How to Make Labor Market Reforms Work for Workers

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To revitalize the Japanese economy, the government should make labor markets work for workers. That would not only improve worker welfare, but it would also boost productivity and consumption, thereby fueling higher growth. To its credit, the government has been shifting in the right direction in recent years – but far too timidly.

As Japan moved from labor surplus to labor shortage in the 2010s, that transformed the politics of labor reform. In the wake of the financial crisis in the 1990s, many Japanese companies sought to lower labor costs, and they asked the government for policies that would give them more flexibility to do so, such as liberalizing the agency temp business and easing rules on night work. The companies improved their balance sheets by restraining wages, reducing new hires, and increasing the non-regular share of the workforce. Over the long term, however, this cost-cutting eroded employee welfare, undermined labor-management relations, and weakened macroeconomic performance.

As the labor market tightened, businesses gradually shifted from demanding policies to help them lower labor costs toward policies to enable them to retain and attract more workers. And the Shinzo Abe administration obliged, shifting to measures to improve worker welfare, such as Womenomics and the Work Style Reform. Japan's center-right ruling party found itself in the unusual position of enacting policies that had been advocated for decades by parties of the left, such as equal pay for equal work and tighter restrictions on the number of working hours.

That shift moved labor policy in the right direction, from zero-sum measures to boost corporate profits at the expense of workers to win-win measures to increase productivity by enhancing worker welfare. But the government should move more boldly. That means boosting minimum wages further, tightening enforcement of equal pay and working-time rules, giving workers more flexibility in their work life, and supporting labor power more broadly.

The Fumio Kishida administration came to power in 2021 heralding "a new form of capitalism" that would prioritize equity as well as growth. Here again the government moved in the right direction, but not decisively enough. The administration quickly became mired in policy debates that seemed to pit growth against equity, such as the proposal to raise the capital gains tax, while falling short of fully embracing the logic of their own slogan by rejecting the tradeoff between growth and equity altogether.

After all, they could foster both growth and equity with a "predistribution" policy agenda. Predistribution refers to measures such as public investment in education and market governance to balance power in the economy and society. Thus it seeks to address inequality at its roots. In contrast, redistribution refers to taxation and welfare spending that compensates the losers from marketplace competition. Let me be clear: Japan needs both predistribution and redistribution. But it should prioritize market governance reforms such as antitrust policies to shift power from incumbent firms to challengers, financial reforms to shift power from financial institutions to investors and consumers, and labor reforms to shift power from employers to workers.

Since this is the "economics classroom" column, let's take a look at what economics can tell us about all of this, and why the Japanese government should boost the minimum wage and bolster worker power. I have recently taken up the strange habit of reading economics textbooks. I do so with a curious combination of awe for the sheer genius of economists who devise such compelling models to illustrate their core concepts, and bewilderment that they often seem to leave out the essence of how markets actually work – especially how power relationships shape bargaining in the real world.

Labor economics generally begins from a model of a perfectly competitive market in which employers and workers are seamlessly and costlessly matched. In this market wages reflect marginal productivity: that is, workers are paid according to the value they contribute. Then the economists gradually relax the assumption of perfect markets; identify various "market failures," and evaluate policies to remedy those failures.

From my perspective, there is still one big problem with this approach. It bestows an unjustified status quo bias because the perfect market model implies that all government intervention is bad because that action moves us away from the market equilibrium, which by definition maximizes welfare. The model gives us a propensity to view government action as the contamination of some pristine perfect market. But that perfect market does not exist, of course. All we have is real-world markets thoroughly sullied with collusion, fraud, and imbalances of power.

But here is the good news. Labor economics provides a ready solution to this problem with the concept of "monopsony." Monopsony refers to the situation of one dominant buyer. So for labor, that means one dominant employer. Imagine a town where there is just one company. Workers who want a job in that town will have virtually only one choice: work for that company or do not work at all. What would happen in that situation? Labor economics tells us that the employer would hire fewer workers at lower wages than it would in a competitive market, resulting in a welfare loss. Monopsony can also be defined more broadly to include situations in which employers have a substantial power advantage over workers, even short of dominance of a particular local labor market. And we can postulate that monopsony of that sort would have the same basic impact: less employment and lower wages.

And here is the interesting part. If we begin with the presumption of monopsony rather than perfectly competitive markets, we arrive at precisely the opposite policy recommendation. That is, labor economics tells us (in theory) that with perfect markets a minimum wage would reduce employment, thereby generating a deadweight loss. But labor economics also tells us that with monopsonistic markets, a minimum wage could increase <u>both</u> wages and employment, improving overall welfare. So a well-designed minimum wage could eliminate monopsony power and prevent the exploitation of workers.

The figure shows how an economics professor might diagram this. In a situation of monopsony, employers pay less and employ fewer workers than they would in a competitive market. If the government imposes a minimum wage, however, it could increase wages and employment, moving the market toward the competitive market equilibrium and thereby improving overall welfare.

We could easily apply the same logic to union power. Economic models suggest that in a perfectly competitive market, union power – just like minimum wages – generates higher wages and less employment, creating a deadweight loss. But in a monopsonistic market, unions might increase wages and employment, thereby generating a welfare gain.

So here's the thing. Most real-world markets are characterized by monopsony not perfect competition. If that is the case, then it follows that the government should raise minimum wages and empower workers. Admittedly, this analysis by itself does not tell us <u>how far</u> to go in that direction. It is certainly possible to raise minimum wages too far and thereby to reduce employment and undermine welfare. And it is possible to raise worker power to the point where workers would be able to stop production and employers would have little recourse, thereby undermining labor markets. In the meantime, however, we know that we are in a monopsony situation – in Japan, as in most everywhere – and therefore some increase in wages and worker power would enhance public welfare.

So how could the government support worker power? It could do so by improving conditions for non-regular workers, who often lack bargaining power. Or it could enhance worker power by more aggressively promoting employment options such as remote work or hybrid work styles that offer job security without forcing workers to accept disruptive changes in working hours or job location.