Managing Pension and Healthcare Costs in Rapidly Ageing Depopulating Countries: The Case of Japan

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1. Introduction[1]

In the past, families and occupational schemes on a private basis were the major old-age safety net in Japan. The principal social security pension program was introduced during the World War II. It had developed gradually under the period of high-speed economic growth. Its development looked like a dividend from economic growth. An enormous shift of the population from farmers to salaried-men took place during the rapid growth period, along with longer life expectancy. The household size has become smaller and smaller on average. The rise and the fall of private enterprises have been very common in this period. These factors forced a major source of old-age income to shift from families and occupational schemes to social security pension programs.

The future demographic and economic situations of Japan will make the current, generous social security pensions hard to maintain, however. It is still an open question whether or not Japan will manage to contain the increasing social security pension cost, while assuring its people stable lives over the whole life-cycle.

Social security healthcare programs in Japan are becoming very similar to those for pensions, since their basic feature is income transfers from younger and middle-aged to older people.

This paper first explains changes in Japan's social security pension programs. Second, it discusses future pension policy options in Japan. Third, it addresses healthcare issues. The final section concludes this paper.

2. Changes in Japan's Social Security Pension Program

Japan had six social security pension programs covering different sectors of the

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population. The earliest plan was established in 1890; the most recent, in 1961. The earliest plan was for military servants, which asked no individual contributions. It was totally financed by general revenue. The scheme was then expanded to civil servants. The old-age benefit for military and civil servants was based on the final salary and its benefit level was generous from the outset.

The principal program mandatory for private sector employees is the Kosei-Nenekin-Hoken (KNH), which was enacted in the wartime in 1942. Old-age pensions of the KNH were forced to suspend immediately after the end of the war and the KNH contribution rate was reduced from 11% to 3%. The KNH was rebuilt in 1954 shifting from an earnings-related pension to a two-tier benefits system with flat-rate basic benefits.

2.1 High-speed Growth Period

The social security pension system was and is to be reformed at least every five years. In the early stages, the KNH benefit level was not charming yet, and for the old-age retirees at that time a lump-sum retirement benefit provided on a private basis by their employers was often of much more significance. On the other hand, pension benefits for civil servants were considerably higher. This difference induced "gap-decreasing" adjustments in benefit levels between private and public sector employees. Drastic improvements in the KNH old-age benefits were taken place in 1965 and in 1973; the replacement ratio in gross wage terms was increased to 40% and then to 60%. In 1973 the updating of past salary together with the benefit indexation enabled retired people to afford to manage in their old-age with the generous KNH benefits. In the meantime, there happened the sharp decline in the real significance of their lump-sum retirement benefits provided privately by their employers.

Under the KNH, equal percentage contributions are required of employees and their employers. The 3% contribution rate had been gradually increased and the total percentage went up to 7.8% in 1973.

At the outset, the KNH was established as a defined-benefit plan on a fully funded basis. It was initially regarded as a compulsory saving program to prevent inflation. Its finance shifted gradually from funded to pay-as-you-go. Currently the KNH has a reserve fund of about 128 trillion yen in March 2010. KNH contributions used to be accumulated in a reserve fund to be invested in social overhead capital for the construction of highways, railways, bridges, airports, and other public projects.

Before 1961 the self-employed, people engaged in agriculture/forestry/fishery, the unemployed, persons with no occupation, and employees working in small firms were still excluded in the social security pension system. The Kokumin-Nenkin (KN) Law was put into effect in April 1961, embracing all the people, previously uncovered, under social security. The participation in the KN has been compulsory for everyone (even for the jobless persons) between 20 and 59 years old.

The basic structure of the KN is a flat-rate basic benefit and a flat-rate contribution on an individual basis. One-third of the KN benefits were financed by subsidy through general revenue. The full old-age benefit of the KN was payable initially after 25 years of contributions from age 65, although an actuarially reduced or increased benefit could be claimed at any age between 60 and 70. The transitional KN old-age benefit with a special 10-year-contribution requirement began to be paid actually in 1971. A majority of the elderly came to enjoy receiving this special benefit, which contributed to making the public aware of a significant role of social security pensions in old-age income security. "Go and Go" policies were immediately adopted. The benefit formula of the KN had been revised to be more and more generous. Meanwhile automatic indexation of the KN benefit was also enforced in 1973.

2.2 Period of Diminished Expectations

The KN started with a very small contribution, which was politically difficult to increase. The KN soon faced severe difficulties in financing benefits. An enormous shift of the population from farmers to salaried-men during the rapid growth period obliged some revenue-sharing scheme between employees' and non-employees' pensions to be necessary. The scheme was established in 1986, and since then, the first-tier basic flat-rate benefits of all the pension systems have been financially integrated. Currently the flat-rate pension benefit is financed on a fully pay-as-you-go basis. The 1986 reform has changed some requirements of the KN; the full old-age pension is payable after 40 years of contributions, provided the contribution were made before 60 years of age. There have been introduced special transitional provisions for those born after 1926 with at least 25 years of coverage. They can receive the maximum pension even with fewer contribution years, provided they had been contributing since 1961.

It should be noted that those covered by the KNH (and the other employee pension systems) are not required to make individual contributions to the KN, while the KNH itself is responsible for the financial participation in the integrated first-tier, flat-rate basic pensions.

Since the 1986 reform, if the husband has the contribution deducted from his salary and placed in the KNH, his dependent wife has been automatically entitled in her own name to the flat-rate basic benefits, and she has not been required to make any individual payments to the public pension system. Through this, the women's right for pension has been comprehensively established.

The 1986 reform included another advance in the flat-rate disability pensions. A dependent child of age less than 20 got to be entitled to the flat-rate basic benefits in case of disability. Though the medical check was (and is) very strict, the handicapped children largely came to be supported by the social security pension system and not by the special welfare program.

Through the 1986 pension reform, the accrual rate for the earnings-related component of the KNH old-age benefits was to be reduced gradually from 1.0% per year to 0.75% cohort by cohort. The reductions corresponded to the longer average contribution years of the younger cohorts. On average, each cohort was expected to receive 30% of his career average monthly real earnings as the earnings-related component.

The future demographic situations of Japan were getting darker and darker; the total fertility rate (TFR) showed an unexpected sharp decline from 1975 and the current level in 2009 is 1.37. There is still little sign that the TFR will stabilize or return to a higher level. Japan's total population began to fall from 2005, reaching 45% of its current level by 2100. On the other hand, life expectancy was steadily increasing. Consequently, the proportion of the elderly (65 years and above) for Japan was 23.1% in 2010 and became the front runner in the world. It is expected to reach 30% by 2020 and more than 40% around 2050. In the 1990s, the Japanese economy changed dramatically, too, when the asset bubble finally burst. The colorful dreams that Japanese youth have placed in their economy would be likely to be destroyed.

Both demographic and economic factors in the future will probably impose greater stresses on social security pension programs which are based on pay-as-you-go defined-benefit financing. The biggest political issue in the Japanese pension system was when to start benefit payments. The pension age was 60 years for workers in the 1990s. The government had proposed twice in 1979 and 1989 to raise the eligibility age for all workers to 65. The proposal was turned down by the Parliament both times since trade unions and opposition parties were strongly against the bill.

In summer 1993, the political situation changed dramatically. The Liberal Democratic Party (LDP), which had been ruling Japan ever since the end of the Second World War, fell from power. It was replaced by a coalition of opposition parities (excluding the Japanese Communist Party). It was this coalition that prepared the 1994 legislation.

The approved legislation guaranteed that the tier-2 earnings-related benefits for retired employees between 60 and 64 will be paid without any reduction. The tier-1 basic benefits for this age group were to be phased out by stages (between 2001 and 2013 for men), and eventually nobody under 65 will receive full basic benefits (the phasing out of basic benefits for female employees will be delayed by five years starting only in 2006).

Up to October 1994, benefits were adjusted in line with the hikes in gross wages, but since 1994, they have been in net wages.

In December 1998, the government decided to increase existing pension benefits in fiscal year 1999 to reflect only changes in the CPI over the previous calendar year, though fiscal year 1999 was previously anticipated as seeing net-wage indexation of existing pension benefits after a five-year interval.

In July 1999, the government submitted the 1999 pension reform bill to the parliament and the bill was passed through it in March 2000. Its main points are as follows:

a) Earnings-related benefits are to be reduced by 5 per cent; specifically, the current annual accrual rate of 0.75 per cent is to be decreased to 0.7125 per cent from fiscal year 2000.
b) Both the flat-rate basic benefits and the earnings-related pension benefits once paid are to be CPI-indexed after age 65 from fiscal year 2000.
c) The normal pensionable age for earnings-related old-age benefits is to be increased step by step from age 60 to 65 for men from fiscal year 2013 to 2025. The phasing out of earnings-related old-age benefits for female employees in their early 60s will be delayed by five years starting only in 2018. In exchange, those between 60 and 64 will become eligible for newly provided advance payment, at a reduced rate, out of the earnings-related benefits. The rate of reduction will be 0.5 per cent by one month (6 percent by one year). If a person begins to receive the advance payment from age 60, his/her benefit level will be 70 per cent of the normal amount.
d) An earnings test for those aged 65 to 69 was to be introduced from fiscal year 2002 (currently Japan has no such test for them). Increases in earnings-related old-age benefits for delayed retirement between ages 65 and 69 are to be abolished accordingly.
e) Employers are to be exempted from paying their share of social security pension contributions for their employees on child-care leave from fiscal year 2000.
f) The monthly standard earnings base for social security pensions is upgraded to the 98,000 to 620,000 yen range from October 2000.

g) The benefit/contribution base is to be shifted from monthly standard earnings to annual earnings including semi-annual bonuses from fiscal year 2003. The shift is to be adjusted to induce no changes in aggregate income from contributions in 2003.
h) The rebates on contributions for contracted-out schemes are to be frozen from fiscal year 1999.
i) A 50 per cent reduced flat-rate contribution for the non-employees is to be newly introduced from fiscal year 2002. This is mainly for low-income groups. Their basic benefit will be two-thirds of the full amount. Students aged 20 and over are to be able to postpone paying in their flat-rate contributions for ten years at the most. They are, however, to be eligible for the full basic disability benefit during years of non-payment.

By these measures, aggregate pension benefits will be reduced by 20 per cent by 2025. As a result, the contribution rate for the KNH will peak by 2025 at 25.4 per cent, instead of 34.5 per cent anticipated without any reforms (the rate estimated on the basis of monthly standard earnings). The flat-rate monthly contributions for non-employee people will peak by 2021 at 18,500 yen (instead of 26,400 yen) at 1999 prices.

2.3 The 2004 Pension Reform

The administration of Prime Minister Koizumi Jun'ichirō submitted a set of pension reform bills to the National Diet on February 10, 2004, and they were enacted on June 5. This section will describe the gist of the approved reforms and explore issues that remain to be addressed.

Salaried workers are, as a rule, enrolled in the KNH, which is part of the public pension system. Contributions under this plan have since October 1996 been set at 13.58% of annual income, paid half by the worker and half by the employer, but the newly enacted reforms raise this rate by 0.354 percentage points every year starting in October 2004. The rate rises every September thereafter until 2017, after which it will remain fixed at 18.30%. The portion paid by workers will accordingly rise from the existing 6.79% of annual income to 9.15%.

For an "average" male company employee earning JPY360,000 a month plus annual bonuses equivalent to 3.6 months' pay, contributions will increase by nearly JPY20,000 a year starting this October 2004, and by the time they stop rising in September 2017, they will have reached just under JPY1.03 million a year, and the share paid by the worker will be just over JPY514,000. This comes to 35% more than the current level of contributions.

Those who are not enrolled in the KNH or another public pension scheme are required to participate in the KN, which provides just the so-called basic pension. (The basic pension also forms the first tier of benefits under the KNH and other public pension system.) Contributions under this plan will rise by JPY280 each April from the existing JPY13,300 per month until they plateau at JPY16,900 (at 2004 prices) in April 2017. The actual rise in KN contribution is adjusted according to increases in general wage levels.

In addition, the government increased its subsidies for the basic pension. One-third of the cost of basic pension benefits is paid from the national treasury; this share was to be raised in stages until it reaches one-half in 2009.

Lower Benefits Despite Higher Contributions

Benefits under the KNH consist of two tiers; the flat-rate basic pension, which is paid to all public pension plan participants, and a separate earnings-related component. The latter is calculated on the basis of the worker's average preretirement income, converted to current values. The index used to convert past income to current values was the rate of increase in take-home pay. Under the 2004 reform, though, this index was subject to a negative adjustment over the course of an "exceptional period" based on changes in two demographic factors, namely, the decline in the number of participants and the increase in life expectancy. This period of adjustment is expected to last through 2023.

The application of the first demographic factor means that benefit levels will be cut to reflect the fact that fewer people are supporting the pension system. The actual number of people enrolled in all public pension schemes was ascertained each year, and the rate of decline would be calculated based on this figure. The average annual decline is projected to be around 0.6 percentage points.

Introducing the second demographic factor, meanwhile, will adjust for the fact that people are living longer and thus collecting their pensions for more years; the aim is to slow the pace of increase in the total amount of benefits paid as a result of increased longevity. This factor will not be calculated by tracking future movements in life expectancy; instead, it has been set at an annual rate of about 0.3 percentage points on the basis of current demographic projections for the period through 2025. Together, the two demographic factors are thus expected to mean a negative adjustment of about 0.9 points a year on average during the period in question.

How will these changes affect people's benefits in concrete terms? Let us consider the case of a pair of "model" KNH beneficiaries as defined by the Ministry of Health, Labor, and Welfare: a 65-year-old man who earned the average wage throughout his

40-year career and his 65-year-old wife who was a full-time homemaker for 40 years from her twentieth birthday. In fiscal 2004 (April 2004 to March 2005), this model couple would receive JPY233,000 a month.

How does this amount compare to what employees are currently taking home? The average monthly income of a salaried worker in 2004 is projected to be around JPY360,000, before taxes and social insurance deductions. Assuming that this is supplemented by bonuses totaling an equivalent of 3.6 months' pay, the average annual income is roughly JPY5.6 million. Deducting 16% of this figure for taxes and social insurance contributions leaves a figure for annual take-home pay of about JPY4.7 million, or JPY393,000 a month.

The JPY233,000 provided to the model pensioners is 59.3% of JPY393,000. But this percentage, which pension specialists call the "income replacement ratio," will gradually decline to an estimated figure of 50.2% as of fiscal 2023 (assuming that consumer prices and nominal wages rise according to government projections by 1% and 2.1% a year, respectively). Over the next two decades, then, benefit levels will decline by roughly 15% by comparison with wage levels.

The revised pension legislation stipulates that the income replacement ratio is not to fall below 50% for the model case described above, and so the exceptional period of negative adjustment will come to an end once the ratio declines to 50%. This provision was included to alleviate fears that benefits would continue to shrink without limit.

How would the reforms affect those who are already receiving their pensions? Until then, benefits for those 65 years old and over were adjusted for fluctuations in the consumer price index. This ensured that pensioners' real purchasing power remained unchanged and helped ease postretirement worries. But this cost-of-living link would effectively be severed during the exceptional period, since the application of the demographic factors would pull down real benefits by around 0.9 points a year. In principle, however, nominal benefits are not to be cut unless there has also been a drop in consumer prices.[2] Once the exceptional period is over, the link to the consumer price index is to be restored.

Provisions for Working Seniors and Divorcees

People aged 60-64 who were receiving pensions and also had wage income, had their benefits reduced by a flat 20%, regardless of how much or little they earned. This rule was abolished so as not to discourage older people from working. But these people still are subject to the existing rule that if the sum of wages and pension benefits exceeds JPY280,000 a month (after factoring in annual bonuses), the pension benefits are to be cut by 50% of the amount in excess of this level.

Workers aged 70 and over, meanwhile, have been exempt from paying into the KNH, even if they are still on a company's payroll. And they had not their benefits reduced no matter how much they earned. Beginning in April 2007, though, their benefits were reduced if they were high-income earners. Those receiving more than an equivalent of JPY480,000 a month in wages and pension benefits will have their benefits cut by 50% of the amount in excess of this level. This is a rule that currently applies to those aged 65 to 69, and it will be maintained for this age group. The over-70 group will still be entitled to the full amount of the basic pension, and they will continue to be exempt from paying contributions.

Divorced wives were not legally entitled to any portion of their former husbands' earnings-related pension benefits, but this changed under the revised legislation. Couples who divorce after April 2007 are able to split the rights to the earnings-related portion of the husband's pension that accrued during their marriage. The wife is able to receive a share of up to 50% of these rights; the actual share is to be determined by agreement between the two. For rights accruing after April 2008, moreover, a full-time homemaker is able to automatically receive half of her husband's benefits in case of divorce by filing a claim at a social insurance office. Underlying this rule is the assumption that even though the contributions are paid in the husband's name, the wife has provided half of the couple's livelihood through her work as a homemaker. (Note that the provisions for working husbands and dependent homemaker wives apply conversely in cases where a home-maker husband is dependent on the wife.)

Widowed spouses younger than 30 and without children under the age of 18 had been entitled to lifelong benefits under the survivor's pension scheme (based on the earnings of the deceased spouse). After April 2007, however, they receive benefits for no longer than five years.

Workers taking child-care leave are exempt from making pension contributions, and to prevent a decrease in their future benefits due to this period of nonpayment, they are treated as having continued their full payments, even when they have no income. This special exemption was claimed for up to one year after childbirth, but starting in April 2005 the period was extended until the child reaches age three.

Also from April 2005, parents who change their working arrangements to put in shorter hours so as to care for children under age three and who take a corresponding cut in pay are treated as having worked full time and earned a full salary. Actual contributions during this three-year period, though, are based on the lower earnings.

Additional Adjustments

As a rule, a person cannot simultaneously receive more than one public pension benefit. But the recent reforms have created an exception. People with disabilities who had gainful employment and paid pension contributions from April 2006 were entitled to not only their basic disability pension but also the earnings-related component of the old-age pension or survivor's pension. This measure is designed to encourage employment among people with handicaps.

Participants in the KN who have low incomes currently pay either half of the regular contributions or none at all. There was a finer tuning of payment exemptions starting in July 2006, when low-income earners also were exempt from paying one-quarter or three-quarters of the regular contributions.

The reform covered private pension plans as well. The upper limit of the amount that could be put aside each month under company-funded defined-contribution pension plans was raised from JPY36,000 to JPY51,000 in cases where there was no other corporate pension plan and from JPY18,000 to JPY25,500 in cases where there was another plan in effect. The ceiling on monthly installments under individually funded defined-contribution plans for salaried workers was raised from JPY15,000 to JPY23,000 where there was no corporate pension coverage, while the cap for the self-employed remained unchanged at JPY68,000. The higher ceilings for private plans were designed to make up for the anticipated smaller benefits of public old-age schemes.

3. Future Pension Policy Issues

Social insurance contributions in Japan already exceed the amount collected in national taxes, and contributions to the pension system are by far the biggest social insurance item. If this already huge sum is increased by more than JPY1 trillion a year, as the government plans, both individuals and companies are bound to change their behavior. Government projections of revenues and expenditures, though, completely ignore the prospect of such changes.

Companies will likely revamp their hiring plans and wage scales to sidestep the higher social insurance burden. They will cut back on recruitment of new graduates and become more selective about midcareer hiring as well. Many young people will be stripped of employment opportunities and driven out of the labor market, instead of being enlisted to support the pension system with a percentage of their income. And most of the employment options for middle-aged women who wish to reenter the work force will be low-paying ones. Only a few older workers will be able to continue commanding high wages; there is likely to be a dramatic rise in the number of aging workers who will be forced to choose between remaining on the payroll with a cut in pay or settling for retirement. Many more companies will either choose or be forced to leave the KNH, causing the number of subscribers to fall far below the government's projections and pushing the system closer to bankruptcy.

The jobless rate on the whole will rise. The Ministry of Economy, Trade, and Industry has estimated that higher pension contributions would lead to the loss of 1 million jobs and boost the unemployment rate by 1.3 points. The government plan to increase pension contributions annually up to 2017 would exert ongoing deflationary pressure on the Japanese economy. For the worker, a rise in contribution levels means less take-home pay; as a result, consumer spending is likely to fall, and this will surely hinder prospects for a self-sustaining recovery and return to steady growth.

Another problem with increasing pension contributions is that they are regressive, since there is a ceiling for the earnings on which payment calculations are based and unearned income is not included in the calculations at all.

One major objective of the reforms is to eventually eliminate the huge excess liabilities of JPY500 trillion in the balance sheet of the KNH. The plan is to generate a surplus equal to this amount by (1) hiking contributions, (2) increasing payments from the national treasury, and (3) reducing benefits. But the combination of higher contributions and lower benefits will mean the future participants will end up getting back less than they pay into the system. It is estimated that their benefits will amount to only about 80% of their contributions. This is hardly likely to encourage people to participate. Higher contributions will further alienate younger workers from the pension system and deepen their distrust of politics.

As noted above, those who are already receiving their pensions would see their benefits decline in real terms by an average 0.9% per year. The government scenario sees consumer prices eventually rising 1% a year and take-home pay 2.1% a year. This means that the model beneficiary who began receiving JPY233,000 a month at age 65 in 2004 would get roughly JPY240,000 at age 84 in 2023; nominal benefits, in other words, will remain virtually unchanged for two decades, despite the fact that average take-home pay of the working population would have risen by over 40%. The income replacement ratio, which stood at nearly 60% at age 65, would dwindle to 43% by the time the model recipient turns 84. The promise of benefits in excess of 50% of take-home pay does not apply, therefore, to those who are already on old-age pensions.

The so-called demographic factors are likely to continue changing for the foreseeable future. The government itself foresees the number of participants in public pension plans declining over the coming century: The estimated figure of 69.4 million participants as of 2005 is expected to fall to 61.0 million in 2025, 45.3 million in 2050, and 29.2 million in 2100. This corresponds to an average annual decline of 0.6% through 2025, 1.2% of the quarter century from 2025, and 0.9% for the half century from 2050. In other words, the decline in the number of workers who are financially supporting the public pension system is not likely to stop after just two decades.

The 2004 reform, though, adjusts benefit levels in keeping with the decline in the contribution paying population for the next 20 years only; the government's "standard case" does not foresee any further downward revisions, even if the number of participants continues to fall. If the government really anticipates an ongoing decline, there is no good reason to abruptly stop adjusting benefit levels after a certain period of time. Sweden and Germany, for instance, have adopted permanent mechanisms whereby benefit levels are automatically adjusted for fluctuations in demographic factors.

The decision to keep the model income replacement ratio at 50% at the point when pension benefit payments commence represents, in effect, the adoption of a defined benefit formula. Maintaining both fixed contributions on the one hand and defined benefit levels on the other is not an easy task, for there is no room to deal flexibly with unforeseen developments. The government will be confronted with a fiscal emergency should its projections for growth in contributions and a reversal in the falling birthrate veer widely from the mark.

The government based its population figures on the January 2002 projections of the National Institute of Population and Social Security Research. Under these projections, the medium variant for the total fertility rate (the average number of childbirths per woman) falls to 1.31 in 2007, after which it begins climbing, reaching 1.39 in 2050 and 1.73 in 2100. Actual figures since the projections were released have been slightly lower than this variant, and there are no signs whatsoever that the fertility rate will stop declining.

If the government is to keep its promise on an upper limit for contributions and a lower limit for benefits, the only policy option it will have in the event of a financial shortfall will be to raise the age at which people begin receiving benefits. The reform package makes no mention of such a possibility; the drafters of the bills no doubt chose to simply put this task off to a future date.

In fiscal 2009 the share of the basic pension benefits funded by the national treasury was raised from one-third to one-half. This means that more taxes will be used to cover the cost of benefits. Taxes are by nature different from contributions paid by participants in specific pension plans, and there is a need to reconsider the benefits that are to be funded by tax revenues.

The leaders of Japanese industry tend to be quite advanced in years. For the most part, they are over the age of 65, which means that they are qualified to receive the flat-rate basic pension. Even though they are among the wealthiest people in the economy, they are entitled to the same basic pension as other older people hovering around the poverty line. Using tax revenues to finance a bigger share of the basic pension essentially means asking taxpayers to foot a bigger bill for the benefits of wealthy households as well. For an elderly couple, the tax-financed portion of the basic pension will rise from JPY530,000 a year to JPY800,000. If a need arises to raise taxes at a future date, who will then actually agree to pay more? Few people will be willing to tolerate such wasteful uses of tax money.

On 30 August 2009, there was a dramatic change in the political arena of Japan. The LDP fell down from power, and it was replaced by the Democratic Party. The new administration plans to implement a drastic pension reform by 2013, including an introduction of a minimum pension funded by consumption tax, with integrating all the existing earnings-related pension systems to a unified one. The concrete reform contents still remain to be drafted.

4. Healthcare Issues in Japan

Brief Outline of the Program

The Japanese system of social security healthcare is universal. Currently, it is broadly composed of four programmes, covering different sectors of the population.[3] The first is the scheme for the "old-old" (those of age 75 and over). For those of age 74 or younger, the major program is the health care system for employees in large firms (*Kumiai*) and for civil servants (*Kyosai*). It is financed on an inidividual employer basis. The third is the scheme for all other employees not covered by the second. Employees in small- and medium-size firms are usually covered with the third scheme, which is managed by the central government (*Kyokai, formerly Seikan*). The fourth scheme is for independent workers, self-employed people and retired workers. It is operated on a municipal basis (*Kokuho*). Dependants are covered by one of the three schemes for those of age 74 or younger.

There are several unique features in the Japanese healthcare system. First, at retirement, employees are usually obliged to move from the second or third scheme to the fourth one.

Second, a revenue-sharing scheme has been established for those aged 75 and over. The "old-old" pay a lower share of medical costs (co-payments and 10 per cent of remaining ones), the major part of which are financed by transfers from social insurance contributions to three remaining programmes mentioned above, and from general revenue of both central and local governments. [4]

Third, the social security coverage of medical care service and its reimbursement to providers are the same for all the programmes. The social insurance coverage of medical care service (including co-insurance payments) is still very wide (around 90 per cent in terms of the aggregate cost). Reimbursement to healthcare providers is principally based on a fee-for-service schedule that is uniform across different regions. The schedule is revised every 2 years by the central government. Each patient in Japan enjoys free access to any medical service providers at any time, purchasing most available medical treatments at a publicly determined price through social insurance programmes for healthcare.

Fourth, in contrast to the benefit side, each programme for healthcare adopts a different financing method. Generally speaking, the principal source of income is the contribution from enrollees (and their employers in the second and the third programmes). Transfers from general revenue of the central and/or local governments are given to the first, third and fourth programmes to compensate for the relatively low income of these groups.

Financing MedicalCosts of the Elderly Population

Average medical costs vary among different age groups. In 2008, the annual cost per person was 130,000 yen for those less than 15 years old, 101,000 yen for those between 15 and 44, 254,100 yen for those between 45-64, and 673,400 yen for those 65 and above, and 830,000 yen for those 75 and over (US$1=82 yen approx.). Older people are heavy users of medical care service and their medical cost per person per annum is about 8.2 times the cost of those between 15 and 44 years old. Consequently, in 2008, 55 per cent of aggregate medical expenses were incurred on the people aged 65 and above, while their share of the total population was 22 per cent. Social security programmes for healthcare are becoming very similar to those for pensions in that the basic feature of the programme is income redistribution from younger and middle-aged to older people.

Annual healthcare expenditure in 2007 in Japan was 7.3 per cent of GDP, which was relatively low among OECD countries. Owing to the rapidly ageing population, it will increase very sharply, however. There is a broad consensus among Japanese economists that it will grow by around 40 per cent in 15 years in real terms.[6]

The financing problems of social security healthcare were getting more and more serious in Japan, especially with respect to the medical cost of the elderly population. There had been growing dissatisfaction within the second and third groups (*Kumiai*, *Kyosai* and *Kyokai*) about transferring their money to the scheme for the "old-old".

Before setting up the scheme for the old-old (*Roken*) in 1983, the medical costs of the elderly population were mainly financed by the *Kokuho*, the lowest income group, with substantial transfers from general revenue. The *Roken* had changed the main financial source for the elderly healthcare from transfers from general revenue to transfers (contributions) from the respective healthcare programmes. The medical costs of the elderly population had been supported by all the programmes.

Substantially increased transfers, especially from the *Kumiai* and *Kyosai*, forced their current account to repeatedly turn into a deficit, causing steady increases in their contribution rate for healthcare. Their complaints about subsidizing the *Roken* were becoming extreme.

The 2008 Reform

After heated debates among stakeholders, the latest healthcare reform was enacted from April 2008. Main contents of the reform are as follows:

- The eligible age for the scheme of the "old-old" was raised from 70 to 75.
- A 10 per cent co-payment is applied to those of age 75 and above. A 30 per cent co-payment is exceptionally applied to those who have a high income.
- 50 per cent of medical expenses for the scheme of the "old-old" are to be covered by transfers from general revenue of central and local governments.
- The co-payment for employees in the second and third programmes (*Kumiai*, *Kyosai* and *Kyokai*) is increased from 20 to 30 per cent, while the rate for infants less than 3 years old is reduced from 30 to 20 per cent.
- The ceiling on co-payment is increased from 63,600 yen to 80,100 yen a month for the employees' group, while it is lifted to 12,000 yen for elderly outpatients and 44,400 for elderly inpatients.
- The contribution base for the second and third programmes was expanded to include semi-annual bonuses, whereas the rate for the *Kyokai* was increased from 7.5 to 9.34 per cent.

Future Options

Social security healthcare in Japan is by and large on a command-and-control model operated by the central government. There is a growing demand for Japan to introduce a contracting model. An agency relationship, which is formed whenever a principal delegates the decision-making authority to another party (the agent), should be built up between patients and service providers, and between insurers and insured persons. Each player would be equal in making contacts. Contracts should include incentive schemes for efficient supply of good quality medical services. In this sense, an insurer should play a more active role than in the traditional indemnity policy. The insurer should be permitted not only to do the *ex post* review of medical practice but also to contract directly with medical service providers, applying a different payment schedule from that determined by the central government.

In reforming the payment schedule, a prospective payment system (PPS) would be advisable. Insurers can evaluate the quality of providers, giving them strong incentives through rewards based on outcome, not on input.

The PPS was first introduced into the inpatient fee for older patients in 1990. It was not mandatory, but it induced lower service input. The area of medical treatments that the PPS covers is expected to be widened.

There should be more competition among providers and among insurers. Many people propose that the programs should be divided up on a prefectural basis.[7]

In addition, many people advocate introduction of gatekeepers, which would place some restrictions on free access to any service providers. The main purpose is efficient use of medical resources.

In 2009, the new government announced a drastic change of Japan’s healthcare program, contemplating to abolish the current scheme for the old-old, by including them in the newly integrated programs on a prefectural basis. The reform draft remains to be seen in the near future.

5. Concluding Remarks

The December 2006 release of future population projections made social security financing more serious. The majority of the population have recognized the gravity of the problem. Japanese people can forgive and forget. They will be sure to drastically change all the existing programmes of social security.

Socioeconomic conditions will change very rapidly. The changes that take place will often be beyond our previous expectations. Never-ending reforms of social security are inevitable in Japan, where only fine-tuning of programmes in the face of changing circumstances is acceptable in the political arena.

Endnotes

[1] This paper is a revised and extended version of Takayama (2002, 2010).

[2] Japan has been suffering from deflation since 1997. The negative adjustment of pension benefit indexation has not taken place, so far.

[3] Yoshikawa et al. (1996) give a detailed explanation of social security healthcare in Japan.

[4] Since 1984, another revenue-sharing scheme had been set up for retirees under 70. From 2008, the age ceiling has been lifted to 75.

[5] Those on very low incomes are exempt from participating in any social insurance programmes for healthcare, and their medical costs are wholly covered by public assistance.

[6] See the MHLW (2010).

[7] See Tanaka (2000) and Ogata (2001) for more details.

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