NIRA Research Report – related article

April 22, 2010

How to fix the Japanese economy: Socialize risk using a two-pronged strategy*

Charles Yuji Horioka (Professor, Osaka University)
Reiko Kanda (Senior Director, NIRA)

The Japanese economy has been in the doldrums more or less continuously for the past two decades, and this long-term recession has imposed at least three costs on Japanese households:

(1) A decline in their standard of living;

(2) An increase in the risks and uncertainties concerning how to make ends meet, employment, old age, etc.; and

(3) An increase in income inequalities.

Many economists, policymakers, etc., focus on (3) but here we would like to focus on (2).

It is not efficient or rational for individuals to bear the entire burden of risks and uncertainties. For example, it is not efficient or rational for an individual to work so hard that she ruins her health and becomes unable to work because she is so worried about losing her job. The market mechanism and income redistribution by the government both play an important role in pooling risk and avoiding such an outcome.

* This article was first published in the online edition of the Asahi Shimbun (asahi.com) on April 22. 2010.

However, the division of labor between these two mechanisms varies from country to country and depends on the values of each country.

Danish sociologist Gosta Esping-Andersen categorizes modern developed capitalist states into three types of welfare states:

(1) "Liberal" or "residual" welfare states, such as the United States and other Anglo-Saxon countries, which emphasize redistribution via the market mechanism, and two types of welfare states that emphasize income redistribution by the government:

(2) "Social democratic" welfare states, such as Sweden and other Scandinavian countries, in which income redistribution is done via the tax system; and

(3) "Conservative" or "corporatist" welfare states, such as France, Germany, and other continental European countries, which rely on mutual assistance within corporations, families, and other collectivist entities.

Where does Japan lie within this taxonomy of welfare states? According to recent research, Japan exhibits both the characteristics of the U.S.-style liberal welfare state (such as the underdevelopment of "welfare" and other government redistribution policies) and those of the French-style conservative welfare state (such as reliance on one's family and employer for mutual assistance and employment security).

Does Japan's two-pronged approach contain an effective risk-coping mechanism? Compared to liberal welfare states such as the United States, Japan offers only a meager menu of non-recourse loans and reverse mortgages, and bankruptcy laws that allow those unable to repay their debts to start afresh are not well-developed. In a liberal welfare state, well-developed financial and legal systems play the important role of complementing meager income redistribution programs by the government and hence are indispensable.

Compared to conservative welfare states such as France, Japanese firms do offer strong employment protection to permanent workers but restrictions on working hours are weak and thus there is a danger that workers have to accept long working hours in exchange for employment protection.

The most serious defect of Japan's policy regime is that the safety net protecting those facing unexpected risks, which is a crucial element of any policy regime, is very weak. As a result of this lacuna in Japan's policy regime, new graduates, temporary workers, single persons, single mothers, and others who do not belong to any firm, family or other collectivist entity are exposed to grave risks.

In a world in which competition is intensifying due to globalization and the structure of families is changing dramatically due to the decline in the birthrate, the increase in the divorce rate, and the decline in extended (three-generation) families, those who are not protected by families, firms and other collectivist entities must bear the entire risk of unexpected contingencies by themselves because they cannot receive government protection, transfer risks to others through financial intermediation, or make a fresh start.

In what follows, we would like to propose what direction Japan should take in order to correct the aforementioned defect in Japan's policy regime. Note that there is no need to imitate existing policy regimes of other countries, and in fact, it is not desirable and quite often disadvantageous to forcibly impose the regimes of other countries on Japan. For example, it is not realistic for Japan to adopt a social democratic policy regime with generous income redistribution policies given that Japan already has the largest government debt to GDP ratio of any developed country.

Taking account of the environment in which Japan finds itself, a National Institute for Research Advancement (NIRA) study group of which we are a part recommends that Japan adopt the following policy pillars:

First, Japan should reduce its emphasis on risk sharing via collectivist entities (the hallmark of a conservative welfare state), which is inefficient as well as inequitable. In a world in which global competition among firms is intensifying, if Japan imposes strict employment guarantees on domestic firms, their labor costs will increase, their productivity and competitiveness will decline, and there is even the possibility that employment will decline.

Moreover, strong employment guarantees will protect the employment of currently employed permanent workers but at a cost of longer unemployment spells for the unemployed, a higher youth unemployment rate, and a lower overall employment rate.

We are, of course, not advocating the complete elimination of employment guarantees by employers although we do feel that firms should be able to fire incompetent workers more easily than they currently can. What we are advocating is allowing firms to offer a full menu of job types, for example, a job type that offers higher wages but also a higher risk of termination and another job type that offers lower wages but better employment security.

Moreover, we believe that Japan should counteract the weakening of employment guarantees by employers by relaxing eligibility requirements for “welfare” and unemployment compensation and by placing more emphasis on deregulation, especially in agriculture, medical care, nursing care, day care, and other service sectors, which in turn will improve the competitiveness of Japanese firms, raise economic growth and expand employment opportunities, thereby reducing employment and other risks.

In addition, we advocate greater investment in infrastructure, especially the development of better risk-sharing mechanisms in the financial system and the passage of more generous bankruptcy laws so that firms and individuals can better deal with the risks they face. For example, if individuals can borrow freely from financial institutions, they will be able to offset the decline in employment income caused by unemployment by borrowing and will therefore be able to get by even without a generous unemployment compensation system.

We believe that this objective can be achieved by greater financial deregulation and institution-building regarding the firewall between banking and insurance, the types of products that financial institutions can offer, etc.

Finally, Japan should create a society in which risks are shared equitably by males and females, permanent and temporary workers, the young, middle-aged and elderly, the singled, married, divorced and widowed, those with and without children, etc. More concretely, Japan should better enforce and/or strengthen existing laws banning discrimination on the basis of gender, age, etc., improve day-care services to make it easier for those with children to work, and allocate government expenditures more equitably among different cohorts (they are currently biased in favor of the elderly in Japan).

In short, Japan should learn about the importance of equity from the social democratic welfare states. However, Japan should adopt a targeted approach of providing benefits only to those who really need help, given the disincentive effects on employment, etc., of government benefits and the already massive debt of the Japanese government.

To summarize, Japan should shift from a mix of a French-type conservative welfare state and a U.S.-type liberal welfare state to a mix of a Swedish-type social democratic welfare state and a U.S.-type liberal welfare state. As we have already seen, what Japan should learn from a social democratic welfare state is not massive income redistribution programs by the government but the importance of equitable risk sharing.

Moreover, what Japan should learn from a liberal welfare state is not only the importance of a market-oriented regime but also the importance of financial and legal systems that protect individuals from risk and encourage competition. This is what we mean by the transition from a society in which individuals bear excessive risks on their own to a society in which risk is shared equitably by society as a whole (i.e., a society in which risk is "socialized").

Turning finally to how Prime Minister Yukio Hatoyama’s economic policies stack up against our recommendations, they don’t get a very good grade because he has adopted a universal approach rather than a targeted approach (for example, doling out child allowances, making high school tuition free, and making some highway tolls free to everyone regardless of their income). Such policies are unnecessarily expensive because they help even those who don’t need help and will make Japan’s government debt even higher than it already is, unless sharp cuts are made elsewhere, which will be hard to do. Moreover, his policy of prohibiting dispatched workers in the manufacturing sector makes it harder for companies to hire workers on a short-term basis and goes against our recommendation to reduce reliance on employers as a guarantor of employment security.

* * *

Charles Yuji Horioka received his B.A. and Ph.D. from Harvard University and is currently a professor of economics at the Institute of Social and Economic Research, Osaka University. Reiko Kanda received her B.Econ. degree from the University of Tokyo, her M.Ec. degree from Northwestern University and is currently director of research at the National Institute for Research Advancement (NIRA).