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Pension coverage and demographic ageing

Securing the future for old age in the Asia and Pacific region:
Short-term and historical challenges

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Introduction

This paper sets out to summarize major conundrums, and some of their solutions, in pension reform policy of the years and decades ahead. Clearly, there is an increasing interest in the study of pension reform in the Asia and Pacific region, which has led to numerous reports by international government agencies and international scholars (Organisation for Economic Co-operation and Development (OECD), 2009; Park, 2009; World Economic Forum (WEF), 2009; OECD/IOPS, 2008; Salditt et al., 2007; Capretta, 2007b; Heller, 2006; the World Bank (WB), 2005; Bonoli and Shinkawa, 2005; Ramesh, 2003; Holzmann et al. 2001). The repercussions for non-action pertaining to the reform and overhaul of public pension systems go far beyond the sphere of social policy or economic development. The twin-issue of old-age poverty and fiscal sustainability of public pension systems *as they are today* will, and already has started to, shape and fundamentally alter politics and society as a whole. Hence, it is high time to point out – financially and politically – possible and sustainable pension reform strategies, recipes and solutions.

The backdrop of this paper is provided by several large developments in social security policy in East Asia, such as, the recent/ongoing universalization of health care services or insurance in Thailand and Mainland China, to cover 90 to 100 per cent of population. More recently, the Prime Minister of Thailand Abhisit Vejjajiva (on April 15, 2009) stated that:

“old age social pension is not a populist policy, but rather a basic human right that everyone deserves. Social pensions promote income security in old age and the government is committed to ensure access to basic social pension for all” (HAI, 2009b).

Even though PM Abhisit Vejjajiva did not envision universalizing the second-tier pensions as well (cf. Chaitrong, 2009; HAI, 2009a; PB, 2006; Duguay and Owararinth, 2006), it is a major step towards full-fledged welfare state development in Thailand, a country that travels faster than most of its neighbors down the road into post-industrial society. And then there is Japan, with the oldest population on earth. At the time of writing, Japan elected a new Prime Minister, Yukio Hatoyama from the DPJ, the Democratic Party of Japan. The DPJ won 64 per cent of seats in the Japanese Parliament, the Diet, and can easily form a coalition government that controls a 2/3 majority in Parliament – enough to change the constitution of Japan, as

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they please. PM Hatoyama was elected on the promise to universalize the whole pension system, and to rebuild it from scratch, even though the new system will take 20 years to mature (cf TJT, 2009; BM 2009).

Consequently, I have taken Thailand and Japan as the prime case studies for this paper on pension reform and the future of pension security in the Asia and Pacific region. This paper will briefly highlight crucial parameters of the current state and the future development of public pension systems, particularly general demographic and social indicators, as well as more specifically indicators of the strength and development of pension systems. Then, I will go on to elaborate the four basic dimensions of social security and pension system reform, which has become a global phenomenon ever since the early 1990s. These are: (i) parametric reforms, (ii) steps toward privatization of the pension system, (iii) steps toward the individualization of the pension system, and (iv) fundamental alteration of the pension system itself. These four dimension of pension reform, in fact, constitute a road map to pension reform, which is able to depict and further explain pension reform efforts of the last two decades across the world and, more importantly, to predict future developments. Especially as the limits of parametric changes have been reached in many regards, more radical systemic changes may become obsolete and necessary to ensure the number one mandate of public pension systems, *effective (and efficient) provision of adequate pensions for all*. If pensions drop below a certain minimum, public pensions have lost their ultimate legitimacy that is to provide income “security” during old age.

In the following, brief case studies on pension systems in Thailand and Japan will provide further empirical evidence for the salience and usefulness of these four basic dimensions of pension system reform in particular, or social security reform in general. The paper concludes with a general recommendation of extending the contribution base for social security and pension systems, to include also other forms of income, and to here and there change existing systems, i.e. adding new components or system elements to the existing pension scheme or system.

Socio-demographic realities and risks

One of the key issues in pension system sustainability is the reliance on births to keep DB pension systems up and running. Migration is not to be considered a solution to the pension crisis, as it is (1) often not a politically feasible option, and (2) not an effective solution in the long run (as migrants age and have less and less children, too). It is for this reason that there is no easy, fast fix for a massive, long-term decline in the total fertility rate, far below the sustainable self-replacement ratio of 2.1.

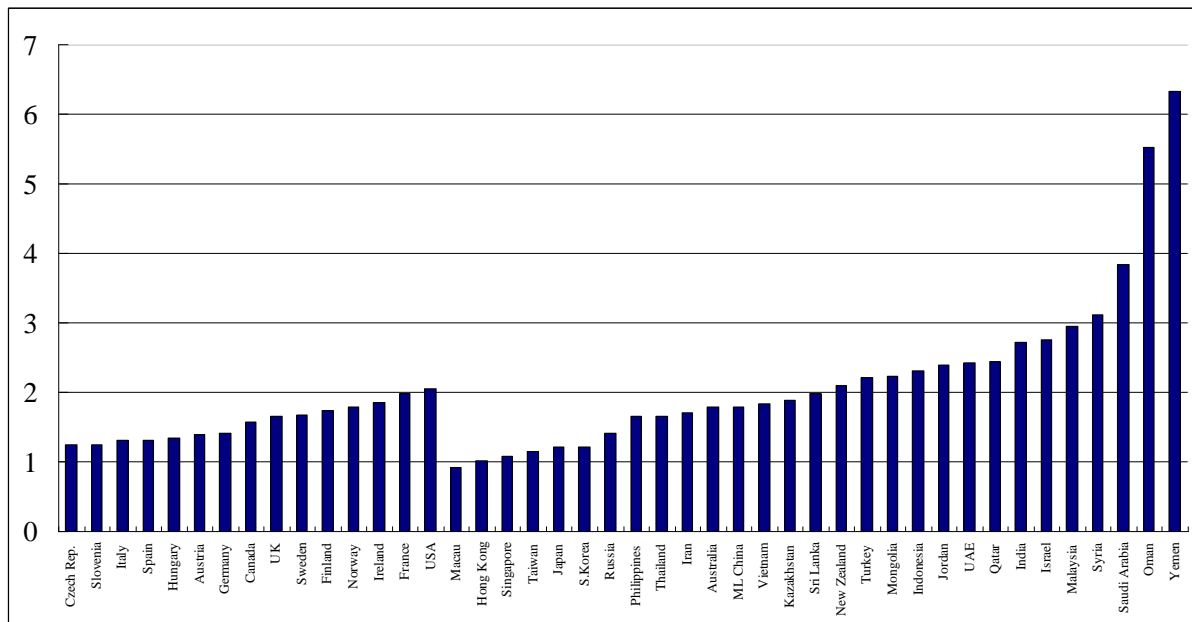
One of the major problems in analyzing population decline is the indicator used, that is a TFR of all women aged 15-49. That, in fact, spans over two generations of mothers, which leads to repeated underestimation of the current trend and future developments in terms of population change. It would be a great deal more accurate to take age-specific TFR rates and compare them on a year to year basis, and internationally, for at least the 15-19, the 20-24, the 25-29, the 30-34, and the 30-35 year olds (as well as respective opinion polls on planed fertility!), as it is them who determine, by and large, current and future developments in total TFR of a country or society.

In absence of such (necessary) data, keeping the just mentioned incorrectness of currently used total TFR rates (for 15 to 49 year olds) in mind we may understand the real magnitude of the problem that awaits all major public DB pension systems. In Table 1, we see that Japan, with a total TFR (of the last two generation of mothers) of 1.21, has one of the lowest fertility rates of all countries, only to be surpassed or matched by countries/societies like Singapore,

Hong Kong, Taiwan, and South Korea, and a number of Eastern- and Western-Central European countries. Japan, Taiwan and South Korea, as well as virtually all Continental European countries, that suffer from a severe lack of births and children, have in fact large DB pension systems. Before we reach the year 2050, we will have to deal with pension crises due to demographic change in countries like Thailand, Vietnam, the Philippines, Mainland China, and Indonesia (cf AFP, 2009; Park, 2009, OECD, 2009; ST, 2009).

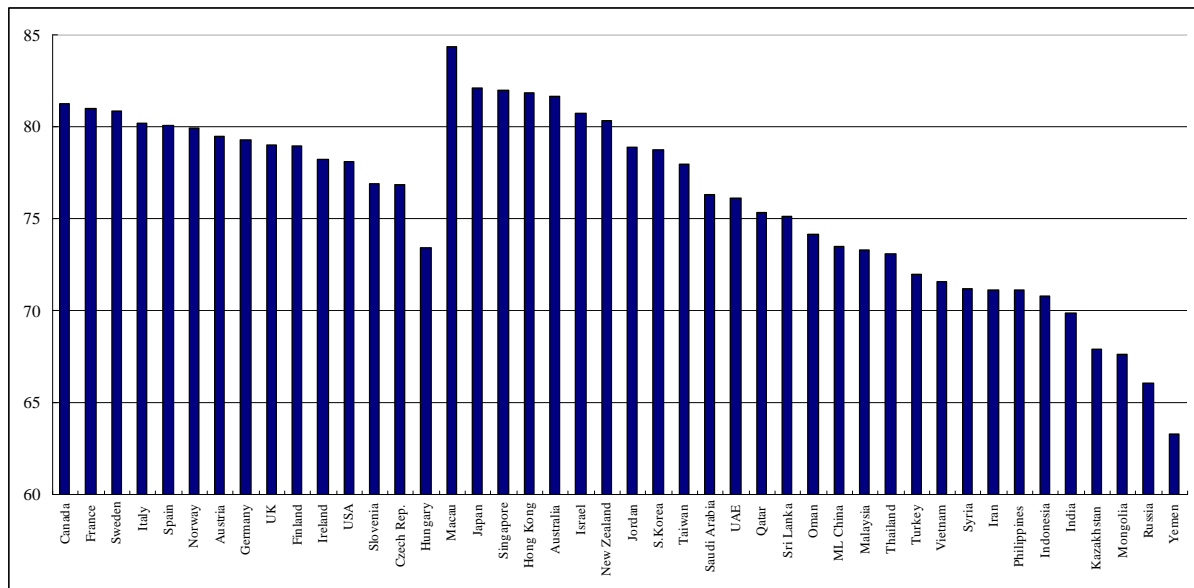
In addition, these East Asian countries also display the highest longevity rates in developed countries. Eastern-Central European countries lag behind in this regard (Table 2). When it comes to the share of elderly population (over 60), Japan leads the world with 28 per cent, closely followed by Italy, Germany and Sweden, with 26, 25, and 24 per cent respectively. Eastern-Central European countries, due to the lower life-expectancy rates, suffer in relative terms less (so far) from population aging when it comes to the fiscal sustainability of public DB pension systems. Japan, Germany, Italy, and Sweden, hence, are the countries where aging of society is most advanced. However, it is East Asian countries and societies that lead the world in terms of “high-speed aging” – particularly, South Korea, Singapore, Taiwan, Thailand, and Mainland China (cf Tables 1-3).

Table 1. International comparison of total fertility rates (Women aged 15-49!)



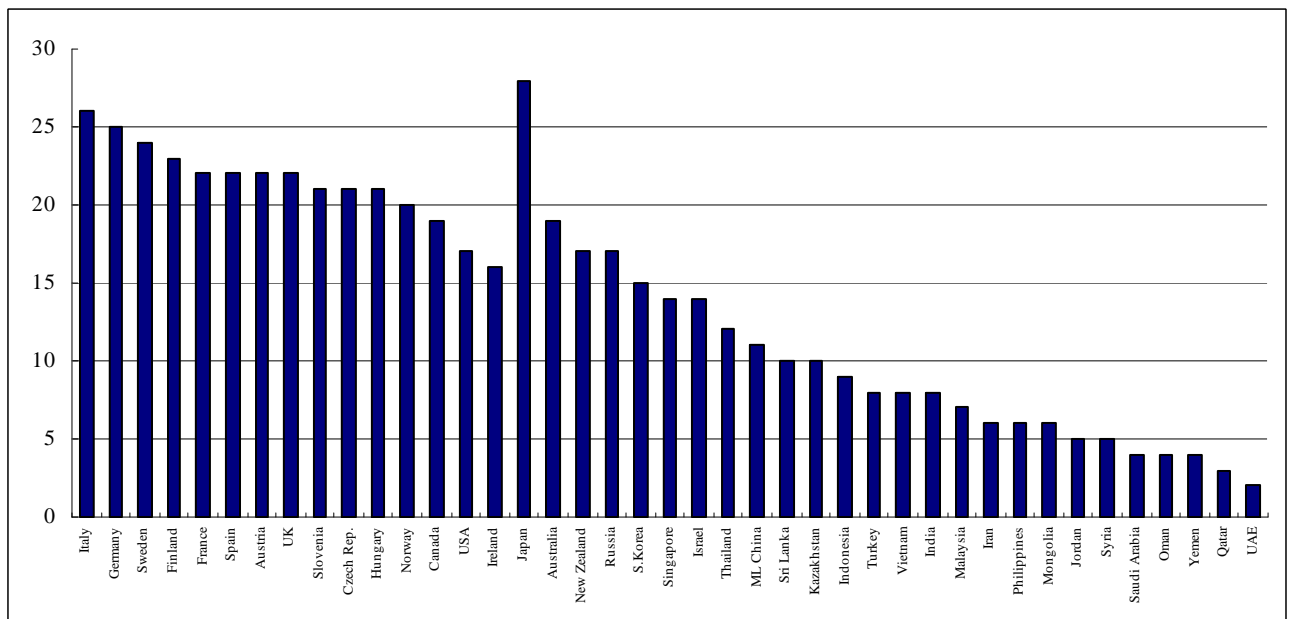
Source: CIA (2009).

Table 2. International comparison of longevity (Life expectancy at birth)

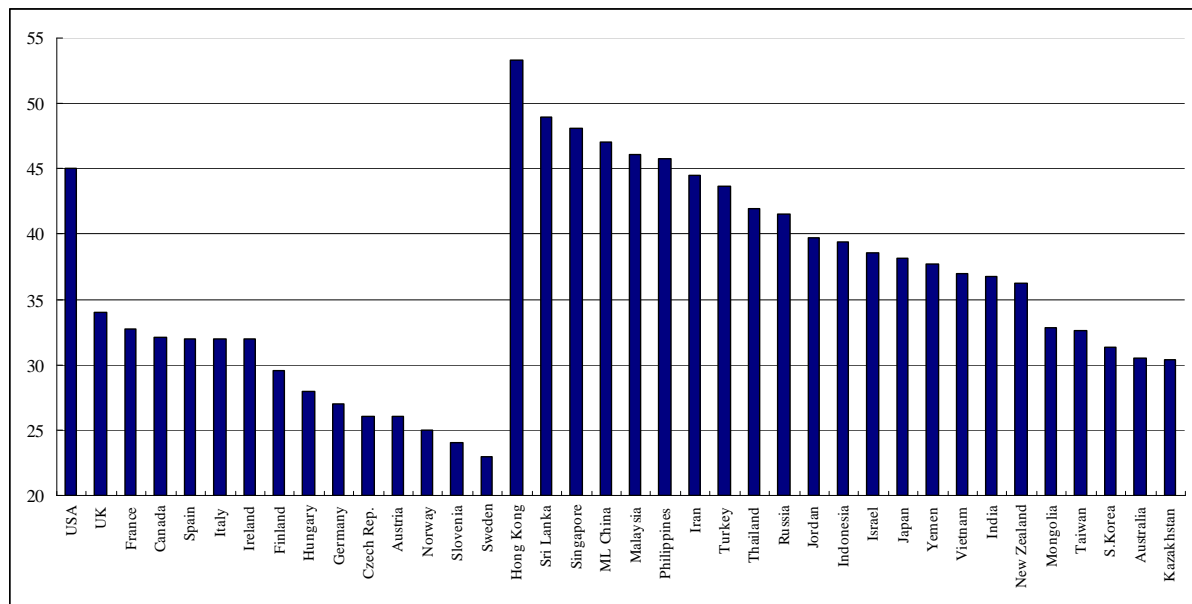


Source: CIA (2009).

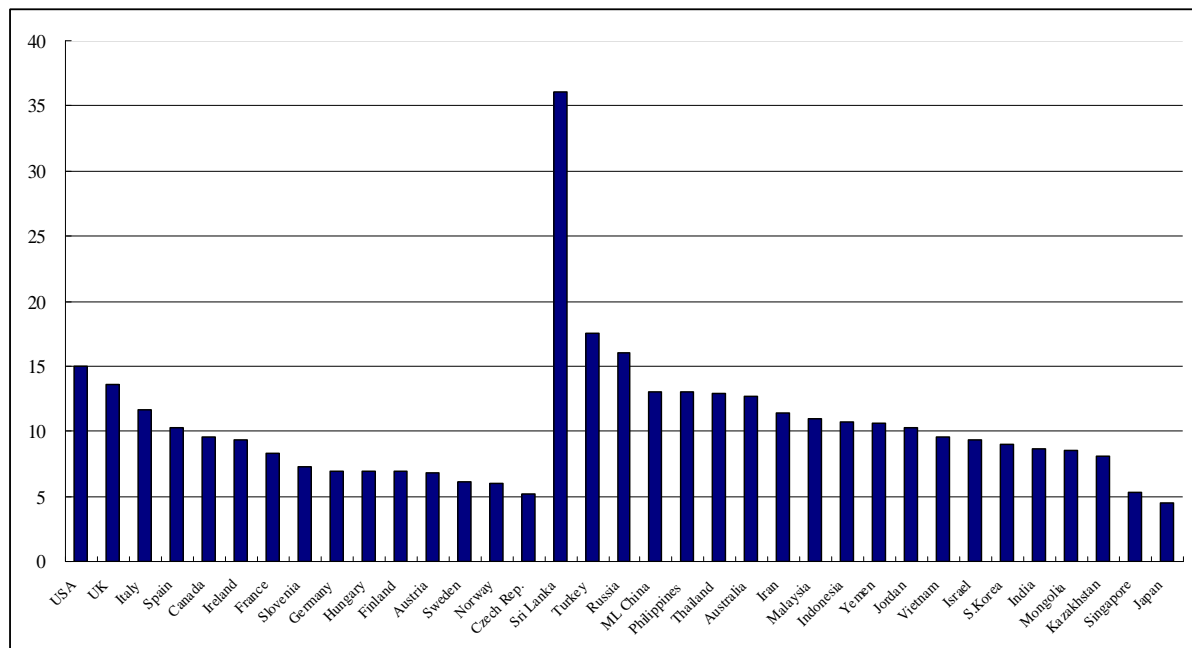
Table 3. International comparison of demographic aging (Population over 60, %)



Source: WHO (2009).

Table 4. International comparison of inequality (Gini index of income distribution)

Source: CIA (2009).

Table 5. International comparison of inequality (Ratio, income of highest/lowest 10%)

Source: own calculations, based on CIA (2009).

In terms of inequality, with regard to the distribution of *income* (Tables 4 and 5), it is particularly Asian countries that exhibit a profound lack of social equality and social redistribution. Yet, it is, from a historical perspective, highly understandable why the largest advances in the history of welfare state development nowadays are seen in this part of the world: (i) the emergence of universal health care systems in South Korea, Taiwan, Thailand,

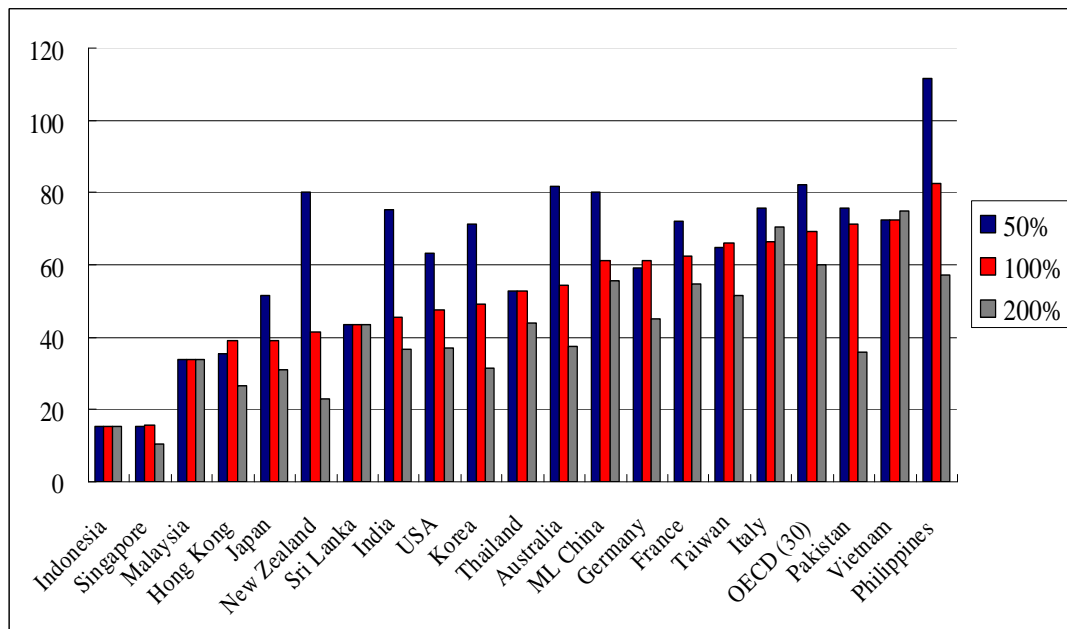
Mainland China, and a large extension of coverage in the case of Indonesia, and (ii) the extension of pensions insurance coverage in e.g. Taiwan (old age allowance and national pension system), Mainland China (roughly 60 per cent increase in this decade, and rising), Indonesia (DB and DC systems), and Thailand (DC systems and soon a social pension system) (cf Aspalter, 2006, 2007a-c, forthcoming; Aspalter, Uchida, and Gauld, 2010).

Pension development in the Asia and Pacific region

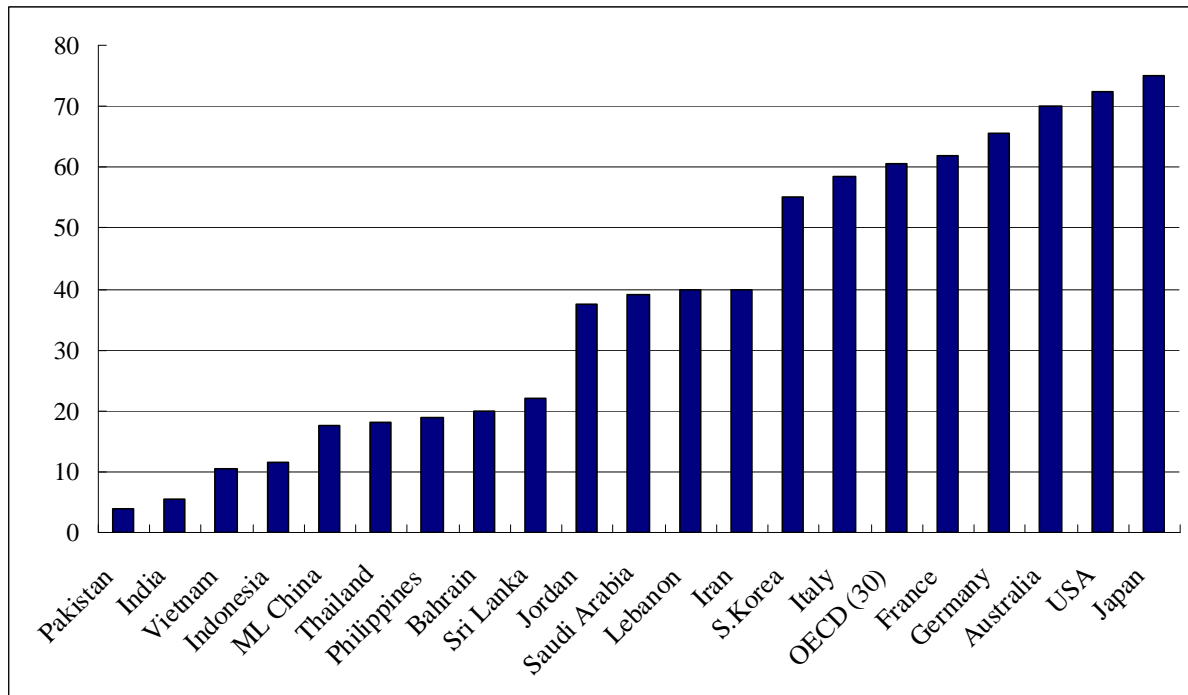
A brief international comparison of (standard) net replacement ratios for average income groups (which first and foremost determines overall poverty and equality) reveals that in East Asian countries the net replacement rates are at a much lower level than in OECD countries, as one may have expected – about 40 and 70 per cent respectively. At the very extreme ends, we find Indonesia and Singapore with net replacement ratios of below 20 per cent and Pakistan, Vietnam, and the Philippines with net replacement ratios of above the OECD average, 70 to 80 per cent, and even higher in the case of the Philippines (Table 6).

A complete different picture is revealed when looking at the coverage rates, where Japan leads the comparison with 75 per cent coverage of population, which is of course still 25 per cent short of the entire working population. There is a marked gap between countries in highly developed countries in Europe (plus Japan) and developing countries in Asia. The lowest coverage rates are exhibited in Pakistan, India, Vietnam, and Indonesia with around 5 to 10 per cent of pension coverage – which is followed by Mainland China, Thailand, the Philippines, and Sri Lanka with around 20 per cent of coverage. South Korea has comparative low levels of coverage when compared to other highly developed countries, particularly also Japan, with only around 55 per cent pension coverage. In the Middle East, pension coverage hovers predominantly at around or just under 40 percent of the workforce (Table 7).

Table 6. International comparison of net replacement rates by earnings (in % of average)



Source: OECD (2009).

Table 7. International comparison of pension coverage (of active population, 15-64)

Sources: OECD (2009) and Muhanna, (2009).

As to the type of major system components/columns applied, the Asia and Pacific region displays a rather colourful picture, with all major types of systems, and combinations thereof, applied. Japan, as a matter of fact, reveals a typical Bismarckian structure, specially catering to privileged groups, i.e. civil servants, school teachers, and employees of larger companies and corporations, who are covered by almost identical high-replacement level DB pension systems. As for the rest, they may rely on meagre benefits from the contributory national pension system, if they can. This in fact has created a two-class society in Japan, which has one of the highest tax levels, which developed major columns of welfare state institutions early on. Also, South Korea and Taiwan have historically relied on Bismarckian public pension systems, while Taiwan has since the early-to-mid 1990s developed a system of various old-age allowances that has been universalized over time. Taiwan is the last of the three Northeast Asian welfare state systems to have established a national pension system, only very recently. Both South Korea and Taiwan also reveal special DB pension systems for highly privileged occupational groups: civil servants, military personnel, as well as employees and teachers in private schools.

Table 8. Comparison of main pension columns

Japan	Flat-Rate National Pension + Special DB Systems for Civil Servants/Teachers and Employees of Larger Companies
South Korea	DB System + Special DB Systems for Civil Servants, Military Personnel, and Teachers
Taiwan	Flat-Rate Old-Age Allowances + plus new DB National Pension System + Special DB Systems for Civil Servants/Teachers and Military Personnel
ML China	DB pension system with NDC pension element
Hong Kong	Mandatory Provident Fund + Special System for Civil Servants
Thailand	DB System + Special System for Civil Servants (new Provident Fund & old DB system) + Voluntary Provident Fund Systems
Singapore	Central Provident Fund
Australia	Mandatory Private DC pension plans
India	Public DB and DC pension plans
Saudi Arabia	DB System + Special Systems for Civil Servants and Military Personnel
Oman	DB System + Special Systems for Civil Servants and Military Personnel + Occupational DB plans

Mainland China has a DB pension system, in which it added a NDC formula applied to a certain part of overall pension contributions. Hong Kong, in 2002, has set out after decades of considerations a Singaporean-style provident fund system, which, on the contrary to Singapore, is managed privately under strong public supervision. Conversely, Thailand has developed an elaborate system of voluntary (and subsidized) provident fund systems for employees in private companies as well as civil servants, while still keeping the old DB system for the older generation of civil servants (to be phased out slowly). Singapore has set up a sophisticated system provident fund accounts that cater not only to pensions and loss of income due to death of the main breadwinner, but also medical, housing and educational needs (Aspalter and Low, 2003). Australia, for example, implemented compulsory private DC pension plans (so-called superannuation plans). Conversely, India has a mix of public DB and DC systems, which however only cover about 10-15 percent of the working population. DB systems dominate in the Middle Eastern Region, exemplified by e.g. Saudi Arabia and Oman, who have public DB systems and special pension plans for civil servants and military personnel, and in the case of Oman, also occupational pension plans (cf e.g. Muhanna, 2009; Aldosary and Aspalter, forthcoming).

Four dimensions of pension system reform

When looking at the global experience of welfare state reform around the world (cf e.g. Aspalter, Uchida, and Gauld, 2010; Fu and Hughes, 2009; Walker and Aspalter, 2008; Aspalter, Kim, and Park, 2008; Mesa-Lago, 2008; Aspalter, 2006, 2007b, c; Bonoli and Shinkawa, 2005; Weiss, 2003; Swank, 2002), four major dimensions of welfare state reform become visible.

First, most countries in the developed world set out to reform their existing social security systems (*the first dimension*), while some opted also to make systematic changes of the welfare state, by privatizing major social security and welfare systems (*the second dimension*), while others have opted to change the logic of financing of the system, replacing a defined-benefit system with a defined-contribution system or adding new NDC or provident fund elements and systems (*the third dimension*). A third systematic change of the welfare state, besides steps toward privatization and individualization, would be then to change the logic and/or system structure of the entire social security system or welfare state as a whole (*the fourth dimension*) (Figure 1).

Figure 1. *Four basic dimension of pension system reform: A strategy map*

1. Parametric changes	3. Individualization
2. Privatization	4. Fundamental system change

The most common and most convenient step to reform DB pension systems, which has been applied by the vast majority of developed countries around the world, is to conduct parametric changes within the old system, mostly attempts that aimed at lowering benefits and entitlements and increasing contributions and coverage.

In principle, today there are the following measures available for implementing *parametric reform* of pension systems: (1) alteration of replacement and contribution rates, (2) new calculation of pension base, (3) addition of multipliers/modifiers (usually <1, e.g. for demographic change, change in longevity, fiscal sustainability, economic change, etc.), (4) increasing or abolishing contribution ceilings, and/or implementing or lowering benefit ceilings, (5) changing of inflation/price indexing, (6) lowering eligibility, (7) deducting formerly free contribution periods (military service, studying at university, maternity, etc.), (8) widening of coverage (workforce, e.g. part-time and short-term workers, informal workers, etc.) and their contribution periods, and (9) widening the base for contributions (add rent & capital income, and asset ownership/value increase).

When it comes to reform measures that aim at, as in most cases, *partial privatization* of public pension systems, policymakers can usually opt to apply the following reforms: (1) replace state pension programs with private pension programs, (2) introduce compulsory private insurance, (3) subsidize voluntary private insurance schemes, (4) subsidize voluntary private savings schemes, and last but not least (5) support and/or set up micro pension systems.

The *partial individualization* of the pension system, by and large, is facilitated by (1) adding a supplementary NDC scheme, (2) adding an NDC element to the DB pension formula,

- (3) adding provident fund schemes/accounts (e.g. to an existing DB scheme), and
 (4) introducing new fully-funded pension columns.

A full system change may be preceded by pension reforms that belong to the other three categories. For the most part, due to the continuing problem of population aging, on top of economic globalization, parametric changes are only the beginning when it comes to a series of major pension reforms. All in all, the governments may choose to (1) change the contribution base from labour to capital income for existing DB systems, (2) add a universal basic pension system, (3) universalize all of the pension system, (4) privatize the whole pension system, and e.g. (5) individualize the whole pension system, to name the most common and likely scenarios.

Two cases in point: Thailand and Japan

Thailand

The fundamentals of the Thai pension system have been laid before the big bang in social security development with the 1990 Social Security Act, which led to the establishment of a DB-type of pension system for non-agricultural workers and the self-employed (benefits also included the needs incurred by sickness, injury, disability, death, maternity, children, and unemployment). In 1975 the first social security scheme for private school teachers started, while in 1987 the Provident Fund Act was established, leading the way to a more profound emphasis on provident fund systems in overall social security system of Thailand. In 1993, the DB pension system was extended to include companies with 10 or more workers (before only companies with 20 or more workers were covered). The Government Pension Fund Act of 1996 enabled the transition from a DB to a DC type of pension system for government employees. The new system was introduced in 1997, while the old system continues to coexist, only to be phased out slowly. In 2002, all companies with 1 or more workers were to be covered by the DB pension system.

Today, the DB social security scheme is financed by 3 per cent of payroll from employers and employees each, and 1 additional per cent from the government. In the private sector provident fund system, which is still a voluntary scheme, contributions of employees are to be matched by the employers one to one. They are to be at least 3 per cent each of the payroll, but not more than 15 per cent. Contributions are fully tax-deductible, investment returns and payouts are tax-free. On top, there are mutual retirement funds (i.e., voluntary savings schemes), which are tax-deductible up to 300,000 Baht a year, investment and benefits are also tax-free. The private teachers provident fund is financed by 3 per cent of employees' and employers' contribution each, and an additional 6 per cent from the government, if offers lump-sum payments. Most government workers are also covered by such provident funds providing lump-sum benefits (Kanjanaphoomin, 2004; IET, 2008; Pfau, 2009; Redondo, 2009).

The majority of workers in Thailand are still employed by the informal sector and 2/3 are not covered by any type of compulsory pension scheme (Suwanrada, 2009). As promised the PM Abhisit Vejjajiva, Thailand is on track to establish a basic social pension system for all.

Japan

The roots of the modern Japanese pension system go back to the early 1940s and late 1950, with the establishment the 1939 Seaman Insurance Scheme and the passing of the 1941 Workers' Pension Insurance Law. One year later, in 1942, the Employees Pension Insurance

system started to operate. The major motivation for the new social security and pension insurance schemes was the ongoing war, particularly with the outbreak of the Second Sino Japanese war in 1937. Towards the end of the Second World War, the Japanese Parliament also passed a Welfare Pension Insurance Law in 1944. Much later, in 1959, the National Pension Law was promulgated, and started to operate in 1961. With the rise of aging as a major social and societal problem, then came the New Basic Pension Scheme in 1985. In 2001, a new attempt of shifting towards DC-based schemes was made with the emergence of individual- or employer-based DC programs. Most recently, in 2009, the PM Yukio Hatoyama was elected with an overwhelming majority (with 64 per cent of seats in the Diet, the Japanese Parliament) on the promise to universalize the overall pension system in Japan, even as it takes 20 years for a new pension system to mature (Aspalter and Lai, 2003; Nakashima, 2009; BM, 2009; Nomura, 2009).

The Japanese government, like in most developed countries with a strong reliance on DB-based pension systems, has first and foremost concentrated on parametric changes within the existing pension system. The 1985 pension reform cut pension benefits and introduced spousal benefits. The 1994 reform began to focus on the issue of effective retirement age, which was generally very low in Japan before, but this was only limited to the flat-rate component of the pension system. The next reform in 2000 again reduced benefits; while it also raised the pensionable age for the earnings-related component and increased the coverage of the employees' pension insurance to workers aged 65-69. The 2004 pension reform fixed the contribution rate with automatically adjusted benefit levels (NRI, 2009).

The 1985, 1994, 2000, and 2004 pension reforms left the Japanese pension system still prone to the pressures exerted by population aging, while the benefit levels of average pension have reached very low replacement rates, of 34 per cent, which puts Japan at the very end of the rime of industrialized countries, matching only the replacement ratio of Mexico. On top, the Japanese pension fund has been losing money in the past three years, which resulted in a worsening of the pension situation (Worsley, 2009a, b). With the election victory of the DPJ, a systematic change of the Japanese pension system is imminent.

Conclusions and outlook

Social insurance in general and insurance-based pension systems in particular are doomed to fade away *if they do not reinvent themselves from time to time*. Who could have predicted that when German Chancellor Konrad Adenauer in 1957 said "people will always have children" that time would prove him wrong (Capretta, 2007a: 2)?

The relative income from life-time or regular full-time salaried employment is gradually declining in historical perspective. The more we increase the burden on regular, full-time employment in terms of ever-increasing pension contribution rates, the more people and companies are trying to escape and avoid joining and contributing to such pensions insurance systems. The more insecure future payments of DB pension systems to the currently young generation are, the more willingness and anxiety there will be for the young, the middle-aged to leave or avoid entering such DB (pay-as-you-go) pension systems. People and companies, after all, react rationally – especially with regard to their pensions, personal income taxation and social security contributions. Hence, *there is a "crowding out effect" in the manifold efforts of governments and social security institutions to increase contribution rates and coverage rates of the working age population.*

In historical perspective, *other forms of income (rent, real estate, capital markets and self-employment) have gained and are gaining in importance.* They are also changing people's lifestyles and work life cycles by allowing them to take up atypical (primarily short-term,

informal and hence uninsured) employment and particularly self-employment (e.g., bus and truck drivers, security guards, technicians, accountants, consultants, nurses, social workers, etc.) also in form of one-person companies.

With the arrival and the progress of the post-industrial society, new forms of self-employment and informal employment, as well as rent income, income from capital markets, and income from real estate investments are – when seen from a historical perspective – crowding out income from formal, salaried employment.

In many places, the loss of formal, stable, lifetime employment opportunities, and with it the loss of social security coverage and fringe benefits, has pushed a large share of people (particularly e.g. in South Korea after 1993 election of Kim Young Sam as President) to look for or rely on non-salaried sources of income or, in many cases, atypical employment for their main source or sources of income. To be sure, a great deal of research on the connection between loss and reduction of life-time employment, employment security, and full-time, regular work opportunities and new types of employment, work and life patterns is needed to resolve the current work-fertility-pension dilemma (so to speak, the ‘Bermuda’ triangle of the pension reform debate). In addition, what we need to have a closer look at, especially for young people, is the relationship between delayed graduation from universities (due to higher degrees obtained), study loans, and affordable housing facilities available for young couples and families and the respective decline in the number and delay of both marriages and children (cf e.g. Esping-Andersen, 2002).

To avoid a sudden system change most countries still have the historical opportunity to extend the base for social security (pension) contributions, as to include rent income, income from capital markets, and e.g. the sale of real estate. Also, a good viable option, in the light of population aging, is to strengthen or set up additional DC elements, DC sub-systems, or additional DC systems. Privatization, as in the case of Germany, has only mixed or moderate positive results, as those who need pensions most are least capable to contribute sufficient pension contributions on their own, and private systems in general are unfit to cater to redistribution from more wealthy to poor segments of society. The German *Riester Rente* was partially achieving good results, as they were subsidized by the state, which increased coverage, but yet benefits paid by private pension plans have remained small in relative terms. Australia went a step further in setting up mandatory private funded DC pension plans, but here, too, coverage has been high (as it is compulsory), but benefit levels are rather insufficient to guarantee a continuation of living support during old age, leading to high rates of old-age poverty (cf OECD, 2009). In the Middle East, pension reform is pioneered e.g. by Oman, which is spearheading parametric reform of public pensions to maintain the sustainability of the pension system (Cf Muhanna, 2009).

Figure 2. Four basis dimensions of pension reform: Varying strategies

1. Parametric changes Japan, Germany, Oman	3. Individualization Thailand
2. Privatization United Kingdom (Germany)	4. Fundamental system change Japan (!?)

To avoid a *"slow historical phasing out of DB-based pensions insurance institutions"* on a global scale, pension insurance systems need to either (a) extend the contribution base to include, and mainly focus on, *income from rent, capital and real estate markets*, rather than continue to concentrate on salaried income of the formal sector alone; and/or (b) significantly or fundamentally change their existing pension system, particularly replacing DB type of pension provision with one that is demographically insensitive and fiscally sustainable in the long run, i.e. DC type of pension provision, plus, wherever necessary due to large incidence of old age poverty; and/or (c) also the emergence or strengthening of basic/social pensions systems, elements, or formulas.

As to the particular case of Thailand, to fill the large gap in coverage, provident fund systems need to be made compulsory for all workers, and contribution rates need to be increased continuously, while a new basic/social pension plan, with benefit levels that prevent poverty during old age, need to cover all citizens, especially those outside the formal sector, i.e. the majority of the workforce (cf PM Abhisit Vejjajiva's promise, above).

In Japan, the country with the oldest population today, the government needs to build a sufficient/adequate pension system for the majority of the people, in order to be elected by the majority of the people. New equity (sharing of contributions/wealth) in pension provision is necessary to ensure stable social, political and economic development of Japan in a highly constraint financial and demographic situation – especially e.g. steps towards unification, and tax-financing for basic pensions (cf Takayama and Kitamura, 2009; Takayama, 2009; Saruyama, 2008). Hence, a new universal pension plan equipped with adequate minimum pensions is vital for the future of the Japanese pension system. As in the case of most development countries that have relied on DB pensions systems in the past, Japan is advised to extend the contribution base for its pension system(s) to include different sorts of capital income, in order to be able to ensure decent pensions for all of its current and future senior citizens. A universalization of the Japanese pension system as promised by PM Yukio Hatoyama is still a timely option (even though it will take 20 years to see the development of a full-fledged, mature pension system), when taking an extension of the contribution base into account to include different forms of income, especially rent income, income from capital markets, and real estate investments.

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