Public pension

Estimate of Additional Funding Needed to Forego Macroeconomic Indexing of the Basic Pension

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The National (Basic) Pension faces key issues not only on the funding side—most recently regarding tax-based funding—but on the benefit side as well. We argue that the rationale for macroeconomic indexing of benefits is weak, and estimate that its removal would require additional funding of five trillion yen per year, the equivalent of a 2-percentage point increase in the consumption tax rate.

In a previous issue (December 2007, in Japanese), we discussed funding options for the Basic Pension, noting the recent debate on tax funding. Below we examine a controversial issue on the benefit side—the reduction of benefits under macroeconomic indexing.

Introduced in the 2004 pension reform, macroeconomic indexing aims to help stabilize public pension finances by adjusting benefits downward until 2023 based on the decline in participants supporting the system. In the near term, implementation is being delayed by special measures and the economy's failure to meet criteria in the 2004 public pension revision. But in the government's view, the measure is deemed critical to balancing public pension finances down the road.

When indexing takes effect, it will impact real benefits under the Employees' Pension Insurance (EPI) as well as National Pension (NP) in two ways. First, it will contain the growth of starting benefits, which are otherwise tied only to the wage growth rate. Second, until the phase-out in 2023, it will reduce ongoing benefits, which would otherwise be tied only to the inflation rate. As a result, benefits will remain below pre-index levels even after 2023 (Exhibit 1).

Exhibit 1　Monthly Benefit of Basic Pension—With and Without Macroeconomic Indexing

(1,000 yen)

Fiscal year / Year of birth	2004	2009	2014	2019	2024	2029	2034	2039	2044	2049
1939	66 (66)	64 (66)	61 (66)	58 (66)	57 (66)					
1944		66 (68)	63 (68)	60 (68)	58 (68)	58 (68)				
1949			65 (71)	62 (71)	60 (71)	60 (71)	60 (71)			
1954				65 (74)	63 (74)	63 (74)	63 (74)	63 (74)		
1959					66 (78)	66 (78)	66 (78)	66 (78)	66 (78)	
1964						70 (83)	70 (83)	70 (83)	70 (83)	70 (83)

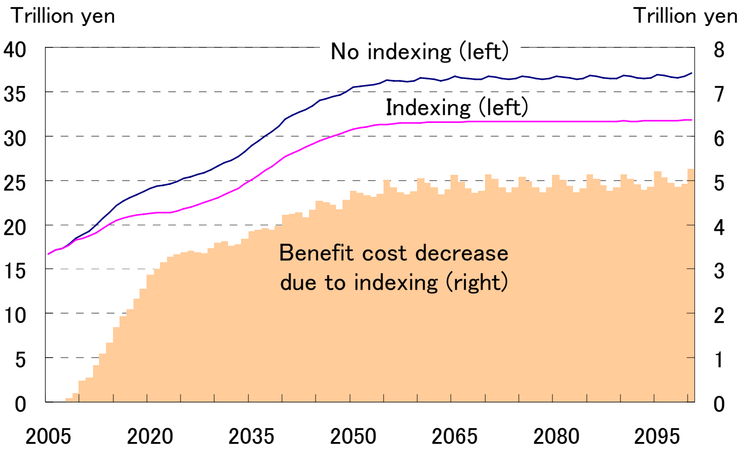
Notes: Shows full monthly benefit after macroeconomic indexing (top) and before (bottom, in parentheses). Based on assumptions used in the 2004 actuarial valuation. Adjusted for inflation (base year 2004).
Source: *Fiscal 2004 Financial Recalculation Results for the Employees' Pension and National Pension,* Actuarial Division, Pension Bureau, Ministry of Health, Labor and Welfare, p. 241. Benefit before indexing is calculated by the author.

Exhibit 1 compares real monthly benefits under two scenarios—the top number in each cell is the benefit after macroeconomic indexing, and the bottom number is the benefit before indexing. As noted above, starting benefits will decrease from they would otherwise be. For example, in 2029 (for persons born in 1964), the starting benefit with indexing is 70,000 yen, or approximately 15% below the 83,000-yen benefit without indexing. Ongoing benefits also decline during the adjustment period to 2023. In the most extreme case, the 2004 starting benefit of 66,000 yen (for 65-year old persons born in 1939) decreases 5% over the next two decades to 57,000 yen by 2024 (at age 85).

Originally, macroeconomic indexing was intended to reduce benefits of the National Pension for self-employed persons (which consists entirely of the Basic Pension) in the same proportion as the EPI for private sector employees (which consists of the Basic Pension and an earnings-related benefit). However, we believe that as far as the Basic Pension is concerned, macroeconomic indexing should be reconsidered in light of the Basic Pension's original concept as a bedrock of retirement savings, and the fact that it already fails to meet the minimum living standard (livelihood assistance allowance) in some regions and household types. In addition, at the time macroeconomic indexing was adopted, the current debate did not exist on tax funding of the Basic Pension and its separation from EPI. If these measures are realized, there is likely to be no need to further pursue linkages between the Basic Pension and earnings-related portion of the EPI.

To forego macroeconomic indexing of the Basic Pension, additional funding will obviously be needed. Under the government's macroeconomic indexing scenario, the Basic Pension benefit cost, which stood at 16 trillion yen in fiscal 2004, eventually levels off at 32 trillion yen (at 2004 prices). In our no-indexing scenario, using the same assumptions for growth in number of beneficiaries and length of pension participation, we estimate the benefit cost will level off at 37 trillion yen. Assuming current consumption tax conditions, the cost difference of five trillion yen is equivalent to a consumption tax rate hike of 2-percentage points.

Exhibit 2 Predicted Basic Pension Benefit Cost (at 2004 prices)



Note: Based on assumptions used in the fiscal 2004 actuarial valuation.
Source: Calculated using materials from Pension Actuarial Subcommittee, Social Security Council (September 1, 2005).

In the present debate on tax funding of the Basic Pension, the estimated consumption tax rate hike only considers the case of macroeconomic indexing. However, to ensure sustainability of the public pension system, we should expand the debate to include possible alternative cost growth scenarios, rationale behind macroeconomic indexing, and relationship between growth of wages, prices, and tax revenue.