

The Trade-off between Efficiency and Equality: the Case of Japan

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More and more people are supporting the notion that competition in the Japanese economy has become fiercer due to economic structural reforms and that this has led to inequality in income. Furthermore, they claim that in order to rectify this situation there should be additional reform. This item is becoming more and more an important political issue, as even in the Diet, the opposition parties have begun to demand accountability from the Prime Minister for this alleged inequality as it was his government that promoted the reforms. In response to this, the Prime Minister has argued that inequality is not necessarily a bad thing, and that having an economy of free competition is more important.

In this paper, we provide a brief summary of the structural reform measures that have taken place with the objective of enhancing market competition and increasing efficiency thus far. Then, we consider how “unequal” Japan has actually become, and finally try to understand how much of a role the reforms played in this widening inequality.

Our results can be summarized in the following three points: One, the widening of inequality that can actually be observed is quite limited. Two, the majority of the inequality can be explained to be a result of the aging of the population and the stagnation in the economy. And three, the real effects of any economic structural reform are close to nil.

1 . Results of the Economic Structural Reform

(1) Summary of Reforms

The economic structural reforms were begun in Japan from 1996 to stimulate the economy, and to help rebuild the fiscal coffers. A part of what necessitated these reforms was the failure of the aggressive fiscal policies implemented previously. After the economic bubble of the late 1980s burst in 1991, the Japanese economy experienced a deep and serious recession. The Japanese government’s response to this was a Keynesian policy of aggressive public investment. In spite of these measures, the recession continued, and these policies ended being complete failures, leaving behind only a huge fiscal deficit.

After this dismal failure, some economic structural reforms were put in place to create a leaner and more efficient government and to revitalize the economy by encouraging competition

in the marketplace. These were widespread reform measures encompassing many areas and including regulatory reform, social insurance reform and administrative reform. These reforms come in many shapes and structures – deregulation, the experimental elimination of regulations in some special economic zones, the privatization of some government services, creating a leaner social insurance system, and a reduction in fiscal spending and number of government employees.

(2) Results of these Reforms

The forms that these reforms would take were deliberated at length among a large pool of resources from the worlds of academia, business and politics. However, because there was strong resistance from the government and politicians, the original reform plans were trimmed down and there was also a long delay until implementation. Thus, the results to date of these reforms are surprisingly insignificant.

1) Regulatory Reform

In 2002, regulations to entry into the taxi industry were eliminated, and taxi fares were also liberalized. As a result of this, the number of taxis in operation in Japan increased by 17,000. If we assume there are two drivers to one taxi, then this is estimated to have created employment for over 30,000 people. However, the taxi fares that were expected to fall from this increased competition did not decline as anticipated, and so the demand for taxi services did not increase.

In 1999, the number of industries that were permitted to have temporary workers dispatched to them was greatly increased. Thereafter, in 2004, the ban on employing temporary workers in the manufacturing industry was lifted. As a result of these measures, the number of temporary workers grew from 900,000 in 1998 to 2,270,000 in 2004, growing to account for a 4% share of all employees.

2) Privatization of Government Institutions

In 2005, the Japan Highway Public Corporation – the government agency that constructs and manages the highways in Japan -- was privatized. This purpose of this measure was to introduce the private sector concept of “profitability” to the entity and thus prevent the further construction of wasteful roads. However, it appears the entity will continue to receive subsidies from the government to build roads. Thus, a “real” privatization has not taken place.

The three business lines of Japan Post – postal services, financial services and insurance -- will be privatized in 2007. Japan Post holds massive funds of savings totaling 250 trillion yen (or 2.2 trillion US dollars), and 150 trillion yen (or 1.3 trillion US dollars) in insurance reserves.

With 300,000 employees, the term Japan Post was considered synonymous with “inefficiency”. The privatization of this entity will be a litmus test of the effectiveness of these reforms, and many will be watching to see how much the privatization of an entity can make it efficient.

3) Outsourcing of Government Services (The “Market Test”)

This refers to the government allowing the provision of services that the government had provided employing civil servants, be put into a competitive tender with private sector companies, and letting the most efficient option be chosen. From 2007, in an experimental phase, three areas including the management of correctional facilities, and the collection of insurance premiums for the national pension, will be conducted by private companies.

4) Special Zones for Reform

These zones are towns or cities that are designated as Special Reform Zones, where a type of deregulation is tested. If there are no major problems arising from the deregulation, the deregulation may be implemented nationwide. It has been reported that there are 548 special zones at the end of 2005, and there were 46 regulations that will be relaxed nationwide as a result. However most of these regulations were small in scale, affecting only a small part of the economy -- such as the fire code for farms that offer guest house services, and conditions to obtain sake brewing licenses. We have actually seen no large-scale full-fledged reforms.

5) Social Insurance Reform

The reform in the public long-term care system that was begun in 2000 was strongly supported by the people, and the number of users is growing rapidly. As a result, however, the fiscal budget is rising by a rate of 10% per year, and it is feared that this could expand even further. Healthcare costs have also increased with the aging of the population, and in order to suppress demand, the co-payment rate was raised to 30%. The increase in costs for the user was met with resistance, but it does not appear as though it has led to enough change in the use of the services to reduce healthcare costs. While social insurance related expenses continue to grow, it appears as though there may be some success in limiting public pension expenditures. The main pillars of the public pension reform are the following: 1) The age to start receiving public pension benefits was raised from 60 to 65. 2) The fixed multiple used to calculate pension benefits (multiplied against the income earned while working), was lowered, and so benefits paid – particularly to high income earners – were reduced. 3) Benefits had been raised by the price index every year, but this has been changed to the price index less 0.9%.

6) Administrative Reform

The government is aiming to enhance efficiency through a reform in the government employees and reducing the scale of the government. In 2001, the central government ministries and agencies were reorganized and simplified, and the number of agencies and ministries were reduced from 22 to 13. However, this measure did little more than bring the

groups together – there was no change in the number of employees and there was little efficiency gained through the exercise.

Also since 2000, there has been a reform in the special public corporations whereby national universities, national research institutes and national art galleries would become independent administrative agencies. However, the government continues to financially support these entities and so any efficiency gained would be from a reduction in spending outside of human resources.

The reform in the civil servant system – one that is notorious for its inefficiency -- has not yet started. It has been determined that the current 4.2 million civil servants will be reduced by 5% in the five years from 2006. There is some consideration on also reducing the salaries of civil servants that attract much criticism and are known to be higher than the public sector.

(3) Reforms and Inequality

As we have observed, we have seen very limited results from the reforms implemented thus far, and any effects on society as a whole have been minimal. Of these, the only reforms that may have played some role in increasing income inequality would be the deregulation in the temporary worker industry, and the pension reforms. Regarding the former, while the measure has increased the number of temporary workers, there have been claims that this has resulted in a wider wage gap between permanent and temporary workers.

Independent of this reform however, in the 1990s, there was a desire to correct the traditional Japanese practice of committed long-term employment. This was supported by both the companies and the workers. Some non-traditional types of employment increased such as temporary and part-time employment as a result. However, it is a mistake to assume that the wage differentials that exist in this new model where traditional and non-traditional employment coexist to be solely a result of reforms.

As for the latter pension reforms, we see this resulting in both a deterioration and an improvement in economic inequality at the same time over differing dimensions. First, by reducing the pension benefits across the board, the livelihoods of those that receive lower benefits may have been negatively affected. At the same time, the change in amount of benefits linked with income levels has resulted in greater reductions of pension benefits the higher the benefit level. This should lead to a correction in inequality.

2 . Has Inequality in Income Increased

Japanese have been of the belief that Japan is one of the countries with the lowest levels of income disparity. There are few that are extremely wealthy, but there are few that are very

poor, resulting in a comfortable society. An economist in 1998 struck some doubt with this view. He stated that Japan is not a utopia of great equality, but rather the country of industrialized countries that has the greatest income inequality. Since then, labor economists have focused on the high unemployment of younger workers and pointed out the inequality in opportunity. Sociologists have acknowledged that this sector of society has become greatly discouraged and are warning of a crisis of a rift in Japanese society.

However, one economist has shown that this so called “widening” income differential is no reason for alarm, and stated that most of it can be explained by the aging of the society. However, his findings did not gain much acclaim outside of the world of research. Though there is little to support the state of the inequality, many are claiming that the inequality is widening and they are due largely to the reforms that have taken place.

However, is the income differential in Japan really widening? In this section, we first try to define the income differential from government-published statistics.

(1) Overall Trends

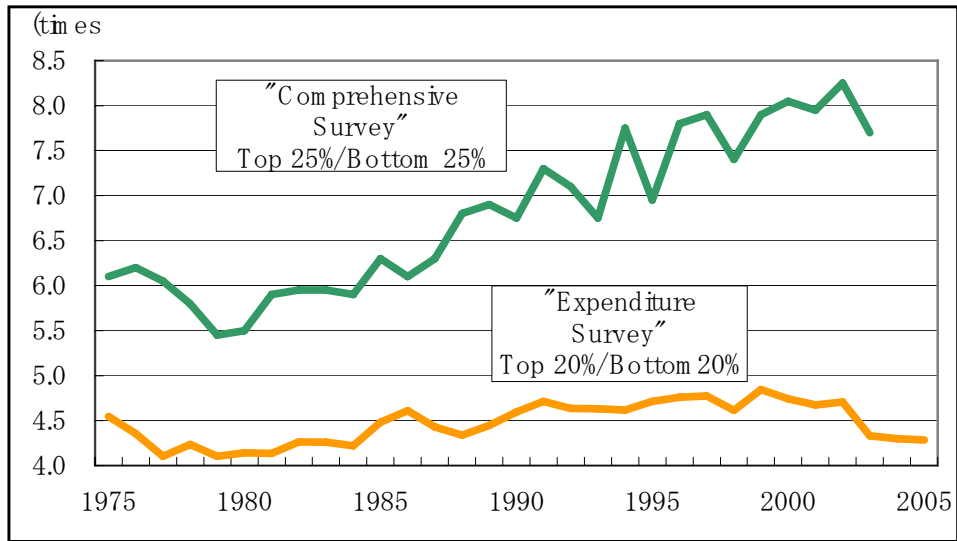
We compare the income distributions in the 27 countries of the OECD in detail (2005). According to this, the Gini coefficient of disposable household income (adjusted for household size) for Japan was ranked tenth worst. For “relative poverty rates” defined as the share of individuals with equivalized disposable income less than 50% of the median for the entire population, Japan ranked 5th most unequal. Moreover, it is reported that in terms of overall trends in income inequality, Japan has been marking small increases in inequality in the 1980s and 1990s. This OECD report supports the claim that the income differential in Japan is widening.

For the OECD study, the “Comprehensive Survey of Living Condition of the People on Health and Welfare” released by the Ministry of Health, Labour and Welfare was used. As these statistics are used mainly to understand the effects of social insurance policies, we can say that this is the appropriate choice of data. Using this data, we find that if we estimate the degree of inequality in the top and bottom 25%, it has shown a linear increase from the 1980s, and this backs up the OECD findings as we can see in Figure 1.

The “Expenditure Survey” released by the Ministry of Internal Affairs and Communication is perhaps a more conventional statistic to understand the household income and consumption. If we use this data to find the degree of inequality of the top 20% income/ bottom 20% income, the results differ somewhat. Though inequality has risen somewhat from in the 1990s, it has been corrected sharply from 2000.

We will explain the reason behind the difference in the two results in a subsequent section.

Figure 1 Income Inequality over Time



Notes: The “Comprehensive Survey of Living Condition of the People on Health and Welfare” includes single person households. “Expenditure Survey” consists only of households of two or more persons.

(2) Temporary Workers

Let us here assess the validity of the claim that due to the structural reforms, there has been an increase in temporary workers and this has led to the income inequality. According to the survey of the Ministry of Health, Labour and Welfare, the average annual income of the temporary worker was 2.395 million yen in 2001. In 2005, it rose by 22% to 2.917 million yen. However in the same period, the average annual income of all employees rose by 3% from 4.875 million yen to 5.03 million yen. As a result, the average annual income of temporary workers relative to all workers increased greatly from 47.6% to 59.8%.

Figure 2 Comparison of Annual Incomes

	2001	2005
All employees (1,000 yen)	5,030	4,875
Temporary workers (1,000 yen)	2,395	2,917
Temporary workers / All employees (%)	47.6	59.8

Source: Ministry of Health, Labour and Welfare, “Basic Survey on Wage Structure”

From this comparison, the notion that the inequality between temporary and permanent employees is growing is inaccurate. In fact this would suggest that it is shrinking rapidly.

(3) Change in Wage Systems

It is more likely that rather than the increase in the number of temporary employees, it was the transition from a seniority-based wage system to the individual performance based wage system (that occurred in private companies in the 1990s) that led to competition within employees and then to the disparity in income. The effects on employee wages are likely greater than any reforms that were implemented. Let us now examine the effects on wages that this “performance based” system has had, from two perspectives.

First is that in Japan where the system of seniority-based wages prevails, there had been a wide wage income disparity between age groups, and this performance based wage system has likely shrunk this gap. The second is that under the seniority system, though the wages between employees of the same age were more or less equal, under the performance based system, the gap between employees of the same age group has likely widened.

Figure 3 Annual wages of standard employee (in same company)

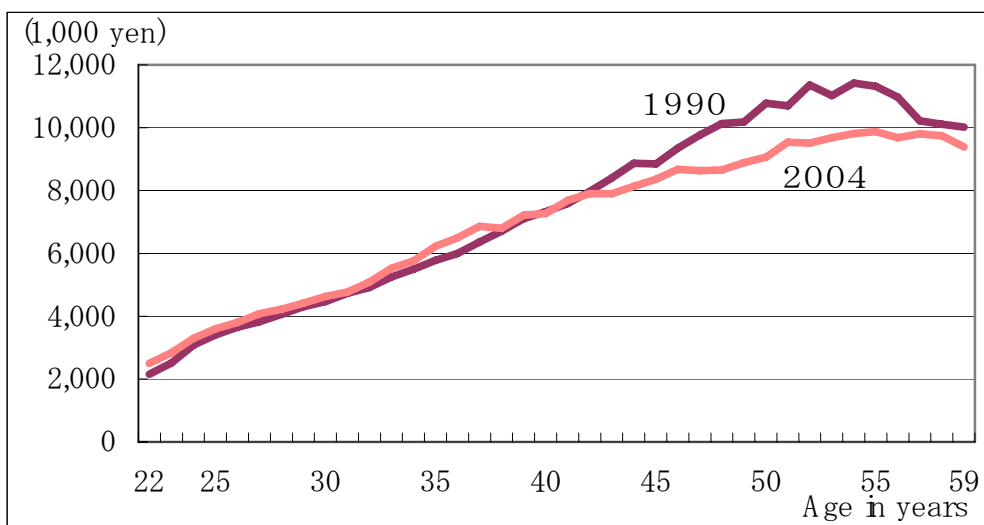
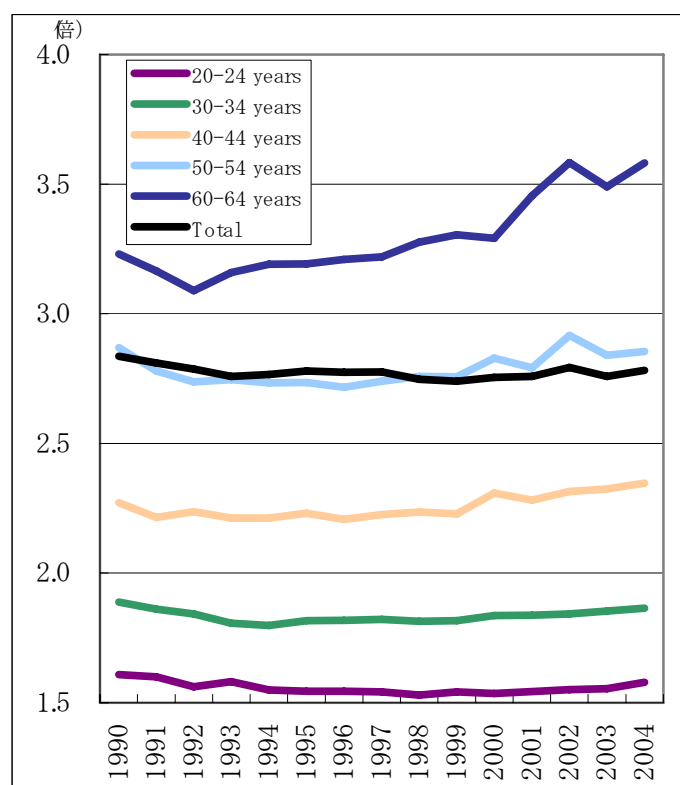


Figure 3 shows the relationship between the ages and wages of employees with continuous years of service working in the same company. Compared to 1990, in 2004, the wages of those aged 40 and over have fallen, while those of employees in their 20s and 30s have increased slightly. It is clear that the wage differential between age groups has shrunk. We believe this is because the share of wages that had been linked to age has been reduced, while compensation related to individual performance has increased.

Second, let us examine inequality amongst employees of the same age. Figure 4 shows the figure found when taking the 9th decile in the wage distribution for that age group, and dividing by the first decile. Generally the wage differential should increase the higher the age group, but the inequality within each group has not widened. Moreover over all ages, we can see that the degree of inequality has been quite consistent. The inequality widens only for the 60-64 age group, but this likely reflects the different employment choices that can be exercised after leaving employment at age 60.

From the above, we can see that although a performance based wage system is beginning to take hold in Japanese companies, at this current time, there has not resulted in a wage disparity between individuals. In the case of the differential between young and old, the differential is even heading towards a correction.

Figure 4 Differentials in Regular Wages of Male Workers



Note: 9th decile/ 1st decile

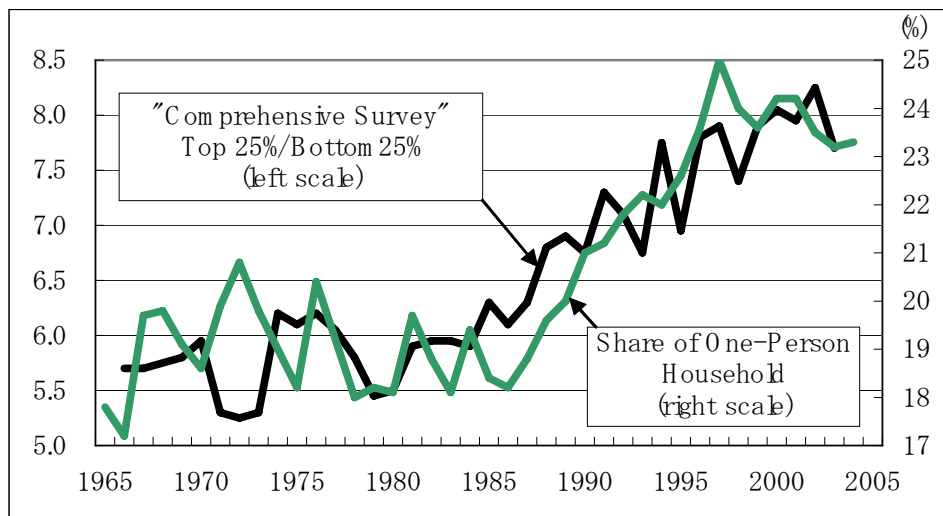
Source: “Basic Survey on Wage Structure”

(4) Aging of the population

Let us now get back to our earlier observation that the two statistics “Comprehensive Survey of Living Condition of the People on Health and Welfare” and “Household Survey” -- have shown conflicting results when used to measure the inequality in household income. We believe the reason for the difference lies in the fact that they survey differing sets of households. The former surveys all households, including those with only one member, while the latter surveys households with two or more members.

Thus, it is likely that the “Comprehensive Survey of Living Condition of the People on Health and Welfare” reflects the effects of the increasing number of single-person households. Recently in Japan, single person households have increased rapidly and in particular those of single women who are older. Since many women have not put in long years of consecutive work, their old age pensions are likely to be low. These low-income single person households are increasing along with the degree of inequality as we saw in Figure 5.

Figure 5 Rising single-person households and income differentials

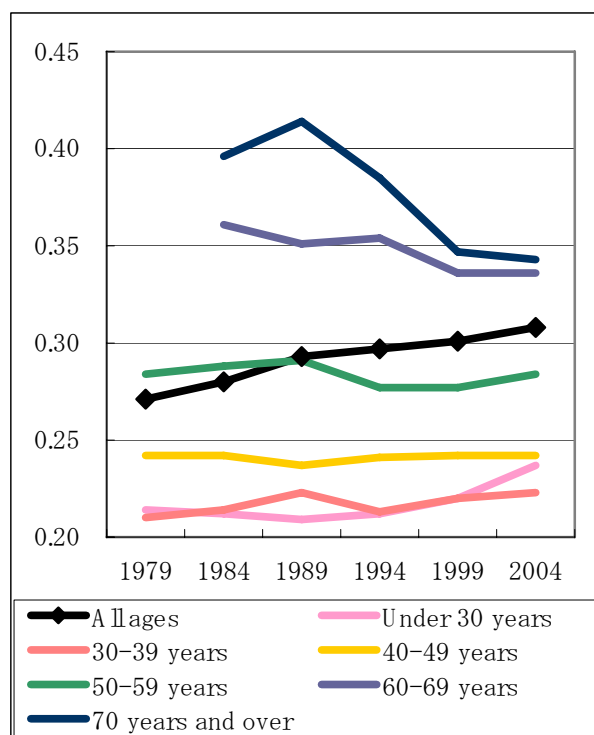


Note: “Comprehensive Survey” includes single person households.

Next we examine the income differential within an age group. The Household Survey conducted monthly does not go into great detail, but once every five years a more comprehensive survey is conducted and the details are released (also for households of two persons or more). According to this survey, as we see in Figure 6, the inequalities within each age group are either unchanged, or they are being reduced. In particular we take note of the fact that for the older age group, they are becoming more equal quite rapidly. We believe this to be a result of the fact that first, the public pension system that was started in the 1960s has

become mature, and all older persons are receiving the benefits. Second, the households receiving larger benefit amounts were relatively more affected by the reduction in pension benefits. Though the inequality is improving within the individual age groups except under 30 years, inequality as a whole for all age groups is widening. We believe this to be a result of the fact that the share of older person households – where there is a higher degree of inequality – has increased from 10.8% in 1979 to 36.4% in 2004.

Figure 6 Gini coefficients of annual income



Note: “National Survey of Family Income and Expenditure” surveys only households of two or more persons.

(5) Economic Conditions

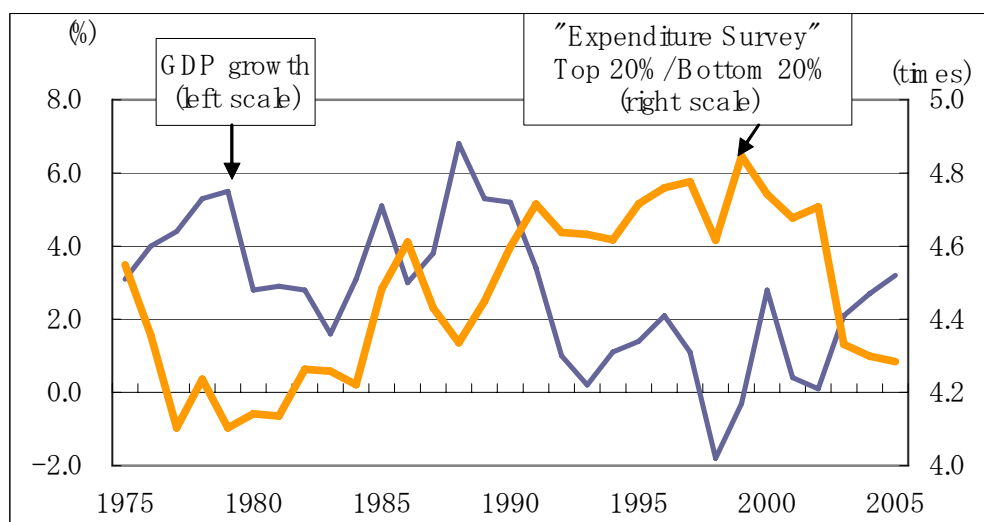
In the beginning of the 1990s, Japan entered into an economic recession that would last for ten years for the first time after the Second World War. During this period, the number of unemployed increased as well as the number of people receiving social assistance. We believe that many Japanese saw this phenomenon and interpreted this to be a result of the increased competition that accompanied the reforms.

Next we will examine if the poor economic performance was a factor in increasing inequality. We examine the relationship between the top 20% income / bottom 20% income according to the Household Survey mentioned above, and the GDP growth rate. Figure 7 shows that in

Japan, during the recession, inequality widened, while during expansionary phases, the degree of inequality is reduced. The correlation coefficient between the two variables is -0.54 and quite high and suggests that the income differential and economic performance are negatively correlated. In an expansionary phase of the economy, we expect the lower income group to see a relatively greater improvement in their income.

The Japanese economy has finally recovered from stagnation and though the growth rates are not spectacular, the economy is steadily expanding. We believe it is safe to assume that with the economic recover, the income inequality in households with two or more people will steadily increase.

Table 7 The economy and income differentials



Note: "Household Survey" ("Expenditure Survey") only surveys households with two or more persons.

3. Summary

From the observations above, we believe the claim that the structural reforms -- introduced to promote market competition -- have resulted in increased efficiency by sacrificing equality in society is wrong.

First, the policies to enhance competition have not been fully implemented. Due to the stand-off between those for and against the structural reforms, there are few reforms that were actually successfully implemented, and of those that were, there are few that were of a scale to have any effect on the economy as a whole. As a result, the competitive environment has not changed greatly and efficiency has not improved.

Some suggest that equality has suffered. However, when we analyze the real numbers, the degree of change in economic equality has been minute, and there is no evidence to suggest that this occurred as a result of structural reforms.

The slight increase in the income disparity was due to aging of the population, and the economic recession. There is greater inequality within the older age groups, and so with the rapid increase in the population of older persons, the inequality has increased. This is obvious in the fact that the degree of inequality has not increased within the various age groups. Also, the income in the older age group is beginning to become more equalized.

We discovered a negative correlation between economic performance and income disparity. The inequality increased as a result of the economic stagnation, but is improving along with the economic recovery that began in 2001. As the forecast for the Japanese economy is for a continued recovery, we believe the income inequality will improve.

We do not, however, suggest that there are no issues of inequality in Japan. Among the older age groups, the single person households, particularly for older women, have low incomes, and the fact that there are few measures in the public pension system to help them is a great problem. Though they could apply for social assistance, many older persons have resistance to being labeled "low income", and so they do not try to access this system. We need to implement a function that will assist the lowest income group within the pension system.

The structural reforms that were implemented have not yet shown large results, and the road to efficiency is still very long. Reforms should begin to be more full-fledged soon. It would be a great mistake to blame the aggravated income disparity in the economy on the reforms -- when they are actually due to the aging of the population and the economic recession -- and for the reforms to be stalled. It is imperative that the reforms continue to be implemented, and that the Japanese market becomes competitive. In a few years, we hope that the reforms will have been implemented and been effective. At this time, we hope to be able to provide a similar report on the Trade-off between efficiency and equality, and find how efficient our economy has become.