**Nagoya University**

**Graduate School of Law**

**Doctoral Thesis**

# ANALYSIS OF THE PRIVATIZATION AS AN APPROACH FOR A PENSION REFORM. THE EXPERIENCE OF BULGARIA AND LESSONS FROM UNITED STATES AND JAPAN

**Student ID Number:**

**431704034**

**Student Name**

**Nikolay Dimitrov BAKALOV**

**Name of the Program:**

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**Academic Supervisors:**

**Prof. Taeko NAKANO, Prof. Frank BENNET, Prof. Masahiro YANO**

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**Abstract**

The public pension systems in developed countries with aging societies are facing problems with their sustainability. As a result, governments seek approaches to make their pension systems more financially sustainable. One of these approaches is the privatization of the public pension plans.

In 2000 the Bulgarian government introduced two private pillars along with the existing public pension plan with the purpose of achieving sustainability of the public pension system and higher pension benefits as a result of successful investments. However, the results from 18 years of operation have not met expectations. The reason is that the privatization of a pension system comes at a cost: it solves one problem, but creates others. In addition, the privatization of the pension system deeply transforms the basis on which the old-age income security is built from insurance to savings.

The present doctoral thesis compares the pension systems of Bulgaria, the United States and Japan in order to show that the Bulgarian approach of privatizing a part of its public pension plan was not optimal. The US pension system is used as an example of the problems that occur in a country in which the social protection provided by the public pension plan is minimal, and individuals have to rely on private pension plans. On the other side is Japan, which has developed public pension plans supplemented by private pension plans. While the Japanese pension system has its own set of problems, it also has a mechanism for indexing the pension benefits designed to ensure the long-term stability of the pension system.

The research comes to the conclusion that the Bulgarian approach to achieving sustainability through privatization is not optimal and gives several recommendations for improvement.

## Contents

## Chapter I: Introduction

### 1.1 The sustainability of a pension system

The pension system is a central pillar of the social security system of any developed country, and in the 21st century, it is facing its biggest challenge. The aging of the population combined with the start of the retirement of the post-war baby boom generation is putting the traditional Pay-As-You-Go pension systems under serious financial stress. As a result, the sustainability of the pension system has become a key parameter for the evaluation of pension reforms.[1]

Sustainability of a pension system may be defined as a property of the pension system, in which outflows are reasonably well linked or balanced by inflows.[2] Depending on the type of pension system the inflows may come from contributions, savings, investment return or any combination of these variables. Graphically, this relation can be represented as follows:

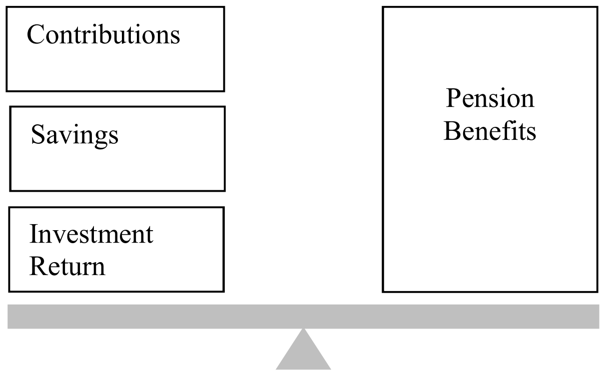


Figure 1: The financial balance of a pension system

Source: Rethinking Pension Reform

For example, in the most common Pay-As-You-Go systems the inflow comes predominantly from contributions and investment return (if there is a surplus), while the share of the savings is zero. On the other side, in savings plans, all three variables become important, and the pension benefits will depend on the accumulated assets, the contribution rate, and the investment return. The practical

[1] Franco Modigliani and Arun S Muralidhar, *Rethinking Pension Reform* (Cambridge; New York: Cambridge University Press, 2004), 39.
[2] Franco Modigliani and Arun S Muralidhar, 19.

importance of breaking down the financial sustainability to its components is that they represent the possible direction for reforms. The reforms of any pension system can be focused on the benefits policy (the eligibility conditions), the contributions policy, and the investment policy.[3]

In 2000, in an attempt to achieve stability, the Bulgarian government implemented a reform that transformed a part of the insurance-based public pension plan into a savings-based one. The instrument for this transformation was privatization in which the contributions in the savings-based portion became under the control of private companies. The present research will analyze whether this reform was a success and if it is not, examine what the causes of its failure are, and will make recommendations for improvement.

However, this is a long term goal and there are different ways of achieving it. The present research will focus on the approaches taken by three different countries – the United States, Japan, and Bulgaria. The purpose of the research is to make an evaluation of these different approaches, of their advantages and disadvantages, and based on the results from this evaluation, to propose measures for improvement, especially for the Bulgarian pension system.

**1.2. Reasons for comparison**

These countries have been chosen for comparison because it will give an answer to the question about whether the Bulgarian approach of privatizing a part of its public pension comes at the expense of decreased social protection. When Bulgaria took the road to a democratic society and market economy, it faced a severe economic crisis and hyperinflation, which resulted in the collapse of the existing socialist model of social security. Around this time, in 1994, the World Bank issued a report containing recommendations for restructuring the pension systems in developing and aging societies. The core of these recommendations and an instrument for achieving sustainability was the establishment of multi-pillar pension system in which one pillar consists of private Defined

[3] Ibid.

Contributions pension plans.[4] This approach, however, was not an invention of the World Bank, it was conceived in the US and more specifically – in the influential and neo-liberal Chicago school of economics. This privatization approach was first applied in Chile in the early 1980s and, at least in the beginning, was successful enough to be recommended by the World Bank in 1994.

At this time, in addition to economic difficulties, Bulgaria was already facing a severe demographic crisis, which put a continuously increasing load on its public pension pillar. As a result, Bulgaria in its efforts to achieve sustainability of its pension system adopted a pension model based on the recommendations of the World Bank. At this time the developed countries in Western Europe were not under such pressure, and since the introduction of the recommendations of the World Bank involved serious political controversies, there was not enough support for them to be adopted in countries like France or Germany.[5] Of course, these countries have developed markets of private pension products, but they are closer to the traditional life insurance, rather than to the Defined Contribution pension plans as they exist in the US and were recommended by the World Bank. These considerations make the US a primary country for comparison. The research on the US pension system as the prototypic will show what advantages and disadvantages can be expected by the model adopted in Bulgaria.

On its part, Japan offers an alternative approach. After the Second World War Japan was heavily influenced by the US legal and economic thought and also has a private pension industry, based on Defined Benefit and Defined Contribution pension plans. However, the approach of Japan is different from that of United States and Bulgaria. While the private pension industry represents the core of the US pension system, in Japan it plays only a complementary role. The public pension system composed of two pillars remains the main source of income security for the elderly. Also, like Bulgaria, Japan also faces a serious demographic crisis and is making efforts to make its pension system more

[4] Since these terms will be used throughout the thesis, a brief explanation is necessary. As the name implies, in the Defined Contribution pension plans, the defined element is contribution that the covered individual has to pay. The amount of the benefit is uncertain and may vary depending on different factors (mostly market fluctuations). On the other hand, in the Defined benefit plans the amount of the benefit is specified from the beginning (usually by a formula), while the amount of the contributions may vary.
[5] Bruno Palier, *The Pension Reform [La réforme des retraites]*, 5th updated edition (Paris: Presses Universitaires de France, 2014).

sustainable. In such a situation, the private pension plans and primarily the Defined Contribution plans have become more and more important. However, there is one big difference between Japan and Bulgaria which is that in Japan the private pension plans have remained outside the institutional public pension system, while in Bulgaria they are part of it. This makes the Bulgarian public pension system partly privatized, which means that the Bulgarian state has stepped back from its obligation to provide social security for the elderly.

### 1.3.Thesis statement

The present research will argue that the US experience shows that the Bulgarian approach of making the private pension plans a significant and institutionalized part of the pension system is a step backward and tries to achieve financial stability at the expense of decreasing social protection and increasing inequality. The current popularity of the Defined Contribution plans reflects a tendency to transform the old age security into a commodity, a good that can be sold on the market. However, this transformation of the old-age security into a commodity means that there will be individuals that lack the means to afford it. In fact, in the US only 54% of the workers in the public sector and only 50% of the workers in the private sector participate in any form of a private pension plan.[6] However, to put the pension insurance system on market foundations, by taking away its social element, would also undermines the main purpose of the pension insurance, which is to share the risk and provide income security in the newly industrialized society. Therefore, the private pension plans and especially the Defined contribution plans should be regarded only as supplementary instruments to stimulate savings (as in Japan), and not as an institutionalized part of the pension system that can replace the public pension insurance plan. Instead, the sustainability of the public pension system could be achieved by increasing the retirement age and matching this age to the increasing life expectancy and increasing the participation of the corporate sector in social security.

[6] Department of Labor Statistics, US Department of Labor, "Employee Benefits in United States - March 2017," News Release, July 21, 2017, https://www.bls.gov/news.release/pdf/ebs2.pdf.
Civilian workers are those employed in the private industry and in the state and local government. Excluded from this category are workers in federal agencies, military personnel, agricultural workers, volunteers and others. The private industry excludes workers in private households and self-employed.

### 1.4. Criteria for making the comparison

For the purpose of proving the thesis, a set of criteria on which to make the evaluations will be needed.

The first criterion is the scope of the pension system. Generally speaking, it means what proportion of the population actually participates in a pension system. The more people that participate, the better. The scope of the pension system can be measured by the ratio of the number of participants in the pension system to the entire number of people of working age.

The second criterion is the depth of social protection a pension system can provide. Unlike the first criterion, this one describes how much an individual can expect to receive for its participation in the pension system. Usually, this is measured by the replacement rate – the ratio of the pension benefits to the income before retirement.

Stability is the third criterion. The pension insurance for saving for retirement is a process that takes many years. Therefore, it is necessary for the legal framework of the pension system to remain stable and not change due to short term political considerations. Unfortunately, there is no unit for measuring stability, so for this criterion, the research will have to rely on circumstantial facts such as the frequency of amendments.

### 1.5. The two approaches to old age income security

A key part of the thesis is the understanding that not every pension system is a pension insurance system. Analyzing a pension insurance system is a complex task. Its design and operation are influenced by a multitude of factors – social, demographic, financial, political and others, which may be specific to the given country, while others also include political decisions and compromises. Therefore, the comparison of two or three pension systems has to start by dismantling this apparent complexity to expose the basic pension model adopted by the respective country.

In this section, the present research will start from the basic purpose of the pension system and the requirements needed to meet to achieve its goal. The purpose of the pension system is simply to provide security against a specific social risk, the risk being the inability to meet the costs of living in old age. To consider this inability to meet the costs of the old age as a risk is important because it also indicates the methods for protection from this risk. In fact, no matter how complex a pension system may look like, its core model is always based on one of the two approaches to deal with risk – saving and/or insurance.

Basically, there are two ways to deal with the risk – one is self-help, which in the context of the old age security translates to saving during one's active years to support one's life in the old age. We can refer to this approach as the savings approach. An implementation of the savings approach is the accumulation of valuable commodities, purchase of the real estate, bank deposits or saving in Defined Contribution pension plans. In this approach, the old age income of the individuals depends entirely on their ability to save during their active years. If their incomes are high and they save, they can enjoy high living standards in their old age.

The other way is to transfer the risk to another individual or entity that can support the consequences of the risk more easily and with less distress. In fact, this second approach meets the definition of insurance and for that reason, we will refer to it as the insurance approach. However, insurance, in this case, needs to be understood not in the narrow context of the insurance industry, but much more broadly as a transfer of the negative consequences of a risk. In the old age security, this approach means that the consequences of the old age (inability to work and need for income) are transferred to another entity – state, company, or another individual. For example, in the public PAYGO schemes, the consequences of the old age are transferred first to the State and then to the working population through the collection of pension insurance contributions. In the private Defined Benefit pension plans, the consequences of the old age are transferred to the former employer. This means that the employer will have to provide the old age income security of its employees. From this perspective, even the moral obligation of the children to take care of their elderly parents can be seen as a form of the insurance approach. The logic behind this transfer is that the party that has to bear the risk and the negative consequences can do it more easily and efficiently. The contributions paid during the active years of the employee represent the insurance premium for the transfer of risk. The higher the insurance premium, the better the insurance protection will be. In the public pension plans and in the Defined Benefit pension plans, the insurance protection is calculated using a formula, which takes into account the contributions paid or the final salary and the length of service.

The insurance approach in its pure form is served by the life insurance policies sold by private companies in which the benefits are calculated based on the actuarial calculations concerning the life expectancy of the individuals and the premiums they paid during their period of insurance. The public pension insurance plans, however, show an important difference from the private life insurance: the life insurance offered by private companies is for profit, while the public pension insurance plans contain a social element. This social element is reflected in the redistribution of wealth that takes place in the public pension systems. This redistribution happens because usually, the people with low income or a short history of paying insurance receive more than what they would have received if their retirement benefits were calculated based only on their contribution to the pension insurance system. On the other hand, people with higher income and a long history of insurance payments receive less than what they would have otherwise received.

The savings approach has no element of insurance. The risk and the negative consequences of old age always stay with the individuals. If they are unable to save enough or their saving strategy fails, they will be the ones to bear the consequences. However the savings approach is rarely implemented in its pure form; usually, it is combined with some level of insurance.

Another point that needs to be taken into consideration is that the risk can never be eliminated completely. In addition, the risks that arise with the savings approach and the insurance approach are different. For example, with the savings approach, there is always a risk that the person will outlive his or her savings. On the other hand, with the insurance approach the risk is that the insuring party will eventually be unable to bear that risk. Referring to the PAYGO pension plans, this means the risk that the stay may be unable to collect enough contributions and taxes to cover the expenses for the pension benefits.

The comparison between the pension systems based on a mixture of insurance and savings approach differ in the level of old-age protection they provide.

## Chapter II – The Bulgarian pension system

### 2.1. The old age security in Bulgaria

The Bulgarian old-age income security system has a long but turbulent history. The first social security Act was enacted in 1880 – almost immediately after the Liberation, following the Russian-Turkish War of 1877-1878. This law provided pensions for the members of the Bulgarian Volunteer Corps that took part in the war on the side of the Russian Army, and the members of various political movements for the liberation of Bulgaria. This Act started the process of a gradual but fragmented build-up of the Bulgarian pension system: until 1948 the Bulgarian Parliament enacted in total 89 laws and ordinances providing pension benefits to different categories of employees including teachers, artists, priests, state servants, military personnel, etc.[7]

The coup d'état of September 9, 1944, and the following establishment of a Communist regime in Bulgaria led to a radical transformation of the Bulgarian pension system. In 1947 the Grand National Assembly adopted a new Constitution, which replaced the monarchial form of government with republican one, under the control of the Bulgarian Communist Party. Art. 75 of this Constitution provided that: "The citizens have the right to pensions, financial assistance, and benefits in case of disease, accident, disability, old-age, and unemployment. This right is implemented in practice by the State through general contributions and affordable healthcare."

This provision of the Constitution of 1947 provided the basis for a legislative codification of the existing legislation in the area of old-age security.[8] As a result, on January 11, 1949, the Bulgarian Parliament adopted the Social Security Act. However, this codification of the existing legislation did not lead to a unification of the eligibility rules for different categories of employees. In fact, it helped create privileges for loyalty to the Communist regime in the form of pensions for different merits.

[7] Iosifiv Nikola (Йосифов Никола), *The Social Security Legislation in Bulgaria (1880 - 1999) [Осигурителното Законодателство в България (1880-1999 г.)]* (Varna: VSU Chernorizetz Hrabur, 2010), 182.
[8] Iosifiv Nikola (Йосифов Никола), 182.

Although this fragmentation decreased in the evolution of the Bulgarian old-age security legislation, it persists to the present day and is one of the serious issues in the Bulgarian pension system.

The next radical transformation came in 1989 when Bulgaria started the transition from socialism and a planned economy to democracy and a market economy. This transformation affected all aspects of social life, which inevitably included the pension system. In this situation, the existing pension system turned out to be completely incapable of meeting the challenges of the market economy. The burden of contributions to the pension system was borne entirely by the employers. This made sense in a planned economy, in which the State was both the only employer, collector of contributions and payer of benefits since the difference is only in the way in which these contributions are accounted. This approach however becomes totally inefficient when the employers are private law entities. Often the contributions to the pension system were used for purposes other than providing pension benefits, and the requirements for eligibility were too lax.[9] During these first years of the transition to a market economy, official employment decreased, while the proportion of the economy evading payment of taxes and social security contributions reached 27.8 of the country's GDP.[10] All these factors, combined with the rising unemployment, led to ballooning financial deficits that grew bigger and bigger.

To rein in the deficits in the pension system, the Bulgarian government tried to restrict the eligibility conditions and make the system self-sustainable, but these efforts collapsed after a series of bank failures followed by hyperinflation in 1995-1996. The result of these events was that the purchasing power of the pension benefits was reduced to just several US dollars.[11] From an economic viewpoint, such a decrease in the purchasing power is equivalent to the abolishment of the system for old-age security.

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[9] Ivanka Daneva, *Finansi Na Osiguritelnite Druzhestva [Finance of the Social Inusrance Companies]* (Sofia: Nov Bulgarski Universitet, 2014).

[10] Petkan Iliev and Center for the Study of Democracy (Bulgaria), eds., *Skritata Ikonomika v Bulgaria [The Grey Economy in Bulgaria]* (Sofia: Center for the Study of Democracy (Bulgaria), 2004), 48.

[11] Nikolay Bakalov, "The Agency Problem In The Bulgarian Private Pension Insurance System" Lessons For Bulgaria From Japan" Master Thesis (Nagoya University, Graduate School of Law, 2016).

Short on money, Bulgaria turned to international creditors for assistance but had to implement far-reaching reforms in many areas. Naturally, one of these areas was the pension system, and in 2000 the Bulgarian parliament passed the current Social Insurance Code.

### 2.2. The private pension pillars

Based on the recommendations of the World Bank, the new Bulgarian pension model was based on three pillars – one public pay-as-you-go pension plan (the white area in Fig. 3), and two[12] fund-type pension plans (the shaded areas in Fig. 3), in which private companies invested the contributions made by the covered individuals.[13] One of these pillars is for the individuals engaged in hazardous work and who retire earlier, while the other is for all other employees. This model was inspired by the Chilean pension system, which was completely run by private companies and was considered a success in the late 1980s and early 1990s. Bulgaria did not fully adopt the Chilean model, as it retained a public pension plan, but aimed to use the two funded plans as a measure to relieve the

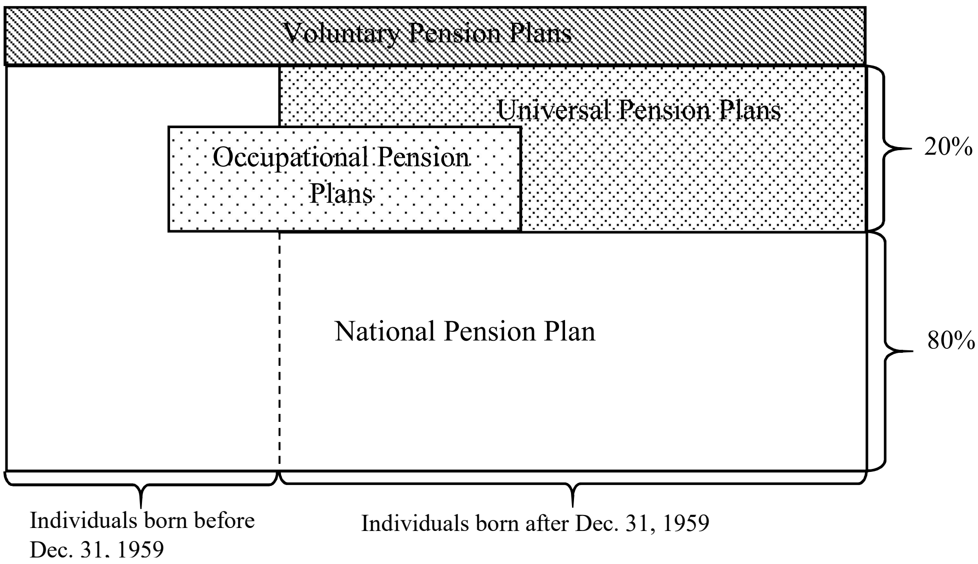


*Figure 3. The structure of the Bulgarian pension system after 2000.*

[12] The current voluntary pension plans were introduced in 2000, but they fall out of the scope of the present research because they do not represent a privatization of the existing public pension plan. Therefore, they are included in Figure 3 with the purpose of completeness only.
[13] This applies for the individuals born after December 31, 1959. The individuals born before that date will be covered only by the public pension plan.

financial burden from the public pension plan. As a result, the Bulgarian pension system adopted the following structure:

The following example illustrates how the new system works: an individual X, born after December 31, 1959, becomes employed. The reason for this division is that in 2000 when this model was adopted, the government considered that the individuals born before that date. The employer of X then notifies the National Revenue Agency which starts collecting old-age contributions from the salary of X. At the same time, X has to choose a company that will manage and invest a part of his or her future contributions.[14] This selection is mandatory. If X does not select a company, the National Revenue Agency will use a lottery to select a company for X.[15] After a company has been selected, the National Revenue Agency will continue to collect contributions of the same amount, but a portion (currently 20%) will be transferred to an account of X in a fund, managed by the selected company. The company then will invest the accumulated contributions in various financial assets, and the investment return will be credited to the account of X. For its services, the company will collect fees from the contributions of X. When X retires, he or she will start receiving one old-age benefit from the public pension plan, and another one from the company. However, since 20% of the contributions did not go to the public pension plan, the benefit from this plan will also be 20% less. The pension from the company will have to compensate for this reduction of the old-age benefit from the public pension plan. If X was employed in a hazardous occupation, he or she would have been covered also in an Occupational pension plan. The reason for these types of plans is that the workers employed in hazardous occupations retire earlier than the rest, and therefore they pay higher contributions to these pension plans. If X would like to save more for his or her old age, X could do that by insurance in a voluntary pension fund.

This mechanism had to achieve two purposes – to relieve the burden of the pension plan and to stimulate the economy through investments by private companies. A look at Figure 3 can explain

[14] Art. 137, Para. 3 of the Bulgarian Social Security Code.
[15] Art. 137, Para. 4 of the Bulgarian Social Security Code.

how it is achieved. The width of the rectangle represents the number of people covered in the pension system, while the height represents the level of the pension benefits. The area of the big rectangle gives the total burden of the pension system on the state and the society. However, after 2000 the surfaces of the Universal pension plans and the Occupational pension plans have to be subtracted from the surface of the big rectangle. The pension benefits provided by these plans are not burden for the public pension plan anymore.

This approach, however, had two serious flaws. The first one is that the regulations did not stimulate competition among the pension companies, the specific requirements[16] limited the number of such companies to only eight, and each individual could transfer contributions to only one of them. The result is monopolistic behavior from the pension companies, which is reflected in the fact that all companies apply the highest management fees allowed by legislation.[17] The second and more complex one is the false premise that private companies will invest exclusively in the interest of the covered individuals, most of which do not have sufficient financial knowledge to properly monitor this process. Such a relationship is prone to suffer from a principal-agent problem.

### 2.2.1. The principal-agent problem and its impact

The principal agent-problem occurs in a broad range of contexts, and especially in investment or property management.

Simply explained, the principal-agent problem arises when the well-being or profit of one party, called the principal, depends on actions taken by another party called "agent."[18] Generally, almost any contractual relationship may suffer from this kind of problem, as long as the principal does not possess enough information or knowledge to exercise effective control on the actions of the agent.

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[16] For example, such requirements are the requirement for capital (Art. 121c of the SSC), the requirements for complex management and information systems (Art. 123j, Para. 1 of the SSC), a controversial requirement for a "good reputation" of the shareholders (Art. 121j, Para. 1, item 7 of the SSC).

[17] Currently the fees collected by the companies managing a private pension plans are 3.75% from each monthly contribution and 0.75% yearly fee of the total value of the managed assets - Art. 201 of the Bulgarian Social Security Code.

[18] Reinier H. Kraakman, ed., *The Anatomy of Corporate Law: A Comparative and Functional Approach*, 2nd ed (Oxford ; New York: Oxford University Press, 2009), 42.

The core of the problem lies in the fact that this informational asymmetry does not allow the principal to verify whether the agent discharges his or her duties in accordance with the contract. The result is a strong incentive for the agent to act in his or her own interest sacrificing the interest of the principal. The greater the complexity of the contracted performance and hence the informational imbalance, the larger the principal-agent problem becomes. In extreme cases, this problem may even destroy the entire value of the contract and transform it into a social cost.[19] In the private pillars of the Bulgarian pension system, the principal-agent problem translates into a strong incentive for the company (and its executives) to act for their own benefit, sacrificing the interests of the covered individual.

The costs the principal-agent problem imposed on the Bulgarian pension system will become completely clear in several years when the private companies will have to start paying pensions. However, the investment results to this date have been disappointing. According to data from the Bulgarian Financial Supervision Commission, the government body that oversees the activity of the private pension insurance companies, the investment return for the period 2004-2014 was "negative 1.7%"[20]

The only other expert that uses detailed financial models to analyze the private pillars of the Bulgarian pension system is the Chairman of the Bulgarian Institute of the Licensed Financial Consultants. During the years he has produced several articles analyzing the performance of the pension fund managed by private companies. His latest analysis is focused on the expected replacement rate[21] between the individuals covered only by the public pension plan, and the individuals covered both by a public and a private pension plan. His analysis shows that in 2040 the replacement rate of the pension benefits of the public pension plan will be no more than 46%, which

[19] Bakalov, N. "The Agency Problem In The Bulgarian Private Pension Insurance System" Lessons For Bulgaria From Japan," 12.

[20] Djalazov Angel, "Temporary Commission for Investigation of the Financial Position of the Pension Insurance Companies and of the Universal and Occupational Pension Funds Managed by Them, and of the Application of the Legal Framework," held on March 4, 2015, http://www.parliament.bg/bg/parliamentarycommittees/members/2395/steno/ID/3568. Last visted on January 17, 2020.

[21] Replacement rate is the ratio between the amount of the pension benefit and the wage of the individual before retirement.

is considerably less than the average replacement rate of the other EU-member states, which stands at 58%.[22]

However, the situation will be even worse for those covered both by a public and by a private pension plan. The projections for these individuals show that they will receive between 3 and 5% less than the people covered only by the public pension plan. As Christoff puts it: “two pensions will be less than one.”[23] This failure of the private pillars of the pension system is a direct consequence of the two unaddressed issues mentioned before: monopolistic behavior and the principal-agent problem.

### 2.2.2. The attempt for reform of 2011

The Bulgarian government understood that the funds in the pillar that was designed to provide pension benefits to employees working in hazardous conditions would be insufficient to pay meaningful pensions, so in 2010 promulgated an Act that ordered the transfer of the accumulated funds to the public pension plan.[24] The constitutionality of this Act was immediately challenged before the Bulgarian constitutional court. The plaintiffs argued that this Act violated several constitutional rights of the citizens, namely the right of ownership and the right to free economic initiative.

The Bulgarian Constitutional Court held that since the individuals can receive the funds accumulated in their accounts, only after they have earned eligibility to public pension, the concept of ownership in its classical dimension is not applicable in this case. Instead, the Bulgarian Constitutional Court held that the Act was infringing the right of free economic initiative of the citizens. The argument of the court can be summarized as follows: the transfer of the funds from the private pension pillar to the public pension plan automatically terminates the contractual relationship between the parties, without any manifestation of will on their part. In the opinion of the court, such disregard to the will of the private parties represents a violation of the Art. 19, Para. 1 of the Constitution of the

[22] Lyubomir Christoff, “Pension (In)Adequacy in Bulgaria [(Не)Адекватност На Пенсиите в България],” *Institute of the Certified Financial Consultants*, March 17, 2019, 13, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3354170.
[23] Christoff, 15.
[24] Another explanation for this transfer was the difficult financial situation of the public pension plan due to the financial crisis at that time.

Republic of Bulgaria, which proclaims that the Bulgarian economy is based on free economic initiatives.[25]

Both of these arguments of the Court are vulnerable to criticism. First, the fact that the individuals can spend the funds in their accounts only after retirement, can hardly justify the view that the property regime is not applicable to these funds. On the contrary, these funds should be considered property for several reasons. First, as the present research argues, the principle on which the private pension pillars is that of savings, with no wealth redistribution, and savings is one form of property. Second, there are several provisions in the Social Insurance Code indicating that these funds are property of the individuals: the individuals can freely choose which company will invest the funds accumulated in their accounts,[26] and the company is liable for damages.[27] Finally, some scholars also claim that the balances in the accounts are the property of the individuals.[28]

The issue of classifying the funds as a property of the covered individuals is important and deserves analysis as this transfer of funds to the public plan (and any future attempts aiming at the same result) is reversing the privatization by eminent domain. It is true that the ownership of the funds is extinguished once they are transferred to the public pay-as-you-go pension plan, but at the same time, the state provides compensation in the form of higher benefits in the public pension plan. This is a strong argument for the constitutionality of such acts, which would reverse the privatization of the public pension plan.

The second argument about the economy, based on free economic initiative, also has a serious flaw. As mentioned above, when an individual does not select a company to invest his or her contributions, he is assigned a company after a drawing carried out by the National Revenues Agency. This shows that the freedom of contract is limited in this field, and contractual relations may arise without the will of the parties. Accordingly, by analogy, it could be possible that contractual

[25] Constitutional Court of the Republic of Bulgaria [*Конституционен съд на Република България*], Decision No 7, May 31, 2011. http://www.constcourt.bg/bg/Acts/GetHtmlContent/f99432ab-f5c6-4e4d-9315-fe3aa41c56a5

[26] Art. 122e, Para. 1, item 4 of the Bulgarian Social Security Code.

[27] Art. 134, Para. 1 and 2 of the Bulgarian Social Security Code.

[28] Vasil Mruchkov (Васил Мръчков), *Social Security Law [Осигурително Право]*, Sixth amended and supplemented edition (Sofia: Sibi, 2014), 391.

relationships could be terminated without the will of the parties. In addition, says this argument, the Bulgarian Constitutional Court protects the interest of the investment companies, rather than the interest of the covered individuals. The principle of free economic initiative is applied when these companies are about to lose funds to invest and from which to collect fees, but not when they receive transfers of contributions without the expressed will of the covered individuals.

Therefore, it could be argued that if the Constitutional Court acknowledged the property character of the funds, it should have ruled that the Act ordering their transfer is constitutional. Instead, the court held that the Act is unconstitutional, protecting the interest of the private companies exclusively, and creating a lot of confusion. This comes from the fact that the decisions of the Constitutional Court declaring an act unconstitutional do not have a retroactive effect, so the funds that were transferred to the public pension plan were not transferred back. In the future, however, the contributions of the individuals working in hazardous conditions will be transferred to private companies.

The problem of "two pensions make less than one" became apparent again in the late November 2019 when the Minister of the Labor and Social Policy Mr. Bisser Petkov admitted that the combined pension benefits (from the public pension plan and the private pension plans) of first retirees will be less than the pension benefits of the individuals who were covered only in the public pension plan.[29]

In summary, the private pillars of the Bulgarian pension system are inefficient because they suffer from inherent problems such as monopolistic behavior, high management and investment fees, and a principal-agent problem. The serious consequences of this inefficiency are that the covered individuals may not receive higher pensions, but there is a substantial risk that they may receive lower pensions as well. Therefore, the privatization of the public pension plan can hardly be regarded as a success story. It may turn out to be a failure.

[29] "Sickness pay, pension and social payments, the Minister of Labor and Social Policy speaks [Болнични, пенсии и социални плащания - говори Министъра на труда и социалната политика]," television broadcast, *More news from today ["Още от деня"]* (Bulgarian National Television [БНТ], November 27, 2019), https://www.bnt.bg/bg/a/bolnichni-pensii-i-sotsialni-plashchaniya-govori-ministr-biser-petkov.

### 2.3. The public pension plan

The Bulgarian public pension plan provides the following types of pension benefits, which will be explained below.

Old age and length of service pension benefits. As of 2019 the basic requirements for this type of pension benefits are age 64 years and 2 months for men and 61 years and 4 months for women, and 38 years and 8 months length of service for men and 35 years and 8 months for women. These values are set to increase gradually until they reach 65 years of age for both sexes[30] and length of service of 37 years for women and 40 years for men.[31] This differential treatment for men and women reflects a concept from the beginning of the 20th century according to which women are not anatomically as strong as men, so they cannot be expected to work as long as men. This differential treatment was designed as a protection for women, but the current approach in Bulgaria is to bring such differences to a minimum.[32]

The pension benefit is calculated using a complex formula in which the main factors are the ratio between the average monthly income for insurance purposes of the individual and the average income for insurance purposes in the country during his or her career and the length of service. As a measure to stimulate employment among the elderly the weight of the length of services increases if the individual continues to work after reaching retirement age. There is a lower limit of the pension, which is set by the Bulgarian National Social Security Institute. For 2019 this amount is BGN 219.43 per month.[33]

For the individuals who cannot meet the requirements for retirement described above, the Bulgarian Social Security Code provides an option for early retirement with decreased amount of the pension benefit. In this case the individual needs to meet the following requirements – age of 66 years

[30] Art. 68, Para. 1, items 1 and 2 of the Bulgarian Social Security Code.
[31] Art. 68, Para. 2 of the Bulgarian Social Security Code.
[32] Vasil Mruchkov (Васил Мръчков), *Social Security Law [Осигурително Право]*, 287.
[33] Equivalent to approximately JPY 13,700.

and 4 months and length of service of 15 years. Its minimal amount cannot be less than 85% of the minimal "full" pension benefit.[34]

The other type of old-age pension is the welfare pension for old age. Unlike the pension for old-age and length of service, this is purely a welfare pension benefit with an age requirement – 70 years. Currently, the Bulgarian National Social Security Institute has set the amount of this benefit at BGN 132,74 per month.[35][36]

The issues of the Bulgarian pension system are by no means limited to the private pillars. The public pension plan also has its problems. The pension coverage in Bulgaria has always suffered from patchwork solutions, which has led to varying retirement rules for different categories of employees.

As previously mentioned, there are individuals working in hazardous or unhealthy conditions who become eligible for pension benefits earlier than the others. These three categories of labor – first which includes the most hazardous to health professions (miners, divers, electricians working with high voltage equipment, etc), the second which covers less risky professions like metallurgical workers, workers in productions using toxic materials, and third which comprises all remaining professions.[37] Currently, there are 9 types of labor activities of Category 1 and 45 types of labor activities of Category 2.[38] The rationale behind this approach is to make these professions attractive[39], without a need for paying higher wages. Currently the employees of Category 1 and 2 enjoy much more favorable retirement conditions than the rest. The provision regulating their pension eligibility is Art. 69b of the Bulgarian Social Insurance Code. The requirements are:

- Length of service in first, second labor category: 10 years and 15 years respectively

[34] Art. 70, Para. 8 of the Bulgarian Social Security Code.
[35] National Social Security Institute, "Pension Benefits Unrelated to Emplyment [Пенсии, Несвързани с Трудова Дейност]," accessed December 16, 2019, https://www.nssi.bg/pensions/grantpensions/424-pntd.
[36] Equivalent to approximately JPY 8,300.
[37] The professions falling in first and second labor categories are listed in Instruction for Application of the Ordinance for Labor Categorization.
[38] Vasil Mruchkov (Васил Мръчков), *Social Security Law [Осигурително Право]*, 290.
[39] Vasil Mruchkov (Васил Мръчков), 289.

– Age 53 years and 2 months for men and 48 years and 8 months for women, and 58 years and 2 months for men, and 53 years and 8 months for women [40]

– The sum of the age and the length of service equals 100 for men and 94 for women.[41]

In addition to these rules for early retirement, the Bulgarian Social Insurance Code also contains rules enabling early retirement for teachers[42] and various categories of state servants such as military personnel, policemen, firemen, prison guards, and others.[43]

The result of this differential retirement regime is that too many people retire early, at an age that allows for further employment. The data of the National Statistics Institute shows that in 2018 18.2% of all newly retired men and 4.5% of all newly retired women retired before the age of 60.[44] The outcome is a deficit in the pension system and lower pensions.

### 2.4. Conclusion

In conclusion, the partial privatization of the Bulgarian pension system did not bring the expected benefits. The private pillars are beset by monopolistic behavior and principal-agent problems, which puts their effectiveness in question. On the other side, the public pension pillar suffers from fragmented regulations of the eligibility, which allows excessively early retirement for a large proportion of the population. The combined outcome is lower pensions and less income security in old age. The next chapter will examine whether a country that relies heavily on private pensions has achieved a higher level of old-age income security.

[40] The retirement ages are gradually increasing until they reach 55 years for men and women with 10 years length of service in first labor category and 60 years for men and women with 15 years length of service in second labor category.

[41] In the calculation of length of service 3 years of work in first labor category count as 5 years and 4 years of work in second labor category count as 5 years.

[42] Art. 69c of the Bulgarian Social Insurance Code

[43] Art. 69a of the Bulgarian Social Insurance Code

[44] National Statistics Institute, *Statistical Yearbook, Pensions 2018 [Статистически Годишник, Пенсии 2018]* (Sofia, 2019), 64, http://www.nssi.bg/images/bg/about/statisticsandanalysis/statistics/pensii/YEARBOOK_PENSION_2018.pdf. Accessed on Dec 6, 2019.

## Chapter III: The old age security in the United States

### 3.1 History and evolution

#### 3.1.1. The early years

The pension system of a country is not something fixed, but a constant process of transformation and adaptation in response to changing social, economic and demographic conditions. At the same time, the pension system is built on specific core principles and values that remain more or less constant but are sometimes hard to distinguish in the tangle of reforms and amendments accumulated during the years. To fully analyze a pension system means to understand its basic principles, which can be seen more clearly through its historical development.

The contemporary old age income security in the US developed on its own path on the basis of concepts and institutions dating back to the colonization of the country. The first colonists did not just settle on the American continent, they brought with them their ideas about economic and social order, including concepts about old age income security. In the case of the American colonists, the approach to old age security was the English "Poor Laws".[45] These "Poor Laws", however, were based on the needs of 16th century England, and had the aim to promote public safety and order rather than the well being of the people in need.[46] These laws were designed to provide care for the poor at the level of the local community, and, as a result, to eliminate the risk of political instability associated with large groups of starving people coming to urban areas. In fact, the laws were sometimes referred to as "laws against the poor."[47]

The reason for this attitude towards the poor was that the agrarian society of that time did not see old age as a reason for the cessation of work. People had to work as long they were physically capable, which combined with external risks like famine, disease and war meant that mostly the

[45] "Social Security History," accessed April 10, 2018, https://www.ssa.gov/history/briefhistory3.html.
[46] Patricia E. Dilley, "The Evolution of Entitlement: Retirement Income and the Problem of Integrating Private Pensions and Social Security," *Loyola of Los Angeles Law Review* 30 (1996–1997): 1063–1198.
[47] Dilley.

affluent people were able to reach the age of sixty.[48] Therefore, the agrarian society did not regard poverty as a social problem, but rather than a result of idleness and unwillingness to work. Poor people were often treated with contempt and the care for them was made as unpleasant as possible in order to discourage this anti-social behavior.[49] At this time there was no system of formal criteria to differentiate between the people eligible to receive help and those that were unworthy in the eyes of the society. The only widespread approach to this problem was the geographical differentiation, the aid was provided only to the people from the local community. The elderly were not subjected to any special rules and were not usually differentiated from the disabled.[50]

Regarding the old-age security of the people that did not need poor aid, the approach to old age was savings as explained in 1.5. above. These individuals remained in the workforce as long as they could, and because they were the legal owners of the family estate, which can be regarded as a form of saving, they could rely on assistance from their offspring.

The event in the US that changed these established approaches to income security and prevention of poverty was the Civil War. The Civil War was the first major conflict fought using the technological achievements of the Industrialization. The result was a dramatic increase in the number of casualties and disabled veterans. The existing poorhouses were simply incapable of dealing with the thousands of war veterans and the orphans and widows of the casualties. This massive emergence of many economically vulnerable people created a problem that the savings approach to income insecurity could not solve. In this respect, the Civil War showed one consequence of the Industrialization that became a critical issue of social policy in the 20th century. This issue revealed that a shock to an industrialized society (such as a war or economic crisis) is capable of producing a previously unimaginably high number of economically vulnerable people and creates a need for the redistribution of wealth. Going back to the Civil War, this was the first time when the US government

[48] Dilley.
[49] "Social Security History."
[50] Dilley, "The Evolution of Entitlement."

had to step in and establish a pension system that will eventually become the precursor of the Social Security Program.

At first, the Civil War pensions were given to people suffering from disabilities resulting from military service[51] and were not subject to a means test.[52] Since the Civil War pensions' purpose was to support the veterans until their deaths, it spanned for several decades and was subjected to many legislative amendments. In 1890 the requirement for military service-related disability was abolished and any former soldier could claim benefits, not only the injured veterans. Fifteen years later, in 1906 old age itself was established as a sufficient condition for conferral of benefits. As a result, in the early 20th century the Civil war pensions program in the US had developed far beyond the original plans. The fact that many young people took part in the Civil War combined with later extensions of the coverage of the program and the fact that widows and orphans could also claim Civil War pensions created a pension system that had rather a similar effect to those created in Europe at the same time. By 1910 18% of all US citizens aged 65 years or more were receiving Civil War benefits, which included 28.5% of the men and 8% of women.[53] However, the Civil War pension program was still far from universal. For example, the Confederate soldiers and their families did not have a right to claim benefits,[54] and expenditure of benefits was concentrated mostly in the Northern States.[55]

### 3.1.2. The industrialization and the transformation of the old-age security

Industrialization began to transform the American society from the mid 19th century and by the first decades of the 20th century, the organization of economy and employment became gradually industrial in nature. For example, in 1880 72% of the US population lived in the countryside and only 28% in the cities. By 1930 this ratio changed to 56% urban population and 44% rural.[56] This change in the living conditions, economics, and labor organizations had profound social effects: it created

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51 "Social Security History."
52 Dilley, "The Evolution of Entitlement."
53 Dilley.
54 "Social Security History."
55 "Social Security History."
56 Larry DeWitt, "The Development of Social Security in America," *Social Security Bulletin* 70, no. 3 (2010): 1–26.

enormous amounts of wealth and consumption, as well as previously unknown risks such as unemployment, occupational disease, and work-related injuries also appeared. The technological advances made many professions redundant and the separation from the farm deprived the industrial workers of one form of social protection. At the same time, advances in medicine started to increase life expectancy significantly. In 1870 only 1.15% of Americans were 65 years old or older, and by 1930 this percentage increased around six times to 6.63%.[57] As a result, the combination of these factors made the industrial workers look at old age with an increasing feeling of uncertainty and fear.

At this point leading European countries such as Germany and France and the US took different approaches to deal with the risk of poverty in old age. In Europe, a new ideology called Socialism was growing due to dissatisfaction and fears of the industrial workers. In 1871 radicalized French workers were able to stage an uprising in Paris, which lasted for several months before being crushed by the government forces. For the German Kaiser Otto von Bismark, the socialist movement was a threat to the existing monarchial order and had to be stopped at any cost. The solution for Bismark was the adoption of social security reforms that would, in his opinion, give the workers a stake in the State and undercut the appeal of the Socialist movement.[58] The social security system (including pension insurance) introduced by Bismark was so successful that it spread not just in most European countries but reached as far as Japan.

However, the situation in America was different. The Civil War pension program had expanded in scope and at the beginning of the 20th century covered, as mentioned above, a large proportion of the elderly population. Therefore, the need for old-age protection was not as pressing in the US as it was in Europe. US had already developed a *de facto* social insurance program, which paid old age, disability and survivors benefits to a limited segment of the American population.[59] The wide coverage of the Civil War pensions is a possible explanation as to why the US did not pass extensive social security legislation before the Great Depression.[60] This does not mean, however, that in the US

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57 DeWitt.
58 James N. Retallack, ed., *Imperial Germany, 1871-1918*, Short Oxford History of Germany (Oxford ; New York: Oxford University Press, 2008), 37.
59 DeWitt, "The Development of Social Security in America."
60 Dilley, "The Evolution of Entitlement."

the employers did not face the problem of controlling the dissent of their workers. The approach they took was to offer employer-sponsored pension plans that still form the backbone of the US pension system. For the employers at that time, the private pension plans offered several advantages. First, the workers exchanged their right to strike for the promise of some economic security in old age.[61] Second, by sending the elderly and already inefficient workers to retirement, the employer was able to streamline its production costs.[62] Third, the establishment of a pension plan did not impose a serious short-time burden on the employer, because those workers who would retire immediately after the introduction of the plan would be few and their benefits low.[63] The pension plan was a way to increase wages without actually paying them in the short term.[64]

### 3.1.3. The Great Depression

On October 24, 1929, the US stock market recorded its biggest loss until that date. Investors started to panic and even the attempt of a group of bankers to calm the situation by providing 240 million dollars was futile.[65] This event triggered what is now known as the Great Depression which was the biggest economic downturn of the 20th century. This period was marked by huge financial losses, which led to massive bankruptcies[66] and soaring unemployment. The US Gross National Product collapsed from 105 billion in 1929 to only 55 billion in 1932 and wages paid dropped from 50 billion in 1929 to only 30 billion in 1932.[67] Every fourth American was left without a job and means to make a living.

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[61] Flexibility Workplace and Georgetown University Law Center, "A Timeline of the Evolution of Retirement in the United States," *Memos and Fact Sheets* 50 (2010), https://scholarship.law.georgetown.edu/legal/50.
[62] Flexibility Workplace and Georgetown University Law Center.
[63] Flexibility Workplace and Georgetown University Law Center.
[64] In 1948 the National Labor Relations Board formally recognized that private pensions are part of the term "wages". Flexibility Workplace and Georgetown University Law Center, "A Timeline of the Evolution of Retirement in the United States," *Memos and Fact Sheets* 50 (2010)
[65] "Social Security History."
[66] Just the number of banks that went bankrupt was around 10,000.
[67] "Social Security History."

Unsurprisingly, the Great Depression gave life to many movements for economic security, most of which were dubious and impracticable.[68] The most well-known movement was the Townsend plan. The basic idea behind this plan was the government to provide a pension of USD 200 per month to every American citizen aged 60 or older.[69] – at a time when the average monthly income of the working Americans was about USD 100 per month.[70] Other popular movements were “Share the Wealth”, “Union for Social Justice” and “End Poverty in California”. Although all of these movements were extremely populist, the American society was so desperate for some kind of economic security that these movements found support among millions of Americans.[71] Given this strong support for populist movements, the US Government had only one option: to step in and offer a practical solution for achieving economic security. This solution was called the Social Security Act and was part of President Roosevelt’s New Deal. It can be argued that the Great Depression showed that private pensions cannot function properly in an economic crisis. In their essence, private pension plans are only a promise to pay a sum and have value as long as the institution behind the promise is sound enough to keep its obligation. However, in an economic downturn trust is scarce and the workers had a good reason not to trust their employers. From 1929 to 1932 forty five private pension plans were terminated and many employers used the accumulated pension funds to cover short-term liabilities.[72] The Government, however, had the power to collect taxes and could redistribute income in order to provide economic security to the most vulnerable citizens. In this difference lies the success of the Social Security Act of 1935.

The adoption of the federal old-age security program in the 1930s may be considered inevitable, but this does not mean that the Social Security Act was passed without struggles and compromises.

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[68] DeWitt, “The Development of Social Security in America.”
[69] “Social Security History.”
[70] DeWitt, “The Development of Social Security in America.”
[71] For example, in 1935 the Townsend plan had around 2.2 million supporters across the US.
[72] Dilley, “The Evolution of Entitlement.”

### 3.1.4. The road to the Social Security Act

In the years before the adoption of the Social Security Act, two competing schools of thought were trying to get public support for their vision of the future federal old-age security program. One group of intellectuals called the Ohio school, which included prominent social security theorists such as Abraham Epstein and Isaac Rubinow, advocated for a system that would create considerable redistribution between people with different levels of income.[73] On the other side was the Wisconsin school, formed around people such as John Commons and John Andrews, who supported policies that would minimize income redistribution. In the end, the supporters of the Wisconsin school prevailed and the final bill was much closer to their views, rather to those of the Ohio school.

On June 29th, 1934 President Roosevelt formed the Committee on Economic Security (CES) to make a proposal about the future Social Security Act. He chose the members of the commission from the advocates of the Wisconsin School of pension insurance.[74] CES borrowed experts from other government agencies and set to work immediately. The experts did comprehensive research on the problems of economic security in the US and analyzed the existing European models.[75] In less than six months the CES was able to produce a Report to Congress and drafted a detailed legislative proposal.[76] As previously mentioned, this model opposed the non-contributory pensions and especially the proposals to redistribute income to the people classified as poor. Instead, it focused on compulsory contributions as a form of accumulating savings for old age. This poverty-preventive approach was designed to conform to market principles, which meant that the final pension benefits would depend on the pre-retirement income and would have a weak redistributive effect.[77] The CES managed to finish its research and report to the President in early January 1935. On January 17th the President introduced the report to both Houses of Congress for simultaneous consideration.[78] Some

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[73] John B. Williamson and Fred C. Pampel, *Old-Age Security in Comparative Perspective* (New York: Oxford University Press, 1993), 94.
[74] Williamson and Pampel, 95.
[75] "Social Security History."
[76] "Social Security History."
[77] Williamson and Pampel, *Old-Age Security in Comparative Perspective*, 95.
[78] "Social Security History."

provisions of the bill barely made it through the committees, but eventually, the bill passed in both houses and on August 14th, 1935 the Social Security Act was signed into law by President Roosevelt.

### 3.1.5. The Social Security Act as a political compromise

However, the high speed at which this important bill passed through the committees and both Houses of the Congress does not mean that everyone approved the new legislation. In fact, the Social Security Act was built on compromises. At the time there were three points of contention. First, the contributions to be paid were considered too low. Many people, including the Ohio school and other left-orientated intellectuals, wanted a European model of Social Security with universal coverage and generous contributions, funded by a progressive tax.[79] For them, linking the social security to merely the amount of contributions was a form of a regressive tax that would lead to very small pensions for the poorest workers. [80] Others found the size of the taxes necessary for social security problematic. At that time only 5% of the population paid income tax, so any program that would significantly increase the tax burden (whether called contribution or not) was a contentious issue.[81]

Second, the business sector was somewhat divided over the program. Not every business leader wanted to pay contributions or to collect them on behalf of the government. small businesses were opposed to the new taxation[82], while the big corporations that had established their private pension plans approved the contributory character of the program and the low level of redistribution.[83]

Third, the Congressmen from the segregated South were opposed to the program because they were afraid that it will raise costs and that they would be unable to afford them. In addition, Social Security promised financial support to African Americans, which was unacceptable to the Southern farm owners.[84]

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[79] Steven Greene Livingston, *U.S. Social Security: A Reference Handbook*, Contemporary World Issues (Santa Barbara, Calif: ABC-CLIO, 2008), 9.
[80] Livingston, 9.
[81] Livingston, 9.
[82] Livingston, 9.
[83] Williamson and Pampel, *Old-Age Security in Comparative Perspective*, 95.
[84] Livingston, *U.S. Social Security*, 10.

As a result, the only way the bill could become law was for President Roosevelt to negotiate a compromise between these conflicting interests. The first compromise was to revise the tax for the program to start from only 2% (divided equally between employer and employee) on the first USD 3 000 and then to rise gradually up to 6%.[85] In response to those who objected to the small pension benefits, Roosevelt pointed out that the situation was either "this or nothing." The implicit principle in the Social Security Act was that it would only keep elderly citizens out of extreme poverty and not provide them a comfortable retirement.[86] To make its proposal more financial appealing to the business, President Roosevelt shaped it as much as possible to function like a pension program offered by a private corporation. He strongly supported the use of a reserve account in which the contributions from employer and employee will be accumulated and from which future benefits will be paid. This approach is very similar to the contemporary Defined Contribution (DC) pension plans.[87] To win the support of the Southern states, Roosevelt, who was a Democrat, allowed the farmworkers to be excluded from the coverage of the Social Security Act. The reason for this exclusion was that the farmworkers in the South were predominantly African Americans and the farm owners wanted to keep down the labor costs.[88] Some representatives just did not want African Americans to have access to a retirement program.[89] The farmworkers were not the only category left out of Social Security. The Government workers and the nonprofit sector[90] were also left out as well. As a result of these compromises around 40% of the labor force was not covered under the Social Security Act.

Regarding the start of the pension program, there were two important issues. Usually, the costs of a pension system are lowest at the beginning when all participants pay contributions and there are few retirees. The costs start to grow when the plan matures and the number of retiring people increases. If the funding of the program is based on the current costs, then the later beneficiaries will

[85] Livingston, 10.
[86] Livingston, 10.
[87] Livingston, 10.
[88] Williamson and Pampel, *Old-Age Security in Comparative Perspective*, 96.
[89] Livingston, *U.S. Social Security*, 11.
[90] The employed in the armed forces, religious, educational and charitable institutions.

have to pay much higher taxes than the first ones.[91] To counter this tendency the CES proposed that a large reserve fund be established in which the initial surplus from the contributions will be accumulated to be used later to cover the costs of the program. This fund was called the Social Security reserve. This fund could invest the accumulated reserves, but only in government securities.[92]

The second issue related to the start of the program was that the early participants did not have the opportunity to work enough in order to qualify for a meaningful amount. For that reason, most pension systems (both state and private) provide for some kind of subsidy for the first beneficiaries, not calculated on strictly actuarial terms.[93] This approach was adopted in the Social Security Act as well. From 1937 until 1940 the Social Security benefits were paid in the form of single lump-sum. The first monthly benefits were expected to start in 1942 and the period from 1937 to 1942 had to be used to build up the trust funds and to provide some minimum period for participation.[94] The first person retired under the provisions of the Social Security Act was Ernest Ackerman from Cleveland, who retired one day after the Social Security program began. During his one day of participation in the program, he contributed just 5 cents but received a lump sum of 17 cents.[95]

### 3.1.6. Structure and principles of the Social Security Act

The Social Security Act can be best understood as a bundle of seven largely independent programs with different social objectives and beneficiaries. In the Social Security Act, these programs were separated under a different title. As a result, the Act had the following structure:

| Title | Program | Description |
|---|---|---|
| I | Old – Age Assistance | Federal financial support and oversight of state-based welfare programs for the elderly. |
| II | Federal Old-Age Benefits | The Social Security Program |
| III | Unemployment Insurance | National unemployment insurance, with federal funding and state administration |

[91] DeWitt, “The Development of Social Security in America.”
[92] DeWitt.
[93] DeWitt.
[94] “Social Security History.”
[95] “Social Security History.”

| | | |
|---|---|---|
| IV | Aid to Dependent Children | State-based welfare for needy children (later becomes Aid to Families with Disabled Children) |
| V | Grants to States for Maternal and Child Welfare | Federal funding of state programs for expectant mothers and newborns |
| VI | Public Health Work | Federal funding for state public health programs |
| X | Aid to the Blind | Federal funding of state programs to the blind |

Source: DeWitt, "The Development of Social Security in America."

Regarding Title II, which is the subject of the present research, the original program was designed in the following way:

First, the payment of benefits was designed to start from the age of 65 and the beneficiaries were specific workers or employees only. The age was set at 65 for two reasons. First, this was the widely adopted age for retirement at that time. Second, the actuarial calculations of the CES showed that this age provided a reasonable actuarial balance in the system. In 1935 the remaining life expectancy at the age of 65 was approximately 12 years for men and 14 years for women.[96]

Second, the amount of the benefits was calculated based on the total cumulative wages that the workers earned during their coverage in the program. The benefit formula, however, contained a small redistributive effect in that the workers with lower wages had a higher replacement rate, compared to the high wage earners.[97]

Third, the coverage was not universal but quite limited. As mentioned above, this was a result of compromises between President Roosevelt and the representatives of Southern states. Large groups of farm workers, domestic workers, state servants, self-employed (such as doctors and lawyers) were excluded from the program.

Fourth, the financing of the program was achieved through a payroll tax with the burden divided equally between workers and employers. Initially, the rate was set at 2% for both parties but

[96] DeWitt, "The Development of Social Security in America."
[97] DeWitt.

was scheduled to increase to 6% by 1949. The taxable income was limited to 3,000 which was enough to cover 92% of all covered wages.[98]

### 3.1.7. Evaluation of the Social Security Act of 1935

During the years after its adoption, the Social Security Act has been amended several times and has evolved from the Act that President Roosevelt signed on August 14th, 1935. Still, some of its initial characteristics have been preserved in the current legislation.

First, it was designed with the aim to provide just a minimal level of economic security. The limit on the taxable income implies a ceiling of the maximum amounts of the benefits as well. Second, the formula for calculation of the benefits provides a better replacement ratio for the low wage workers compared with the high wage workers. As a result, the program contains a redistributive effect which is limited by the benefit ceiling.

The Social Security Act of 1935 was a government response to the economic consequences of the Great Depression. It was born out of compromises which limited its coverage of workers and the amount of the benefits. Regarding its approach to achieving economic security, it was mostly savings oriented and close to a Defined Contribution plan.

### 3.1.8. Further developments of the Social Security program

The Social Security Act of 1935 was born out of compromise and even after it passed through the Congress there were interest groups that were not content with the final outcome. The Republicans were still very skeptical about the Reserve fund and how the money from this fund would be spent. In the course of the operation of the program, vast amounts of savings would accumulate, which the Republicans were afraid, could become a resource for state intervention.[99] For that reason, Republicans led by the Michigan senator Arthur Vandenberg proposed liberalization of the eligibility conditions and starting the first payments from 1940 instead of 1942. To move the date of the first

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[98] DeWitt.
[99] Livingston, *U.S. Social Security*, 13.

payments earlier meant that there would not be enough funds accumulated to ensure payments in a meaningful amount. The Republican proposal to deal with this problem was to use the contributions of the current workers as a source of payments for the first cohorts of retirees. In fact, this proposal radically transformed the essence of the program and marked a switched from the Defined Contribution and savings approach to the Pay As You Go principle.[100] The big businesses also opposed the accumulation of large amounts in the Reserve fund. They argued that this would deprive the US economy of the money that was desperately needed for spending programs during the Great Depression. Eventually, after negotiations with President Roosevelt, the proposal was adopted.

However, this shift to Pay as you go program posed its own problems because the number of people, covered by the Social Security Act was not enough to provide enough contributions to pay for the benefits of the current generation of elderly. The solution to this problem was either to increase the rate of the contributions or to increase the pool of the people paying contributions to the system. In the end, the second approach was adopted, and the coverage restrictions were liberalized.[101]

Another reform from 1939 was the expansion of the survivors' benefits. Under the original legislation, only the individuals who had paid contributions could claim benefits, and upon their death, the benefits expired.[102] The amendments of 1939 expanded the claim to benefits to cover the families of the workers. As a result, two new categories of benefits were created: benefits to the spouse and minor children of a retired worker and survivors benefits paid in case of premature death of a covered worker.[103] This expansion of the benefits coverage also led to a change in the name of the Social Security program, which was now retitled Old-Age and Survivors Insurance Program (OASDI).

The 1939 amendments had a profound effect on the Social Security program. They transformed it in two aspects. First, these amendments effectively transformed the Social Security program from a retirement plan for the workers into a family-oriented program for economic

[100] Livingston, 13.
[101] Livingston, 14.
[102] "Social Security History."
[103] "Social Security History."

security.[104] Second, expansion in the coverage made the future expansion of Social Security possible.[105]

### 3.1.9. The constitutional challenges to Social Security

The Social Security program legislation had a deep social impact, and interested groups started to challenge it immediately after its enactment. The main initial challenge was that the programs and their legal mechanisms were beyond the legislative powers of the Congress and that the legislation was in effect a usurpation of powers left to the States by the Tenth Amendment of the Constitution.[106] The Supreme Court upheld the constitutionality of the Social Security Act in two cases decided on the same day. First, in, *Charles C. Steward Machine Co. v. Davis* 301, U.S. 548 (1937) the Court upheld the unemployment program of Social Security and as a result allowed the federal intervention in social programs that were ineffectively implemented on the state level.[107] The case of *Helvering v. Davis* 301 U.S. 619, 57 S.Ct. 904 (1937) concerned the constitutionality of the Old Age program. The Court upheld the constitutionality of the program and the opinion of the Court delivered by Justice Cardozo showed a deep understanding regarding the essence of economic security. The following paragraph is particularly insightful:

> The problem is plainly national in area and dimensions. Moreover, laws of the separate states cannot deal with it effectively. Congress, at least, had a basis for that belief. States and local governments are often lacking in the resources that are necessary to finance an adequate program of security for the aged. This is brought out with a wealth of illustration in recent studies of the problem. Apart from the failure of resources, states and local governments are at times reluctant to increase so heavily the burden of taxation to be borne by their residents for fear of placing themselves in a position of economic disadvantage as compared with neighbors or competitors. We have seen this in our study of the problem of unemployment compensation. *Steward Machine Co. v. Davis*, supra. A system of old-age pensions has special dangers of its own if put in force in one state and rejected in another. The existence of such a system is a bait to the needy and dependent elsewhere, encouraging them to migrate and seek a haven of repose. Only a power that is national can serve the interests of all.[108]

[104] "Social Security History."
[105] Livingston, *U.S. Social Security*, 16.
[106] Frank S. Bloch and Jon C. Dubin, *Social Security Law, Policy, and Practice: Cases and Materials*, American Casebook Series (St. Paul, MN: West Academic Publishing, 2016), 23. The full text of the amendment is "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."
[107] Bloch and Dubin, 23.
[108] *Helvering v. Davis* 301 U.S. 619, 57 S.Ct. 904 (1937).

This paragraph is, in fact, a recognition by the Supreme Court that the problem of social security is a problem of the entire country, both geographically and socially. The resources of the states were clearly insufficient to deal with the problem of old-age security and only the government with its broad powers could cope with this problem. This also leads to the conclusion that if the states do not possess enough means to deal with the issue, then the government needs to step in, so there is no reason to expect that individuals or corporations could achieve this individually.

### 3.1.10. The 1950 amendments

The next serious reforms took place in 1950 stemming from another episode of opposition between President and Congress. After the end of the Second World War, President Harry S. Truman made an attempt to expand the scope of the Social Security, but Congress opposed his idea and in 1948 it succeeded in narrowing the definition of an employee under the Social Security Act, which effectively cut 500,000 people from the program.[109] Truman, however, did not give up on his views to expand Social Security and made it an essential part of his platform for the 1948 elections and was reelected. The economic conditions were also favorable for expansion of welfare since the unemployment was low and the reserves in the Social Security Trust fund reached 13 billion dollars in 1950.[110]

At this time the program was still in its early years and because the rate of contributions was low, the retirement benefits were even lower than the welfare benefits provided under the old-age assistance provisions of the Social Security Act Title I. In addition, because of coverage limitations, in 1950 only 16% of the elderly Americans were eligible for benefits under the OASI program, while Old-Age Assistance provided support to 23% percent of the elderly.[111] This situation meant that the retirement program of the Social Security Act was not viable and was losing in the competition with the old-age anti-poverty program. To save the program, President Truman called for ending almost all

[109] Livingston, *U.S. Social Security*, 17.
[110] Livingston, 17.
[111] Williamson and Pampel, *Old-Age Security in Comparative Perspective*, 113.

coverage exclusions existing since the original legislation of 1935. Second, he proposed an immediate increase in the benefits by 77%, but even this large increase could only restore the purchasing power to its 1940 level.[112]

President Eisenhower continued the reforms of his predecessor, although some of his Republican supporters expected him to dismantle the program. Instead, he pushed for coverage of workers still excluded from coverage, which resulted in a near-universal US old-age pension program.[113]

Over the years new forms of social security were added. In 1956 disability insurance was introduced and the program was renamed to OASDI (Old-Age Survivors and Disability Insurance Program), which remains to this day. However, the eligibility requirements for this new program were relatively strict.[114] First, only individuals, aged 50 or over could receive benefits. Second, only the workers that had paid Social Security contributions for a minimum number of calendar quarters and that worked in an employment covered by the program were eligible.[115] As a result, access to the benefits under the disability program was practically limited to the individuals that had contributed significantly to the program and were close to the onset of the disability.

The idea behind this restrictive approach was to prevent individuals from stopping work and later claiming benefits for a disability that had occurred a relatively long time ago.[116] Nevertheless, the Senate opposed the Disability Insurance Benefits program, because many senators believed that the link between physical disability and economic hardship was not so straightforward. In addition, there were fears that such benefits might undermine rehabilitation programs. In the end, Congress prevailed and this program served as a stepping stone for further expansions of the disability coverage. For example, just two years later, in 1958, Congress lifted some of the restrictive requirements of the disability program like the requirement the individual to be currently insured as at the quarter in which

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[112] Williamson and Pampel, 113.
[113] Livingston, *U.S. Social Security*, 19.
[114] Bloch and Dubin, *Social Security Law, Policy, and Practice*, 36.
[115] Bloch and Dubin, 37.
[116] Bloch and Dubin, 36.

the disability began and the compensation of the disability benefits with any other federal benefits or worker's compensation.[117] In addition, the Congress introduced a better coverage for dependents of disabled and retired workers by providing monthly benefits to wives and dependent husbands, who had reached retirement age, unmarried dependent children, including children that had become disabled in their childhood and wives, who had a dependent child in their care.[118] This structure of the program has basically remained unchanged other than for the Medicare and Medicaid programs[119] that were added in 1965.

### 3.1.11. The birth of the SSI

By the early 1970s, the welfare programs under the Social Security Act were evolving into a complex mix of federal and state public assistance programs, whose administration was shared between state and federal authorities.[120] This shared administration made the programs almost unmanageable in terms of size and complexity to the point that the welfare system in the US was characterized as moving towards a state of crisis and chaos.[121] In 1969 President Nixon decided that the administration of these programs needs reform "to bring reason, order, and purpose into a tangle of overlapping programs."[122] As a radical solution, the various federal-state programs for the elderly, blind and disabled were replaced by a comprehensive federal system called Supplemental Security Income (SSI).

The new SSI program became effective on January 1, 1974, and established a uniform federal welfare system for the elderly and disabled, to be administered by the existing Social Security Administration which had a nationwide network and extensive data processing and record-keeping capabilities.[123]

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[117] Charles I Schottland, "Social Security Amendments of 1958: A Summary and Legislative History," *Social Security Bulletin*, October 1958, 12.
[118] Bloch and Dubin, *Social Security Law, Policy, and Practice*, 36.
[119] Medicare is a US federal health insurance program, while Medicaid is a state-level program designed to provide health coverage for low-income individuals.
[120] Bloch and Dubin, *Social Security Law, Policy, and Practice*, 37.
[121] Bloch and Dubin, 37.
[122] "Social Security History."
[123] "Social Security History."

### 3.1.12. Adjusting the benefits to the costs of living

In the first years of Social Security, the amount of the monthly benefits was set by law, and Congress could, at any time, increase this amount by simply passing a new law. However, in the 1960s the economic boom in the US brought increasing standards of living to the working Americans, but the income of the elderly could increase by legislative amendments. Both parties in Congress saw these benefit-increasing legislative amendments as a way to receive popular support. Consequently, by the early 1970s, Congress was voting for such increases almost annually.[124]

The experts, however, were not very supportive of this approach to obtaining political support. They argued that the political parties could abuse this legislative process for benefits increase, and that could become a disaster in not so distant future. As an alternative, they proposed that the increases in the benefits' amount be adjusted to the increase in the costs of living. Such adjustments (called Costs Of Living Adjustments or COLA) could be made annually by using the Consumer Price Index as a reference. The bill immediately became a subject of political struggles in the Congress, but eventually, on July 1, 1972, President Nixon signed it into law. [125]

This amendment, combined with the previous increases had a profound effect on the living standards of elderly Americans. The poverty rate among seniors declined dramatically to the extent that the US did not practically need an anti-poverty program for the elderly. The addition of COLA finally brought Social Security to its present shape.[126]

### 3.1.13. Prosperity leading to financial disaster

The introduction of COLA put the Social Security benefits on autopilot, but 10 years later this autopilot was already taking the program to a crash-landing. The reason was in the economic developments in the US during the 1970s. After the oil shock in 1973, the US economy entered a period of stagflation, which is a stagnant economy combined with high inflation. This high rate of

[124] Livingston, *U.S. Social Security*, 21.
[125] Livingston, 21.
[126] Livingston, 22.

inflation was not something that was planned at the introduction of COLA and the result was that the expenditures for benefits grew larger and larger. By itself, this was not a problem since the inflation also reduced the real value of the money. A much more serious problem was the fact the inflation was growing faster than the wages, and since the benefits were paid through contributions from the working population, the cash outflow for benefits became bigger than the cash inflow from contributions. from 1975 until 1981 the Social Security program ran an annual deficit[127] and the actuaries of the Trust Fund were projecting that the Fund would be depleted by mid-1981.[128] This serious situation was further exacerbated by changing demographic conditions; the life expectancy and the number of elderly were increasingly and the ratio of workers to retirees began to drop.

The first response to these problems came in 1977 when the mechanism that led to benefit increases outpacing the wage increases was amended. However, this measure provided a solution only in the long-term, while the short-run deficit was becoming a much more serious issue. In 1980, inflation reached 13.5% while the wage growth declined by 4.9%.[129] These figures really shook the program and the 1981 Trustees Report called for drastic measures to be taken. They had to be taken by the Reagan administration.

President Ronald Reagan came to power promising large-scale tax cuts, which would produce a big budget deficit if government spending remained at the same levels. For that reason, the tax cuts had to be accompanied by cuts in government spending as well. In 1981 the President was looking for government programs he could cut quickly to produce big savings. From this perspective, Social Security was an ideal candidate. As a result, the Reagan plan proposed a series of reforms including drastic Social Security cuts such an immediate 38% decrease in early retirement benefits.[130] Congress, however, met these proposals with very strong opposition and they were rejected by a large margin. The response of President Reagan was to form a bipartisan commission called the National

[127] DeWitt, "The Development of Social Security in America."
[128] Livingston, *U.S. Social Security*, 22.
[129] DeWitt, "The Development of Social Security in America."
[130] DeWitt.

Commission on Social Security Reform[131] to conduct a detailed study and of the Social Security finances and to come up with proposals for measures to solve the deficit problems. After intense negotiations, the members of the commission reached an agreement that Social Security had to be rescued by a combination of reductions in benefits and raises in taxes.[132] In the end, the National Commission on Social Security Reform made 16 proposals for long-term and short-term policy reforms. Four of these proposals increased the expenditures slightly, and 12 proposals were designed to achieve significant savings.[133] The most important proposals for balancing expenditures and inflows were to phase in an increase in the retirement age beginning in 2000 and to make up to one-half of the Social Security benefits a taxable income. As a result of these cuts, the actuarial calculations then predicted that the Trust Fund would last until 2063.[134] However, this calculation was based on assumptions that were too optimistic and were later revised to show that the Trust Fund would become depleted much earlier.

The amendments of 1983 were the last large-scale reforms of the Social Security program of the 20th century.[135] They shaped the Social Security program up to the present day and their financial targets have shaped the program ever since.[136] However, this solution to this first Social Security crisis did not solve its fundamental problems, but only postponed their effects.[137] The Social Security program is currently facing the same issues and the debate about its future is as actual as before.

### 3.1.14. Developments after 1983

The reforms of 1983 were the last amendments to profoundly change Social Security. However, there have been several pieces of legislation that fixed specific issues within the system.

[131] Also known as the Greenspan Commission because of its chairman.
[132] Livingston, *U.S. Social Security*, 24.
[133] DeWitt, "The Development of Social Security in America."
[134] Livingston, *U.S. Social Security*, 24.
[135] DeWitt, "The Development of Social Security in America."
[136] DeWitt.
[137] Livingston, *U.S. Social Security*, 24.

The first of these was the Omnibus Budget Reconciliation Act of 1993 which raised the percentage of Social Security benefits which could be subject to federal taxation from 50% to 85%.

Next was the Contract with America Advancement Act of 1996 which prohibited the receipt of disability benefits if the cause of the disability was drug addiction or alcoholism.[138]

Three years later, in 1999 the Congress passed the Ticket to Work and Work Incentives Improvement Act of 1999, which provided disabled individuals with vouchers for professional rehabilitation services, employment services, and other employment support services. The purpose of this Act was to switch from cash benefits for disabled individuals to employment rehabilitation and return to employment.[139]

The original Social Security Act prohibited retirees from working, since, benefits were considered social insurance, replacing the income that has been lost after as a result of retirement.[140] This requirement was enforced through the Retirement Income Test (RET), which changed significantly during the years. Eventually, RET was relaxed because working after retirement was becoming increasingly popular among the elderly. The RET was liberalized 21 times in total until it was finally repealed with the Senior Citizens Freedom to Work Act of 2000.[141]

Presidents Bush and Obama did not introduce significant reforms in the way Social Security operated. In 2001 President Bush declared his intention to reform Social Security and one of his proposals was the introduction of personal savings accounts to young workers who wanted them.[142] However, none of his proposals was eventually enacted into law.

The administration of President Obama had to take measures against the most serious financial crisis since the Great Depression. In order to provide liquidity to the financial system, the President signed the American Recovery and Reinvestment Act of 2009. This law appropriated an additional one billion dollars to the administrative budget of the Social Security Administration and

[138] "Social Security History."
[139] "Social Security History."
[140] DeWitt, "The Development of Social Security in America."
[141] This applies only to those individuals who have reached full retirement age.
[142] "Social Security History."

also provided a one-time payment of up to 250 dollars to adults who were eligible for benefits from Social Security and SSI.[143]

Later in 2009, President Obama signed the No Social Security Benefits for Prisoners Act of 2009. This act aimed to stop Social Security payments going to individuals in prison, or are in violation of their parole conditions, or fleeing to avoid prosecution for a serious crime.

### 3.1.15. Social Security in retrospect

Social Security is undoubtedly a successful welfare program and the numbers prove it. The poverty rate among the elderly dropped from 50% in 1935 to just 10% in 2008, while during the same period the program coverage grew from 45% to more than 90% of the age-eligible population.[144] However, the path to success was not an easy one. In its first decades, the idea of welfare for the elderly was pushed through despite a serious opposition in Congress. The Republicans and some Democrats feared the large funds that Social Security could accumulate would be spent for political purposes. To some extent, they were right, because as the coverage grew the Social Security program really became a tool for gaining political support. However, the success of the Social Security as an anti-poverty measure and its political importance show also something really profound – the idea that every American could and should independently provide for himself or herself in old age is not so deeply rooted in American society and is more utopian than realistic.

Still, Social Security did not achieve complete success – it proved vulnerable in a funding crisis and remains only an anti-poverty program. The next section will analyze the current legal framework of the program to explain how the basic principles are transformed in old-age income security.

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[143] These payments were also provided to participants in two other programs – Railroad Retirement and Veteran Disability.

[144] DeWitt, "The Development of Social Security in America."

### 3.2.The nature of the retirement benefits in the US pension system

Any social security legislation, regardless of how complex it is, contains a basic set of rules: definitions of covered individuals, conditions for payment of benefits, formulae for calculating contributions and benefits, and administrative provisions (procedures for proving the necessary conditions for coverage and payment of benefits). However, the legislation rarely provides a theoretical framework of the right to retirement benefits. This task is accomplished through interpretation by academics and by the courts.

#### 3.2.1. Nature and protection of the right to old-age benefits

The purpose of any social security system is to provide benefits which depend on coverage and participation records. However, the mechanism behind this benefit-providing system can only be properly understood by examining the nature of the right to benefits and the legal remedies for its protection.

In United States the most important protection of the individual rights comes from the Constitution and its Fifth Amendment, which declares that "No person shall […] be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation." However, the simplicity of this constitutional provision is deceiving, because its true meaning depends on the meanings of the terms "property" and "due process of law".[145] For years the Supreme Court has used the flexibility of these terms as an instrument for the protection of the rights and liberties of the individuals against the state.

More than two decades passed before the Supreme Court had to answer the question about the nature of the right to old-age benefits and its protection. The case in which these issues were raised was *Flemming v. Nestor*. In 1913 Ephram Nestor emigrated from Bulgaria to the US and became eligible for old-age benefits in 1955. From 1933 to 1939 Mr. Nestor was a member of the Communist Party. Many years after he had left the party, the Congress passed two retroactive laws – the first one

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[145] Matthew H. Hawes, "So No Damn Politician Can Ever Scrap It: The Constitutional Protection of Social Security Benefits," *University of Pittsburgh Law Review* 65 (2003): 865.

made the membership in this party a grounds for deportation, while the second one made the deportation for having been a member of the Communist Party a separate grounds for loss of retirement benefits. In 1956 Mr. Nestor was deported and soon after that, the payment of benefits to his wife was terminated. Mr. Nestor unsuccessfully tried to obtain an administrative reversal of the decision and then filed an action in the District Court. The District Court ruled for the appellee, holding that the termination was in violation of the Due Clause Process of the Fifth Amendment and that the appellee was deprived of an accrued property right.[146] The Secretary of Health Education and Welfare filed an appeal and the case was brought before the US Supreme Court. Therefore, the key question in this case, which Supreme Court Justices had to answer was: is the right to old-age benefits an acquired property?

The Supreme Court rejected the concept of a right to old-age benefits as an accrued property right and held that "A person covered by the Social Security Act has not such a right in old-age benefit payments as would make every defeasance of "accrued" interests violative of the Due Process Clause of the Fifth Amendment."[147] Before reaching this conclusion, the Court considered the following two angles.

First, the Supreme Court had to decide whether there was a contractual obligation between the US Government and the appellee and if there was such a relationship, whether the US Government had breached its obligation. On this question the Supreme Court reached the following conclusion:

> The Social Security system may be accurately described as a form of social insurance, enacted pursuant to Congress' power to "spend money in aid of the `general welfare,' […] whereby persons gainfully employed, and those who employ them, are taxed to permit the payment of benefits to the retired and disabled, and their dependents. Plainly the expectation is that many members of the present productive workforce will, in turn, become beneficiaries rather than supporters of the program. But each worker's benefits, though flowing from the contributions he made to the national economy while actively employed, are not dependent on the degree to which he was called upon to support the system by taxation. It is apparent that the noncontractual interest of an employee covered by the Act cannot be soundly analogized to that of the holder of an annuity, whose right to benefits is bottomed on his contractual premium payments.[148]

[146] Flemming v. Nestor, 363 S.Ct. 603, 1960.
[147] Flemming v. Nestor, 363 S.Ct.
[148] Flemming v. Nestor, 363 S.Ct.

Second, the Supreme Court had to examine the question, whether the right to Social Security benefits was a form of property rights that was violated by the US Government. In answering this question, the court pointed out:

> "That program was designed to function into the indefinite future, and its specific provisions rest on predictions as to expected economic conditions which must inevitably prove less than wholly accurate, and on judgments and preferences as to the proper allocation of the Nation's resources which evolving economic and social conditions will of necessity in some degree modify.
>
> To engraft upon the Social Security system a concept of "accrued property rights" would deprive it of the flexibility and boldness in adjustment to ever-changing conditions which it demands. […] It was doubtless out of an awareness of the need for such flexibility that Congress included in the original Act, and has since retained, a clause expressly reserving to it "[t]he right to alter, amend, or repeal any provision" of the Act. […]. That provision makes express what is implicit in the institutional needs of the program."[149]

Based on this reasoning, the Supreme Court rejected both claims, that the right to Social Security benefits was a contractual obligation of the government, and that it was a kind of property right that enjoyed protection from the Constitution. However, the most important part is the recognition of the Supreme Court that Congress has the power to alter, amend or repeal any provision of the Social Security Act, which also includes terminating benefits. To put a barrier before possible discretionary acts of the Congress, the Supreme Court also held that:

> "[…] This is not to say, however, that Congress may exercise its power to modify the statutory scheme free of all constitutional restraint. The interest of a covered employee under the Act is of sufficient substance to fall within the protection from arbitrary governmental action afforded by the Due Process Clause."

In summary, according to the US Supreme court in *Flemming v. Nestor*, Congress has the power to modify or repeal any Social Security provision, as long as this is not done arbitrarily.

[149] Flemming v. Nestor, 363 S.Ct.

#### 3.2.1.1. Criticisms of *Flemming v. Nestor*

*Flemming v. Nestor* became a landmark case and the Supreme Court received a lot of criticism both for the unmotivated dismissal of the contractual character of the benefits,[150] as well as for its failure to recognize social security rights as property.[151]

##### 3.2.1.1.1. The contract aspect

Regarding a possible implied contract, a basic principle of the US law is that unilateral promises can be binding. According to the Second Restatement of Contracts, the promise is a "manifestation to act or to refrain from acting in a specified way, so made as to justify a promise in understanding that a commitment has been made."[152] Moreover, the promise does not need to be made expressly, or in the Second Restatement of Contracts "A promise may be stated in words either oral or written, or maybe inferred wholly or partly from conduct."[153]

The US Supreme Court was very active in finding implicit contracts and especially in the area of employment and social insurance. For example in the case of *Rose City Transit Co. v. City of Portland* the court held that the twenty-two-years of paying a pension to non-union employees bound the employer.[154] In the case of *Flemming v. Nestor*, a possible explanation for the decision of the Supreme Court to reject a contract between the beneficiary and the government was that Congress had specifically reserved the power to amend or reform the Social Security program.[155] However, this possible explanation fails in the light of a previous decision of the Supreme Court in *Lynch v. the United States*. This case concerned an attempt by Congress to renege on its promises to pay benefits under the War Risk Insurance Act of 1917. The Supreme Court found that the war risk policies were different from military pensions and compensation allowances and that they were in fact contracts with the US government. In exchange for premiums, the government became obligated to pay

[150] Hawes, "So No Damn Politician Can Ever Scrap It."
[151] Hawes.
[152] Restatement (Second) of Contracts § 2 (1) (1981).
[153] Ibid § 4.
[154] Hawes, "So No Damn Politician Can Ever Scrap It."
[155] Hawes.

insurance for injuries incurred during the war. According to the Supreme court the gratuities, such as military pensions, involve no agreement and may be redistributed or withdrawn, at any time, at the discretion of the Congress. The War Risk policies, however, were contracts and as such, they were property and created vested rights. Consequently, the attempt to repudiate such a contract represented a violation of the Constitution.[156]

In the *Flemming v. Nestor*, the Supreme Court barely mentioned this decision and instead pointed that the earned right simply means that the contributors may rely on the US economy to keep them away from the poorhouse. Therefore, *Lynch v. the United States* was inapplicable in this case. This conclusion, however, disregard, the fact that the Social Security program was designed as a self-sufficient program, entirely funded by Social Security contributions. Justice Black, who dissented in *Flemming v. Nestor,* wrote the following critical opinion, showing that Social Security cannot be regarded as a form of gratuity:

> These are nice words but they cannot conceal the fact that they simply tell the contributors to this insurance fund that despite their own and their employers' payments the Government, in paying the beneficiaries out of the fund, is merely giving them something for nothing and can stop doing so when it pleases. This, in my judgment, reveals a complete misunderstanding of the purpose Congress and the country had in passing that law. It was then generally agreed, as it is today, that it is not desirable that aged people think of the Government as giving them something for nothing. An excellent statement of this view, quoted by Mr. Justice Douglas in another connection, was made by Senator George, the Chairman of the Finance Committee when the Social Security Act was passed, and one very familiar with the philosophy that brought it about:
>
> "It comports better than any substitute we have discovered with the American concept that free men want to earn their security and not ask for doles - that what is due as a matter of earned right is far better than a gratuity.
>
> […]
>
> "Social Security is not a handout; it is not charity; it is not relief. It is an earned right based upon the contributions and earnings of the individual. As an earned right, the individual is eligible to receive his benefit in dignity and self-respect."[157]

Justice Black also criticized the argument that the broad powers of the Congress to alter, amend or repeal can justify the termination of a retirement benefit. For him this could apply only to the current contributors and that the termination of payment to current beneficiaries violates the Fifth Amendment.

[156] Hawes.
[157] Flemming v. Nestor, 363 S.Ct.

Based on the arguments explained above, some commentators have concluded that for more than 80 years, the Social Security and its operations has created an implied promise that is just as enforceable as a contract, as a promise by a company to provide retirement benefits to its employees. This is especially true since the government itself encourages people to participate in the Social Security program and to rely on future benefits.[158]

**3.2.1.1.2. The property aspect**

Another line of criticism against the reasoning of the Supreme Court in *Nestor v. Flemming* comes from Prof. Charles Reich, and his flexible use of the term "property". In 1964 he published an influential and critical article titled "New Property" in which he argues that the government had transformed into a major source of wealth for the population. The government had always had the function of income redistribution, but in contemporary times it has reached levels never seen before.[159] This huge wealth distribution, or largess as Prof. Reich calls it, started to take the place of traditional forms of wealth such as private property. For example, social insurance can be looked at as a substitute for private savings. [160] As a result, Prof. Rich argues, the growth of government largess had a profound effect on the society, human rights individualism and independence.[161] One of the proofs of the assertion that government largess represented a new kind of property was the case of *Nestor v. Flemming*. For Prof. Reich, the old-age pension is the most personal form of government largess and it represented an obvious compulsory substitute for private property because the contributions to the social security programs could have been easily used for higher pay or private savings.[162] From this perspective, Congress and the Supreme Court have infringed upon this new kind of property with the purpose of serving some other public interest. The individual right had lost the battle against the public policy.

[158] Hawes, "So No Damn Politician Can Ever Scrap It."
[159] Charles A. Reich, "The New Property," *The Yale Law Journal* 73, no. 5 (1964): 733–87.
[160] Reich.
[161] Reich.
[162] Reich.

In his criticism, Professor Reich goes even further by pointing out that in this respect the philosophy behind the reasoning of the Supreme Court resembles the basic principles of feudal tenure. In a feudal state, the property right is not absolute but is instead a link between a vassal and lord, which ensures dependence and obedience, while in modern times the state provides largess in exchange for loyalty and punishes the disloyal individuals by terminating the flow of wealth to them. To Professor Reich, the Communist and the Nazi states are typical examples of modern states, build on this feudal principle as both regimes carried out wealth distribution based on loyalty to the government.[163]

After showing the dangers to individual freedoms Prof. Reich then comes to the conclusion that the increasing dependence on government largess also requires a new set of rules to better protect the individuals' freedoms.

**3.2.1.1.3. Recognition of the earned rights to benefits as a property right**

The theory of Prof. Reich had such a profound impact that it achieved recognition even in the jurisprudence of the Supreme Court. Ten years after *Flemming v. Nestor* the Supreme Court had to decide another case related to the protection of Social Security benefits in *Goldberg v. Kelly*., in this case, the issue involves the termination of a welfare program without prior notice, the conclusions of the Supreme Court would apply by analogy to the old-age benefits as well, which makes necessary the discussion of this case.

In *Goldberg v. Kelly* the appellees were residents of the State of New York and were receiving Aid to Families with Dependent Children. They alleged that the officials administering the program terminated or were about to terminate the aid without prior notice and hearing, thereby denying them due process of law.[164] The District Court held that the constitutional requirement of due process could be satisfied only by a hearing before the termination and rejected the argument of the welfare agency

[163] Reich.
[164] Goldberg v. Kelly, 397 U.S. 254 (1970).

that a combination of informal pre-termination review and post-termination “fair hearing” was sufficient.[165]

This time the Supreme Court upheld the decision of the District Court that “welfare benefits are a matter of statutory entitlement for persons qualified to receive them, and procedural due process is applicable to their termination.”[166] In addition, the Supreme Court held also that “A pre-termination evidentiary hearing is necessary to provide the welfare recipient with procedural due process.”[167] However, the Supreme Court added a footnote that could transform the entire concept of property in the United States and suggested that this statutory grant was, in fact, closer to property than to a gratuity.[168] In fact, the Supreme Court cited an article by Prof. Reich as an argument for its conclusion:

> Society today is built around entitlement. The automobile dealer has his franchise, the doctor and lawyer their professional licenses, the worker his union membership, contract and pension rights, the executive his contract and stock options; all are devices to aid security and independence. Many of the most important of these entitlements now flow from the government: subsidies to farmers and businessmen, […]. Such sources of security, whether private or public, are no longer regarded as luxuries or gratuities; to the recipients they are essentials, fully deserved, and in no sense a form of charity. It is only the poor whose entitlements, although recognized by public policy, have not been effectively enforced.

In fact, with these arguments, the Supreme Court confirmed the conclusion of Prof. Reich that the existing common concepts need to be interpreted flexibly to meet the demands of contemporary society. Later, the Supreme Court expanded its arguments on the notions of entitlements and property. First, in *Board of Regents v. Roth*, the Supreme Court declared that the property rights are not created by the Constitution, but rather by an independent source such as state law and used this argument to conclude that the eligibility for benefits[169] enjoys the same constitutional protection as property.[170] In 1976, the Supreme Court was even more precise by declaring that disability benefits represent statutorily created “property” interest protected by the Fifth Amendment.[171] The right to a retirement benefit that started its life as a promise from a political compromise had finally become a right, which

[165] Goldberg v. Kelly, 397 U.S.
[166] Goldberg v. Kelly, 397 U.S.
[167] Goldberg v. Kelly, 397 U.S.
[168] Hawes, “So No Damn Politician Can Ever Scrap It.”
[169] In this case – welfare benefits.
[170] Board of Regents of State Colleges v. Roth, 408 U.S. 564 (1972).
[171] Mathews v. Eldridge, 424 U.S. 319 (1976).

independent of the discretionary power of the federal government. The practical result from this property protection is that the federal government cannot revoke or abolish a right to retirement benefit of an individual without providing just compensation first.

In conclusion, the US Supreme Court had to go a long way before it provided a clear answer to the questions of what the right to old-age benefits under the Social Security program is, and how this right is protected. After the initial pro-government approach to the old-age benefit as a form of gratuity by the state, which can be taken away as long as this is not done completely arbitrarily, the strong criticisms of the *Flemming v. Nestor* case convinced the Supreme Court to reconsider the eligibility for benefits as a statutory "property" interest and to provide it with the same level of protection as property rights.

### 3.3.1. Overview of the coverage and operation of the US public pension system

The picture of the US pension system would be incomplete without a description of how it operates and what the conditions for eligibility are. They directly influence the outcome of the pension system and often become a topic of hot political debates.

As described above, the US public pension system experienced more than 80 years of evolution and political compromises, which have left their mark up to the present day. Today the two main pillars of the US public pension system are the Old-Age and Survivors and Disability Insurance Program (OASDI) and Supplemental Security Income (SSI).

Eligibility for each of these programs is governed by two sets of requirements; financial and personal. The first set of criteria concerns the insurance history of the individual and the financial need for public assistance. The OASDI is a social insurance program available only to persons who have made contributions to the program. On the other hand, SSI is a poverty relief program and it is intended to support only people with insufficient income or property. The key personal requirements are old age and disability. As a rule, only elderly or disabled individuals may be eligible for OASDI, SSI, or both. The only exception is provided in OASDI for certain dependents or survivors of insured individuals.

### 3.3.2. Insurance-based eligibility

The main financial requirement for OASDI eligibility is a sufficient history of employment, which is measured not in months or years, but in a special unit called a quarter. One quarter of coverage is a period of three calendar months, ending on March 31, June 30, September 30 and December 31. The individuals receive a quarter of coverage to their credit if during the respective quarter they had a specified minimum amount of earnings, on which Social Security contributions have been paid.

The employers used to report the wages on a quarterly basis until 1978. After that, they started reporting wages on a yearly basis. This change in the wages reporting leads to a change in the way quarters of coverage are credited to the individuals. Now, quarters of coverage are credited based on the yearly income of the individuals. They will receive a quarter of coverage for each part of their yearly income which is equal to the amount for a quarter of coverage required by the law in that respective year. If their yearly income exceeds the sum necessary for four credits, they still will be credited with only four quarters of coverage. The amount necessary to gain a quarter of coverage changes every year in accordance with the changes in the average wages in the US. For 2018 it was USD 1,320.[172]

As a general rule an individual needs 40 quarters of coverage to be considered fully insured, which means that a person needs to work only 10 years to earn eligibility for benefits. The 40 quarters of coverage may be accumulated at any time. For each quarter of insurance, the individual has to pay a social security contribution called the Federal Insurance Contributions Act (FICA) tax. The burden of the contribution is shared equally between employer and employee, while the self-employed pay the full amount themselves. Initially the amount of the contribution was 1% of the earned income, but currently, it has increased to 6.2% for both employer and employee. Individuals with high income make contributions only to a maximum earnings amount which for 2018 was USD 128,400. About 85% of the FICA contributions are transferred to the Social Security Trust Fund, which pays the

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[172] Sue Kunkel, "Quarter of Coverage," accessed August 30, 2018, https://www.ssa.gov/oact/cola/QC.html.

benefits of the current generation of retirees and if there is any reminder, it is invested in special U.S Treasury bonds.[173]

The retirement age in the US is flexible. Initially, the retirement age was set at 65, but the reforms from 1983 introduced a sliding scale that gradually increases the retirement age for the people born in 1938 or later until it reaches 67.[174] This age is called full retirement age and the individuals who retire at this age will receive full retirement benefits. However, it is possible to retire as early as 62, but in this case, the benefits will decrease by 20 to 30 percent depending on their year of birth.[175] The other option is to retire later, at the age of 70. In this case, the pension benefits will be higher by 5.5 to 8 percent, again depending on the year of birth. The main goal of these adjustments in the amount of the pension benefits is to ensure equal lifetime payments, but it also stimulates later retirement.[176] In case an individual chooses this option, he or she will continue to earn quarters of Coverage and will have to pay FICA contributions.

Another option is for the individual to retire early and to keep working. In such a case, the worker will be subjected to an earnings test and a portion of the retirement benefit will be withheld, because of the additional income from employment.

The amount that an individual will receive upon retirement is calculated using a complex formula. First, the earnings of the individual for each year of employment are adjusted in accordance with the increase in the average American wages for the same year. After that, the 35 years with the highest adjusted income are summed together, and the result is the lifetime earnings of the individual. The lifetime earnings are then divided by the number of months in 35 years and the result is called Average Indexed Monthly Earnings (AIME). AIME then becomes the basis for calculating the amount of the first monthly benefit, which is called the Primary Insurance Amount (PIA). The formula that is used in the calculation gives preferential treatment to low-income individuals.

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[173] Livingston, *U.S. Social Security*, 26.
[174] "Benefits Planner: Retirement | Retirement Age Calculator | Social Security Administration," accessed September 5, 2018, https://www.ssa.gov/planners/retire/ageincrease.html.
[175] Livingston, *U.S. Social Security*, 27.
[176] Livingston, 27.

The law requires that the PIA cannot exceed a specified amount. For example, the maximum PIA for 2018 for individuals who retire at the age of 66 is USD 2,788, and for those who retire at 70, the amount increases to USD 3,698.[177] This is, however, the maximum a person can hope to receive as a retirement benefit and the average amount is much less. For 2018, the average was just USD 1,404 a month,[178] which is close to the poverty guideline set by the Federal Government for 2018 of USD 1,040 a month.

Individuals who die or become disabled before obtaining 40 quarters of coverage may become "currently insured." This status means that they have no claim to OASDI benefits, but their spouses and children may become entitled to some secondary benefits. The condition for an individual to become currently insured is to have earned 6 quarters of coverage within a 13 month period immediately before the death or the eligibility for disability benefits.[179]

The requirements for eligibility are strict and the US courts do not apply a *de minimis* rule[180] to avoid the subjectivity involved in such a determination. For example, in the case *McGlocklin v. Chater,* the claimant was denied disability coverage because her yearly earnings were one dollar less than the amount required by law. As a result, she had only 19 quarters of coverage instead of 20. The district judge held that the law draws bright lines of eligibility and the complex system of social security needs strict categories. To decide otherwise would mean creating injustices.[181]

### 3.3.3. Disability – based benefits

To become eligible for disability benefits an individual needs to be fully insured and also achieve a "disability insured status". In most cases, this is achieved by the so-called "20/40 rule." This rule means that individuals are considered eligible for the purpose of Disability Insurance benefits if

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[177] Sue Kunkel, "Maximum-Taxable Benefit Examples," accessed September 8, 2018, https://www.ssa.gov/oact/cola/examplemax.html.
[178] David Rae, "What Is The Most I Can Receive From My Social Security Retirement Benefits?," Forbes, accessed January 25, 2019, https://www.forbes.com/sites/davidrae/2018/04/18/maximize-social-security/.
[179] "42 U.S.C. § 414(b)" (n.d.).
[180] Rule that allows the courts to disregard insignificant facts when deciding a case.
[181] McGlocklin v. Chater, 948 F.Supp. 589 (W.D. Va. 1996).

they have at least 20 quarters of coverage within the 40 quarters period ending with the quarter in which the disability occurred. The disability is defined as the

> Inability to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months; or in case of an individual who has attained the age of 55 and is blind – inability by reason of such blindness to engage in substantial gainful activity requiring skills or abilities to those of any gainful activity in which he has previously engaged with some regularity and over a substantial period of time.[182]

In addition, the severity of the physical or mental impairment has to be such that the individual is not only unable to do his or her previous work but cannot, considering his or her age, education and work experience, engage in any other kind of substantial gainful work which exists in the national economy, regardless of whether such work exists in the immediate area in which he or she lives, or whether he or she would be hired in he applied for work.

The purpose of this approach is to eliminate the individuals who do not have a continuous and considerable attachment to the workforce. The period between stopping work and becoming disabled can be limited to as short as one quarter. For instance, under the 20/40 rule, if an individual worked for 10 years but only every other quarter, he or she would lose eligibility for disability benefits after only two quarters of not working.[183] The more quarters in a row one has, the longer the eligibility period after stopping work will be. The longest possible period is 20 quarters or five years after stopping work.

The United States Code provides a special set of rules for the individuals that have become disabled before the age of 31. The general rule in such a case is that the individual will be considered insured if he or she has accumulated at least 6 quarters of coverage and at least half of them have been accumulated between the age of 21 and the date of the disability.[184]

The 20/40 rule was challenged for constitutionality in *Harvel v. Chater*. The United States Court of Appeals, Ninth Circuit pointed out that the 20/40 rule was intended to fulfill two goals. First, it had to make the Social Security system self-supporting, by ensuring that beneficiaries made some

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[182] 42 U.S.C. § 414(b), 11.
[183] Bloch and Dubin, *Social Security Law, Policy, and Practice*, 100.
[184] 42 U.S.C. § 414(b).

substantial contributions to the system before claiming disability benefits. The second goal was to provide benefits only to individuals with employment income. The court also recognized that Congress decided that "it is reasonable and desirable that there be a reliable means of limiting . protection to those persons who have had sufficiently long and sufficiently recent covered employment to indicate that they probably have been dependent upon their earnings."[185] Based on these arguments, the United States Court of Appeals, the Ninth Circuit held that the 20/40 rule is not unconstitutional.[186]

### 3.3.4. Need-based eligibility for Supplemental Security Income (SSI)

Unlike the OASDI, the SSI is a public assistance program that is based on needs and not on prior employment history. Its purpose is to provide support only to individuals with insufficient income and resources. Therefore, the income requirements, especially the definition of income and the maximum limit for eligibility become of primary importance.

The US federal law defines income as "anything you receive in cash or in-kind that you can use to meet your needs for food and shelter."[187] Some items do not count as income, because they cannot be used to obtain food and shelter.[188] Such items are include types of medical care and services (such those provided free of charge), certain types of social services, income tax refunds and bills paid by another person.[189] Anything received from sale or exchange of personal property is considered a "resource" and not income.

The income limits for eligibility are set each year, based on the amount for the previous year increased with a cost-of-living, depending on the inflation rate. For example for 2018 the effective amount is USD 750 for an eligible individual and USD 1,125 for an eligible individual with an eligible spouse.[190] The result of meeting the eligibility requirement is that the individual may claim SSI benefits, but it does not mean that the benefits will be set at the full amount. Instead, the income of the

[185] Harvel v. Chater, 87 F.3d 371 (9th Cir. 1996).
[186] Harvel v. Chater, 87 F.3d.
[187] 20 C.F.R. } 416.1102
[188] 20 C.F.R. § 416.1103
[189] 20 C.F.R § 406.1103 (a)-(j)
[190] Sue Kunkel, "SSI Federal Payment Amounts for 2018," accessed September 10, 2018, https://www.ssa.gov/oact/cola/SSI.html.

individual is a factor in determining the amount of SSI benefits. The more income an individual has, the less the amount of the SSI benefits will be.

### 3.3.5. Calculation of the SSI benefits

Since the definition of income is very broad and some services do not count as income, this uncountable income needs to be subtracted from the total gross income of the individual. The result is called countable income. This countable income is then subtracted from the SSI benefit rate. The result is the amount of the SSI benefit. A simplified example, if an individual has a gross total income of USD 500 of which USD 200 are uncountable income, the countable income is USD 500 – USD 200 = USD 300. The next step is to include the benefit rate for 2018 in the calculation. Based on the process described above, this gives -- USD 750 – USD 300 = USD 450. Therefore the SSI benefit is USD 450.

As this example shows the role of the non-countable income is very important and the federal law contains numerous provisions differentiating countable income and uncountable income.[191]

## 3.3. Challenges facing the US pension system

### 3.4.1. The mechanism of the Trust Fund and the deficit in its account

The US Social Security program is a pay-as-you-go program. This means that the social security contributions of the current generation of workers are accumulated in a fund, and then the benefits of the current generation of retirees are paid from the same fund. In case the amount of the contributions exceeds the amount of the retirement benefit, the excess is used to buy Treasury bonds. These bonds are held in the Old-Age and Survivors Insurance Trust Fund. This Trust Fund is purely an accounting mechanism;[192] it does not have physical possession of assets or stocks that can be sold. The bonds the fund holds are nothing but a claim against the future tax revenues of the government. As a result, the excess contributions flow back to the government, but against an interest-bearing promise to repay them to the future retirees.[193]

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[191] 20 C.F.R § 416. 1112 and 20 C.F.R § 416. 1124.
[192] Livingston, *U.S. Social Security*, 32.
[193] Livingston, 33.

As a result of this imaginary accounting nature of the Trust Fund, it can have a surplus, be balanced or run a deficit. If there is a deficit, it is covered by the Treasury bonds, which are then struck off the balance sheet. If the deficit continues the balance sheet can run down to zero and all the benefits will have to be paid solely from the current stream of contributions. In case the retirement liabilities of the government exceed the contributions that are available, the government will have to either break its promise or find another source of revenues to cover the deficit.[194]

The Social Security Act also established a Board of Trustees which performs actuarial calculations based on demographic trends and issues an annual report about the status of the Trust Fund. The Board of Trustees has been issuing warnings for some time that the funds' reserves will become exhausted in 2034. At this time the flow of contributions into the system will only be able to pay approximately 79% of the promised benefits.[195]

### 3.4.2. Legal problems created by the deficit in the Trust fund

This inability to fulfill the promises to retirees will lead to a serious legal problem. Since Social Security is an entitlement program, the federal government is legally obliged to pay benefits to the beneficiaries who satisfy the statutory eligibility requirements regardless of whether the funds are available or not.[196] In case of breach of this obligation, the entitled individuals could take legal action. Insolvency does not relieve the government from its promise to provide benefits.[197]

However, this obligation of the government collides with Article I of the US Constitution, which provides that "no money shall be drawn from the Treasury, but in consequence of Appropriations made by Law." The appropriations clause is implemented in practice by the Antideficiency Act. This Act prohibits any government official from making or authorizing

[194] Livingston, *U.S. Social Security*.
[195] Board of Trustees, "The 2018 Annual Report of the Board of Trustees of The Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds," 2018, 5.
[196] Kathryn L. Moore, "Social Security in an Era of Retrenchment: What Would Happen If the Social Security Trust Funds Were Exhausted?," *ABA Journal of Labor & Employment Law*, 2012, 43–57.
[197] Christine Scott, "Social Security: What Would Happen If the Trust Funds Ran Out?," 2013, 5.

expenditures or obligations that exceeds the amount available through an appropriation or fund.[198] The violations of the Antideficiency Act are sanctioned with administrative and criminal penalties, which include removal from office,[199] fines of up to USD 5,000 or imprisonment of up to two years.[200]

The result will be that on one hand, under the Antideficiency Act, the balance of the Trust Fund determines whether the Treasury Department has the legal authority to issue Social Security checks, but on the other hand, the Social Security Act entitles individuals to benefits, regardless of the availability of funds. The Social Security Act does not regulate the situation in which the Trust Fund is exhausted.[201] Despite this lack of explicit regulation, the most probable outcome will be that the benefits will likely be reduced by either timely payment of reduced benefits or delayed payment of full benefits.[202]

### 3.4.3. Causes for the deficit in the Trust fund

The deficit problem in the US Social Security system is the result of several demographic factors. The first of them is the increased life expectancy of the Americans. In 1935 the life expectancy of the average American was a little bit more than 65 years.[203] Nowadays, a man who reaches the age of 65 is expected to live on average until age 84.3 years, while a woman turning 65 today is expected to die, on average, at the age of 86.7.[204] As a result, the period during which the average American was able to collect retirement benefits has increased from 12.7 years for men and 14.7 years for women in 1935[205] to about 20 years now. In addition, the percentage of the population that is expected to reach retirement age has also increased. In 1940 less than 60% of working Americans were able to reach retirement age, now this ratio has increased to close to 80%.[206]

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198 31 U.S.C. § 1341(a)(1)(A)
199 31 U.S.C. § 1349 (2006)
200 Id. § 1350 (2006)
201 Scott, "Social Security," 6.
202 Moore, "Social Security in an Era of Retrenchment."
203 Livingston, *U.S. Social Security*, 35.
204 "Benefits Planner | Life Expectancy | Social Security Administration," accessed September 16, 2018, https://www.ssa.gov/planners/lifeexpectancy.html.
205 Livingston, *U.S. Social Security*, 35.
206 Livingston, 35.

Another demographic cause for the coming deficit in the Trust Fund is the fact that today American women are giving birth, on average, to fewer children. In 2017 the general fertility rate was 60.2 births per 1,000 women aged 15-44.[207]

The cost of the OASDI program is another reason for concern. As mentioned before, when the average indexed monthly earnings are calculated, they are indexed to the growth of wages since that time. This preserves the purchasing power of income from inflation. The problem comes from the fact that historically, wages have risen more than the prices. As a result, the long-term value of the benefits increases and so does the burden on the Trust fund.

### 3.4.4. Privatization as a solution

This worsening demographic situation and the resulting increasing burden on the Trust fund has sparked a lot of discussion about how to reform the OASDI program. President Clinton in his second term made one of the first proposals for significant reforms. In his 1999 State of the Union address, he called for 60 percent of the budget surplus over the next 15 years to be committed to Social Security and to invest a small portion in the private sector, just as any private or state government pension would do. This would earn a higher return and keep Social Security solvent for 55 years.[208] Eventually, Congress did not react to this call for reforms by the President, and his successor came up with much more drastic proposals for reform.

In his 2005 State of the Union Address, President George W. Bush was much more critical in his evaluation of Social Security. He pointed out that the system was headed for bankruptcy and that its problems needed to be solved once and for all. The core of his reform proposal was the introduction of voluntary personal retirement accounts for each American worker born after 1950.[209] The workers that opt for such personal retirement accounts could transfer up to 4% of their payroll taxes as savings. The workers would then choose a private investment fund to invest these savings and may select an

[207] Brady E. Hamilton et al., "Births: Provisional Data for 2017," no. 4 (May 2018).
[208] William Jefferson Clinton, "1999 State Of The Union Address" accessed September 17, 2018, https://clintonwhitehouse4.archives.gov/WH/New/html/19990119-2656.html.
[209] George W. Bush, "State of the Union Address," February 2, 2005, https://georgewbush-whitehouse.archives.gov/stateoftheunion/2005/index.html#2.

investment plan depending on their preferences. Upon retirement, the individuals would have several options to withdraw their savings, which will also be part of their estate and inheritance upon death.

This approach is not very different from the reform that Bulgaria carried out in 2001, but unlike Bulgaria, the United States has a long history with private pensions, and knowing their advantages and risks.

### 3.5. The US Private Pension Plans

#### 3.5.1. Historical overview

Similarly to Social Security, it is not possible to understand the basic principles and factors that drive the contemporary private pension industry in the US without first examining its historical background.

The beginnings of the US private pension plans can be traced back as far as 1875 when the American Express Company established the first formal pension plan in North America. At this time the pensions were regarded as a gift in recognition of long service and often had strict eligibility requirements.[210] For example, the pension plan of American Express Company (AEC) provided benefits only to permanently disabled workers who have reached the age of 60 and who had worked for the company at least 20 years. In addition, at AEC a recommendation from the general manager was needed, which, in turn, had to be approved by the executive committee of the board of directors.[211] Because of their voluntary character these early pensions did not enjoy any level of protection. The employer could terminate them at will and in case of bankruptcy, the workers did not have any claim against the remaining assets. There was no vesting of benefits for employees who terminated employment before reaching the prescribed retirement age.[212]

However strict the conditions in these first pension plans were, at the end of the 19th century and the beginning of the 20th century private pension plans started to spread swiftly across America.

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[210] Terrence D. Anderson, ed., *Overview of the Employee Retirement Income Security Act (ERISA): Protecting Employee Benefit Plan* (Hauppauge, NY: Nova Science Publishers, 2010), 19.
[211] John H. Langbein et al., *Pension and Employee Benefit Law*, Sixth edition, University Casebook Series (St. Paul, MN: Foundation Press, 2015), 8.
[212] Langbein et al., 9.

Industrialization created new professions and the work with machines greatly increased the risk of disability. As a result, the private pension plans were most popular in the railroad industry.

Similarly to Social Security, the Great Depression was the most important catalyst for the development of private pension plans in the US. After 1929 the American railroad companies were facing decreasing revenues and increasing competition from the trucking industry. At the same time, the pension plans these companies had established were mostly unfunded, which means they did not have reserves but operated on the pay-as-you-go principle. In this situation, the troubled railroad companies were becoming increasingly incapable of meeting their pension obligations. Because of the sheer number of affected workers, the problems of the railroad pension plans became a serious political issue. The federal government tried to take over and nationalize the railroad pension plans, but this initiative was declared unconstitutional.

Eventually, federal legislation created the current Railroad Retirement System in which general public taxes are added to employee and employer contributions. Today, the importance of Railroad Retirement System has decreased, but it still embodies a very important lesson in that private pension plans can fail. In such cases, the government has to step in and provide rescue.[213] This concept of "too big to fail" contains a strong element of moral hazard as the profits remain private, while the risks are socialized.

The popularity of private pension plans increased again in the years of the Second World War for two reasons. First, the Revenue Acts of 1938 and 1942 introduced specific requirements for the preferential tax treatment of private plans. This preferential tax treatment called also "qualification" allowed employers to deduct their contributions to the plan from their taxable revenue, while the covered employees did not pay income tax on the employer's contributions. Second, during the Second World War, the US economy was working under government control, one form of which was the wage controls.[214] The promise to pay pension at a later stage however, was not included in the wage controls, so it was used as an alternative way to increase wages during wartime.

[213] Langbein et al., 11.
[214] Wage controls are common measure to prevent inflation and rising prices during wartime, thus allowing the government to procure large quantities of arms.

After the end of the War, the US economy continued its rapid growth and private pension plans continued to proliferate. A major event in this period was the establishment of the General Motors pension plan. The radical innovation in this plan was it would be an “investment trust”. The previous pension plans were “annuity” plans, which invested the contributions in standard life-insurance investments such as government bonds, mortgages and other fixed interest assets.[215] Charles Wilson, the president of General Motors at that time, considered this approach financially unsound or even impossible. He believed that the low-interest bearing assets could provide pensions for only a small group of workers. In the case of a company with many workers, this would put an unbearable debt burden on the company. In his opinion, a broad pension plan had to invest in the productive US economy and its ability to grow.[216] This would mean investing in equity in the capital market.

The pension plan that General Motors introduced had an enormous impact on pension insurance in the US and set the foundations of the contemporary private pension plans. It was built on four rules set by Charles Wilson:

1. Professional independent management of corporate pension funds as “investment funds”;
2. Minimal or no investment in the company for which the employee works;
3. No investment in any company in excess of 5% of the total capital of the company;
4. No investment in any company of more than 10% of the total assets of the pension funds.[217]

These four rules became so popular that they were incorporated into the most important legislative act regulating the activity of the private pension plans, the Employee Retirement Income Security Act of 1974 (ERISA).[218] Interestingly, even the investment limits and requirements of the Bulgarian Social Security Code closely follow these four rules, even if they are much more detailed and complex.

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[215] Peter Drucker, *The Unseen Revolution, How Pension Fund Socialism Came to America* (London: William Heineman Ltd, 1976), 7.
[216] Drucker, 7.
[217] Drucker, 10.
[218] Drucker, 11.

As the number and the size of the private pension plans grew in the 1950s, so did the number of cases in which employers tried to use the funds in the pension plans for purposes, other than paying pension benefits. As a response, in 1958 the Congress passed The Welfare and Pension Plans Disclosure Act, which required public disclosure of pension plan finances. The authors of the proposal expected that by making the financial conditions of the pension plan transparent, they would prevent further misuse of pension plans' assets and thus protect the rights of the workers. However, these hopes were dashed quickly in 1963 when the Studebaker automobile company experienced financial difficulties.

### 3.5.2. The bankruptcy of Studebaker - Packard and the enactment of the Employee Retirement Income Security Act (ERISA)

Studebaker Corporation and Packard Motor Company were two of the several major auto companies that were able to survive the Great Depression. However, they were relatively small compared to the Big three of General Motors Corporation, Ford Motor Company and Chrysler Corporation, which put them at a disadvantage in production, marketing, and technical innovation.[219] After the Korean War, the market domination of the Big three led to the bankruptcy of many of the small companies, including Studebaker. The reason why this company is important in the history of private pension plans in the U.S. is the bankruptcy of the company, which led to the failure of its DB pension plan. This failure of the Studebaker-Packard pension plan and the subsequent distribution of its assets produced strong discontent and resentment among the company workers, who had their benefits cut severely or lost completely. In this situation, the US Government no longer could disregard the problems in the private pension plans and had to step in and provide federal protection for the beneficiaries in employee benefit plans.[220] This would take about 10 years of discussions, hearings reports and proposals, before, finally, on 2 September 1974 President Gerald Ford signed the Employee Retirement Income Security Act (ERISA) into law.

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[219] James A. Wooten, "The Most Glorious Story of Failure in the Business: The Studebaker-Packard Corporation and the Origins of ERISA," *Buffalo Law Review* 49 (2001): 683–740.
[220] These include not only retirement benefit plans, but also health benefit plans and welfare benefit plans.

### 3.5.3. Purpose and basic principles of ERISA

ERISA was enacted as an attempt to create a coordinated set of approaches to achieve increased benefit security for a greater portion of the private-sector labor force. The previous attempts were more or less directed to specific issues and did not try to address the problem of benefit security as a whole. To achieve their purpose the drafters of ERISA used several instruments: fiduciary standards, funding standards, reporting and disclosure rules and plan termination insurance[221]

The legislators of ERISA regarded the pension plan, in its essence, as an arrangement by which one person undertakes to manage the property of another for the benefit of the latter. Therefore, they regulated the pension plans as a type of trust and the plan trustees were the individuals who had to guarantee that the plans were well-administered and dispose with enough funds to meet their pension promises. The trustees had to act "solely in the interest"[222] of the pension plan beneficiaries. The legislators of ERISA modified the "prudent man rule" of common law that governs the duties of the fiduciaries and introduced a rule that required the trustees to manage the pension plan for the "exclusive benefit" of its participants and beneficiaries.[223] Later the Department of Labor issued regulations, which further defined the meaning of this "exclusive benefit" rule, based on the modern theory of asset management. Nevertheless, the existing regulations are so scant and the relations arising within a pension plan so complex, that the fiduciary approach has been criticized as flawed.[224][225]

The basic concepts of the fiduciary law such as "prudent man rule", "exclusive benefit" "duty of loyalty" etc. are too general in meaning to be applied independently. The enforcement of these

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[221] Special Committee on Ageing United States Senate, "The Employee Retirement Income Security Act of 1974: The First Decade" (U.S. Government Printing Office, August 1984), 28.
[222] 29 U.S.C. § 1104(a)(1)
[223] Special Committee on Ageing United States Senate, "The Employee Retirement Income Security Act of 1974," 28.
[224] Natalya Shnitser, "Trusts No More: Rethinking the Regulation of Retirement Savings in the United States," *Brigham Young University Law Review*, 2016, 629, 682.
[225] Daniel Fischel and John H. Langbein, "ERISA's Fundamental Contradiction: The Exclusive Benefit Rule," *The University of Chicago Law Review* 55, no. 4 (1988): 1105–1160.

fiduciary standards demands reporting, disclosure of accounting, investment and actuarial data, which in turn requires strict disclosure regulations. The legislators of ERISA were aware of this and also of the need for the beneficiaries to have detailed information about the characteristics of their pension plan, so their next priority was to introduce extensive requirements concerning disclosure and reporting.[226]

Another issue was the protection of the retirement funds themselves. When ERISA was passed in 1974 experts in the U.S. Congress believed that the pension benefits in the defined benefit pension plans could be guaranteed by insurance, whose premiums had to be paid by the defined benefit pension plans depending on the number of participants. The defined benefit plans were divided into two groups, multiemployer pension plans and single-employer pension plans with per capita insurance premium of USD 0.50 per capita and USD 1 per capita respectively. In any case, the legislators of ERISA saw this insurance as a last resort, hoping that the other regulations would prevent failures of defined benefit pension plans.[227]

The next area in which ERISA actually provided better protection for the employees was their benefit eligibility. Until then, the participation and service requirements of the pension plans in the US were so restrictive that a very small proportion of the employees could actually receive retirement benefits. For example, in 1972 only 32% of the full-time private-sector employees who were covered by pension plans reported that they were actually entitled to eventual retirement benefits.[228] To remedy this situation ERISA set rules for all tax-qualified plans concerning eligibility, length of service and vesting of rights. Furthermore, the plans had to show that they benefitted a large proportion of the employees and did not apply discriminative rules.

This approach contradicted the basic idea that was laid in the first pension plans which was to provide a reward for full career employees. The requirement to relax the rules about service and participation increased the costs for the employers to provide retirement benefits to their most valued

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226 Special Committee on Ageing United States Senate, “The Employee Retirement Income Security Act of 1974,” 28.
227 Special Committee on Ageing United States Senate, 29.
228 Langbein et al., *Pension and Employee Benefit Law*, 115.

employees. At this time, the last vestiges of the concept of retirement as a reward were abolished. The view that retirement benefits were an entitlement i.e. a kind of right had won.[229] As a result, the vesting rate for private-sector employees increased gradually to 48% in 1979, to 64% in 1988 and to 93% in 2003.[230]

The last big objective of ERISA was to increase the participation rate in the private pension plans. However, unlike mandatory participation as in Bulgaria, according to the Report of the Committee on Education and Labor, (House Report No. 93-533 dated October 2, 1973) a higher participation ratio could be achieved voluntarily through tax and other incentives that had already existed at the time ERISA was passed.[231] In this case, however, ERISA failed. The reason for this failure is that the tax incentives were not enough to offset the higher costs arising from unclear and ambiguous regulations. This issue will be explained further below.

The ambitious set goals that ERISA tried to achieve required regulating a vast array of complex and interconnected relations. As a result of this, ERISA became one of the most complex and controversial pieces of US legislation. The Federal Judicial Caseload Statistics for 2017 show that during the twelve-month period ending on March 31, 2017, the actions under ERISA brought before the district courts in the US reached 6,651, which is around 30% of all labor-related lawsuits, second only to the Fair Labor Standards Act.[232]

### 3.5.4. The impact of ERISA old-age security in the United States

ERISA deeply transformed the employee benefit scene in the US for several reasons. The strict regulations regarding the Defined Benefit (DB) pension plans increased the costs of the employers to operate such plans. ERISA imposed complex requirements for minimum funding of the

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229 Special Committee on Ageing United States Senate, "The Employee Retirement Income Security Act of 1974," 30.
230 Langbein et al., *Pension and Employee Benefit Law*, 115.
231 Special Committee on Ageing United States Senate, "The Employee Retirement Income Security Act of 1974," 30.
232 Administrative Office of the United States Courts, "Federal Judicial Caseload Statistics 2017, Table C2," n.d., http://www.uscourts.gov/sites/default/files/data_tables/fjcs_c2_0331.2017.pdf.

DB pension plans. These requirements also increased the administrative costs for DB pension plans such as actuarial costs, accounting, and legal fees.[233] Another serious cost imposed on the DB pension plans was the premium payments to the Pension Benefit Guarantee Corporation (PBGC) which is a government insurance body that ensures basic pension benefits. On the other hand, the regulations of ERISA made the DC pension more attractive. First, ERISA introduced the Individual Retirement Account (IRA). The need for this account came from the regulations that relaxed the strict vesting rules for the participants in a DB pension plan. The drafters of ERISA, however, had to provide a mechanism to enable employees to carry their benefits from one job to another and that allowed them to earn additional income as they approached retirement.[234] The instrument to achieve this was the IRA. This was an account to which an employee could transfer funds from a pre-retirement distribution from a pension plan without paying taxes. Once in this account, the funds could increase tax-free. The final result is a prototype of the accounts of DC pension plans.

As a result, the number of DB plans started to decrease, while the number of DC pension plans started to increase. This tendency has continued to the present, with the result that the DC pension plans have become predominant. The transition from DB to DC may look trivial because these two types of pension plans seem to be a sub-categories of the same "pension plan". However, the distinction goes much deeper to the very nature of the retirement income security. The switch from DB to DC pension plans happened silently but it changed the fundamentals on which the retirement benefits are based moving from insurance to savings.

### 3.5.5. Defined Benefit and Defined Contribution plans contrasted

A short explanation and comparison of the DB and the DC pension plans will explain this change from insurance to savings.

The Defined Benefit pension plan is a promise of the plan sponsor to pay the beneficiary, after retirement, determinable benefits over a period of years, usually for life. The amount of the benefit is

[233] Edward A. Zelinsky, "The Defined Contribution Paradigm," *Yale Law Journal* 114 (2004): 451, 534.
[234] Zelinsky.

calculated using a formula, which may vary from plan to plan, and which usually includes the length of service of the employee with the current employer, as well as his or her salary. The beneficiary is entitled to the defined benefit amount at retirement regardless of the amount of the assets in the plan or its investment performance. The plan is called “defined” because the sponsor is obliged to pay regardless of the investment performance of the assets in the plan. If the assets in the plan exceed the liabilities, the sponsor will easily keep its promise. Conversely, if the assets perform poorly, the sponsor of the plan will have to make up the difference. This illustrates that the risk associated with the operation of a DB pension plan is for the employer and if it is a corporation, for its shareholders. No employer is required to establish a pension plan. However, governments usually regard these pension plans as something positive and to stimulate their establishment have long offered preferential tax treatments to such plans.[235] The insurance component lies in the fact that by meeting the requirements of the pension plan, the beneficiaries effectively shift the risk of insufficient income in old age from themselves to the plan sponsor. The similarity with life insurance becomes clear if the costs[236] for the beneficiary to meet the requirements of the plan are considered an insurance premium for which the beneficiary receives a claim to a life annuity payment from the life sponsor. When ERISA was enacted in 1974, the majority of retirement plan beneficiaries participated in Defined Benefit plans.[237]

On the other side, the DC contribution plan does not promise a specific amount of retirement income. Instead, an employee that participates in a defined contribution plan is assigned an individual account to which money is accumulated by the employee, the employer, or both.[238] The employees are the beneficial owners of the funds accumulated to her individual account. Upon retirement, the balance in the account becomes the amount of the retirement benefit. Accordingly, the amount of the balance will increase or decrease depending on the performance of the investments in which the funds are invested. In other words, a DC pension plan is a savings account with a preferential tax treatment.

[235] The plans that meet the statutory conditions for preferential tax treatment are often called “qualified.”
[236] For example the cost to turn down a job offer with better working conditions or salary.
[237] Brendan S. Maher and Peter K. Stris, “ERISA & Uncertainty,” *Washington University Law Review* 88 (2010): 433.
[238] 29 U.S.C. § 1002 (34).

The DC plans come in several varieties. The simplest of them is the money purchase pension plan. This plan requires specified annual contributions (which are usually calculated based on the salary of the participants) regardless of the employer's profits. Next comes the profit-sharing plan in which the number of contributions may be related to the profits or left to the discretion of the board of directors. This plan also requires a formula for distribution of the contributions in the accounts of the participants. A stock bonus plan is similar to the profit-sharing plan with the difference that the contributions to the accounts take the form of employer stock. The most common DC plan, however, is the 401(k). This plan is named after a provision in the Internal Revenue Code (IRC) adopted in 1978.[239] This provision allows participants to contribute a portion of their salary to such a plan or take it all in cash. Employers may also make contributions to the accounts of their employees. Then the employees select how this money will be invested, using options provided by their employer. If the plan meets the requirement of §401k of the IRC the participants are not treated as having actually received the amounts they contribute, so the payment of tax is deferred until the funds are withdrawn.[240]

### 3.5.6. The significance of the shift from DB to DC pension plans as a transition from insurance to savings

The implications of the change from DB to DC pension plans are far-reaching. The state-operated pension plans are insurance-based DB plans, while the privatization creates savings-based DC plans. As previously mentioned,, the modern retirement system was born when it became clear that in a society in which wages provide the main form of livelihood, relying on savings alone dooms to poverty the workers who have low income and insufficient savings. The state-operated DB plan tries to avoid such an outcome through the redistributive effect of the insurance. The operation of social insurance is based on the following principle.

[239] Robin Blackburn, *Banking on Death: Or, Investing in Life ; the History and Future of Pensions* (London: Verso, 2002), 80.
[240] Peter J. Wiedenbeck, *ERISA: Principles of Employee Benefit Law* (Oxford; New York: Oxford University Press, 2010), 8.

The people faced with a specific risk can protect themselves from eventual losses by forming a group with others facing the same risk. Each member of the group contributes an amount of money depending on the likelihood that a loss will occur. If and when the loss occurs, the members that experience the loss are paid from the group fund. As a result, each group member is protected against a large uncertain loss by paying a smaller but certain contribution.[241] Referred to the old age income security the uncertain loss is the disability due to old age. At first sight, it may seem paradoxical that the old age can be regarded as a risk. After all, aging is the natural course of life. In fact, old age is the same risk as death. All people are mortal, but some people die much sooner than others. Life insurance is a way to provide security for the insurance policy beneficiary against losses caused by premature death of the insurance policyholder. Regarding old-age social insurance, the risk is an old-age disability, not death, and the beneficiary is the insured. Some people will not reach retirement age and their insurance contributions will be redistributed as benefits to the people who have reached the retirement age. Another way of redistribution is through the formula for calculating benefits.

From this perspective, saving is a poor alternative to insurance. In contrast to insurance, which is based on actuarial calculations, savings are a straightforward accumulation of assets. Depending on how well these assets are invested, they may increase or decrease in value. They might be eroded by inflation as well.

Another proof that insurance is superior to savings when facing a risk, is the mandatory insurance. Car owners are required to have car insurance not car accident private accounts.[242] This comes from the fact that people simply do not have sufficient information about all variables and contingent events to properly calculate how much they should save. Referring to old-age security, this means the uncertainty about how long one will live, or whether one will outlive his or her savings, the so-called longevity risk. Another uncertainty is the savings rate, how much people should save for old age. At a young age, deciding how much to save is closer to coin-tossing, rather than a calculation. Yet, the consequences of choosing the wrong or inappropriate savings rate can have a disastrous effect

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[241] Nancy J. Altman, "The Striking Superiority of Social Security in the Provision of Wage Insurance," *Harvard Journal on Legislation* 50 (2013): 109.
[242] Altman.

on a person relying on savings for old age. Even if complete destitution is avoided, this may mean selling and moving to a smaller dwelling and a significant reduction in the standard of living. Even if people could calculate how much to save in their early 20s, they would still face the investment risk. The savings cannot be left under the mattress, because it would be eroded by decades of inflation. The only way to deal with inflation is to invest the savings in other assets, such as stocks and bonds. However, this imposes the savings to investment risk and the fluctuations of the market. It has been calculated that workers with identical forty-year careers, identical salaries, investing six percent in stocks, retiring at the same age of 62 and selling all the accumulated savings in stocks to buy life annuities, can have dramatically different benefits, depending on the time they retire. For example, a worker who retired in 1980 at the age of 62 would be able to buy an annuity equal to 47% of his salary. However, a worker with an identical career who retired the next year would be able to buy annuity equal to 68% of his or her past earnings. The worker that reached 62 and retired in 1993 would be able to enjoy an annuity equal only to 42% of his or her past earnings. Impressively, the workers who retired just four years later in 1997, would receive 72% of their past earnings.[243] In contrast to savings, insurance is able to deal with the uncertainties with ease and is the most effective way to protect workers and their families from wage loss due to old age, disability or death.

An additional factor that can erode the balance of the DC pension plan accounts' are the management and investment fees. They are often overlooked because they usually are a small percentage, but their compounded effect for the entire period of investment can be significant. For example, an employee with 35 years until retirement and a 401k account balance of USD 25,000 who selects an investment option that brings a 7% average return for these 35 years for a fee of 0.5% will have accumulated upon retirement USD 227,000. However, if the fees increase by one percentage point to 1.5% their compounded effect will erode the account balance to only USD 163,000. The one percentage point difference in fees can reduce the account balance at retirement by 28%.[244]

[243] Altman.
[244] U.S. Department of Labor, and Employee Benefits Security Administration, "A Look at 401k Plan Fees," 2013, https://www.dol.gov/sites/dolgov/files/ebsa/about-ebsa/our-activities/resource-center/publications/a-look-at-401k-plan-fees.pdf.

In addition, the savings approach is unfavorable to the low-income workers, since they often have irregular incomes or often consume savings completely. Statistics show that 88% of the individuals with the highest 10% income have access to a private pension plan, and the participation ratio among that group is 80%. On the other end of the scale, only 32% of the individuals with the lowest 10% income have access to a private pension plan, and just 13% of them participate in such plans.[245]

In fact, it could be argued one step further that replacing the insurance with savings destroys the model of social insurance and returns the workers to the position they were at the end of the 19th century when the first state-operated DB pension plans were established. From this perspective, abolishing social security for the sake of tackling deficits, as Bulgaria did in the early 2000s, can hardly be justified.

In addition to stimulating a shift towards savings rather than insurance, ERISA introduced other problems. The present research will not focus on the other issues with ERISA such as its preemptive effect over state law, or the taxation of benefits, as they are a product of factors specific to the U.S. and have a weak connection with this research topic. The second problem that the present research will deal with is the legislative ambiguity, connected with the privatization of old-age security and the high costs that it entails.

### 3.5.7. The ambiguity of ERISA

The problems with the regulations of ERISA arise, on one hand, from the practically endless variety of arrangements between employers and employees that fall into its scope, and on the other – the strict requirements that ERISA imposes on the employers. Since many employers would prefer to escape the ERISA requirements and try to find loopholes in the applicable definitions, the Act uses definitions that are often ambiguous and circular. This approach, however, increases the uncertainty and the costs of operating private pension plans. In fact, this uncertainty affects even the basic pillars

[245] Bureau of Labor Statistics, "Retirement Benefits: Access, Participation, and Take-up Rates," accessed October 12, 2019, https://www.bls.gov/ncs/ebs/benefits/2018/ownership/private/table02a.pdf.

of the private pension plans, such as what is retirement benefit plan, who can be beneficiary, and what are the duties of the sponsor with regard to the plan.

Probably the most important definition in ERISA is the definition of an employee benefit plan. The Act provides for the following lengthy, but a rather unclear definition:

> (A) Except as provided in subparagraph (B), the terms "employee pension benefit plan" and "pension plan" mean any plan, fund, or program which was heretofore or is hereafter established or maintained by an employer or by an employee organization, or by both, to the extent that by its express terms or as a result of surrounding circumstances such plan, fund, or program —
>
> (i) provides retirement income to employees, or
>
> (ii) results in a deferral of income by employees for periods extending to the termination of covered employment or beyond,
>
> regardless of the method of calculating the contributions made to the plan, the method of calculating the benefits under the plan or the method of distributing benefits from the plan. A distribution from a plan, fund, or program shall not be treated as made in a form other than retirement income or as a distribution prior to termination of covered employment solely because such distribution is made to an employee who has attained age 62 and who is not separated from employment at the time of such distribution.[246]

Despite its length, this definition contains a serious flaw in that it is circular in logic. It uses the term to be defined as part of the definition. The Employee benefit plan is defined as "plan, fund or program", without explaining what a plan is. As a result, this definition of the plan had to evolve through case law.[247] The basic decision in this area is *Fort Halifax Packing Co. v. Coyne* in which the Supreme Court held that an ERISA plan is an "ongoing administrative program for processing claims and paying benefits."[248] This administrative criterion is complemented by the so-called Dillingham factors set in *Donovan v. Dillingham*. Answering the question of what is a plan, Judge Godbold wrote the following minimal conditions for the establishment of the plan: "At a minimum, however, a plan fund or program under ERISA implies the existence of intended benefits, intended beneficiaries, a source of financing, and a procedure to apply and collect benefits."[249] This Dillingham test, however, does not bring sufficient clarity about what is a plan under ERISA. For example, this test has been criticized that if the source of funding is unknown, the result is that there is no ERISA plan, while it

[246] 29 U.S.C. § 1002 (1) (2).
[247] Kirsten K. Solberg, "What Constitutes an ERISA Plan," *Probate & Property* 13 (1999): 56.
[248] *Fort Halifax Packing Co. v. Coyne*, 482 U.S. 1 (Supreme Court 1987).
[249] Donovan v. Dillingham, 688 F.2d 1367 (11th Cir. 1982).

could be a plan in violation of ERISA.[250] The final result of this highly flexible definition is that employers often cannot be sure that a promise made to the employees may be interpreted as an ERISA benefit plan and be subject to its requirements.

The problems with the ambiguities in ERISA continues with the beneficiary of the retirement benefit plan or more precise definition of "employee". Unlike the definition of the employee benefit plan, the definition of "employee" given by ERISA is short, but again circular: "The term 'employee' means any individual employed by an employer."[251] As a result, it is not surprising that this provision also created a need for interpretation by the Supreme Court. The case in which the Supreme Court had to clarify the meaning of "employee" was *Nationwide Mutual Ins. Co. v. Darden*.

Robert Darden was an insurance broker for Nationwide Mutual Insurance Company (Nationwide) from 1962 to 1982, and according to his agency contract, Nationwide enrolled him in a company retirement plan for agents. However, the same contract stipulated that he would forfeit his entitlement to benefits if within a year of his termination he started selling insurance policies for a competitor of Nationwide and within 25 miles of his prior business location. In November 1980 Nationwide terminated his contract and less than one year later he started selling insurance policies for a competitor within less than 25 miles of his previous place of employment. Nationwide claimed that this disqualified him for benefits from the retirement plan. On his part, Darden claimed that ERISA protected him as an employee, his retirement benefits had been vested and could not be forfeited. In turn, Nationwide claimed that the vesting rules did not apply to the plan, because it was not an employee benefit plan, covered by ERISA, but rather a business deal between independent contractors, which precluded the application of ERISA.[252] The Supreme Court understood that Darden's claim could succeed only if he was considered an employee of Nationwide under the lacking definition of ERISA.

The Fourth Circuit Appellate court tried to extract a test for employee based on the preamble of ERISA and decided that a person can become an employee in the ERISA sense by showing: first,

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[250] Langbein et al., *Pension and Employee Benefit Law*, 89.
[251] 29 U.S.C. § 1002 (6).
[252] Nationwide Mutual Ins. Co. v. Darden, 503 U.S. 318 (1992).

that he had reasonable expectation that he would receive benefits, second, that he relied on this expectation, and third, that he lacked the economic power to contract out of the forfeiture provisions in the pension plan.[253] The Supreme Court, however, criticized this test and pointed out that it was also circular. According to the Supreme Court, the Fourth Circuit Appellate Court was wrong to rest its test on the basis of expectation to receive benefits since this expectation depended on the "statutory entitlement to relief, which itself depends on his very status as an 'employee.'"

In its unanimous opinion, the Supreme Court decided to adopt a common-law test for determining who qualifies as an employee under ERISA. The Court based its test on the relevant principles of common law from its earlier opinion in the case *Community for Creative Non-violence v. Reid* in which the term "employee" was interpreted as used in the Copyright Act of 1976. The "employee" test according to the Reid case lies in "hiring party's right to control the manner and means by which the product is accomplished" and adds a variety of factors,[254] pointed to answer the question whether the purported employer exercised sufficient control to make the other party an employee.

Privatized pensions can face even more uncertainty and costs arising from the principal agent-problem. This problem occurs when a person (agent) has to manage property or money for the benefit of another (principal). In such a situation the agent often has a strong incentive to find a way to misappropriate the entrusted money rather than to discharge his or her obligations for the benefit of the principal. This may increase the costs for the principal to a point at which the services of the agent do more harm than good. There are several strategies to deal with this problem and still, none can provide a complete solution.

When ERISA was enacted the legislators were completely aware of the principal-agent problem, since in the years before there had been several occasions in which managers abused pension funds. As a result, the drafters of ERISA searched for a solution in the common law. What they finally

[253] Darden v. Nationwide Mutual Ins. Co., 922 F.2d 203–5 (Court.Appeals 1991).

[254] Such as the required skill, the provider of instruments and tools, the location of the work, the duration of the relationship between the parties, whether the hiring party has the right to assign additional projects to the hired party, the extent of the hired party's discretion over when and how long to work, the method of payment, whether the work is part of the regular business of the hiring party etc. *Community for Creative Non-Violence* v. *Reid*, 490 U.S. 730, 740 (1989).

selected as a mechanism to prevent abuse with retirement funds was the trust. This choice was motivated by two features of the trust: its ability to protect a pool of assets for a specific purpose or individual, and the protective regime of trust fiduciary law.[255]

Broadly defined, the trust is an arrangement in which one person (the settlor) engages another (trustee) to manage the property as a fiduciary for one or more beneficiaries. The result of this arrangement is that the settlor transfers the legal title of the property to the trustee, and the beneficiary acquires a right against the trustee.[256] In this situation, the material position of the beneficiary depends on the trustee: the eventual profits or losses from the management will be for the beneficiary. To protect the interest of the beneficiary the common law developed the trust fiduciary law and especially the duties of prudence and loyalty of the trustee. The duty of prudence requires the trustee to discharge his or her duties with reasonable care, skill, and caution, while the duty of loyalty demands that the trustee act solely in the interest of the beneficiary and prohibits conflict-of-interest transactions.[257]

On the surface, this mechanism looks like an efficient solution for the principal-agent problem in the private pension plans. However, under the superficial simplicity, the trust hides an implicit requirement that undermines its use for private pension plans: to be effective the trust requires a clear division of the roles of the settlor, trustee, and beneficiary. Employer and employee do not fit perfectly in these roles in a private pension plan, especially the popular 401k DC pension plans. In fact, the employers could become settlor, trustee, and beneficiary. When they provide funds, the employers become settlers, but when they select the possible investment options they become trustees. On top of that, the employer establishes a pension plan not out of generosity, but because he or she expects gains in the form of hiring and keeping good employees. From this perspective, the employer can be regarded even as a beneficiary. The employee is the beneficiary of the pension plan, but when he or she makes own contributions, then the employee becomes also a settlor.[258]

[255] Shnitser, "Trusts No More."
[256] Elizabeth A. Martin, ed., *Oxford Dictionary of Law*, 5. ed., reissued with new covers, Oxford Paperback Reference (Oxford: Oxford Univ. Press, 2003), 510.
[257] Shnitser, "Trusts No More."
[258] Shnitser.

The result of this unclear division between the settlor, trustee, and the beneficiary is ambiguity about the respective duties of the employer and the employee. This is especially important for the employer since he or she can be regarded as a trustee and therefore be subjected to the rigorous standards of care and loyalty. This ambiguity does not remain abstract, it is a burden, a form of cost that the employer has to pay in order to establish a private pension plan, and as with any other cost, if it exceeds the benefits, the employer will simply avoid by not offering such plans to the employees. As of 2017, only 48% percent of the employers offer a private pension plan to their employees.[259] The percentage of Americans who have access to retirement benefits is low at only 68%.[260] , and the actual participation ratio is even lower at just 51%.[261] It could be debated whether the ambiguity of ERISA is the main reason for these low figures since there are also important economic factors, but it certainly is a contributing legal factor.

### 3.6. Conclusion

The pension system of the United States could hardly be regarded as a success story. Due to the results of the Civil War pensions, American society did not feel an acute need for a comprehensive old-age security system. Therefore, the OASDI system was born out of political compromise at the time of the New Deal and it could never develop into a comprehensive retirement plan. By design, the benefits it provides are low and today benefits are not much higher than the poverty threshold.

The legal protection of pension benefits underwent a long evolution comparable to the evolution of the OASDI system itself. Initially, the US Supreme Court denied property right protection to the public pension benefits, but after a wave of criticism it reversed its interpretation and in a series of decisions unequivocally affirmed that the pension benefits are protected under the Fifth Amendment of the US Constitution. Still, in case the Trust fund is exhausted the level of the pension benefits can be decreased.

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[259] Bureau of Labor Statistics, "Establishments Offering Retirement and Healthcare Benefits," accessed January 23, 2019, https://www.bls.gov/ncs/ebs/benefits/2017/ownership/private/table01a.pdf.
[260] Bureau of Labor Statistics, "Retirement Benefits."
[261] Ibid.

The private alternative that the policymakers thought would be able to provide income security to the elderly Americans also disappointed. The shift to DC pension plans means that the employees are being increasingly left to their own ability to save. This requires a long term planning that takes into account so many variables, that it is practically impossible for the ordinary employees to make accurate long term planning. Even if the employees were able to save during their working careers, this does not guarantee them retirement benefits replacing a predetermined portion of their wages. The investment performance can vary greatly through time, and as shown above, the amount of the pension benefit could depend to a large extent from the moment in which an employee retires. At the same time, the unclear and ambiguous regulations of the market of retirement savings products creates additional costs for employers and employees in the form of uncertainty about their rights and obligations, which are a major factor for the rather low participation ratio in the DC pension plans.

The facts outlined above lead to the conclusion that the U.S. experience can serve as an example that the private retirement plans, and especially those based on savings, cannot make up for a lack of a comprehensive public pension plan, based on the principle of insurance.

### Chapter IV: The Japanese pension system

## 4. The Japanese public pension system

### 4.1. Introduction and historical overview

The current Japanese public pension system is a two-pillar system, with one flat-rate pillar and one income-based pillar. Similar to the OASDI in the US, it has a long history of evolution and its current state and rules could not be properly understood without a brief historical overview.

For the purposes of clarity, present research adopts the following division of the history of the Japanese pension system:

- Formation period which lasted from the enactment of the first pension laws to the reforms of 1954.
- Expansion period which lasted from 1954 to the reforms of 1985 which gave the final shape of the current Japanese public pension system. During this period the Japanese pension system expanded both in coverage and depth. The result was that in the early 1970s Japan became a welfare state, but not long after the oil-shock and the aging population led to the perception that the Japanese pension system was suffering from its own success.
- Period of adjustments beginning in 1985 and continuing to this day, in which the Japanese government tries to balance the expenditures for pension benefits with the need to provide social security.

#### 4.1.1. Formation Period

The beginning of the Japanese public pension system goes back to 1875 when Japan introduced pensions for retired naval officers and state servants as a form of gift for their loyal service. It was not until 1939 that pension legislation began to cover the workers in private industry.[262] The first such piece of legislation was the Act for Insurance of Sailors from 1939, which was followed in

[262] Kasagi Eri (笠木 映里) et al., *Social Security Law [社会保障法]* (Yuhikaku, 2018), 89.

1941 by the Workers' Pension Insurance Act, which in 1944 was renamed Employees' Pension Insurance Act, in Japanese – *koseinenkinhokenho*. The pension benefits were provided on the basis of accumulated contributions, and this form of retirement income security was initially available only to workers in businesses, employing more than 10 male workers. Three years later, in 1944 this lower limit was relaxed to businesses with more than five people.

Japanese scholars are divided about the role of this first retirement insurance law. Prof. Kikuchi includes this law in a series of several other social insurance laws from the mid-1930s such as the National Health Insurance Act[263] (*"Kokuminkenkohokenho"*) of 1938, Sailors' Insurance Act, Employees' Health Insurance Act[264] of 1939, which all were adopted as measures for the approaching Second World War. For example, the National Health Insurance Act implemented the policy, *kenminkenpei,* meaning healthy people, healthy soldiers. According to Prof. Kikuchi, the real purpose of the Workers' Pension Insurance Act was to "suck out purchasing power and provide funds for war expenses."[265]

On the other side is Professor Hori who lists several reasons why the Workers' Pension Insurance Act cannot be regarded as a war measure. He points out that at the time the bill was proposed the Japanese military was against it, which would not have happened if the retirement contributions were to be used as military expenses. Even stronger evidence against the theory of the pension system as a war measure is the fact that contributions were collected as postal savings or in the Treasury fund. Therefore, they had to be eventually returned to the Ministry of Welfare or the Ministry of Communications. If these funds were to be used in the military effort, it would have been impossible to transfer them back. This leads Prof. Hori to the conclusion, that even if the funds were used for war expenses, this was not their primary purpose.[266] In his opinion, there is no doubt that the primary purpose of this act was to provide a pension to workers.[267]

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[263] Designed to cover farm workers.
[264] Designed to cove white collar workers.
[265] Yoshimi Kikuchi (菊池 馨実), *Social Security Law [社会保障法]* (Tokyo: Yuhikaku, 2018), 17.
[266] Hori Katsuhiro (堀 勝洋), *Pension Insurance Law, Basic Theory and Interpretation, Case Law [年金保険法: 基本理論と解釈・判例]*, 4th ed. (Tokyo: Houritsubunkasha, 2017), 103.
[267] Hori Katsuhiro (堀 勝洋), 104.

However, this conclusion appears exaggerated in its claim that the primary purpose of the introduction of the pension system in Japan was not for military purposes. The introduction of a public pension system for a large proportion of the population profoundly affects the entire economy and the government budget. Considering that the Workers' Pension Insurance Act was adopted just months before the outbreak of the war, it is hardly conceivable that the Act was adopted without careful evaluation of its impact on the military capabilities of the country.

### 4.1.2. The Expansion Period

At the end of the Second World War, Japan was in economic collapse. Inflation and unemployment were on the rise. In this situation, the payment of retirement contributions in full amount was considered impractical and, as a temporary measure, in 1948 the contribution rate was decreased from the calculated rate that balanced inflow and expenditures to one-third of it. This practically froze the operation of the pension system but did not create immediate social problems since there were no people satisfying the conditions for retirement.

The 1950s were a period of rapid economic development in Japan in which the unemployment decreased, but inflation remained relatively high. As a result, the comprehensive reform in the pension system became an increasingly pressing issue. A new Employees' Pension Insurance Act was enacted in 1954 and it introduced the following reforms:

- The structure of the pension benefit changed so that now it was composed of two parts: one flat-rate and one proportional to income;
- The retirement age was raised to 60 years (from 55 years) for men and 55 years for women;
- The contribution rate was left at 3%, but it would be reexamined and increased every five years;
- The portion of State funding was increased from 10 to 15%.[268]

[268] Yoshimi Kikuchi (菊池 馨実), *Shakai Hoshōhō*, 125.

These amendments from 1954 gave the Japanese public pension system the character it had until the next big reform in 1985, and the Employees' Pension Insurance Act of 1954 remains in effect to this day.

At the same time, the Japanese public pension system did not stop expanding its coverage. In 1959 the National Pension Act (*Kokuminnenkinho*) was passed, which provided an insurance-type pension for old-age and also welfare pension benefits for old age and disability. This Act provided coverage to the categories of workers that were hitherto excluded from coverage under other pension laws: self-employed and agricultural workers. From that moment on all Japanese citizens aged between 20 and 60 became covered by this Act. This was a step that brought the Japanese public pension system very close to universal coverage and the so-called *kokuminkainenkin*[269] was achieved. At this time, the contemporary phenomena of atomization of the family and aging of the population were beginning to appear, and this law was also a measure against these social risks.[270]

At this time the retirement system for public officials was also undergoing transformation. In 1948 the Mutual Aid Association for State Servants Act was enacted, and in 1958 this act was replaced by a new one, having the same title. In addition, the special legislation was passed in 1953 and 1962 to cover the teachers in private schools and the public servants in local municipalities.

During the 1960s the Japanese economy developed rapidly and the financial condition of the State improved. This allowed rapid expansion of social security in Japan, including old-age security. The amount of the benefits from the public pension plan were increased to JPY 10,000 in 1965 and to JPY 20 000 in 1969 for households composed of husband and wife.[271]

The economic development and the expansion of social security reached their peak in 1973, which is referred to as "The first year of the welfare state."[272] However, this year also saw the rapid increase of the oil price, known in Japan as the "Oil Shock." The increase in oil prices led to high

[269] This term was coined to express a situation in which the entire population of Japan is covered by a public pension plan.
[270] Hori Katsuhiro (堀 勝洋), *Pension Insurance Law, Basic Theory and Interpretation, Case Law [年金保険法*, 106.
[271] Hori Katsuhiro (堀 勝洋), 107.
[272] Hori Katsuhiro (堀 勝洋), 107.

inflation and slow economic growth. The Japanese government started to struggle with budget deficits accumulating year after year. To remedy this trend, in 1981 the Japanese government called the Second Special Meeting for Examination of the Administration and initiated a reform in the government policy.

Social security was the biggest expense in the State budget, so it naturally became a major subject for reform. Some aspects of social security were modified, but this did not lead to more stable public finances. The reason is that the structure of the post-war Japanese social security was designed to respond to changes in the economy. However, this time the economic transformation was really deep – the slowing economy was accompanied by social changes such as an aging society and globalization. This reform in Social security was called "Revision of the Welfare State" or "Abolishing the Welfare State". [273]

### 4.1.3. The Period of Adjustments

The reform in Social security also affected the Japanese pension system. In 1985 it underwent the biggest reform since 1954 and it has remained basically unchanged to this day. The reforms of 1985 profoundly modified the Japanese public pension.

A new pension fund with flat-rate contributions and benefits was established the so-called National Basic Pension Plan (NPP), or *Kisonenkin*. This plan covered all Japanese citizens aged between 20 and 60 with no optional coverage. The creation of NPP pursued three goals. The first one was to decrease the inequality in the existing pension benefits. Until then, workers, employees and state servants were insured in different pension funds, and the amounts of the pension benefits varied greatly from individual to individual. The introduction of the basic flat-rate benefit paid by the NPP was expected to decrease this variance.[274] Another goal was to financially relieve the industry-specific pension plans that were starting to experience financial difficulties because of the shrinking numbers employed in these industries (mostly agriculture). Next, the introduction of this pension had to address the issue of old-age income security for the so-called "full-time housewives."[275]

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[273] Hori Katsuhiro (堀 勝洋), 107.
[274] Hori Katsuhiro (堀 勝洋), 108.
[275] Yoshimi Kikuchi (菊池 馨実), *Shakai Hoshoho*, 126.

To achieve these main goals, the National Pension Act divided the participants of the plan to three categories. The first category was self-employed, the second comprised individuals occupied in the private industry or the public sector, and the dependent spouses became the third category.

The result of this 1985 reform is a public pension structure in which the National Basic Pension Plan provides coverage for basic needs for practically all permanent residents in Japan and the Employees' Pension Plan pays benefits depending on earnings-based contributions.

**4.1.4. The reforms after 1985**

The pension system that came into being in 1985 was far from perfect and has had to be reformed on average every five years.

The first reform was conducted in 1989 when the adjustment of the amount of the pension benefits to the level of prices in the country became automatic, while before such adjustment was carried out only when the price level moved up by more than 5%. In addition, the participation of students in the National Basic Pension Plan became mandatory.

In 1994 the public pension system was reformed once again. The age at which individuals could receive the special, fixed amount, old-age benefits under Employees' Pension Insurance Act was raised from 60 to 65 years. In addition, the amount of the earnings-based pensions would be adjusted based on the wages after taxes and not based on the nominal wages as it was done up to that point.[276]

The next pension reform was enacted in 2000. This time the age at which individuals could receive the special, earnings-based, old-age benefits under Employees' Pension Insurance Act was raised from 60 to 65 years. At the same time, the level of the benefits under the Employees' Pension Insurance Act was decreased by 5 percentage points. To increase the revenue in the system, the bonuses of the employees were included in the income, used for calculation of retirement contributions and pension benefits. The rate of the contribution was lowered so the net effect of the revenue in the

[276] Hori Katsuhiro (堀 勝洋), *Pension Insurance Law, Basic Theory and Interpretation, Case Law [年金保険法*, 108.

system would be zero. However, the reform of 2000 also froze the rate of the insurance contributions, which led some specialists to claim that the pension system was going bankrupt.[277]

In 2004 the Japanese pension system was thoroughly reformed once again in order to achieve financial stability. Most important was the abolishment of the gradual increases in the contribution rates and the adoption of a fixed rate. The purpose of this reform was to lift some of the burden on the younger generation. At the same time, the level of the benefits would decrease in case of an economic downturn, but in case the level of the pension benefits falls below a specified threshold, the whole system would be reformed again. The proportion of state participation in the funding was increased from one third to one half. On a micro level, the reform introduced division of the Employees' Pension benefit after divorce and expanded the coverage of the pension system for working senior citizens (those aged over 70).

The next set of reforms was implemented in 2012 which were a part of a package to unify the tax regime and the social security contributions. Along with these reforms, the Japanese government introduced widower pensions from the NPP and shortened the period for qualification for old-age pension benefits from 25 years to 10 years. As a measure to increase the birth rate, the parents in maternity leave became exempt from social security contributions. In addition, the reforms from 2012 unified the preexisting separate plans for private employees and state servants.

The last series of reforms was introduced in 2016. The most important of them was the expansion of the Employees' Pension Plan to include short-term workers. The period of exemption from social security contributions for mothers was extended to leave before and after birth.

As a result of this evolution, Japan developed a unique public pension system. On one hand, it is different from the pension systems, which have only an income-based pillar like that of Germany and France, but also differs from the purely tax-funded systems like those of New Zealand and Australia. The UK pension system comes close to it but has a more limited scope, since the participation of the unemployed is only optional.[278]

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[277] Hori Katsuhiro (堀 勝洋), 109.
[278] Kasagi Eri (笠木 映里) et al., *Social Security Law [社会保障法]*, 93.

## 4.2. The constitutional framework of the Japanese public pension system.

### 4.2.1. The protection of the pension benefits

In contrast to the U.S. Constitution, the Japanese Constitution provides a framework of social security and for the pension system as a part of it. The main pillar of the constitutional framework of the Japanese public pension system is Article 25. The English translation of the provision is as follows:

"Article 25. (1) All people shall have the right to maintain the minimum standards of wholesome and civilized living.

(2) In all spheres of life, the State shall use its endeavors for the promotion and extension of social welfare and security, and of public health."[279]

Like other constitutional provisions, the meaning of Art. 25 depends on its textual interpretation. In this aspect, the Japanese legal scholars have been prolific. The scope of the first paragraph of Art. 25 received three interpretations. According to the first theory, the so-called "program theory", this paragraph does not create a legally protected claim but is a declaration of a political obligation for the executive power to adopt policy and implement measures.[280] The most widely[281] accepted theory is the "abstract right" theory which does not regard Art. 25 as grounds for legal action on its own, but as a starting point for the development of social security laws, which in turn may serve as grounds for legal action against the government.[282] Finally, there is also a theory that considers that in exceptional cases in which there is no secondary law concerning the right to exist, Art. 25, Para. 1 can become specific grounds for claims of the people for a remedy from the government.[283]

The interpretation of the Japanese Supreme Court did not bring clarity to the issue of "minimum standards." The first case in which the Supreme Court had to provide an interpretation of

[279] The Constitution of Japan, accessed March 12, 2019, https://japan.kantei.go.jp/constitution_and_government_of_japan/constitution_e.html.
[280] Kasagi Eri (笠木 映里) et al., *Social Security Law [社会保障法]*, 45.
[281] Munesue Toshiyuki [棟居快行], *The Possibility of Constitutional Law Jurisprudence [憲法学の可能性]* (Shinzansha [信山社], 2012), 394.
[282] Kasagi Eri (笠木 映里) et al., *Social Security Law [社会保障法]*, 46.
[283] Kasagi Eri (笠木 映里) et al., 46.

Art. 25, Para. 1 was the so-called "*Asahi* case." The case concerned the adequacy of monthly benefit JPY 600 per month to an individual suffering from tuberculosis in a healthcare facility. The Court held that the determining the minimum standard of wholesome and cultured living is largely within the competence of the Minister of Welfare at this time, and this discretion may become a subject of judicial review in case it is an illegal act that goes beyond the limits of the ministerial competence or is an abuse of power.[284]

The second case in which the Supreme Court had to provide an interpretation of Art. 25, the so-called "*Horiki*" case, also became a landmark case in the field of social security. In this case, a visually impaired single mother, who was receiving a welfare disability pension filed an application for child support benefit, but her application was rejected because she was eligible for a public pension. She appealed pointing out that this violates Art. 13, Art. 14, and Art. 25, Para. 2 of the Constitution. The district court ruled in her favor, but its decision was overturned by the appellate court and eventually, the Supreme Court rejected her appeal. The really important part of this decision is the interpretation of the Art. 25 by the Supreme Court about the role of the state and the competence of the judiciary in the field of social security, more specifically old-age security. Concerning Art. 25, Para 1 the Court held that:

> Based on the idea of a welfare state for all the people, [Art. 25] declares the actions, that the government must do to ensure that the citizens are able to enjoy a minimal level of healthy and civilized lifestyle, to be a state obligation. In the same manner, Art. 25 Para. 2 declares that, based on the same idea of the welfare state, the efforts necessary for the sufficient implementation of the social security legislation and establishment of the social security institutions are also state obligations. However, Para. 1 [of Art. 25] does not provide that there is a specific, actual obligation of the State to an individual based on this state obligation. […] The rule of Art. 25 of the Constitution has the effect of setting a specific goal and expectation for active implementation to the governmental activities. However, minimal level of healthy and civilized lifestyle is an extremely abstract and relativistic notion and its specific contents has to be determined considering the correlation with the cultural development, the socio-economic conditions, the living standards of the general population at the specific point in time. At the same time, considering the legislative concretization of this rule, we cannot disregard the condition of the public finances, and also there is a need for an administrative judgment, based on multi-dimensional, complex considerations with high-level of technical specialization. Therefore, we have to say that the choice of what practical measures will be taken, is delegated to the wide discretionary power of the legislature, and except for the cases of obvious deviations or abuses of these discretionary powers with striking irrationality, [this choice] is not fit for judicial review.[285]

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[284] Asahi [朝日], Minshu [民集] Vol. 21, No. 5, p. 1043 (Sup. Ct. May 24, 1967).
[285] Horiki [堀木], Minshu [民集] Vol. 36, No. 7, p. 1235 (Sup. Ct. July 7, 1982).

The result of the *Asahi* case and the *Horiki* case is that the Japanese Supreme Court turned over the practical implementation of Art 25 to the executive and the legislative powers, but leaves an option for judicial review in cases of manifest deviation or abuse. This approach can be considered correct, since unlike the government, the courts simply do not possess the necessary data to make a detailed data-based evaluation of a given policy. Therefore, the court could intervene only if the deviation or abuse is flagrant.

This conclusion leads to the next important issue concerning the right to existence enshrined in Art. 25 and that is: to what extent is it permissible for the government to use its discretionary powers to decrease the level of social protection. This answers the question as to what extent the government can retreat from its promises, concerning the old-age income security.

There are several interpretations of this issue by Japanese constitutional law scholars. One of them is developed by Professor Masayuki Uchino and is based on Art. 25, Para. 2 and especially the section that states, "the State shall use its endeavors for the promotion and extension of social welfare and security." Prof. Masayuki Uchino argues that this part of the provision prevents the shrinking of the social security safety net unless there are reasonable grounds for such act. On the other side, Prof. Toshiyuki Munesue argues that in case of shrinking of the social security safety net, the state has to prove in the process of judicial review that this shrinking conforms to accepted social values.[286] Both interpretations allow shrinking of social protection, either when the "reasonable grounds" requirement is met or when the conformity to accepted values is proven.[287]

However, Professor. Munesue also makes an important addition. In his view, a problem that remains is how to distribute the burden of the decreasing social protection among the people that have been enjoying it up to this moment.[288] In this regard, Professor Munesue argues that Art. 25 contains

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[286] Munesue Toshiyuki [棟居快行], *The Possibility of Constitutional Law Jurisprudence [憲法学の可能性]*, 404.

[287] 大沢秀介 (Osawa Hideyuki), 葛西まゆこ (Kasai Mayuko), and 大林啓吾 (Obayashi Keigo), *Constitutional Law.Com [憲法.Com]* (成文堂 (Seibunndo), 2010), 234.

[288] Munesue Toshiyuki [棟居快行], *The Possibility of Constitutional Law Jurisprudence [憲法学の可能性]*, 406.

an abstract right, as well as a duty for the legislative and executive bodies to use their powers to redistribute the state budget, and to set the level of benefits in a way that favors the most vulnerable users of the social security system.[289]

In addition, Art. 25 of the Constitution of Japan bears relation to the issue of privatization of the pension system. However, the Japanese legal scholarship has not reached a unanimous opinion as to whether this article prohibits privatization of the pension system or not. One reason for the diverging opinions is that the meaning of privatization is not exactly clear. For example, if privatization is understood as transfer of the management of the public pension plan to a private entity, and the powers of the legislature are interpreted strictly, then the question arises whether this is not a shrinking of the state's welfare and social security obligations and therefore unconstitutional.[290] On the other hand, if the powers of legislature to regulate the social security are interpreted broadly, and the State is free to select the measures to promote welfare, then the privatization approach does not seem unconstitutional anymore.[291]

Still, the author of the present research considers that it could be argued that Paragraph 2 of Art. 2 provides better support to the first interpretation. The reason, in his opinion, is that the duty to endeavor to promote and extend the social security is definitely for the State. At the same time, privatization does not mean only delegating the performance of specific social security services to private entities. This could be called subcontracting. Privatization also implies that a part of the decision-making power[292] in the field of social security and welfare will shift from the State to a private entity. Therefore, to privatize the pension system, completely or partially, would mean that a private entity will have to make independent decisions concerning at least partially the way the pension system will operate. Yet, Art. 25, Para. 2 proclaims that the promotion of the social security and welfare, which inevitably includes the decision-making powers, is a duty of the State, not of a private

[289] Munesue Toshiyuki [棟居快行], 392.
[290] Kasagi Eri (笠木 映里) et al., *Social Security Law [社会保障法]*, 95.
[291] Kasagi Eri (笠木 映里) et al., 95.
[292] The investment policy is a typical example of such independent decision-making power.

entity. This creates a collision with the nature of the privatization, with the final result being that a privatization of the pension system would be a violation of Art. 25 Para. 2 of the Constitution of Japan.

Another argument for this conclusion comes from the fact only an economic asset, something that has economic value can be privatized. However, the pension system does not have an economic value *per se*. Therefore, privatization of the pension system would always involve a preliminary step in which the State will transform the pension system to give it some kind of economic value. In its turn, this economic value of the pension system is directly related to the possible profit that can be extracted from it. Therefore, from the viewpoint of the private entity the privatized pension system is an economic asset from which profits can be extracted. As a result, the driving force in the decision-making process of the private entity will profit maximization. Improvement in the old-age income protection will occur only as a byproduct of this profit maximization. This leads to a direct contradiction with the State's obligation under Art. 25, Para. 2 of the Constitution of Japan.

#### 4.2.1. The property aspect of the pension benefits in Japan.

Section 3.2.1.1.2. in Chapter III of the present research showed that after a long evolution the public pension benefits in the US are now protected as a property right by the Fifth Amendment of the US Constitution. This raises the question whether in Japan the pension benefits from the public pension plans are also protected as a property right and whether they enjoy the same level of protection.

The provision of the Constitution of Japan that explicitly protects the property right is Art. 29 which states:

"Article 29. (1) The right to own or to hold property is inviolable.

(2) Property rights shall be defined by law, in conformity with the public welfare.

(3) Private property may be taken for public use upon just compensation therefor."

The first paragraph of Art. 29 does not define what is property. It simply states that property is protected as "inviolable." As with the US this raises the question whether the pension benefits are property enjoying the protection of Art. 29, Para. 1.

Prof. Hasebe defines property broadly as anything of economic value.[293] Based on this definition the right to pension benefit meets the condition for property and enjoys the protection of Art. 29 of the Constitution of Japan. However, this property right protection is not absolute. Paragraphs 2 and 3 of Art. 29 provide wide discretionary power to the government to define the property rights and to take property for public use, as long as it provides just compensation. Therefore, the property protection of the pension benefits under Art. 29, Para. 1 is necessarily limited by paragraphs 2 and 3. The Japanese Supreme Court further developed Art. 29, Para. 2 and established the following criteria that have to be taken into consideration when deciding on the constitutionality of legislation, which modifies the contents of an existing property right:

- The nature of the existing property right, which is being modified;
- The extent to which it is being modified;
- The nature of the public welfare that is being protected by the modification of the existing property right.[294]

In addition, in the famous *Shinrinhokyoyurinjiken* the Japanese Supreme Court held that the purposes of the government in setting the limits of the property rights may vary from active social policies like helping disadvantaged people to the passive preservation of the existing social order.[295] Concerning the field of old-age income security a question arises whether these active social policies may include decrease in the level of the pension benefits. This issue very delicate as not only the criteria mentioned above have to be taken into consideration, but also the balance between the flexibility of the pension system to adapt to new economic situations on one hand and the need to preserve the public trust in the pension system.[296]

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[293] Yasuo Hasebe [長谷部　恭男], *Constitutional Law [憲法]*, 7th ed., New Library of Legal Studies [新法学ライブラリ] 2 (Tokyo: Saiensusha [サイエンス社], 2018), 272.
[294] Minshu [民集] Vol. 32, No. 5, p. 946 (Sup. Ct. July 12, 1978).
[295] Minshu [民集], Vol. 41, No. 3, p. 408 (Sup. Ct., April 22, 1987).
[296] Kasagi Eri (笠木 映里) et al., *Social Security Law [社会保障法]*, 122.

### 4.3. The Japanese Public Pension System Explained

Any pension system is basically a set of rules that needs to answer at least the following three fundamental questions: who can become covered the pension system, what are the eligibility requirements (age, a period of coverage), and what amount of retirement benefit can the individual expect in exchange for the contributions made. As a result, the pension legislation is structured around three subsets of rules; definitions of covered individuals, provisions about the eligibility requirements (including contribution rate), and provisions with a formula for calculating the amount of benefits.

Currently, the Japanese public pension system can be understood by the following illustration. It has two pillars and three categories of covered individuals. The National Basic Pension Plan and Employees' Pension Plan, as well as the categories of covered individuals, will be explained in more detail below.

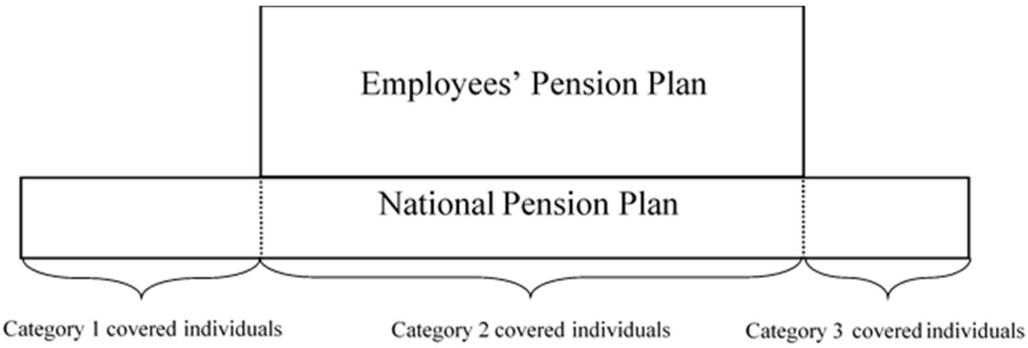


Figure 2: Structure of the Japanese public pension system

Source: Ministry of Health and Welfare

#### 4.3.1. The National Pension Plan

The National Pension Plan was established in 1959 with the adoption of the National Pension Act (NPA), effective from November 1 that year.

Art. 1 of the NPA is of special interest since it provides insight into the underlying principle of National Pension Plan Act. A translation of Art. 1 would be as follows:

> Art. 1. Based on the ideas set out in Art. 25, Para. 2 of the Constitution, the National Pension Plan aims to contribute to the preservation and improvement of the healthy life of the

population by using cooperative solidarity among the people to prevent loss of economic security arising from old-age, disability or death.

The keywords in this paragraph are "cooperative solidarity", which shows that the National Pension Plan operates based on the principle of social insurance, and not individual savings. In addition, Art 3 NPA clearly points out that the task of operating the National Pension Plan and achieving this economic solidarity fall to the Japanese government.

The "cooperative solidarity" principle of Art. 1 NPA requires that as many people as possible participate in the National Pension Plan. This would not only decrease the risk for the individuals but will also provide protection for the largest number of people. As a result, participation in the National Pension Plan is mandatory, and the definition of "insured individual" is designed to be as broad as possible.

Art. 7, Para. 1 NPA outlines three categories of people that are considered insured individuals according to the Act – Category 1, 2 and 3. Category 1 covers all residents in Japan, aged between 20 and 60, who do not fall in the definitions of Category 2 or 3. The individuals that typically fall in that category are self-employed, students aged above 20 and unemployed.[297] Insured individuals of Category 2 are those covered by the Employees' Pension Plan, which is usually the common salarymen. Category 3 is comprised of individuals that depend on the income of the individuals of Category 2 and are aged between 20 and 60. Their classical representative is the full-time housewife.

In addition, Japanese citizens aged between 20 and 65, without an address in the country may also participate in the National Pension Plan if they meet certain requirements.

However, the expansion of the scope of insured individuals has not been without legal disputes and one of them provides insight into the interpretation of Art. 14 of the Constitution of Japan, and the view of the Supreme Court about the powers of the Japanese government in the field of social security. At the time the NPA was passed, dependents of the insured individuals and students above the age of 20 were added as insured individuals, but their participation was optional. The insurance of the dependents became mandatory in 1985, while that of the students remained optional until 1991

[297] Kasagi Eri (笠木 映里) et al., 95.

when it also became mandatory. At that time, some students who had suffered an injury during the period of optional insurance, and were older than 20 years old, applied for disability pensions. However, their applications were rejected on the grounds that they were not covered at the time of the injury because they had not applied for the optional pension coverage. The students filed a lawsuit and the main points of contention were as follows:

1. The students that were less than 20 years old at the time the disability was confirmed could receive a welfare disability pension under the previous law and could receive a non-contributory basic disability pension under the new law. The students that were at the time older than 20 years and who had not applied for the optional coverage could not receive either. In their view, this was discrimination under Art. 14 of the Constitution.
2. The students who were not eligible for pension claimed that the State had neglected its obligation to provide adequate support, and claimed damages.

The Tokyo district court heard the case as first instance and held that regarding the disability pension system, which provides coverage regardless of payment of contributions, the fact that the students who suffered disabilities before the age of 20 can claim benefits, while those who became disabled after the age of 20 cannot, is a form of age discrimination. The court also determined as a result of this unlawful act by the legislative power, that claimants are entitled to damages from the State. As soon as the decision was delivered, the Japanese government initiated a legislative procedure and in December 2004 the Act For Providing Special Benefits Support To Individuals With Specific Disabilities was passed. Currently, students are mandatorily covered by the National Pension Plan, and in 2000 a system for a temporary exemption from contributions for students was introduced, so similar cases are unlikely to happen again.[298]

[298] Kumiko (久美子) Hirota (廣田), "The Disabled People Without Pension Due To The Optional Insurance In The Pension System and the Constitution [任意加入の年金制度に起因する無年金障碍者と憲法]," in *Social Security Case Law, the Landmark 100 Cases [社会保障判例百選]*, 5th ed., Jurist, Special Edition [別冊ジュリスト] 227 (Tokyo: Yhikaku [有斐閣 ], 2016), 23.

However, the case remains important and the reason why it is discussed in the present research is that the interpretation of the Supreme Court provides insight about the role of the State and the government in old-age security. After the Tokyo district court held in favor of the plaintiff, the appellate court overturned the decision of the district court, and eventually, the Supreme Court upheld this decision. The Court based its decision on the *ratio decidendi* in *Horiki* case and held regarding the pension system:

> Practically, the choice of what legislative measures will be adopted is entrusted to the wide discretionary power of the legislature. Except for the cases when it is clear that [this choice] has been manifestly irrational or exceeds or abuses this discretionary power, the court in its judgment cannot state that [the choice] has been inappropriate."[299]

The court also pointed out that the legislative body had an even wider discretion when it came to setting the requirements for coverage and eligibility for benefits, which are not based on the previous history of paid contributions. In its opinion, the different treatment of the students with disabilities over 20 age compared to those above that age does not amount to unfair and unreasonable discrimination.[300]

Another point of contention in the Japanese pension system that concerns both the pensions provided under the National Pension Act and the Employees' Pension Act, comes from the provisions governing the adjustment of the benefits in accordance with the economic conditions. The National pension is designed to provide economic security for the basic needs of the population. The Employees' Pension Plan also provides income-related benefits. Until 1989, adjustments were made to the pension benefits to preserve purchasing power, but only if the price level changed by more than 5%.[301] After the legislative amendments of 1989, the adjustment became automatic in accordance with the consumer price index.

However, because of the worsening finances in the public pension plans, and to avoid future excessive increases in the insurance premiums, in 2004 the Japanese government introduced a formula for calculating insurance premiums that included a fixed upper limit. To balance the effect of this

[299] Minshu [民集] Vol. 61, No. 6, p. 2345 (Sup. Ct. Sep. 29, 2005).
[300] Minshu [民集] Vol. 61, No. 6, p. 2345 (Sup. Ct. Sep. 29, 2005).
[301] Kasagi Eri (笠木 映里) et al., *Social Security Law [社会保障法]*, 118.

formula, the Japanese government also introduced provisions that would limit the expenditures for retirement benefits by linking their increase to the fluctuations of macroeconomic factors. This is the so-called macroeconomic slide system. Since the macroeconomic factors that most significantly affect the Pay-As-You-Go pension systems are demographic, the Japanese macroeconomic slide ratio is a function of the ratio of change in the working population and the increase of pension expenditures due to the increasing life expectancy.[302]

The system works as follows: when price and wage levels increase, so does the level of the pension benefits within the frame of available funds. A simulation is conducted every five years to confirm that the pension system will be balanced for 100 years.[303] If the result is negative, the macroeconomic slide adjustment kicks in to restore the balance.

The effect of the macroeconomic slide and the price and wage level fluctuations on the level of the pension benefits can be more easily understood if we imagine the level of the pension benefits as an elastic ball (the black circle in the figure below).

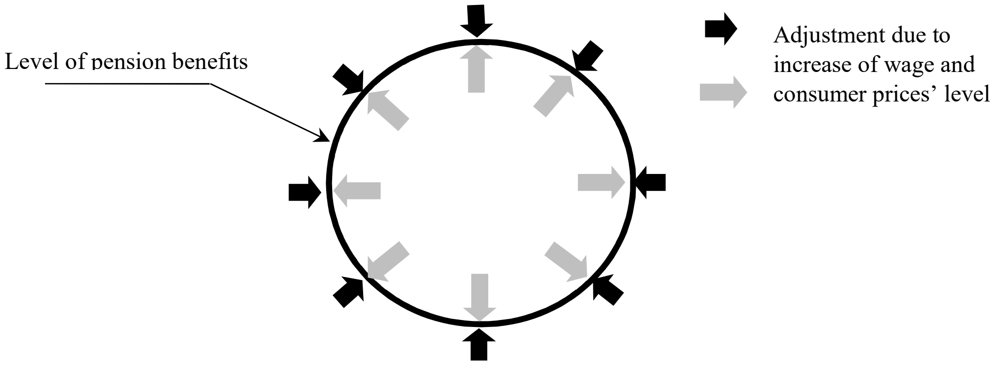


Figure 3: The macroeconomic slide adjustment mechanism

Source: Author

The level of the wages and consumer prices acts as inner pressure (grey arrows), and as it increases the volume of the ball (the level of the pension benefits) will increase as well. The macroeconomic slide acts as external pressure and opposes the inner pressure. The result is that the volume of the ball will increase less than it would have if there were no macroeconomic slide. However,

[302] Ministry of Health, Labor and Welfare, "What is Macroeconomic Slide [マクロ経済スライドってなに？]," accessed June 12, 2019, https://www.mhlw.go.jp/nenkinkenshou/finance/popup1.html.
[303] Art. 4-3, Para. 1 and 2 NPA.

this is only one of the possible scenarios; the one in which an increase in the level of wages and consumer prices is higher than the macroeconomic slide. If the ratio of the macroeconomic slide is high but the increase of the level of wages and consumer prices is low, the black arrows will become longer, the grey ones – shorter, and the ball will have to shrink. However, Art. 27-4, Para. 2 and Art. 27-5, Para. 2 NPA explicitly prevent such scenario by stating that in such cases the effect of the macroeconomic slide is limited to the amount of change in the wage level. In other words, the size of the ball will stay the same despite the stronger external pressure. The last possible scenario is when the level of the wages and consumer prices does not increase but decrease. In this case, the grey arrows will change their direction inwards, and the ball will shrink. If the external pressure macroeconomic slide is added, then the ball will have to shrink even more. Art. 27-4, Para. 2, and Art. 27-5, Para. 2 NPA do not allow this case to happen and limits the shrinking effect to the decrease of the level of the wages and the consumer prices. In this last case, the effect of the macroeconomic slide will be carried over in the future, when the economic situation improves and the wages and the consumer prices will have increased enough.

The macroeconomic slide is applied as long as the calculations show that the system is not balanced, and the period during which it is applied is called a period of adjustment.

The macroeconomic slide mechanism is a powerful tool for achieving financial balance in the Japanese public pension plans. It has the merit of aiming at a long-term balance, and of being linked to demographic factors with macroeconomic importance. This design makes the macroeconomic slide a tool to some extent independent from short-term policy goals.

The application of the macroeconomic slide also led to two sets of problems. The first one is related to funding. In June 2014, when the results of the simulation were announced, it became clear that the replacement rate[304] for the standard household[305] will drop from 62.7% in 2014 to just 51% in 2043. This was the scenario in the case of favorable economic development. In the case of unfavorable economic development, the replacement ratio would fall to under 50%.[306] However, Art. 2 of the

[304] The ratio of pension benefit to pre-retirement income.
[305] Working husband and a full-time housewife.
[306] Kasagi Eri (笠木 映里) et al., *Social Security Law [社会保障法]*, 120.

supplementary provisions to the Act for reform of the pension system of 2004 provides that in case the replacement ratio is expected to fall under 50%, the government must terminate the period of adjustment and adopt other necessary measures to match the level of the insurance contributions with the benefit expenditures.[307]

#### 4.3.2. Pension benefits from the National Pension Plan

Participation in the National Pension Plan provides insurance against three types of social risks, which are reflected in the different types of pensions and benefits. Art. 15 NPA lists the following types of benefits:

1. Basic old-age pension
2. Basic disability pension
3. Basic survivors' pension
4. Supplementary pension, widowers' pension and lump-sum benefit upon death.

Of these types of pensions, the most important one is the old-age pension, which will be examined in more detail.

##### 4.3.2.1. Basic old-age pension

The basic conditions for receiving an old-age pension from the National Pension Plan are set out in Art. 26 of the NPA. The individuals are required to have a period of paid contributions or exemption from contributions and to have reached the age of 65. However, in case the sum of the period with paid contributions and the exemption period is less than 10 years, the individual is not entitled to a pension. Until recently this period was 25 years, which is much longer compared to the US, where an individual can accumulate the necessary 40 quarters of coverage in 10 years. This strict condition for eligibility led to an increased number of seniors who could not qualify or could not expect to qualify. As of June 2010, their number reached almost 1.2 million people. To relieve their condition, in 2012 the Japanese government introduced legislative amendments, which raised the sales

[307] Kasagi Eri (笠木 映里) et al., 120.

tax from 5% to 10%, and decreased the period for eligibility to 10 years. However, the tax increase was postponed twice and pressed by the worsening situation of the people who could not qualify, the Japanese government decided not to wait for the tax increase to enter into force, and cut the eligibility period to 10 years as from August 2017.[308]

The eligible individuals are entitled to a pension benefit, which is calculated by multiplying the amount of the pension benefit (also called full pension) by an individual coefficient. The basic formula for the calculation of benefits is as follows: [309]

$$IP = FP \times AC \times NPC \div 480$$

where:

IP is Individual Pension,

FP is Full Pension,

AC is Adjustment Coefficient, and

NPC is the Number of months with Paid Contributions.

Currently, Art. 27 of the National Pension Act sets the amount of the full pension at JPY 780,900. This amount is the annual full pension.[310]

The adjustment coefficient is the ratio of the macroeconomic slide and is fixed on a yearly basis (usually on April, 1) as a function of the change in the consumer prices and the level of nominal net wages in the country.

The Number of months with Paid Contributions reflects the temporal aspect of old-age insurance. In principle, the full period of old-age insurance is 40 years or 480 months (the age between 20 and 60). As a result, the fraction of the Number of months with paid contributions divided by 480 shows whether the individuals have a full history of insurance. The individuals who have paid contributions for less than 480 months will receive a fraction of the adjusted full pension. For example,

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[308] Kasagi Eri (笠木 映里) et al., 122.
[309] Hori Katsuhiro (堀 勝洋), *Pension Insurance Law, Basic Theory and Interpretation, Case Law [年金保険法*, 382.
[310] Unless stated otherwise, the amounts of benefits in Japan, mentioned in the present research, represent an annual amount.

if an individual has paid contributions for 360 months, he or she will receive three-fourths of the adjusted full pension.

A slightly modified version of the formula above is also used to calculate the pension benefit in case of exemption of pension insurance contributions.[311] The modified part concerns the NPC variable, which is used to adjust for the periods of exemption depending on the exemption rate. In such case, NPC includes the number of months with full contributions plus the number of months with exemption from contribution multiplied by:

- 7/8 when the exemption rate is ¼;
- ¾ when the exemption rate is ½;
- 5/8 when the exemption rate is 4/3;
- ½ for a full exemption.

The reason for these complicated calculations with fractions comes from the distribution of the burden of the contribution between the government and the individual. At present, this burden is divided equally.[312] As a result, in the first case where the exemption rate is ¼, the government pays ½ of the contribution, and the individual pays ½ of the contribution multiplied by ¾ (the ¼ exemption is subtracted from unity). Therefore, the sum of the fraction of the government and the fraction of the individual is 1/2 + 3/8 = 7/8,[313] which is the portion of the full contribution actually paid to the National Pension Plan. The same logic applies to the months during which the burden of the government was 1/3.

#### 4.3.2.2. Disability pension

The disability pension is regulated in Art. 30 to 36 of the NPA and depending on the age of the disabled it can become a welfare benefit or pension. The reason for this dual character is the fact

[311] Art. 27, items 2, 4, 6 and 8 of the National Pension Act.
[312] Until 2008 the burden of the government was 1/3.
[313] Hori Katsuhiro (堀 勝洋), *Pension Insurance Law, Basic Theory and Interpretation, Case Law [年金保険法*, 383.

that if the disability occurs before the age of 20, no history of insurance is required for eligibility. The basic conditions for eligibility are:

1. As of the date of the initial medical examination, the claimant is insured in the National Pension Plan, or was insured in the National Pension Plan, has an address in the country and is aged between 60 and 65 years. In case the initial medical examination is conducted before the age of 20 (the age from which insurance starts), the disabled individual is entitled to disability payments, even if the date of the final diagnosis is after the age of 20.[314]
2. As of the date of final diagnose, the disability due to injury falls in one of the two possible categories established by the Minister of Labor and Welfare. Category 1 is defined as a disability to an extent that makes impossible the performance of everyday tasks. Category 2 is a disability to an extent that imposes a considerable limitation on the performance of everyday tasks. [315]
3. As of the date of the initial medical examination, the sum of the period with paid contributions and the period of exemption from contributions is not less than two-thirds of the total insurance history.

The disability benefits from the National Pension Plan depend on the level of disability. For Category 2 disability the benefit is JPY 780,900 per year, and the individuals with Category 1 disability receive a benefit 1.25 times this amount.[316]

#### 4.3.2.3. Survivors' pension

The Survivors' pension is designed to provide support to the family of the deceased insured individuals; their spouses, and their children under the age of 18.[317]

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[314] Art. 30-4, Para. 1 of the NPA.
[315] Hori Katsuhiro (堀 勝洋), *Pension Insurance Law, Basic Theory and Interpretation, Case Law [年金保険法*, 446.
[316] Art. 33, Para. 1 and 2 of the NPA.
[317] Hori Katsuhiro (堀 勝洋), *Pension Insurance Law, Basic Theory and Interpretation, Case Law [年金保険法*, 506.

This pension is provided upon the death of individuals within the following four categories according to Art. 37 of the National Pension Act:

1. Insured individuals;
2. Insured individuals aged between 60 and 65, and are having an address in the country
3. Individuals receiving a Basic old-age pension. In addition, they need to have 25 years combined history of paid contributions and periods of exemption;
4. Individuals, who upon their death have 25 years of combined history of paid contributions and periods of exemption.[318]

The Survivors' pension is available only to spouse and children of the deceased under the age of 18, and they also need to meet one primary and one secondary condition. The primary condition is that the deceased insured individual must have been supporting the household. If this condition is not met, the spouse and the children of the deceased cannot claim survivors' pension. If the primary condition is met, they have to meet one secondary condition. The secondary condition for the spouse is that he or she must live in the same household with a child of the deceased, who is under the age of 18 and is not married (Art. 37-2, Para. 1, item 1). For the children, the secondary condition is that they are under the age of 18 and are not married (Art. 37-2, Para 1, item 2).

The claims of the spouse and the child of the deceased are of the same order, but as a principle when the deceased is survived by a spouse and a child, only the spouse receives survivors' pension and the pension of the child is stopped. However, if the pension of the spouse is stopped, the child remains eligible if the conditions are met.[319] If the deceased has several children, their claims are also of the same order.[320]

The amount of the pension benefit is calculated by a formula, in which a basic amount is multiplied by a coefficient of adjustment. However, in case the spouse of the deceased is living in the

[318] Art. 37, items 1 to 4 of the NPA.
[319] Hori Katsuhiro (堀 勝洋), *Pension Insurance Law, Basic Theory and Interpretation, Case Law [年金保険法*, 508.
[320] Hori Katsuhiro (堀 勝洋), 509.

same household with his or her child, a fixed amount is also added.[321] Currently, the amount of the pension benefit is JPY 780 900 per year. The coefficient of adjustment adjusts the amount according to the economic situation. For the newly calculated pensions, the value of this coefficient depends on the change in the net salary, while for already calculated pensions the value of the coefficient depends on the change in the price level.[322]

#### 4.3.3. The Employees' Pension Plan.

The Employees' pension plan is the second pillar of the Japanese pension system. This plan is established by the Employees' Pension Plan and has a different purpose than the National Pension Plan. Its purpose is stated in Art. 1 of the Employees' Pension Act (EPA) as follows:

> "The purpose of this Act is to contribute to the improvement of the security and welfare of the employees and their surviving families by providing pension benefits for old-age, disability and death."

There are two obvious differences with the purpose stated in the NPA. First, the NPA covers the entire population, while EPA focuses only on the employees. Second, NPA states as its purpose the "preservation and improvement of the healthy life of the population while EPA aims to promote the welfare of the employees. This conceptual difference has been developed further in the case law. The interpretation of the Tokyo District Court is that for the employees the supply of workforce is the most important source income for living, and the Employees' Pension Plan covers only those employees who support themselves by working. The casual and short-time workers fall outside of the scope of the EPA.[323]

As a result of its purpose to provide welfare only to "real" employees EPA introduces a complex set of rules to regulate the scope of the covered individuals.

First, the Employees' Pension Plan sets several important conditions for coverage:

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[321] Kasagi Eri (笠木 映里) et al., *Social Security Law [社会保障法]*, 134.
[322] Hori Katsuhiro (堀 勝洋), *Pension Insurance Law, Basic Theory and Interpretation, Case Law [年金保険法*, 510.
[323] Berlitz Japan [ベルリッツ　ジャパン], Roudouhanrei [労働判例] Vol. 1142, No. 5 (Tokyo District Ct. June 17, 2016).

1. Age
2. Qualified workplace
3. The scale of the business enterprise.

The age requirement is the simplest. Art. 9 of the EPA provides that the individuals employed in the industries specified in Art. 6, Para. 1, aged less than 70, are covered, and this coverage is mandatory. In case an individual is not employed in any of the specified industries, he or she may ask the Minister of Labor and Welfare for permission to become voluntarily covered.[324] However, the consent of the employer is required for this voluntary coverage.[325]

The next most important condition for coverage is the type of industry an individual works in. Art. 6, Para. 1, item 1 EPA lists 16 types of industries,[326] and if an enterprise from this industry employs more than 5 people, its workers become mandatorily covered. This is to ensure that only individuals with regular and serious employment could become covered.[327] Another reason for this condition are the practical difficulties in establishing the labor relationship and the wages in very small enterprises.[328] In addition, item 2 of the same paragraph provides that the state servants working for the state or municipality or employees working for a corporation are also considered covered.

As mentioned above, the EPA was adopted in 1954 at which time the labor organization in the economy was very much different from its current form. Back then, the life-long employment, mostly in the industries listed in Art. 6, Para. 1 EPA, was the norm, while today the temporary and the part-time employment is becoming more and more prevalent. The result of this shift in the labor market is that fewer employees could meet the coverage requirements of EPA. In 2012 the EPA was modified to include to some extent the temporary and the part-time workers.

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[324] "Employees' Pension Act" (1954), Art. 10, Para. 1.
[325] Employees' Pension Act, Art. 10, Para. 2.
[326] For example: production, processing, separation, repair or disassembly of goods, construction, mining, generation and supply of electricity, transportation of goods and passengers, sales and distribution, finance and insurance, and others.
[327] Hori Katsuhiro (堀 勝洋), *Pension Insurance Law, Basic Theory and Interpretation, Case Law [年金保険法*, 160.
[328] *Commentary of the Employees' Welfare Pension Act [厚生年金保険法解説]* (Tokyo: Hoken, 2002), 446.

Their conditions for their coverage are defined negatively in detail in Art. 12 EPA, which sets out which workers are not covered, even though they work in an enterprise meeting the conditions of Art. 6, Para. 1 EPA. The workers that remain are covered by the EPA.

Art. 12 excludes the coverage of the following types of workers:

- Temporary workers: those employed on a day-to-day basis, and those with a fixed-term employment contract shorter than 2 months;
- The workers without a permanent place of work;
- Seasonal workers;
- The workers employed at a temporary place of work.
- Part-time workers
    - Part-time workers whose weekly working hours are less than ¾ of the weekly working hours of the regular workers or
    - Part-time workers whose monthly working hours are less than ¾ of the monthly working hours of the regular workers, and
        - who work less than 20 working hours per week;
        - whose salary is less than JPY 88 000 per month;
        - are high-school or university students.

The list of conditions that temporary and part-time workers must not meet to become covered shows that when the Japanese government decided to extend the scope of coverage to temporary and part-time workers special consideration was given to the interests of the employers. Another possible problem comes from the fact that if a large number of low-wage workers become covered, this would increase the ration of income redistribution within the system, with the respective political consequences.[329]

When individuals meet the conditions for coverage they automatically acquire the status of a covered individual from the day they have met the conditions.[330] However, this does not meet that the

[329] Kasagi Eri (笠木 映里) et al., *Social Security Law [社会保障法]*, 100.
[330] Art. 13 and 14 EPA

coverage so acquired can become legal grounds for claim to benefits. To produce this effect Art 18, Para. 1 EPA sets out one more condition – the Minister of Health Labor and Welfare has to confirm the coverage status (covered or lost coverage). The Tokyo District Court has provided a clear explanation as to why this additional step is necessary. Until to 1954, there was no administrative confirmation about the coverage status and there were cases in which individuals believed for many years that they are covered and expected pension benefits upon retirement, only to find out that for some reason they were not considered covered and are not entitled to pension benefits. At this point, it becomes very difficult for them to prove their status because many years could have passed from the day they allegedly met the conditions for coverage. As a result, many people could be left without pension benefits even if they actually had met the conditions for coverage. By adding the requirement for confirmation by the Minister of Health Labor and Welfare, the legal dispute about the status of coverage could be moved much earlier, at a time when it is easier to collect evidence.[331] From a theoretical viewpoint, this confirmation by the Minister of Health Labor and Welfare represents administrative disposal which gives concrete dimensions to an abstractly existing insurance relationship. In addition, it also serves to show the existence of a significant legal relationship between the employer and the employee.[332]

The procedure for obtaining confirmation by the Minister of Health Labor and Welfare starts either by notification by the employer (Art. 27 EPA) or by request from the employee (Art. 31 EPA), or ex officio by the administration (Art. 18, Para. 2 EPA).

The effect of the confirmation is from the future (ex tunc).[333] The decision of the Minister of Health Labor and Welfare to confirm or to refuse to confirm the insurance status is subject to a judicial review, in which the employer can also participate as an interested party.[334]

However, this approach solved one problem, but at the cost of creating another. As mentioned, the procedure for obtaining confirmation of the insurance status can be started by the employer, and

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[331] Hori Katsuhiro (堀 勝洋), *Pension Insurance Law, Basic Theory and Interpretation, Case Law [年金保険法*, 181.
[332] Kasagi Eri (笠木 映里) et al., *Social Security Law [社会保障法]*, 102.
[333] Employees' Pension Act. Art. 18.
[334] Kasagi Eri (笠木 映里) et al., *Social Security Law [社会保障法]*, 102.

this is the common practice. The problem arises when the employer does not properly discharge its obligation to notify the Minister of Health, Labor and Welfare. This could have very serious consequences for the employee because when the Minister of Health Labor and Welfare is not notified, he or she will not confirm the insurance status of the employee. As a result, the employee will not be covered by the EPA, even if he or she meets all the requirements.

The Japanese legal scholars are divided about the nature of the failure of the employer to notify the Minister of Health Labor and Welfare – whether it is a breach of the labor contract or a form of tort. The present research will not go into the details of this discussion because this would mean a review of the Japanese civil law.

#### 4.3.3.1. The insurance contribution

The insurance contribution is calculated by multiplying the average monthly salary of the individual by the contribution rate. The average monthly salary is specified in Art. 20 EPA through a table with average salaries divided into 31 salary levels. A salary range and average salary correspond to each salary level. For example, an individual with a monthly salary of JPY 265,000 will fall into the salary range of level 17 and his or her corresponding average salary will be JPY 260,000. The individuals with a salary of more than 605,000 fall into the last, 31st salary and their average monthly average is JPY 620,000. This upper limit of the average monthly salary leads also to an upper limit of the contribution.

The average amount of the salary is calculated by taking into consideration the salaries of the employee for the 3 months before July 1 of the respective year.[335] The calculated average amount is then used from September of the respective year to August next year.[336]

[335] Employees' Pension Act. Art. 21, Para. 1.
[336] Employees' Pension Act. Art. 21, Para. 2.

The bonuses of employees are another source for pension insurance contributions. Unlike the salary, which is paid regularly, the bonuses are not averaged, rather the contributions are levied on their actual amount.[337]

The average salary and the bonuses described above are then multiplied by the contribution ratio, which according to the table in Art. 81 Para. 4 EPA for 2019 and after is set at 18.3%.

The burden to pay the contribution is shared equally between employee and employer, and the employer has the obligation to collect the portion of the employee.

**4.3.3.2. Types of pensions:**

Art. 32 EPA provides for the following types of pensions:

- Old-age pension;
- Disability pension;
- Survivor's pension.

**4.3.3.2.1. Old-age pension**

As mentioned in the previous section, until 1985 the retirement age for the Employees Pension Plan was 60 years. The reform increased the retirement age, but this formed a gap of 5 years between the retirement before and after the reform. To cover this gap from the age of 60 to the age of 65, two types of special pension benefits were introduced – one of a fixed amount and one proportional to the salary.

However, in 1994 the deteriorating financial situation forced the Japanese government to introduce a new law to gradually raise the age from which these special pensions would be paid. First, it increased the age from which the fixed amount benefit will be paid, and in 2000 it also increased the age for payment of the benefit proportional to the salary.[338] Every three years the age will increase by

[337] Employees' Pension Act. Art. 24 – 4, Para. 1. The amount of the bonus is rounded to the lower JPY 1000.
[338] Kato Tomoaki (加藤智章) et al., eds., *Social Security Law [社会保障法]*, 7th ed., Yūhikaku Aruma. Specialized (Tokyo: Yuhikaku (有斐閣), 2019), 95.

one year, and by 2025 this system of special pensions will disappear because of the age requirement for their eligibility and the eligibility of the regular old-age pension from the Employees' Pension Plan (*Roureikouseinenkin*) will be the same – 65 years.[339]

The eligibility conditions for the *Roureikouseinenkin* are listed in the Art. 42 of the EPA:

- History of insurance in the Employees' Pension Plan;
- Age above 65;
- The period of insurance and the period of exemption from insurance premiums combined exceed 10 years.

The pension benefit is calculated using the following formula:

Average income$\times \frac{5.481}{1000} \times$Period of insurance[340] = Benefit amount[341]

For the individuals with a history of insurance before 2003 the Average income is multiplied by $\frac{7.125}{1000}$.[342]

The variable in this formula that needs further explanation is the Average income. It is calculated as the sum of all salaries, multiplied by the adjustment coefficient, plus the sum of all bonuses, also multiplied by the adjustment coefficient, all this divided by the number of months with paid insurance contributions.[343]

#### 4.3.3.2.2. Old-age pension and employed retirees

The old-age pension is at the center of significant social problems in Japan – what happens when a retiree becomes employed again?

The Japanese approach to the income of the working retirees demonstrates why the old-age pension needs to be regarded as a form of insurance, and not as delayed consumption or forced saving. Art. 46 EPA provides that in case a retiree is employed, his or her salary is added to his or her pension

[339] Kasagi Eri (笠木 映里) et al., *Social Security Law [社会保障法]*, 125.
[340] Calculated as number of months.
[341] Art. 43 EWPA.
[342] Kasagi Eri (笠木 映里) et al., *Social Security Law [社会保障法]*, 123.
[343] Kasagi Eri (笠木 映里) et al., 124.

benefit and if the sum exceeds a specific amount, the payment of a portion of the benefit will be suspended. The threshold amount is set at JPY 470,000. In case the sum of the salary and the pension benefit is more than this amount, the pension benefit exceeding this amount is cut by one half.[344]

The explanation for this approach is that receiving pension benefits is incompatible with receiving a salary.[345] This explanation is true, but it needs to be developed one step further. Indeed, the main reason for this incompatibility is that the risk of old-age insurance – the inability to work has not been materialized.

However, this approach needs to be applied with caution. Cutting the pension benefits for working retirees creates a strong disincentive for them to find employment. In exchange for the salary, they not only have to offer their workforce but may also need to give up a part of income, received without having to work.

The importance of suspending the pension benefits when the salary of the working retiree reaches a certain threshold and rationale behind it come from the fact that they could be applied only if the old-age pension is regarded as a form of insurance, and not as saving or a form of property.

#### 4.3.3.2.3. Disability pension

The disability pension provided by the EPA is the second source of income security in case of disability. The EPA imposes conditions for eligibility similar to those of the National Pension Act, but there are also significant differences.

The three conditions for eligibility for the EPA disability pension are set out in Art. 47, Para. 1 EPA. They are:

- To be covered as at the date of the medical examination on which the disease or injury that cause the disability was first diagnosed;
- Disability of category 1, 2 or 3;

[344] Hori Katsuhiro (堀 勝洋), *Pension Insurance Law, Basic Theory and Interpretation, Case Law [年金保険法*, 399.
[345] Kasagi Eri (笠木 映里) et al., *Social Security Law [社会保障法]*, 126.

- To have been covered by the two months preceding the day of diagnosis and the ratio of the number of exempted months to the number of insured months is 2/3 or above.

The most important difference in this list of conditions compared to the conditions for disability pension under the National Pension Act is the additional third category of disability. As mentioned above, the National Pension Act recognizes only two categories – 1 and 2. While the EPA uses the same criteria as the NPA for establishing disability of categories 1 and 2, category 3 is defined as: "considerable occupational impairment caused by injury or disease which has been treated successfully, occupational impairment caused by disease or injury, which is under treatment."[346]

The practical importance of this disability categorization concerns the possibilities for the disabled individuals with children or spouse to claim additional disability benefits. Only individuals with disability of category 1 and 2 may receive benefits both from the National Pension Plan and the Employees' Pension Plan, and they also receive additional amount for spouse or children, provided the other conditions are met. The individuals with a disability of category 3 may claim only disability pension under the EPA.[347]

The amount of the pension benefit is calculated using the same formulas for calculating the old-age pension benefits. This may seem a technical detail, but it is also proof of the close similarity between the disability risk and old-age risk. This similarity is also another reason why the old-age pension system has to viewed as a form of risk insurance, and not as a forced saving, delayed consumption, or something else.

#### 4.3.3.2.4. Survivors' pension

The survivors' pension is the last type of pension benefit provided by the EPA and will be briefly examined. The conditions for eligibility are listed alternatively in Art. 58, Para. 1 EPA:

- Death of a covered individual;

[346] Hori Katsuhiro (堀 勝洋), *Pension Insurance Law, Basic Theory and Interpretation, Case Law [年金保険法*, 476.
[347] Hori Katsuhiro (堀 勝洋), 467.

- Death of an individual that has been covered, which has passed away from a disease or injury diagnosed for the first time during the period in which he or she was covered, and the death as occurred within five years from the day of the initial diagnosis.
- Death of individual with a disability of category 1 or 2, who receives disability pension under EPA.
- Death of an individual who has right to old-age benefits. Additional condition is that this individual needs to have a combined history of paid insurance contributions and of exemption from contributions of at least 25 years.

The scope of the individuals who may receive this kind of pension is listed in the next article – spouse, children, parents, grandchildren and grandparents. The general rule for calculating the amount of the survivors' benefit also uses the formula for calculating old-age pension benefits, which as mentioned above, serves as proof that the old-age pension is a form of risk insurance.

### 4.4. Problems in the Japanese public pension system

The efforts of the Ministry of Health, Labor and Welfare have been concentrated in two main directions. The first one is to decrease the burden on the current working generation. The macroeconomic slide mechanism described above serves exactly this purpose – it sets an upper limit on the contributions rate from the current generation, and the pension system. The estimates of the Japanese government show that this measure would decrease the ratio of the pension benefits to GDP from the current 10.1% to 9.3% in 2025 and this ratio will be maintained until 2040.[348]

However, the macroeconomic slide ignited a debate. On one hand, there are economists who see it as a step in a transition towards a savings based pension system. The macroeconomic slide will limit the amount of the pension contributions from the working generation, which would free funds to be saved for old-age.[349]

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[348] Oshio Takashi (小塩隆士), "The Issues and the Future of the Public Pension System [公的年金制度の課題と将来]," *Social Security Weekly [週刊社会保障]* 3034 (2019): 138–41.
[349] Oshio Takashi (小塩隆士).

On the other side is the effect that this measure has on the retired generation. If the evaluation is based on the level of protection, rather than financial sustainability, the outlook does not look positive anymore. The Working Group on Markets to the Financial System Council reported that the public pension will not be sufficient to maintain the standard of living and that a household of two retirees will face a JPY 50,000 deficit per month. In case they collect pension benefits for 20 years this deficit will reach JPY 20,000,000.[350] This conclusion shocked the Japanese society, and became the so-called "20 million yen problem." The calculations of the Japanese government also show that the macroeconomic slide will make impossible to sustain a replacement ratio of at least 50%. A model of the Ministry of Health, Labor and Welfare demonstrates that when a male born in 1979 retires, his pension benefits will have a replacement rate of 50.6%, which is barely above the target. However, by the age of 85, the replacement rate will have fallen to 40.65.[351]

Another aspect of the macroeconomic slide is the effect it will have on the most vulnerable part of the population. The falling replacement rate will push a significant portion of elderly people in the income level in which they will need welfare benefits. There are calculations showing that if the current patterns of employment continue, by 2060 the percentage of elderly people in need of welfare benefits will increase by 100%.[352]

The data about the replacement rate and the increasing ratio of elderly people in poverty show that the macroeconomic slide mechanism, successful as it may be, pushes the Japanese system in a situation in which the adequacy of the pension benefits is put into question. In this case the approach of tweaking only the amount of the benefits seems to have reached its limits. If the Japanese pension system is to provide sustainable, but meaningful income security, the reforms will have to extend to the conditions of eligibility like increasing the retirement age and extending the scope of coverage.

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[350] Working Group on Markets to the Financial System Council (金融審議会 市場ワーキング・グループ), "Asset Forms and Management in an Ageing Society [高齢社会における資産形成・管理]," June 3, 2019, 16, https://www.fsa.go.jp/singi/singi_kinyu/tosin/20190603/01.pdf.
[351] Oshio Takashi (小塩隆士), "The Issues and the Future of the Public Pension System [公的年金制度の課題と将来]."
[352] Oshio Takashi (小塩隆士).

However, increasing the retirement age is an extremely sensitive political issue, and currently, it is not a part of the reform discussions.[353]

### 4.5. The Japanese private pension system

In Japan, the private pension system is the third layer of the pension system, and as the macroeconomic slide adjustment mechanism is putting pressure on the public pensions, the private pensions have become increasingly important.[354]

As in the United States, the Japanese private pensions started as a system for providing benefits to a retiring employee after a long and loyal service. In Japan, the usual practice was the employer to provide to retiring employees a lump sum payment called *taishokukin*. The first corporate pension plans were established as far as the Taisho period (1912-1926) and were modeled after the public plans that provided benefits to civil servants and military officers.[355] Still, these corporate pension plans did not become widespread.

The real expansion of the corporate pension plans started after the Second World War. At that time the Employees' Pension Plan was still immature, and the Japanese employers saw the *taishokukin* as a means to keep their best employees. The amount of the benefit and the formula for its calculation became a subject of negotiation between trade-unions and employers. In addition, the conditions for eligibility were relaxed, and as a result, the employees started to look at the corporate pension benefit as a right that became one of the important conditions for employment.[356]

Despite this expansion, the corporate pensions were still lacking a vital element to become complete. In the 1950s the rising inflation and labor shortages were driving up not only the salaries but also the amount of the *taishokukin*. In order to spread more evenly the payment of this amount,

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[353] Oshio Takashi (小塩隆士).
[354] Kasagi Eri (笠木 映里) et al., *Social Security Law [社会保障法]*, 80.
[355] Hideyuki Morito (森戸英幸), *Corporate Pensions, Law Policy [企業年金の法と政策]*, (Tokyo: Yuhikaku (有斐閣), 2003), 51.
[356] Hideyuki Morito (森戸英幸), 52.

that was getting bigger and bigger, several Japanese employers started implementing regular payments. However, the contributions that the employers made for these pensions were not considered losses for tax purposes and they were taxed.[357] This problem was finally solved in 1962 through amendments in the tax legislation, which created the so-called Tax Qualified Pension Plans. If a corporate pension plan met the conditions to become tax-qualified, the contributions to the plan were not taxed. This new tax treatment was what finally made the Japanese corporate pension plan a working mechanism for old-age income security.

Before long, the Employees' Pension Plan started to get traction and the burden for the employers started to become increasingly heavier. They had to pay contributions to the public pension plan, and they also had to pay contributions to their own corporate pension plans. As a result, the Japanese employers started to raise voices for reduction of their obligations for the retirement security of their employees.[358] In 1963 the Japanese employers expressed their view that the public and the corporate pensions were overlapping, and made a proposal for adjustment between these two sources of old-age income. As expected, the trade-unions disagreed and pointed out that such adjustment would mean a reduction of their old-age security. Eventually, the view of the employers prevailed, and after consulting the English pension system, in 1965 the Japanese government introduced the so-called *koseinenkinkikin*, a system in which a portion of the public pension from the Employees' Pension Plan was replaced by a corporate pension by the employer.[359] Although some of the details differ, the overall resemblance of the *koseinenkinkikin* system with the Bulgarian approach to privatizing a part of its pension system is striking.

During the bubble years of the Japanese economy, both the public and the corporate pensions were doing well. However, in the early 1990s, this all ended and the following period of stagnation put the Japanese pension system, and especially the corporate pension plans who had to replace a portion of the public pension, into real difficulties.[360] The main problem for the employers was that

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[357] Hideyuki Morito (森戸英幸), 52.
[358] Hideyuki Morito (森戸英幸), 53.
[359] Hideyuki Morito (森戸英幸), 53.
[360] Kasagi Eri (笠木 映里) et al., *Social Security Law [社会保障法]*, 82.

the investment performance of their corporate pension plans was below the one needed to meet their obligation to replace a portion of the public pension.

At the same time the changing labor market also deeply influenced the corporate pension landscape. The life-long employment was being replaced by more flexible employment, and because of the relatively strict vesting requirements, the existing corporate pension plans were ill-suited to this new form of employment. As a result, a new form of corporate pension plan began to gain popularity in Japan – the Defined Contribution pension plan – *kakuteikyoshutsukigyounenkin*. It offered two major advantages: first, it could not generate liability for the employer above the duty for contributions, and second - the pension rights of the employees were more easily portable when they find a new job. In response to these new trends in employment and old-age insurance, in 2001 the Japanese government adopted two laws that currently form the base of the Japanese corporate pension plans – the DC Pension Act and the DB Pension Act.[361]

In the meantime, the troubles in the *koseinenkinkikin* system continued, and after a series of bankruptcies and accounting scandals, in 2014 the Japanese government introduced new legislation, which abolished the formation of such pension plans. The troubled plans were encouraged to merge in another pension plan, and a special bankruptcy procedure was introduced. Only the financially sound plans were allowed to exist.[362]

#### 4.5.1. The Japanese corporate pension plans today

As a result of the evolution described above, currently, there are two types of pension plans in Japan – Defined Benefit and Defined Contribution. The DB pension plan was a traditional form of pension plan during the economic boom, and they are still more numerous than the DC plans, although the latter are gaining in popularity.

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[361] Kasagi Eri (笠木 映里) et al., 82.
[362] Kasagi Eri (笠木 映里) et al., 82.

### 4.5.2. The nature of the Japanese corporate pension plans

One of the most prominent Japanese researchers of the Japanese corporate pension plans – Prof. Morito Hideyuki gives the following definition of a corporate pension: "[The corporate pension] is a pension, established voluntarily by the employer, or a lump sum payment provided to the employees as a remuneration for their work, one of whose principal functions is to secure the old-age income of the employees after retirement."[363]

This definition shows two very important characteristics of the Japanese corporate pension plans – first, they are voluntary, and second – they pursue several goals, and only one of them is to provide old-age income security.

This evolution of the Japanese corporate pensions shows their other main purposes – to keep the efficient employees in the company and to provide a means for promotion.[364] As the definition shows, the initiative for the establishment of corporate pension plans is for the employers. As economic actors, they will do so only if it would maximize their profit. This means that the employers expect to recover the costs for establishing and operating a pension plan, by profiting from the long-term employment of their qualified employees. On the other hand, the employees give up opportunities to work in other companies in consideration of a higher income after retirement. This characteristic is important because it shows that in Japan the corporate pension plans serve primarily the private interests of employers and employees.

### 4.5.3. The Defined Benefit (DB) pension plans

Art. 1 of the DB Corporate Pensions Act (DBCPA) states the purpose of the Act as follows:

> "Considering the worsening demographic situation and the changing socio-economic conditions like the transformation of the industrial production, and in order employers and employees to reach agreements about the contents of the benefits, and the employees to be able to receive these benefits in old age, the present law provides the necessary regulation of the DB pension plans, aiming to support the independent efforts of the people to secure their old-age income, and especially to contribute to the increase the welfare and security of the people, by combining [these benefits] with the public pensions."

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363 Hideyuki Morito (森戸英幸), *企業年金の法と政策 [Corporate Pensions, Law, Policy]*, Shohan (Tokyo: Yhikaku, 2003) 18.

364 Hideyuki Morito (森戸英幸), *企業年金の法と政策 [Corporate Pensions, Law, Policy]*, Shohan (Tokyo: Yhikaku, 2003) 47.

In other words, the DB Corporate Pensions Act aims to reduce the obstacles before employers and employees to reach a DB pension plan agreement, and the role of the DB pensions is to supplement the public ones, not to replace them, even partially. As, the name implies, in the Japanese DB pension plan, the amount of the benefit to the employees is defined, using a formula, while the contributions are not. This effectively shifts the risk of lack of income in old-age from the employee to the employer. However, employees also pay a price for this shift of risk – they do not receive their full salary, as part of it is saved in the pension plan, and they also have to work for the same employer for many years, missing opportunities for a career with another employer.

The establishment of a corporate pension plan starts with an agreement about the clauses of the DB pension plan between the employer, who has to be covered by the Employees' Pension Act, and the respective trade union representing the majority of the workers.[365] If there is no trade union, representing the majority of the employees, a representative of the majority of the employees can also agree. The Minister of Health, Labor and Welfare then approves the agreement about the pension plan. The Defined Benefit Corporate Pensions Act provides for two types of pension plans – contractual type and fund type. The contractual type is similar to the first tax-qualified pension plans, but it has to meet more stringent regulations about financial reporting. In the contractual DB pension plan, the employer concludes a contract with a trust bank or life insurance company for the management of the pension funds. As a result, investment and administration activities are carried outside of the employer's company. This is also the defining difference between the contractual type and the fund type of DB pension plans. In the fund-type of DB pension plans, the employer creates a special legal entity – a fund, which then undertakes the administration and the investment of the employees' contributions.

Art. 29 DBCPA regulates the types of benefits a DB pension plan has to provide. Two of them are mandatory, regardless of the pension plan agreement. These are the old-age benefit, and the lump-sum paid upon retirement. Paragraph 2 of Art. 29 provides two optional benefits – disability benefit,

[365] Art. 3 of the Defined Benefit Corporate Pensions Act [確定給付企業年金法] (2001).

and survivors' benefit. In addition, Art. 31 DBCPA provides that the pension plan agreement may not contain discriminatory provisions.

The conditions for eligibility for old-age benefits are provided in the respective DB pension plan agreement but have to meet the requirements of Art. 36 of the DBCPA. The pension plan agreement has to stipulate an eligibility age between 60 and 65. In addition, the covered individuals, who have reached an age specified in the pension plan agreement, which has to be above the age specified in a separate government ordinance become eligible when they stop being employed with the respective employer. According to Paragraph 3 of Art. 36 the age specified in the government ordinance cannot be less than 50 years. Currently, Art. 28 of the Government Ordinance on the Implementation of the DBCPA sets this age at 50 years. The last requirement of Art. 36 is that the pension plan agreement cannot stipulate a period of coverage longer than 20 years as a condition for eligibility.

The old-age benefit can be paid either as a pension or if it is stipulated in the pension plan agreement, as a lump sum.[366]

In case an individual has met the conditions for receiving a lump sum, and his or her coverage is terminated on grounds other than death, then he or she is entitled to the lump sum. In addition, the pension plan agreement cannot stipulate a period of coverage longer than 3 years as a condition for eligibility.[367]

#### 4.5.3.1. Operation of the DB pension plans

According to Art. 55 DBCPA provides that the employer[368] has the obligation to pay the necessary contributions more than once a year. The same articles specify that the contributions have to be paid either as a fixed amount or as a proportion of the salary. In addition, Art. 57 DBCPA imposes an obligation, the amount of the contributions stipulated in the pension plan agreement to be calculated with respect to the amount necessary for payment of benefits and the expected investment return in

[366] Art. 38 DBCPA.
[367] Art. 41 DBCPA.
[368] It is possible the burden of the contributions to be shared between employee and employer.

order a long-term balance of the pension plan's incomings and expenditures to be achieved. The employer also bears the burden to pay each year the amount necessary for the actuarial reserves of the pension plan.[369] In case of deficit, the employer has to recalculate the contributions to the pension plan.[370] On the other hand, in case of a surplus, it will be kept in the pension plan, and only in case the surplus exceeds a specified amount, the difference may be deducted from the amount of the contributions.[371]

In the contractual type, the employer then concludes a contract for administration and management of the contributions with a trust bank, or the life insurance company.[372] This part of the operation of the DB pension plan involves the highest risk for the beneficiaries. They have to rely that employer or the trust bank or the life insurance company will administer the funds for their future retirement with due care, and will not misappropriate them. As explained in the previous chapter, in US the individuals covered by private pension plans are protected as trust beneficiaries. Japan, however, being a civil law country does not have a complete equivalent of the trust in the US law. Therefore, in Japan, the interests of the individuals covered in corporate pension plans are protected by a broadly formulated fiduciary duty (*jutakushasekinin*). The legal basis of the Japanese fiduciary duty is formed by the following three articles of the Civil Code of Japan – Art. 644, Art. 415 and Art. 709. Art. 644 provides that "A mandatary shall assume a duty to administer the mandated business with the care of a good manager compliance with the main purport of the mandate.", while Art. 415 entitles the obligee to claim damages in case the obligor fails to perform duly. Art 709 is the general tort provision of the Civil Code of Japan. This fiduciary duty is subdivided into two more specific categories: duty of loyalty (*chuujitsugimu*) and duty of care (*chuuigimu*).[373]

The fiduciary duty applies to the individuals and entities involved in the management of the pension funds in both the DB and the DC pension plans. However, because of the differences in the

[369] Art. 59 DBCPA.
[370] Art. 62 DBCPA.
[371] Art. 64 DBCPA.
[372] Art. 65 DBCPA.
[373] Hideyuki Morito (森戸英幸), *企業年金の法と政策　[Corporate Pensions, Law, Policy]*, Shohan (Tokyo: Yhikaku, 2003), 130.

operation of the DB and the DC pension plans, the behavior, that the fiduciary duty requires, is different. The specifics of the duty of care and the duty of loyalty in the DC pension plans will be described below.

#### 4.5.3.2. The duty of loyalty in the Japanese DB pension plans

Compared to the DC pension plans, the duty of loyalty has a wider application, because in the DB pension plans the beneficiary has to rely on the investment decisions of the employer or on his good choice of trust bank or life insurance company to manage the accumulated funds. In contrast, in the DC pension plans, the participants are largely responsible for their own investment decisions, which makes the trust relationship much weaker.

As in the US, in Japan, the meaning of the duty of loyalty is not completely clear in the context of corporate pensions. Professor Morito Hideyuki defines it as a duty for the trustees to perform their obligations exclusively for the benefit of the members of the pension plan. In other words, this duty requires the trustees not to act for the benefit of any other person, other than the participants in the pension plan.[374] This definition closely follows the provision of Art. 69 DBCPA. A textbook example of breach of this duty would be the case when the employer concludes a contract for investment management with a financial institution which he has close relations with, but which charges high fees.

On the other side, another view is also possible. The wellbeing of the employer could be more beneficial to the employees than the eventual benefits from the lower fees. After all, if the employer goes bankrupt, the employees will be hit hard and will lose their benefits from the DB pension plan. Therefore, in case the employer has especially important relations with a financial institution like a bank, the higher fees may not be considered to be a breach of the duty of loyalty.[375]

Another issue in this connection is the so-called Socially Responsible Investment (SRI). It means that the investment activity should not be carried only for the purpose of higher earnings, but should also consider the environment, social or moral values. For example, SRI would mean that it is

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[374] Hideyuki Morito (森戸英幸), “Survey of The Legal Issues in the Corporate Pensions [総論一企業年金の法的論点],” *Jurist [ジュリスト]*, no. 1379 (2009.6.1): 4–11.
[375] Hideyuki Morito (森戸英幸), 140.

not appropriate to make investments in countries in which human rights are not respected, or in tobacco companies, but rather in businesses that take care of the environment or that promote gender equality.

#### 4.5.3.3. The duty of care

The duty of care has a slightly different purpose than the duty of loyalty. While the duty of loyalty requires the trustee to act exclusively in the interest of the employees, the duty of care requires from the trustee to apply all his knowledge and skill in the management of the pension funds. In Japan, the DBCPA requires the employers in the DB pension plan to manage and administer the pension funds with due care. Art. 67 of the DBCPA provides that in the DB pension plans the accumulated contributions have to be managed safely and efficiently. The key to this is diversified investments.[376] This view is supported by the provision of Art. 46, Para. 1 of the Government Ordinance on the Implementation of the DBCPA, which requires the trust institution or the employer to make efforts to achieve diversification.

Another form of the duty of care is the duty to exercise adequate supervision. The common practice is the Japanese employers with a DB pension plan to delegate the management of the funds to an external financial institution. As a result, their duty of care now requires them to make a proper and good faith selection of a financial institution and to constantly and properly monitor its performance.

### 4.5.4. The DC pension plans.

The other type of private pensions in Japan is the Defined Contribution (DC) pension plans. Art. 1 of the DC Pensions Act gives the purpose of the DC pension plans as follows.

> Art. 1 "Considering the worsening demographic situation and the changing socio-economic conditions like the lifestyle diversity in old age, and in order the individuals to be able to give management instructions with self-responsibility about the funds they or their employer have contributed, and to be able to receive benefits thereof in old age, the present Act provides the necessary regulation of the Defined Contribution pension plans, with the aim to support the independent efforts of the people to secure their old-age income, and especially

[376] Hideyuki Morito (森戸英幸), 企業年金の法と政策　[Corporate Pensions, Law, Policy], Shohan (Tokyo: Yhikaku, 2003), 143.

to contribute to the increase the welfare and security of the people, by combining [these benefits] with the public pensions.“

An analysis of this provision shows that the aim of this Act is the same as that of the DBCPA – to support the independent efforts of the people to secure their old-age income and to increase the welfare of the population by combining the DC pension plans and the existing public pension system. In addition, the provision stresses "self-responsibility" and "independent efforts", which indicate that the guiding principle in the DC pension plans is individualism.

#### 4.5.4.1. Types of DC pension plans

As with the DB corporate pension plans, the DC corporate pension plans can also be divided into two categories, based on the role of the employer. In the first category, the so-called corporate type, the employer adopts the bylaws of the pension plan, while the other category – the individual type, is open to all individuals, including housewives and self-employed. In addition, after an amendment in 2016, the coverage of the DC plans was further expanded. Now employees can be covered in both corporate type DC pension plan or DB pension plan, and individual-type (also called iDeCo) at the same time.[377] The only limitation is when the corporate-type DC pension plan agreement excludes such an option.

#### 4.5.4.2. The DC corporate pension plans

Similarly to the DB pension plans, the DC corporate pension plans are established by an agreement between the employer and the majority of the employees covered by the Employees' Pension Plan.[378] This agreement represents the bylaws of the pension plan, and its basic contents are regulated by the DCPA. For example, it has to contain provisions regarding the conditions for coverage of the employees, the amount of the contributions, the Operations Management Institution (OMI), the

[377] Ministry of Health, Labor and Welfare, "The Reforms in the DC Pension System (Effective from January 1, 2016) [確定拠出年金制度の主な改正（平成 29 年 1 月 1 日施行）]," accessed November 23, 2019, https://www.mhlw.go.jp/stf/seisakunitsuite/bunya/kaisei.html.
[378] Art. 3, Para. 1 DCPA

management of the contributions, the amount of the administrative costs of the pension and others. The pension plan bylaws are also subject to approval by the Minister of Health, Labor and Welfare.

The operation of the DC corporate pension plan involves two important activities – asset management and administration. Art.8, Para. 1 DCPA requires the employer to conclude a contract for asset management with an asset management institution (AMI). In most cases, asset management is carried by a trust bank or a life insurance company. The next critical activity in the DC corporate pension plans is the administration of the plan. This includes keeping records of the personal data of the covered individuals, consolidating the investment orders, sending notifications, and making decisions about eligibility for pension benefits.[379] Unlike asset management, the employer has no duty to conclude a contract with a third party to carry out this activity.[380] In case the employer concludes such a contract, this third party is called Operations management institution (OMI) of a DC pension plan (*kakuteikyoshutsunenkin-uneikanrikikan*).[381] For brevity, in the present research, it will be referred to as Operations management institution (OMI).

As a result, the DC corporate pension plan operates in the following way. The employer transfers the contributions according to the pension plan agreement to the AMI. The OMI offers investment options to the covered individuals. They select the investment option that best fits their preferences and send their investment orders. The OMI then consolidates the investment orders and sends them to the asset management institution.[382] The AMI performs the actual investment activity, investing in assets like stocks, bonds, postal savings, and life insurance companies.

#### 4.5.4.3. The DC individual type pension plan.

The DC individual type pension plan operates similarly to the DC corporate type, but with several important differences. In the DC individual corporate pension plan, the employer plays a very limited role. Instead, the individuals that would like to be covered by a DC individual type pension

[379] Art. 2, Para. 7, item 1, letters a to c. DCPA
[380] Art. 7 Para. 1 DCPA.
[381] Art. 3, Para. 3, item 4 DCPA.
[382] Kasagi Eri (笠木 映里) et al., *Social Security Law [社会保障法]*, 85.

plan have to conclude a contract with the National Pension Fund Association (NPFA). NPFA is a public legal entity and it is the only legal entity permitted to conclude contracts for DC individual type pension plans.[383] Unlike the employer in the DC corporate pension plan, who may carry out the operations management on its own, NPFA is obliged to conclude a contract with an OMI.[384]

The operation of the DC individual type pension plans is also similar to the operation of the DC corporate pension plans. The most significant difference is that asset management is carried out by the NPFA.

#### 4.5.4.4. The duty of loyalty in the Japanese DC pension plans

As with the DB pension plans, the protection of the interests of the individuals covered by a Japanese DC pension plan is based on the same duties of loyalty and care. However, there are some important differences.

The main provision concerning the duty of loyalty of the employer is Art. 43, Para. 1 DCPA, which states, “the employer has to perform its duties in compliance with the law, the administrative acts of the Minister of Health, Labor and Welfare, issued in accordance with the law, and the corporate pension plan bylaws, and loyally to the interests of the members in the plan.” Furthermore, Para. 3, item 1 and Para. 4, item 1 of the same article state that the employer, when performing its obligations, may not act with the purpose to obtain a benefit for itself or a party other than the participants in the corporate pension plan.[385]

The duty of loyalty of the OMI is regulated in a similar manner to that of the employer. According to Art. 99, Para. 1 of the DCPA: “the Operations management institution has to perform its duties in compliance with the law, the administrative acts of the Minister of Health, Labor and Welfare, issued in accordance with the law, and the management contract, and loyally protect the interests of the participants in the plan”. Article 100 also prohibits several acts that may be considered a breach of

[383] Art. 2, Para. 5 DCPA.
[384] Art. 60, Para. 1 DCPA.
[385] Bakalov, “The Agency Problem In The Bulgarian Private Pension Insurance System” Lessons For Bulgaria From Japan,” 35.

the duty of loyalty. For example, item four prohibits the Operations management institution from intentionally concealing facts or state untrue facts about important aspects of its duty in order to influence the other party to sign a contract or to refrain from terminating a contract. According to item five, the Operations management institution cannot offer special investment products for the purpose of obtaining gain for itself or a third party.[386]

#### 4.5.4.5. The duty of care in the Japanese DC pension plans

In the DC pension plans, the investment orders come from the covered individuals, and as a result, they have to bear the eventual financial losses. There is no direct liability for the employer for financial losses.[387] The duty of care of the employer in the DC corporate pension plans is limited to creating a structure that will allow the individuals to carry out self-responsible investments. For that purpose the employer has a duty to select an OMI and AMI with due care after taking into consideration their performance and fees, and if needed to rescind the management contract and to conclude a contract with another OMI or AMI. In addition, following the 2016 amendments, the employer also has to continuously provide materials about the basics of asset management and the other necessary activities.[388] These other activities are also called "financial education" of the employees.

Section 3, Para. 3 of the Notice on Interpretation of DCPA, describes in detail the topics that this education has to cover such as information about the DC pension system, structure, and types of financial products, the structure of the financial system, and the relationship between risk and return.[389]

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[386] Bakalov, 36.
[387] Hideyuki Morito (森戸英幸), 企業年金の法と政策 [Corporate Pensions, Law, Policy], Shohan (Tokyo: Yhikaku, 2003), 143.
[388] Art. 22, Para. 1 DCPA.
[389] Minister of Health, Labor and Welfare, "Notice in the Interpretation of the DBCPA [確定拠出年金法並びにこれに基づく政令及び省令について（法令解釈）（平成 13 年 8 月 21 日年発第 213 号）]," accessed November 23, 2019, https://www.mhlw.go.jp/file/06-Seisakujouhou-12500000-Nenkinkyoku/0000192435.pdf.

In practice, this education is usually assigned to the OMI because most employers, especially smaller ones, do not have human resources divisions capable of providing education on such complex matters.[390]

#### 4.5.5.6. The issues in the Japanese corporate pension plans

The crucial question about the Japanese private pension plans is how efficient protection they can provide. From this perspective, the Japanese corporate pensions system achieved only limited success. The number of individuals covered by corporate pension plans increased until 1995 when it reached its peak of around 23 million people. After that, it started to decline gradually, and in 2018 the number of individuals covered by a corporate pension plan decreased to around 16 and a half million people. The long period of economic decline also had a detrimental effect on the willingness of employers to offer corporate pension plans. In 1993 the percentage of companies offering a corporate pension plan or a lump-sum payment upon retirement decreased from 92% to 80%.[391] In addition, the employers show a preference for the DC pension plans to the DB pension plans – in 2001, when the DC corporate pension plans were introduced, all corporate pension plans were DB type, while in 2018 the DC type plans make up for 40% of all corporate pension plans.[392] At the same time, the DB pension plans experience decline. According to the statistics of the Minister of Health Labor and Welfare, the number of DB pension plan reached its peak of about 15 000 plans in 2011. Since then, the number of DB pension plans is slowly going down.[393]

The impact of the Japanese corporate pensions is not high either. In 2018 the average income of the households of elderly people (those aged above 65) was JPY 3 349 000 of which 61% were coming from public pensions, while the share of the corporate pensions was no more than 5%.[394]

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[390] Bakalov, "The Agency Problem In The Bulgarian Private Pension Insurance System" Lessons For Bulgaria From Japan," 40.
[391] Usuki Masaharu (臼杵政治), "The Issues and the Future of the Corporate Pensions System [企業年金制度の課題と将来]," *Social Security Weekly [週刊社会保障]* 3034 (2019): 142–45.
[392] Usuki Masaharu (臼杵政治).
[393] "2018 White Paper of the Ministry of Health Labor and Welfare, Data Section, Chapter 11, Pension System [平成 30 年版厚生労働白書、資料編、第 11 章]," 248, accessed December 22, 2019, https://www.mhlw.go.jp/wp/hakusyo/kousei/18-2/dl/11.pdf.
[394] Usuki Masaharu (臼杵政治).

Prof. Usuki sees the problems in the Japanese corporate pension plans in several areas. First, the employers are reluctant to offer DB corporate pension plans, because they bear the risk entirely. Second, the requirements regarding the investment and the administration of the corporate pension plans (especially the DB type) are so complex that they act as a deterrent for the employers to offer such plans. Finally, the tax treatment of the different types of pension plans is not uniform: the contributions and the pension benefits from the DC pension plans are exempt only to a certain amount, while there is no such amount for the DB corporate pension plans. In addition, the individual DC pension plan remains the only tax-exempt option for the employees that are not covered by a corporate DB or DC pension plan.

The tax issue could be solved relatively easy by legislative amendments, but the first two issue reveals that the inherent problems of the private pension plans also exist in Japan. The purpose of the pension insurance is to transfer the risks related to old age to an entity that can bear them more easily compared to the individuals. In the DB corporate pension plans, these risks are transferred to the employer and can become a serious financial liability. The shift to DC corporate pension plans shows that many employers try to avoid this financial liability, which means that they are unable to provide the old-age security of their employees. Even the employees covered by a DB pension plan cannot have risk-free expectations

The issue of the complex requirements for management and administration is a manifestation of the principal-agent problem. Relaxing these requirements will come at the cost of a higher number of misappropriations by unscrupulous employers. In this regard, the Japanese corporate pension plans suffer from the same problems as the private pension.

In conclusion, the Japanese corporate pension system also serves a good example of the main disadvantages of the privatization of the pension system – limited coverage and low pension benefits.

#### 4.5.5.7. The Japanese corporate pension plans compared to the public pension plans.

In comparison with the public pension plans, the Japanese corporate pensions do not offer any advantages. The individuals covered in the public pension plans are exposed to risks related to the aging society and the activation of the macro-slide mechanism, but similar risks exist in the private pensions as well. For example, the employees covered in a DB corporate pension plans run the risk of the employer unilaterally imposing cuts on their pension benefits. In the contractual DB pension plans the permission of the Minister of Health, Labor and Welfare is needed, while in the fund-type DB pension plan only approval is enough.[395] The cut in the pension benefits is possible when two conditions – one material, and one procedural are met.[396] The material condition is when the decrease in the pension benefit is inevitable because the employer experiences difficulties due to a dire economic situation, or to a considerable increase in the amount of the contributions. The procedural condition is that more than two-thirds of the covered employees agree to the reduction and measures to preserve the minimum accumulated benefit before the reduction took effect.[397]

In the DC pension plans, the mere nature of the plan exposes the covered individuals to a reduction of their benefits (or savings) caused by a depreciation of the assets in which they have invested due to market fluctuations.

As a result, the coverage in the corporate pension plan in Japan does not guarantee income security. Furthermore, the coverage in a private pension often comes at a price. As mentioned above, in the DB pension plans the employees pay for their pensions with missed career opportunities with other employers.

The conclusions made above naturally explain the structure of the Japanese pension system. Unlike the Bulgarian one, in which the private pensions are designed to supplant a portion of the public pension plan, the Japanese corporate pensions are designed to "contribute to the increase of the welfare." The Japanese solution to the problem of the aging population is not privatization, which would effectively transform the system fundamentally, but a macro-slide mechanism, which is designed to prevent the burden of the pension obligations to spiral out of control. The advantage of this mechanism is that it is designed to operate automatically as a function of objective macroeconomic indicators. However, the public pension system usually has a very strong political dimension, due to

395 Art. 6, Para. 1 and Art 16, Para. 1 DBCPA
396 Kasagi Eri (笠木 映里) et al., *Social Security Law [社会保障法]*, 88.
397 Kasagi Eri (笠木 映里) et al., 88.

its wealth redistributing character, and often suffers from undue political influence with short-term goals.

## Chapter V: Analysis of the results

The multifaceted character of the pension system makes giving objective recommendations for improvement a particularly difficult task. The pension system is closely connected to the labor market, the demographic situation and the economy of the country. Any changes in these connected variables will have also an impact on the pension system.

The present research, however, is focused on the legal aspects of the pension system. Therefore it will not discuss proposals that fall outside the legal framework of the pension system. Such proposals would be measures to improve the demographic situation or to increase the retirement age.

### 5.1. The nature of the pension system

The first important conclusion from the present research concerns the nature of the pension system and its role in society. This conclusion is important because it forms the basis for recommendations.

The most appropriate way to look at the pension system is as a form of insurance against the risks associated with old age, and not as an instrument for saving. The historical evolution of the pension systems shows that they have been established to meet the needs of old age industrial workers for income security at an age at which they are no longer capable to provide for themselves. Being old and without a source of income was the risk that the pension system has to provide insurance for. This determines the basic nature of the public pension plans – they are a form of insurance. This conclusion, however, is not unanimous. There are two arguments against it. First, there is no income test as a condition of eligibility for old-age pension. Second, one of the conditions for eligibility is reaching a specified age, not the materialization of insurance risk. These two viewpoints lead to controversy in Japan about the nature of the pension benefits.[398] They may be regarded as an insurance payout, or as an earned right. The earned right view, however, is based on a rather textual interpretation of the law, and cannot give answers to two important practical questions. First, why is this right necessary at all?

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[398] Kasagi Eri (笠木 映里) et al., 127.

Second, why is reaching the age of 65 a condition for earning this right, and not just a specified history of paid contributions?

This controversy could be resolved if the pension system is considered a type of insurance in which it is presumed that the risk of the individuals becoming unable to continue working is materialized at the age specified in the law. Adding this presumption helps to explain why simply reaching the retirement age can be sufficient for eligibility.[399] Different people will become unable to work at different ages depending on factors like occupation, health habits, and others. Determining the exact moment this condition has materialized can be a difficult, costly, and time-consuming process. If the procedure for disability benefits is used as a yardstick, the available data shows that in the US, for example, the claimants whose applications for SSDI benefits have been denied at the first two levels of adjudication have to wait for hearing between 7 and 22 months.[400] For the old-age benefits, this problem is avoided by presuming that the risk of the individuals becoming unable to work has materialized at the age provided for by the law.

However, this is a presumption and it can be refuted by the mere fact that the individual continues working. In such cases, as in Japan, because of the insurance nature of the pension system the cuts or the suspension of the pension benefits are appropriate.

The view that a pension system has to be looked at as a form of insurance is needed to explain the other lessons from the present research.

### 5.2. The inherent disadvantages of the private pension plans make them suboptimal approach to sustainability

The experience of Bulgaria and the US shows that the privatization approach to the pension system is not a better alternative to the state-run pension plans. It can relieve to some extent the financial burden of the pension system to the public finances, but at a high price. The reason is that the public pension system and the private one work under completely different principles. The first

[399] The other conditions for retirement are considered fulfilled.
[400] "Average Wait Time Until Hearing Held Report | Public Data Files," accessed October 10, 2019, https://www.ssa.gov/appeals/DataSets/01_NetStat_Report.html.

one is the biggest insurance plan in a country, redistributing wealth in accordance with the socially accepted ideas of solidarity and social justice. The second one is a savings instrument, based on individual accounts, which excludes the redistribution of wealth. The guiding principle of the private pension plans is the maximization of profit, and not maximizing social welfare. Of course one could argue that maximizing private profits is the best way to maximize social welfare. However, the problems in the Bulgarian private pension pillars prove that this is simply not true. In the case where the interest of the investment company is opposite to that of the covered individuals, there is no reason to believe that the management body will prefer the interest of the covered individuals to that of its shareholders. In Japan, the DB and the DC corporate pension plans are established by agreement between employer and employees, and the employer will only agree if he or she expects some kind of consideration in return.

Another reason why the privatization approach is failing is the scope of employees' coverage it can provide. As mentioned, the first public pension plans were established to provide security to the low-income workers that they would not end in the poorhouse. This means that the first and the foremost target group of the pension system are the low-income workers, which by definition are not able to save enough for their old age. The result of privatization is that the principle on which the pension system operates also changes – from insurance to savings. The inevitable result of this change will be that the low-income workers, who rarely have anything left to save, will fall out of the coverage of the pension system. Clear proof for this conclusion comes from the US where, as mentioned above, only 51% of the Americans participate in a private pension plan. In addition, the low-income workers, who need pension most, have the least access to pension plans. The basic idea behind pension insurance becomes completely misapplied.

However, this is not the complete picture, even the individuals who can save in a DC pension plan face a serious challenge. At the beginning of their employment careers, it is practically impossible for the individuals to calculate with any degree of certainty how much they need to save for old age. The example of the US shows that the replacement ratio depends very much on the investment performance of the accumulated funds, and on the moment of retirement. In addition, it is possible that some people will eventually make bad investment decisions – investing too riskily or too conservatively. On the other hand, the amount of the pension benefit from an insurance-type pension plan (public or private) can be much more easily calculated using the respective formula.

The investment aspect of the savings approach presents another set of problems. Like the US, Japanese and Bulgarian experience shows, it is very hard to design a private pensions system that effectively protects the interests of the covered individuals and prevents abuses like self-dealing. The answer to this problem in the US was the concept of trust, which, as it was explained above, was developed for other purposes, and is not suitable for this kind of relationship, because it created too much uncertainty. This uncertainty is a cost for introducing such kind of system, and it should be taken into consideration when evaluating the advantages and disadvantages of public insurance against private savings approaches. The Bulgarian approach was at the other extreme – a detailed set of regulations about investment limits and forbidden transactions. This is not a perfect solution either since the more complex and detailed the regulations become, the easier it is to find a loophole in them.

The high management and investment fees are other problems of the privatized pensions because they can significantly erode the balance on the account. The example about the U.S. 401k plans shows that one percentage point difference in fees can lead to a 28% difference in the account. This problem is even further exacerbated in Bulgaria, where the market of private pension is monopolistic, and the fees reach a 3.75% investment fee on each contribution plus 0.75% on the balance of the account.

### 5.3.Recommendations for reforms in Bulgaria

#### 5.3.1 Restoring the full extent of the public pension plan and introducing a mechanism for a long-term financial sustainability

For Bulgaria, the result of these disadvantages of the privatized pensions can be summarized as “two pensions may well make less than one.” The individuals that under the effective legislation will receive two pensions, may well receive less than the individuals who will receive a pension only from the public pension plan. Therefore, the first recommendation of the present research would be

Bulgaria to restore the public pension plan to its full extent. This would not necessarily mean the abolition of the private pensions and could continue to exist, but as a private and voluntary savings mechanism, as in Japan. This would create a competitive environment for the companies offering private pension plans

Of course, restoring the public pension plan would bring back the problem of financial sustainability. In this regard, the Japanese macroeconomic slide mechanism can serve as an example of how to ensure long-term financial sustainability. However, the data in Chapter IV shows that the macroeconomic slide mechanism can press down the income of many retirees to the poverty level. Therefore, only the introduction of such a mechanism in Bulgaria is unlikely to bring significant improvement, unless it is combined with other reforms that can exploit the internal reserves of the public pension plan.

### 5.3.2. Reforming the early retirement

One of the areas in which the Bulgarian public pension plan possesses internal reserves for reforms is the early retirement. As mentioned above, the Bulgarian public pension plan also has a serious problem of fragmented eligibility rules, which allow specific categories of employees to become eligible much earlier than the rest of the population. As explained, the rationale is to make these professions more attractive, without the need to offer high wages. This approach could work in a communist state in which the state is the only employer, who also collects contributions and pays pension benefits. In such a social organization, the product of the labor benefits the whole society and the burden of the retiring workers is also for the whole society. However, this rationale collapses in a market economy based on private ownership. The product of the labor of these categories now becomes a source of private profit, while the burden of the early retired workers remains for society. In other words – the profits are privatized while the costs are nationalized.

On the other side, the U.S. and Japan serve good examples of functioning labor market and public pension plans without such preferential regulations. Therefore, the second proposal for amendment of the Bulgarian pension system in this regard would be to unify the eligibility regime, without discrimination, based on occupation. This probably would not be enough to completely restore the balance in the pension system, but it will definitely be a step in the right direction.

Another area in which reforms could have a positive effect on the financial sustainability of the pension system is the benefits of the working retirees. In this area Japan has taken the correct approach to decrease the pension benefits of the working retirees. The reason why this approach is correct comes from the insurance nature of the public pension plan. The pension benefits are compensation for a risk (inability to get employment due to old age) that has occurred. The fact that an individual is employed after retirement shows that this risk has not yet occurred, and this should be reflected in the amount of the pension benefits this individual receives. A situation in which employed retirees continue to receive pension benefits in full amount is not much different than a situation in which healthy individuals receive disability benefits. If the insurance principle of the old age income security is disregarded, then the question about the nature of the pension benefits remains unanswered. The only remaining answer will be the theory that the pension benefits are a form of government generosity and reward for meeting a set of conditions put forward by Prof. Reich in 1964. However, such an understanding of the nature of the pension benefits is a step backward, and since it gives wide discretionary powers to the government to set eligibility conditions, it can dangerously undermine essential human rights and freedoms.[401]

Of course, in many cases retirees continue working because their pension benefits are too low, and they try to maintain their standards of living. Therefore, as in Japan, the percentage, by which the pension benefits of the employed retirees are decreased, has to depend on their employment income.

A possible argument against this proposal could be that the law does not require the inability to get employment as a condition to receive old-age pension benefits. The abolishment of income-test and means-test is an important character of a social insurance, including pension insurance. To decrease the amount of the old-age pension benefits considering the pensioners' income would be against this basic character of social insurance.

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[401] The case of *Flemming v. Nestor* discussed in Chapter III, Section 3.2.1., is a classic example of such dangers.

It is true that the law does not require, at least explicitly, the inability to get employment as a condition for eligibility. However, the reason behind the age requirement for eligibility cannot remain unexplained. If there is no explanation behind this requirement, then it becomes completely arbitrary. In this case, theoretically, anything could become a condition for eligibility.

The author considers that the reason for the adoption of old age condition and not the inability to find employment is the burden of proof. If the law explicitly stated inability to get employment due to old age as a condition for eligibility, this would mean that the individual will have to prove two things: first, that he or she is unable to find employment, and second that there is a cause-effect relationship between this inability and old age. For many people this burden of proof will be impossible to overcome. This problem is solved by the presumption that reaching retirement age leads to an inability to find employment.

Regarding the means test, the author considers that to decrease the amount of the pension benefits to the employed retirees does not constitute a means test for the following reason. The means test is an element of the public assistance programs, whose purpose is to set the income and property level under which an individual becomes eligible for public assistance benefits. This eligibility is not conditioned on previously paid contributions, it is based on the current living standards of the respective individual. If they improve, he or she may lose the right to public assistance. On the other hand, in the pension system the eligibility is based on previously paid contributions and the reason why the pension benefits of the working retirees need to be decreased is the fact that the social risk, that they have paid contributions for, has not materialized. The eligibility for pension benefits It is worth pointing out that the individuals receiving public assistance. From law and economics perspective it could be argued that the gradual decrease of the pension benefits of the working employees depending on their combined income is necessary not as a means test, but because the complete suspension of the pension benefits will discourage many retirees to seek employment at all. The reason is that from the perspective of the retirees their net salary will be not the amount that they receive from their employer, but only the difference between their suspended pension benefit and their salary. For example, if a retiree receives pension benefits of JPY 200,000 per month, and finds a job for JPY 230,000, taking this job will mean that he or she will have to work one month for just JPY 30 000 (the difference between the suspended pension and the salary).

Naturally, the solutions proposed above will inevitably cause serious opposition and will become a political issue. This illustrates the next serious problem, which is common in all three compared countries – excessive political influence in the pension system.

### 5.3.3. Decreasing the political influence on the pension system

In addition to being a form of insurance policy, the public pension plan is also an instrument for income redistribution, and naturally, any income redistribution can become an important political issue. The political decisions are seldom stable – they are often reversed or modified by the following government. On the other hand, the public pension system operates in the long term, and the stability of the rules is essential for lifelong planning. As the historical experiences of Bulgaria, U.S. and Japan show, their pension systems are much more a product of political compromise than a careful designs on solid theoretical foundations.

Therefore, the last recommendation of the present research would be the transformation of the Bulgarian Social Security Institute into an independent pension regulatory body, with powers to apply macroeconomic indexation, set the rate of contributions, amount of benefits, and determine retirement age, based on actuarial calculations and models for long-term sustainability. A possible objection to such a proposal could be that it would involve the delegation of important government powers, including the power to redistribute income. This may be true, and such an institution will definitely be a novelty, but it is not something exceptional. In fact, any advanced country has a similar institution, called National Bank, that independently (at least in theory) manages the money supply and the interest rate, depending on the macroeconomic conditions. And, the social impact of the power to set the interest rate is just as considerable as the power to set the contributions rate in the pension insurance or the retirement age. Currently, in Bulgaria, the National Social Security Institute may only implement the policy of the government and set the lower limit of the pension benefits for old age and length of service and the amount of the welfare pension benefit for old age. Providing more powers and independence to the National Social Security Institute would have the advantage that it would be able to implement a long-term policy for sustainability based on measurable indicators like replacement ratio. From this perspective, the Japanese practice of making projections for decades to come is to be recommended.

The long-term course, without short-term political influence, would allow the individuals to better plan for their retirement, and increase their confidence in the public pension insurance plan. The trust in the way it functions is just as important as its financial sustainability.

Another argument for more politically neutral regulation of the pension system comes from the *Felemming v. Nestor* case which shows that the pension benefits can become an instrument for political control.

## Conclusion

The present research focused on a specific problem in the search of sustainability – privatization of the pension system. Bulgaria chose this path in 2001, and until now the private pension has not met the set high expectations. The present research showed that privatization involves problems, which are not specific to Bulgaria, but are inherent in any private pensions system.

The first of these problems is the principal-agent problem. As mentioned in the section concerning the constitutionality of privatization of the pension system in Japan, a private agent will first attempt to maximize its profits and any increase in the old-age security will come only as a byproduct of this profit maximization. Minimizing the effects of the principal-agent problem would require a complex legal framework like ERISA, and abstractly formulated rules that could protect the interest of the covered individuals in various situations. This approach however is costly – the uncertainty regarding the specific dimensions of the duties of loyalty and care imposes high costs on the fiduciaries (employers or plan settlors). These costs are not negligible – they could increase to prohibitive levels and the effectively limit the scope of the covered individuals.

An additional problem with the private pension plans is the uncertainty of the outcome. It is practically impossible to calculate several decades in advance how much an individual would need for living and how much he or she needs to save in order to accumulate enough funds for the retirement lifestyle he or she would like to enjoy in his or her later years.

This problem is closely connected with the next one – the savings are not risk-free, but are exposed to some serious risks. The most important of them is the market risk, which is the risk of depreciation of the assets in which the retirement savings have been invested. The example of the US shows that people with comparable income and employment history, the replacement ratio of their retirement benefits may vary considerably due to market fluctuations.

The most important reason why a private pension system cannot replace the public one is that they function based on a different principle – the private pension system is savings-based, while the public pension plans are usually insurance-based. The implication of this different operation is that in the public pension system, there is a transfer of income from high-income individuals to low-income individuals. This income redistribution allows the public pension systems to provide old-age income security to individuals who cannot save sufficiently for old age. On the other hand, with the savings approach there is no income redistribution, which will automatically deny old-age income security to the people whose income is so low, that they cannot save.

The US experience confirms this conclusion. Social Security was born out of a political compromise, and its benefits were never designed to provide comprehensive old-age income security. As a result, private pensions have become increasingly important. However, they also fail to provide old-age income security to the most vulnerable groups. Due to the problems described above the coverage ratio for low-income individuals is modest at best.

On the other hand, the pension benefits in the US enjoy strong property-right protection under the Fifth Amendment. However, this high level of protection is a result of a long evolution in which Congress initially attempted to tie the pension benefits to political loyalty, and only after strong criticism the US Supreme Court reversed its position and extended the property right protection to the pension benefits.

On the other side is Japan where Art. 25, Para. 2 of the Constitution may be used as an argument to prevent the privatization. In Japan the private pensions were never intended to replace the public pensions, even partially. Their purpose is to provide additional benefit on top of the pension benefit coming from the public pension plans. The mechanism that Japan adopted to bring sustainability to its public pension plan is called “macroeconomic slide”, which adjusts the pension benefits to the demographic conditions and the price and wage levels. The result is that despite the rapidly aging population, the Japanese pension system will be able to provide a replacement rate of around 50%. However, this does not mean that the Japanese pension is problem-free either. The problems of poverty risk for the elderly and insufficient coverage are also present in Japan.

In addition, unlike the US Supreme Court, the Japanese Supreme Court recognizes wide discretionary powers of the government to implement practical measures in the pension system, including decreasing the level of the pension benefits. The judicial review is limited only to the cases of manifest abuse or deviation.

The lesson is that Bulgaria needs to reevaluate its pension system and to change its approach for achieving sustainability of the pension system. The recommendation of the present research is that the public pension plan be restored to its full extent, and the current private pension plans be transformed into voluntary pension plans as in Japan. The sources of sustainability should be sought elsewhere, and especially in unifying the eligibility conditions, and reforming the rules for early retirement. In addition, Bulgaria needs to adopt measures that would increase the confidence in the pension system and its resilience to short-term political decisions. This has been identified as a problem common to all three countries.

Finally, the author of the present research is aware that the conclusions he has made are by no means a complete solution to the problems in the contemporary pension systems. Instead, he hopes that they may become points of discussion in the academic debate which is currently focused on the financial aspects of the pension systems. In the author's opinion, no matter how important the financial issues may become, they should not mask the fundamental question "What is the nature of the pension system?" and "Why does a society need a pension system?"

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