What Japan Can Learn from Germany's Labor Market Reform

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Labor Market Reform in Germany

The Substance & Context of Labor Market Reform

At the time of the introduction of the euro in 1999, Germany was called the "sick man of Europe" because its economy was stagnating under the double burden of structural rigidity and reunification costs. It is structural reform that has enabled the German economy to escape this predicament and achieve a recovery that has been called miraculous. This sweeping structural reform was started by Chancellor Gerhard Schroeder of the Social Democratic Party (SPD) and continued by Chancellor Angela Merkel of the Christian Democratic Union (CDU). Labor market reform, which is the subject of this report, has been at the heart of this process.

There have been many twists and turns in the development of Germany's labor market reform, but taken as a whole in retrospect, it has formed a systematic framework consisting of the following:

- Increasing labor supply through changes in unemployment benefits and other means
- Increasing labor demand through changes in the regulation of employment relationships
- Making labor market services more efficient through the privatization of employment agencies and other means.

Germany's labor market reform was developed in close coordination with the reform of its social welfare system. For example, "Agenda 2010", which was issued in March 2003, embraced a wide range of measures including the following:

- The Meister system: curtailing the areas in which qualification as a *Meister* was required in order to start or manage a business
- Vocational training: promoting the acceptance of trainees at enterprises
- Regulation of dismissals: having employees choose between lawsuit and cash compensation
- Unemployment benefits: connecting unemployment benefits to job mediation by the government
- Public pension: collecting nursing-care insurance premiums from pensioners
- Medical insurance: introducing competition between insurers and increasing the expenses of the insured.

Labor market reform was also part of a broader reform process encompassing the enterprise system, capital market, taxation, and other areas. Together, they comprised a comprehensive structural reform that also included individual measures that affected multiple areas. For example, as public pension payment levels were adjusted, an installment-based private pension system for investing in stock and other assets was introduced, and subsidized by the fiscal funds saved by the reduction of state contributions to the public pension system.

The Structural Reform Process in Germany

It is notable of Germany's structural reform process that it was launched by the Schroeder administration, which was led by the SPD, whose core support comes from labor unions. Although much of this was due to Chancellor Schroeder's personal inclinations, it also reflected the urgent need to deal with the German economy's predicament at the time. Germany's public pension system had become unsustainable because of its aging demographics, while rising unemployment caused by competition from cheap labor in the former socialist countries had exacerbated the condition of unemployment insurance. Namely, the social welfare finances faced the brink of collapse. At the same time, in facing the challenges of global competition posed by the information and communication technology revolution and other factors, the rigid labor market stood as an obstacle to structural transformation, while interlocking shareholding led by banks and insurance companies called "Deutschland AG" was regarded as fetters on industry renovation.

Schroeder set up expert commissions such as the Hartz Commission on labor and the Baums Commission on enterprises, and accepted their conclusions wholesale and implemented them. In their deliberations, the commissions disregarded the pre-existing stovepipe system and sought to develop market-friendly, crosscutting systems. The Hartz Commission adopted the principle that "all possibilities based on one's assets and capabilities must be exhausted before seeking assistance", while the Baums Commission announced that "the deteriorating social security system shall be replaced by the capital market." Although each individual measure may have been unspectacular, the overall effect was massive because of the systems developed on the basis of such systemic considerations.

This basic framework for structural reform was maintained by the Merkel administration led by the CDU. For example, the Labor Market Policy Reorganization Law (*Gesetz zur Neuausrichtung der arbeitsmarktpolitischen Instrumente*), enacted immediately after the global financial crisis struck, took measures focused on expanding employment opportunities for youths and the elderly while holding fast to the objective of quickly integrating jobseekers into the labor market. In the background of the continuity in the institutional reform process regardless of the nature of the administration was the response to the integration process of the European market, in addition to the national consensus on the need for structural reform. The basis had existed in Germany, as the key state of the Eurozone, for promoting structural reform in order to revitalize the economy while maintaining firm fiscal discipline.

The Fruits of Structural Reform

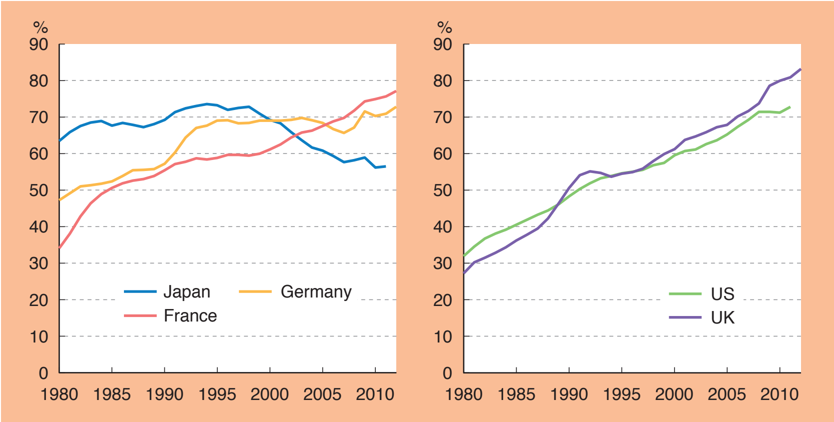
Germany's economic performances improved dramatically as these reforms were implemented, demonstrating strong growth figures except during the global financial crisis. In the process, the unemployment rate, hovering in the 11% range in the early 2000s, has now dropped to 5% plus, which means full employment has been substantially achieved. German industry has turned the tables on the other Eurozone members in terms of competitiveness to the point that Germany is now being criticized for "excessive" current accounts surpluses. Order is returning to its fiscal house as well, as a balanced budget is now in sight.

In the background of the great success that structural reform achieved in Germany was the fact that the German public accepted the pains of reform and exercised ingenuity and resourcefulness throughout the process. There was fierce political debate at the beginning of the Schroeder administration, and little was achieved by way of success, but public support grew after the inauguration of his second cabinet. Meanwhile, German enterprises went through a process of selection and concentration including small and medium-sized businesses and actively sought business opportunities abroad while the domestic market has been further opened not only to EU members but also to emerging economies.

All the while, South European countries remained content with their bubble economies and mushrooming public sectors against the backdrop of the low long-term interest rates that resulted from the introduction of the euro. They have finally come to grips with fiscal consolidation and structural reform in recent years, but have not been able to avoid political difficulties. Either way, economic structural reform was inevitable in the face of shifting demographics and competition from emerging economies. The main cause of the current gap between the solid performance of the Germans and the dire straits that the South European countries find themselves in is the difference in the timing of the inauguration of the reform process.

CHART 1

Unit labor costs



Note: Unit labor costs are calculated as the quotient of total labor costs and real output.
Source: OECD Database, UN data

Comparison with Japan

Common Features

When making international comparisons of the structure of the Japanese economy, there has been a tendency to accept the United States as the *a priori* standard and measure Japan against it. However, Germany is more similar to Japan because it too is a mid-sized nation state, has a civil law system based on statutory law, has a relatively heavy weight of manufacturing in its industrial base, and has rapidly shifting demographics due to shrinking and aging. In considering structural reform in Japan, I believe that comparisons not only with the US but also with Germany are meaningful.

Another common thread running between Japan and Germany is the fall from the post-World War II high-growth experience to the economic stagnation of the 1990s, when Japan faced the challenge of dealing with a casual assets problem after the bubble economy while Germany shouldered the burden of reunification even as it had to compete with the former socialist countries for industrial sites.

It was under these circumstances that the two countries embarked on structural reform in the first half of the 2000s. At that time in Japan, some people argued that Germany, with its economy further deteriorating after the introduction of the euro, "was becoming a second Japan, but was in an even more difficult situation because it was constrained in following independent fiscal and monetary policies."

The Results of Structural Reform

However, the respective outcomes of structural reform at this point are quite different.

There is no denying that Japan is doing substantially worse on industry and public finance. Looking at industrial competitiveness, German enterprises – particularly mid-sized firms (*Mittelstand*) – have been expanding international transactions and securing high profits, whereas Japanese enterprises have low profits while their exports are conspicuously static even as the yen has fallen. As for the public deficit, Germany has almost managed to balance its budget while Japan still requires arduous adjustments towards the target of achieving a primary balance six years from now.

Regarding the labor market, Germany achieved rapid improvement from the bottom, as we saw, while Japan's unemployment rate continued to be low and stable. All the while, however, employee compensation deteriorated in Japan. As for unit labor costs, in Germany they have only slowed down their increase in tempo, but in Japan they have fallen remarkably *(Chart 1)*. Besides, labor productivity in Germany is higher than in Japan, led by the non-manufacturing sectors. In sum, the Japanese worker has maintained stability in employment at the cost of lower productivity and income.

One cause for the gap in the outcome of structural reform was the fact that Germany's structural reform was carried out in parallel with the economic integration of Europe. Specifically, Germany needed to maintain policy continuity even in the case of regime change, since the direction of Europe as a whole was unchanged in the construction of institutions geared toward market integration and the fiscal discipline needed to secure confidence in the euro. The German government also had to design its institutions in accordance with economic rationality lest enterprises move their operations out of Germany. Moreover, it became clear to German enterprises and workers that business-as-usual would no longer do, as they faced direct competition from the outside.

By contrast, the Japanese economy is very much closed on the

TABLE

Openness & metabolism of industry

	Germany			Japan			US		
	2000	2005	2010	2000	2005	2010	2000	2005	2010
FDI outstanding (per GDP)	43.1	50.7	65.9	6.9	10.7	19.1	54.9	51.0	56.2
<Outside Euro-zone for Germany>	<25.8>	<31.2>	<35.7>						89
Inward FDI (per GDP)	14.4	17.2	21.7	1.1	2.2	3.9	27.9	22.3	23.4
<Outside Euro-zone for Germany>	<6.3>	<6.9>	<7.7>						
Foreign workers (per labor force)	8.8	9.3	9.4	0.8	1.1	1.0	12.9	15.2	16.2
New-Business openings (per all offices)		8.8			4.5			9.3	
Business shut-downs (per all offices)		8.0			4.1			10.3	
Entrepreneurships (per all enterprises) <ii>	6.3	5.1	5.6	3.1	2.2	5.2	11.1	12.4	12.3
Management metabolism (2000s) <iii>		<1.0>			<0.5>			<1.8>	
Average years of service <iv>			<11.2>			<11.9>			<4.6>

Note: <i> Figures in the column of 2010 are those in 2009 for the US and Germany.
<ii> Figures in the columns of 2000 and 2010 are those in 2001 and 2011 respectively.
<iii> The ratio of numbers of entrepreneurs per those of existing managements.
<iv> For Japan figures in 2011, for the others those in 2012.

Source: "Chuushoukigyou Hakusho" *(METI), "International Comparison in Labor Statistics" (JILPT),* "Roudoukeizai no Bunseki" *(MHLW), Bundesbank, Eurostat, Global Entrepreneurship Monitor, OECD, UNCTAD*

supply side, with low involvement in the international movement of capital and labor. For example, Germany's ratio of inbound foreign direct investment to GDP has reached 21.7%, while the same figure for Japan is merely at 3.9%. The proportion of foreign workers in the domestic labor force is 9.4% in Germany, while that of Japan is a paltry 1.0% *(Table)*. In a closed environment like this, enterprises and workers tend to think as if they could continue without much difficulty even without sweeping structural reforms that follow economic rationality. Not being embedded in a framework like the European Union, the government had a freer hand in fiscal and monetary policies, but had less of a need to secure continuity in designing institutions following economic rationality.

Mid- to Long-term Challenges for the Japanese Economy

However, the Japanese economy is in a very difficult situation from a mid- to long-term perspective. The fiscal challenge in particular requires massive adjustments in fiscal expenditures and revenues, since a large primary balance deficit corresponding to 1.8% of GDP will remain in 2020 even assuming consumption tax hikes to 10% and an annual 2.3% GDP growth rate in real terms.

The 2.3% real growth rate predicated here will be by no means easy to achieve when the potential growth rate hovers barely above 0% due to a declining working-age population *(Chart 2)*. In this regard, participation of women and the elderly in the labor force is currently being promoted in Japan. This is an attempt to catch up to global norms where Japan is lagging, and will hopefully make up for the decline in the working-age population if effective. However, looking at the contribution of this to the size of the working population, it will not continue to counterbalance the negative impact of the accelerating decline of the working-age population once the labor force participation of women and the elderly peaks. Therefore, in order to augment the labor force, it is necessary to consider radical measures such as inviting foreign labor and stopping the decline of the national population in addition to the measures that are being currently pursued.

Besides, we can expect only moderate productivity improvement through the increase of the capital-labor ratio. The average productivity improvement based on the capital-labor ratio from 1980 to 2012 was 1.1%, while the 1980s was the period when the weight of manufacturing in the industry was higher so that capital investment could effectively bring higher productivity improvement.

Therefore, thoroughgoing structural reform surpassing that of Germany is absolutely required for both labor and capital in order to secure a fundamental improvement in the potential growth rate.

Lessons from Germany's Structural Reform

Reforming the Labor Market & the Enterprise System

From what we have seen so far, the first lesson to be learned by Japan from structural reform in Germany is a drastic opening up of its economy and society to the outside world. However, this can only be executed in conjunction with foreign governments, and it is not clear that foreign capital and labor might flow in even if Japan opens its markets. In order to make sure that the potential growth rate of the Japanese economy is increased, it is necessary to raise total factor productivity within its supply frontier through optimizing the allocation of supply factors by enhancing capital and labor mobility.

When learning from labor market reform in Germany toward this purpose, it is necessary to keep in mind the difference in labor practices between the two countries. In Japan, unlike in Germany, the job description of a worker is not clearly defined. The relationship between the employee and the enterprise is more like a personal belonging derived from lifetime employment and protection of a standard of living than a contractual relationship consisting of the execution of a described job in return for compensation.

Because of this, it is extremely difficult for a distressed enterprise that intends to execute dismissals for the purpose of reorganization. Namely, Japan has a precedent regarding the abuse of employment dismissal procedures. According to this rule, dismissal is deemed void unless the following are satisfied:

- necessity to eliminate redundant employment positions in the light of an enterprise's survival
- efforts to avoid dismissal
- fair selection of individuals to be dismissed
- prior explanations to the employees and consultation with labor union.

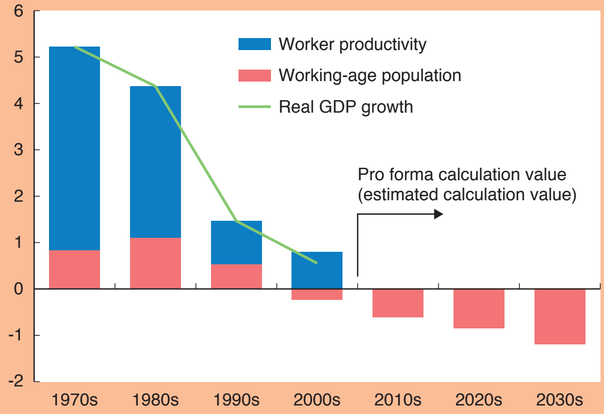
Particularly, it is almost impossible for large enterprises to be determined by a judge that they have exhausted measures to avoid dismissal and secure employment including transfers and reduction of compensation.

At the same time, a capable worker who wants to move to a workplace where he can make better use of his skills must be ready to shoulder a massive risk due to the underdevelopment of the external labor market. Under these circumstances, it is insufficient to merely imitate Germany and execute reform that emphasizes securing employment opportunities.

CHART 2

Labor force & productivity of Japan

<Decrease of working-age population>



<Labor Participation Policy>

	2000~2012	Status quo	Revitalization*
Real GDP growth	0.8	0.3	2.3
Increase of workers	▲ 0.2	▲ 0.8	▲ 0.0
Productivity improvement	1.1	1.1	2.3

*Higher participation of women and the elderly in the labor force

<Real Productivity Improvement>

	1980~2012 Average
Worker productivity	1.7%
Capital-Labor ratio	1.1%
TFP	0.6%

Note: Decrease in working-age population after 2013 is the annual rate of decline of the working population estimated in the forecast of future population and the predicted labor participation rate (assuming the labor participation rate in each age group and gender group would be the same as in 2012).

Source: Cabinet Office, Ministry of Internal Affairs and Communications, National Institute of Population and Social Security Research

In addition, a look at the supply side of the Japanese economy highlights the fact that in contrast to Germany, the unemployment rate has been consistently low, while at the same time business turnover remains extremely low. The business start-up ratio for Japan is merely 4.5% against Germany's 8.8%, and the business closing ratio for Japan is 4.1% against Germany's 8.0%. At the same time, Japanese employees including those at small and medium-sized companies and non-regular employees on average continue to work for the same business for 11.9 years, not much different from 11.2 years in Germany *(Table)*.

Furthermore, currently the labor shortage has already created a bottleneck for economic growth. Without improvement of the allocation of labor and capital, Japan's economy cannot grow at a higher rate than its potential growth rate which hovers barely above 0%.

All these considerations indicate that it is indispensable to focus on reorganization at the business establishment level rather than labor movement through individual job changes when learning from Germany in optimizing the allocation of supply factors.

Moreover, an assessment of the Japanese economic structure in its entirety indicates that the need for reform is greater on the enterprise side. There are many matters that require fundamental reform in business reorganization, such as the postponement of bankruptcy, and obstacles to corporate acquisitions. There are also deficiencies in the corporate governance system. For example, the vast majority of big business management are insiders who are drawn from the ranks of lifetime employees; an insularity not seen anywhere else in the world.

Thus, the "Japan Revitalization Strategy" as revised in 2014 places enterprise institutional reform at the top of the agenda.

Lessons from Germany

As we have seen, in drawing lessons for Japan from labor market reform in Germany, the important thing is that it was part of a broader, comprehensive structural reform. Since the economic integration of Europe required enterprise systems to follow common standards while there was much room for individual states to go their own ways in labor market and social welfare system reform, the spotlight tends to focus on the latter in discussing political initiatives. However, given the impact on the economic structure, it is important to combine reform of enterprise and employment systems. In a country like Japan where working conditions such as wages and job locations are highly flexible while compensation for employees is slumping in a sluggish economy, it would be effective for the government to promote reform that emphasizes the acceleration of enterprise turnover while encouraging the enhancement of productivity and wages.

The dispute settlement system is also of particular importance among the individual items for discussion in the labor market reform agenda. In Germany, the job description of an individual employee is clear. Employment protection is very strict in Germany too. However, there are established guidelines for monetary compensation in a case where the employer intends to conduct justifiable dismissal for the purpose of reorganization. By contrast, in Japan, much time is spent on lawsuits seeking reinstatement, particularly with regard to dismissals by large enterprises. This is an obstacle to facilitating reorganization by enterprises and job-switching by workers. There is an obvious need to construct a dispute resolution system with high predictability.

As for lessons for the formulation process of structural reform, it was important that Germany took a law-and-economics approach in which relevant legal systems were set up in a cross-sectorial manner to achieve economic objectives. For example, in considering enterprise system reform, it was stated that "legal systems that are functioning effectively in other countries shall be introduced to the maximum possible for the purpose of revitalizing the capital market while keeping in mind the 'path dependency' of the existing legal system in Germany." Japan should take a similar approach in constructing its own structural reform framework. JS

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