

Labor Market Reform in Japan Is a Top Priority

By Randall S. Jones



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Prime Minister Shinzo Abe has launched a strategy of three arrows — a bold monetary policy, flexible fiscal policy and a growth strategy — to exit deflation and revitalize Japan. The third arrow took flight with the Japan Revitalization Strategy announced in 2013 and revised in June 2014. The strategy, which includes 10 key reforms, has the ambitious goal of boosting Japan's growth rate, which has averaged 0.9% since 1994, to 2% during the next decade.

The labor market will be a determining factor in the success of “Abenomics”. In particular, nominal wage growth continues to lag behind inflation, which has increased under qualitative and quantitative monetary easing. Falling real wages have weakened private consumption, resulting in falling GDP in two consecutive quarters in 2014. The strategy includes three reforms — “realizing flexible and diversified ways of working”, “enhancing women's participation and advancement”, and “attracting talent from overseas” — that directly concern the labor market.

Realizing Flexible & Diversified Ways of Working

According to the strategy, Japan has “shifted from an excessive employment stability policy to a policy of supporting labor movement to enable individuals to smoothly change jobs, fulfill their potential and play active roles for economic growth”. In practice, this means reducing the Employment Adjustment Subsidy (EAS), which maintains existing jobs, and expanding the Labor Mobility Subsidy that aims at fostering “mobility without unemployment”. Downsizing the EAS, which was used by 0.8 million firms and covered 21 million employees in 2009, is appropriate because it risks locking workers in jobs that are no longer competitive, even as more dynamic sectors face growing labor shortages.

Innovation, a major driver of economic growth, requires the continuous reallocation of labor and other resources within and across firms and sectors. Labor should flow to innovative activities, while enterprises that fail to adapt have to downsize or exit. Policies and practices that hinder labor mobility reduce the ability of innovative firms to attract the resources needed to implement and commercialize new ideas and discourage R&D expenditure, according to OECD research.

Young firms have a comparative advantage in commercializing radical innovations and creating employment. In OECD countries, firms less than five years old, regardless of size, generated half of all new jobs over the decade 2001-11, despite accounting for less than a fifth of total non-financial business employment. In Japan, firms aged less than five years old created around 2 million jobs between 2001 and 2006, in contrast to firms older than 10 years, which reduced employment.

Increased labor mobility would help boost Japan's sluggish economic metabolism. The strategy set a target of raising the business start-up and closure rates from the 4.5% average over 2004-09 to the 10% rate in the United States and the United

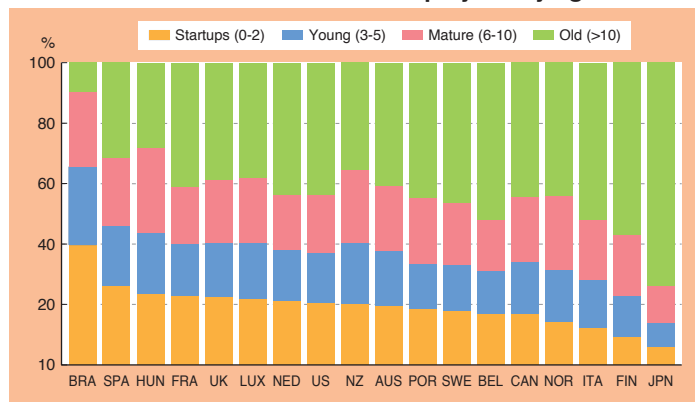
Kingdom. Given the low rate of firm creation, Japan's small company sector is dominated by older firms: three-quarters are more than 10 years old compared to less than half in most OECD countries (*Chart 1*).

The problem of labor market dualism in Japan

However, Japan's traditional labor market practices, such as long-term job security and seniority-based wages, do not facilitate mobility. These practices developed during Japan's high-growth era as a way of retaining skilled workers. However, they are ill-suited to the slower growth during the past 25 years, which makes flexibility in adjusting labor costs important. Firms have adapted by reducing the share of employees protected by traditional employment practices, resulting in a labor market segmented between regular workers — full-time employees with indefinite contracts — and non-regular workers,

CHART 1

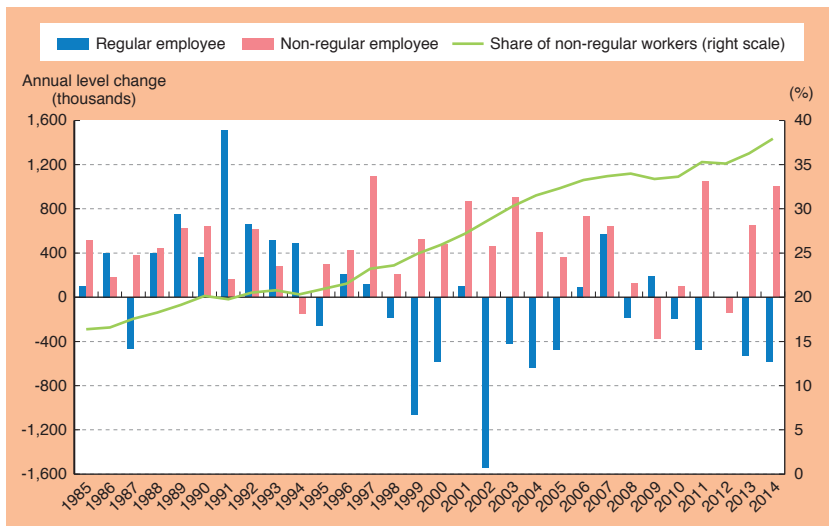
Small firms in Japan are relatively old Share of firms with less than 250 employees by age



Source: C. Criscuolo, P. Gal, and C. Menon (2014), “The Dynamics of Employment Growth”, OECD Science, Technology and Industry Policy Papers, No. 14, OECD Publishing, <http://dx.doi.org/10.1787/5jz417bj6hg6-en>

CHART 2

The share of non-regular workers is rising¹



1. Data are for February for each year through 2001 and for the first quarter since 2002. Source: Ministry of Internal Affairs and Communications, Labour Force Survey

primarily part-time, fixed-term and dispatched workers. In fact, the share of non-regular workers has risen rapidly from 16% of employees in 1986 to 38% in 2014 (Chart 2).

According to government surveys of firms, the most important reason for hiring non-regular workers is to ensure adequate employment flexibility to cope with demand fluctuations. As Japan's average growth rate slowed during the past 40 years, the cost of keeping excess workers has risen significantly. Firms hedge against uncertainty about business conditions by using non-regular workers to enhance employment flexibility. Recent studies show that the greater the volatility of a firm's sales, the greater the share of non-regular workers in its workforce. Non-regular workers play an important role as shock absorbers to protect regular workers in whom firms have invested significant resources. The stability of employment for regular workers is based on the instability of employment for non-regular workers.

Cutting labor costs is another reason for hiring non-regular workers. In fact, non-regular workers are paid only about 60% of regular workers per hour (excluding bonus payments). The gap widens with age, as regular workers' earnings are based primarily on seniority. In addition to lower hourly wages, non-regular workers receive smaller bonus payments or none at all and some are not included in the retirement allowance. Hiring non-regular workers also reduces non-wage costs: less than half of non-regular workers are included in employees' pension and health insurance, while less than two-thirds are covered by employment insurance, in contrast to virtually complete coverage of regular workers. Employing non-regular workers not covered by any social insurance system saves firms around 13% in non-wage costs.

As for workers, some choose non-regular employment to achieve work-life balance by reducing working time and working more flexible

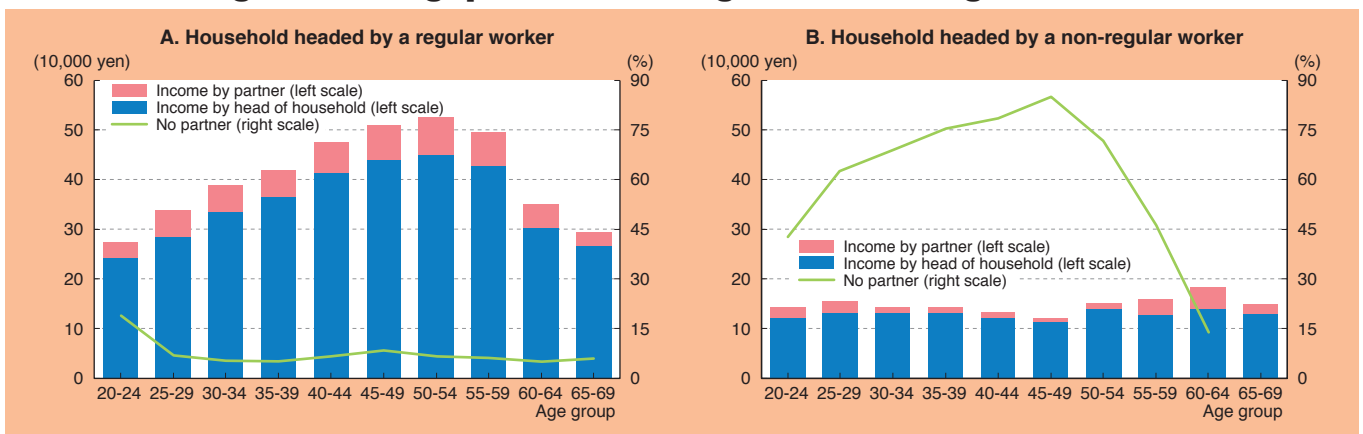
schedules. Regular employment is demanding, with long hours, including overtime, intense pressure and frequent transfers, making it difficult to balance family life with regular jobs for both parents. Nevertheless, 3.4 million employees were involuntarily employed as non-regular workers, according to a 2013 government survey.

While labor market dualism helps firms achieve greater employment flexibility and reduce labor costs, it creates a number of problems for growth and equity:

- **A significant wage gap:** After adjusting for type of job and educational attainment, the wage gap between full and part-time workers is 54.8% for men and 69.5% for women. The income of households headed by a regular worker in the 46-50 age group was more than four times higher than for a household headed by a non-regular worker (Chart 3). The 2012 *White Paper on the Labour Economy* by the Ministry of Health, Labour and Welfare stated that the rising share of non-regular workers is the major cause of

CHART 3

There are large income gaps between regular & non-regular workers



Source: Ministry of Health, Labour and Welfare, 2014 White Paper on Labour Economics

increasing income inequality in Japan.

- **Lower marriage rates:** The lower income of non-regular workers discourages marriage and hence reduces the fertility rate. A government survey of households with two or more persons showed the non-regular workers in the 46-50 age group were 10 times more likely to be unmarried compared to regular workers of a similar age (*Chart 3*).
- **Less firm-based training:** The short tenure of non-regular workers reduces the incentive for firms to invest in training them, thus reducing their human capital accumulation and earning power, as well as Japan's growth potential. Only about a quarter of firms provide systematic on-the-job training to non-regular workers, less than half the proportion for regular workers.
- **Less coverage by the social safety net:** Around 35% of non-regular workers are not covered by employment insurance, even though they have higher unemployment rates. Moreover, less than half of non-regular workers are covered by employee pension insurance.
- **Limited mobility between regular and non-regular employment:** Non-regular employment is not a stepping-stone to regular employment, which increases concern about the negative impact of dualism on equity. One study found that only about 10% of non-regular workers became regular workers. The “entrapment” hypothesis is supported by studies showing that initial status as a non-regular worker reduces opportunities for success later in life in terms of career stability, incomes and marriage.
- **Less labor mobility:** International evidence shows that employment protection reduces labor market mobility, in turn reducing productivity.
- **Less happiness:** The government's 2012 survey on well-being found that the happiness level reported by non-regular workers is below that of regular workers and the self-employed.

Policies to break down labor market dualism

The negative implications of the rising share of non-regular workers call for reform. Measures have been passed to limit non-regular employment by restricting the use of dispatched workers and limiting the length of fixed-term contracts. However, experience in some European countries shows that simply restricting the use of non-regular workers may not necessarily prompt firms to hire more regular workers. Given the importance of employment flexibility, firms may rely more on increased overtime by current employees, capital deepening or shifting production overseas.

The strategy includes two proposals related to dualism. First, “spread and promote model cases of ‘diversified regular workers’”. In contrast to regular workers, whose duties are all-inclusive, this reform would create a third category — regular workers whose duties are clearly defined. Second, “develop a system...which is globally recognized as fair, transparent and objective” to resolve labor conflicts, including the dismissal of workers.

However, to reduce labor market dualism, it is necessary to reduce firms' incentives to hire non-regular workers. One priority is to increase the coverage of non-regular workers by firm-based social insurance systems, thereby reducing the gap in labor costs with regular workers and improving the welfare of non-regular workers. Even more important is to relax effective employment protection for

regular workers so that firms do not have to hire non-regular workers to ensure employment flexibility.

Employment protection in Japan is problematic because of its ambiguity. The 2007 revision of the Labour Contract Law states that any dismissal of workers that is not considered to be acceptable by society's standards shall be deemed an abuse of power and is therefore invalid. The vagueness of the law leaves the legal system broad scope for interpretation. Judicial precedents have set four criteria to determine whether employment adjustment as a result of corporate downsizing can be deemed an abuse of power by a firm: i) the necessity of the firm reducing its workforce; ii) whether efforts were made to avoid dismissals; iii) whether the selection of employees for dismissal was reasonable and objective; and iv) whether the overall dismissal procedure was judged to be acceptable.

If a dismissal fails to meet these criteria, it may be rendered invalid and the court usually orders reinstatement with back pay. There is no time limit on when former workers can make a claim of unfair dismissal. The unpredictability of judicial procedures to review *ex post* employment adjustment increases the cost and uncertainty for firms, thus discouraging them from hiring regular workers. International evidence demonstrates that the creation of temporary jobs is a common response by firms to the high costs of reducing permanent jobs. There has been discussion of introducing a “third way” that combines the higher pay than non-regular workers with less employment protection. However, rather than introducing a new type of employment contract, the priority should be to enhance employment flexibility for regular workers, in part by clearly specifying the compensation required for dismissed workers, thereby reducing the uncertainty resulting from *ex post* judicial reviews.

Enhancing Women's Participation & Advancement

Japan's working-age population (15-64) is already falling by more than one million per year and is projected to decline by nearly 40% by 2050. Consequently, Japan's elderly dependency ratio — the over-65 age group as a percentage of the working-age population — will remain the highest in the OECD area through mid-century. The ratio of working-age persons to the elderly in Japan will plummet from 2.5 in 2013 to 1.3 in 2050. Already, Japan is facing worker shortages in certain industries, such as nursing and construction, and in certain areas, such as Tohoku.

Greater gender equality is key to mitigating the looming labor shortages and sustaining economic growth. Employment outcomes in Japan show large gender differences: the male labor force participation rate, at 84%, is 21 percentage points above that of women. If female employment rates were to converge to those of men over the next 20 years, the fall in the labor supply would be limited to 5% (*Chart 4*), increasing GDP by almost 20% over two decades compared to unchanged participation rates. If participation rates do not change, the labor force would contract by 17% by 2030 and by 40% by 2050. Gender imbalances in the workplace represent a substantial opportunity cost for society, given that 63% of young women (25-34 years) in 2011 had a university degree compared to 55% of young men.

Policies to increase women's employment

The large gender gap in employment reflects the withdrawal of around 70% of women from the labor force for a decade or more when their first child is born. To facilitate work by mothers, the strategy plans to eliminate childcare waiting lists by boosting the number of childcare spots by 400,000 by 2017. In addition, the government plans to ensure 300,000 places in after-school childcare centers for older children. At present, Japan spends only about one-third as much as Denmark, France and Sweden on childcare and after-school care. In addition, other policy reforms are needed.

First, the tax and benefit systems should be reformed to remove disincentives to work by secondary earners in households. Spouses with annual earnings below 1.03 million yen (about 30% of average full-time earnings) are exempt from income tax, and can be claimed as a tax deduction by the primary earner. In addition, second-earners are covered by the primary earner's pension, health and long-term care insurance, without paying contributions themselves, if their earnings are below 1.3 million yen. The government has promised to consider how tax and benefit systems could be made more neutral with regard to women's decisions on work.

Second, the culture of long working hours makes it difficult to combine employment and family responsibilities. Indeed, 23% of employees in 2012 worked more than 50 hours a week, the fourth-highest among the 34 OECD countries. The government has taken measures to improve work-life balance by expanding childcare leave from 12 to 14 months if both parents take leave and raising the benefits from half to two-thirds of wages prior to the leave for the first six months. In addition, companies are required to draw up work-life balance action plans. In practice, though, the tradition of long working hours is difficult to change.

Third, the large gender wage gap and limited opportunity for career progression discourage women from working. The gender wage gap is 27% at median earnings, the second-highest in the OECD, and less than 5% of board members in listed companies in Japan are female, the second-lowest in the OECD. The World Economic Forum ranked Japan 105th out of 136 countries in its 2013 Global Gender Gap Index.

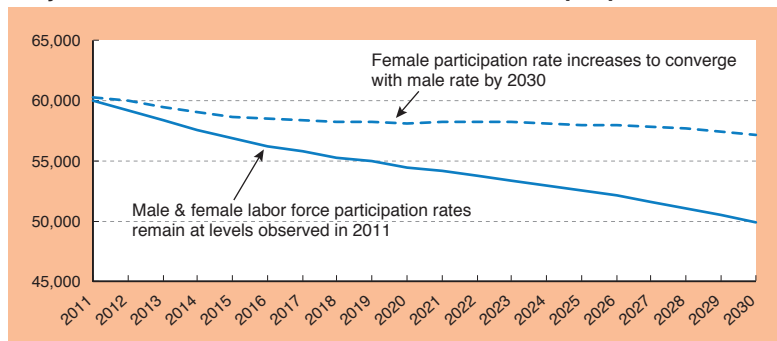
"Womenomics" is a vital component of Abenomics. The prime minister has set a target of having women occupy 30% of all "leadership" positions, including members of the Diet, heads of local government and corporate executives, by 2020. To help achieve this, listed companies will be required to disclose the number of women in executive positions beginning in 2015, while the government will provide subsidies to firms that "proactively recruit" women. As Abe has noted, women are Japan's "most underutilized resource".

Gender differences in pay and seniority are closely linked to labor market dualism. Women make up 70% of the relatively low-paid non-regular workers, while men make up 70% of regular employees.

CHART 4

Increasing female employment can help avoid looming labor supply shortages

Projected size of the labor force in thousands of people¹

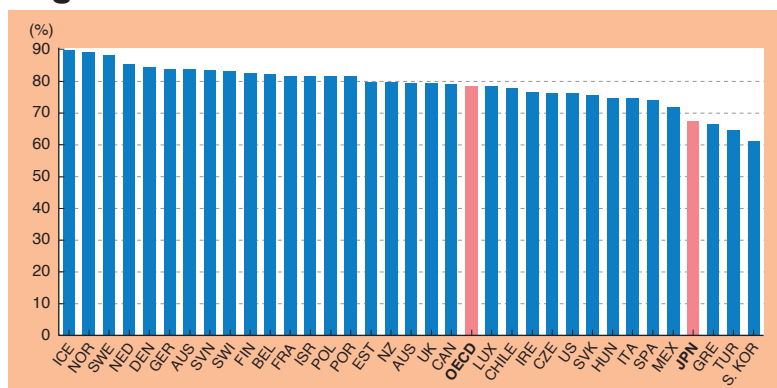


1. Based on population projections for persons aged 15-64 years and assuming that the labor force participation rate for men remains constant from 2011 to 2030.

Source: OECD (2014), "Japan - Advancing the third arrow for a resilient economy and inclusive growth", Better Policies Series, OECD Publishing, Paris, April, http://www.oecd.org/japan/2014.04_JAPAN_EN.pdf

CHART 5

Employment ratio for women with university degrees¹ in 2012



1. Including other types of tertiary education.

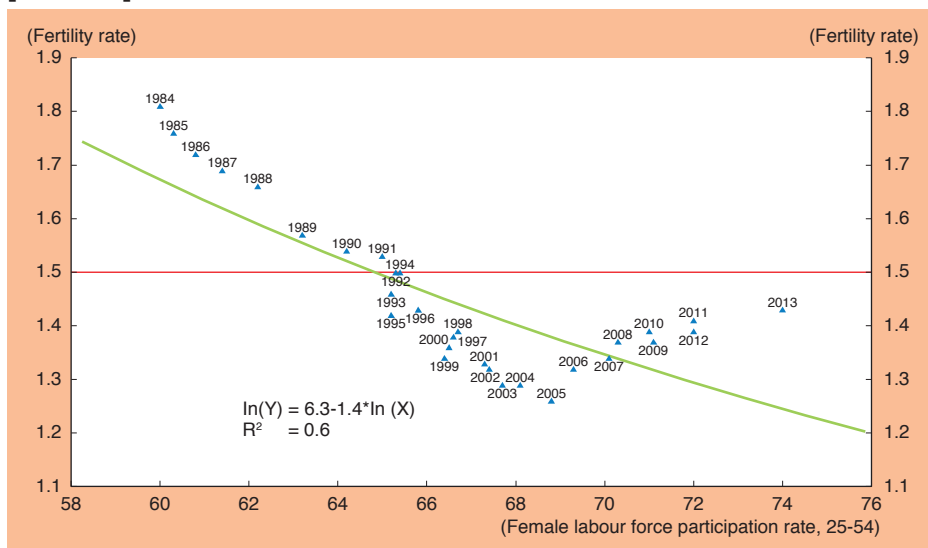
Source: OECD Employment Outlook, 2014

Women employed as regular workers before leaving their careers for children are likely to end up as non-regular workers, making a return to employment less attractive, particularly for highly-educated women. In fact, the employment rate for women with a university education was the fourth-lowest among OECD countries in 2013 (Chart 5), even though Japan's rate for all women in the 15-64 age group is above the OECD average (63% to 58%). Earnings and career profiles should more closely reflect performance rather than seniority and employment status in order to attract more women to the labor force. In sum, the demographic challenges are too severe and the untapped economic potential of Japanese women too large to ignore.

The rise in female participation since 1984 has been accompanied by a sharp fall in the fertility rate (Chart 6). Although the rate has rebounded somewhat since 2005 to 1.4, it is due primarily to births by women in the 30-40 age group, while there has been no increase in fertility among women in their 20s. Increasing both the fertility rate and female employment requires expanding the availability of childcare. Indeed, a positive relationship between childcare and female employment and between childcare and the fertility rate has

CHART 6

The fertility rate has fallen while female labour force participation has risen



Source: 2013 OECD Economic Survey of Japan

been found in many countries. In addition, improving work-life balance would help Japan increase both fertility and female employment.

Promoting more efficient use of older and younger workers

Raising the share of older persons who are employed would also help mitigate demographic pressures. However, most firms still have a mandatory retirement age of 60, reflecting several factors. First, given that employment protection makes it difficult to dismiss regular workers, firms rely on mandatory retirement to reduce staff. Second, firms agree to steep seniority-based wage profiles on the condition that they can force older workers to retire when wages surpass productivity. However, a large number of retirees are re-employed as non-regular workers: the share of non-regular workers among employees over the age of 65 was 72% in 2010, an increase of almost 20 percentage points since 1994. However, moving to non-regular status reduces wages by up to half, prompting many older workers to leave the labor force. Consequently, the employment rate falls from 77% in the 55 to 59 group in 2010 to 59% in the 60 to 64 group and 39% in the 65 to 69 group.

Given that Japan has the longest life expectancy (83.4 years) in the OECD, mandatory retirement at age 60 is not appropriate. The government should abolish the right of firms to set mandatory retirement and move to a flexible employment and wage system, based on ability rather than age. Such a system would encourage productive workers to remain employed beyond the age of 60.

As for youth, the employment ratio has fallen below 40% for the 15-29 age group, while the share of non-regular workers has doubled from 22% in 1994 to 49%. The experience of other OECD countries shows that a high level of employment protection for permanent workers hinders the integration of young people in the labor market. In addition, 17% of tertiary graduates in the 15-29 group are idle, engaged “neither in employment nor in education nor in training”

(NEETs). The reduced hiring of new graduates as regular workers in recent years has pushed more youth into inactivity or non-regular employment. It is essential to ensure adequate training opportunities for non-regular workers, who have limited opportunities for training provided by firms, as noted above.

Attracting Talent from Overseas

The share of foreign workers is estimated at less than 2% of Japan's total labor force, a low proportion compared to an average of 10% in European countries and 16% in the United States. The strategy also calls for attracting talent from overseas, in part by extending the training period for foreign trainees from three to five years

and expanding the quotas. In addition, rules on foreign workers may be eased in the National Strategic Special Zones. While the strategy envisions allowing 200,000 foreign workers per year, this is far below the 1.2 million decline in the working-age population each year. Given looming labor shortages, a greater opening to foreign workers is required.

Conclusion

Japan faces two major challenges: breaking down labor market dualism and raising labor force participation. Breaking down dualism, which is essential to reduce income inequality, promote labor mobility and boost productivity, requires a comprehensive approach. First, it is important to relax employment protection in practice for regular workers, thereby reducing the hiring of non-regular workers for employment flexibility. Second, it is important to improve the coverage of non-regular workers by the social security system. Third, vocational training for non-regular workers should be expanded to enhance their employability and the transition to regular employment.

Increasing labor force participation requires making great use of women, as well as older persons and youth. Breaking down labor market dualism would encourage women to work. In addition, the government should address the factors discouraging female employment by:

- Enhancing the availability of affordable and high-quality childcare.
- Reforming the tax and benefit system to remove disincentives to work for secondary earners.
- Improving work-life balance, notably by reducing long working hours and increasing working-time flexibility.

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