar targeting measure spreads the uses of consumption tax revenue to include long-term care and elderly medical care, it moves the basic pension program in the opposite direction from being fully tax funded.

Table 2 Tax Funding Sources and Their Characteristics

Scheme	Merit	Demerit
Ordinary funding (annual payments from ordinary budget)	No funding constraints Responsive to needs	Subject to budget cuts, means test Expenditure is rewarding
Extraordinary funding (earmarked tax from extraordinary budget)	Stable funding source Expenditure is not rewarding Tax rate is determined objectively	Funding source is constrained Tax system is inflexible Difficulty with funding *

＊Switching to a fully tax-funded method today would add ￥9 trillion to the present ￥5 trillion national treasury burden.

2. Diversity of Tax Funding Methods

Among the tax funding methods, the earmarked tax scheme is not necessarily a consensus choice. Tax funding schemes fall into two categories: funding from ordinary revenues, and from special revenues such as earmarked taxes. Each method has unique characteristics. (The new welfare-targeted tax scheme represents a compromise.)

Normally, a comparison of the two brings up the advantages and disadvantages shown in the following table. For a genuine earmarked tax, of course, the earmarked tax and premium rate approach each other. But in addition to this discussion of pro-forma funding, differences emerge in the specifics of pension system operation as well as in the accompanying political process.

In other words, the question is which is to be determined first — the pension benefit amount or funding source.

For designated funding sources — for example, an earmarked consumption tax — tax revenue is directly linked to consumption nationwide. But it would be unreasonable to calculate and set pension amounts based solely on the tax revenue. (Doing so would resemble defined benefit corporate pensions that allocate profits.) If we advocate a basic pension, the obvious place to start is to first determine what pension level is desirable.

However, the next problem that arises is that annual tax revenue will probably fluctuate and not match what is needed for pension funds.

The prevalent method in Europe and the U.S. is to carry some reserve funds and operate a pay-as-you-go system. From a policy standpoint, clear rules have to be set on how to adjust tax revenue with pension standards over the medium term.

On the other hand, in the case of ordinary funding sources, pension levels can be set freely within the scope of the ordinary budget.

This method is better suited for achieving desired pension levels. However, it also entails major problems involving as the stability of the system and reliability of policies.

Unfortunately, tax-funded welfare benefits have historically been prone to cutbacks due to the dictates of public finance. Benefits have been frozen, reduced, or eliminated, while eligibility requirements have been toughened by income limitations or a means test (an indicator of wealth).

While such occurrences are usually associated with Europe and the U.S., there have also been such cases in Japan involving child welfare benefits.[1] The present social insurance scheme assumes an approach in which benefits are commensurate to premiums. If we sweep away this framework — leaving aside the issue of how well it currently works — the question of how much to pay and to whom may become decided arbitrarily (or, positively stated, responsively and flexibly). There is significant doubt as to whether the public pension should be subjected to this mechanism.[2]

3. Basic Pension Benefits – Levels and Payment Method

While the above discussion has dealt mainly with funding, we now turn to the actual benefits. There are two issues here: how much to pay out (benefit levels of pensions), and how to pay out the benefits (eligibility requirements). These issues need to be discussed in light of the prevalent idea that the basic pension should ensure a national minimum standard of life for everyone.

The present (old age) basic pension level is explained as the level at which elderly persons can pay their basic consumption expenditures. This type of explanation is important since for self-employed persons, if the National Pension Fund portion is excluded, the amount corresponding to the basic pension is the actual public pension that they receive.

The basic pension system was added as a revision in 1985. It is an integral part of the public pension system, which was essentially designed to guarantee a fixed portion of one's pre-retirement income. Thus the basic pension is does not have its own independent criteria. The Employee's Pension plan, which exists for salaried workers, was (and still is) designed to provide financial security in retirement, it is of questionable merit to examine the basic pension removed from this context (and still is) designed to be a component of the Employees' Pension plan. Thus it would be inappropriate to study the basic pension independently on its own merits.[3]

With this in mind, when we consider the concept of a national minimum standard, the question immediately arises as to how the basic pension is related to the relief system under the National Assistance Act.

As Table 3 shows, there are many views on how to approach the basic pension. The view that the basic pension is meaningless unless it exceeds the relief allowance, while common, shows a lack of understanding of the relief program. The following points need special attention.

Table 3 Opinions Regarding Basic Pension Benefit Levels

Stance	Reasons
Pension should meet or exceed relief allowance	Public pension's role is to provide a better standard of retirement life than the subsistence level standard of relief allowance. If the pension benefit is equal to relief allowance, public will not have any incentive to support the system.
Pension should be less than relief allowance	Pension should be augmented with other income sources to achieve subsistence level. Pension level should be determined based on contributions, not subsistence standard.

First is whether we should identify a standard level of relief allowance for some model household, and compare that with the basic pension. However the standard level of relief allowance varies considerable across households. [4]

Second, while the relief allowance level is often cited as a minimum living standard, the relief allowance itself uses a relative standard called a market basket standard (which posits a basket of necessities for living) that fluctuates with the economy. It would be difficult to use something that fluctuates like this as a standard for the basic pension.

Third, benefit levels need to be discussed in connection with the issue of payment method and eligibility. This is elaborated below.

There are two alternatives for benefit payment method and eligibility: universal benefits which are uniform for everyone, and selective benefits targeted at those in need and as needed.

As Table 4 shows, while both alternatives have their advantages and disadvantages, the roles unique to the basic pension and relief allowance need clarification. (The relief allowance and basic pension cannot both be used to satisfy the national minimum. Explanations invoking safety nets and income redistribution schemes have yet to clarify how the basic pension would differ from minimum living standards.)

Table 4 Approaches to Basic Pension Payment

Stance	Reasons
Universal benefits	Basic pension should be evenly distributed to ensure a national minimum or safety net (with possible tax adjustments) Total expense increases due to cost of determining eligibility based on income/ wealth. Also, it becomes indistinguishable from relief allowance.
Selective benefits	Limited funds should be directed at people truly in need, as needed. Paying benefits to wealthy persons ignores national minimum and creates rich pensioners.

For example, selective benefits can become almost indistinguishable from relief allowances (the living assistance portion paid to elderly households), which are paid based on criteria such as a means test. On the other hand, universal benefits could be retrogressive in that they would distribute tax revenue to both rich and poor.

In any case, the concept of national minimum appears too vague to provide sufficient guidelines in designing the basic pension system. Further deliberation is necessary to produce more concrete guidelines.

Proponents of a tax-funded basic pension need to formulate a blueprint that shows its feasibility and specifically addresses the key issues. Likewise, those advocating the continuation of a premium-funded basic pension must not only identify the problems of tax funding, but show how in concrete terms how collection and other problems can be solved.

We must make sure that design improvements to the system are not merely superficial adjustments in public finances or clever fixes, but substantive reforms. They must address fundamental issues such as eligibility requirements (or benefit rights). Unless these points are clarified, there is a risk that the pension debate may regress and treat pension benefits not as a right but as a privilege.

4. Reconsidering the National Minimum

The above discussion inevitably leads us to reexamine the concept of national minimum. While our treatment is necessarily brief, a few points need to be made in this regard.[5]

First, the concept of national minimum has undergone change. When the term was first discussed in England, it referred mainly to an income guarantee pertaining to pensions. Medical care was fully covered and not subject to a minimum standard.

However, economic and social changes have significantly altered the risks of daily life such as risks associated with aging, changes in disease patterns, and long-term care. Growing uncertainties in all aspects of life including employment and the natural environment have produced a "risk society." [6]

Reexamination of the national minimum concept is warranted especially in light of the risk society. Needless to say, the basic pension must also be approached from a perspective broader than that of pensions.

Second, as the social security scheme diversifies and assumes new forms, it makes less sense to cast the government as the only participant in carrying out the national minimum. Rather than blindly following the traditional division of roles between the public and private sectors, we need to be open to more flexible schemes.[7]

Third, the conventional concept of national minimum emphasizes quantitative factors (for example pension benefit size). More attention must be paid to qualitative factors. This includes not only the quality of service (such as medical care and long-term care), but also such things as accessibility to benefits under the national minimum and distribution of information (such as notification of future pension benefits, procedure for becoming recipient, etc.).

The above issues pertaining to national minimum must be confronted directly, but not dogmatically. Most importantly, we must keep in mind the perspective of the people that will be affected. The following points also require that we take the same perspective.

5. Political Support for the Tax-Funded Method

In addition to the above considerations regarding system design, we must also consider the possibility that a tax-funded basic pension could effectively reduce the contribution that employers pay while increasing it for individuals and households.

The actual outcome is unclear because it depends on factors such as the labor allocation ratio (whether companies will compensate for reduced contributions by increasing wages) and response to the consumption tax (whether companies will pass on the consumption tax imposed on raw materials to customers).[8]

But in any case, it is clear that companies basically hold the initiative regarding the outcome. A declining corporate burden, along with lower corporate tax rates, may be consistent with trends in other industrialized countries. But in Japan's case, there is another consideration — the risk of resurgence in corporate capitalism.[9]

Many politicians are in favor of shifting to tax-funded basic pension. Due to the evolving political situation, it is possible that the tax-funded method could come into existence unexpectedly. Of course, such a development would not be welcome until adequate discussion has taken place and known problems are resolved.

Policy decisions should not be swerved by the simplistic argument that since the basic pension represents a national minimum standard of living, it should be supported by everyone through tax funding. Only after a thorough examination of policy implications, costs and benefits, and policy process dynamics can we begin the decision-making process.

Notes

1. Policymakers at the Ministry of Health and Welfare claim that a dilemma exists in their relationship with the Finance Ministry in that tax funding implies the need for a means test. Actually, this is simply the result of a policy decision.

2. In this regard, the political process involving the recent issuance of shopping coupons is instructive. When funds from the ordinary budget are used, a variety of external factors affect decisions on the value of coupons, eligible recipients, as well as whether the coupons will be issued in the first place.

3. The basic pension portion is treated as an independent unit from the unspoken premise that the present approach (that pensions are supposed to guarantee income at pre-retirement levels) will be changed. While this is compatible with the call to privatize the pension component that is proportional to income – which is an important alternative – it should be acknowledged in the deliberations if true.

4. According to the fiscal1999 budget, the old age basic pension pays ￥67,017 per month (￥134,000 per couple), while the relief allowance standard is ￥163,806 for a 3-person household in the Tokyo area (the allowance covers any deficiency after all other income sources are counted). However, the relief allowance standard can vary by tens of thousands

of yen by region, and there are also separate allowances for rent, education, medical care, occupation, etc.

5. For further information, see K. Naganuma, "Desired Social Security Reforms from the Public's Viewpoint," (English) *NLI Research*, May 1997; H. Yamamura and K. Naganuma, "The Dire Need to Reform the Pension and Medical Care Systems," (Japanese) in *2025-nen no Sekai to Nihon*, Toyo Keizai Shinposha, 1998.

6. See Ulrich Beck, *The Risk Society.*

7. Part of the debate is based on a quasi-market theory (separation of public finance role from that of provider). But dichotomies such as public/private and financing/provider appear to be inadequate.

8. With regard to transfer of cost to prices and its implications, see K. Naganuma, "Normative Evaluation of Living Risk and Insurance Prices," (Japanese) in *Legal Risk Management,* Japan Risk Management Association, 1999.

9. For recent trends in industrialized countries, see O. Tasaka, "The Medium to Long-term Perspective of Social Security (Part 1)," (Japanese), in *Shukan Shakai Hosh*o no. 2021, 1999.