J. Japanese Int. Economies 38 (2015) 111–126

Contents lists available at ScienceDirect

Journal of The Japanese and International Economies

journal homepage: www.elsevier.com/locate/jjie

Pension reform and individual retirement accounts in Japan

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ARTICLE INFO

Article history:
Received 17 April 2015
Revised 20 June 2015
Available online 6 July 2015

JEL classification:
H55
H60
J11
J32

Keywords:
Pension reform
Individual retirement account
Aging demographics
Japanese economy

ABSTRACT

Kitao, Sagiri—Pension reform and individual retirement accounts in Japan

The paper studies effects of introducing individual retirement accounts (IRA) as an alternative to the employer-based pay-as-you-go public pension in Japan. Without any reform, projected demographic transition implies a massive increase in government expenditures in the magnitude of 40% of total consumption at the peak. Gradually shifting earnings-related part of pension towards self-financed IRA, expenditures can be reduced by 20% of consumption, providing a major relief for the government budget. The reform generates a significant rise in capital, as individuals save more for retirement, which is invested for many years. As a result, wage, output and consumption are also higher, leading to a sizeable welfare gain in the intermediate and long-run. Current generations, however, can face a large welfare loss depending on how the transition is financed. *J. Japanese Int. Economies* **38** (2015) 111–126. Hunter College and Graduate Center, City University of New York, United States; Keio University, Tokyo, Japan.
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1. Introduction

Japan will face a significant rise in government expenditures as it will go through rapid demographic aging during coming decades. The dependency ratio will reach an unprecedented level

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http://dx.doi.org/10.1016/j.jjie.2015.06.002
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of 85% in mid 2050s and stays above 80% until after the end of the century.[1] Research has found that a major increase in taxation is inevitable unless there is reform on age-related transfer system, in particular public pension and health insurance programs.[2]

Kitao (2015) shows that demographic transition financed by consumption taxes will require the tax rate to reach 48% in 2080s without any reform. Hansen and Imrohoroglu (2013) estimate fiscal adjustments of 30–40% of consumption are needed to deal with rising expenditures. Braun and Joines (2015) also show that a consumption tax increase of a similar range is necessary without major reform of pension and health insurance programs. Such high taxes on consumption are most likely unrealistic and politically infeasible, although they represent the magnitude of the fiscal problem that Japan has to deal with, one way or another.

Could the government handle rising expenditures through an alternative source of funding other than consumption taxes? Kitao (2015) shows that using labor income tax would be extremely distortionary, shrinking labor supply that would be already scarce. İmrohoroğlu et al. (forthcoming) show that the government debt would explode and quickly become uncontrollable if the transition is financed by borrowing. Studies also suggest that a new growth path such as that advocated under the "Abenomics" strategy would not be enough to achieve fiscal sustainability alone and more aggressive reforms are needed.[3]

These results suggest that it is inevitable to implement a policy to reduce expenditures. In this paper we explore a system of individual retirement accounts ("IRA"), in which individuals, or employers on behalf of employees, are required to contribute a given fraction of their earnings to a retirement account. The contribution to the account is set aside from regular assets which individuals are free to use for consumption or saving. The balance in the account is invested in capital and used in production. Once an individual reaches a set retirement age, the balance in his account is paid out and can be used for consumption and saving in the same way as regular assets.

We introduce a simple IRA system described above and set the contribution amount, which will be equivalent to and replace the premium that an employee currently pays for employer-based pension system (*kosei nenkin*). At the same time, we gradually reduce and eventually eliminate part of pension benefits that is based on past earnings. The tax on labor income is reduced by the same amount as the IRA contribution rate so that the net earnings will be the same in the benchmark economy and in the economy with the IRA. The idea is to initiate a transition from the pay-as-you-go pension system to a retirement system that relies on individuals' own savings and investment while keeping constant the rate of contribution imposed on earnings.[4]

We find that the shift can slash the rise in consumption taxes due to the demographic transition by almost 20 percentage points at the peak, generating a significant relief for the government budget. The largest change in the aggregate economy induced by the policy is in the level of capital. In the benchmark economy, due to a sharp decline in population and demographic aging, capital will start to decline rapidly after 2030s and will fall by more than 50% by the end of the century compared to the level in 2010. With the IRA, capital will not begin to decline until 2050 and will be close to the 2010 level at the very end of the century. The major difference from the pay-as-you-go pension system that drives the result is that contribution collected for the retirement system is invested and used as

[1] The dependency ratio is defined as the ratio of the population aged 65 and above to those at age 20–64. The number is based on the projection of the National Institute of Population and Social Security Research (IPSS).

[2] Current fiscal issues in Japan and various reform proposals to restore the fiscal balance are discussed and summarized in Fiscal System Council (2014b,a).

[3] See, for example, Arai and Ueda (2013) and Miyazawa and Yamada (forthcoming) on the growth strategy. There are other quantitative studies focused on the fiscal consolidation and social security reform options, such as Ueda et al. (2014) and Kashiwase et al. (2012). These studies simulate the path of government budget assuming exogenous paths of economic variables, such as the wage rate, per-capita social security expenditures, consumption and output. Our paper differs in that individuals take the path of factor prices and policies as given and make the optimal life-cycle decisions, which in turn endogenously determine the path of aggregate variables and required fiscal parameters in general equilibrium.

[4] Of course there are many alternative ways to introduce the IRA. Papers such as İmrohoroğlu et al. (1998), Kitao (2010), Nishiyama (2011) and Ho (2014) build a dynamic general equilibrium model to study effects of tax-deferred retirement saving account, that approximates 401(k) plans in the context of the U.S. economy. The IRA considered in this paper is different in that the contribution is mandatory, rather than optional and that there is no tax deduction or early withdrawal options.

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