

# Changing Japanese Employment Practices and Their Implications for the Labor Market

By Yashiro Naohiro

Japan's unemployment rate has risen rapidly, reaching close to 5 per cent in early 2000, which was a historically high level by Japanese standards (Diagram 1). The unemployment rate had remained at a maximum of 3 per cent in the 1980s even during recessionary periods, unlike the United States and Europe. This was mainly because of the long-term employment practice in many Japanese firms, averting lay-offs despite falling production. But, in the recent recession starting in 1997, the behavior of Japanese firms has changed significantly to curtail employment. In order for Japanese firms to be able to understand the recent sharp rise in the unemployment rate, it is necessary to look for the major factors underlying the changes in Japanese firms' employment policies, that also reflect the changes in the economic environment.

## 1. Understanding Japanese employment practices

One of the main characteristics of Japanese employment practices is an efficient mechanism for intra-firm skill formation. This has been a source of the strength of Japan's international competitiveness of its manufacturing firms. These employment practices are particularly prevalent among large firms, which are usually defined as those with 1000 or more employees, and the public sector; both accounted for 30 per cent of the total employment in 1994. Employment practices are nonetheless not exclusive to large firms, but are spreading in a less rigid form among the medium-sized firms, so that it is difficult to draw a clear line between them.

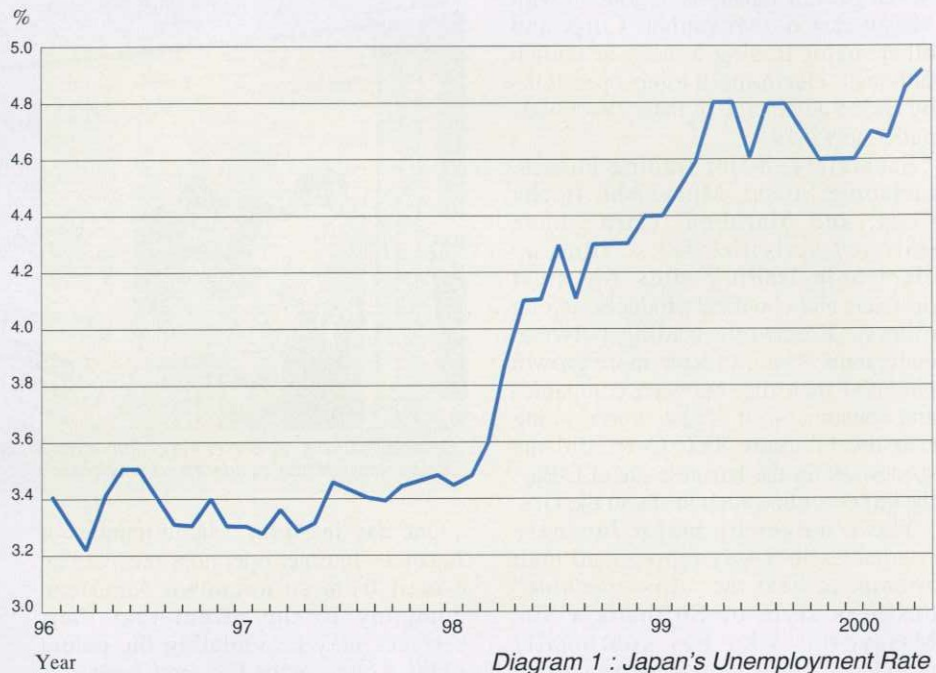


Diagram 1 : Japan's Unemployment Rate

Japanese employment practices are based on the following three principals; long-term employment practices, a seniority-based wage structure, and company-specific labor unions. They used to be considered particular to Japanese firms, for example, what makes Japanese firms different from Western ones is a lack of individualism, just like in traditional society. According to this view, job security in recessionary periods and seniority wages meeting with a life-cycle pattern of necessary life-expenses are mainly due to the employer's moral obligation, which is closely related to its cultural tradition of paternalism in families and villages. In this respect, therefore, the behavior of Japanese firms is entirely different from those in other OECD countries, and the "rules of the game" in the market are also different, so that "fair competition" between Japan and others is not really

possible.

However, what appears to be different from Western practices is merely due to different economic circumstances, and the principal mechanism underlying Japanese employment practices is no different from those in other industrial countries. Otherwise, it is rather difficult for Japanese manufacturing companies with pre-industrial management practices to compete on the world market

### Long-term employment

The "fixed nature" of Japanese employment practices - hoarding a surplus of employees in times of recession - has been considered one of the particular characteristics of the Japanese system. This is contrary to U.S. firms which lay-off their workers as soon as production falls in order to maintain a certain level of labor productivity and profit. Why, then, do



Japanese firms maintain a surplus of employees in recessions, allowing a significant decline in their profits? It is because a firm needs to utilize the substantial investment made in employees' skill formation.

The postwar economic development in Japan was marked by a high rate of economic growth. On average it stood at 10 per cent from 1950 to the early 1970s, stimulating the demand for skilled workers to meet the demand of expanding production. Also, one of the major sources of this development was based on imported technologies, narrowing the large gap between domestic standards and other industrial countries. Many Japanese firms had no alternative but to create the necessary skills through the "hands-on process" while actually being employed. For Japanese firms, skilled workers are like machines, which cannot be thrown away in a recession. Job security, therefore, is not mainly due to the paternalism of the firm, but is a rational choice based on intensive on-the-job training for employees.

#### *Seniority-based wage structure*

Job-security alone is not a sufficient condition for keeping skilled workers within a firm. The more capable workers seek better employment opportunities outside the firm, while the less capable tend to remain under employment security practices. In order to minimize the risk, the employer should offer capable workers the possibility of future promotion within the firm. Thus the wage structure has to be positively sloped with the length of years-of-service in the firm, thus reducing a worker's desire to move to another firm.

Japanese firms offer substantial lump-sum severance payments on retirement, amounting to more than two years annual earnings. These lump-sum

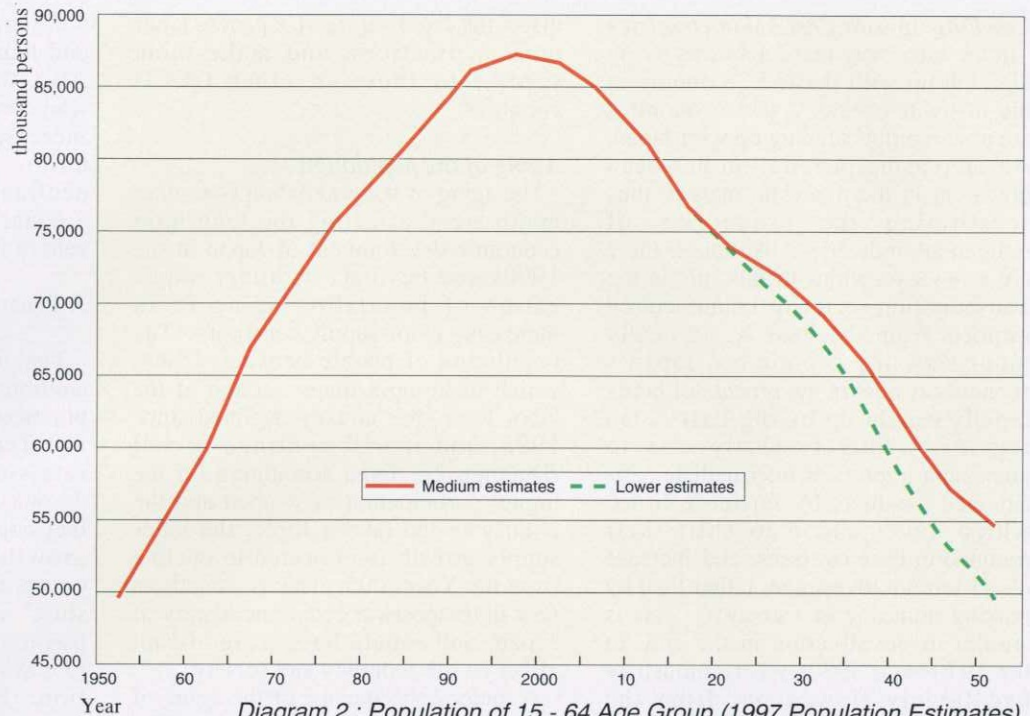


Diagram 2 : Population of 15 - 64 Age Group (1997 Population Estimates)

payments have two implications; one is a de facto back-payment of the accumulated lower wages and the other is the substitute for a company pension. The amounts of these lump-sum payments are strongly based on a seniority principle, i.e. the length of service with the firm and the wages just before the retirement which are also parallel to the age. Thus, the lump-sum payment effectively works to prevent employees from leaving the firm.

#### *Company-specific labor unions*

Japan's labor unions are organized on an individual firm basis with a few exceptions in the transportation sector. Though both blue-collar and white-collar workers belong to the same union, there are hardly any conflicts among the union membership. How can this be possible?

– First, there is a wide-range of job rotations across different occupations within a firm; this is mainly associated with the need for on-the-job training for various types of skills in the firm and a wide range of promotion;  
– Second, a firm and its labor union share common interests for the

sustainability of the organization through long-term job security and substantial back-payments at retirement;

– Third, most of the managers in large Japanese firms are recruited not from the large share-holders, but senior employees and former union members. Thus, there is close contact between the labor union and managers.

In summary, so-called Japanese specific labor practices are efficient devices for intensive skill formation of workers within a firm, a situation which was stimulated by the period of rapid postwar economic growth.

## 2. Changing economic circumstances

The economic circumstances of Japanese firms have changed radically in the 1990s. Economic growth has significantly decelerated in the 1990s, just as it did in the mid-1970s after the Oil Crisis. This is mainly attributed to a globalization of economic activities and a rapid aging of the population.



## *Catching up with East Asian countries*

In the same way that Japan was trying to catch up with the U.S. economy in the postwar period, Asian economies are now rapidly catching up with Japan. An increasing penetration has been prevalent in the domestic market, thus substituting the production of indigenous industries. Although there are a few exceptions to this rule in the transportation sector of manufactured imports from the East Asian newly industrializing economies, Japan's economy is now in the process of being rapidly caught up by the East Asian regions. This is partly due to increasing imports of intermediate part-finished products by Japanese firms, which have tended to shift their production base overseas, and increase direct foreign investment rather than by making domestic investments. This is similar to the situation in the U.S. in the 1970s and 1980s where industries had largely flowed out from the domestic market for profiting wage differentials.

While the growing Asian market is a factor for stimulating the demand for Japanese products, they do not have to be produced in Japan, and can be produced elsewhere by Japanese subsidiary firms. This implies that the ability of Asian economies to catch up will be a factor to lower Japan's medium-term GDP growth rate by shifting demand away from Japan. The deceleration of economic growth would discourage a firm's incentive for investment both in physical capital and the employees' skill formation by lowering the expected rates of return.

Japanese firms have traditionally shifted the labor force within the firm across industry; for example, a coal mining company shifts their major production field to chemical and other related industries by establishing new subsidiary companies. However, such positive investment behavior can only be possible at a time of high rates of economic growth. With the deceleration of economic activities, however, labor movements through the labor market become more frequent like in other industrial economies. This will

affect the fixed nature of Japanese labor market practices, and make them similar to those in other OECD countries.

## *Aging of the population*

The aging of the population is another major trend affecting the long-term economic development of Japan in the 1990s and beyond. A direct implication of population aging is an increasing labor-supply constraint. The population of people between 15-64, which make up a major section of the labor force, has already declined since 1995, and it will continue to fall (Diagram 2). Even accounting for the higher participation of women and the elderly in the labour force, the labor supply growth is projected to decline from the Year 2005. This is something new in the postwar economic history of Japan, and should have a significant effect on the economy and society.

A major consequence of the aging of the population is an increasing number of older workers in the labor force; while the labor force aged below 35 is projected to decline after 2000, those above 55 will increase up to 2020. Rapid aging of the population increases the costs of age-related human resource management, including the seniority-based wage practice. An increasing scarcity of young workers will push up their wages through competition in the market, while the excess of older workers will press their wages in the opposite direction. The average wage profile measured by the relative wage of the older workers to that of the young, reflecting the changing ratios of the labor force composition, is estimated to continue declining up to 2020. This, coupled with the projected tightening of the labor market conditions, is likely to raise the labor turnover ratio.

Another major characteristic in the Japanese labor market is an increasing number of women in the labor force. This is partly due to widening job opportunities in the service sector, and also to an increasing incentive to work among married women who used to stay at home. They are in most cases

non-regular workers such as part-time and temporarily dispatched workers. Also, the ratio of unmarried women who continue to work full-time has also increased. As a result, the ratio of union membership has steadily declined, and union members now account for slightly more than 20 per cent of the total workforce.

## **3. Prospects for the labor market**

The above changes in the economic environment have affected employment practices, and thus the unemployment rate. The increase in the unemployment rate since 1998 partly reflects the "down-sizing" of Japanese firms as they adjust to an expected lower market growth. This takes the form of a company's "employment portfolio shift" away from regular workers to part-time workers or "out-sourcing" of jobs which used to be done inside the firm. From the Japanese company's viewpoint, regular workers, who are equipped with firm-specific skills and for whom job security is required, are "high risk, high return" human assets. As average economic growth has decelerated, the expected return on human assets would be lower, and the preference for "low risk, low return" assets becomes relatively higher. Indeed, labor demand by the large firms has stagnated through the 1990s, and new employment opportunities are found in small and medium-sized firms with lower wages and less stability of employment. The rapid shift of employment away from those with high job stability to less stability is a major factor behind the sharp increase in the unemployment rate in the recessionary period since 1997 (Diagram 3).

With a recent sharp increase in Japan's unemployment rate, there is a widespread view that it will continue to rise to the level of 10 per cent as in many European countries. A major rationale behind this view is that with continuing sluggish economic growth in coming years, it would not be possible to maintain an excess labor force in many regulated industries such as in the agriculture, retail and



transportation sectors. Also, deregulatory measures are to be implemented more intensively by the government. This implies that Japan will face the same "jobless growth" that has been observed in European economies.

However, the view that changes in both employment practices and government regulation will have a negative impact on unemployment in the long-run is too pessimistic, because of the following:

– First, while an excess labor hoarding in large companies should help to reduce unemployment in recessionary periods, it also prevents the early demand recovery of employment by sacrificing the firms' profits. Changing labor practices simply shift the function of labor demand adjustments from firms to the market, thus increasing the fluctuations in unemployment rates, but not necessarily the average level over the business cycle;

– Second, it is a general principle in the labor market that the more wage adjustment works, the less the unemployment pressure becomes. Outsourcing of job opportunities from large companies with higher average wages to smaller companies with lower wages is, in a sense, the wage adjustment in the macro economy, thereby reducing overall unemployment;

– Third, the low-productivity sectors with excess employment bear the costs of the other sectors in the economy by their higher prices. Thus, the decline in the excess labor force in these sectors may well stimulate production and employment in high-productivity sectors.

In sum, structural reform in the economy with improving productivity should have a favorable impact on the economy and thus employment in the medium-term, rather than vice versa. The "European decrease" is mainly attributable to a lack of wage flexibility in the labor market, which makes macro-economic adjustment more difficult. Examples are the minimum wage standard which is set too high for

unskilled young workers, overly rigid job security regulations, and expensive non-wage costs for financing earlier retirement. These are fortunately quite different from the Japanese labor market conditions. If such reforms moving the current labor market toward a more market-based one were pushed forward, the risk of an excessively high rate of unemployment such as in Europe will become less likely in Japan.

#### 4. Structural reforms in the labor market

##### *Reforming labor market regulations*

Japan's labor market policies are based on a principle of "the more we have stability, the better jobs are." Thus, the government depends on the fixed employment practices of large firms and aims to support them through various regulations:

– First, there is a limited portability of retirement benefits. The lump-sum severance payments, which account for a significant portion of retirement

benefits in Japan, are proportional to the consecutive years of work at a particular firm. Thus, those who change jobs in their 40s are severely penalized by losing as much as 40 per cent of their maximum life-time aggregated retirement incomes. There is also favorable income tax treatment for retirement incomes only in the form of lump-sum severance payments for employees, encouraging firms to prevent their employees from quitting before retirement age. Also, corporate pension schemes are fragmented and limit portability across different schemes;

– Secondly, regulations on various job-matching business activities are still restrictive. Job matching businesses by private companies are now free except for a certain number of jobs, but it is still prohibited to charge a worker for fees of job-matching services. This is reflected by "exploitation" of manual job workers in the prewar period. There is also a ceiling on the commission fees of job matching from the firm to prevent the case that too

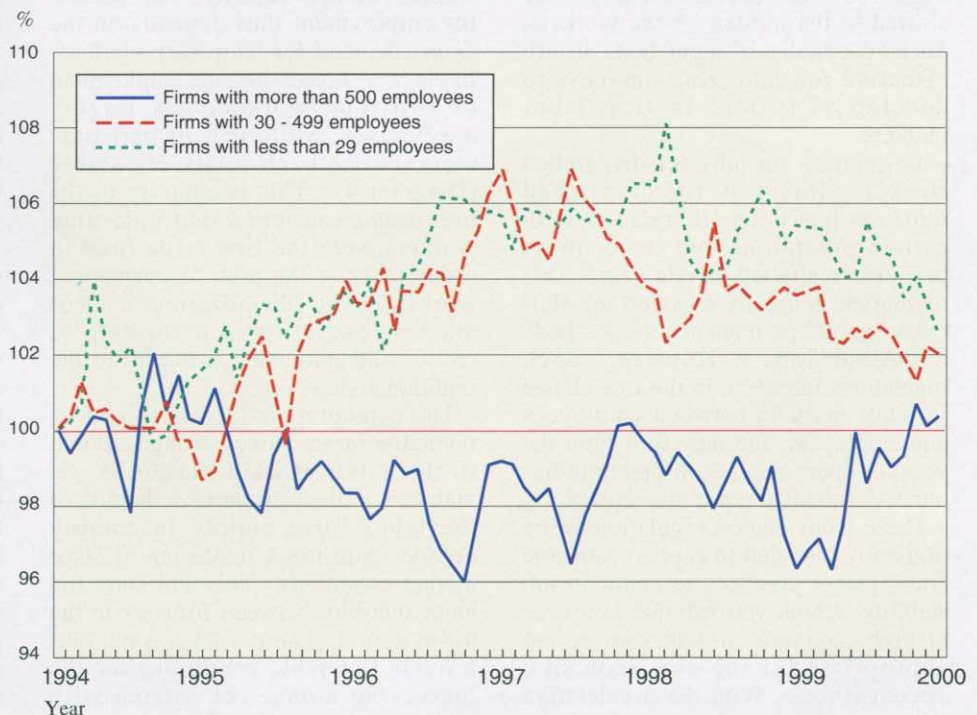


Diagram 3 : Employment by Firm's Size ( Seasonally adjusted, Jan.1994 = 100 )



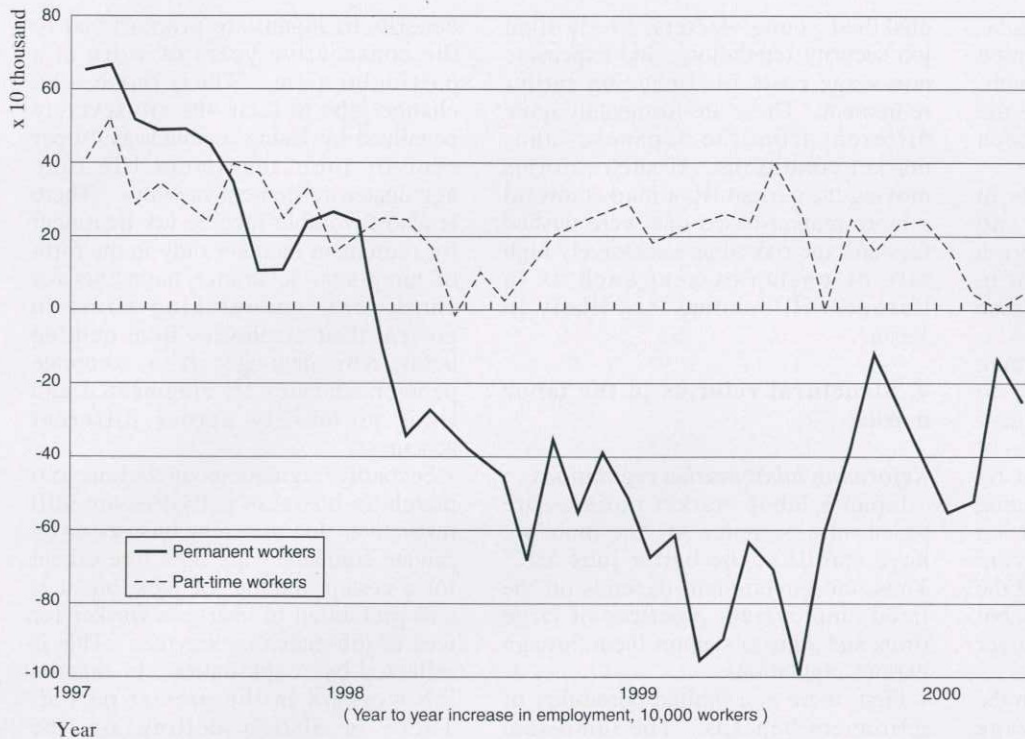


Diagram 4 : Permanent and Part-time Employment

high costs for recruiting might be shifted to the burden on the workers. Such “paternalistic” regulations disturb effective job matching business to develop as it does in U.S. labor markets;

– Regulation on jobs for dispatched workers. Business for dispatched workers has been liberalized with certain exceptions, but the contract period is restricted to one year. This regulation is mainly to avoid the shift from “good” permanent jobs to “bad” part-time jobs. However, such regulations intervene in the free choice in labor markets between employees and employers, and may well limit the possible increases in job opportunities under decelerated economic growth.

These labor market regulations were originally intended to support Japanese employment practices to maintain job stability, which was rational at a time of high economic growth, but are not appropriate for the new economic circumstances. With the deceleration of economic growth, Japanese firms have to reduce the number of full-time

workers with job security. The demand for employment thus depends on the firms’ demand for temporary workers. In the recent recession, the employment of full-time workers has largely decelerated, while that of part-time workers has been relatively stable (Diagram 4). This is contrary to the previous experience that part-time workers were the first to be fired in order to keep the jobs of permanent workers. The liberalization of labor market regulations should help to reduce unemployment, contrary to the traditional view.

The demographic factors should be favorable for the policy changes. First, if the labor market flexibility is maintained, the substantial reduction of the labor force supply in coming decades indicates a tightening of labor market conditions. This will stimulate labor mobility between firms as in the boom period. Labor market conditions provide favorable conditions for the increasing number of women with higher education, for whom not many good mid-career job opportunities were

available after their child-rearing period. Also, it is beneficial for an increasing number of older workers who want good part-time job opportunities.

### Company initiatives

According to changing economic environments, major Japanese companies have shifted to more flexible labor market practices. One notable example is the option for front-loading the retirement benefits introduced by Matsushita Electronics Co. a few years ago. As already mentioned, Japanese lump-sum retirement benefits, which grow with years of service to a particular firm, effectively entrap the workers in the firm. Matsushita’s new option for the employees is simply to pay them in advance with monthly salaries. This option is welcomed mainly by

young workers, and 40 per cent of young employees took this option. While this policy seems to be contrary to the traditional company’s policy of retaining the workers in the firm, it is necessary to attract highly qualified workers who pursue a higher “market value” rather than stability in employment.

Another example is to introduce a yearly-based salary (*Nenposei*) instead of traditional seniority-based wages. This new wage formula is more short-term in nature in matching an employee’s wages to his contributions to a company. This implies widening wage differentials across the workers in the same age group, though narrowing that between different age groups. Flattening the age-wage profile, which differentiating wage gap in the same age group, is necessary to lower the barrier between the two labor markets in and out of the company. This should stimulate competition in the labor market with different work experiences.



### Foreign workers

Another major issue in the Japanese labor market is the policy for foreign workers. With the prospect of a rapid decline in the supply of labor, the policy option of accepting foreign workers from other Asian countries is being discussed. There are two types of foreign workers. There is no reason to restrict the entry in the Japanese market of those foreign workers with professional skills, such workers would stimulate competition with Japanese workers. However, most of the foreign workers in Japan are unskilled, and they are offered a job with much lower wages than the market level. They are concentrated in the low-productivity sectors where firms cannot employ Japanese workers. Accepting those unskilled foreign workers would simply deter the structural adjustment in industry for the efficient use of an increasingly scarce labor force.

An alternative way to utilize foreign workers is to employ them in their home country by exporting Japanese capital through direct investment. Importing labor-intensive products from abroad is the same in economic terms as importing foreign workers indirectly. Shifting Japanese labor-intensive industries abroad would also stimulate changes in the structure of Japanese industry, thus making it more knowledge-intensive, which is important for the better division of labor in the East Asian Region. This opening up of the Japanese domestic market has to be done in parallel with the shifting of the labor force in the domestic labor market from low productivity sectors to higher ones. Otherwise, it will cause increasing unemployment in traditional sectors, and a shortage in the newly-developing sectors. Internationalization of the economy needs liberalization of the domestic market for the efficient allocation of scarce human resources, and vice versa.

Nevertheless, not all the necessary services are imported from abroad; and an organized way of utilizing foreign workers in the field of personal care services, for example, will no doubt

expand in the near future. In that case, a bilateral agreement between Japan and some Asian countries will become necessary so that various workers in the domestic market will have exactly the same working conditions as Japanese. A model case for this kind of treaty can be found in the 1950s between Germany and Japan, when Japanese coal miners were "exported," in an arrangement which was quite welcomed in both countries.

### Conclusion

The essence of Japanese employment practices is a long-term contract between the employer and the employees, which consists of employment security for decades, a seniority-based wage structure, and company-specific labor unions. This system has worked quite effectively for workers' skill formation through a profit-sharing mechanism between the employer and the employees. However, the system, which proved to be very efficient in the period of "catching up" with the advanced industrial countries, is likely to become obsolete in the near future as significant changes in economic environments arise.

With the internationalization of Japanese economic activities, aging of the population, the spread of information technology, Japanese firms' employment policy has gradually shifted from permanent employment toward an increase in part-time workers or "out-sourcing" of traditional activities. Labor market regulation has also changed toward liberalizing the labor contracts of various work categories.

Traditional employment policies in Japan encourage a firm to maintain Japanese employment practices, mainly to minimize unemployment arising from cyclical fluctuations and structural changes. They consist of regulation of the labor markets on job-matching businesses and part-time workers on the one hand, and subsidies to firms related to increases in employment opportunities on the other. These policies may have had rationality in the


past by preventing frictional unemployment. However, as economic growth decelerates, long-term implicit labor contracts become more risky for both the employer and employees. Also, with a declining labor population in the near future, the policy of keeping workers in firms adds to the distortion of the labor market in allocating an increasingly scarce labor force. It is also important to shift the labor force from declining sectors to developing ones in a period of globalization. A more efficient labor market rather than keeping workers within a firm will be more important in Japan in the 21st century.

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