

Revamping Japan's Labor Market

- Options for Reducing Duality



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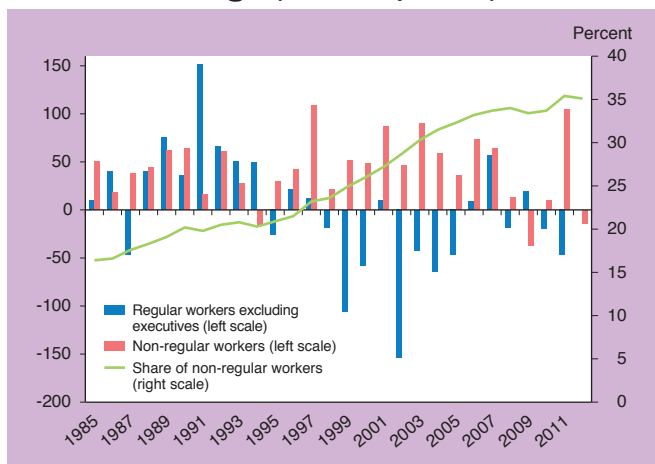
Japan's Labor Market

Japan's labor market has traditionally been characterized by the lifetime employment system, under which employers refrain from firing workers and workers implicitly commit not to switch employment until retirement. The lifetime employment system has served the country well in high-growth decades, by facilitating accumulation of firm-specific human capital and building trust between employer and employee. The image of the Japanese "salaryman", who comes back home from work late at night only to set off again for the company in the early hours of the morning, has become legendary around the world. Such devotion has been traditionally rewarded by employers, who in Japan tend to feel personally responsible for the welfare of employees and their families and are very reluctant to lay off workers. Even during 2009-2010, as Japan felt the impact of the global economic crisis, unemployment was just slightly above 5%, compared to the about 8% OECD average.

If we scratch below the surface of aggregate unemployment data, however, a closer look at Japan's labor market trends shows that over the last two decades labor market duality — a two-tier job market — has forcefully emerged. Japan's traditional lifetime employment system, often referred to as regular employment, was challenged by declining job growth in the wake of the asset bubble collapse in the early 1990s, which led to Japan's so-called "lost decade". The prolonged recession, together with labor law reforms — which made it easier to hire non-regular workers — gave firms incentives to explore alternative human resource practices. One result of these factors is that a growing number of workers were shut out from the traditional lifetime employment model.

CHART 1

Annual change (thousand persons)



Source: Ministry of International Affairs and Communications, IMF staff calculations

Dramatic Increase in Duality

The share of non-regular workers, which was below 20% before the burst of the bubble in the early 1990s, has now reached 35% (Chart 1). The status of regular versus non-regular worker is based on the *de facto* relationship between workers and their employers, rather than on legal grounds. Regular workers are those who (i) are hired directly by the employer; (ii) work full time; and (iii) have an open-ended contract. Workers who satisfy these three conditions are referred to as *seishain*, a word composed of three Kanji ideograms (正社員) which can be roughly translated into English as "proper-company-member". Various combinations of failing to meet conditions (i) (ii) and (iii) correspond to different typologies of non-regular workers. Compared to regular workers, non-regular workers have a much lower level of job security, are paid lower wages and receive significantly less social insurance coverage.

Japan's dual labor market is also large from an international perspective. One available indicator for international comparisons of labor market duality is the share of temporary workers. This is not a perfect indicator because, while virtually all temporary workers are non-regular workers, non-regular workers are not necessarily temporary (for example, they can have open-ended part-time employment). Given that the shares of non-regular and temporary workers tend to be correlated, however, we can use the latter as a proxy of labor market duality. An international comparison using this indicator puts Japan above the OECD average (Chart 2). It is also important to stress that this indicator underestimates the relative size of Japan's dual labor market, because the definition of temporary work in many European countries includes contracts of any duration, while Japan's definition only includes contracts of less than one year. Perhaps more worryingly, microeconomic studies have shown that the probability of moving from a non-regular to a regular job in Japan — ranging between 1.7% and 10.3% — is very low compared to other advanced countries (for example, about 45% in Germany and 30% in the United Kingdom). These data mean that in Japan, unless reforms to address duality are put in place, young people who fail to find a regular job at the beginning of their working lives are very likely to be stuck in a non-regular job for their entire careers.

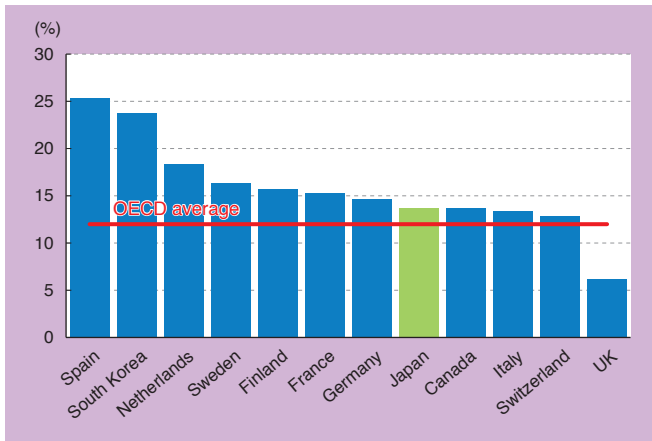
Women make up a large part of non-regular workers. Among non-regular workers, about 70% are women. Among all female employees, 55% are non-regular workers, of which 60% are part-time workers. These trends are more evident amongst married women, suggesting that family responsibilities are one important determinant for women to seek part-time jobs, which offer more work flexibility (Chart 3). Low-value added service sectors are highly reliant on non-regular employment. In restaurants and hospitality services, and wholesale and retail trade, for example, the shares of non-regular employees are 69% and 47% respectively.

Costs & Benefits of Labor Market Duality

Japan's labor market duality has some positive aspects. For example, the

CHART 2

Share of temporary workers (2011)



Sources: OECD

possibility for firms to hire a growing part of the labor force outside the lifetime employment framework, combined with downward wage flexibility, helped keep overall unemployment relatively low. Another positive aspect of non-regular employment in Japan is that part of it is voluntary and contributed to bringing new “voluntary non-regular” workers into the workforce, especially segments of the population which are constrained to take up full-time employment. For example, part-time work contribution to increased female labor employment was high (29%) in the last two decades, suggesting that part of female non-regular employment is voluntary and contributed to satisfy increased demand for flexible working hours.

Despite the positive aspects discussed above, duality also has large economic costs, such as disincentives to exert efforts which can reduce productivity. Microeconomic survey studies show that the majority of Japanese non-regular workers would be willing to work as regular employees. It is conceivable that working involuntarily as non-regular employees adversely affects morale and job effort, thus lowering labor productivity. This is supported for example by the findings of Kyoji Fukao et al. (2007), who estimate that Japanese part-time workers are 75% less productive than full-time ones.

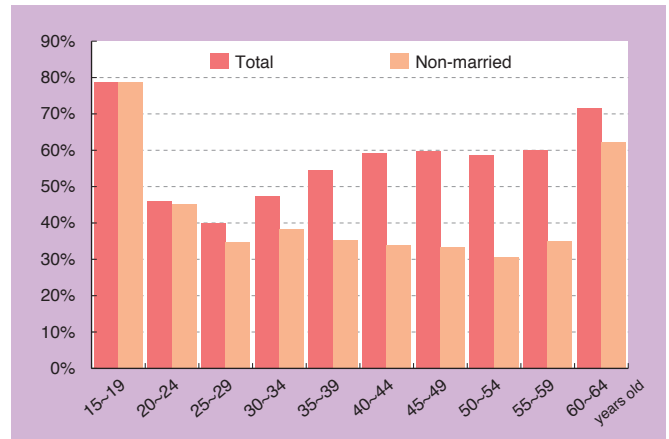
Another economic cost of duality is related to limited training opportunities for non-regular workers, which is also likely to reduce productivity. Despite legal provisions aimed at preventing discrimination, survey studies show that non-regular workers have limited training opportunities in Japan, and empirical evidence based on Japanese firm data suggests that workers who receive less training are less productive. A negative impact of duality on productivity in Japan is also supported by the observation that the share of non-regular workers is high in sectors in which labor productivity is low (Chart 4).

A more indirect economic cost of Japan’s labor market duality is that it could potentially lead to the perception that economic growth is not inclusive, thus eroding support for structural reforms needed to increase potential growth. Empirical evidence suggests that Japan’s labor market duality increases income inequality and has a negative impact on job satisfaction and social cohesion. If these factors lead to the perception that economic growth is not being shared fairly within society, they could erode support for other economic measures, such as fiscal consolidation and further international trade integration, which are needed to boost long-term potential growth but which might imply some short-term costs for some segments of the population.

International experience also suggests that excessive duality can reduce

CHART 3

Share of non-regular workers among female employees (2007)



Source: Ministry of International Affairs and Communications, IMF staff calculations

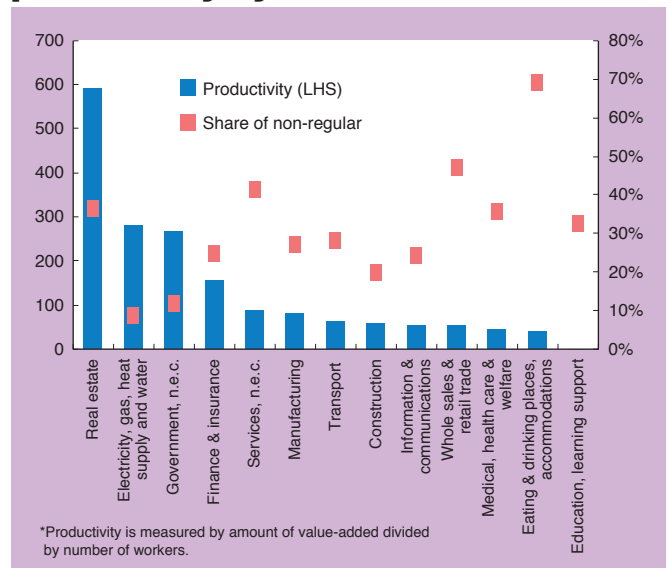
Total Factor Productivity (TFP) and therefore growth. Juan José Dolado et al. (2011), for example, find that 20% of the productivity slowdown in Spanish manufacturing between 1992 and 2005 is due to reliance on temporary work. Similarly, Mirella Damiani et al. (2011) conclude that deregulation of temporary contracts negatively influences the growth rates of TFP in a panel of 14 EU countries and that these negative effects are stronger in industries where firms are more used to opening short-term positions.

Determinants of Duality

In light of the discussion above, we can conclude that Japan’s excessive labor market duality entails high economic and social costs, and that reducing duality would be beneficial to enhance TFP and growth, as well as to

CHART 4

Japan: labor market duality & productivity by economic sector



*Productivity is measured by amount of value-added divided by number of workers.

Source: Mizuho Research Institute, Ministry of International Affairs and Communications; IMF staff calculations

strengthen social inclusion and cohesion. A recent study by Chie Aoyagi and Giovanni Ganelli (“The Path to Higher Growth: Does Revamping Japan’s Labor Market Matter?” — IMF Working Paper, 2013) looks in detail at the determinants of labor market duality, and suggests some options for reforms in Japan.

The study uses econometric panel data techniques to assess how various economic, demographic, and policy factors affect the degree of labor market duality in OECD countries. A key finding of the study is that an increase in the level of employment protection of regular workers (as measured by an OECD index) tends to increase labor market duality, while an increase in the level of employment protection of temporary workers has the opposite effect. One policy implication of these findings is that reducing the difference in the degree of protection between the two categories of workers can go a long way in reducing duality.

The study suggests that, in the case of Japan, a reform which would reduce the level of employment protection of regular employees to levels similar to those observed in Denmark or in the UK, could bring the share of non-regular workers close to or below 30%. The study also stresses that these estimates are based only on *ceteris paribus* first-round effects. If, as expected, the reduction in labor market duality results in higher growth, this would reduce unemployment and help exiting deflation. According to the econometric results presented in the study, a fall in unemployment and an increase in inflation would result in a second-round effect of the initial reform, which would further reduce duality.

Options for Reform: Single Open-Ended Contract

Options to reform Japan’s labor market should take into account country-specific preferences with regard to employment protection. Country preferences differ widely on this issue (with the US on one side and many European countries on the other end of the scale) and there is no first-best level of protection which is appropriate for every country at every time. The options for reform mentioned in this article aim to strike a balance between maintaining several aspects of the Japanese labor market model which have served the country well in the past — such as a high level of employment stability and labor relations based on trust between employer and employee — while at the same time reducing the impact of the negative effects of excessive labor market duality.

On the basis of their empirical analysis, Aoyagi and Ganelli suggest that an effective measure to reduce labor market duality in Japan could be replacing all regular and non-regular contracts currently offered to new hires with a Single Open-Ended Contract (SOEC). Under the SOEC employment protection would increase gradually and severance pay would rise with tenure. Implementing this reform would imply introducing a formal severance pay system, which currently does not exist in Japan. Introducing a SOEC would therefore drastically reduce firms’ marginal costs of converting non-regular to regular positions. The SOEC would imply lower job security compared to current regular employment but higher job security compared to current non-regular employment. While no country has yet introduced a SOEC, simulations carried out by Jose Ignacio García-Perez and Victoria Osuna (2011) suggest that it would significantly reduce labor market duality in Spain.

A possible first step to implement the recommendations given in Aoyagi and Ganelli could be a wider use of limited regular (*gentei seishain*) contracts. In Japan, employees who are classified as limited regular workers still enjoy regular worker status and benefits, but with limitations on one or more of the following: (i) job content; (ii) working hours; and (iii) mandatory relocations. Contracts of this kind implicitly introduce lower job protection compared to traditional regular workers, most notably in cases in which the limited regular position is cancelled for economic reasons. For currently non-regular workers,

on the other hand, the possibility to transition to such limited regular contracts would imply an increase in employment protection and in career and training prospects. Discussions in governmental committees and policy seminars have recently focused on the possibility of expanding the use of this kind of contract, while at the same time clarifying the legal framework for dismissals of limited regular workers, thus reducing uncertainties for firms and encouraging them to move non-regular workers to limited regular status. The limitations that the limited regular status put on working hours, job content, and mandatory relocations are also consistent with the need to improve work-life balance, which would be important to facilitate acceptance of reduced employment protection compared to current regular employment, as discussed below.

Some reforms recently approved in Japan go in the direction of facilitating the transition from non-regular to regular employment, but are unlikely to be effective. These include a five-year rule for conversion from non-regular to regular status, as well as subsidies for firms which convert workers. Under the five-year rule, fixed-term contracts are limited to five years in duration, after which the employees get the option to convert their contract to an indefinite term contract on the same terms. However, the five-year rule is not likely to be effective because firms can circumvent it by letting temporary workers go before they hit that tenure. For example, Kotaro Tsuru (2012) pointed out the fact that although European countries have set the maximum allowable duration of successive fixed-term contracts at two to four years, the average total duration of such contracts is significantly shorter than the legal limit in most countries. At the time of writing, the five-year rule was under review by the government. The subsidies are also unlikely to be effective, because they are too small compared to the expected cost increase of conversion for firms.

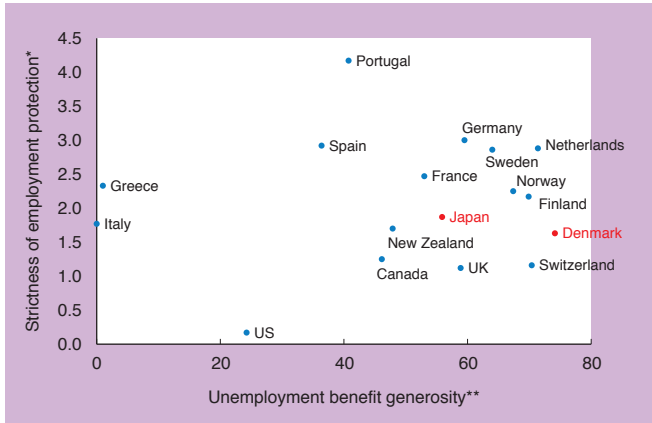
Shift Toward “Flexicurity”

The introduction of the SOEC or an extension of the use of limited regular contracts could be complemented by other measures aimed at reducing duality while also helping build consensus for the reform package. One useful reform would be giving workers the right to choose between part-time and full-time work (after a certain tenure period) while maintaining the same hourly wage and legal rights. This would eliminate the incentive for employers to discriminate in favor of full-time workers and against part-time workers in terms of on-the-job training, because any full-time worker might at any point in time decide to switch to part-time (and *vice versa*). Ultimately, part-time workers would no longer be considered as non-regular workers. A similar reform was introduced in The Netherlands in 2000 and contributed to a significant increase in Female Labor Participation (FLP). Guaranteeing new hires the future right to choose between part-time and full-time work would facilitate social and political acceptance of the reduced employment protection (compared to current regular employment) implied by the SOEC.

In general, some elements of the so-called “flexicurity” model could be exported to Japan. Reduced employment protection of regular workers could be complemented by measures to encourage more job mobility and support workers during periods of temporary unemployment, such as strengthening programs which help the unemployed to upgrade their skills and encourage job seeking. This would mark a shift away from the current Japanese labor market — characterized by excessive duality and lifetime employment for regular workers — to one more similar to the Danish “flexicurity” model, in which the focus is on protecting workers rather than jobs. One important measure in this regard would be increasing unemployment insurance benefits, which are low in Japan compared to Denmark and other countries which rely on the “flexicurity” model ([Chart 5](#)).

CHART 5

Strictness of employment protection & unemployment benefit generosity



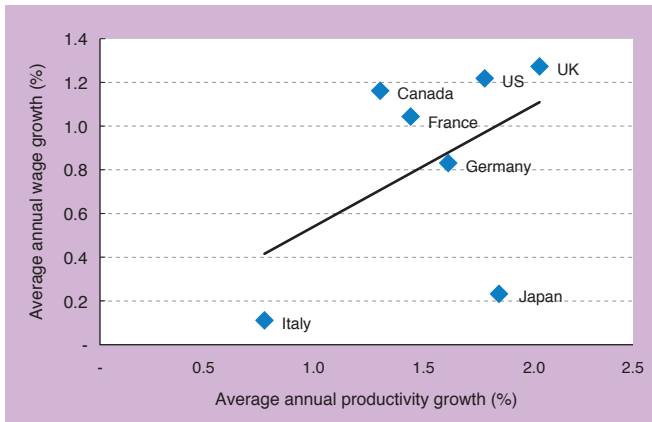
Note: * Strictness of employment protection measure as EPL for regular contracts (2007).
 ** Unemployment benefit generosity measured as net replacement over five years of unemployment (2007).
 Source: OECD

Raising Wages

Higher wages would also facilitate acceptance of reduced employment protection compared to current regular employment, while at the same time helping to exit deflation. Real wage and productivity growth trends in the last 20 years suggest that there is scope for wage increases in Japan. As shown in *Chart 6*, labor productivity growth in Japan outstripped real wage growth over the last 20 years. Japan also stands exceptionally low amongst G7 countries in terms of average annual real wage growth rate despite its relatively high productivity growth (*Chart 7*). Against this backdrop, the authorities have recently been using moral suasion and tax incentives to encourage companies to increase wages. Given the importance of increasing wages to exit deflation, the implementation of policies aimed at encouraging wage growth is appropriate. The latter could include: continued reliance on moral suasion; a move towards a wider policy of “social concertation”, in which the government becomes more directly involved in wage negotiations with firms and trade unions; and a carefully calibrated increase in the minimum wage.

CHART 7

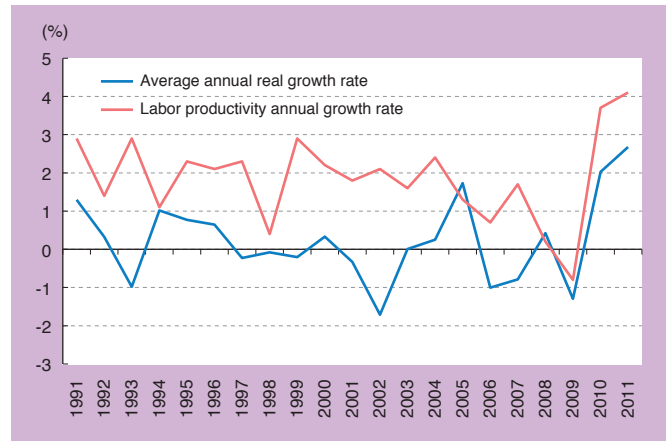
Real wage & productivity growth (1991-2011)



Source: OECD, IMF staff calculations

CHART 6

Japan



Source: OECD, IMF staff calculations

Changing Soft Institutions

For the proposed package of reforms to work, “soft institutions” would also need to change. In particular, in order to make the reduction in employment protection of regular workers socially and politically acceptable, some negative aspects of regular work also need to be reformed. The loss of job protection for regular workers can be compensated for by reforms which improve the work-life balance, such as increased accessibility to annual leave, the right to refuse involuntary relocations, and reduction of overtime work. Working until very late in the night (a lot more than total 49 hours per week) among full-time workers is very common in Japan and anecdotal evidence suggests that the problem is more serious than in most other advanced countries. One of the reasons for this is that it is cheaper for firms to ask regular workers to do overtime than to expand employment. The premium which employers have to pay for work outside statutory hours is only 25 percent of the regular hourly wage. Overtime also does not count toward bonuses, which account for 20-30% of worker’s annual earnings in big firms. Measures aimed at eliminating these biases in favor of overtime use would help, but a voluntary change in working practices by firms (“soft institutions”) would also be required.

Comprehensive Reform Package

The labor market reforms aimed at reducing duality discussed in this article should be a key component of Japan’s strategy to revive growth and exit deflation. Other important reforms in this regard should include raising female labor participation, deregulation in the agriculture and service sectors, financial sector reforms to achieve a more efficient allocation of credit, and relaxation of immigration requirements to address labor shortages. Reviving growth and ending deflation would be beneficial not only for Japan but also for the rest of the world.

(This article draws on the paper “The Path to Higher Growth: Does Revamping Japan’s Dual Labor Market Matter?” — Aoyagi and Ganelli, IMF Working Paper, 2013. The views expressed here are those of the author and do not necessarily represent those of the IMF.)

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