

JAPAN ECONOMIC CURRENTS

A COMMENTARY ON ECONOMIC AND BUSINESS TRENDS

Reform of Social Security Swings into Motion

BY HIROSHI MIYAJIMA, WASEDA UNIVERSITY

Major reform is underway in Japan's social security system. The process was kicked off in 2004 with a reform of the pension system, moved on to nursing care insurance in 2005, and will reach the medical care system in 2006. In parallel with these reforms, full-scale measures to counter the decline in the birthrate are being put into effect.

Three general causes are driving this series of social security reforms, particularly the fundamental reform of the social insurance system, which accounts for nearly 90% of Japan's total spending on social security benefits. First, in January 2002 the National Institute of Population and Social Security Research released a new statistical projection of Japan's population for 2001–50 that revealed that the decline in Japan's birthrate and the aging of the population have grown more serious. These trends of increased fragility in the population

Dear Readers,

The Japan Business Federation (Keidanren), its non-profit arm, the Keizai Koho Center, and all our member companies were deeply moved by the scenes of tragedy and loss in Louisiana, Mississippi and the US gulf region in the wake of Hurricane Katrina.

A fund has been established by Keidanren to aid the victims of Katrina, with the hope that those who have been hardest-hit will be enabled to rebuild their lives. The Hurricane Katrina Fund will be disbursed through the Red Cross by October 6, 2005.

With deepest regards,

Katsunori Nemoto
Director, Keidanren-USA

base have darkened the outlook for social security finances.

Second, economic globalization has heightened the need to upgrade the economy's structure and overhaul the administrative system. This means that Japanese policymakers are focusing their attention on ways to boost international competitiveness by holding down labor costs and making government smaller and more efficient.

Third, the need to cut budget deficits and rein in mounting government debt has grown more imperative. By one means or another, the government

needs to regain equilibrium in the key measure of public finance known as the "primary balance."

Given these trends, current conditions and outlook for the population, the economy, and public finance, which form the base of the social security system, were looking increasingly severe. The sustainability of the social security system itself was being questioned, making an overall reform inevitable. The sense of crisis was particularly acute in the Council on Economic and Fiscal Policy, a government advisory body. In its report "Basic Policies

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2003," which was published ahead of the reform of the pension system, the Council recommended restraining the government's size so as to hold the "latent national burden"—the ratio of taxes, social insurance premiums, and the budget deficit to national income—to the level of 50 percent. And the Council also announced ambitious target: reversing the deficit in the primary balance to a surplus by the beginning of 2010.

Projected growth in social security costs

These targets for economic and fiscal management represent very tight constraints. With the graying of Japanese society proceeding at a fast pace, the upward trend of increase in the burdens and benefits of the social security system must be suppressed. According to a Ministry of Health, Labor, and Welfare's long-term forecast published prior to the reforms, the ratio of social security benefits to national income was set to rise from the current ratio of 23 percent to about 32 percent in 2025, at which point the ratio of the aged (65 and over) was projected to be 29 percent, up from 19 percent today. At that level, the overall national burden rate would have climbed from the present latent level of 46 percent to an arguably unsustainable 58 percent.

The percentage of the elderly in the population provides a useful yardstick for assessing the maximum level of the burden a government imposes on the public. In Scandinavian and other

children and nursing the elderly, and companies have been paying for job security and occupational training. But with the birthrate still in decline, the aging process moving rapidly, and

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West European countries where the percentage of working age to elderly in 2002 was 16–17 percent, the latent national burden was well in excess of 50 percent. In this light, the Japanese government is and will continue to be comparatively modest in size. At least compared with the situation in Western Europe, spending on social security benefits is on the low side.

The main reason that Japan has been able to restrain the size of the public sector's social security expenditures, despite the falling birthrate and the swelling ranks of the elderly, is that the private sector has carried out social security functions in place of the government. Families have been bearing the bulk of the costs of raising

globalization in full swing, the private sector is losing its capacity to provide social security. This decline in capacity must be borne in mind as a new policy factor that may boost the bill for social security in the years to come.

Containing contributions while indexing benefits

The goal of the 2004 pension reform was to safeguard the pension system far into the future, even in the context of a graying and globalizing society, without departing fundamentally from current fiscal policy, which is structured on a "pay-as-you-go" financing basis. The reform, which is premised on a hike in treasury funding of the "basic pension," controls and fixes final

contribution levels while taking into account intergenerational burdens and labor costs.

The new design accommodates the risks of unanticipated trends in population and economic growth with flexibility in benefit levels. That is, it incorporates an automatic adjustment of benefit levels by means of macroeconomic indexation, so that the level rises or falls with changes in socioeconomic conditions. If, for instance, there is a decline in the number of people insured (the workforce population) or an increase in average life expectancy, benefits will become less generous.

The adoption of an arrangement that fixes contribution levels while automatically adjusting benefit levels has significantly lowered the final contribution rates. In the case of an employee's pension, the total contributions from the employer and employee will be capped at 18.3 percent, down from 26 percent before the reform. Against this, the rate at which benefits replace wages will fall from 59 percent to slightly over 50 percent. Even as it enacted this reform to keep the pension system in good health, the government revised the tax system to strengthen taxation of pension income. This change was made to secure equitable distribution of pension benefits among

the generation receiving benefits (in which there are large disparities in income and assets), and also to secure resources for fiscal subsidies.

Reform of the pension system has now been settled for the time being. In the course of the debate, however, a sense of crisis arose over the strong impact that a dip in the birthrate could have on benefits levels. Since people were already worrying about the dangers of a shrinking population – which could cause the economy to stall and regional communities to collapse – the government

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launched the nation's first full-fledged initiative to counter the downward trend in the number of children being born. At the same time, in order to soften the economic impact of falling birthrates, aging, and a shrinking population, the authorities have attached greater importance to measures aimed at boosting productivity and encouraging older citizens to work.

A new tack for nursing and medical care

As the first item on the reform agenda, pension reform made people aware of how demographic and economic factors form the base of the social security system. It brought into relief a number of issues that are also involved in reform of nursing care insurance and medical care, and it provided an opportunity for people to look broadly at the social security system and to rethink assumptions about benefit and burden levels and the revenue choice between insurance premiums and tax payments.

After the pension reform, the Health, Labor, and Welfare Ministry conducted a second long-term forecast of social security benefits and burdens and found that reform could hold the increase in expenditures for pension benefits within the range of economic growth. As a result, the ratio of benefits to national income in 2025 are expected to be

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three percentage points below what it would have been had reforms not been undertaken. On the other hand, benefits for medical care and nursing for the elderly were projected to rise faster than economic growth, reflecting the aging of society. As a result, the latent national burden was still expected to rise as high as 56 percent.

Social security reform therefore moved on to the next stage of restraining the bill for nursing and medical care — a different matter than providing pensions for old age in a number of respects. First, the benefits are benefits in kind, not cash, and they are deliv-

third, since this is security provided against direct risks to life and health, the funding of benefits depends heavily on public financial resources.

These differences make it difficult to curb the climb in benefit payments by adopting a rational cost management system of the sort applied to pensions, where benefits have been contained by macroeconomic indexation. In addition, nursing and medical care are closely linked to public finance and can be directly affected by measures the government adopts in other areas. A program to regain a better fiscal balance, for instance, could

care on the other. Another that promises to be of greater importance was a reordering of priorities to place more emphasis on support to keep elderly people healthy and independent. This change, which was made in response to a spurt in demand for light nursing services triggered by the introduction of the nursing care system, was a preventive move to reduce round-the-clock care. As a result, the reform of nursing care insurance involved an overhaul of social security systems to provide seamless support for the aged and also marked the start of a shift in the principles of the social security system toward restraining costs through risk prevention.

Guiding principles for future reforms

Reform of Japan's national medical care system is scheduled for 2006. Compared with nursing care, medical care is expected to have a low growth rate of spending on benefits. As the scale of these expenditures is far greater, however, restraining growth will be the key challenge in Japan's bid to hold down the latent national burden and return the primary balance to a surplus. For a number of reasons, containing medical expenditures is a difficult proposition. These include the special characteristics of medical services, such as its so-called asymmetrical information and

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ered through services that vary in quality, price, and productivity. Second, there is great diversity in the quality and quantity of the demand for these services. The demand differs depending on the nature, degree, and characteristics of the disability or ailment, as well as the family circumstances of the individual receiving the service. And

entail cuts in social security outlays and hikes in taxes.

For these reasons, the reform of nursing care insurance in 2005 made use of new methods for restraining expenditures. One was an adjustment between systems aimed at eliminating a duplication of benefits provided for pensions on the one hand and nursing

its constant technological advances. There are also ethical considerations, since many of the benefits go to people in advanced old age, whose numbers are rapidly swelling, and to the terminally ill.

From the perspective of economic and fiscal management, some say that the best approach would be to link total expenditures to macroeconomic indicators, such as the economic growth rate. From the perspective of the health and life of the people, however, others say that the fairness and universality of medical services should be the guiding principles. The government will have to strike a balance between the two sides.

Realistically, securing adequate resources to finance the medical care system will not be possible if expenditures balloon too rapidly. For the short-term and medium-term future,

accordingly, the authorities will simply have to mobilize all the tools at their disposal to hold benefits in check, all the while trying to maintain the quality of medical care. In the long term, the ideal solution would be to place a greater emphasis on risk prevention to curtail the incidence of lifestyle-related diseases and to reduce the reliance on public medical care expenditures, by making use of the decentralization of the providers of medical care insurance.

Drawing from the above trends, three general directions for future social security reforms are needed. First, with the goal in mind of attaining a small and efficient government, strict constraints on social security burdens and benefits should be maintained while urging people to take the care of their health into their own hands. Second, given that the trend

toward a society of many older people and fewer children is bound to continue and that families and companies will find it increasingly difficult to provide social security in place of the government, a reconsideration of the targets set for containing social security burdens and benefits is necessary, including the target for the latent national burden. And third, the public's dependence on benefits should be lessened by refocusing social security goals in line with reversing the decline in the birthrate and lengthening healthy life and working life expectancies. The Japanese people should have much say in the choices facing Japan.

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What to do in economic policy with Koizumi's mandate

By ADAM S. POSEN, INSTITUTE FOR INTERNATIONAL ECONOMICS

The resounding victory of Japan's Liberal Democratic Party [LDP], led by incumbent Prime Minister Junichiro Koizumi, in Sunday's Lower House election is very good news for the Japanese economy. It promises continuation of Koizumi's constructive policies in financial and fiscal affairs (not least avoiding his predecessors' mistakes of the 1990s), and of his backing of the Bank of Japan's anti-deflation commitment.

Koizumi's mandate also raises hope for the passage of a new agenda of reforms. Given Heizo Takenaka's successful clean-up (with Koizumi's backing) of the banking-system problems in Japan, there is no reason to hesitate pursuing an aggressive agenda. If such a constructive agenda were implemented, the reforms are likely to add as much three of tenths of a percent to Japanese annual potential growth rate, as well as increasing efficiency, fairness, and stability in the economy.

Since Koizumi did not offer much in the way of specific proposals on economic policy during the campaign beyond the commitments to remaking the LDP's dependence on pork barrel projects and to pushing through postal reform, there is room for discussion. A constructive Koizumi agenda should include some subset of the following ambitious but politically feasible proposals, each of which should both

enhance the Japanese general welfare and respond to his new urban and younger sources of support:

- **A better postal reform bill** — The current version stretched out privatization twelve years, all the way to 2017, and had other self-defeating limitations following the Diet's amendments. A new version would speed up privatization, more aggressively constrain Postal Savings' subsidized product offerings, and make more room for competition to Postal Life Insurance. Since life insurance remains the most fragile part of the Japanese financial system, privatization of Postal Insurance could be a springboard to more thorough clean-up of that part of the financial sector.
- **Fiscal consolidation** — Getting Japanese public finances back onto a path to long-run sustainability is more tractable than many realize, but still will take action. Lasting cuts in public spending would be more conducive to long-run improvement in balances, as well as less damaging to the short-term outlook, than an increase in taxes. Given the political impetus for Koizumi to continue cutting off the traditional LDP rural districts' pork projects and his commitment not to raise the value added tax (VAT) until 2007, one can hope for strong movement with this prioritization.
- **Pension reform** — Along with reduction in public works spending, bolstering social security is a key step to fiscal sustainability. As with the overall picture, the viability of Japan's current pension system is higher due to recent reforms than many recognize. Further efforts should focus on raising the retirement age.
- **Agriculture protection cuts** — In mid-2004, Koizumi pushed hard against Japanese agricultural privileges during negotiations for a Japan-Mexico free trade agreement (FTA). Since these supports also follow the old LDP political logic like public works spending, there is good reason to think that this may be the opportunity to do away with Japan's most extreme protection in this area. It would also offer Koizumi a way to assert leadership on a global stage in the trade round and reach out to less developed countries. This also would be a way to respond to United States' legitimate agricultural interests without compromising on safety concerns about beef.
- **Promotion of inwards FDI** — A long-stated goal of Koizumi's has been to increase the amount of foreign direct investment coming into Japan, particularly from the US. While many regulations already have changed to make mergers and investments easier, the implementation still relies on

acceptance by Japanese authorities (and public opinion), as recent examples show. Privatization of the postal system itself would give two major opportunities for there to be sales to foreigners that could have clear demonstration effects:

- first, parts of the postal delivery system itself could be sold to a Fedex, DHL, UPS, or the like and have significant efficiency enhancing effects on commercial distribution and logistics, which currently impose substantial costs on all commercial transactions in Japan;
- second, privatization of postal savings and insurance could be used to expand the variety of investment products made directly available to the holders of the system's \$3.5 trillion in deposits and \$1 trillion in insurance policies (outright sale of part of postal savings to a foreigner remains politically impossible). American and other foreign financial firms would be the logical and efficient providers of this variety.
- **Strengthening of Diet over the bureaucrats** — Koizumi has to reward those LDP members who stood by him as well as those 'assassins' who took on the rebel old-line members. True 'administrative reform' should include reducing the ability of the ministries to set policy

without regard for the views of elected officials, and with unduly high regard for relationships with interest groups in the private sector. Giving the Diet members more control over the creation of policy and increasing transparency of policymaking would play to the younger LDP politicians. Koizumi has a record of strengthening his own hand (such as creating the expanded Cabinet Office out of the former Economic Planning Agency) and taking on the ministries he deems arrogant (such as his battles with the Ministry of Foreign Affairs early in his term) and may go further.

- **Targeted hosting of Asian health care workers** — This remains more of a hope than of a current proposal, but has more chance of becoming real now than at any previous time. Japan remains short of skilled and affordable health care workers (nurses, techs, etc.) while having a rapidly aging population. Thailand and the Philippines, among other neighboring nations, have large available pools of such workers who would be available for long-term guest worker status. Recognition of the advantages of importing such services is proceeding apace in public discussion. Properly played, this could be the first step towards a more sensible and eventually more open immigration policy in Japan.

- **Begin formally deepening the US-Japan economic relationship** —

Japan's break from a solely multilateral trade policy in recent years, and the aggressive pursuit of bilateral FTAs by the Bush administration, has reflected the changing global context for trade. It is looking less and less likely that there will be a satisfactory substantive conclusion to the Doha Round; China's emergence is making it more rather than less difficult either to conclude a deal with the large emerging markets, or to forge a coherent front among the rich countries. Meanwhile, the very congenial climate of US-Japan relations at present is focused almost solely in the security arena, with no positive agenda in the economic sphere.

Koizumi should open negotiations to formalize a deeper US-Japan economic relationship that would extend into behind the border harmonization and dispute settlement. The advantages of such an approach — which could be based on an exploration of a US-Japan FTA — would include:

- Assuring the longevity of transpacific economic ties and thus creating a greater incentive for emerging Asia to tilt towards Japan and the US economically as much as they do China;
- Increasing the incentive for Japan to finally open up some protected

markets like agriculture that have blocked developing its positive role in Asian and world trade, while ensuring that Japanese companies would not be subject to protectionist threats from the US;

- Supporting progress in the Doha round, in North American economic integration, and in APEC initiatives that may be undertaken, by creating common ground between US and Japanese officials, and removing distortions from cross-cutting relationships (such as with Mexico);
- And allowing Koizumi and Bush to build something lasting on the economics side to continue good relations in that sphere in the

years ahead more independently of what may develop in the security relationship.

One cautionary note must go with this avowedly optimistic set of proposals: This note ignores the diplomatic issue of current tensions between Japan and China, South Korea, and some other Asian nations over symbolic and historical issues (as well as over military commitments and energy exploration in the region). Some policies Koizumi has pursued or at least encouraged in this area do have the potential to throw a wrench into trade and investment flows between Japan and its neighbors, beyond their serious foreign policy implications. These would not directly

interfere with the domestic agenda items proposed here, however, and the international economic initiatives proposed might help to offset some of those tensions.

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