

JAPANESE LABOR MARKET REFORM
WHY IS IT SO DIFFICULT?

by
Hiroshi Ono

Working Paper No 146
April 2002

Postal address: P.O. Box 6501, S-113 83 Stockholm, Sweden. Office address: Sveavägen 65
Telephone: +46 8 736 93 60 Telefax: +46 8 31 30 17 E-mail: japan@hhs.se Internet: <http://www.hhs.se/eijs>

Japanese Labor Market Reform

Why Is It So Difficult?

April 2002

Hiroshi Ono¹

Stockholm School of Economics

ABSTRACT

Socially embedded features in Japanese markets and how market activities in Japan deviate from the West have attracted considerable attention from a wide range of scholars in the social sciences. But the period of economic stagnation following the burst of the bubble economy in 1990 has brought about a deluge of criticism and reform pressures focusing on restructuring, sometimes taken to be synonymous with the dismantling of the very same institutions that were once viewed as the pillars of Japan's postwar economic expansion. Amidst the economic downturn, the benefits of social exchange in Japan are overshadowed by its costs, and there is mounting pressure that transactions must become more market driven. This paper examines how embedded features in the Japanese labor market impede the efficient mobility and allocation of workers. The gains from economic exchange may be many, and numerous economists and policy makers have proposed measures that facilitate the dismissal of workers to set the stage for a more fluid labor market. But a market that matured under the tradition of long-term employment governed by the norms of social exchange has yet to develop an infrastructure for job-seekers, and there remain numerous barriers that prevent the mobility of workers across different organizations.

Keywords: Social exchange; economic exchange; embeddedness; labor mobility; public policy

JEL Codes: A14; J60; J68; Z13

¹ Paper originally presented at the Japan Information Access Project Symposium on "Fixing Japan's Economy," Washington D.C., April 2002. I am grateful to Kenn Ariga, Masayuki Kakuho, Ari Kokko, and Fumio Ohtake for comments and suggestions.

Pressures to reform and restructure the Japanese economy are often taken to be synonymous with the dismantling of the very institutions that were viewed as the pillars of Japan's postwar economic success. The restructuring plan proposed by the Koizumi government calls for "no pain no gain" measures. Policymakers and academics, both inside and outside Japan, have proposed that reform focus on making Japan a true market-oriented economy. To many, this means that Japan must become more Westernized, or *less Japanese*, in order to break out of the economic recession.

The pains of restructuring will be many, but the pain in the labor market is already heartfelt and spreading. By February 2002, Japan's unemployment rate reached postwar record levels as bankruptcies and downsizing reduce the workforce. But the Japanese labor market matured in the tradition of long-term employment where mobility takes place *within* firms, but not *between* firms. The practice of job mobility among firms is new and underdeveloped in Japan. Without a market that can facilitate the efficient re-allocation and mobility of workers, economic reform will continue hesitantly and painfully.

Barriers to Mobility in the Japanese Labor Market

Labor market transactions in Japan are embedded in an intricate web of social relations or *social exchanges*. Economic exchanges are characterized by short-lasting impersonal transactions between anonymous actors. In contrast, there is an implicit understanding and trust in social exchanges that the relationship will be long-lasting, and transactions will lead to a deepening of the social relationship.

This highly-personalized aspect of Japan's employment system is not without its drawbacks. There is increasing tension that the costs of maintaining such social relationships now outweigh the benefits. For example, as firms are obliged to retain excess labor in times of hardship, the labor market loses its fluidity. The lack of fluidity, in particular the lack of exit of redundant workers, hinders job creation and impedes the entry of newcomers such as new graduates and fresh recruits. This undermines efficiency and productivity². The practice of training workers from within instead of hiring specialists from outside also becomes costly in the face of rapid technological change that demands a more diversified and specialized work force.

Why Japanese do not change jobs

The top five reasons why workers do not (or *cannot*) change jobs in Japan are summarized in Table 1. This list only provides a one-sided view of the labor market, i.e., the worker's perspective. However, behind each reason there is an employer's explanation that points to deeper problems.

TABLE 1 Top 5 reasons why workers don't change jobs

Reasons	Percent
I exceed the age limit of the job postings	40.8
My work experience is not transferable to the general society	23.4
Returns to seniority will be lost and I will suffer wage loss	21.8
I do not know how to look for jobs	19.1
I will lose personal contacts established through my work	14.1

[SOURCE: Recruit 2000]

(a) Remnants of long-term employment and the seniority system

² Ono and Rebeck (forthcoming) argue that the lack of mobility in the labor market has a sizable negative impact on Japan's economic growth. Ono, Hiroshi and Marcus E. Rebeck, "Impediments to the Productive Employment of Labor in Japan." In *Structural Impediments to Growth in Japan*. Edited by Magnus Blomström, Jennifer Corbett, Fumio Hayashi and Anil Kashyap. NBER/University of Chicago Press. *Forthcoming*

To claim that long-term employment is a thing of the past maybe an overstatement. There is, however, a growing consensus that the practice is becoming difficult to maintain amidst the current economic crisis. The Economic Planning Agency³ (EPA) reports that the proportion of firms that “emphasizes permanent employment” was 27 percent in 1990, but has declined to 10 percent in 1999. A February 2002 survey conducted by Nikkei Research reports that over half the firms surveyed can no longer sustain permanent employment practices⁴. In business circles, Matsushita’s announcement to cut 8,000 jobs through voluntary layoffs by the end of fiscal year 2002 was viewed as a marked turning point in Japanese labor relations⁵. Matsushita, its organization and history, had always been seen as the microcosm of the Japanese firm. Their announcement was an impetus to change as it triggered an avalanche of corporate downsizing plans among other Japanese companies.

A long-standing tradition cannot change overnight. There are several factors stemming from the legacy of long-term employment that impede the transition to a more fluid system. First, because the labor market matured presuming long-term employment, job-movers are viewed as job-quitters or defects. Similar to a marriage, a breakup signals failure of goodwill or lack of sincerity⁶. The stigma attached to job-movers thus discourages workers from quitting their jobs, and employers from hiring mid-career job seekers.

Second, workers have accumulated skills that are deeply rooted in their employers, such that their skills are rendered useless in other firms, i.e., their skills have no option value outside of the firm. As documented in numerous studies, Japanese workers accumulate considerable

³ The EPA is now part of the Cabinet Office.

⁴ Based on a survey of 805 firms listed in the Tokyo Stock Exchange and JASDAQ, from *Nihon Keizai Shimbun*, February 26, 2002.

⁵ This view has been popularized in the media. See for example, a *Nikkei* article entitled “Can Matsushita Come Back?” (August 4, 2001).

⁶ Dore, Ronald. 1983. “Goodwill and the Spirit of Market Capitalism.” *British Journal of Sociology* 34:459-482.

firm-specific skills in comparison to their U.S. counterparts⁷. These firm-specific skills are products of a risk-sharing agreement, or an implicit understanding that workers do not engage in opportunistic behavior, and employers do not dismiss workers, regardless of fluctuations in the business environment. The obvious drawback of such an intimate relationship is that workers are endowed with skills that are only useful with their current employer. This inhibits their mobility to other firms. Hence, mid-career workers are trapped in something of a Catch-22: They cannot quit their jobs because they have accumulated firm-specific skills, and they accumulate firm-specific skills because they cannot quit.

Third, strong legal employment protection hinders the dismissal of workers. Japanese labor law does not, in itself, provide guarantees to employees. The Japanese Constitution, however, enshrines the individual's right to work (Article 27) and the right to a minimum standard of "wholesome and cultured living" (Article 25). On this basis, the process of providing justifiable evidence for employee dismissal becomes overburdening for employers.

And fourth, dismissal of workers, even in cases of redundancy, signals a breach of the implicit social contract that is the very foundation of the Japanese employment system. Repercussions of such violations will be far-reaching, as they will inevitably affect the psychology of other workers. Recent government statistics report that employee dismissal is still the last tactic used in Japanese firms in adjusting their employment levels⁸.

(b) The age-limit problem and notions of equity

⁷ See for example, Mincer, Jacob and Yoshio Higuchi. 1987. "Wage Structures and Labor Turnover in the U.S. and in Japan." NBER Working Paper No.2306.

⁸ Japan Institute of Labor. 2001b. "Reorganization of Businesses and Employment Adjustment Aimed at Middle-aged and Older Workers." *Japan Labor Bulletin* (May 2001).

One of the consequences of the legacy of long-term employment and the seniority system is that Japanese firms impose age limits on their recruiting and hiring. This problem, specifically that workers exceed the age limit of the jobs posted, continues to be the most common reason for workers not changing jobs in the Japanese labor market. Table 1 above supports this reason as do many government studies and statistics⁹. The Japan Institute of Labor reports that over 90 percent of Japanese firms impose age restrictions ranging from under the ages of 35 to 40 on their job openings with little variation across industry, firm size and city size. Reasons why firms impose age limits are many, but the primary belief is that older workers do not fit into the firm's current employment system (Table 2).

⁹ Japan Institute of Labor. 2001. "Guidelines to Abolish Age Limits in the Revised Employment Measures Law." *Japan Labor Bulletin* (November 2001).

Table 2 Reasons why Japanese firms impose age restrictions in recruitment

Reasons	Percent
Older workers lack physical endurance	33.8
Older workers require higher wages	26.9
Occupational skills of older workers do not match firm's expectations	24.9
Desire to maintain a young workforce	23.8
To restrict number of job applicants	20.2
Older workers do not mix well with younger workers	14.9
Older workers are hard to handle	12.9
Older workers do not adapt well to corporate culture	9.9
To avoid exceeding the age structure of previous hires	8.8
Older workers lack motivation	6.7
Relative ease of hiring young workers	5.7
We have no posts for older workers and cannot accommodate them	4.8
Because other firms impose age limits	3.0

[SOURCE: Japan Institute of Labor 2001]

Because of the prevailing norm of long-term employment, there remains a stigma attached to older or mid-career job seekers. They are viewed as “hard to handle” or that they “do not fit well into the corporate culture.” Moreover, because older workers have accumulated firm-specific skills, there is a mismatch problem between the supply and demand for skills, leading potential employers to judge that their skills do not match the firm's expectations.

The hesitation for Japanese firms to hire mid-career workers is partly rooted in the notion of equity and the desire to preserve homogeneity among Japanese firms. Under a system where wages and promotion are determined primarily by age and seniority, careful measures are taken to ensure that workers are promoted in accordance with seniority, and that deviations from the main career track are minimized. Empirically, Japan-U.S. comparisons have consistently shown that the variance in wages and promotion patterns among Japanese organizations is smaller than their U.S. counterparts¹⁰. Hence, bringing in older workers into

¹⁰ Kalleberg, Arne L. and James R. Lincoln. 1988. “The Structure of Earnings Inequality in the United States and Japan.” *American Journal of Sociology* 94:S121-S153. Ishida, Hiroshi, Kuo-Hsien Su, and Seymour Spilerman. 2000. “Path Dependency in Career Advancement in Japanese and U.S. Firms.” Paper presented at the International Sociological Association (Research Committee on Social Stratification), Libourne, France, May 11-14, 2000.

the workforce disrupts the wage and promotion structures, because the pre-existing seniority system presumes entry from below.

Pressures for employment reform have pushed forward “guidelines” to abolish age limits in recruiting and hiring were introduced in October 2001 as part of the revised Employment Measures Law. However, the guidelines specify ten cases or exceptions where imposing age limits are acceptable. Most notably, one of the exceptions is phrased almost specifically to prevent disruptions in the seniority system¹¹.

As it stands, the new guidelines are viewed mainly as a cosmetic gesture. They simply state that employers should *voluntarily* make efforts to abolish age limits. Unlike the legal sanctions that are enforced in certain countries in violation of age discrimination legislation, the Japanese guidelines do not impose any penalty on violators. A cursory glance at job postings after the guidelines were put into affect confirms that a majority, if not all job-postings, continue to require age limits¹². It is questionable whether the guidelines will have any effective results in the foreseeable future.

(c) Firm-size differences and the hierarchical structure of organizations

The *keiretsu* system and the hierarchical segmentation of organizations by establishment size have facilitated a pattern of asymmetric downward mobility where workers in large firms may migrate downward to smaller firms, but not vice versa. On the other hand, horizontal mobility, or mobility across firms of similar scale, e.g., from Sumitomo to Mitsubishi, is also complicated given the *keiretsu* grouping of firms.

¹¹ Under Guideline Number 4, employers are allowed to impose age limits in “(c)ases where recruiting or hiring is intended for workers under a certain age in situations where in order to make wage payments regardless of age to new employees, companies will be required to revise present regulations determining wages mainly in accordance with age.”

In the wake of the current economic downturn, large firms took advantage of their extensive network of subsidiaries and group firms (e.g., suppliers) as potential employers for their redundant workers. Today, the smaller firms can no longer absorb such “redundancies from above,” as they face labor problems themselves. Personnel managers in smaller firms now decline requests for personnel transfers from larger companies, forcing large firms to seek other ways to transfer their workers.

As such, these are difficult times for Japanese firms as they run out of ways to adjust their employment levels. It is not surprising that recent headlines in Japanese newspapers report the large-scale voluntary retirement programs underway among Japan’s most prestigious firms such as Mitsubishi Motors, Matsushita, Hitachi, and Toshiba. As of November 2001, 82 firms have announced plans to dismiss a total of 120,000 workers within the next few years, mainly through voluntary retirement plans¹³. Most are targeted toward older employees with at least ten years of tenure. However, some economists have estimated that on average, a voluntary retirement package is a bad deal, i.e., the loss in lifetime earnings resulting from early retirement is greater than the lump sum benefits offered by these packages¹⁴. Moreover, voluntary retirement risks adverse selection problems: It is often the higher-ability workers that quit, and not the lower-ability workers who the firm wants to dismiss. Japanese firms that have offered voluntary retirement programs in the past no longer do as they realize that they risk losing their best workers.

¹² See for example, job postings on *Yahoo! Japan* at: <http://employment.yahoo.co.jp/> (in Japanese).

¹³ *Nihon Keizai Shimbun (European Edition)*, November 18, 2001.

¹⁴ Ichinose, Tomohiro. 2001. “Early Retirement Plans and the Decline in Lifetime Income Resulting from Job Changes” (*Tenshoku ni yoru shougai chingin no gensho to souki taishoku yugu seido*). *Rosei Jiho*. No. 3484: 27-34. The discussion here concerns pecuniary benefits. It can be argued that early retirement packages maximize workers’ non-pecuniary benefits more than the pecuniary benefits.

(d) Information problems

An emerging problem among recent job-changers is a lack of employment information available about the labor market. Workers do not know what skills they have, and employers do not know what skills they need. “Better information for job seekers” has been a persistent problem in the Japanese labor market where job postings tend to be ambiguous and crucial information such as job descriptions and required skills are missing.

It is, therefore, not surprising that human resource firms that specialize in headhunting and re-employment services are rapidly growing in a society where a market for job-changers is only just evolving. As indicated by one of the top responses for barriers to job changes in Japan (see Table 1), many workers simply “do not know how to look for jobs.”

Policy Implications

In his book, *Pack Your Own Parachute*, Hirsch (1987) outlined the following five career strategies for managers that enable them to survive corporate disasters¹⁵.

- 1.Cultivate networks, maintain visibility
- 2.Return recruiters’ calls, maintain marketability
- 3.Avoid overspecialization, maintain generality
- 4.Avoid long-term and group assignments, maintain credibility
- 5.Keep your bags packed, maintain mobility

The average Japanese worker does not meet any of these “qualifications.” Meanwhile, Japanese workers face the risk of becoming victims of restructuring much like their U.S. counterparts did in the 1980s when the book was originally written. Although the proposed strategies partly reflect differences in the corporate cultures between the U.S. and Japan and should not be taken at face value, the Japanese labor market may benefit from incorporating

some of the messages underlying these propositions--mainly that workers must increase their option value. Indeed, if the Japanese government is seriously committed to their restructuring efforts, then it is time that they start thinking about how mobility can be facilitated, and not how employment can be protected.

Policy Prescriptions

* ***Abolish age restrictions.*** The age-limit problem remains the number one reason inhibiting mid-career workers from changing jobs. The current guidelines are cosmetic, and abolishing the age limit remains a voluntary gesture. Stricter legislation must be imposed where sanctions are enforced and violations are penalized.

* ***Facilitate the dismissal of workers.*** Labor laws must be revised to facilitate the dismissal of workers. Labor contracts must allow for more flexible and diverse work arrangements. For example, employers should be allowed to hire workers on a probationary basis¹⁶.

* ***Develop external labor market.*** Under the current internal labor market structure, the only port of entry for new hires comes from below, and workers are nurtured within the firm through inhouse and on-the-job training. The internal labor market is an institutional feature that cannot be deconstructed in the short-run, but there are still ways to facilitate labor mobility while keeping the internal labor market structure intact. One way is to develop an external labor market, where employers can shop around for labor and skills on an as-needed basis. As firms face tough times, the internal labor market structure becomes increasingly difficult and costly to maintain. An external labor market consisting of contingent workers

¹⁵ Hirsch, Paul M. 1987. *Pack Your Own Parachute: How to Survive Mergers, Takeovers, and Other Corporate Disasters*. Reading: Addison-Wesley Publishing, p.119.

¹⁶ Ohtake, Fumio. 2001. *Employment-Related Problems in Japan* (Koyo mondai wo kangaeru). Osaka: Osaka University Press.

such as contract and temporary workers can both absorb and supply workers in accordance to demand fluctuations.

* *Establish external training programs.* A market for job-changers by definition entails a market for general or professional skills (as opposed to firm-specific skills). There are some early indications that workers are responding to this change, for example, by acquiring licenses and certifications. In recent years, the government program to subsidize the general training of workers has been met with great demand¹⁷. Some critics point out that the skills acquired from the training do not always meet the skills demanded by employers. To the extent that it increases the outside opportunities of workers, the program is on the right track. Further initiatives, be they public or private, should be introduced that foster the development of general professional skills.

* *Educational reform.* Educational institutions must respond to the changing demand for skills in the labor market. Japanese universities in particular have been criticized for their “leisureland” culture of allowing students to graduate without much effort. But as firms lower their emphasis on in-house training and seek professional and specialized skills, institutions of higher learning must respond by training students to match those skills. As it stands, there is a considerable mismatch problem between the supply and demand for skills, and valuable human capital is lost.

Conclusion

Economists ascertain that “the world has moved, and is moving, from social to economic exchange, and is inherently destined to be governed by economic exchange in the future.”¹⁸

¹⁷ Workers may take courses from accredited institutions and receive a maximum subsidy of 300,000 yen.

¹⁸ Murakami, Yasusuke and Thomas P. Rohlen. 1992. “Social-Exchange Aspects of the Japanese Political

Amidst the economic downturn, the benefits of social exchange in Japan are overshadowed by its costs, and there is mounting pressure that transactions must become more market driven. However, to the extent that social exchange can be a complement to economic exchange, it is perilous to assume that all aspects of social exchange relationships inflict harm and should be dismantled. Proponents of the Japanese system warn that organizations should maintain a longer time horizon and should not act in the interest of short-term gains.¹⁹ Hence the Japanese economy faces a difficult task of preserving their heritage, while at the same time attempting to internalize the gains that are realized from transactions based on economic exchange.

Economy: Culture, Efficiency, and Change.” Pp. 63-105 in *The Political Economy of Japan, Volume 3: Cultural and Social Dynamics*, edited by S. Kumon and H. Rosovsky. Stanford: Stanford University Press.

¹⁹ Saeki, Keichi. 1993. *The End of Americanism* (Americanism no shuen). Tokyo: TBS Britannica. See also interview in *Nikkei*, January 10, 2001 where Saeki objects to recent downsizing measures taken by automobile manufacturers under the management of foreign companies.