Reform of the Income Tax and Public Pension Systems, and their Effect on Households

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1. Introduction

Japanese society is aging at an accelerating pace. Unfortunately,when Japan failed to pull itself out of the recession in the second half of the 1990s, the government focused on short-term policy measures to stimulate the economy and postponed the much-needed fundamental reform of tax and social security systems. While the economy finally started a gradual recovery in spring 1999, continued weakness in private sector demand leaves unchanged the priority for achieving a sustained recovery. But there is now evidence of a subtle change in policy-making. A report by the Government Tax Commission on tax reform for fiscal 2000 cited its basic principle as ensuring that reforms "do not hinder the fundamental overhaul of the tax system." Although "tax reform" was generally perceived to be synonymous with tax cuts in the past, it is evident that fundamental reform is now in the picture.

Against this backdrop, we review the details of income tax and public pension system reforms. In this paper, we concentrate on benefits and contribution burdens that are particularly relevant to households, analyze the short and long-term effects of reform, and discuss the direction of future reform measures.

Figure 1 Trends in Income Tax and Local Tax Reductions Since FY1994

	Form of tax cut, etc.	Temporary tax cut equivalent		Remarks
		Income tax cuts	Local tax cuts	
FY94	Temporary tax cuts (fixed-rate tax cuts)	20%, maximum ¥2 million	20%, maximum ¥200,000	
FY95	Permanent tax cuts and temporary tax cuts (fixed-rate tax cuts)	15%, maximum ¥50,000	15%, maximum ¥20,000	Tax burden about the same as previous year
FY96	Temporary tax cuts (fixed-rate tax cuts)	15%, maximum ¥50,000	15%, maximum ¥20,000	Tax burden about the same as previous year
FY97	Temporary tax cuts abolished			Consumption tax rate hike (from 3% to 5%)
FY98	Temporary tax cuts (fixed-amount tax cut)	¥38,000 per taxpayer, ¥19,000 per dependent	¥17,000 per taxpayer, ¥8,500 per dependent	
FY99	Permanent tax cut (including fixed-rate tax cut)	20%, maximum ¥250,000	15%, maximum ¥40,000	Cut in maximum tax rate (income tax and local tax)
FY00		20%, maximum ¥250,000	5%, maximum ¥40,000	Basically previous year's measures continued

Note: Although the FY99 fixed-rate tax cut is part of a "permanent tax cut," it is included in the temporary tax cut column for comparison purposes.
Source: Compiled from annual issues of Ministry of Finance, *Tax Reform Overview.*

2. Direction of the FY2000 Income Tax Reform

The fiscal 2000 tax reform overview contains many specific measures, but few comprehensive or universal measures. As a whole, it maintains “tax reduction” mode while keeping the transition to “neutral mode” in sight and preparing the groundwork for fundamental reform. There are no new measures for income tax, which gets the same treatment as in fiscal 1999. Abolition of the special child tax credit can be seen as a response to the increase in child allowance, and curbs generous payouts.

Figure 2 Maintenance of “Permanent Tax Cuts” in FY1999 (Income Tax Related)

Category	FY99 measure	Continued into FY2000?
Reduction of maximum tax rate	From 50% on taxable income over ¥30 million,to 37% on taxable income over ¥18 million	Yes
Increase in child tax credit (for dependents under 16)	From ¥380,000 to ¥480,000	No (was up to ¥380,000)
Increase in tax credit for older dependents (aged 16–22)	From ¥580,000 to ¥630,000	Yes
Fixed-rate tax cut	20% of overall tax, maximum ¥250,000	Yes

Source: MOF, *Fiscal 2000 Tax Reform Overview.*

(1) Income Tax and Local Tax Burden of Households in FY2000

The fiscal 1999 income tax cut, though called a permanent tax cut, is essentially a time-limited measure. The reduction in the maximum tax rate, increase in tax credit for dependents and special tax credit for older dependents, and fixed-rate income tax cut are all special measures based on a law applicable for a temporary period, “to be implemented while a fundamental review [of the tax system] is carried out.” Since the length of the temporary period has not been clearly specified, however, for now they can be considered permanent tax cuts.

Despite discontinuation of the special exemption for dependents in fiscal 2000, the tax burden on households will not increase significantly because fixed-rate tax cuts and other tax cut measures will remain in effect. The actual tax burden will decrease for households receiving the ¥60,000 per year child allowance (for the first and second child).

Figure 3 Tax and Social Security Burden of Single-Income Salaried Worker Households in 2000

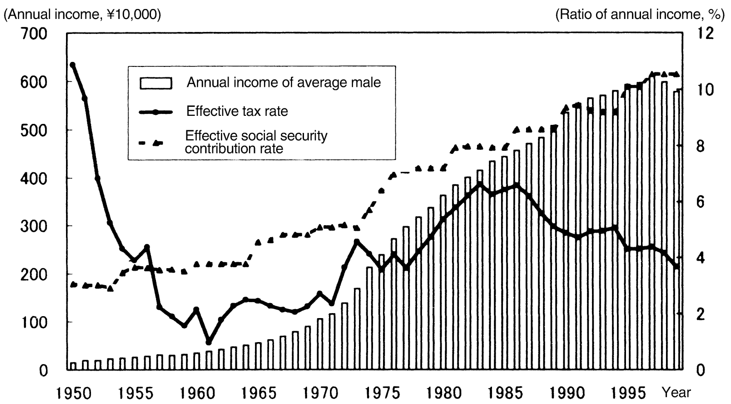
Salary income (¥10,000)	Social security contributions	Employees' Pension Insurance premiums	After fixed-rate tax cut is applied: Income tax	Local tax	Total tax	Difference in tax burden between 1999 and 2000
300	30.7	19.9	0.0	0.0	0.0	0.0
400	40.9	26.5	0.8	2.0	2.9	0.8
500	51.1	33.2	6.4	5.0	11.4	0.8
600	61.3	39.8	12.0	8.0	20.0	0.8
700	71.5	46.4	17.9	13.7	31.6	0.8
800	81.8	53.1	24.3	20.5	44.8	0.8
900	92.0	59.7	34.9	28.1	63.0	1.6
1000	98.5	62.7	48.2	36.4	84.7	1.6
1100	102.3	62.8	62.8	45.6	108.4	1.6
1200	106.0	62.9	77.4	54.7	132.1	1.6
1300	109.7	63.0	98.1	70.5	168.6	1.6
1400	113.4	63.2	115.9	82.3	198.3	2.0
1500	117.1	63.3	140.3	94.2	234.5	3.0

Note:
1) "Social security" denotes Employees' Pension Insurance, public health insurance, and unemployment insurance.
2) Local tax is calculated using standard tax rates.
3) The household consists of husband, wife, one child under 16, and one aged between 16–22.
Source: Author's estimate based on FY2000 tax treatment.

Social security is a larger burden than tax in terms of direct contribution. When groups are compared by annual income, those with an annual income of ¥8 million or less pay more in Employees' Pension Insurance premiums than in income tax and local (inhabitant) tax.

Trends in the tax burden of average income earners in the past 50 years show that the ratio of income tax and local tax to earned income (effective tax rate) peaked in the mid-1980s and has since continued a slow decline. Although part of this is offset by the consumption tax, it contrasts with the sustained increase in the ratio of social security contributions to earned income (effective social security contribution rate). Currently, the effective income and local tax rate is under 4%, compared with an effective social security contribution rate of over 10%.

Figure 4 Trends in Income Tax/Local Tax and Social Security Burdens



Note: Social security contributions consist of employee contributions to Employees' Pension Insurance, public health insurance, and unemployment insurance. Taxes are income tax and local tax payable by a single-income family of four.
Source: Annual income taken from Ministry of Labor, *Monthly Labor Statistics Survey.* Other figures are estimated based on each year's tax and social security systems.

The average annual income in 1999 was approximately ¥5.8 million, or 38 times higher than 50 years ago. The effective income and local tax rates have been kept relatively low even under the progressive tax system by design in the MOF's annual tax reforms. There was a period after the first oil shock until the mid-1980s when effective tax rates increased, but this is because the authorities refrained from tax cuts while nominal income rose due to inflation, i.e., the government succeeded in increasing tax revenue by an "inflation tax." Including this period, tax authorities have always tried to ensure that the effective household tax burden is neither too large or small.

(2) Direction of Fundamental Review of Tax System

How will the income tax system change from fiscal 2001 onward? Since the current "tax reduction mode" is intended to shore up the economy, it is likely to return to "neutral mode" when the economy has recovered to a certain point. But in view of the economic slowdown caused in fiscal 1997 by the simultaneous abolition of tax cuts, increase in social security contribution rate, and consumption tax rate hike, the government is likely to start slow by abolishing the time-limited, "special treatment" tax cut measure.

Special measures are temporary, lasting until fundamental reform actually takes place. Even then, however, income tax rates are unlikely to be raised because as the population ages, it becomes increasingly important to maintain economic and social vitality by rewarding productive, hard workers. The tax system will be a crucial part of the incentive system.

Thus, the basic requirement of reform is a comprehensive review of all taxes that apply to individuals – the consumption tax, taxes on assets as well as income tax – to ensure that specific groups of individuals are not overtaxed, and that there is not too much emphasis on income tax. The trend that started in the mid-1980s of relaxing the progressive tax structure is expected to continue, and reliance on the more broadly based consumption tax will probably increase. The range of taxable income may also be widened by reducing tax-exempt income.

However, a social system compatible with the aging population cannot be achieved through taxation alone. Considering the already hefty burden of public pension contributions for many households, the role of the consumption tax needs to be re-evaluated, along with that of the public pension and social security system as a whole.

With regard to the public pension system, whose finances are recalculated every five years, a new law was enacted in the spring of 2000.

3. Details of Public Pension System Reform and Their Short-Term Effects

Unlike taxes, since public pensions pay out benefits in proportion to contributions, the actual burden needs to be discussed in terms of contribution-to-benefit ratio. The subject is complicated by the fact that the contributions and benefits are paid at different times, and that the benefit provided by the system can change. Moreover, the rules governing the system are not applied equally to all generations. These issues need to be considered when discussing the details of pension reform and how to tackle remaining problems.

(1) Main Points of Reform

The latest reform is derived from the five broad options proposed by the Ministry of Health and Welfare (MHW) in December 1997 and subsequent debate. Its basic structure is based on "Proposal C" which had the most public support in opinion polls, and incorporates a 20% reduction in total payout and keeping final insurance contributions below 20% of annual income.

However, since the proposal emphasized that contributions would be unchanged for the time being to support current economic growth, the true purpose of the proposal – that contributions increase in stages, but the increase would be smaller than if the present system were to continue – has been obscured.

That issue aside, there are six key points to pension reform: (1) basic rates of calculation are changed, (2) pension contributions and benefits are calculated based on total earned income (including bonuses), (3) the sliding benefits scale is changed, (4) earnings related benefits are cut 5%, (5) eligibility age for the earnings related benefit is raised, and (6) a separate pension system for working senior citizens aged 65–69 is introduced. All these will contribute to strengthening the financial base for National Pension and Employees' Pension schemes.

Figure 5 Summary of the "Five Options"

Proposal	Concept	Benefit	Final contribution
A	Maintain current benefit structure	Maintain same benefit levels as FY94 reform	34.3% of monthly income (26.43% of annual income, including bonuses)
B	Keep Employees' Pension Insurance premiums below 30% of monthly income	10% cut in total benefit	30% of monthly income (23% of annual income, including bonuses)
C	Keep Employees' Pension Insurance premiums below 20% of annual income	20% cut in total benefit	20% of annual income, including bonuses (26% of monthly income)
D	Maintain Employees' Pension Insurance premiums at current levels	40% cut in total benefit	20% of monthly income (15% of annual income, including bonuses)
E	Abolish Employees' Pension Insurance Scheme	Retain basic pension only and abolish Employees' Pension Insurance Scheme	

Source: MHW, "Five Options."

(1) Change in basic rates for calculation – Interest, wage growth, and inflation rate assumptions used in formulating a long-term plan for pension finances will be changed to reflect recent economic conditions. The interest rate has been reduced from 5.5% to 4%, the wage growth rate from 4.0% to 2.5%, and inflation rate from 2.0% to 1.5%. However, the structure of the formula, in which the interest rate is 1.5% higher than the wage growth rate, remains unchanged.

(2) Total annual earned income as the basis for pension calculations – The “standard pay” on which Employees Pension Insurance premiums and benefit calculations are based will change from “wages excluding bonuses” to “wages including bonuses” (total annual earned income). Thus the same monthly contribution rate will be applied to bonuses, and benefits will also reflect the bonus part of contributions. Under the current system, individuals with the same annual income may have different contributions and benefits due to the size of the bonus. The new system based on total annual earned income is designed so that people with the same annual income pay the same contributions and receive the same benefits. However, since simply applying the monthly contribution rate to bonuses will increase the annual burden, contribution rates and benefit rates are reduced on the assumption that bonuses are equivalent to 3.6 months’ salary, so that the average person will see no actual difference in contribution and benefit amounts. Thus most people will not be affected by this measure.

(3) Change in sliding scale for benefits – When a person reaches pension age, after the initial basic pension benefit and earnings related benefit have been determined, the sliding scale for benefits will switch from after-tax income growth to inflation adjustments. This measure will curb the increase in pension benefits. However, after fiscal 1999, a net wage sliding scale reflecting the after-tax income growth rate will continue to apply when the pension benefit amount is first determined.

(4) 5% cut in earnings-related benefit – A 5% reduction in the benefit multiplier decreases the earnings related benefit by 5%. Thus a person to whom a multiplier of 7.5/1000 applies under the current system will have a new rate of 7.125/1000 (or 5.481/1000 on a total earnings basis) after the reform.

(5) Raising age of eligibility for earnings-related benefits – The age at which pensioners can receive earnings related benefit proportional to pay will be raised in stages from the current 60 to 65. Men born in 1961 or later and women born in 1966 or later will receive this portion of their pension benefit from the age of 65. Figure 6 below shows the age at which men and women will begin receiving their pension benefits (including the fixed portion), according to their dates of birth.

(6) Introduction of working pension system for senior citizens aged 65–70 – The pension benefit of senior citizens aged 65–70 in employment will be reduced according to their wage levels.

Figure 6 Phased Plan to Postpone Eligibility Age for Benefits (Men)

Year (FY)	FY94 reform Basic benefit		FY99 reform Eamings related benefit	
	Eligibility age	Year of birth	Eligibility age	Year of birth
2000	60	1940	60	1940
2001			60	1941
2002	61	1941	60	1942
2003	61	1942	60	1943
2004			60	1944
2005	62	1943	60	1945
2006	62	1944	60	1946
2007			60	1947
2008	63	1945	60	1948
2009	63	1946	60	1949
2010			60	1950
2011	64	1947	60	1951
2012	64	1948	60	1952
2013				
2014	65	1949	61	1953
2015	65	1950	61	1954
2016	65	1951		
2017	65	1952	62	1955
2018	65	1953	62	1956
2019	65	1954		
2020	65	1955	63	1957
2021	65	1956	63	1958
2022	65	1957		
2023	65	1958	64	1959
2024	65	1959	64	1960
2025	65	1960		
2026	65	1961	65	1961
2027	65	1962	65	1962
2028	65	1963	65	1963
2029	65	1964	65	1964
2030	65	1965	65	1965

Notes: (1) Arrows denote phase-in period
(2) Five-year delay for women

(2) Effect on Benefit Amount

The above reforms will help contain total benefit payments and stabilize pension system finances as a whole, but the reforms will not affect all individuals equally. Unfortunately, official data on the effects of pension reform on people categorized by date of birth have not been made public.

A simple calculation confirms that the effects will be relatively minor on persons expecting to receive pensions in the near future. The reduction in benefit multiplier on the earnings related benefit is scheduled for April 2000. A pensioner who earned an average income of ¥340,000 during his years of employment and paid in contributions for 40 years will only see a ¥5,000 per month reduction in benefit. Those who will not receive benefits until age 65 belong to a much younger generation. The change in the sliding scale for benefits is also planned for April 2000, but with wage increase and inflation rates close to zero, the measure will have minimal impact.

How will younger generations be affected in the years ahead? This should be a key point of debate, since they must shoulder the burden of the pension system in the coming years.

4. “Generation Gap” in Lifetime Benefits and Contributions

It is generally accepted that one of the main problems of the public pension system is that younger generations must contribute more while receiving less. Will this “generation gap” close in the wake of the latest reforms? Will the sense of inequality perceived by younger generations be rectified?

The author made estimates of lifetime pension contributions and benefits for average income earners by year of birth, on the assumption that the contribution rate will be fixed for the next five years before increasing gradually until 2024, and that the government contribution rate remains unchanged. The results are as follows.

First, the older the person, the higher the benefit in relation to contribution. This feature is no different from the former system.

Second, the post-reform benefit-to-contribution ratio falls for all ages. The generations that received benefits in excess of lifetime contributions (including company contributions) are those born before 1965 under the current system, but only those born before 1955 after the reforms.

Third, as a proportion of lifetime wages, the “generation gap” is greater for contributions rather than benefits. Also, generations born after 1970 will make net contributions (contributions – benefits) in excess of the current effective income tax and local tax (which is almost 4%).

The high benefit-to-contribution ratio enjoyed by older generations is supported by a heavier burden on younger generations, causing an income transfer from younger to older generations. It is reasonable in theory for income to be transferred from generations with higher lifetime wages to those with lower lifetime wages, but the problem lies in the fact that today’s younger generation can no longer expect robust economic growth as in the past.

How should we view the government’s decision to leave contribution rates unchanged so as to minimize any negative effect on the current economy, and in particular to maintain household disposable income levels? If this measure is secured by a future increase in contributions, younger generations will suffer later on.

The failure of reforms to address the dissatisfaction of younger generations is a troubling sign. A system not fully supported by later generations will not relieve the anxieties of the older generations.

In addition to the "generation gap," there are also unresolved issues within generations, such as disparities between single-income and double-income households, and between high and low income earners.

5. Intergenerational Transfers and Same-Generation Disparities

As seen from the estimates for average wage earners, lifetime benefits can exceed contributions for persons born before 1955. However, this changes if we look at different income groups within a generation. For wage earners earning 30% above the average for their generation, the breakeven year is 1950; conversely, for wage earners earning 30% below average, the breakeven year is 1960.

Thus the balance of contributions and benefits under the public pension system varies not only from generation to generation, but depends on whether a person's wages are above or below the average for his generation. That is, even people in the same generation are affected differently. The system can thus potentially expand or contract wage disparities between workers.

It is possible to measure the effect on income disparities by comparing lifetime wages alone before the public pension system is applied, with the lifetime disposable income levels (wages – personal contribution + benefit) for average, above average, and below average wage earners of the same generation.

A study of the above figures based on year of birth shows that for the generation born before 1955, disparities for lifetime disposable income are greater than those for lifetime wages alone. In other words, the pension system widens the initial income gap within the generation, i.e., it is structured to make the rich even better off. Under the former system before the reforms, since same-generation income disparity widened among those born before 1965, reforms have partially rectified the income gap within the generation. The problem remains, however, that the growing income gap within the generation is based on the transfer of income from younger to older generations.

6. What Is Required in Future Reforms

Thus while public pension reforms contain significant changes to stabilize the financial base of the pension system, they have failed to address the problem of income disparities within the same generation and between generations.

Also, questions still remain such as when the government contribution to the basic pension will increase from one-third to one-half, and how this should be funded. Social security contribution levels will change according to whether or not the government contribution to the basic pension is raised. Although several contribution estimates have been calculated based on different government contribution figures, there has been no direct attempt at decision-making, as in the "Five Options."

To ensure that the public pension system works smoothly, it is essential not only to stabilize the financial base, but also to gain the acceptance and trust of as many people as possible. Considering that the generation gap is especially marked in the area of contributions, it is critical to increase government contributions and find ways to finance this increase. Since the general direction of government policy is to increase government contributions to one-half by 2004, the subject urgently needs to be reviewed.

The most promising way to fund the additional government pension contribution is the consumption tax (VAT). The tax has several advantages. First, it can be collected from both employed workers and pensioners. Second, since lifetime consumption is linked to lifetime income, people with high consumption levels (i.e., with a high lifetime income) – both employed and pensioners – can be expected to pay more. Third, the burden is thus more widely distributed than social security contributions, which are primarily paid by working generations whose population is expected to decline in the coming years. Also, the upper income limit in the contribution scale makes the burden relatively small for high income earners. If government contributions funded by the consumption tax were to take over a part of social security contributions paid by workers, disparities between generations could be rectified to a considerable extent.

Of course, the consumption tax is not without its problems – it is regressive with respect to after-tax income, and is a subtraction-method VAT that is easy to evade or delay payment to the central government – and could stifle government finances if earmarked for welfare funding. Debate is urgently needed on reforming the tax and social security systems, including the use of the consumption tax. Time is running out when we consider that the postwar generation will reach retirement age in 2005. We thus look forward to progress in the Government Tax Commission's interim report scheduled for July.

Figure 7 Lifetime Contributions and Benefits After Pension Reform (average single-income household)

Year of birth:	1930	35	40	45	50	55	60	65	70	75	80	85	90	95
① Lifetime contrib. / wage (%)	7.0	8.1	9.1	10.1	11.1	12.4	14.0	15.6	17.1	18.4	19.5	20.4	21.0	21.4
① Lifetime benefit / wage (%)	35.1	25.9	19.6	15.5	13.9	12.9	12.4	12.4	12.4	12.5	12.6	12.5	12.5	12.1
Lifetime (contrib. - ben) / wage (%) (① - ②)	-28.2	-17.9	-10.4	-5.4	-2.8	-0.5	1.5	3.2	4.7	5.9	6.9	7.8	8.5	9.3
Lifetime benefit / contrib. (multiple)	5.0	3.2	2.1	1.5	1.3	1.0	0.9	0.8	0.7	0.7	0.6	0.6	0.6	0.6
- Under former system -	5.8	3.8	2.6	1.8	1.5	1.3	1.1	1.0	0.9	0.8	0.8	0.7	0.7	0.7

Note: Discounted present values for 1999 are calculated assuming 4% interest rate, 2.5% wage growth rate, and 1.5% inflation rate.

Figure 8 Effect of Public Pension on Same–Generation Income Disparity (¥ million)

Year of birth	1930	35	40	45	50	55	60	65	70	75	80	85	90	95
① Wage disparity														
30% below avg. - Avg. household	-55.0	-65.2	-73.6	-77.8	-78.1	-75.4	-70.7	-65.8	-60.9	-56.0	-51.9	-48.3	-44. 9	-41.8
30% above avg. - Avg. household	55.0	65.2	73.6	77.8	78.1	75.4	70.7	65.8	60.9	56.0	51.9	48.3	44.9	41.8
② Disposable income disparity (wage & net benefits)														
30% below avg. - Avg. household	-62.9	-71.5	-77.9	-80.7	-80.0	-76.0	-70.2	-64.6	-59.3	-54.3	-50.0	-46.3	-42. 9	-39.7
30% above avg. - Avg. household	62.9	71.5	77.9	80.7	80.0	76.0	70.2	64.6	59.3	54.3	50.0	46.3	42.9	39.7
③ Pensions' effect on disparity (② - ①)														
30% below avg. - Avg. household	7.9	6.3	4.3	2.8	1.9	0.6	-0.5	-1.2	-1.5	-1.8	-1.9	-2.0	-2.0	-2.1
30% above avg. - Avg. household	7.9	6.3	4.3	2.9	1.9	5.8	-5.0	-1.2	-1.5	-1.8	-1.9	-2.0	-2.0	-2.1
- Effect under former system -														
30% below avg. - Avg. household	9.6	8.0	6.2	4.4	3.1	2.1	1.2	3.9	-3.1	-8.3	-1.2	-1.5	-1.6	-1.7
30% above avg. - Avg. household	9.6	8.0	6.2	4.4	3.1	2.1	1.2	3.9	-3.1	-8.3	-1.2	-1.5	-1.6	-1.7

Note: Discounted present values for 1999 are calculated using a 4% discount rate.
For ③, negative value indicates reduction in disparity.