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Defined Contribution Plan Reform Proposal for Japan

- Enhancing private pension systems -

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In 2019, Japanese citizens began to demonstrate an understanding that they would be responsible for ensuring they would have enough savings to be able to retire. A growing anxiety regarding future sufficiency of funds had slowly begun to drive this shift in sentiment. However, from the government's point of view, this shift resulted from society generally moving in the right direction, without the aid of new tax breaks or financial stimulus.

Unfortunately, despite this shift in awareness, the system and mechanism necessary to save funds for retirement is underdeveloped in Japan. The limit on contributions to defined contribution pension plans is 1/10th the size that it is in the United States. Additionally, there are many similar but smaller plan types that serve same purpose, including as Tsumitate NISA and Zaikei Nenkin, which are difficult to understand for the average person. To offer a simple metaphor, consider a pitcher who has an incredible variety of pitches, but there is currently no single catcher available because there are too many candidates for the position and no individual seems to stand out.

Indeed, as overseas research on private pensions is progressing behind the scenes to improve the retirement savings system, full-scale discussions on the system should begin this summer. 2020 will be an important year for us to discuss the ideal private pension system for Japan from the perspective of the people. The people have the will, determination and basic knowledge to start talking about this topic and so the time is ripe. This paper aims to facilitate and contribute to that important discussion.

Some background information on defined contribution (DC) plans in Japan:

- Japanese DC plans became available in October 2001 under the Defined Contribution Plan Act.
- There are two types of DC plans in Japan --- employer-sponsored and individual.
- Originally, in an employer-sponsored plan, only the employer could make contributions (no employee contributions were permitted). In the individual DC plan, only individuals could make contributions. However, this distinction has become vague over the years.
- DC contribution limits are restrictive and equal to tax beneficial limit, i.e. no after-tax contribution limits are allowed. This has not changed at all although there have been many minor revisions to the system.

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Special thank you for the English version:

Jenilee Pudas: Introduction, Preface, Chapter 1 & 5
Richard Edgar: Chapter 2
Raji Menon: Chapter 3
Lesley Greenfield: Chapter 4 & 6
Nick Dougal: Conclusion & Appendix
Overall review: David Collins

Preface

Private pension is the key to relieving people's anxiety about their old age

In a society where the birthrate is declining and the population is aging, an increasing number of people are arguing that the current pay-as-you-go public pension system alone is insufficient for preparing for retirement. It is also a challenge to incorporate the previously proposed accumulation method into the public pension system. Why? Because the current working generation will experience difficulty bearing both the pay-as-you-go system and the accumulation system.

The sustainability of Japan's public pension system is ensured through fiscal adjustment based on the Japanese *Macroeconomic Slide*[1]. However, if the level of benefits is constrained by the macroeconomic slide, there will be a shortfall. While social welfare and public assistance systems are intended to be maintained, if there is a portion that cannot be covered by the public pension system, this shortfall must be covered by the private pension system.

Private pensions are not compulsory like public pensions, but instead are a bit random and autonomous. However, if individuals begin to believe that the solution to the shortfall is through private pension systems, then they are by nature more inclined to learn about what they need to prepare for their own old age at some stage in their life. Likewise, they will also be more driven to take actions in order to “help oneself.” While this report will touch upon the need of retirement/investment education in Chapter 6, the main theme of our discussion focuses on building/improving systems for retirement.

At present, Japan is not well equipped for private pensions. There are some available, but none of them are widely used, and the large variety of them, to be completely honest, confuses the public. The ones that are best known are iDeCo (individual-type defined contribution plan) and Tsumitate NISA, both of which have low contribution limits and unique sets of rules. This makes it difficult to use these systems, and as a result, supply-side financial institutions cannot make a profit by offering them. Therefore, these industries do not grow, which is also associated with the lack of education on asset formation.

Currently, few life insurance companies are actively selling individual annuity products due to the impact of low interest rates. Products that guarantee a certain yield (in other words, pension payments) are risky for insurers.

1. “Macroeconomic Slide” is terminology adopted by the Japanese government. To offer a short explanation on what this is, social security pension benefits (public pension benefits) in many countries increase as CPI and/or wages increase in order to maintain purchasing power. However, in 2004, Japan decided against increasing benefits 100% in line with price/wage increases and instead chose less than 100% depending on macroeconomic factors. In this sense the Japanese government would be able to manage the costs of the system to be more sustainable by adjusting the “Macroeconomic Slide.”

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They are also reluctant to sell these products because they offer a level of return that doesn't make sense to guarantee. Most of the products on sale are in sets with death benefits or Tontine-type pension products that benefit from long life. As a result, these days, individual annuity products do not function as a vehicle for providing retirement funds.

Corporate pension plans are different from individual pension plans

Previously, I used the term “private pension,” but this term must be handled with caution. The term private pension is important only in the sense that it is not a public pension. It is important to understand that corporate pension plans (occupational pensions) and individual pensions are quite different in nature and therefore not interchangeable.

Corporate pension plans and individual pension plans have different financial sources. This is a crucial difference. The direct objectives (aside from the ultimate goal of both) differ accordingly. Employers introduce and maintain corporate pension plans as a means of implementing their own HR and financial strategies. On the other hand, the purpose of the individual pension plan is to prepare for the retirement of the individual and/or his/her family. Knowing this, it is important to keep in mind that companies and individuals are separate economic entities and distinct decision makers.

What kind of corporate pension plans will companies adopt? This important HR strategy governs the cycle of how employees are attracted, retained, and in some cases released. It is also deeply related to the company's cash management strategy and its accounting of debt and cost management. These management strategies allow for companies to compete domestically and internationally and survive far into the future.

On the other hand, the act of an individual preparing for his or her old age is a very personal but irreplaceable act that the individual performs for himself/herself or his/her family.

Therefore, rather than lumping them all together as private pensions, it is necessary to consider corporate pensions from the perspective of maintaining the flexibility and competitiveness of corporate economic activities, and individual pensions from the perspective of social policy, including retirement preparation and consideration of income disparities

The contribution limit is not equal to the tax benefit limit

The argument that both corporate and individual pension plans should be treated as private pension plans seems to have begun with the subject of tax breaks. However, I think it would be better to begin from a different perspective. In Japan, for example, it is said that "contribution limits for defined contribution pension plans = the tax benefit limit."

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But from a global viewpoint, this is by no means a standard rule. As will be discussed later, in countries with well-established schemes, limits on contributions and benefits are managed separately from tax breaks.

If taxes are the initial and primary driver of these discussions, the system will only remain the patchwork that we see today. At this stage, it is advisable to set aside the subject of taxes for now and instead consider the true nature of the system from the perspective of social security and industrial policy. After considering these two key inputs, if we fold in the perspective of tax policy to try to achieve overall harmony within a proposed system, we may find a way to make some headway.

There is a learning opportunity in observing overseas cases

Observing the systems utilized by other nations can give us a good bellwether in order to judge and improve our own system. With this, we will seek to introduce some of the best examples globally. Instead of saying "This is Japan. Japan has its own unique circumstances," it is important to incorporate knowledge gained from overseas cases and decide whether it is an appropriate fit for Japan.

Considering all of this background, it is time to begin our main discussion, focused on defined contribution plans (hereinafter referred to as "DC" as appropriate).

Chapter 1 Problem Awareness

"What is the problem with DC in Japan?" is a fairly commonplace topic. Although I won't go into detail, in order to provide an abridged background on DC, please review the following bullet points.

■ From the employer's standpoint (concerning Corporate DC)

- The contribution limit is low (the maximum limit is 660,000 yen, approximately US$6,000, per individual per annum although the limit varies depending on several conditions) → unable to fully migrate from DB[2]→ continue to be exposed to inherent risks of DB (interest rate, asset management risk, and longevity risk in the case of lifetime annuities) → unfavorable in international competition (in the U.K. and U.S., the transition to DC is progressing, and in Asia, DC is the standard.)
- Also, since the contribution limit is low → unable to fully migrate from DB → incompatible with HR strategy in an era of job mobility.
- No withdrawal until age 60 → difficult to use as retirement allowance.

■ From the individual's standpoint (Corporate DC: Looking at it as a retirement benefit plan)

- The contribution limit is low → not completely transferred from DB → employees' vested pension rights are left up to the fate of the company with the DB plan, which can be risky in an era where companies are engaged in intense international competition. (On the other hand, in DC, even if the company disappears, the account balance is retained by the individual and the protection of the right to receive benefits is quite strong).
- Also, since the contribution limit is low → not completely transferred from DB → greater length of service results in more funds retained in an individual's DB plan, so it is disadvantageous to change jobs.

■ From the individual's standpoint (Individual-type DC: A self-help system)

- The contribution limit is low → it is difficult to utilize it as the main retirement reserve system.
- You are not allowed to withdraw funds until the age of 60 → it is difficult to use as one must attempt to provide for various life milestones.
- There is no incentive for people without taxable income to use the system.
- Even if you have taxable income, it is difficult to understand the benefits of income deduction.

[2] Defined benefit corporate pension plan (DBCPP) and Employee Pension Fund (EPF).

From an industry standpoint

- The contribution limit is low → the balance of assets does not increase, so it is not a worthwhile business investment to build out → the vendors will not maintain their fiduciary duty and are incentivized to charge high fees to the participants who are not educated enough to make a wise decision.
- Also, the contribution limit is low → the balance of assets does not increase, so it is not a worthwhile business investment to build out → since this business does not grow, there is no incentive to improve services like investment education → payments go to participants who cannot enjoy service standards that would be available to participants in other countries.
- The contribution limit is low → past DC reforms were all about tinkering with rules within a narrow frame → mass production of complicated and bizarre rules → DC, which was supposed to be known for its simplicity and transparency, became "very difficult.“
- Also, the contribution limit is low → past DC reforms were all about tinkering with rules within a narrow framework → repetition of nonessential system development → generation of enormous social costs.

Many of the starting points of the problems here are attributable to "a low contribution limit," which is at the heart of Japan's DC issues. There are also challenges with regulation that prohibit withdrawals until the age of 60 and incentives in place as a system of self-saving for retirement efforts.

Chapter 2 Setting the DB + DC common framework

■ Japan's contribution limit to defined contribution plans is low

As pointed out in the previous chapter, Japan's DC contribution limit is low[3]. I have been consulting on the design of corporate pension systems for a long time, and in introducing DC plans, almost every case has presented difficulties. In switching from a previous DB plan to a new DC plan, employers try to maintain benefit levels (for example, if the existing DB provides benefits of 25 million yen in a lump-sum value at the age of 60, employers want to design DC employer-contribution rates so that participants would accumulate somewhere around 25 million yen in their DC accounts at the age of 60). However, due to low DC contribution limits, it is difficult to provide sufficient employer contributions and, as a result, there is a gap. The issue of how to fill that gap arising from the low contribution limit almost always arises. A major point in designing the system has been whether the shortfall should be paid in cash, or whether it should be covered by a lump-sum retirement allowance, or whether it should be accepted as an unfortunate side effect of the rule. Company managers have to make their decisions based on accounting, cash flow, HR fairness, and the cost of administrating the scheme, all of which present problems for the management. As for the low limit, I provide reference material at the end of this paper, with analysis. It also shows Japan's DC contribution limit is lower than that of other countries.

The DB premium is calculated based on several actuarial assumptions, but unlike DC there is no upper limit, and all the amounts determined to be necessary can be contributed and all of them can be included in deductible expenses.

So why have DC contribution limits been set so low? The answer lies in the tax breaks they precipitate. Raising the DC limit theoretically means a corresponding decrease in tax revenue, which Japan, with the largest budget deficit among developed countries (in relation to GDP), cannot afford. That ought to apply to DB as well, but DC schemes are the only target here. For the past 20 years, since the schemes were introduced, that has led to an unfair environment for companies which have chosen the DC path, and ultimately, their employees

■ Increasing the contribution limit for corporate DC plans does not necessarily lead to a decrease in tax revenues

Does raising the DC contribution limit really bring about a decrease in tax revenues? This is the assumption, but is it true? There have been three increases in corporate DC funding limits so far, in 2004, 2010, and 2014. Did the contribution to pension systems increase each time, and the amount included in deductible expenses grow, resulting in a decrease in tax revenue?

[3] Currently it is 660,000 yen (approximately USD 6,000) per person per annum (55,000 yen per month), if an individual has no other corporate pension plan (DB), and 330,000 yen (approximately USD 3,000) per person per annum (27,500 yen per month), if they have access to a corporate pension plan.

Why should this be? We expect any decrease in tax revenue following an increase in the allowances for DC to be matched by a fall in the deductible DB contributions made by employers. They will aim to maintain the same level of retirement benefits for employees. There should be no net change in tax revenues. Unfortunately, the Japanese government has not disclosed statistics on this, or they may not have analyzed these figures yet.

However, they could do so quite easily by comparing the sum of the DB premiums and the corporate DC premiums ("total premium for DB + DC") of the year before the increase in the contribution limit against the "total premium for DB + DC" of the year when the limit was increased. If there is no change – and no significant cut to the government's revenues from taxes – then that would remove one significant objection to the changes.

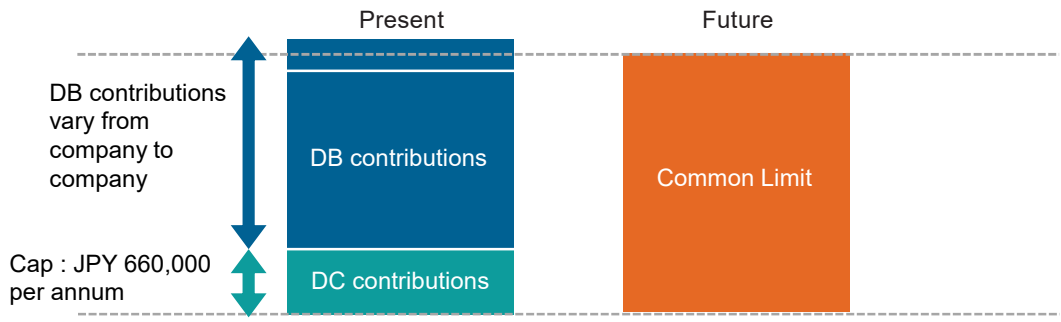
■ Setting the DB + DC common framework

Another approach proposes setting a common tax benefit for each person, regardless of whether it is a corporate pension or an individual pension, and regardless of whether the corporate pension is a DB or a DC, so that the benefit can be used freely within that limit. As will be described later, this is an extreme case of prioritizing the tax benefit, but I understand that it is being proposed as a way of breaking through the current situation.

(It helps to understand this argument by considering who benefits: private pensions may be funded by employers and individuals, but the benefits are received by individuals. Therefore, the discussion of the common framework should be viewed from an individual's point of view).

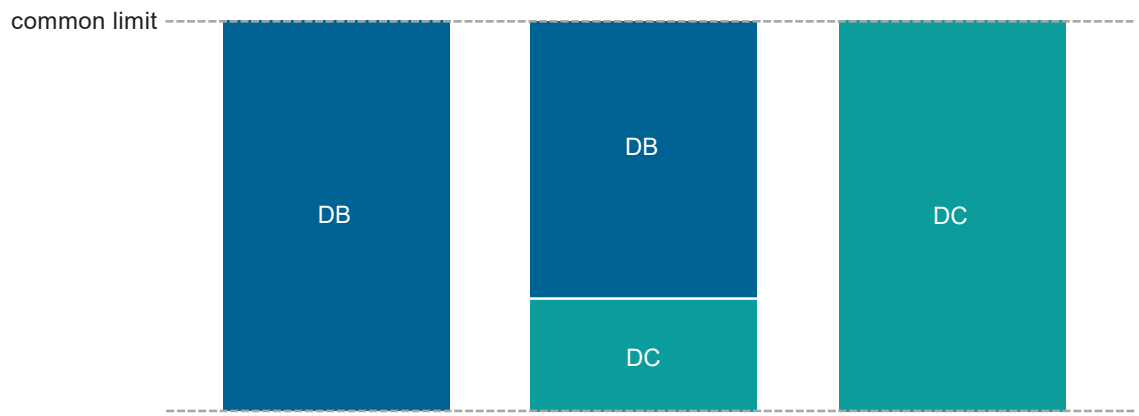
Figure 1 shows an image of the DB + DC common framework. As shown on the left, while the maximum amount of contribution for DC is 660,000 yen (or 330,000 yen) per person per year, the amount of contribution for DB varies from company to company. The image on the right sets a cap for DC and DB contributions.

Figure 1: DB + DC Common Framework Image



The amounts chosen can vary, as shown in Figure 2, below. The employer could choose 100% DB on the left, 100% DC on the right or a combination of DB and DC in the middle. For example, existing employees could follow the current pattern on the left or the middle, while new hires could follow the pattern on the right.

Figure 2: DB and DC Combined Limit Image

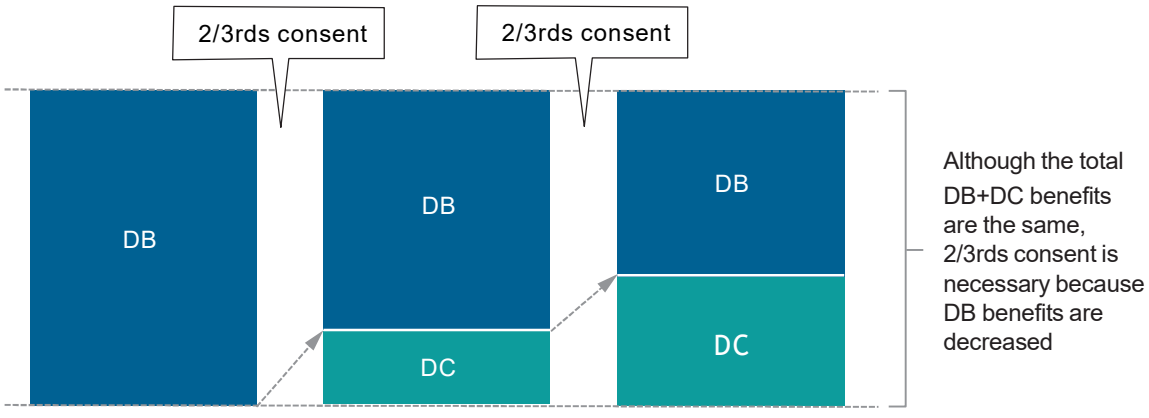


Necessity of removing the 2/3 consent requirement

There is one significant hurdle to blocking this sort of flexible model: the rule which requires two thirds of members of a pension scheme (or of a representative union) to agree to the reduction in DB benefits.

As mentioned in the previous section, there have been three increases in the contribution limit for DC, but there are still some business owners who have not moved from the maximum limit of 432,000 yen per year (36,000 yen per month), which is the oldest limit. While the company might want to increase the portion of DC, and maintain the total benefit level by reducing the portion of DB, obtaining a 2/3 approval requires a lot of work. There are high practical barriers (Figure 3).

Figure 3: 2/3 Consent at DB Benefit Reduction



This consent requirement was set in the days when only DB existed in Japan, and removing it should have been considered when DC was introduced. In contrast, when a DC employer's premium is reduced, the consent of employees (or a union) representing a simple majority of insured persons under the Employees' Pension Insurance is required.[4] A labor agreement is still required, but the hurdle is lower. If discussions on the common framework are to proceed, it is essential to reconsider the DB-consent requirement. Otherwise, the effectiveness of the common limit would be negated.

In Japan, once the 2/3 consent is obtained, DB benefits can be transferred to DC even if they were accrued in the past. On the other hand, policy in Britain and the United States strictly distinguishes between benefits accrued in the past from any future accruals. In other words, the past portion of the DB is a right already vested to the participants, and no changes are allowed. On the other hand, there is no requirement to secure the agreement of workers for future schemes, and employers are free to design and modify them.[5]

Even in Japan, the requirement of 2/3 consent is not necessary when the system is changed to lower the DB benefit level of new employees entering the company.[6] Taking these into consideration, we consider it excessive to ask for 2/3 consent for future changes, and it should be corrected.

■ U.K. case of the DB + DC common framework

The United Kingdom is an example of a country that already manages a common framework for DB + DC. The United States had a similar concept until 1999.[7] The U.K. common framework rules are explained in a report titled "*Consideration of the introduction of common DB + DC framework in Japan - Common Framework of DB + DC and Incentives for Self-help Efforts in the United Kingdom*".

① Multiple of 16

DC is a simple system for defining premiums when setting a common framework, but it is difficult to evaluate DB. DB defines future benefits, so you have to assume the value of a future pension or lump-sum payment and then discount it back to the current monetary value.

Moreover, the U.K. understanding of defined benefits is to "pay an annual pension in perpetuity from a starting age in the future." If members have spouses or dependents, some plans provide them with pensions after the death of the member. In addition, the pension amount is adjusted according to inflation, just like the public pension. It requires a complex calculation to convert that back to its current value.

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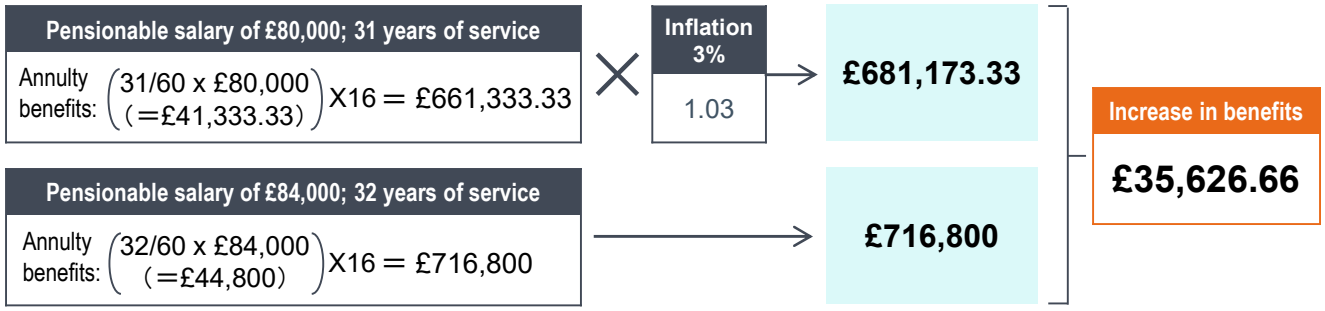
4. At the time of the Lehman shock, there were some business owners who made a DC premium reduction through this procedure, but I heard a number of surprises, "It's that easy," perhaps because of the comparison with DB.
5. Except the collective bargaining plan (union membership system).
6. Consent to change regulations (consent of a person or a union representing a majority of employees' pension insurers) is required.
7. In the United States, the rule was scrapped because it was too complicated and unpopular, and because it became less necessary as more and more companies were closing or freezing their DB and consolidating them in DC.

It is important to note that Britain is not looking at pensions in terms of how much DB premium was paid in any given year. It wouldn't make sense because the amount of the DB premium varies depending on how the calculation is made. In addition, it is not practical to calculate the premium amount for each individual in DB (although not impossible). For this reason, in the United Kingdom, the evaluation of DB is based on an "increase in benefits from one year of service" rather than the premium amount.

It is easier to understand using specific examples. Let's assume the final salary-related method with the following formula: life annuity equal to 1/60 of the pensionable salary accrues per year of service.[8] For example, employee A's pensionable salary is £80,000, and the length of service is 31 years. He gets a raise of £84,000 a year later. The annual inflation rate is 3%. At this time, the benefit increase is calculated as shown in Figure 4.

Figure 4: Calculation of DB Benefit Increase in the United Kingdom



The increase in DB benefits comes from both years of service and salary growth, but the first step is to check "How much have DB benefits (pension amount) increased over one year of service?" Then, considering "How much would it cost to accumulate it in DC?", a procedure is taken to convert DB benefits into DC contributions.

A coefficient of 16 can be seen in the formula in Figure 4, which is an important magic number that was established after many calculations to convert DB benefits into DC contributions based on several assumptions. It is used assuming "If a DB's pension benefit is 1 per year, its value is equivalent to today's DC premium of 16"

[8] In the United Kingdom, many designs use a factor of 1/60 to 1/180 per year of service.

② Annual allowance

These calculations allow us to compare DB and DC in the same way. Then, a numerical value called the "annual allowance" (abbreviated as AA) is set as the common framework of DB + DC. The amount is currently £40,000 (approx. 6 million yen) per year. Within this framework, it can be used freely across DB, DC, individual pensions, or any combination. On the other hand, if this amount is exceeded, a penalty tax is imposed on the participants (not the employer). For this reason, AA is the de facto contribution limit [9].

AA is a numerical value applied across the total of all plans a user may subscribe to, across multiple DC and DB plans. It applies to both corporate and individual pension plans. It is also a figure that applies not only the premiums of the participants themselves but also the employer premiums and the premiums by third parties (premiums, etc. for children by parents).

■ Concern about the common framework in Japan

Although this common framework is a useful concept, it has not yet been adopted by business owners, service providers and experts who implement DB in Japan. It is natural to think that the common framework will be set at a level that does not damage the current levels of DB and DC, that is, the image shown in Figure 1 will be realized, but there is no guarantee. The risk that the Government may establish a lower common framework is not zero. If it does, it would remove a vital element of flexibility from DB as well as DC schemes.
This would be an unpopular move with employers.

Simply put, the idea of a combined DB + DC framework is complex and, I argue, unnecessary. DC schemes require simplicity for their members, for example, a contribution number they can memorize. On the other hand, DB schemes deliver a pension to members as a finished product. Combining the two forces round pegs into square holes.

This fruitless task seems driven by the persistent perception that Japan simply cannot afford to extend tax breaks to DC schemes. For the past 20 years, proposals to raise contribution limits have been turned away as the government pointed to the country's huge debts. This circular argument has stymied reform. To break free requires bold and original thinking.

[9]. In theory, it is possible to contribute more than this amount. On the other hand, even if an individual cannot receive the tax benefit, he or she can contribute without penalty within the AA limit (That is, it is possible to make after-tax contributions.).

Chapter 3 Contribution Limit ≠ Tax Benefit Limit

For DC plans in Japan, the accepted wisdom is that "contribution limit = tax benefit limit." While many consider this as normal, from a more global perspective, this is not common practice. And if this “equal” sign holds up, we could have a problem. It is also important to note that when you talk about preferential tax treatment, it is necessary to be aware of whether it is a matter of corporate tax or income tax; otherwise it is easy to get lost in the details.

For example, in a corporate DC plan, an employer who does not have a DB plan can contribute up to 660,000 yen per year (55,000 yen per month) per participant. The amount can then be included in deductible expenses to reduce the corporation tax. This is the tax benefit for employers.

In the individual-type DC, for example, a salaried worker working at a company without a DB or a corporate DC can contribute up to 276,000 yen per year (23,000 yen per month) from his or her own income, and this amount can be deducted for calculating income tax and residential tax to reduce income tax and residential tax. This is the tax benefit for individuals.

Every contribution to DC comes with a tax break. However, if the tax breaks are too generous, the income of the central and local governments will decrease. Also, if the amount that can be contributed is equal to the amount of tax benefits, the amount of contribution will be too small. So, what can businesses and individuals that want to make more contributions do? Can contributions be made without tax breaks? The answer is no. But there is no rational reason to ban it.

In this chapter, we examine the relationship between these contribution limits and tax benefit limits. I propose that we stop thinking the "Contribution limit must be equal to the tax benefit limit."

■ Contribution limit and the tax benefit limit are separately controlled in U.K. and U.S.

Chapter 2 introduced AA in the U.K. as acting as a de facto funding limit. However, you may have noticed that AA was not actually a tax limit.

① United Kingdom

In the United Kingdom, there is no upper limit for the inclusion of employer contributions in deductible expenses for corporate tax calculations. If deemed necessary for business[10], all of these are deductible. Employers are expected to not use the corporate pension system to

10. 'Solely and exclusively' for the purposes of the employer’s trade or business.

manipulate taxes. For instance, reducing corporate taxes by increasing contributions in profitable years. There is an awareness that a penalty tax will be imposed on participants if they exceed AA, but there are no other tax-related restrictions, and there is an environment in which employers can freely design retirement benefit plans that match their companies.

In the case of individual income tax, the tax benefit of the individual contribution is applied up to "100% of earned income in the United Kingdom" or "£3,600," whichever is larger. This is a different system from AA.

② United States

In the United States, the contribution limit is different from the tax benefit limit. For DC, the 2020 contribution limit is $57,000 (approx. 6.2 million yen) and the pretax contribution limit for employees to the 401(k) plan is $19,500 (approx. 2.1 million yen). The amount that an employer can include in deductible expenses in the 401(k) plan is stipulated as "(Total salary of all eligible participants - Total pretax contribution) x 15%."

For DB, there is a "DB benefit limit" which is the annual amount of benefits that a participant is entitled to receive, and the amount is $230,000 (25 million yen). From the viewpoint of business owners, "upper limit of the contribution" and "tax cap" are considered as separate concepts. As is the case in Japan, there is no upper limit for this contribution. It can be freely determined based on the accumulation strategy of each company.[11]

The difference from Japan is that there is an upper limit of deductible expenses, which is high enough not to cause inconvenience in design, as specified by the following formula[12] .

"Actuarial liabilities - plan assets (= underfunding)" + "pension cost covering benefits incurred during the year" + "adjustment.[13]"

In the United Kingdom and the United States, where corporate pension schemes have a long history, the maximum amount of contributions and the maximum amount of tax benefits are stipulated separately. The contribution limit is formed from a social security policy approach and the tax benefit limit is a product of tax policy. They appear similar, but are different.

■ Corporate and income taxes are separate

Furthermore, in the case of tax breaks, the rules are carefully divided into those that favor corporate tax and those that favor income tax, depending on who pays the contributions.

On the other hand, Japan is completely undifferentiated. Participant contributions to corporate-type DC must be within the contribution limit of 55,000 yen (half if you have DB), in total with the employer's contributions.

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11. There is a minimum requirement.

12. As far as Fidelity knows, there are no business owners who actually hit this amount.

13. Basically, 50% of actuarial liabilities + increase in liabilities when future salary increases are expected.

Here, tax benefits under the Corporation Tax Act (deductible limit) and those under the Income Tax Act (income deduction limit) are mixed.

Corporate and income taxes are subject to different laws and different tax rates. The payer of taxes is the employer and the individual, and both are different economic entities. It is not sensible to ignore this fact and say, "Maximum monthly amount of employer and participant contributions is 55,000 yen."

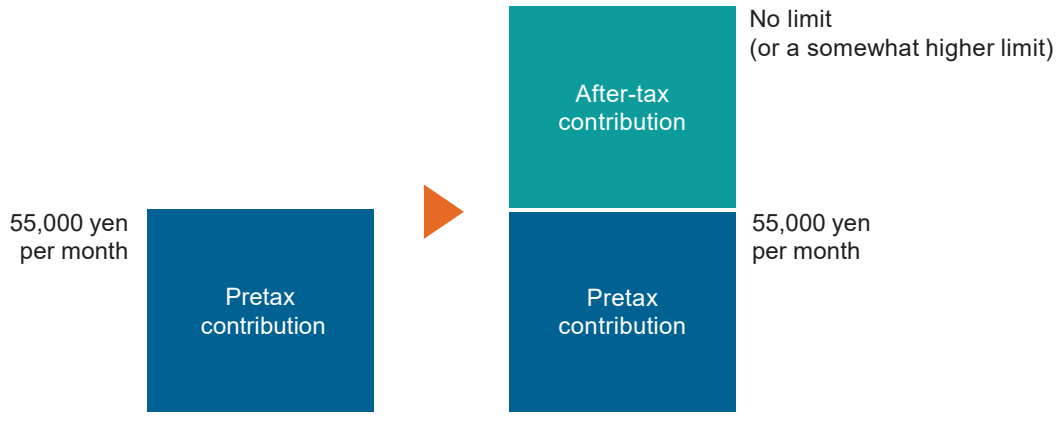
Resulting introduction of after-tax contributions

We have seen that the limits on contribution and tax benefits are different in both the United Kingdom and the United States, but in fact, both limits are sufficiently high in these countries that there are no practical problems. Practitioners said that they had no experience or memory of lobbying to raise the ceiling. It is only in Japan that people repeatedly ask for a raise in the ceiling every year, and for these requests to be rejected.

Under the Japanese system, which equates the two, the upper limit is kept low for fear of a decrease in tax revenue, resulting in an insufficient system for preparing for retirement.

The government should seek ways to increase the freedom of the private sector to build assets for the elderly while securing tax revenues. In other words, it is time for the government to seriously consider a prescription that allows tax breaks to be limited to a certain level while allowing employers and individuals who need them to make contributions even if they do not have tax benefits. In other words, the ban on after-tax contributions should be lifted (Figure 5).

Figure 5: Image of after-tax contributions



Diversify a company's strategic planning

First, let's consider employer contributions. If some companies can eliminate the retirement benefit obligation arising from the DB (“Projected Benefit Obligation” or PBO) or stabilize the pension cost on the P/L, then they may want to move to DC entirely, even if they cannot deduct the entire contribution. Whether they want to

pursue tax benefits or accounting benefits depends on the company's priority. Companies develop strategies from multiple angles, including HR, finance, and accounting. It is also necessary to create an environment in which comprehensive decisions can be made on corporate pension plans. Isn't it important to provide such a foundation for companies doing business in Japan?

Schools and medical corporations, which are tax-exempt organizations, have introduced DCs, but this shows that tax breaks are not everything for DCs. DC has been adopted because of its stable cash flow in providing employee retirement benefits.

But that doesn't mean tax breaks are unnecessary. For a profit-making corporation, tax breaks cannot be conceded. Pension-related costs are labor costs, just like salaries, and are necessary expenses for doing business. If only a small amount of contribution can be deductible, companies may shift labor costs from pensions to (fully deductible) salaries. However, this could lead to a decline in corporate pension funds and a contraction of the capital market through a decrease in stock and bond investment, which would have a serious impact on the economy.

If there is a company that wants to contribute more than the maximum amount of tax benefits, then it is part of its corporate strategy and should be allowed to do so freely.

■ Avoid tax breaks only for the rich for individual contributions

Next is the individual contribution. Even if the entire amount is not deducted, it is convenient to accumulate the necessary amount in one place. If you can manage your retirement funds in a DC account, it will be easy to understand and plan.

It is only necessary to set income tax deductions while paying attention to the fact that they do not give preferential treatment to the rich, and the amount of contribution itself does not need to be tied to the amount of tax benefits. Separate from the actual management of contributions, a method of granting tax benefits to individuals can be developed. I think it would be a good idea to utilize the government-issued identifier “My Number,” which is increasing in usage in Japan, to allow tax deductions up to a certain amount through tax returns (year-end adjustment)[14] . As individuals receive preferential tax treatment, the government can let them handle the process themselves. Of course, it does not exclude the help of business owners.

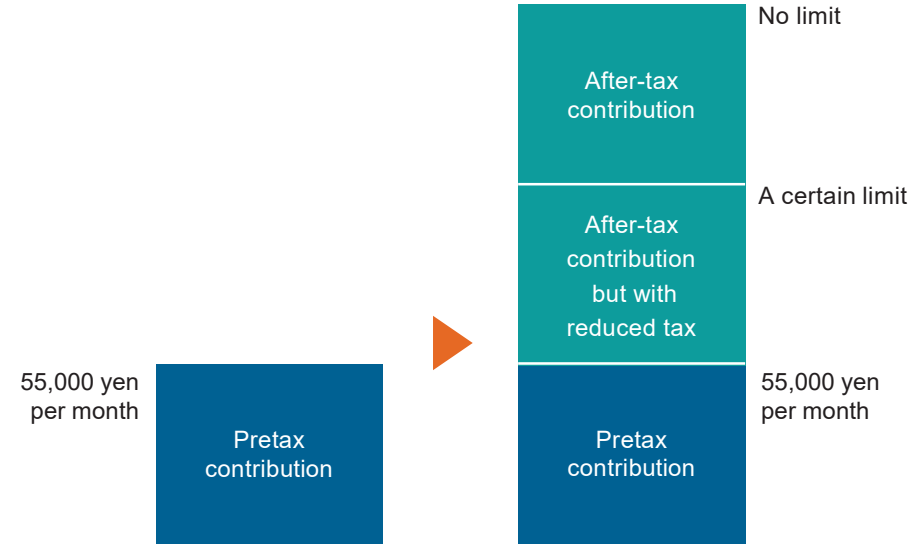
I think the reduction effect of this on the social cost is huge. In the past, record-keeping companies have complained as they were forced to revise their systems every time a fairly inconsequential DC rule was revised.

[14] The U.S. IRA is a good reference for this mechanism.

Australian system

Australia, a country with a well-developed DC scheme, has adopted a unique contribution model. The premiums paid by participants are after-tax contributions but are subject to a lower tax rate than salary income. The system is highly effective as one that can secure tax revenue while providing incentives for self-help efforts through the application of low tax rates. Figure 6 shows the image if the Australian model were applied to Japan.

Figure 6: Application of the Australian Model

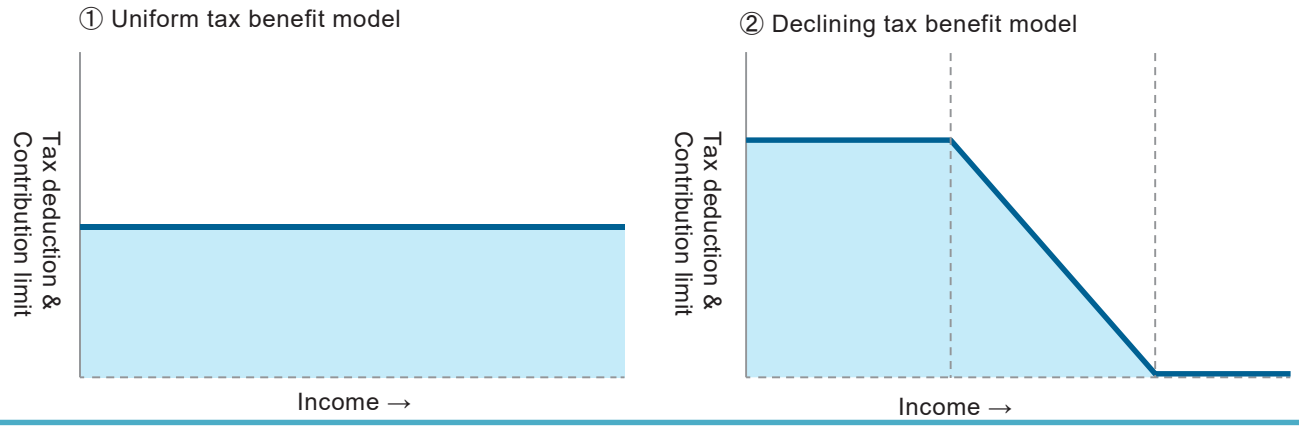


Effective use of limited tax budget as an incentive

These considerations lead us to the idea of a design that takes the limited resources of tax breaks and makes greater use of DC as a post-retirement preparation instrument. Here we focus on individual contributions.

A picture of the current system is shown in Figure 7-1. Here the maximum amount of preferential tax treatment (= contribution limit) is uniformly granted regardless of individual income. This may seem fair at first glance, but, as we will see in Chapter 6, it works in favor of higher income groups under progressive tax rates. In addition, because it has an open-end (the right side extends indefinitely) with no income limit, even the very rich can benefit.

Figure 7: Model of Tax Preference and Contribution Limit



On the other hand, Figure 7-2 shows a model in which a uniform tax benefit is granted to a certain extent, but when income exceeds a fixed value, the tax benefit gradually decreases, and when income exceeds another fixed value, the tax benefit completely disappears. The concept is that while most people are allowed to stay in the flat highland zone on the left side, the amount of tax-beneficial contributions is higher than the current system.

Figures 7-1 and 7-2 show the shaded areas so that they appear to be the same area. In other words, the total theoretical value of tax benefits is drawn in the same image, but in reality, figure 7-2 is closed-end, which should make it easier for the Government to control tax benefits.

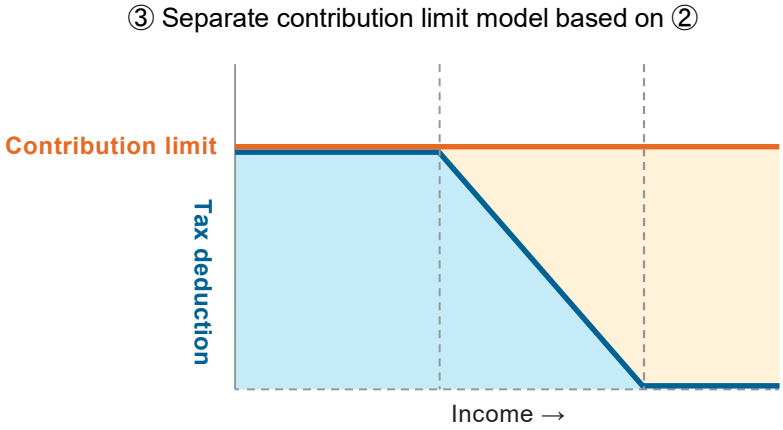


Figure 7-3 shows the development of the model described in Figure 7-2 and the idea of separating the contribution limit while maintaining the tax benefit curve. It provides more room to make greater use of DC without changing tax incentives when contributions are made.

The idea is to allow people to continue preparing for retirement by using DC even if their income exceeds the tax benefit limit. Retirement funds are formed over the long term. Tax breaks should provide the impetus for that, and not all contributions need to be taken care of. Even if tax breaks are limited, the effect of payroll deductions or bank account debits on retirement preparation will be significant, and this may be called the “stretch effect” of DC. It is the significance of after-tax contributions that makes it possible to take advantage of this merit.

Chapter 4 Separation of Participant and Employer Contributions

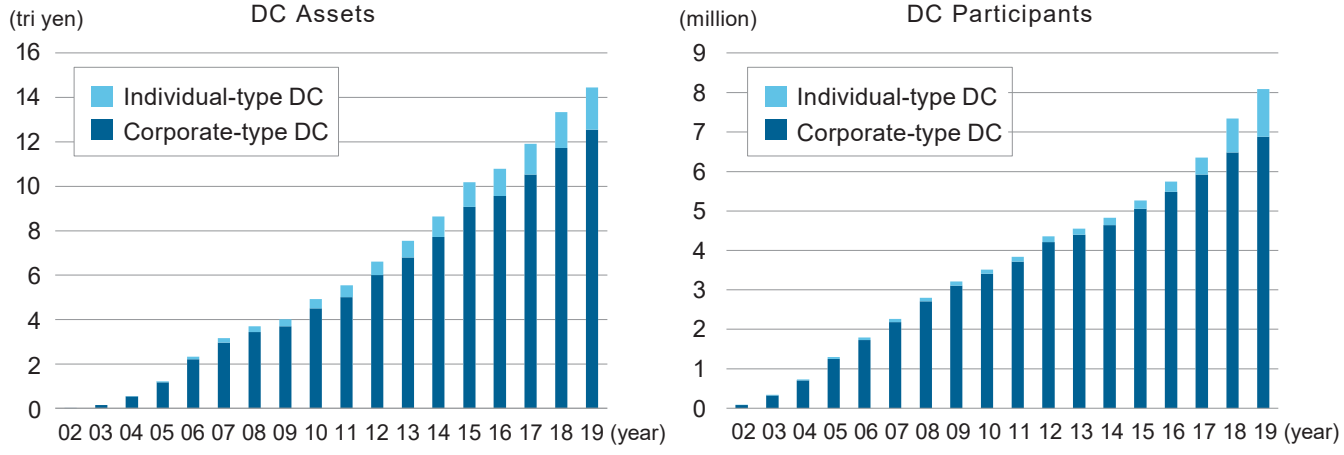
Retrospective of the DC Law

When the DC Law was enacted at the beginning of the 21 century, two types of pension schemes were defined: corporate-type DC schemes were defined as contributions paid by employers (individuals cannot make a contribution), and individual-type DC schemes were defined as contributions paid by individuals (employers cannot make a contribution). However, the same rules were applied to both schemes. Working-level officials at that time were aware of the problem this may cause, but it ended up with rules that should be applied only to one side extended to the other. Thus, the DC system was unnecessarily hampered from its inception.

The establishment of the DC system in Japan was requested originally for the purpose of tackling "Another Year 2000 Problem[15] ." This referred to the introduction of the new accounting rule in 2000 that required recognition of retirement benefit obligations of DB on an employer's balance sheet, which would make their financial statements look bad. Employers wanted to minimize the retirement benefit obligation and to control the fluctuation of the retirement benefit cost, and DC was desired as a solution to satisfy these needs. Corporate-type DC was needed.

On the other hand, there was little demand for individual-type DC plans at that time. The individual-type DC plan was introduced simply because of political considerations for self-employed persons and employees of SMEs. As a matter of fact, the system started with the sharing of 68,000 yen a month, which is the maximum amount of contributions for the existing National Pension Fund system for self-employed persons. No new tax benefits were granted (it remains the same now). Employees working in companies without DB plans or corporate-type DC plans were allowed to make contributions up to 15,000 yen per month (at that time), which was the only new tax benefit in individual-type DC plans.

Figure 8: Trends in DC



(Source) Council of DC Plan Administrators "Defined Contribution Pension Statistics from March 2002 to March 2019"

15. The original "Year 2000 Problem" was related to supposed widespread computer malfunctions caused by the numerical switch from 1999 to 2000 causing various social and economic problems.

Create a rule based on who is paying

Subsequently, in 2012, the ban on individual contributions to corporate-type DC plans was lifted. In 2017, individual-type DC plans, under the nickname “iDeCo,” was opened to all workers. In 2018, small and medium-sized companies were allowed to make employer contributions to iDeCo.

At this point, the dichotomy that the employer contribution was to corporate-type and the participant contribution was to individual-type had collapsed.

A great deal of attention must be paid to who is the primary contributor. With regard to contributions made by individuals, the individual has the choice to decide whether or not to contribute and is eligible for tax benefits in accordance with the amount of the contributions. Hence, the rule that benefits are paid on or after the age of 60 in order to claim that the contributions were "pension, not savings,", was insisted upon by the government at that time. In addition, it is necessary to set a ceiling in order to avoid tax breaks for the rich. Both the contribution in individual-type DC plans (iDeCo), and the participant contribution in the corporate-type DC plans are the same individual's money. Since the purpose of funding is the same even if the containers are different, it would be strange if a unified limit and a unified reason for payments were not applied across the board.

Employers' contributions, on the other hand, are generally paid to employees as retirement benefit plans, and employees do not have the right to choose what to use them for. The money remaining after the decision whether or not to consume is "saving" and therefore the employer's contributions cannot become "saving.“[16] In that context, the current rule that withdrawals can be made on or after age 60 is unnecessary. Because traditional retirement allowances originate with the employer contribution, as with DB in Japan, it is natural to be able to withdraw money at the time of retirement.[17]

Subaccounts in the US

Under the U.S. 401(k) plan, participant contributions and employer contributions are separately managed by setting up sub-accounts in a single individual account, and the amount of contribution and the resource for payment are separately specified.

The establishment of sub-accounts contributes to risk-taking because it is possible to give separate investment instructions for each of the participant's contributions and the employer's contributions. This is because people don't want to reduce the amount of money they earn from their labor, but there are some people who are willing to take a little risk with the money provided by their employer.

[16] Employers' contributions cannot be classified as "saving" as evidenced by the fact that contributions can be forfeited in the event that employees retire with less than three years of service.

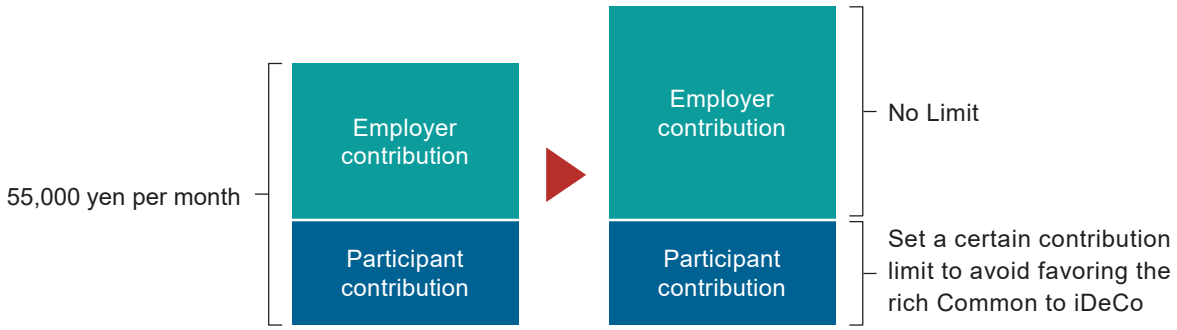
[17] Retirement should always be the reason for receiving benefits, but this does not mean that benefits are allowed at any time the participant wishes.

Diffusion to SMEs is key

At the time of the DC system's establishment in Japan, an original proposal included individual contributions to corporate-type DC. As a result, the restriction on withdrawals up to the age of 60, including the employer's contribution, was introduced. However, this provision should have been reconsidered when the corporate-type was defined as a system consisting solely of the employer's contribution.

Users feel that they should be paid when they retire because the source of the employer's contribution is retirement-allowance money. Against this notion, DC has not spread to small and medium-sized companies[18], even though they are in the original DC “diffusion zone.”[19] This is a major reason why corporate pension coverage has been sluggish.

Figure 9: Image of Separation of Employer Contribution and Participant Contribution



Employer contributions are derived from retirement allowances, and retirement allowances have no limit. A company's ability to pay for its retirement benefits is naturally limited, and excessive retirement benefits threaten the company's survival. In the first place, only about 30% of Japanese corporations pay corporation tax.[20] 。 Taking all these circumstances into consideration, setting a ceiling is more of a disadvantage in that it deprives employers of their freedom to design.

It is groundless to think that if there is no limit, the employer will change the contribution level based on profit and manipulating taxes. For example, it is extremely difficult to change DC Plan Documents to obtain the approval of the Minister of Health, Labor and Welfare in years in which profits are made, in order to reduce corporate taxes by increasing contributions.

18. When it was decided that the tax-qualified pension plan (QPP), one old type of DB scheme in Japan, would be abolished and DC was recommended to small and medium-sized companies as a successor system, many small and medium-sized company presidents said, "I want to give money when employees leave. If it can't be used as a retirement allowance, it's useless."

19. The 401(k) plan in the United States rapidly spread in the 1990s as a retirement benefit system that is easy to adopt for small and medium-sized companies that have difficulty adopting a DB.

20. Statements Statistics of Corporations by Industry (Fiscal 2017 version) "After subtracting the number of consolidated subsidiaries (12,671 companies) from the number of corporations in fiscal 2017, which was 2,706,627, out of 2,693,956 corporations, there were 1,687,099 loss-making corporations, accounting for 62.6% of the total."

Even if there is an employer who changes contributions frequently, if there is any doubt after checking the actual situation,[21] the Regional Bureaus of Health and Welfare would simply not approve the revision of the plan document. Isn't it more effective to deal with individual cases on an ongoing basis, rather than to impose regulations in advance?

Payroll-source DC

By rearranging the rules according to contributors, the various problems that have hobbled the DC system for the past 20 years (low contribution limits, 60-year old withdrawal requirements, etc.) can be largely solved.

The only remaining issue is the so-called “payroll source DC” (hereinafter referred to as "payroll source DC" including bonus source DC). Payroll source DC is a system in which the amount that should have been received as salary can be contributed to DC as an employer's contribution at the option of the participant. While the choice of salary or contribution is economically equivalent for the participant, it has become popular for business owners because they can introduce DCs without incurring new funding. As described above, the corporate DC was originally a system in which only business owners could contribute money, and participants could not. A technique devised at the private level to overcome this problem was the payroll source DC. This is a product of the creativity of Japanese financial institutions, and it can be said that it is a scheme that greatly contributed to the spread of corporate-type DC.

However, the strain remained. Since this method was not assumed when the DC law was enacted, it was not linked to social insurance. Currently, the money that is converted into an employer's contribution at the option of a participant, is treated as not being paid by the participant, and is excluded from the calculation basis of social insurance premiums. However, the fact that employees are not required to pay social security old-age pension premiums is extremely inconvenient. This is because the private pension system is being expanded at the expense of the public pension system.[22]

This problem can be solved by simply changing the rule: "The contribution of the payroll source DC is regarded as the remuneration obtained by the person for the purpose of social insurance and is used as the basis for calculating social insurance premiums."

In the United States and Europe, this method of contributing to retirement benefits without receiving the original salary is called the “salary-sacrificed contribution” (contribution at the expense of one's salary) and has been widely used since long ago. The U.S. 401(k) plan is this type of structure. However, while the pretax contribution of the employees of the 401(k) plan is treated as the employer contribution and is not subject to income tax, it is subject to social security tax in the field of social insurance. This is because public pensions are sacrificed to improve private pensions.

21. For example, if you plan to make multiple contribution changes within five years, or if you plan to increase - > decrease or decrease - > increase, the government may want to check.

22. With regard to taxes, the effects are the same in terms of for this mechanism.

If the DC system were to become very popular in Japan as well, it should be assumed that the contributions paid by the employee will be included in social insurance premiums for the future. It makes sense to apply the same rules, because the revenue, whether it's a participant contribution under corporate-type DC, a payroll source DC, or in iDeCo, is the income of the individual and all of the money is of the same nature. It is strange the way the structure has evolved and the way we handle it changes.

■ Value of system development

An update to the record keeping system is required to separate contributions into employer and participant contributions, or pretax and after-tax contributions. However, since this computer system development is characterized by preparing multiple iterations of logic with a similar structure, it may not be as complicated as development projects in the past when laws were revised. Moreover, this will be a trump card to overcome the bottleneck in the DC system that has been mentioned thus far, and I think it will be significant. However, I would like to respect the opinions of practitioners regarding the system development burden.

Chapter 5 The Issue of Retirement Income Taxation

■ Annuity receipts are unpopular

When it comes to the subject of benefit payments from DC plans, the number of lump-sum payments received is approximately three times that of annuities[23]. The purpose of the system stipulated in the DC Act says “DC is to ensure adequate income for people in their old age, thereby contributing to the stability of their lives and the improvement of their welfare in combination with the retirement funding of public pensions.”[24] With this in mind, the original, ideal method of payment is defined and recommended by the system as an annuity.[25]

Nevertheless, the reason that people select lump sum payments over annuities is three-fold: (1) employees equate their employer's contribution as a lump-sum “retirement allowance” to be paid out at the time of retirement, (2) small contribution limits do not add up to a large enough total account balance to make it worthwhile to select annuity payments, since each of those payments would be quite small (and furthermore, annuities are charged extra remittance fees), and (3) it is more advantageous to receive a lump-sum payment for tax purposes.

Under the Income Tax Law in Japan, lump-sum payments are classified as retirement income. The retirement income tax is a preferential treatment that combines the benefits of the following three-tier system: (1) deduction of retirement income according to the length of service,[26] (2) the amount remaining after deduction, if any, multiplied by 1/2, and (3) a separate tax.

On the other hand, although the public-pension deduction is applied to annuity payments, this deduction is first applied to each person’s public pension, and therefore there is a possibility that the deduction may only apply to the public pension funds and there won’t be any left over for the DC benefits due to total applicable deduction limits. The tax rate tends to be high under a progressive tax rate system since a comprehensive taxation system (calculated by totaling the amount with other income and the amount of tax) is applied to the amount remaining post-deduction.

In this way, it is tax-advantageous to receive retirement benefits from DC via a lump-sum payment rather than an annuity. This is the reason why participants are reluctant to select an annuity as the method of payment, which is contrary to the intention of the DC Act.

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23. 62,828 lump sum payments and 23,232 annuity payments were made in fiscal 2018 (Council of DC Plan Administrators "Defined Contribution Pension Statistics for the period from the end of March 2002 to the end of March 2019").

24. Excerpt from Article 1 of the Defined Contribution Pension Act.

25. Paragraph 1 of Article 35 of the Defined Contribution Pension Act "The old-age benefit shall be paid as an annuity." (Paragraph 2 provides that lump-sum payments may be made in accordance with the provisions of the plan documents.)

26. 400,000 yen per year for 20 years or less and 700,000 yen per year for more than 20 years.

■ Due to the retirement income taxation system, tax-beneficial contribution limits cannot be increased

Of course, this is not the end of this story. The retirement income tax system has led to the following serious problems.

Pension taxation in countries around the world is divided into three stages: (1) whether contributions paid by individuals are deducted from their income when they make the contributions (employer contributions, if any, are not taxed the same as the income of the participants); (2) whether investment income is taxed at the time of the investment; and (3) whether benefits are taxed when payments are made.

The letter “T” (Taxed) is used to indicate the implementation of taxation and “E” (Tax-Exempt) to indicate the absence of taxation. Therefore, EET indicates non-taxable at the time of contribution, non-taxable at the time of investment, and taxable at the time of payment. This is what we typically see in U.K. and U.S. private pensions.

However, the U.S. Roth IRA[27] and Japan’s Zaikei Nenkin and Tsumitate NISA, are all TEE, or taxable at the time of contribution, non-taxable at the time of investment, and non-taxable at the time of payment. Although there is no difference in tax revenue between EET and TEE under certain conditions, countries with fiscal deficit issues prefer TEE, which can immediately secure tax revenue. For this reason, every year in the U.S., there are discussions around a bill being drafted to eliminate pre-tax contributions to 401 (k) plans and shift it to a Roth model (after-tax contribution).

Please refer to the section at the end of this chapter regarding the impact of taxation at each stage.

In the case of DC in Japan, although lump-sum payments should be subject to taxes, most people are exempt from taxation at the time of payment due to the deduction of retirement income, i.e. the status of EEE seems to be expanding.[28] So once money is contributed to DC, the government will not be able to collect taxes on the funds indefinitely. This structure may be the reason why tax authorities have thus far stubbornly refused to allow an increase in DC limits.

Tax authorities have long said contribution ceilings will not be raised unless other sources of revenue are provided. Therefore, the waiver of the retirement income tax deduction would be key to raising the tax-beneficial contribution limit in DC. The question of whether or not to eliminate the special corporate tax system is often debated, but the bigger predicament lies in whether or not to apply retirement income tax.

■ Mobilization of employment and the retirement income tax system

In general, if a person receives their retirement allowance as a lump-sum payment and is subject to normal salary taxation, this would result in a huge amount of tax payments, which in turn would affect household management and human behavior. It is for this reason that the retirement income taxation system has been created. This meaningful system was based on Japanese employment and compensation practices.

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27. Roth IRA allows for an after-tax contribution. Instead, investment income and benefits are tax-free. Named after a senator who devised it.

28. A small number of people may be taxed on a lump sum. We do not have statistics on hand, but we should be able to find out what percentage of those who received lump-sum payments from DC were actually taxed.

However, since the beginning of the 2000s, there has been a growing realization that the retirement income tax system is designed to give preferential treatment to long-term employees and discourage job mobility. In the future, the significance of the retirement income tax system could diminish if job mobility becomes the norm in Japanese society as opposed to lifetime employment. In the United States, where employment is increasingly liquid, lump-sum payments received from corporate pension funds do not offer special benefits and are taxed as ordinary income, just like salaries. In the U.K., the first 25% of lump-sum payments are tax-free, but the remainder are taxed in the same way as regular income.

■ Tax on individual contributions

As mentioned above, the application of the retirement-income tax system to the employer's contribution heavily discourages employment mobility, but the bigger issue here is the application of the retirement income tax system to the individual's contribution.

Under the current rules, the portion of money an individual contributes from his or her wallet to a DC plan is also subject to retirement income tax if he or she selects lump-sum payments. Since the start of the Japanese DC system in the early 2000s, corporate DCs were the main type of plan, and there was a rule that only employers' contributions were permitted, which was why at the time it made sense to impose retirement income tax on lump-sum payments.

But these days, more and more individuals' money is flowing into the DC system. Whether an individual makes a contribution to a DC plan is essentially just a choice of "receive now or defer until the future (cash or defer)" in terms of timing, and of course, then, this is just a question of timing of taxation. The application of the retirement income tax may be too enticing to most.

It would be better to separate the individual contribution from the employer contribution for taxation on benefits. For example, with regard to the individual contribution portion, it would be a good idea to impose a one-time income tax on lump-sum payments and a miscellaneous income tax on annuity payments (i.e. different taxation).

In any case, unless the issue of whether to apply the retirement income tax system is addressed, it would be difficult for the government to start discussing ways to raise the ceiling on preferential tax treatment on contributions.

■ Special corporate tax

Japan has a special corporate tax, which is very different from other countries. As stipulated in the Corporate Tax Law, a tax of 1.173% is levied on pension assets of defined contribution pension plans, defined benefit corporate pension plans, and employee pension funds each year. It is odd that a corporate tax is imposed on individual DCs, which are not corporate pension funds. However, beginning in fiscal year 1999, a period of sluggish growth for asset managers, the government chose to freeze the special corporate tax.

The freeze was supposed to be a temporary measure for a few years. However, the government has extended the measure multiple times, and it remains to this day. In fact, the special corporate tax freeze is currently extended until March 31, 2023.

As a result, the tax has never actually been imposed on DC assets from its inception. And therefore, it is understandable that the record-keeping system for DC plans is not designed with this special corporate tax in mind.

Let's look at the background of this special corporate tax in Japan. Japanese companies have historically paid a lump sum retirement allowance when employees leave the company. As these retirement allowances are typically unfunded pensions (or paid out via company contributions as opposed to advance funds set aside for growth), companies deduct these retirement allowance amounts from taxable income when they are paid. [29]

Externally-funded (non-government) pension plans were first introduced in Japan in 1962 when the tax-qualified pension plan (QPP) was created. With the introduction of QPP, companies were allowed to deduct any contributions made to the plan as an advance on business expenses. The special corporate tax was introduced in order to recover the loss caused by this difference in timing in collecting tax revenues. Thus, the special corporate tax is unique to Japan. Since a DC plan is a pre-funded vehicle (i.e., with contributions set aside in planning for a payout date), the special corporate tax should be theoretically applied.

Nonetheless, the tax deduction for retirement income benefits needs to be reduced as lifetime employment becomes less standard and employment becomes more liquid. It is unclear how much tax revenue was lost due to the freeze put on the special corporate tax, but there is the possibility to balance tax revenue and expenditure related to corporate pensions by systemically eliminating the special corporate tax and by ceasing any application of the retirement income tax system to pension plans, i.e. imposing taxes on pension benefits. Of course, an immediate change would cause confusion, so it is necessary to transitionally apply these changes.

■ Impacts of taxation on contributions, investments and benefits

Previously, I commented that "there is no difference in tax revenue between EET and TEE if the conditions are met." I would like to confirm the impact of taxation on contributions, investments and benefits by using several mathematical examples to sum up this chapter.

There are eight logical combinations of taxation and non-taxation, because it depends on whether taxation occurs at each stage of contribution, investment, and benefit (2 x 2 x 2 = 8). As stated earlier, T stands for taxation and E stands for tax exemption. Of these, EEE and ETE are unlikely to become policies because they are rarely subject to taxation. Also, TET and TTT impose double taxes and therefore are not practical. As a result, patterns of EET ((1)), TEE ((2)), TTE ((3)), and ETT ((4)) remain.

[29] There was a time when a certain percentage of the amount required to be paid at the end of the fiscal year could be included in deductible expenses as a tax system for the provision of retirement allowances.

Let's assume you contribute 100 yen, invest it over 10 years and receive it as a benefit. The tax rate is set at 20% at the time of contribution, investment and payment. The investment yield is 3%. Figure 10 shows the difference among the four patterns. The table is shaded where taxes are levied.

Based on this assumption, the take-home benefits of (1) EET and (2) TEE are equal. (3) TTE and (4) ETT are the same amount, but the amount is smaller than those of the former. We can see that (1) and (2) are more advantageous to individuals.

On the other hand, from the viewpoint of tax revenue, the story is different. In the lower part of Figure 10, tax revenues at the time of contribution, investment, payment and also total tax revenues are shown. The total tax revenue of (1) EET is larger than that of (2) TEE. Furthermore, the total tax revenue of (4) ETT is larger than that of (3) TTE. It is strange at first glance that the total tax revenue differs among those with the same take-home benefits. This is because the timing of the taxation period is different. As anyone who knows the concept of the value of time will readily understand, generally speaking, the present value of 100 yen is more than the future 100 yen.

Formally, the DC tax system is (1) EET. The tax system for general financial instruments is (3) TTE. A comparison of these two shows that (1) EET has larger tax revenues although it also has larger take-home benefits. These discrepancies in the amount of tax revenue are also caused by timing differences in application of the tax.

Figure 10: Numerical Verification of the Patterns of Taxation

		① EET	② TEE	③ TTE	④ ETT
Income (A)		100	100	100	100
Tax at contribution (B)	20%	0	20	20	0
Contribution (C=A-B)		100	80	80	100
Investment returns	3%				
Tax at investment	20%			Taxed every year	Taxed every year
Account balance after 10 years (D)		134.39	107.51	101.41	126.77
Tax at benefit (E)	20%	26.88	0.00	0.00	25.35
Take-home money (F=D-E)		**107.51**	**107.51**	**101.41**	**101.41**
Applicable systems/products		DC	NISA	Finance products in general	

Tax amounts for contributions	0	20	20	0
Tax amounts for investment returns	0	0	5.35	6.69
Tax amount for benefits	26.88	0.00	0.00	25.35
Total taxes	**26.88**	**20.00**	**25.35**	**32.04**

For the three patterns of (1) EET, (2) TEE, and (3) TTE, what will happen to the tax revenue if the conditions are changed? When the other conditions are fixed and only one condition is changed, the following is observed:

- If only the investment yield increases, (1) EET and (3) TTE tax revenues increase, but (2) TEE remains unchanged.
- If only the tax rate at the time of contribution increases, (2) TEE and (3) TTE tax revenues increase, but (1) EET remains unchanged.
- If only the tax rate at the time of investment increases, (3) the tax revenue from TTE increases, but (1) EET and (2) TEE remain unchanged.
- If only the tax rate at the time of benefit increases, (1) the tax revenue from EET increases, but (2) TEE and (3) TTE remain unchanged.

In general, since income after retirement should decrease, a lower tax rate is applied under a progressive tax rate system. Investment education under U.S. 401(k) plans teaches that it is more advantageous to put money in a retirement vehicle and receive it in the future rather than receiving it as part of current salary payments. This is based on the assumption that the tax rates at the time of contribution and at the time of payment are different.

Therefore, honestly, it is questionable whether the assumption we stated at the beginning where the tax rate is set at 20% at the time of contribution, investment and payment is realistic. It is indeed also true that tax rates fluctuate from time to time. As a result, when comparing systems, it is not necessarily wrong to understand that (1) EET and (2) TEE could have the same value if the tax rates at each stage are the same.

It is also true that tax authorities prefer immediate tax revenue rather than receiving it sometime in the future. This is why the question of whether current tax revenue should be used to encourage self-help saving for retirement efforts is always being challenged and discussed.

Chapter 6 Means of Incentivizing Self-help Efforts

I have thus far stated that it is reasonable to set a contribution limit, a benefit reason, and a tax system separately for employers and individuals.

In the final chapter, we will focus on individual contributions, and we will ask whether tax benefits are all there are, or whether there are other ways to encourage individuals to voluntarily save their retirement funds.[30] More specifically, I would like to consider whether there is a way to develop the DC system free from the burden of taxes.

In the world of capitalism, those who have knowledge and those who are willing to seek out information will be winners. This is especially true in the financial world. The liberalization of interest rates on housing loans and insurance premiums has accelerated the tendency for people with information to benefit, especially thanks to the Internet infrastructure. However, individuals vary in their ability to acquire information. The ability to acquire information depends on a variety of personal circumstances and qualities, such as whether there is time to research, whether there is someone who can teach you, and whether you are motivated to become knowledgeable in the first place. In the face of the fact that the starting points of people are so different, is it right to ask for self-help from the beginning?

In particular, private pensions, as mentioned above, play a role in supplementing public pensions. It may not be a good idea to stick to the principle of self-help efforts. I think the private pension system needs to include some kind of social-policy measures and support mechanisms.

■ Tax deduction system favors high-income earners

In many countries, income tax deductions are used as incentives for individual contributions. Japan, for its part, has adopted an income deduction system. This system is aimed at killing two birds with one stone because it reduces income tax and resident's tax, and at the same time, accumulates funds for retirement. However, it is controversial whether this is the best in terms of fairness and awareness. Especially in Japan, it cannot be said that there is no doubt.

In the first place, income tax employs a progressive tax rate, and the higher the income, the higher the marginal tax rate is applied. In other words, the absolute amount of tax benefits varies depending on the tax rate category even if the contributions are the same (Figure 11).

30. I wrote that it was voluntary, but there are countries in the world that have adopted the rule of compulsory application in private pensions such as Australia and U.K. (under the automatic enrollment system). Such countries also have incentives to contribute. A minimum contribution rate is set for mandatory private pensions, but contributions beyond that are voluntary. This is the difference between the public pension system and the compulsory private pension system.

Figure 11: Regression of Tax Benefits under the Progressive Tax Rate

In the case of a person subject to the income tax rate of 20% (assuming that taxable income is 500):

	A. Taxable Income	B. Income Tax (20%)	C. Inhabitant Tax (10%)	D. Total Tax Amount (B + C)	E. Take-home amount (A-D)	F. DC Balance	G. Real value (E + F)	H. Benefits of using DC
No contributions to DC	500	100	50	150	350	0	350	
100 contributions to DC	400	80	40	120	280	100	380	30

In the case of a person subject to the income tax rate of 40% (assuming taxable income is 2,000):

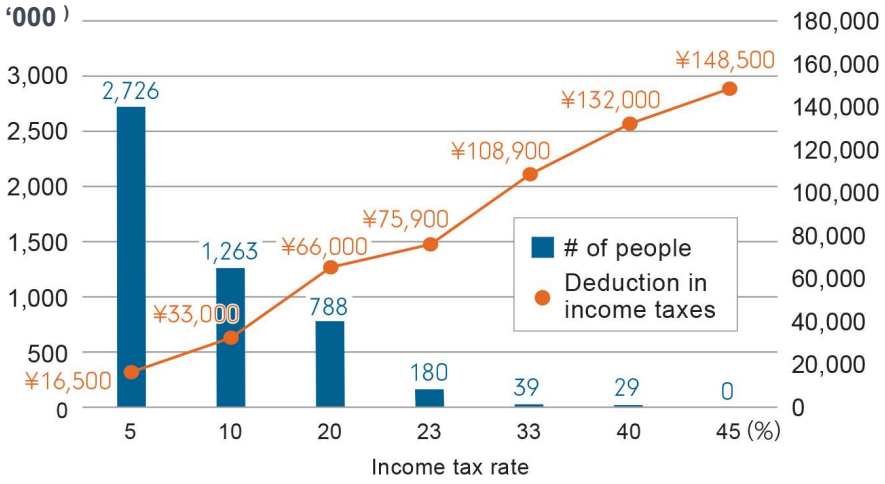
	A. Taxable Income	B. Income Tax (20%)	C. Inhabitant Tax (10%)	D. Total Tax Amount (B + C)	E. Take-home amount (A-D)	F. DC Balance	G. Real value (E + F)	H. Benefits of using DC
No contributions to DC	2000	800	200	1000	1000	0	1000	
100 contributions to DC	1900	760	190	950	950	100	1050	50

The income tax deduction would result in greater tax benefits for high-income earners. The higher the income bracket, the more money they have at their disposal, and the more motivated they are to avoid the current high taxes. For this reason, the income tax deduction system is more effective in supporting the retirement savings of high-income earners than others. Some analysts say that in the U.K., 2/3 of tax breaks through income tax deductions are used by those who apply the highest tax rate. As a social policy, it is necessary for the average income-earning class to make their own efforts to prepare for retirement. The income tax deduction system has unintended consequences.

Figure 12 shows that Japan's income tax deduction system gives preferential treatment to higher-income earners. Japan's income tax rate is now divided into seven levels, from 5% to 45%.[31] These are plotted on the horizontal axis, and the distribution of population by marginal tax rate is shown in the bar graph. On the other hand, the line graph plots how much income tax would be reduced if a person belonging to each tax rate category made a uniform annual contribution of 330,000 yen to DC. Since there is a nine-fold difference between the minimum tax rate and the maximum tax rate, there is also a nine-fold difference in absolute amounts (16,500 yen for the person with the lowest tax rate and 148,500 yen for the person with the highest tax rate).

[31] The U.S. federal income tax rate has seven brackets from 10% to 37%, and the U.K. has three, from 20% to 45%.

Figure 12: Population Distribution and Tax Relief by Income Tax Rate

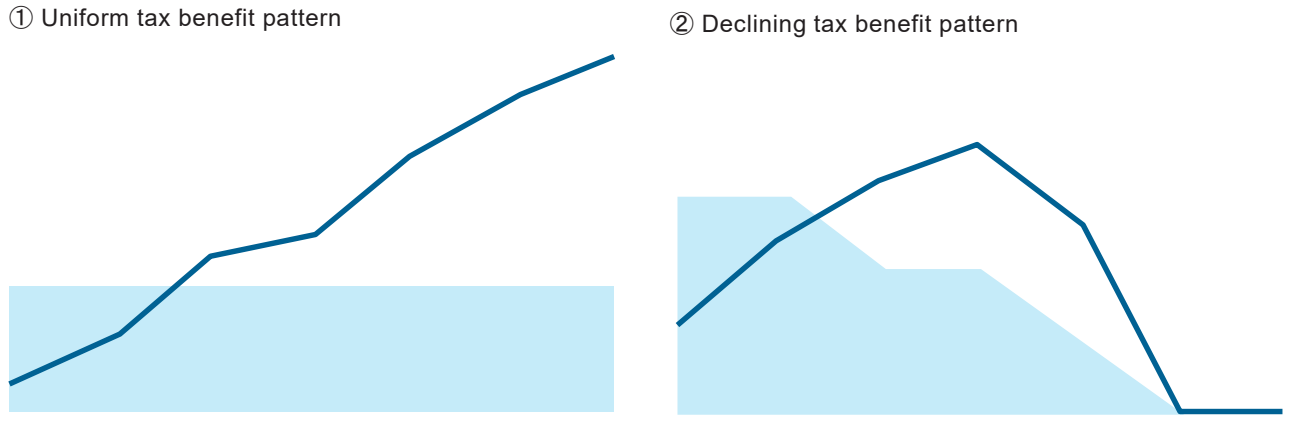


(Source) Fidelity Investment (Japan) Ltd., prepared based on the 2018 Survey of Private-Sector Salaries (September 2019)

In Chapter 3, Figure 7-1 shows a model in which all tax benefits are the same across the population. Figure 13-1 shows the effect of tax reductions based on income. The black line graph shows the tax benefits. Naturally, when incomes rise (as you go to the right side of the graph), tax incentives produce greater effects.

On the other hand, Figure 7-2 shows a model in which tax benefits are gradually reduced according to income. It is possible to create an image of tax benefit curves as shown in Figure 13-2.

Figure 13: Relationship between Preferential Tax Design and Resulting Amount (Image)



Tax deductions are not an incentive for low-income people

The income tax deduction method does not work as an incentive at all for low-income earners who do not pay income taxes, or for those without income. In order to solve this problem, in the United Kingdom, the government provides additional contributions to individual contributions,[32] thus giving benefits equivalent to income tax deductions. In addition, the U.K. government is taking measures to allow people to deduct contributions for spouses and dependents from their income. The United States has a system that allows spousal contributions to be deducted by individuals. Such measures are not yet in place in Japan.[33]

Insensitivity to tax resulting from mechanism of withholding and year-end adjustments

In addition, there are many salaried workers in Japan who are not sensitive to income taxation. In Japan, income taxes are processed through payroll withholding and year-end adjustments. There is no need to file a tax return, except for high-earners[34]. While this is a measure to ensure tax collection and to facilitate the convenience of taxpayers, it also makes it difficult for taxpayers to gain an understanding and interest in income tax and to feel the benefits of income tax deductions. This is the difference between Japan and the United States, where everyone[35] files tax returns. Japan has unique issues regarding income tax deductions.

Government matching

Some countries adopt a "government matching contribution" in place of an income tax deduction system or in a form that coexists with it. In addition to the U.K., other countries include Australia, Chile, New Zealand, Germany, Turkey and Malaysia. Government matching uses the national budget instead of income tax deductions for encouraging the formation of retirement funds through self-help efforts.

In government matching, for example, if a person makes 100 contributions, the government will make an additional 50 contribution to their account. For those who contribute 200, the government gives half, or 100. On the other hand, government matching is zero for those who do not make contributions, and it is designed to start self-help efforts and encourage people to contribute as much as possible.

Participants can see the balance of the account increase, and the investment yield seems to be 50% in an instant, so the effect as an incentive is quite high. It is particularly effective for young people who are less interested in preparing for retirement, and some countries focus on young people (20's and 30's in Malaysia). Alternatively, the target population can be limited to low-income earners (Australia).

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32. Relief at source method.

33. In Japan the national pension and national pension funds allow individuals to deduct premiums for spouses and dependents (such as students) from their income, but these rules are not applicable to DC.

34. Those who earn more than 20 million yen, those who received salaries from two or more places, and those whose non-salary income exceeded 200,000 yen.

35. Those with low incomes are excluded. For example, a single making less than $12,200 a year (2019).

Figure 14 shows a comparison between the income tax deduction method and the government matching method.

Figure 14: Comparison of the Income Tax Deduction Method and the Government Matching Method

	Income tax deduction method	Government matching method
Target	Limited to those paying income tax (there is no benefit for low or no-income people)	Can be provided to all citizens Targeting young and low-income groups is also possible
Fairness	The higher the income, the better under a progressive tax rate	Can be designed to be fair regardless of income level
Recognition	Difficult to perceive the merit without filing a tax return	Easier to perceive the merit more directly

The government matching method has many positive attributes, but at the national level in Japan there are some obstacles. While tax deduction is a matter of the Tax Bureau, the Budget Bureau oversees the matching by the government, which is part of the compilation of the budget itself. The use of the budget is decided by the Diet every year according to the provisions of the Constitution of Japan. However, it's possible the budget may not be extended to matching contributions, depending on the budget priorities of the times. Therefore, it could be difficult to guarantee permanence and stability in government matching.

If government matching is to be introduced, it may be better to use it as a temporary trigger to promote awareness of the system and prepare people for retirement, as a supplement to the income tax deduction limit, rather than as the main incentive.

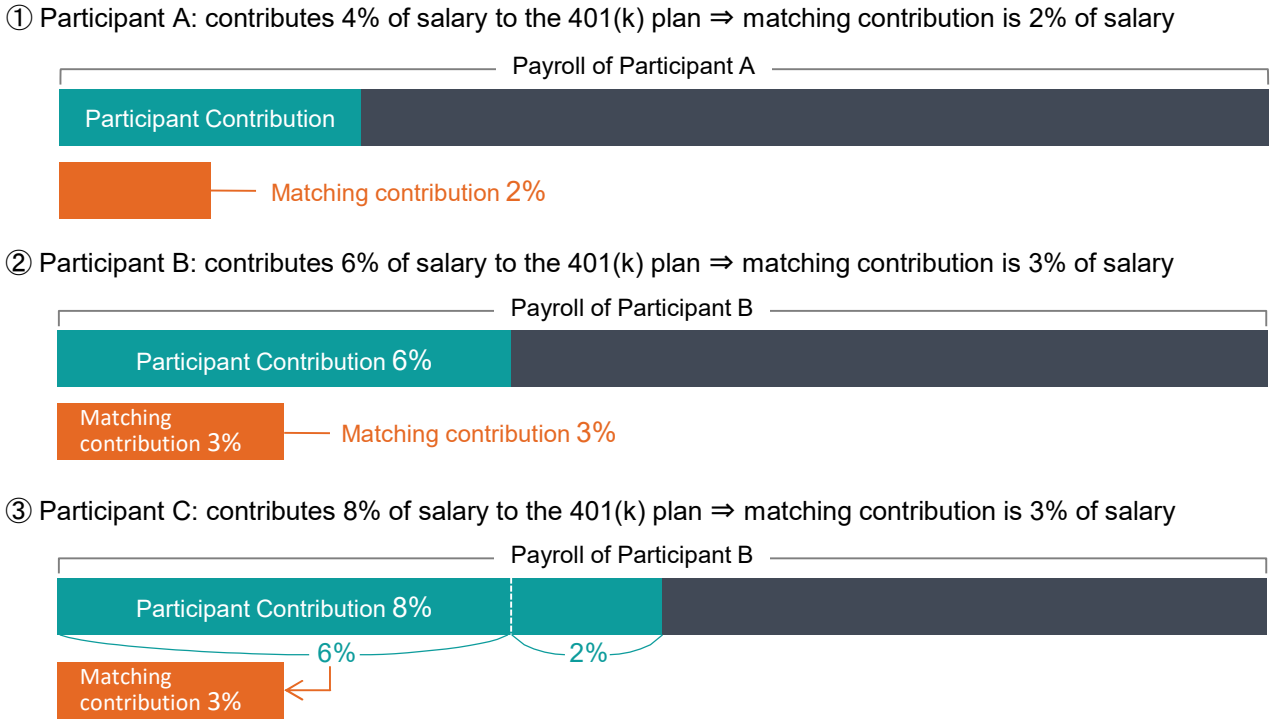
■ Employer matching

Matching contributions can be made on a per-employer basis. When the DC system was launched in 2001, there was a strict classification in which only business owners could make contributions to corporate-type plans and individuals could make contributions to individual-type plans. But now that this classification has lapsed, there is no reason to prohibit business owners from making matching contributions. The ban should be lifted as soon as possible.

When I was selling 401(k) plans in the U.S. in the 1990s, matching contributions by business owners were much more of an incentive for participants to contribute as much as possible. Although the U.S. 401(k) plan provides a double incentive with income tax deductions, it was the matching contribution that incentivized participants.

A typical design of the employer matching contribution scheme is to match up to 50% of an employee's salary, up to 6%. The mechanism is shown in Figure 15. Participant A contributes 4% of his/her salary to the 401(k) plan. The employer will contribute 2% of his/her salary to Participant A's personal account. Meanwhile, Participant B contributes 6% of his/her salary. In this case, the matching contribution from the employer is half, or 3%. As a result, if things continue as they are, the higher the income, the more money the employee can afford to contribute. So there is a question of fairness related to employer matching: there is an upper limit here. Participant C, for example, contributes 8% of his/her salary, but employer matching comes in at less than half of 4%. This is because the 8% is broken down into the first 6% and the remaining 2%, with employer matching applied to only the first 6%.

Figure 15: Employer Matching Contribution



If employer matching is judged to be an effective HR policy, there is no alternative but to introduce it. It would be much more effective to design these plans by changing the current "6% of salaries paid uniformly to all participants" (as is the case with current corporate-type DC designs), to "In addition to the uniform contribution of 3%, half of the participant's contribution will be added (up to 6% of salary)."

People will listen once they understand the benefits

"Compounding is the strongest force in the universe" (Albert Einstein)

"Young people need to think about saving, but they don't understand it at all. It is because they cannot understand the concept of "long-term." (partial omission) They should not think of it as savings, but as magic. Put $1000 in a magic box and 40 years from now it will be $10,000 to $25,000.[36]" (Scott Galloway)

Today, with zero interest rates, "compound interest" may be an appropriate way to express the "mechanism by which returns yield returns". Understanding the effects of compounding is the essence of investment education in a self-help pension. It would be a good idea to have people understand this point as the gateway of asset management, and then move on to other basics such as the need for diversified investment.

The bridge to this understanding is the incentive measures, that is, the mechanism that makes people think they would "be better off doing" something. Young people have the resource of time and can make the most of the effects of compounding, but they have low incomes and a high propensity to consume. As a result, no action is taken to prepare for retirement. There are many expensive events in life, such as marriage, childbirth, education, and buying a house, and retirement comes much later in life. However, if they save even a small amount every month, they can make more preparations with far less money than if they were to prepare later in life. That's because compounding lasts for years. In other words, differences in the design of savings incentives that are readily apparent are called into question.[37]

Withdrawals other than for retirement

While promoting saving and investment, it’s necessary to reduce insecurity to encourage self-help preparations. This is because people have concerns about withholding contributions for fear of being locked into retirement funds.

The U.S. IRA allows withdrawals for purposes such as paying high medical costs (more than 7.5% of income), initial home purchases, or higher education costs for yourself or your family. Therefore, it is possible to accumulate funds for retirement with peace of mind.

In Japan, DC benefits are accessible only for retirement, death, and severe disability. This is reasonable for employer contributions that are derived from retirement benefit allowances. However, the situation is different when it comes to individual contributions, in which an individual decides whether or not to pay money based on his or her own will. Restrictions on the use of the money will make it difficult to fully utilize the system.

Employers and participants can contribute to the U.S. 401(k) plan, but benefits can be paid for different reasons, depending on who contributes. With respect to participant contributions, hardship withdrawals similar to the IRA[38] are allowed. That allows people to prepare for retirement with ease. Again, this shows that it is meaningful to separate the sources of benefits for employers’ and participants’ contributions.

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36. Galloway, The Algebra of Happiness (Toyo Keizai Inc. 2019). Direct translation. Of course, how much $1000 will be in 40 years depends on the investment environment and asset allocation.

37. It is said “These days, young people consume less. They are saving money for fear of the future. This is having a negative impact on the economy". In the absence of information, excessive anxiety increases inaction. It would be good to show an indicator of what percentage of annual income should be saved at what age. See Fidelity Institute for Retirement and Investment Education, Viewpoint Vol 9 “Fidelity Retirement Reserve Indicator," 2018.

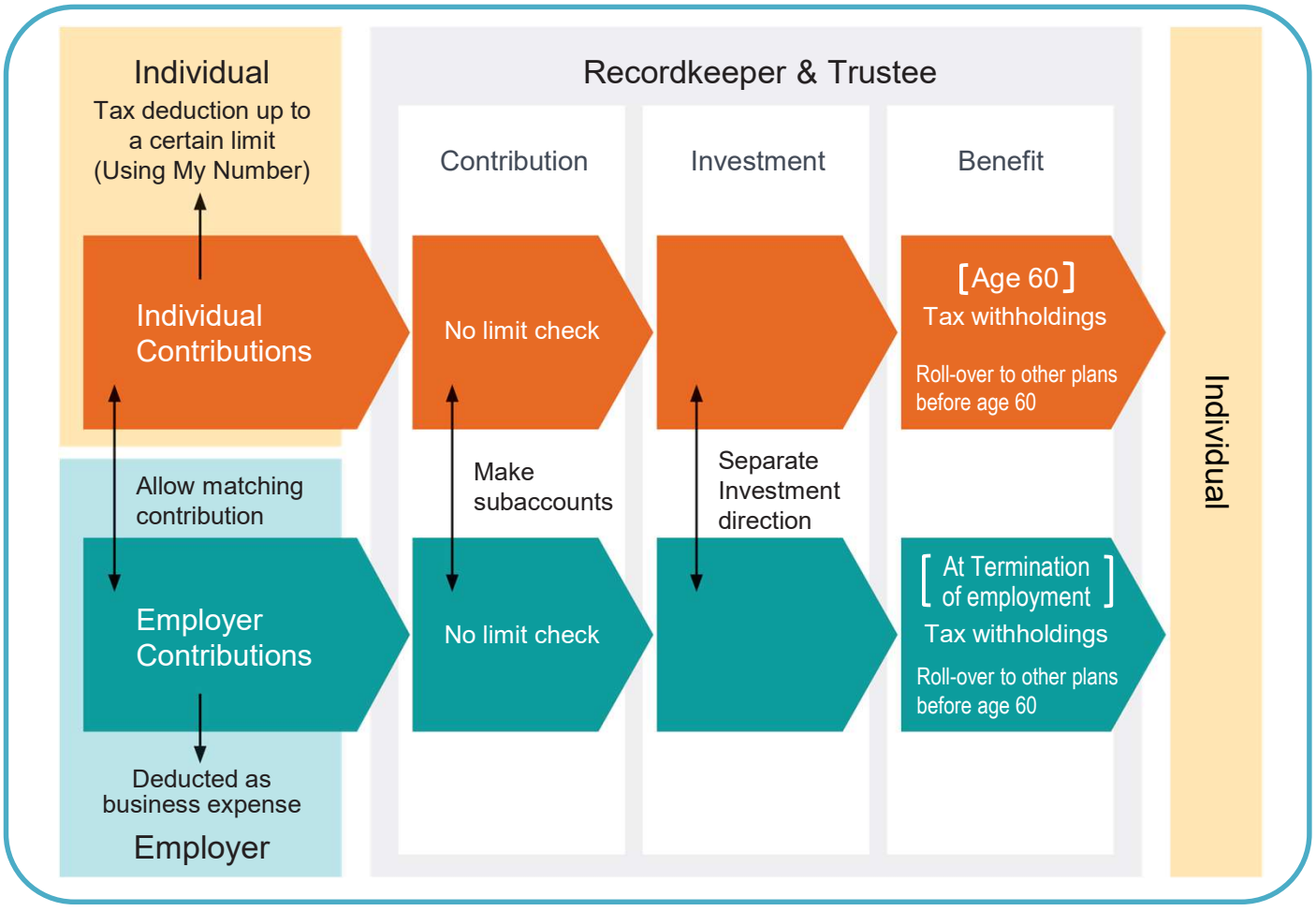
38. It lists the costs of higher education, the purchase of homes and the prevention of evictions and foreclosures, and medical costs, as well as the individual circumstances of the participant.

Conclusion

My proposals are summarized as follows:

1. Eliminate the distinction between corporate-type DC and individual DC. Instead, define the contribution limits, benefit reasons, and taxation based on who makes contributions (employers and individuals).
2. Expanding tax breaks is the best option. However, if it is difficult to do so, then the maximum amount of contribution and the maximum amount of tax breaks should be set separately and, if necessary, allow after-tax contributions.
3. The biggest advantage of defined contribution pension plans is that they are easy to understand. Introduce uniform limits that everyone can remember, an administration system that does not incur social costs, and easy-to-understand incentives.

These are illustrated as follows:



Conclusion

2020 marks 20 years for DC in Japan. In the case of humans, 20 years represents coming of age. However, this is not the case for DC plans today.

The former Ministry of Labor was one of the first administrative agencies to consider the introduction of DC plans. Since the Zaikei Nenkin (asset-building pension system) under its jurisdiction is similar to the 401(k) plan in the U.S., the idea was to develop it in this way. The study was conducted in 1997, and I participated in the study as a person with actual experience in U.S. 401(k) plans. The NLI Research Institute compiled the results in the "Report of the Study Group on the Management of Worker Contribution Pension Systems" in March of the following year. However, it was considered difficult to obtain tax benefits such as the 401(k) plan in the era when the preferential tax system for savings had been abolished, and the plan was aborted.

Concrete work on DC legislation started in December 1998 when the Liberal Democratic Party's Tax Reform Outline sought "to take tax measures if defined contribution pension plans are to be realized." In the following year deliberations began at so-called “four-ministry” conferences between the Ministry of Health and Welfare, the Ministry of Labor, the Ministry of Finance, and the Ministry of International Trade and Industry (all names at that time).

At that time, the need was to control retirement benefit obligations by DB with the introduction of the new corporate accounting system in 2000, as mentioned above. The argument for the establishment of a system to support the creation of assets in old age through self-help efforts had not yet matured, and the time had come too soon.

20 years have passed since then, however, and self-help efforts have become a keyword, and people have become more aware of how to prepare for retirement. I think it is time to explore the approach of the former Ministry of Labor.

It is highly likely that the "equal pay for equal work" paradigm which was applied in April 2020 will eventually evolve to prohibit unreasonable discrimination in retirement benefits. At present, the eligibility of DB and DC are mostly limited to regular employees. If this is to be extended to non-regular employees, what form will it take? Is it "fairness of eligibility for membership" that allows anyone to join regardless of whether employment is regular or irregular, or is it going beyond that to "level of fairness" such as "same contribution for the same labor?" It will depend on future discussions. The taboo would be tougher regulations that would make business owners think, "if that's the rule, we'll abolish retirement benefits."

The system must continue to be upgraded in accordance with the development of people's consciousness, technology, and social and economic changes. We hope that discussions on reforming corporate and individual pension systems will be held in a way that is acceptable to everyone.

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Appendix Study on the Contribution Limits for Corporate Defined Contribution Pensions in Japan

In the September 2009 issue of the Securities Analyst Journal (Volume 47, No. 9), the author wrote an article titled "Problems related to defined contribution pension plans" in which he extracted the portion related to the contribution limits and updated the figures.

1 Issue of contribution limits

(1) Low contribution limit

About 19 years have passed since the defined contribution pension plan was introduced in October 2001. As of March 31, 2020, the number of corporate-type DC plans was 6,107, the number of employers implementing the plan was 33,599, and the number of participants was about 7 million (approximately 1.8 million individual participants, etc.)[39]. These indicators are now comparable to defined benefit corporate pension plans.[40] However, there is a large gap between the assets size of approximately 12.5 trillion yen of corporate-type DC plans (the individual-type DC is 1.9 trillion yen.) and that of the defined benefit corporate pension plan of approximately 63 trillion yen. The presence of defined contribution pension plans in the Japanese corporate pension system remains small.

Unless the defined contribution pension market grows significantly and the number of players involved in this business increases the principle of competition will not work, and as a result, the service to participants will not be improved. The main reason why the assets size of defined contribution pension plans remains low is the low limit of contributions.

The maximum amount of contribution of a defined contribution pension plan is 660,000 yen per year (55,000 yen per month) per person when there are no other DB pensions, and 330,000 yen per year (27,500 yen per month) per person when there are other DB pensions. We will first examine how inadequate these levels are.

In many cases, defined contribution pension plans in Japan are introduced in a form that shifts from existing defined benefit retirement plans. In doing so, contributions for the defined contribution pension plan are set using certain assumptions so that the level of benefits at the age of 60 under the previous system is almost equal to the balance of the defined contribution pension plan at the age of 60 (Figure A).

39. DC Plan Administrator Association "Defined Contribution Pension Statistics from March 2002 to March 2019"

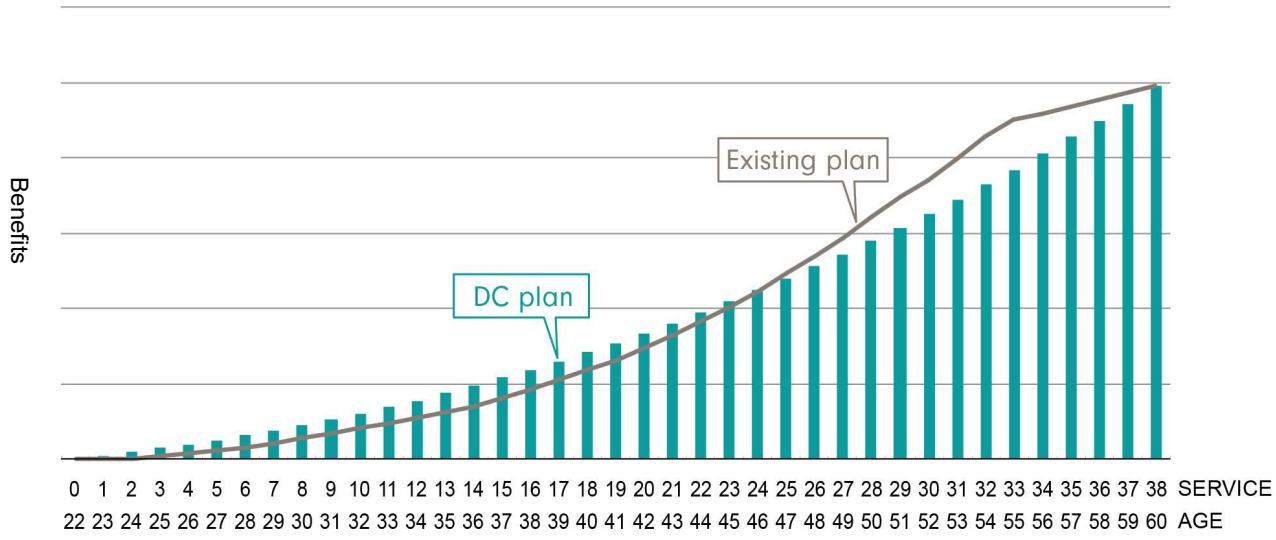
40. The number of defined benefit corporate pension plans is 12,952 and the number of participants is approximately 9.4 million (Pension Fund Association "Basic data on corporate pension plans, 2019 edition").

As a concrete example, we assume a model employee who enters the company at the age of 22 and retires at the age of 60. Under the current system, benefits are calculated by multiplying the pensionable salary by the factor according to years of service. Values for the pensionable salary (usually part of one's annual income), rate of return, and amount of benefits for each age were prepared by referring to the Central Labor Relations Commission "2017 Survey of Wage Situation Table 10 Model Prescribed Wages," "2017 Survey of Retirement Allowance, Pension, and Mandatory Retirement System (Table 11) Model Retirement Amount," and supplementing the values as appropriate. According to the survey of the latter (career-track position), the model retirement amount at the age of 60 was calculated in three ways: (1) the retirement allowance on involuntary termination is about 28 million yen, (2) the retirement allowance on voluntary termination is about 26.32 million yen, and (3) both the retirement allowance and pension are about 30.38 million yen[41]. Figure B shows the case of (1).

On the other hand, the contribution for the defined contribution pension plan shall be a fixed rate of the pensionable salary, and the balance shall be accumulated by adding the return on assets. Then, at the age of 60, the three levels are set as described above.

Figure A: Benefit curves for defined benefit plans and defined contribution pension plans

Figure A: Benefit curves for defined benefit plans and defined contribution pension plans



The balance of defined contribution pension plans consists of contributions and investment income, but the amount of investment income cannot be predicted in advance. Therefore, we calculate back the contribution required to reach the target balance by assuming a certain assumed yield first. At this time, the higher the assumed yield, the smaller the contribution, and the lower the assumed yield, the larger the contribution. The Pension Fund Association compiled data on assumed yields actually adopted by companies. As shown in Figure C, most of them were over 1.5% and less than 2.5%, with an average of 1.96%.

41. The figure for the manufacturing industry is higher than the total for the surveyed industries: about 30.38 million yen for (1), about 28.9 million yen for (2) and about 33.17 million yen for (3).

In Figure B, the expected yield was set at 2.0%, and a contribution to reach a balance of nearly 28 million yen at the age of 60 was calculated. As a result, it was found that if 9.65% of the pensionable salary was set as contributions, it would approach the target amount.

However, if the pensionable salary is multiplied by 9.65%, the contribution amount exceeds the DC contribution limit at a certain age as the salary increases. In the column G of Figure B, the amount in the event that the maximum annual contribution amount exceeds 660,000 yen is shown. In this example, the amount in excess of the maximum annual contribution amount occurs at the age of 48 years. The portion in excess of the limit is calculated on the assumption that the assumed yield will be given for illustrative purposes.

Figure B: Trends in Benefits for Model Employees

(A) Age	(B) Service	(C) Pensionable salary (annual)	(D) Multiples based on years-of-service	(E) Final-pay benefits	(F) DC annual contribution	(G) Over-the-limit portion	(H) DC accout balance (at the beginning of the year)
22	0	2,598,000	0.0	0	250,707	0	0
23	1	2,726,800	0.0	0	263,136	0	253,214
24	2	2,855,600	0.0	0	275,565	0	524,046
25	3	2,984,400	0.9	223,876	287,995	0	812,848
26	4	3,163,200	1.8	474,578	305,249	0	1,119,979
27	5	3,342,000	2.7	752,105	322,503	0	1,450,680
28	6	3,520,800	3.6	1,056,458	339,757	0	1,805,422
29	7	3,699,600	4.5	1,387,636	357,011	0	2,184,685
30	8	3,878,400	5.4	1,745,640	374,266	0	2,588,960
31	9	4,057,200	6.3	2,130,469	391,520	0	3,018,748
32	10	4,236,000	7.2	2,542,124	408,774	0	3,474,558
33	11	4,414,800	8.1	2,980,605	426,028	0	3,956,911
34	12	4,593,600	9.0	3,445,911	443,282	0	4,466,337
35	13	4,772,400	9.9	3,938,042	460,537	0	5,003,379
36	14	4,941,360	10.8	4,448,141	476,841	0	5,568,589
37	15	5,110,320	12.2	5,175,266	493,146	0	6,161,570
38	16	5,279,280	13.5	5,940,415	509,451	0	6,782,879
39	17	5,448,240	14.9	6,743,588	525,755	0	7,433,082
40	18	5,617,200	16.2	7,584,784	542,060	0	8,112,756
41	19	5,812,080	17.6	8,501,920	560,866	0	8,822,491
42	20	6,006,960	19.4	9,688,221	579,672	0	9,565,416
43	21	6,201,840	21.2	10,932,998	598,478	0	10,342,192
44	22	6,396,720	23.0	12,236,250	617,283	0	11,153,499
45	23	6,591,600	24.8	13,597,979	636,089	0	12,000,025
46	24	6,711,600	26.6	14,852,478	647,669	0	12,882,476
47	25	6,831,600	28.8	16,399,222	659,249	0	13,794,271
48	26	6,951,600	31.1	17,990,975	670,829	10,829	14,735,999
49	27	7,071,600	33.3	19,627,737	682,409	22,409	15,708,256
50	28	7,191,600	35.6	21,309,509	693,989	33,989	16,711,655
51	29	7,256,400	37.8	22,862,375	700,243	40,243	17,746,817
52	30	7,321,200	39.6	24,164,943	706,496	46,496	18,808,999
53	31	7,386,000	41.2	25,348,440	712,749	52,749	19,898,739
54	32	7,450,800	42.8	26,548,950	719,002	59,002	21,016,591
55	33	7,515,600	43.7	27,343,634	725,255	65,255	22,163,115
56	34	6,978,000	44.6	25,911,168	673,377	13,377	23,338,885
57	35	6,978,000	45.5	26,434,626	673,377	13,377	24,485,773
58	36	6,978,000	46.4	26,958,084	673,377	13,377	25,655,600
59	37	6,978,000	47.3	27,481,542	673,377	13,377	26,848,822
60	38	6,978,000	48.2	28,005,000			28,065,910

Figure C: Assumed yield distribution of defined contribution pension plans

Assumed investment returns	# of employers	Proportion
0.00%	14	3.5%
Over 0.0%～0.5%	4	1.0%
Over 0.5%～1.0%	41	10.1%
Over 1.0%～1.5%	49	12.1%
Over 1.5%～2.0%	158	39.1%
Over 2.0%～2.5%	110	27.2%
Over 2.5%～3.0%	20	5.0%
Over 3.0%～4.0%	6	1.5%
Over 4.0%～5.0%	0	0.0%
Over 5.0%～	2	0.5%
Average	1.96%	

(Source) Pension Fund Association [2020] "Basic data on corporate pension in FY 2019"

Changing the expected yield will change the required contribution rate (Figure D). If the rate is set at a conservative level of 1.5%, the required contribution rate will increase to 10.5% and the age at which the limit is exceeded will be earlier. Conversely, if the assumed yield is raised, the age at which the amount exceeds the limit will be delayed.

Figure D: Assumed yield, required contribution rate, and age in excess of the contribution limit

Scenario①: Retirement allowance on involuntary termination: General industry at 60: 28,005,000 yen

Assumed investment returns	Necessary contribution rates	Account balance at age 60	Age when exceeding the contribution limit
1.50%	10.50%	27,984,463	44
2.00%	9.65%	28,065,910	48
2.50%	8.80%	27,990,818	55
3.00%	8.05%	28,064,487	—

Scenario②: Retirement allowance on voluntary termination: General industry at 60: 26,320,000 yen

Assumed investment returns	Necessary contribution rates	Account balance at age 60	Age when exceeding the contribution limit
1.50%	9.85%	26,252,091	46
2.00%	9.05%	26,320,879	52
2.50%	8.25%	26,241,932	—
3.00%	7.55%	26,321,351	—

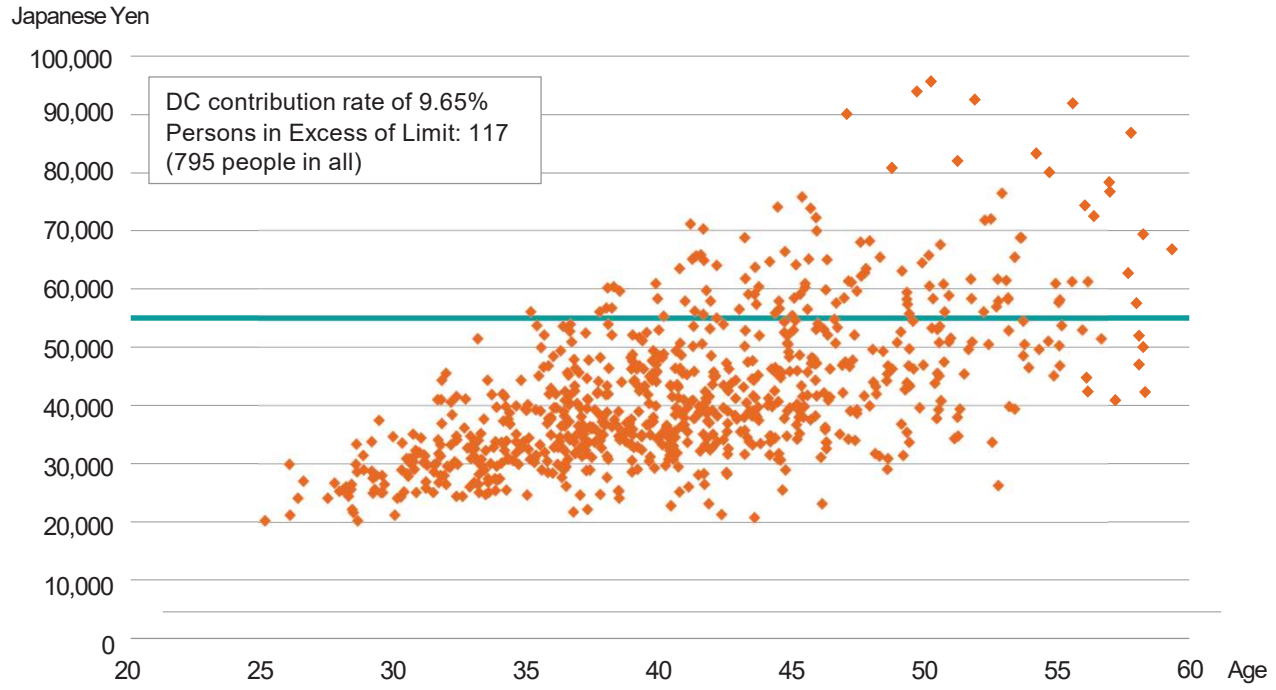
Scenario③: Retirement allowance annuities on involuntary termination: General industry at 60: 30,381,000 yen

Assumed investment returns	Necessary contribution rates	Account balance at age 60	Age when exceeding the contribution limit
1.50%	11.40%	30,383,131	43
2.00%	10.45%	30,392,617	44
2.50%	9.55%	30,376,400	48
3.00%	8.75%	30,504,877	—

The above results are based on an examination of model employees at companies that provide an average level of retirement benefits. In fact, some employees receive more than this amount, and in the first place, there are companies with higher retirement benefits than this amount. Therefore, the contribution limit of the current defined contribution pension plan is not sufficient.

Figure E shows the distribution of the contribution level of employees of companies with retirement benefit plans similar to the above model. The horizontal axis is age and the vertical axis is contribution amount, and each point represents each employee. Above the thick bars are those who exceed the DC contribution limit. Assuming a contribution rate of 9.65%, we can see that 117 out of 795 employees exceed the limit.

Figure E: Relationship between individual employee's contribution and the DC contribution limit



(Source) Willis Towers Watson

Because the contribution limit is low the defined contribution pension plan alone cannot provide the former retirement benefit level and many companies have no choice but to have other retirement plans at the same time. Worse yet, when a defined benefit corporate pension plan (DB) coexists, the lower 330,000 yen (27,500 yen per month) is applied as the contribution limit to the defined contribution pension plan. The mere fact that there are other defined benefit corporate pension plans, regardless of the level of benefits, makes the design of defined contribution pension plans even more restrictive because the limits are uniformly halved.

(2) DC contribution limits in other countries

It would be meaningful to compare the DC contribution limits with those of other countries as are shown in Figure F. In many countries, employer contributions have no limits or are sufficiently high. As a matter of course, participant contribution is allowed, and in many countries, after-tax contribution is allowed even if there is a tax-free limit. The meagre level of contribution in Japan is obvious.

Figure F: DC contribution limits of major countries

	Employer's contribution	Participant contribution
United States	The annual per capita contribution limit for employer and participant contributions for 2020 is whichever is smaller of the following: - USD 57,000 (Approx. 6.14 million yen) - 100% of his/her salary	
	The deductible amount is 25% of the total salaries of all eligible participants	In 2020, the annual tax-free limit (elective deferral) is USD19,500 (Approx. 2.1 million yen). It is increased by USD6,500 (Approx. 700,000 yen) for those aged 50 and over Additional after-tax contributions are allowed
United Kingdom	No limit for deductible expenses for business purposes.	Greater of the following - 100% of earned income in the U.K. - £3,600
	Annual allowance £40,000 (Approx. 5.3 million yen) per person per year for both DB and DC plans that include contributions of employers and participants There is a separate Lifetime Allowance of £1,055,000 (Approx. 140.32 million yen).	
Hong Kong	A mandatory contribution of up to 5% of each employee's salary. Voluntary contributions are allowed and there is no contribution limit, but up to 15% of the total employee salary, including the mandatory portion, is deductible.	5% of salaries are compulsory (tax free). It is possible to make voluntary contributions and there is no limit to the amount of contribution, but there is no benefit of tax exemption.
South Korea	No contribution limit (deductible in full). The minimum contribution rate is set at 8.33% (= 1/12).	No contribution limit. However, the tax-free limit is 7 million won per year (Approx. 610,000 yen).

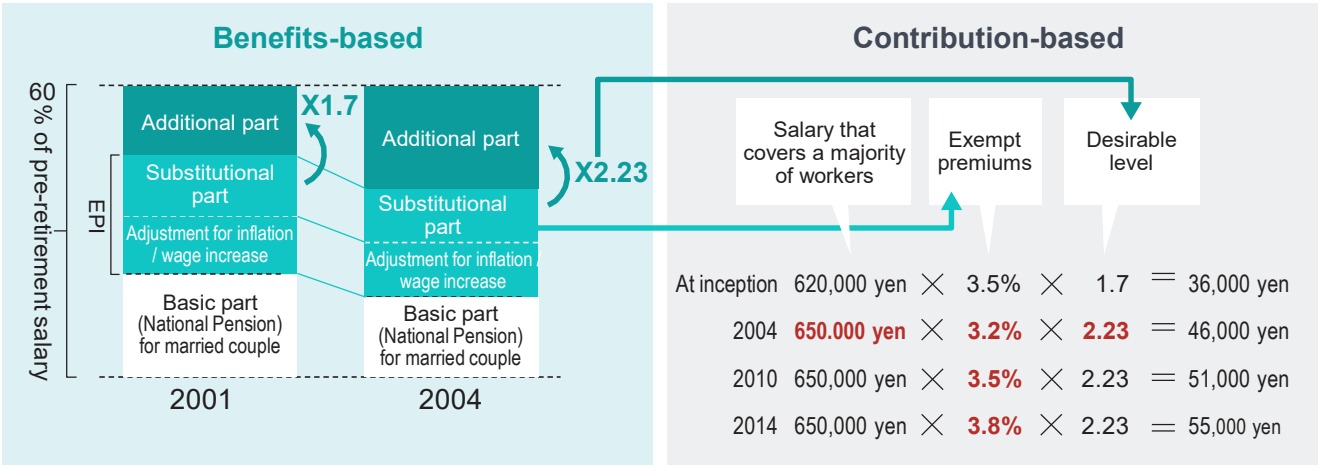
※Exchange rates as of this writing

(3) How the current contribution limit was derived in Japan

The Ministry of Health, Labor and Welfare explains the basis for the current contribution limit as follows. "Set DC contribution limits to ensure that benefits are equivalent to the preferred benefit level of the additional portion of the Employee Pension Fund (EPF). This is the level which is equivalent to approximately 60% of pre-retirement salary if combined with social security old age pension for married couples."

This explanation is complicated, but Figure G will help you understand. First of all, it is assumed that a company has an EPF. An EPF is a corporate pension system that substitutes a part of the social security old age pension (employee pension insurance) and provides additional benefits on its own. The level of the additional benefits varies from EPF to EPF, but it was determined that the total of the social security old age pension and EPF benefits reached 60% of the salary just before retirement as the "desirable level." To reach that level, the additional portion of EPF would need 1.7 times the amount of the substitutional portion.

Figure G: Deriving the DC Contribution Limit



(Source) Ministry of Health, Labour and Welfare

Up to this point, we have been discussing the level of benefits, but from now on, we will be discussing the amount of contributions required to cover that level of benefits. First of all, if you have an EPF, the premiums to cover the substitutional portion (called the exempt premium) is paid to the EPF rather than to the national government (the term "exemption" is established this way). Originally, the exempt premium is determined by multiplying the standard monthly remuneration of an individual by different exempt premium rates by respective EPF. At the time when the DC system was established, it was decided that the amount obtained by multiplying the monthly income of 8 million yen (the salary level that covers nearly 90% of private-sector salaried workers), which was 620,000 yen, by the exempt premium rate of 3.5%, was the exempt premium. And then, multiplying this amount by 1.7 produced the contribution necessary to cover the "desirable level". The monthly amount was calculated to be about 36,000 yen, which became the first limit of the DC contribution. At the same time, however, a contribution limit of 18,000 yen, half of the amount, was uniformly set to "deduct the contribution from the average benefit level of the EPF" for those who participate in DB plans.

Subsequently, reflecting a future decrease in benefits due to the revision of the public pension system in 2004, the coverage ratio to achieve the "desirable level" was raised from 1.7 to 2.23, and the contribution limit was raised to 46,000 yen per month. In addition, the contribution limit will be increased from 51,000 yen per month in 2010 to the current 55,000 yen per month in 2014, based on the increase in the exempt premium rate resulting from the decrease in the death rate (longevity).

This shows that the DC contribution limit was derived from an EPF that is no longer a major plan.[42] With this as the starting point, various assumptions such as “1.7 times as much as the desirable level," “an exempt premium rate of 3.5% (the maximum exempt premium rate stipulated is 5.0%.),” and “uniform half regardless of the benefit level of the DB plan” that do not seem to be very persuasive were used. In addition, the idea of setting an upper limit is not persuasive because it is based on numerical values such as average and mode.

EPFs have completed their historical role and it is no longer reasonable to use them as a starting point for setting DC contribution limits. If the limit on employer's contribution to the corporate-type DC plan is to be maintained, a new rule that makes sense to everyone is needed.

[42] As of the end of March 2019, only eight EPFs are in existence.

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