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The Political-Economic Dimension of Pensions: The Case of Japan

GENE PARK*

This article examines how pensions are interwoven with the public and private financial system in Japan and the consequences for pension reform. A growing literature focuses on the multifaceted ways in which pensions are interwoven with the larger political economy. This study builds on this literature and finds that (a) public and private pensions have been integrated deeply into Japan's system of developmental finance, (b) this integration has created new economic and political problems as governments have attempted to shift away from its developmental model through deregulation, liberalization, and administrative reform, and (c) because pension reform is intimately linked with these reforms, it involves addressing fundamental issues regarding the role of the state, finance, and firms. These findings collectively illustrate that pension reform is not only driven by issues of fiscal viability and benefit levels, but also by the nature of the way in which pensions are integrated into a country's system of finance.

In the postwar era, the Japanese pension system played a critical role in the broader system of public and private finance, providing funds to finance industrial development and to reward supporters of the ruling party. In recent years, however, the pensions–finance nexus has generated a host of new political and economic problems that reach deeply into Japan's political economy. Much of the existing welfare state literature focuses on pensions as benefit provision, and analyzes pension politics from the perspective of benefit levels and battles over retrenchment (Baldwin; Bonoli; Esping-Andersen and Korpi; Myles and Pierson; Pierson). More recent work has begun to explore connections between pensions and political economy more broadly, including the links between pensions and industrial relations and between pensions and systems of finance (Ebbinghaus and Manow; Estevez-Abe 2001; Jackson and Vitols; Manow 2001a, 2001b).[1] This article builds on this new research to explore the pension–finance connection, demonstrating how the specific nature of the linkage between pensions and finance in Japan has produced unanticipated problems today.

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The Japanese public pension system is partially funded, meaning that it has accumulated massive funds, in contrast to the so-called *pay-as-you-go* (PAYG) pensions common in most advanced industrialized countries.[2] These funds have become an important source of public finance for a wide variety of purposes, from supporting development to buying political support. Private pensions have also become an important source of finance. *Book-reserve* plans have provided firms with patient capital, and the capital from funded private pensions has been heavily regulated, with the Ministry of Finance (MOF) strongly influencing investment decisions. But the integration of pensions into Japan's system of finance has given rise to a set of new pension and economic problems as Japan has attempted to shift away from its developmental model through deregulation, liberalization, and administrative reform. As political actors attempt to determine who invests pension funds and how investments are made, they must address fundamental issues regarding the role of the state, finance, and firms. Japanese officials are increasingly aware that the goal of pension investments should not be to provide patient capital or public finance, but rather to ensure the solvency of the pension funds themselves. Making this transition, however, has been neither easy nor fully successful. Pension problems are woven deeply into Japan's political economy and current financial problems. Political and bureaucratic actors strongly influence the substance of reforms, and they are often reluctant to cede access to financial resources that have served a multitude of useful economic, political, and bureaucratic ends.

JAPAN'S PENSION SYSTEM: FINANCIAL ROLE IN THE DEVELOPMENTAL STATE

This section describes the basic outlines of both the public and private pension systems and explains how each was incorporated into Japan's developmental financial system. Japan's pension system is very complex and fragmented.[3] The key distinction, though, for the purposes of this essay is the difference between public (*kōteki nenkin*) and private pensions (*shiteki nenkin*). While both public and private pension systems have been used to promote developmental ends, they have been integrated into Japan's system of finance in very different ways. Public pensions, which are partially funded, have become an important source of public finance. Private pensions, by contrast, have been used as a source of "patient capital" by firms and as a means for solidifying corporate ties.

Public Pensions

There are three main public pensions—the National Pension (*kokumin nenkin*), Employee Pension (*kōsei nenkin*), and Mutual Aid Pension (*kyosai nenkin*). The Mutual Aid pensions are the oldest. They cover civil servants, teachers, and several other occupational groups. The Employee Pension

covers employees in firms with over five persons. While the Employee Pension is mandatory and the government manages the funds, there is also an additional private component—the Employee Pension Fund (*kosei nenkin kikin*)—that companies can self-manage if they choose to do so. This distinction is pointed out to avoid confusion because the names of the pensions are so similar. The critical point is that one part is public and the other private. The National Pension was created in 1959 and acts as a type of residual pension for those not covered by the Employee Pension or Mutual Aid Pension.

Japan's public pension system is a partially funded system. The National Pension is essentially PAYG, but the Employee Pension has been partially funded since its creation. At present, the combined sum of Japan's public pensions, excluding the Mutual Aid pensions, is about 1.4 trillion yen, or about just over 1 trillion dollars (Table 1). Relative to pension payments, this is a relatively large sum. In 1996, the total reserves for the public pension funds were enough to cover benefits for 5.2 years. In the United States, there was only about a year's reserve, and France and Germany maintain only a few months reserve (Shibata).

The funds from the National Pension and Employee Pension, until April 2001, were transferred to the Trust Fund Bureau, which is overseen by the MOF (the changes to this system are discussed in the following section). Funds from the postal savings system were also deposited to the Trust Fund Bureau. The MOF oversaw these combined funds and distributed the pension and postal savings funds through the Fiscal Investment Loan Program (FILP) or *zaito*. In 1999, the total cumulative funds of the Trust Fund Bureau were 436 trillion yen—at about 120 yen to the dollar, that is 4 trillion dollars, a sum larger than Japan's economy or about three times the size of the British economy. The postal savings deposits consti-

TABLE 1
Japan's Public Pensions (100 million yen)

FY	Employees Pension Insurance	National Pension	Total
1989	702,175	32,216	734,391
1990	768,605	36,317	804,922
1991	839,970	43,572	883,542
1992	911,340	51,275	962,615
1993	978,705	58,468	1,037,174
1994	1,045,318	63,712	1,109,030
1995	1,118,111	69,516	1,187,628
1996	1,184,579	74,493	1,263,072
1997	1,257,560	84,683	1,342,243
1998 (est.)	1,308,074	91,402	1,399,476

Source: Ministry of Health, Labor, and Welfare.

tute the majority of the Trust Fund Bureau, but pension deposits have grown, and in 1999, accounted for 134 trillion yen out of 436 trillion yen.

The funds from the Trust Fund Bureau and FILP have been the key link between Japan's pension system and the nation's developmental policies. The Trust Fund Bureau was created after World War II to rationalize the collection and distribution of various funds and to centralize the MOF's control of the allocation of these funds. In the early 1950s, the consolidation of these funds was paralleled by the creation of specialized public corporations that served public purposes, which in the early years of FILP revolved around promoting industrialization. The Japan Development Bank (JDB) and the Export-Import Bank of Japan, two of the most well-known public corporations, both served as key institutional pillars in Japan's industrialization strategy.

In the early postwar period, capital was highly scarce. Government control over the allocation of FILP funds enabled the government to steer capital to key industries. The JDB alone provided 22 percent of capital to these industries. Between 1953 and 1955, JDB financing accounted for 23.1 percent of all investments in electric power, 33.6 percent in shipbuilding, 29.8 percent in coalmining and 10.6 percent in new steel plants (Johnson). These figures underestimate the real impact of government financing, because such financing had a strong signaling effect to the private sector by indicating the government's commitment to strategic sectors (Johnson).

As Table 2 shows, "industry/technology" uses accounted for the largest share of FILP funds in 1955 with "transportation/communications"

TABLE 2
Allocation of FILP Funds by Use, Various Years

	1955	1965	1975	1985	1997	1998	1999
1 Housing	13.8	13.9	21.4	25.4	35.3	35.6	32.7
2 Living environment	7.7	12.4	16.7	15.7	18.5	17.5	17.1
3 Social welfare	2.1	3.6	3.4	2.8	4.2	4	3.8
4 Education	4.5	3.1	2.9	3.6	2.1	2.1	2.1
5 Small and mid-sized businesses	8.1	12.6	15.6	18	13	16.7	16.1
6 Agriculture, forestry, and fisheries	8.9	7.2	4.1	4.3	2.6	2.4	2.2
7 National land preservation in the event of disaster	7.7	3.1	1.2	2.3	1.4	1.5	1.7
8 Road construction	3.7	7.9	8	8.8	9.7	9.1	8.6
9 Transportation/ Communications	12.2	13.9	12.7	8.4	4.2	1.7	1.9
10 Regional development	8.5	7	3.3	2.4	2.7	2.9	3.5
11 Industry/Technology	15.8	7.8	3	2.9	2.4	2.4	3.6
12 Trade/Economic cooperation	7	7.5	7.7	5.4	3.9	4.1	6.7

Source: Ministry of Finance.

and "trade/economic cooperation" also accounting for relatively large shares. With priority on industrialization-related activities, returns on the pension fund investments were not a priority. This bias has continued even after FILP funds shifted away from industrialization toward more politically motivated uses—such as responding to calls for greater environmental spending, housing, and welfare in the late 1960s and 1970s (see Table 2).

The amount of funds increased exponentially growing between 1955 and 1999 by a factor of 131 and became a source of funds that the Liberal Democratic Party (LDP) has used to respond to the demands of key constituencies and co-opt opposition issues. Opaque accounting, minimal oversight, and lack of deliberation in the Diet allowed the funds to be used easily for politically expedient purposes, but the political nature of investment decisions has also hindered sound decision making. As will be discussed in the subsequent section, criticisms of the current system have led to several key reform initiatives. Who controls these funds and under what conditions one exercises control have emerged as contested political issues.

The use of pension funds to invest in infrastructure projects or other public goods is not unique to Japan. Sweden's AP pension system, like Japan's public pension, has been used to achieve a wide variety of ends, such as investment in housing and the provision of debt capital to firms. These funds, as in Japan, have also been a very large source of financing. Between 1970 and 1973, Sweden's pension system accounted for 35 percent of Sweden's total credit supply, although this figure declined in subsequent years (Pontusson).

There are, however, several interesting differences worth noting. In Sweden, labor unions and the Social Democratic Party, SAP, have played a key role in the creation of the pension funds and the management of these funds. SAP was responsible for creating a partially funded pension system as opposed to a PAYG system. SAP justified partial funding as a way to create a "buffer" that could be used to protect against sharp increases in pension fees. Another key justification was that the funds would create an important source of investment capital. The confederation of blue-collar unions, LO, oversees the pension funds, and the use of pension funds has been partly driven by the concerns of labor. Providing access to low-cost housing and keeping investment levels high are both good examples. At the same time, there is a built-in countervailing incentive to maximize returns because strong investment performance makes it possible to limit worker contributions (Pontusson).

Another key difference with the Japanese pension system is the high level of built-in controls about how investment decisions are made. The rules governing the investment of funds are more codified in Sweden and the central bank plays a key role in overseeing the investment of these funds. Moreover, the boards that actually manage the funds are organized along neocorporatist lines with representation from labor, capital, and the

state, and thus provide a built-in system of balance between these constituencies. The funds have not been used to pursue the development of specific industries (Pontusson).

The different ways that Japan and Sweden have institutionalized the management of their pension systems has important consequences. In Sweden, the management of pensions is transparent and codified, and management of the funds is clearly delineated. In Japan, by contrast, labor and management are both more or less excluded from the investment of public pensions and do not bear the risks of these investment choices. One result is that there has not been an incentive to monitor the performance of the public pensions. The state, particularly the MOF, is the key actor in pension management. This has led to a conflict of interests as the MOF has used the pension funds to achieve both its own ends, as well as those of the LDP, rather than managing the funds to protect investments. Bureaucrats and politicians have had a very high degree of discretion over the management of the funds and there has not been a strong constituency concerned with pension fund returns, a point that will be returned to later.

Private Pensions

Private pensions have also come to play an important role in Japan's financial system. In the case of Japan, two ways of covering pension liabilities have led to two distinct types of linkages between private pensions and Japan's financial system. First, in cases where private pensions are *book reserve* plans, firms indicate pension liabilities in their financial accounts but do not set aside money in a separate fund to cover future liabilities as with "funded pensions." In addition to Japan, Germany, Austria, and Luxembourg have such pension plans. The attraction of book reserve plans is that they provide firms with an internal source of working capital. As Philip Manow has pointed out, such working capital is an important source of "patient capital" for such firms (Manow 2001a, 2001b). Patient capital, unlike equity capital obtained through stock markets, has a longer time horizon and is provided without major concessions over management control. Access to this type of capital has a close relationship to forms of corporate governance and strategies. The management, independent of investors demanding short-term profits, allows companies to invest in longer-term projects and to give priority to the company's interest over investors. Indeed, this aspect of Japanese capitalism has been widely noted as one of its distinguishing features (Dore; Estevez-Abe; Gerlach; Manow 2001b). The attraction of access to such capital explains why book reserve plans have been popular in Japan despite tax laws that are not very favorable to such plans (Turner and Watanabe, 56–57). According to a Ministry of Labor Survey in 1997, 46.2 percent of corporate pension plans were book reserve plans (Shimizu). The downside of such plans, though, is that the viability of the pensions

depends on the health of the firm, and in the case of book reserve pensions, there are few protections for beneficiaries.

A second method for covering private pension liabilities is through the creation of a funded corporate pension. Funded corporate pensions form the basis for Japan's modern private pension system, which was created after the public pension system. In 1962, the Japanese government with the support of life insurance firms and trust banks, which wanted to manage the private pensions, and Nikkeiren, a peak association of employers, created the Tax Qualified Pension (*zeisei teikaku nenkin*). The system was designed to provide tax benefits for private pensions. The new program would also help employers' transition from the practice of providing large lump-sum payments to employees upon retirement with pensions paid in installments. In 1966, another private pension, the Employee Pension Fund (*kōsei nenkin kikin*) was established. The Employee Pension Fund allows firms to manage a portion of their Employee Pension Fund, in which participation is mandatory, if they provided benefits 30 percent or higher than that offered by the public portion and if they guaranteed an annual rate of return of 5.5 percent (this figure has been lowered in recent years).

While both the Employee Pension Fund and Tax Qualified Pension allow corporations to control a portion of their pension funds, strict regulations have governed both how funds are to be invested and which firms are to handle the management of these funds. The private opt-out portion of these funds had to be invested through either trust banks or life insurance companies. As will be discussed below, these regulations are the key mechanism that allowed bureaucrats to steer investments toward developmental objectives, but as such regulations were gradually loosened, a new set of economic problems have emerged exacerbating Japan's problem of transitioning to a more liberal financial system.

Despite these regulations, both private pensions grew rapidly (Table 3 and 4). Growing labor scarcity made the private pensions an attractive option for firms because attractive benefits could help attract and retain workers. At least initially, when the labor force was relatively young and economic growth was rapid, meeting the stipulated benefit level requirements was not a problem.

The Employee Pension Fund and Tax Qualified Pension have played an important role both in promoting industrialization and shaping Japan's system of corporate finance and corporate governance.[4] As mentioned earlier, corporations were required to use either trust or life insurance companies, until recently. Both types of companies have been highly concentrated with several very large firms dominating each line of business. The MOF has actively guided their investment decisions to promote industrialization by instructing these financial institutions to invest in public projects and lend to key sectors (Estevez-Abe).

TABLE 3
Employee Pensions Funds

FY	Number of Funds	Subscribers (000s)
1966	142	500
1975	929	5,340
1980	991	5,964
1985	1,091	7,058
1990	1,474	9,845
1991	1,593	10,678
1992	1,735	11,517
1993	1,804	11,919
1994	1,842	12,501
1995	1,878	12,130
1996	1,883	12,096
1997	1,974	12,254

Source: Ministry of Health, Labor, and Welfare.

TABLE 4
Corporate Pensions

	Fiscal Years					
	1992	1993	1994	1995	1996	1997
Tax-qualified pension (trillion yen)	15	16	16	17	18	19
Employee pension fund (trillion yen)	32	35	38	42	44	48

Source: Ministry of Health, Labor, and Welfare.

Funded private pensions, like book reserve plans, also provided a source of "patient capital" but in very different ways. The private pension system helped generate patient capital and also reinforced Japan's system of corporate governance in two key ways. First, in exchange for the right to manage a corporation's pensions, life insurance companies often invested directly in the corporation whose pension business it received. Life insurance companies did not pressure the companies in which they invested for profits, in part, because these companies were not owned by shareholders, but rather by their clients, collectively as mutual companies. Over time, life insurance companies became some of the largest equity holders of Japanese corporations. A second way of creating patient capital was through the banking system. In anticipation of liberalization in the 1960s, the government, corporations and banks feared foreign competition and the takeover of Japanese banks. In response to this threat, the MOF coordinated the purchase of bank shares by life insurance companies and trust banks. As banks were also owned by friendly patient

capital, their lending to corporations was shielded from the demands for short-term gain (Estevez-Abe).

In South Korea and Germany, pensions have been a source of patient capital as well. In South Korea, Article 28 of the Labor Standards Act enacted in 1953 requires employers to provide a lump-sum payment upon retirement equal to one month's salary (of the final three months of employment) for every year of service. This "retirement allowance scheme" has few regulations governing how the funds should be accumulated and managed. Firms can keep pension reserves in-house and use them as a source of internal capital. Firms have often used the reserves as working capital or as collateral for loans (Moon).

Similarly, in Germany, private pensions have served as an important source of internal capital. After World War II, the German government used restrictive credit policies to help channel credit to key industries for post-war reconstruction. Using tax incentives, the German government was able to make investments in government industrial bonds and construction more attractive. To counter the potential negative effects of the restrictive access to capital, the government allowed private pensions to develop into a source of internal credit. Tax incentives encouraged the formation of private pensions. Also, accumulated reserves could be treated as "book reserves" which meant that pension commitments could be recorded simply as a future commitment. Prior to pension payout, funds could be used as a source of internal capital. As a result of these policies, private pensions became an important source of internal capital. As Manow points out, this internal investment also helped build solidarity with employees by showing a commitment to reinvestment in a company (Manow 2001b).

THE CHALLENGES: UNWINDING THE DEVELOPMENTAL STATE

While Japan does clearly face many of the same "external" pressures on its pension system as other advanced industrialized countries, such as an aging population and low fertility, there are other problems that are the legacy of how pensions have been integrated into Japan's financial system and recent attempts to transition to a more liberal financial regime. Recent reforms—regulatory, corporate accounting, and administrative—related to Japan's on-going process of transitioning out of its developmental regime have opened an economic and political Pandora's box with respect to the pension system. Underfunded private pensions have turned out to be major liabilities for many companies' balance sheets as firms prepare for transition to new accounting rules. Deregulation of private pension investments has increased incentives to focus on pension returns and weakened incentives to hold onto cross-holdings, which in turn has created downward pressure on the stock market, exacerbating Japan's banking problems. Administrative reforms have partly removed public pensions from the MOF's Fiscal Investment Loan Program, but how pen-

sion funds will be invested and who will exercise control over fund management have emerged as contested and not fully resolved political issues. This section discusses the nature of these challenges, focusing on how deregulation, administrative reform, and changes in corporate accounting have contributed both to pension problems and economic problems more broadly.

Private Pensions

As described above, private pensions have played an important role in Japan's system of finance. Book reserve plans provide firms with a source of patient capital, and the MOF has used highly regulated private pension funds to solidify *keiretsu* ties and to promote industrial development. While such integration into Japan's financial system has played a role supportive of Japan's past developmental policies, it has also contributed to large pension liabilities that are likely to be a drain on corporate profits for years to come.

Several features of Japan's private pension system have weakened the incentive to focus on pension investment returns and delayed reaction to the growing problem of pension liabilities. First, regulations have limited how funds can be invested and who can invest these funds. As described earlier, regulations required that trust banks or insurance firms handle pension fund management. Asset allocation requirements have also stipulated the ratio of investments, including limits on the amounts that could be invested in securities, bonds, foreign companies, etc. These regulations have meant that firms have had very little control over how pension funds are invested, and thus pension liability problems have been largely beyond their control. At the same time, firms were required to provide returns on the Employee Pension funds of 5.5 percent until 1996 when the rate was lowered to 2.5 percent. If the companies' investments do not yield the required returns, they are responsible for covering the difference. During Japan's boom years, these targets were easy to meet, however, as Japan's economic growth slowed, its asset bubble collapsed, and Japan entered a decade of multiple recessions, the required rate of return proved difficult, if not impossible, to meet. The result has been poor pension fund performance. Trust bank returns on pensions between 1985 and 1995 were only 59 percent. The comparable figure for the United States was 249 percent over the same period (Economist). In terms of compound annual growth the Japanese figure is less than 5.3 percent. Between 1989 and 1997, the return on all corporate pension investments was only 3.47 percent (*Nikkei Weekly* 1999). According to the Ministry of Health, Labor, and Welfare (MHLW), of 1,858 funds only 30 percent were solvent as of March 31, 1999.[5]

Second, corporate accounting rules have allowed firms to keep their pensions off their main balance sheets. This means that pension performance has not had any direct impact on the firms' bottom lines (e.g., net

profit/loss). During Japan's period of rapid economic and population growth, pension investments performed well and this accounting practice had little consequence. But this accounting practice, combined with another accounting rule that allowed firms to use the price at which they purchased investments "book value" rather than their current market value to assess pension assets, allowed firms to ignore mounting pension problems even as the book value began to diverge sharply with actual market value.

The problem of pension liabilities, though, has existed for some time. Changes in corporate accounting have exacerbated the problem substantially by changing the impact of these pension liabilities on firms. In an effort to facilitate the ability of firms to raise funds on international capital markets, Japan has inched toward "international accounting standards." Since the end of the fiscal year in 1997, corporations have been required to use mark-to-market accounting rules for pensions. Prior to this change, corporations used book values rather than actual market values. This accounting practice, though, has drastically overstated the true value of many firm assets, including pension investments. Many investments have been assessed on the basis of their purchase value, but since the collapse of the bubble at the end of the 1980s the market value of stocks and real estate has dropped precipitously. With Japan's new accounting changes, firms must revalue their pension assets downward.

Another key change is that as of March 2001, firms must publish their pension reserve status. The prospect of greater public and shareholder scrutiny created a much sharper incentive for many firms to clear up their pension shortfalls, which for the largest 65 corporations alone equaled 6.2 trillion yen, although many firms lack the reserves to do so immediately (*Nikkei Weekly* 1999). Japanese firms have been given a 15-year period to solve their pension shortfall problem, a process that will eat into future earnings.

Japan has also transitioned to consolidated accounting starting in April 2000. Under this accounting system, liabilities that were kept off the books (e.g., pension liabilities) are to be included in consolidated statements. With the inclusion of pension liabilities, companies suddenly will have dramatically poorer balance sheets. Net income, price/earnings ratios, cash flows, and debt-to-equity ratios will all be affected. Some companies have started to fix their pension problems in expectation of these changes. In one six-month period in 1999, Nissan, for instance, set aside about $2.6 billion to fill gaps in its pension reserve (*New York Times*). As mentioned earlier, the scope of the problem is very large as only 30 percent of private pension funds are solvent. The transition to consolidated accounting, however, has been a slow process and as others have pointed out, Japanese corporate finance and governance reforms have followed a path very different than in Anglo-American countries (Vogel). In fact, the transition has not been codified legally. Instead, a deliberative council (*shingikai*) has issued nonbinding guidelines that cannot be enforced legally. The lack of

teeth in Japanese corporate reforms reflects the reluctance to unleash many of the problems bottling up in Japan's pension system.

In the meantime, one "solution" to the funding problem has been a fairly draconian one. Many Japanese firms are choosing simply to dissolve their Employee Pension Funds. As may be recalled earlier, the Employee Pension Funds provides benefit levels higher than the national pension. But if a fund becomes insolvent, firms can seek approval from the MHLW, to dissolve their funds. In order to dissolve a fund, firms apply at the Regional Public Welfare Office (*chihō kōsei kyoku*), then the application is forwarded to the Minister of Health, Labor, and Welfare for approval. In recent years, firms that are dissolving their Employer Pension Funds have grown dramatically. In FY2000, a record of 29 Employee Pension Funds were dissolved (Nagamori). A survey by the Employer Pension Fund Association shows that 21 percent of funds are considering dissolving (*Nikkei Financial Daily* 2002). Employers also now have the opportunity to take advantage of a new defined benefit Japanese "401(K) plan," which began in April 2002.[6] The new 401(K) transfers pension investment risk from firms to workers, a fact not lost on Rengo, Japan's confederation of labor unions, which ineffectually opposed the creation of a defined contribution plan. Rengo, in a public statement, complained that the new 401(K) bill "mitigates the burden and responsibility of a company under the name of self-responsibility and 'choice'" of an individual, and imputes an investment risk to an individual (Sasamori).

Another more complex problem is related to the unwinding of corporate cross-holdings and the downward pressure created on asset prices, in particular stocks. The mass liquidation of cross-holdings, it is feared, will lower the price of stocks, many of which are held by banks that are currently in precarious financial condition. Lowering the capital base of banks in turn adversely affects BIS capital ratios, further adding to Japan's credit crunch.

The causes of the unwinding corporate cross-holdings are multiple, many having little to do with the pension system. One regulation, for instance, has directly limited the amount of cross-holdings that can be held by a company. Another proximate cause is related to changes in corporate accounting mentioned above. With mark-to-market valuations, firms have no incentive to hold on to stocks that have been revalued according to market prices. In the past, holding on to such inflated assets padded balance sheets, but since this is no longer an option, it is expected that many firms will get rid of unproductive assets.

There are, however, other ways in which the unwinding of corporate cross-holdings is related to Japan's corporate pension system. As mentioned earlier, Japan's corporate pension system in the past helped solidify close corporate connections, *keiretsu* ties and cross-holdings. Firms that opted-out and chose to create their own Employee Pension Funds did so through life insurance companies or trust banks which were already

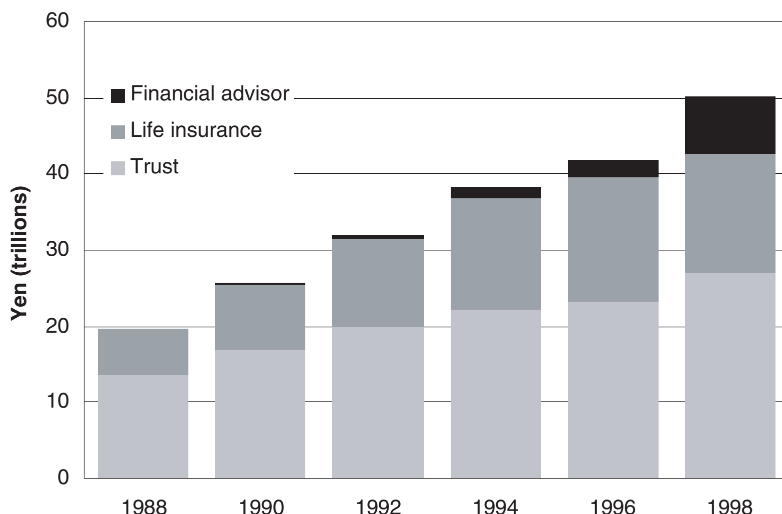
members of their *keiretsu* groups or at least invested in the companies whose pension business they received.

There have been several critical changes that have begun to undermine this system, the most important of which has been the loosening of restrictions on Employee Pension Fund and the Tax Qualified Pensions. Beginning in the 1990s, a series of deregulatory measures have given greater discretion to companies over their pension investments. In 1990, companies with Employee Pension funds were permitted for the first time to use investment advisory companies to manage new contributions to their funds. In 1994, up to one-third of an Employee Pension Fund could be invested through investment advisory firms. In short, the trust bank and life insurance monopoly over the pension business had eroded. In the same year, the restrictions over the allocation of investments were also liberalized. The so-called 5-3-3-2 rule, which stipulated 50 percent investment in domestic principal-guaranteed investments, 30 percent in domestic equities, 30 percent in foreign securities, and 20 percent in property, was gradually loosened. In 1997, firms with Employee Pension Funds could manage their own plans internally although they were still required to follow guidelines for asset allocations. In 1998, companies were given total discretion over asset-allocation decisions. The Tax Qualified Plans have been deregulated, but more slowly. In 1997, firms with such plans were permitted to invest on their own.

With full control over their investments, firms now have more options for maximizing their pension returns, in some cases by jettisoning their trust banks or life insurance companies. And critically, now that the liabilities of their pensions are both public and affect their bottom line, firms have every incentive to do so. As a result, there is less reason to maintain close ties with their trust banks or life insurance companies. Similarly, these firms have less incentive to hold on to many of the shares of their clients if they no longer manage their pension funds. Moreover, new accounting changes raise the short-term costs for holding onto bad investments, as investors scrutinize pension liabilities more. In short, the pension system that helped provide patient capital and promote corporate ties is coming undone. Life insurance banks and trust banks are some of the largest institutional shareholders in Japan; if they sell off shares, there is a real possibility of significant share price declines. In 1990, life insurers owned 17.3 percent of Japanese shares. There are no separate figures for trust banks, but for all banks the figure is 22.5 percent (Estevez-Abe, table 9.4, 205). In the beginning of 2003, stock market investors have closely followed the activities of pension funds by tracking trust fund activities, which are used as a proxy for pension fund investment. Trust fund investments turned negative at the end of 2002 and the trend appears to be accelerating (*Nikkei Weekly* 2003).

One outstanding question, though, is how fast these ties will come undone. As Figure 1 shows, the use of financial advisors, either in-house or outside investment advisories, has grown rapidly. From 1990 to 1998,

FIGURE 1
Employee Pension Fund by Type of Fund Management



Source: Ministry of Health, Labour and Welfare

the share of Employee Pension Fund managed by financial advisors rose from 0.2 percent to 7.4 percent.

While the increase is rapid, the share is still relatively small, a predictable result considering how recently investment has been deregulated. Firms have also started to make asset allocations on their own. Of firms with Employee Pension Funds, 36.9 percent are reported to have taken some responsibility in making asset allocation. The figure is substantially lower at 7.4 percent for firms with Tax Qualified Plans (*Nikkei Weekly* 1999). The transition to more independent investment decision making has been slowed by the lack of capacity in many firms (*Nikkei Weekly* 1999).

Among the ironies of Japan's pension problems, one of the most striking is that the government may use pensions to attempt to solve the problem posed by the liquidation of cross-holdings, sagging stock prices, and distressed banks. One idea that has been discussed publicly is encouraging corporations to transfer newly market-valued stocks to their Employer Pension Funds in order to prevent a sell-off. Firms, though, have little incentive to do so after they have revalued their pensions' assets, since they no longer have any reason to hold onto to such investments to prop up their balance sheet numbers. More critically, doing so may not be in their best interest if unproductive assets are transferred. This plan potentially goes directly against many of the reforms, such as investment deregulation and corporate accounting changes, which would make firms more sensitive to returns on their pension investments.

Another more radical option is government-led intervention in the stock market to prop up stock prices. In the early 1990s, public pension funds and postal savings were used in this manner, in some cases to directly counteract the effect of sell-offs of private pension holdings. These interventions were dubbed "price-keeping operations" or PKOs. These interventions have continued into the latter half of the 1990s, although the government is often not forthcoming about its interventions. But this takes us full circle back to public pension funds and the debate over who should control these funds, an issue that lies at the core of Japan's pension reform politics.

Public Pensions

As suggested above, there is an ironic connection between the public and private pension system. Private pension sell-offs have put downward pressure on the stock market, and the government has used its public pension funds to intervene in the stock market to prop up stocks in an effort to stave off financial disaster. This, however, is only one aspect of a larger story over the control of Japan's extremely large, partially funded public pension system. Despite its enormous demographic challenges, more severe than those even of Germany, the amount of Japan's public pension funds over the course of the next several decades will continue to be very large.

As Table 5 shows, even by the year 2050 the reserves of the Employee Pension will be roughly equal to one's years benefit expenditures if the projections are accurate. Who will control the pension funds and under what conditions investments will be made is a heated political issue that has yet to be resolved.

The issue of control of public pension funds has been around for decades. The MHLW (at the time MHW) has argued that they should manage the pension funds, because they would oversee fund performance more vigilantly than the MOF, which has distributed funds to a wide range of public corporations that have been criticized as inefficient and wasteful. The MHLW won some control over the pension funds when the MOF agreed to lend a portion of pension funds to an existing public corporation—the Public Welfare Services Corporation—under the jurisdiction of the MHLW. In 1987, the Public Welfare Services Corporation, or "nenpuku" (short for *nenkin fukushi jigyōdan*), began setting up a pension fund program that would have 13 separate funds.

Nenpuku operated by borrowing money from the Trust Fund Bureau and investing it. The initial belief was that Nenpuku would be able to secure gains above the 5.5 percent rate at which it borrowed funds from the Trust Fund Bureau. Nenpuku gradually borrowed more from the Trust Fund and invested it independently. As with the corporate pensions, the asset allocations were highly regulated. Until 1990, Nenpuku was subject to the same 5-3-3-2 rule. Like the Employer Pension Funds,

TABLE 5
Public Pension Projections

FY	Premium Rate or Total Renumeration (Calculated in proportion to standard renumeration amounts)		Total Revenue[a]			Total[a] Expenditure	Balance[a]	Reserve at Year End (FY 1999 Value)[a]	Degree of Funding
	%	%		From Premium	From Investment				
2000	—	17.35	33.10	22.90	6.20	28.1	5.0	177.0	6.1
2010	17.42	(22.35)	50.80	36.40	8.20	47.5	3.2	168.9	4.4
2020	21.27	(27.35)	71.90	54.40	9.20	64.7	7.3	152.2	3.6
2025	21.40	(27.35)	80.20	60.40	10.80	70.8	9.4	160.0	3.8
2030	21.40	(27.35)	88.20	65.60	12.80	78	10.2	167.7	4.1
2040	21.40	(27.35)	103.80	74.60	15.80	101	2.1	159.0	4.0
2050	21.40	(27.35)	118.00	87.00	15.40	121	(3.0)	120.8	3.3
2060	21.40	(27.35)	137.20	104.50	15.40	134	3.2	94.6	2.9

[a]In trillion yen.
Notes: 1. Premium rate is deferred for the time being as 19.85% by October 2004, from when it will be increased by 2.5% every five years.
2. Wage increase rate 2.5%; Price increase rate 1.5%; Investment yield 4.0%.
3. The degree of funding is the ratio of total expenditure for the current FY to the reserve fund at the end of the previous FY.
4. This future projection is based on the plan requested to the Advisory Council on Social Security.
The "reserve at year end" includes Mutual Aid pensions, which is why it is higher than the 140 trillion that had been deposited in the Trust Fund Bureau (Mutual Aid pensions have not been transferred).
Source: Ministry of Health, Labor, and Welfare.

Nenpuku also had to invest through trust banks and life insurance companies. The government gradually loosened asset allocations requirements, and Nenpuku subsequently invested more in equities, which in 1999 accounted for over 40 percent of its holdings (*Japan Times* 1999b). But the investment performance of Nenpuku has been dismal. At the end of fiscal year 2000, Nenpuku had invested 27 trillion yen. The cumulative loss on investment was 1.46 trillion yen. If the interest payment that Nenpuku must pay back to the Trust Fund Bureau is included, the total losses exceed 2.31 trillion yen (*Nikkei Weekly* 2001b).

The story of control of the public pensions shifted dramatically in the late 1990s with the reform of the entire FILP set in motion by Prime Minister Hashimoto as part of his administrative reforms. In the past, the funds from two of the public pensions (Employee Pension and National Pension) as well as the postal savings deposits were transferred, as stipulated by law, to the Trust Fund Bureau, overseen by the MOF, which distributed the funds through FILP. Reformers, though, increasingly criticized the MOF's management of the funds. This criticism accelerated after several highly publicized FILP-financed projects turned out to be financial failures.[7] The public corporations that received these funds and served as sites to which bureaucrats could "*amakudari*" (descend from heaven) also came under increasing attack, and in some cases led to calls for their abolition or privatization.

The outcome of these reform efforts was the breakup of the FILP system. As of April 2001, pension funds and postal savings deposits would no longer be transferred to the MOF. As part of this restructuring, the Public Welfare Services Corporation was abolished. Its debts were to be paid out of the public pension system. Nenpuku was replaced by the Government Pension Investment Fund (GPIF), another public corporation that was established on April 1, 2001. Unlike Nenpuku, the GPIF would have direct control over the pension funds and thus would not have to pay interest for "borrowing" from the pension fund. Although the new GPIF has the right to self-management (*jishu unyō*), the break with the MOF is in practice not complete. The GPIF will continue to buy new special "FILP bonds" with public pension funds over a seven-year transition period. The purchase of these bonds will in effect keep some funds flowing to the MOF over the next seven years. The possible continuation of the purchase of these bonds at least creates the possibility that the old system will not be fully broken up, but at this point the issue of whether or not the link to the MOF will be fully broken is one of speculation.

There were several justifications for creating the new GPIF. The MHLW argued that it would be more vigilant in pursing an investment strategy to maximize return and limit risk. Another key reason put forward by the MHLW was that the government should not be a direct investor in private companies. As a public corporation, the GPIF would serve as an intermediary and help avoid any potential conflicts of interest (*Nikkei Financial Daily* 2001). The GPIF, with its more flexible hiring policies, would also

be able to better staff itself with experts in investment and other relevant skills.

The largest opposition party, the Democrats (Minshuto), has been quick to attack the transfer of funds to MHLW. The MHLW, they have argued, has neither the capacity to oversee these investments nor the track record, as Nenpuku's short and unsuccessful experience illustrates. Naoto Kan, one of the leading spokespersons for the Democrats and former Minister of MHLW, publicly asked, "How can you assure us that the Health and Welfare Ministry can do better with the 140 trillion yen after its own corporation created debts of more than one trillion yen?" (*Japan Times* 1999a).

It remains to be seen to what extent pension investments will be free from political interference or bureaucratic interests remains to be seen. To date, a combination of political motives and bureaucratic preferences has driven the investment of public pensions. MOF bureaucrats and LDP politicians have at various points in time used pension funds for industrialization, a way to finance government debt, and to prop up the price of the stock market. Politicians have also used the FILP system to finance pork-barrel projects, and bureaucrats have used funds to create cushy jobs for themselves when they retire by funding public corporations where they occupy posts after retiring as bureaucrats. These pressures will continue. In January 2001, Kamei Shizuka, chairman of the Policy Affairs Council, one of the most powerful positions within the LDP with direct responsibility for policy making, created the Committee on Stock Market Revitalization to discuss how to improve the Nikkei's performance.[8] One member, Aizawa Hideyuki, head of the Council and LDP member, candidly remarked, "Some party members say we should refrain from intervening in the market. But as politicians, we cannot allow this" (*Nikkei Weekly* 2001a). This remark nicely captures the dilemma posed by the massive financial resources of the pension reserves (and postal savings)—it is difficult not to use such resources to solve problems, whether they are economic or political.

The MHLW does, however, appear to have a much more direct stake in fund performance and recognizes that its performance will be heavily scrutinized. The MHLW appears to want to improve fund performance in order to limit premium increases and to minimize outside political and bureaucratic influence. There are, though, several indications that suggest that the funds may still be subject to political and bureaucratic influence. First, the law itself, the Government Pension Investment Fund (GPIF) Law, is relatively vague. As a professor from Keio University, Kato Hideki, testified before the Diet, "Rules to oblige [the ministry] to be cautious in managing funds are written in the bills, but they are abstract. It's essential to require [bureaucrats] to take responsibility for the results of their investments" (*Japan Times* 1999b). Also, although investment allocation targets will be drawn up, this process is being handled through a special deliberation council, a process susceptible to bureaucratic steering.

At the moment, two MHLW study groups are discussing asset allocations, as well as guidelines about how the GPIF should behave as a shareholder in private companies. No final decisions have been made. Moreover, even if the asset allocations are fixed, they can easily be changed, a provision written into the law itself. And finally, the management of the GPIF is not insulated from political pressure. The minister of MHLW appoints the chairman of GPIF to a four-year term and the supervisor to a two-year term. The director, in turn, with the approval of the MHLW, appoints two directors. The minister of MHLW, however, has the power to remove executives.[9]

Thus far, the GPIF appears to be susceptible to bureaucratic and political influence as funds appear to be used in PKO-like interventions. The deliberation council for setting allocation targets, as well as the MHLW have both publicly stated their support for investment in domestic stocks despite rising public criticism and poor investment performance. Indeed, purchases of domestic stocks have increased as a share of total portfolio allocation with the government planning to invest 1.7 trillion yen in domestic stocks over the current fiscal year. Interestingly, this sum is more than enough to offset the predicted 1.5 trillion yen sell-off by private pension funds (*Nikkei Weekly* 2003).

This discussion of how open the GPIF will be to political pressure may soon be moot. The highly popular Prime Minister Koizumi Junichiro has been launching a highly publicized reform campaign, much of it targeted toward Japan's web of public corporations. He is pushing to abolish or privatize 34 out of 163 of these public corporations. In the reform proposal drawn up by Minister of Administrative Reform Ishihara Nobuteru, the abolition of GPIF was recommended. The MHLW has predictably responded very negatively to this proposal and argued that the government should not directly take stakes in private companies. The GPIF has also argued that direct government control might lead to further PKOs. Minister Tsutomu Sakaguchi of the MHLW publicly alluded to this influence, "When the government invests a large amount of funds, it exerts too great an influence on things such as the stock market" (*Nihon Keizai Shimbun*). The MHLW has also argued that the government should not directly own stocks because that would put the government in the position of exercising influence over corporate decision making. The MHLW issued a statement, "If the country directly manages stocks there is a concern that it directly interferes with the corporate management" (*Nikkei Financial Daily* 2001). The GPIF as a public corporation, the MHLW claims, creates a firewall between the government and corporations. But on the other hand, not exercising shareholder rights and influencing corporate management may potentially work against fund performance. The precise extent to which the GPIF should exercise its shareholder rights, though, has not been clearly determined.

A final decision has yet to be made about the fate of the GPIF. For the time being, a decision has been postponed for three years, at which time

the subject will be revisited. But ultimately even if Junichiro or another prime minister does abolish the GPIF, this would only reopen the issue of how the pension funds should be used and who should have control.

CONCLUSION

Japan's private and public pensions have been deeply integrated into its developmental financial system. Public pensions were directly tied to one of the key institutions of Japan's developmental state—the Fiscal and Investment Loan Program. Private pensions facilitated the creation of "patient capital" and solidified business networks. But the tight integration with Japan's system of corporate finance and state financial instruments has triggered a series of problems, almost a domino effect, as Japan transitioned out of this regime. Changes in corporate accounting standards have exposed the private pension system's underfunding; and in the case of public pensions, as the accumulated funds dramatically increased, a political battle has ensued over how these funds should be used and by whom, issues that have yet to be resolved.

The case of Japanese pensions shows that the ways in which pensions are integrated into a country's political economy have long-term implications and that a specific politics follows from these choices. The nature of this integration has created a distinct set of problems and a specific politics of reform that distinguish Japan's pension politics from other advanced industrialized countries. The relatively unique trajectory of Japan's pension system can be summarized as follows:

- Pension policies were highly integrated with Japan's developmental financial system.
- The easing of developmental policies (e.g., deregulation, corporate reform, and liberalization) interacted with and exacerbated pension problems more generally.
- These pension problems are structural, difficult to reform and linked to reconfiguring state, finance, and firm relationships.

Pensions policies are highly integrated with the financial system. Japan's pension system reflects the country's developmental course. The degree and extent of the integration of Japan's pension policies with economic and industrial ones has been very high compared to those of other advanced industrialized countries. Although pensions have been used for economic, industrial and other ends in European countries—corporate finance in Germany, social investment in Sweden, etc.—there are important differences. In contrast to Germany, Japan's *public and private pensions* have been leveraged to raise capital for economic development. In Germany, experience with inflation, which destroyed the value of pension funds, exposed the dangers of its partially funded pension system, and

since 1957, the German public pension fund has been PAYG (pay as you go). While Sweden's public pension, like Japan's, is partially funded, the funds have been controlled by the unions and managed by tripartite corporatist boards. As a result, the funds have not been used primarily for industrialization, but rather as a way to advance the mutual interests of labor and capital.

The easing of developmental policies interacts with and exacerbates pension problems. Japan's developmental legacy and the ways in which pensions have become entwined with this system explain some of the pension problems that Japan currently faces. Japan, like many other advanced industrial countries, faces pressure from a wide range of demographic trends—low fertility and an aging population—economic stagnation and fiscal constraints. Indeed, in many cases, Japan's problems in these areas are more severe than those of Western countries. Nonetheless, there is another set of relatively unique problems that are related to Japan's developmental legacy and the difficulties Japan has had in transitioning out of this model. The literature on retrenchment in Western countries does not provide much analytic leverage in understanding these problems—such as massive private pension liabilities and the battle for control over Japan's public pension funds, which arose as Japan attempted to change its models of corporate governance, corporate finance, and public finance.

These pension problems are structural, difficult to reform, and linked to reconfiguring state, finance, and firm relationships. One pattern that has emerged from the comparative study of pension reforms in Europe and the United States is that reforms tend to be modest, incremental, negotiated, and mostly focused on shoring up the fiscal viability of the pension systems. Other work has shown that pensions can be saved through combining modest benefit cuts and contribution increases with increased fertility, lower unemployment, increased labor force participation, and higher economic growth (Boldrin, Dolado, Jimeno, and Peracchi). The case of Japan suggests a different picture. Because of the high level of integration with its developmental regime, reforms of the pension system are more intimately linked to Japan's restructuring of its economy at large. In particular, liberalization, deregulation, and transition to new modes of financing require a more fundamental reconfiguration of the relations between state, finance, and firms.

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NOTES

1. On industrial relations, see Manow 2001a and also Ebbinghaus and Manow. See Estevez-Abe; Jackson and Vitols; and Manow 2001b for literature exploring the connection between finance and pensions. This article builds on this new literature.
2. The line between PAYG systems and funded systems is not clear-cut. Demographic shifts, such as declining birth rates and a growing elderly population, can push funded systems into future deficits, essentially converting them into PAYG systems. This demographic dynamic is on the horizon in Japan, and Japanese pension assets are expected to decline.
3. For a political account of why Japan's pension system is fragmented, see Campbell.
4. See Estevez-Abe for a detailed description of the connection between pensions and corporate governance.
5. The Ministry of Health and Welfare and the Ministry of Labor were merged in January 2001.
6. The "Defined Contribution Pension Law"—*Kakutei kyoshitsu nenkin ho*—was passed on October 1, 2001.
7. Examples include the Honshu-Shikoku Bridge and the Japan National Railways Settlement Corporation.
8. There are others within the LDP and among its minor coalition partners who have expressed disapproval, including LDP heavyweight Nonaka Hiromu.
9. See *Nenkin Shikin Unyou Kikin Ho* (Government Pension Investment Fund Law). Available online at http://www.hourei.mhlw.go.jp

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