

An Interview with Giovanni Ganelli, Senior Economist of the Regional Office for Asia and the Pacific at the International Monetary Fund (IMF)

Labor Market Reform Under “Abenomics” — a Key to a Fully Revitalized Economy

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Assessment of Current Status of Abenomics

Q: First of all, what is your impression of the current state of the Japanese economy?

Ganelli: My view is that the first phase of Abenomics has been successful. We have seen that Japan is making at least an initial exit from deflation. But this success is based on expansionary monetary and fiscal policies, which cannot continue forever. What is important now is for Abenomics to make the transition to a new phase in which growth will be led by the private sector.

For that to happen, of course, we also need investment, wages and consumption to go up. For that, all the three arrows should be fully launched, because so far we could say that only the first arrow, monetary policy, has been fully launched, while the other two — the fiscal and structural reforms — are only partially launched. On the fiscal reforms, we have seen fiscal stimulus, and the consumption tax increase, which in our view is a positive thing, but what is still missing is a medium-term plan for fiscal consolidation. And on the third arrow, the government has a plan, and everything in that plan goes in the right direction, but in many areas reforms could be more ambitious.

Q: Some economists are suggesting cutting corporate income tax is a good strategy to encourage private investment. What do you think about this proposal?

Ganelli: The government has already announced a plan to cut



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corporate income tax. We think that would be positive, because corporate income tax is high in Japan compared to other OECD countries. A cut could have some positive effects on growth and be part of the strategy to increase investment, so we support it. But it will also create some revenue shortfall, so again there is a need to ensure fiscal sustainability, and the shortfall needs to be addressed by other fiscal measures. So we think that at the same time other things are needed, for example corporate governance reform. I wrote a paper about this, with my colleague Chie Aoyagi, titled “Unstash the Cash”, arguing that corporate governance reform can give incentives to Japanese companies to use their large amounts of cash in a more productive way, for example for investment and wages. So it is really a package: reducing corporate income tax, but also reforming corporate governance to stimulate higher investment.

A Step in the Right Direction

Q: Whether we see a significant increase in private investment with these measures could depend, as you say, on the outcome of the third arrow: structural reform. Do you see labor market reform as an important vehicle to encourage innovation?

Ganelli: I think what is needed for Japan in terms of structural reforms is to increase both the supply of labor and productivity, as well as giving incentives to companies to use their cash and create opportunities for Japanese workers. So what does this mean in

practice? Structural reforms should increase the labor pool by increasing the labor supply, and increasing labor participation by women, foreigners, and older workers. Increasing productivity, at the same time, has many elements to it. For example, deregulating some protected sectors, and opening up to trade, including in the context of the Trans-Pacific Partnership, can give incentives for productivity increases.

Going into more detail on labor market reforms, there are things which have already been announced, and other things which should also be done to increase productivity. I think the government plan goes in the right direction: for example, they are announcing that they will implement measures to introduce more flexible working hours, limit overworking, and establish a new working-hour system under which payment would be made based on outcome rather than on input. I think this can help create a labor market based more on output, performance and productivity, rather than just on the input of how much you work. But at the same time, this plan only applies to a small number of workers who are above a certain quite high income level. Nevertheless, it is a step in the right direction, as is the plan on more flexible working styles, and the efforts to increase female labor participation, for example by enhancing the availability of childcare. So some progress has already been made.

At the same time, the reforms could be a little bit more ambitious. For example there are tax distortions which create disincentives for women to join the labor force as regular workers; those could be removed. We also need to increase productivity, for which it is also important to reduce the labor market duality. And to increase the labor supply, it is also important to rely more on foreign workers. So this is my overall assessment of labor market reform. It is a positive thing that the discussion has started, and I hope that it will move forward.

Addressing the Question of Labor Shortage

Q: How would you address the labor shortage question in Japan? Would these labor market reforms be a good solution?

Ganelli: I agree that this is a serious problem for Japan at the moment. The labor market is very tight: unemployment in the last few months has been in the range of 3.5% to 4%, very low for an advanced country like Japan. And the job-to-applicant ratio is above 1. But that is only the aggregate picture. If you look in more detail, the situation is even tighter — in some sectors, like nursing and construction, there are two or more jobs for each applicant. So the implication is that many companies cannot find the workers they need and many projects, including reconstruction in the Tohoku area affected by the March 2011 disaster, have been delayed because of these shortages.

It is quite puzzling that despite these labor shortages, we are not seeing a substantial increase in wages. We have seen some nominal increase in the last few months, but real wage growth is still in



negative territory. And, maybe even more importantly, most of this nominal wage growth is not coming from the base wage but from bonuses or overtime. For the economy to pick up and for Abenomics to be successful it is increasing the base wage that is really important, because that is what workers perceive as permanent income. So increasing wages could be part of the solution to the shortage problem, and draw more workers into the labor force.

I also think that increasing foreign labor is required. This is another area in which reforms could be more ambitious. We know that the government is planning to increase reliance on foreign workers, but as I understand the plan is to do this mainly through expansion of training programs and some limited experiments in special economic zones. So again, this is a step in the right direction, but I think it falls short of what Japan needs to address the labor shortage. I also know that it might not be easy to push reform in this area from a political point of view; but we are not suggesting mass immigration, just that Japan could loosen up, and ease the entry requirements a little for foreign workers in all the areas with labor shortages, with maybe a sector-by-sector and skill-based approach.

Labor Market Duality

Q: Japanese businesses today seem dependent upon non-permanent workers. What do you think about this labor market duality?

Ganelli: About two-thirds of Japanese workers are regular workers, who basically have jobs for life, and about one-third are non-regular workers who, compared to regular workers, have much lower levels of job security, training, and career prospects. Among the latter, many are women and young people. There are many international

studies which show that an excessive labor market duality is negative for productivity. Why? Mainly because of two channels: the training channel and the effort channel. The training channel means that non-regular workers are less trained compared to regular workers, and there are studies which show this is relevant for Japan, where companies tend to train non-regular workers less than regular workers. This reduces productivity. Then regarding the effort channel, people who are working as non-regulars on an involuntary basis — meaning they would like to be regulars but are working as non-regulars — are less motivated by this situation, which also reduces productivity. This too seems to be relevant for Japan, where survey studies show that many non-regular workers would prefer to be regular workers if they had the chance.

So I think the excessive duality in Japan is contributing to keeping productivity as well as wages low. Furthermore, some studies show that non-regular workers, even though they are paid less than regular workers, still have wages higher than their marginal productivity. In other words, this situation is negative not only from a macro point of view, and from the workers' point of view, but also costly for the companies.

I wrote an IMF working paper on this problem with Chie Aoyagi (IMF WP 13/202, 2013), and the main finding of our empirical analysis is that to reduce duality it is necessary to reduce the difference in the degree of employment protection between regular and non-regular workers. There are various ways in which this could be done, but basically it involves contract reform. One suggestion could be to have a single open-ended contract, where your level of protection when you are very junior is low, but then it increases with tenure. This would give more protection compared to current non-regular workers, but a bit less protection compared to current regular workers. But again, this might be difficult politically in Japan because it involves introducing a severance pay system, which does not exist here at the moment. Another option could be to increase reliance on the so-called limited regular contracts (*gentei seishain*). These already exist, and workers on them have better career

prospects and employment protection than non-regular workers, but companies are reluctant to use them because the legal framework is not clear. So another reform could be to clarify the legal framework on the *gentei seishain* contracts, giving more incentives for companies to use them.

Again, the discussion has started, and I hope it will go ahead. There are also a lot of complementarities between reforms. If you need to reduce the level of protection for regular workers, then if at the same time you reform some of the more difficult or unpleasant aspects of regular work, like the long working hours, that can facilitate acceptance. So you move to a new model where there is a little bit less protection, but people also do not need to work very long hours and are assessed based on their performance.

Q: How about the impact of the introduction of a job performance assessment system? Even regular workers can be fired under this system.

Ganelli: I think this question relates to the transformation happening in the Japanese lifetime employment system. In my view this system has served the country well in the high-growth decades, because it created a lot of trust between employers and employees, and also encouraged accumulation of firm-specific human capital, by which workers come to know their firms very well. But now only two-thirds of workers fall under this system, while one-third are non-regulars.

So labor relations are already moving away from this system, and part of the reason for the shift is that in the last two decades companies' returns from firm-specific knowledge have fallen, partly because of more information technology and computerization. So this might be making Japanese companies more reluctant to employ everybody as a regular worker as before, because from the employer's point of view the cost of having regular workers, especially the firing cost, is still the same as in the past, but the benefit is lower because economic returns from firm-specific human capital have fallen. So rather than reducing the level of protection a little bit for everybody, the companies have been trying to solve this dilemma in a different way, by hiring two-thirds of workers as regulars and one-third as non-regulars. What I am saying is that maybe a more efficient way to do it could be to have a level of protection lower compared to regulars, higher compared to non-regulars, but a little bit more equal for everybody. That I think would be better for productivity.

The key is that Japan has to reform the labor market in a way that increases overall flexibility, both for the companies and for the workers, and at the same time try to maintain the positive aspects of the lifetime employment system, like the trust between employer and employee. So if you try to reduce labor market duality with labor contract reform, and then complement that with some changes in managerial and human resource practices, I think that can go a long way towards increasing productivity and flexibility, and reducing duality.



Q: Japanese companies tend to be dependent upon non-permanent workers because they are cheaper in the current conditions of deficits and a stagnant economy. In this situation, would it still be useful to raise the minimum wage as you have suggested?

Ganelli: My short answer is yes. An increase in the real wage is necessary to get Abenomics off the ground, and in my opinion Japan could think outside the box and consider using the minimum wage as a policy tool. Japanese wages are flexible downward but tend to be rigid upward, and do not automatically increase when the labor market is tight. And in the data, real wage growth in Japan has been lagging behind productivity growth for the last two decades. Even during 2002-2008 when there was economic revival, real wage growth was slightly higher than productivity only in two years. Given this background, and the fact that the Japanese minimum wage is one of the lowest among the OECD countries, I think a substantial minimum wage hike could be considered as a policy to increase wage growth. An analysis I did with Chie Aoyagi suggests that a 1 yen increase in the minimum hourly wage could increase the average hourly wage by 0.6 yen.

But we also need to keep in mind some concerns about unemployment and business costs. According to the IMF paper “Jobs and Growth: Analytical and Operational Considerations for the Fund”, in many countries higher minimum wages tend to have a small or no effect on unemployment. But the paper also finds that for some specific groups of workers, for example women, youth, and workers in small firms, the unemployment effect tends to be more negative. So this can be a useful policy for Japan, but you need to think about the trade-offs and try to limit the negative consequences for some categories of workers, for example by exempting them. Also, given that some small and medium enterprises (SMEs) might be hit harder by these policies, it is important to implement complementary reforms such as financial sector reforms, making it easier for SMEs to access credit on a market basis. The government could also pre-announce the policies — announcing for example that there will be a series of significant increases in the minimum wage, perhaps setting an explicit target — which would give an immediate boost to permanent income, and change people’s expectations, but smooth the negative effect on competitiveness.

Flexible Mindsets & Aging Society

Q: Do you think we need greater flexibility of mind, and that this can only be achieved through education reform?

Ganelli: In order for this package of policies to work, there is a need for a change in mentality; soft institutions need to change. At the moment many Japanese companies are emphasizing long hours, but there are also some signs that many companies are starting to understand that embracing a culture of more flexible working hours

could be in their own interest. So companies need to shift the focus from longer working hours to performance and productivity, and in addition make it easier for people to change their jobs in mid-career; this will encourage creativity and circulation of new ideas. At the moment there is a lack of horizontal mobility between companies, and most regular positions go to the newly graduated. So usually the first job that new graduates get determines their whole career: either they stay with that company for the rest of their working life, or get stuck in non-regular jobs forever. We think this situation needs to change, and policies can help. For example, the government recently decided to change the focus of subsidies from hoarding labor to actually hiring people. But there is also a need for a voluntary change in the corporate culture and management style.

This might seem difficult to achieve, but there is a lot of awareness. Some time ago I attended a seminar at the University of Tokyo on “The Science of Japanese Personnel Management” which presented firm-level empirical case studies suggesting that the reason for Japan’s long working hours is that junior regular workers have to use them to signal their commitment to the company. Researchers at the seminar concluded that this is a very inefficient signaling device and that companies should find a better alternative. Academics and the government are aware of it, and there are some signs that companies are also aware of it. So I am hopeful for the future.

Q: Finally, how can labor market reform take advantage of an aging society with more aged workers in the labor force? Do you think the mandatory retirement age should be abolished, like in the US?

Ganelli: Again, what Japan needs is a comprehensive set of reforms to increase both labor supply and productivity. There is a need to increase the labor participation of women, of foreigners, and of older workers as well; to reduce labor market duality, deregulate protected sectors, and give incentives to corporations to use their cash holdings in a more productive way. At the same time Japan needs a medium-term fiscal consolidation plan, and needs to stabilize its public debt and reduce fiscal risks. Some reforms of the retirement age have also started in Japan: it is being gradually increased. It should not necessarily be abolished: I think every country has to find its own way, and there is no solution which works for every country.

In other words, I think the best way to deal with the aging society is for all three arrows of Abenomics to be fully launched. If you do that, and increase potential growth, there will be more opportunities for everybody, including for older workers who might be highly educated and have a lot of experience. Once they retire from their regular careers they might find other jobs, or even start their own companies. If you increase the vitality of the overall economy, you also benefit from these more experienced older workers. **JS**

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