

A Flexible Labor Market Will Save Japan

By Hiroaki Miyamoto



Author
Hiroaki Miyamoto

Key Points

- Employment is a derived demand of production. As the environment surrounding the economy and society changes, Japan's employment and workstyle will inevitably have to change.
- Japan is facing changes in mega-trends, and a flexible labor market is required so that workers can work flexibly in line with the changes.
- A flexible labor market is expected to bring improvements in productivity by achieving smooth labor reallocation and by placing the right people for the right jobs.
- The content and quality of work must be assessed fairly and wages should reflect labor performance. A new human capital investment strategy is also required. The government should consider introducing a "tax incentive system for self-development".
- Japan has not been able to offer attractive labor and social environment to highly skilled foreign professionals. There is a need for a head-on discussion on immigration policy.

Introduction

Japan has suffered from sluggish economic growth for the past 30 years. Until the early 1990s, Japan's per capita nominal gross domestic product (GDP, dollar equivalent) was among the highest in the world, outperforming the United States, but has since dropped significantly, and fell to 28th in the world by 2021. Looking at the trends in wages, while in other advanced countries wages rose by 1.3 times to 1.5 times in the last 25 years, Japan's wages have barely gone up.

The factors behind the stagnation of the Japanese economy are so many and intricately intertwined that no single issue can explain it. However, the declining competitiveness of the Japanese economy is a major factor, and seemingly to symbolize this, productivity is stagnant. According to data from the Organization for Economic Co-operation and Development (OECD), Japan's labor productivity per hour in 2020 was \$49.5, ranking 23rd amongst the 38 member countries. This was the lowest ranking since 1970 when data became available¹. In addition, Japan has been at the bottom of the seven advanced nations (G7) for the past 50 years.

To increase competitiveness and productivity, it is necessary to increase value-added and at the same time improve the metabolism of the economy. A flexible labor market is key. Data shows that economies with flexible labor markets tend to be more productive. This is because the labor force is reallocated smoothly from declining sectors to growing sectors, promoting economic growth.

The benefits of a flexible labor market go beyond productivity improvements. There are significant benefits for individual workers. It is often feared that employment becomes unstable when the labor market becomes mobile, but the opposite is true. In a fluid labor market, individuals can change their workstyles freely depending on their lifestyles, which is a huge advantage for the workers. In particular, as the environment surrounding the Japanese economy changes drastically, mobilization of the labor market is imperative.

Employment is a derived demand of production and when the environment surrounding the economy and society changes, the way of the labor market and workstyles inevitably need to change. Japan is currently faced with four mega-trend changes: change in demographic structure, technology advancement, decarbonization (going green) as measures against global warming, and globalization. In an era where changes are frequent, a flexible labor market is desired so that workers are able to adapt.

However, various data have shown that the Japanese labor market is rigid. So what can be done?

What is important when constructing a flexible labor market is the assessment of the abilities of workers. There is a need to assess the content and quality of labor fairly and establish a wage system according to labor performance, or in other words productivity.

Human capital investment is also important. During the high-growth era half a century ago, economic growth was promoted by corporations implementing internal training of workers, thereby heightening productivity. Such a model was shattered after the burst of the bubble economy in Japan, and while a new human capital investment strategy is required, Japan lacks the structure to formulate the abilities of each individual. In a flexible labor market, since the axis of human capital investment shifts from corporations to individuals, reskilling and recurrent education becomes important. In order to support workers investing in education and training at their own will, the government should consider a "tax incentive

¹ Japan Productivity Center. International Comparison of Labour Productivity 2021.

system for self-development” which allows deduction of investment expenses from taxable income.

There is also a need to reform the tax system and labor market policies to allow job changes to be easier. Enhancement of the matching functions between corporations and workers, such as strengthening career placements and information-providing systems, is essential.

In Japan, where globalization is progressing and the population is declining, the utilization of foreign workers is also important. There is a need to proceed with building a country that is attractive for foreign professionals including the development of an “immigration law”. It is essential to create an environment in which foreigners are warmly welcomed as members of society and in which the Japanese can also be happy about it.

Mega-Trend Changes

The Japanese labor market has a structural issue. The root cause of the issue is the drastic change in the environment surrounding the labor market.

Employment is a derived demand of production. This means that employment is created only when there is production activity. Thus, if the environment surrounding the labor market changes, the way of employment and the labor market inevitably has to change accordingly.

The Japanese economy is currently exposed to four mega-trend changes: change in demographic structure, advances in technology such as artificial intelligence (AI) and automation, going green, and globalization².

In Japan, the population is declining accompanied by an aging population. Japan’s population has been declining continuously from its peak of about 128 million people in 2008. According to estimates by the National Institute of Population and Social Security Research, the population is estimated to be about 119.2 million people by 2050, and 88 million by 2065. This indicates that the decline in the next 40-plus years will be equivalent to the current population of Canada (approximately 37 million people), and its impact on the Japanese economy and society will be huge. The percentage of those aged over 65 in the total population is 29%, making Japan the world’s number one aging nation, and this number will continue to rise and is estimated to be close to 40% by 2060.

Longevity is also an issue. The average life expectancy for the Japanese in 2020 was 87.74 years for women and 81.64 years for men, recording historical highs. Both men and women saw life

extending by more than three years compared to 20 years ago. According to estimations by the Ministry of Health, Labour and Welfare, among Japanese born in 2021, 52.0% of women and 27.5% of men will live to age 90³. In a longevity society, people are more likely to work for longer periods to secure their living expenses after retirement, which affects the labor of all generations⁴.

On technological progress, the Fourth Industrial Revolution represented by AI, big data, and IoT (Internet of Things) is currently under way. These new technologies are expected to significantly change the labor environment. Research by Carl B. Frey and Michael A. Osborne of Oxford University shows that 47% of workers in the US face the risk of their work being replaced by automation or by machines in the next 10 to 20 years⁵. The study on Japan reports that 49% of employed workers are more likely to be replaced by machines⁶.

Greening as a measure to address global warming may change the entire industrial structure. To reduce greenhouse gas, the world has changed course towards decarbonization. In order to achieve decarbonization, there is a need to drastically change the existing economic structure, including the industrial structure of energy and automobiles. These changes are expected to have a great impact on people’s behavior, lifestyles and workstyles. For example, the shift to electric vehicles (EVs) will eliminate engines that require complex processing, and the number of parts needed will decrease. This may lead to lower employment in domestic auto parts manufacturers. On the other hand, if EVs become more widespread, new occupations and jobs may be created along with it.

Globalization, while it brings great benefits to the economy, also has a negative impact and its limitations have been pointed out. Some opinions point to “de-globalization” progressing with the novel coronavirus pandemic and the Ukraine crisis. While it is a fact that there has been a backlash against globalization, the fundamental trend does not seem to change.

As such, while the environment surrounding the Japanese labor market is greatly changing, the employment system has not been able to respond to these mega-trend changes, and it is causing the Japanese economy to stagnate.

Merits of a Flexible Labor Market

Up until now, the standard life-course of a Japanese person was to start a job after graduating from school, basically work for the same corporation or its affiliates until retirement, and then live out the rest of their life. But as people live longer, this three-stage life-course of

2 For details on megatrend changes, please refer to Miyamoto (2022).

3 Ministry of Health, Labour and Welfare. “Overview of Simplified Mortality Table for 2020”.

4 How to finance post-retirement lives is important for individuals. According to a Financial Services Agency report (Report from the Market Working Group of the Financial System Council, “Asset formulation and management in an ageing society”, June 3, 2019), aside from public pensions, financial assets worth 20 million yen are required for a married couple to live to the age of 95.

5 Frey and Osborne (2017).

6 Nomura Research Institute (2015).

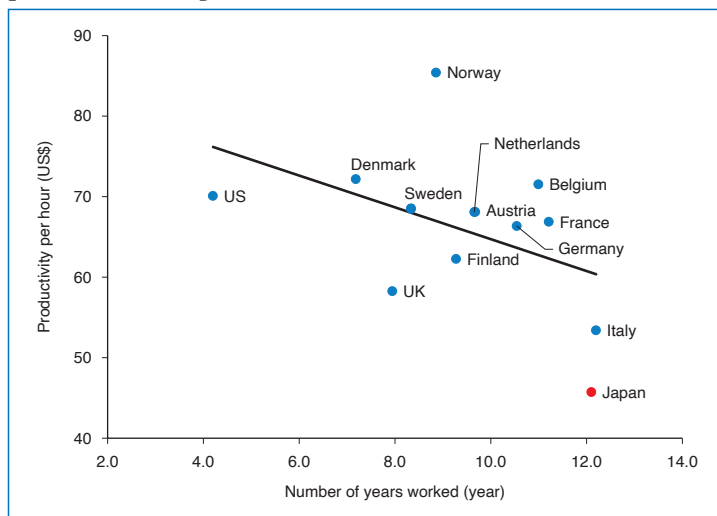
education, work and retirement no longer holds. This is because the life period after retirement is too long. Going forward, people are expected to continue working for longer periods of time.

The longer people work, the longer they have the opportunity to face changes in the working environment. In other words, opportunities to face mega-trend changes will increase. Technological progress and going green will greatly change the industrial structure. While new jobs emerge, old ones will disappear, and as a result there is great chance that corporations and industries that lead the economy will change.

Google, Amazon, Meta (formerly Facebook) and Apple, the giant US IT corporations called GAFA, were established after the mid-1990s, except for Apple, and they have only been around for just under 30 years. Considering the changes that have occurred in our lives and the social economic environment in the last 30 years, it may be natural to assume that corporations or industries that do not yet exist will lead the world and exert a great impact on our lives and the way we work.

In a rapidly changing environment, individuals are more likely to change their careers in their working lives. As the economic environment changes, workstyles and the way of employment must be flexible for individuals to achieve optimal careers in line with their

CHART 1
Relationship between labor market mobility (number of years worked) & productivity



Source: Created by author using data from OECD etc.

lifestyles. What is required is a flexible labor market. A flexible labor market not only implies that movement of labor is active, but also a market that fully recognizes the freedom of workers to move.

Since the labor force can readily move in a flexible labor market, the matching of workers and corporations can be done smoothly. As a result, the investment profitability of corporations will rise and because finding the right people for the right job becomes more achievable, improvements in workers' productivity can be expected. In fact, as shown in *Chart 1*, economies with high labor mobility (shorter number of years worked) have higher labor productivity.

A flexible labor market will also promote economic growth. The economy grows through the entry of firms with high productivity and the exit of firms with low productivity. In this metabolism process, it is important that economic resources, such as labor and capital, are reallocated smoothly from declining sectors to growing sectors. If the labor market is rigid, it is difficult to reallocate labor, which will hinder economic growth.

Analysis using data from OECD countries showed that countries with higher labor market mobility have higher labor force participation and employment rates and lower unemployment (especially long-term unemployment)⁷. Analysis conducted by a research group of the International Monetary Fund (IMF) using data from 97 countries around the world also shows that in a flexible labor market, unemployment of young people and long-term unemployment are lower⁸.

Changing jobs is easier in a mobile labor market and therefore workers can benefit from increased labor opportunities. Through changing jobs, workers can obtain better working conditions and higher wages. In addition, individuals can acquire new experiences in a new workplace, brush up their skills, and further expand their careers through changing jobs. Indeed, it has been reported that in the US where people actively change jobs, changing jobs has led to higher wages and career advancement⁹.

Labor market mobility is known to affect the effectiveness of economic policies. Fiscal policies such as public investment are expected to increase output and employment, and IMF research shows that the effects are greater when labor markets are more fluid¹⁰. Public investment will become important for the trend of going green, and its success will likely depend on the mobility of the labor market.

As for the effect of fiscal policy, it is known that its effect on economic growth is weakened in aging economies¹¹. This

7 Di Tella and MacCulloch (2005).

8 Bernal-Verdugo, Furceri, and Guillaume (2012).

9 Topel and Ward (1992) states that after entry into the labor market, approximately 40% of the increase in labor income for the first 10 years is due to a change in jobs. For macroeconomics of changing jobs, please refer to Mukoyama (2022).

is because the multiplier effect of fiscal policies decreases with a decline in the labor force due to aging. Promoting labor market reforms and encouraging employment of the elderly and women is important for increasing the effectiveness of fiscal policy by alleviating the decline of the labor force.

To keep the elderly employed, it is important to utilize new technologies. For example, the use of working remotely may encourage employment of elderly people who have difficulty commuting physically. It is also important to work on technology development of robots and AI to support employment of the elderly. If such technologies are developed in Japan, the leading aging society, exports to other countries facing an aging society will become possible, and it may become a leading industry.

Is the Japanese Labor Market Mobile?

How flexible is Japan's labor market? Data indicates that the Japanese labor market is rigid. Looking at the turnover rate, which is often used to measure the mobility of the labor market, Japan's turnover rate is a little less than 5%. On the other hand, in the US where the labor market is flexible, the job-to-job transitions rate averages 2% per month. Also, while the average length of service in the US is 4.1 years, it is 11.9 years in Japan, about three times longer than in the US.

Worker flows also measure labor market mobility by focusing on the movements of workers. There are three states of the people in the labor market: employed, unemployed, and inactive where people are neither working nor searching for jobs. The number of workers who move between these three states is the worker flow.

Data over the past 30 years shows that about 3% of the people in the labor market in Japan change their labor force status each month, compared to 6.5% of people in the US. From this point of view, the Japanese labor market is more rigid than the US¹².

While the job-finding rate and separation rate for Japan is a monthly average of 14.2% and 0.4% respectively, the job-finding rate and separation rate for the US is 25-32% and 3-5% respectively. Compared to the US, the probability of losing a job in Japan is considerably low, and the probability of finding a job is also low. In other words, once a job is found in Japan, it is difficult to lose it, but once unemployed, it is difficult to find a job.

Mobility in the labor market is also greatly influenced by the employment system. According to the Fraser Institute in Canada,

Japan's labor market is not as flexible as the G7 when focusing on hiring and dismissal regulations.

A major factor behind the rigidity of Japan's labor market is Japanese-style employment practices such as lifetime employment and seniority-based wages. These practices supported the postwar economic growth and were praised by the world, but with the changes in the environment surrounding the Japanese economy they have become obsolete, and as a result not only are they not functioning well, but they have been causing various negative impacts on the economy and society¹³.

The standard worker that Japanese-style employment practices assume is a male full-time employee whose wife is a full-time homemaker. In other words, women, the elderly and non-regular employees are not considered. Thus if we try to maintain Japanese-style employment practices, it will be difficult for women to balance work and family, for the elderly to find jobs, and there will be a significant disparity between regular and non-regular employees.

What Can Be Done?

So how can we increase the mobility of the labor market?

What is first needed is a wage system based on skill assessments and labor performance. Japanese corporations have tended to give promotions and raise salary based on years of service and internal factions. They have not fully looked at what abilities and skills the workers have and the performance they have delivered. Going forward, there is a need to assess the content and quality of labor fairly, and set a wage structure based on labor performance.

Under seniority-based wages, which prevailed in Japanese companies, workers' productivity and wages do not match, and the wages of the elderly (young people) are higher (lower) than their productivity. Under these circumstances, companies are reluctant to hire the elderly. If the wage structure is one that matches labor performance, corporations will have the incentive to hire workers regardless of their age, and as a result all generations will benefit from employment opportunities. Existing research points out that productivity increases when people with different experiences and skills from various age groups were to complement one another.

If the value of labor was assessed based on performance and a corresponding wage system was established, new workstyles such as teleworking could be more utilized. It is also important in attracting foreign professionals accustomed to performance-based

10 Cacciatore et al. (2021).

11 For reference, see Yoshino and Miyamoto (2017), Honda and Miyamoto (2021), Miyamoto and Yoshino (2022).

12 Lin and Miyamoto (2012).

13 Japanese-style employment practices became established and widespread during the postwar high economic growth period, on the back of rapid and sustainable economic growth and a population structure with abundant young people. With Japanese-style employment practices gone and the trend of the environment surrounding employment changing, the rationale for Japanese-style employment practices has dropped. For more on this, please refer to Shimada (2012) for example.

systems.

As the mega-trends surrounding the economy and society greatly change, workers will be required to continuously brush up their skills. Companies used to play an important role in improving workers' skills, but in a flexible labor market, career development needs to be conducted by individual workers. Individuals will pursue their own preferences and think about what they want to do amongst various job possibilities. This means that different workers require different training and education. As support for encouraging workers to invest in self-development, the government should consider the introduction of a "tax incentive system for self-development" which deducts personal investment expenses on education and training from taxable income for those who conduct their own investments. Online education is also a way to acquire skills in one's free time and is considered to encourage self-development. Promoting reskilling and recurrent education is also important.

The government should also encourage investment towards skills that are high in demand. In particular, learning opportunities should be offered for workers who are not ready to benefit from technological progress. Some countries already support training subsidies for their workers. Singapore provides benefit payments for those aged 25 or above so that workers can receive training at any stage of their working lives. In France also, all workers are eligible for benefit payment towards vocational training in every sector.

There is also a need to abolish systems and policies that put labor mobility at a disadvantage, and to make the market mechanism work. Many Japanese corporate systems set long-term employment as a prerequisite, and are designed to make employment rigid and disadvantageous to changing jobs. And what is supporting this is the Japanese tax system and public policies. Social security and tax systems should be reformed so that they are neutral to changing jobs.

For example, while the retirement income tax system favors long-term employment, it is a disadvantageous mechanism for changing jobs. There is also a need to clarify dismissals and keep

employment adjustment costs low so that employment is flexible for corporations. In addition, while employment adjustment subsidies have played a certain role in limiting unemployment under the coronavirus pandemic, it is a fact that they have allowed corporations to postpone structural reform of their businesses¹⁴. Excessive support for companies delays metabolism and becomes a hindrance to growth. A shift to policies that support employment which do not obstruct labor movement is required. Expansion of the matching function is also essential such as strengthening employment placements and information service systems.

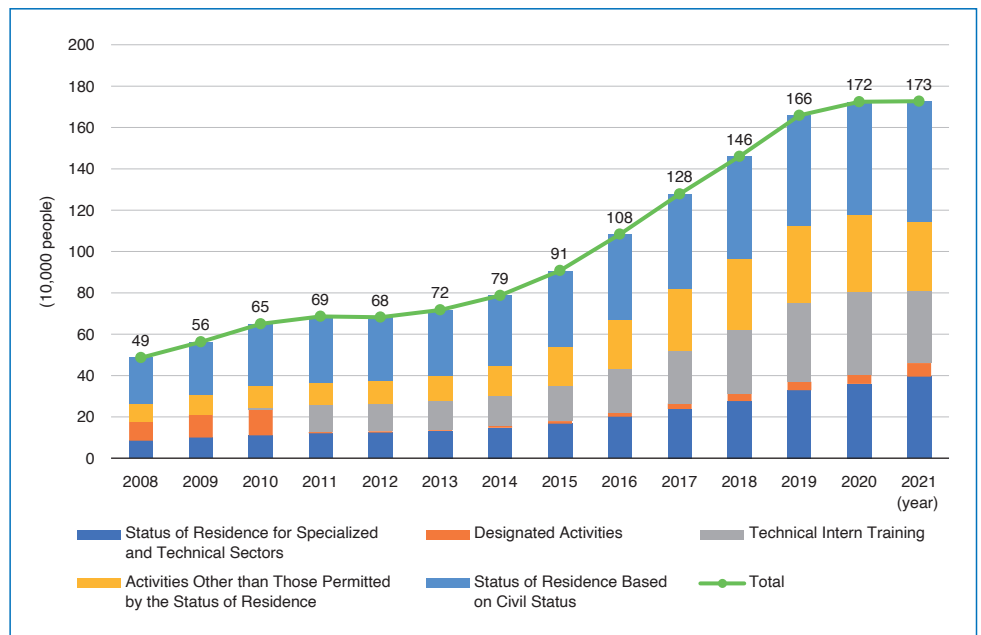
On Immigration Policy

Equally important as the fluidization of the labor market is the utilization of the foreign workforce. As globalization progresses and the labor force decreases due to the declining birthrate and aging population, the labor force of foreign workers becomes important in addition to the employment of women and the elderly.

Japan has two laws related to foreign human resources: the immigration control law and the refugee relief law, but there is no actual immigration law. In 2019, a new status of residence called "specified skills" was stipulated, and Japan turned to accept

CHART 2

Trends in number of foreign workers by status of residence



Source: Ministry of Health, Labour and Welfare

¹⁴ According to "National Corporate Bankruptcy Status" from Tokyo Shoko Research, while the number of bankruptcies was 8,383 in 2019, it was 7,773 in 2020, seeing a decline from the pre-coronavirus pandemic.

unskilled workers.

In recent years, the number of foreign workers has been increasing (Chart 2). From 2020 to 2021, the number of foreign workers did not increase much due to the impact of the coronavirus pandemic. The rate of increase in foreign workers was high at 13.6% in 2019, but fell sharply to 4.0% in 2020 and 0.2% in 2021. However, the number of foreign workers has more than tripled in the last 10 years. Foreign workers account for about 2.5% of all workers. Thus, one in 40 workers is now a foreigner.

While some express hopes for foreign professionals to play active roles, various serious issues have been pointed out in accepting them. In particular, it is a problem that foreign technical intern trainees and foreign exchange students are forced to work in a poor working environment. According to a survey by the Ministry of Health, Labour and Welfare, about 70% of the companies where foreign technical interns work are found to violate laws, such as illegal overtime, low wages, and unpaid wages. Improving and securing the working and living environment for foreign workers is needed. In addition, putting in place a structure free of prejudice and discrimination is vital to accepting people with different cultures and thoughts.

Another problem is that today's Japan is not very attractive to "highly skilled professionals" for whom competition is intensifying around the world. According to the "World Talent Ranking" by IMD, a business school in Switzerland, of 63 countries and regions around the world, Japan was ranked 54th in 2020, making it a country with poor attractiveness for foreign professionals. In the "OECD Indicators of Talent Attractiveness" rankings (covering 35 countries) released in May 2019, Japan was ranked 25th in the "attractive country" for workers with higher academic qualifications.

Japan had thus far benefitted from employing cheap unskilled foreign workers. In a knowledge society going forward, attracting talented highly-skilled foreign professionals is important. In addition, it is essential to create an environment where foreign nationals are warmly welcomed as members of society and Japanese people are happy about it.

While the environment surrounding the Japanese economy changes drastically, Japan has not conducted self-reform. Japanese corporations relied too much on cheap temporary workers, contract labor, and cheap foreign workers as represented by technical interns, and have neglected to make necessary investments such as digitalization. From now on, Japan should make the labor market flexible, heighten competitiveness, reverse the tendency to decline, and put itself on a development path.

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Hiroaki Miyamoto is a professor of Economics and Business Administration at the Tokyo Metropolitan University. He has been a professor and special advisor to the president of International University of Japan, a project associate professor of the Graduate School of Public Policy, University of Tokyo, and an economist at the International Monetary Fund. His primary areas of research are macroeconomics, labor economics, and the Japanese economy. His commentaries on the Japanese economy, especially the labor market, appear in both Japanese and foreign media outlets such as the *Wall Street Journal*, *Bloomberg*, *World Economic Forum* and the *Nikkei*. He earned a Ph.D. in Economics from the University of Wisconsin-Madison.