The Principles of Public Pension Insurance That Should be Taught to Young People: From the Perspective of Their Future Lives

＜Executive Summary＞

1. The Principles of the Pension Insurance System (Chapters 1–3)

(i) Public pension insurance is "insurance against longevity risks"; it is not an installment savings scheme or a savings-oriented financial product.

• What the government provides the public with under the public pension insurance system is *insurance*, not an *installment savings scheme* or a *savings-oriented financial product*.

As the name implies, *insurance* should be designed to assume risks of some sort and cope with them. The risks pension insurance is designed to cope with are "longevity risks." How can longevity constitute a risk? The longer people live, the more money they need to cover their living expenses. Senior citizens who do not work to receive income can be left out in the cold unless they have enough savings.

• Let us imagine a married couple of two only children in a society without a pension system. They and their four parents (two couples) will live to the age of 100 after retiring at age 70, and the annual living expenses for each couple will be ¥3 million. None of the four parents have savings. This couple is burdened with the following expenses:

Living expenses for this couple: ¥3 million/year × 30 (years) = ¥90 million

Living expenses for the couples' parents: ¥3 million/year × 2 (couples) × 30 (years) = ¥180 million

The younger couple needs a total of ¥270 million in retirement savings. Such longevity risks are unmanageable.

The hard fact is that behind longevity, which might be described as the biggest blessing for humans, lies the challenge of securing resources to live while being unable to work because of old age.

The problem is that you *will never know* beforehand how long you, your parents, and the parents of your spouse will live. This is one of the largest uncertainties in life. It is often the case that you *cannot cope with* such longevity. The average working couple cannot afford to support themselves and their four parents until they reach the age of 100. *Not knowing* and *(perhaps) being unable to cope with this constitute anxiety*. This is where public pension *insurance*, which is *nonrefundable*, comes into play.

• This *insurance* is a scheme whereby:
both people who will live long and those who will not pay contributions (premiums), and
the contributions from the latter are used to support the former (nonrefundable),

in order to allow you or your parents to secure resources to live if you live long lives.

Under this scheme, the burden on the individual is limited to paying his or her contributions when they are in active service, which significantly increases the predictability of such a burden, reducing *anxiety,* or conversely, increasing *assurance*. This is bound to happen as a matter of *principle*.

(ii) The phenomenon dubbed "generational inequality" and the phenomenon of an aging population with a declining birthrate are two sides of the same coin.

• The phenomenon dubbed "generational inequality" is explained based on "generational accounting," which accounts for the money flow between the public and the government under the pension system for different generations for comparison. This accounting does not constitute a new discovery; it only describes the phenomenon that more senior citizens and fewer children are resulting in a smaller productive population and a smaller national income, from a different perspective, using money flow.

• Generational accounting leaves much to be desired. Above all, it does not take into account the fact that insurance brings about assurance. Therefore, generational accounting fails to serve as a profit-and-loss statement for individual pension subscribers.

• Generational accounting assumes that the average individual in each generation dies at the average age of life expectancy, excluding longevity risks. It handles the public pension insurance system as if it were an installment savings scheme and compares the earning rates of such "savings" for different generations. The generational gaps thus identified are used to demonstrate the existence of "generational inequality."
The analogy with an installment savings scheme without taking longevity risks into account hampers the proper understanding that public pension insurance is insurance by definition; it serves as a hotbed for meaningless discussion surrounding "generational inequality."

• The expression "generational inequality" is *harmful* in that it is resulting in young people who are on a weaker economic base and more vulnerable to longevity risks distancing themselves from the insurance function of the pension system.

(iii) The burden of supporting the elderly under the pension system is measured by the amount of benefits paid, not by the amount of contributions collected.

• First, the "burden" on the working population is defined as the "reduction in consumption to support retired seniors," in order words, "a reduction in living standards for the working population."

• Under a pension system involving reserves, the burden should be measured by the amount of benefits, not by the amount of contributions, in two phases: (i) the phase in which contributions continue to exceed benefits (the pension balance in cash flow is in the black), accumulating reserves; and (ii) the phase in which benefits exceed contributions (the pension balance in cash flow is in the red), breaking into reserves. Suppose, for example, that benefits total 100 units whereas contributions total 120 units and that the difference of 20 units becomes a reserve fund at the hand of the government. What will become of the difference?

The answer depends on the fiscal system. Under the Japanese system, the reserve fund generated as the difference between the contributions (premiums) and the benefits under public pension insurance are used to purchase government bonds or invest in stocks. If the reserve fund is diverted to government bond purchase, the need for the public to buy government bonds to cover fiscal spending will decrease accordingly. If it is diverted to stock purchases to cover corporate investment, the need for the savings of the public to be spend to buy stocks will decrease accordingly. In other words, a part of the savings the public needs to build up to sustain national economic activity is achieved in the form of a reserve fund (20 units).

In sum, the real burden on the working population is represented by benefits (100 units), not by contributions (120 units). This is because the consumption of the elderly increases by the amount equal to 100 units in benefits—the amount affecting the consumption of the working population.

If you see things only within the scope of the pension system, you will likely "misinterpret the burden of supporting the elderly."

- In the case where benefits exceed contributions, the gap is filled by breaking into the reserves, or more precisely, by selling off working assets.

A sell-off is a transaction, which entails a buyer. The seller is the government whereas the buyer is the public. Who among the public? It must be the working population, who save part of their income.

If the working population are to be the buyer, they have to reduce their consumption to save. They thus shoulder the *burden* in the form of *a reduction in the consumption of the working population to support the elderly*, in other words, *a reduction in living standards for the working population.*

The act of breaking into reserves (selling off working assets) represents the process of making the working population slash their consumption, which in turn reduces demand for goods and services, and thus generating funds to finance the consumption of goods and services by the elderly. This proves wrong in the argument to the effect: "In the face of an aging population with a declining birthrate, the Japanese economy will shrink, making it impossible to sustain the pension system with the pay-as-you-go system; it will be all right, however, to adopt the funded system and secure large reserve funds accordingly."

(iv) The funded system does not provide a solution to the phenomenon dubbed "generational inequality."

- As the burden is measured by benefits, the mere adoption of the funded system will not change the burden on younger generations. Thus the funded system will not resolve the phenomenon dubbed "generational inequality."

- If reserves are to be broken into, national income must be large enough at that point in time. This proves wrong in the argument that a funded system should be adopted because of concerns about the pay-as-you-go system as national income is expected to dwindle. When national income shrinks (when the radius of the pie chart representing national income decreases), there is no way of maintaining the living standards for both the working population and the elderly.

- A "generation-specific" funded system will effectively divide the pension system among generations and shatter the rule of mutual help among generations. Under this system, each generation will receive benefits solely from the aggregate of premiums it has paid and earnings gained by managing such reserves as assets, with no transfers between generations. Even if the birth rate of the next generations declines, the ratio between the amount of premiums collected and the amount of benefits paid for the generation in question will remain unchanged. Within the scope of the pension system, the phenomenon dubbed "generational inequality" will not occur. The fact remains, however, that when the government breaks into reserves, even a generation-specific funded system will give rise to a burden in the form of a reduction in the consumption of the working population.

(v) The pay-as-you-go system is so designed that it will be changed whenever appropriate in the future based on the ideas that there is no predicting the future. It cannot be a "system whose financial standing is assured for 100 years" as the government reportedly once claimed that the system is "*100 nen anshin*," assured for 100 years.

- The pay-as-you-go system is intrinsically dynamic; it constantly changes according to the changing size of the "demographic pie" or the pie of national income, just as a ship goes up and down in line with the water surface. National income that supports future senior citizens will be generated in the future. As there is no knowing about the future now, the only option is to adapt the pension system to the situation at each point in time in the future.

This is a highly stressful process indeed. Everyone wants the *assurance* of *post-retirement security*. It is our hope that the pension system can, if designed successfully, fulfill that desire and that such system design is possible. However, the financial sustainability of the pension system primarily depends on the balance among the level of national income (the size of the "pie" or the contribution base), the number of senior citizens, and the level of living standards the government intends to assure for the elderly. Unfortunately, it is impossible to make accurate projections about national income or demography from several years from now.

• The Japanese word *anshin* generally has a connotation that "it is all right now" or that "there is no need to change anything." Thus the expression *"100 nen anshin"* or "100-year assurance" gives the false impression, completely inconsistent with the essence of the pay-as-you-go system, that it will continue to change flexibly in response to changes in demographic and economic aspects in the future.

The realities of the system are a far cry from what the expression "100-year assurance" suggests. Every time such realities came to light, the public became more convinced that what the government had told them was false. As a result, more and more people came to believe that the government hid the inconvenient truth and papered over the realities, and even that to believe what the government says is to bring about disaster. Along these lines, the public distrust of the pension system must have deepened.

The pay-as-you-go pension system is in constant need of change. The public needs to be ready for any such change. Why was the expression "100-year assurance" coined? If the intention was to give the public fleeting peace of mind, it was indeed a grave mistake in that it has distorted public understanding of the pension system and squandered the finite time and energy of the public.

• The process of identifying problems associated with the expression "100-year assurance" has highlighted the bothersome nature of the pay-as-you-go system. The need for constant change to accommodate the changing situation means that the government and the public need to reach a transgenerational consensus as often as necessary. Every time such an occasion arises, tremendous energy is required for a transgenerational consensus. This gives rise to the desire to "reform the system 'fundamentally' once and for all."

This desire paves the way for the slogan "fundamental reform of the pension system." This slogan sounds daring and cool. However, as far as the pay-as-you-go system—which is designed to constantly adapt to the unforeseeable changes in the environment surrounding the pension system—is concerned, there are no such magic remedies as "one-time fundamental reform" or a "cure-all that makes things better for all." This constitutes a trap into which the "argument for fundamental reform" tends to fall.

• The available energy that Japanese society has for policy debate may be rather limited. In that case, if the limited energy is wasted on the relatively unproductive debate over fundamental pension reform, little energy is left to discuss not only health care and long-term care issues stemming from the root problem of an aging population with a declining birthrate but also structural reforms aimed at increasing the size of the national income pie—the central issue to be addressed to fundamentally solve many of the problems with social security. (It is worth adding that social security is just one of the major challenges facing Japan.)

Now is the time to get out of the framework characterized by meaningless discussion and an incessant exchange of views and instead concentrate national energy on the effort to steer the nation toward a better course.

2. Challenges Facing Media Reporting on the Pension System and What It Offered to the Public (Chapter 4)

- Media reporting on the pension system has difficulties of its own. Amid growing public distrust of the government in general, such difficulties seemingly prompted the media to choose the easy way in its reporting on the amendment of the National Pension Act in 2004, effectively contributing to increasing public distrust of the pension system in particular. It seems that many reporters and journalists thought that the pension system would not be financially viable any longer without fundamental reform. They criticized the government amendment draft, citing such reasons as "it will not address the problem that many fail to pay pension premiums" and "it is based on overoptimistic economic assumptions."

- The media toned down its criticism in its reporting on the 2014 review of the economic assumptions and finances. The government came up with eight scenarios, ranging from an overoptimistic one to a quite pessimistic one. The stereotypical media criticism that the economic assumptions are overoptimistic somewhat dissipated. Media criticism of the wide-ranging assumptions (the argument that the government should take responsibility for charting the course of action) was not so conspicuous.

In contrast, the media showed much interest in the investment yields of reserves as economic assumptions were discussed in line with the ongoing reform of the Government Pension Investment Fund (GPIF), which was part of the growth strategy of the Abe Cabinet.

Media attention, however, focused on *nominal yields,* which is of little relevance to the soundness or sustainability of pension finances; little attention was paid to the yield spread in relation to income.

The special commission that discussed the economic assumptions released a report that included some descriptions that the GPIF may have already determined the direction for changing its basic portfolio. However, the media generally failed to pay them the attention they deserved.

3. How to Educate Young People about the Pension System (Chapter 5)

- A review of high school textbooks on civics shows that their descriptions of the pension and social security systems have a number of characteristics:

(i) Textbooks explain that pension is part of social insurance.
(ii) Textbooks explain in detail about the *institutional* aspect of the pension system.
(iii) Many of the textbooks state that Japan's social security systems face a number of challenges. Some of the textbooks refer to "generational inequality" and "fundamental reform" of the pension system.

- Explanations about the pension system for high school students and the public at large put weight on the institutional aspect of the system. This involves the risk of disregarding the essence of the pay-as-you-go pension system, that is, its quality of providing "insurance against longevity risks."

Young people have a long way to go before reaching their retirement age. In explaining the pension system to them, it may be more effective to focus on a nearer future, specifically, on longevity risks for their parents and the parents of their spouses as part of the discussion on how to support them. Explaining that the pension system provides insurance against longevity risks may constitute the first step toward improving their pension literacy and dispelling their distrust of the system.