REFORM

by Richard Katz

A Nordic mirror for Japan, part 1

"Flexicurity" & reform

Scandinavia seems so different from Japan that it is hard to believe the land of the rising sun could learn anything about reform from the lands of the midnight sun. Yet, they have more in common than the fact that Norway also hunts whales while protecting farmers from imports.

Like Japan, the once-poverty-stricken Nordic countries enjoyed rapid growth. Then, they too suffered from mounting structural flaws that finally culminated in a big macroeconomic calamity in the early 1990s. In Denmark and Sweden, unemployment hit 10%, in Finland, 17%. Obituaries for the "the Swedish way" joined those for the Japanese economic model.

The difference is that the Nordic countries made a remarkable recovery. In the years since 1995, Finland and Sweden have achieved the fourth and fifth highest rates of per capita GDP growth among a group of 19 rich countries, at 3.5% and 2.7% respectively. The US came in 10th at 2.2% (see figure).

Meanwhile, Denmark has lowered its unemployment rate to 2.9% and Norway to 2.6% Denmark, Norway and Sweden have the second, third and fifth highest ratios of working age people holding jobs among 22 countries in the OECD (Organization for Economic Cooperation and Development), the club of rich countries.

Today, Denmark, Sweden, and Finland stand at 3rd and 4th and 6th place as the world's most competitive economies, according to the famous ranking by the World Economic Forum.

Unlike in Japan, recovery did not come at the expense of ordinary people. Danish workers simultaneously enjoy the highest real wages in Europe and the highest income equality in the OECD. Swedes enjoyed one of the highest rates of real wage growth over the past decade. (For more on equality and growth, see October *TOE*, pg. 12).

How did the Nordic countries manage to reform and recover so much more quickly than Japan? We believe the answer lies in their different approaches to "creative destruction." In the long run, the primary source for sustained per capita GDP growth is creative destruction, including the death of old, inferior jobs and firms and the creation of new ones in their place.

In most countries, half of growth in Total Factor Productivity (TFP)—i.e. growth in output per unit of labor and capital—is provided either by better firms seizing market share from inferior firms, or by the death of inferior firms and the rise of newer, better firms.

But what if lives shattered by the destruction are unable to find reprieve in the creation due to barriers to entry, rigid labor markets and the like? In that case, there will be a lot of political resistance to destruction, lots of pressure to keep zombie firms alive.

Three models of capitalism

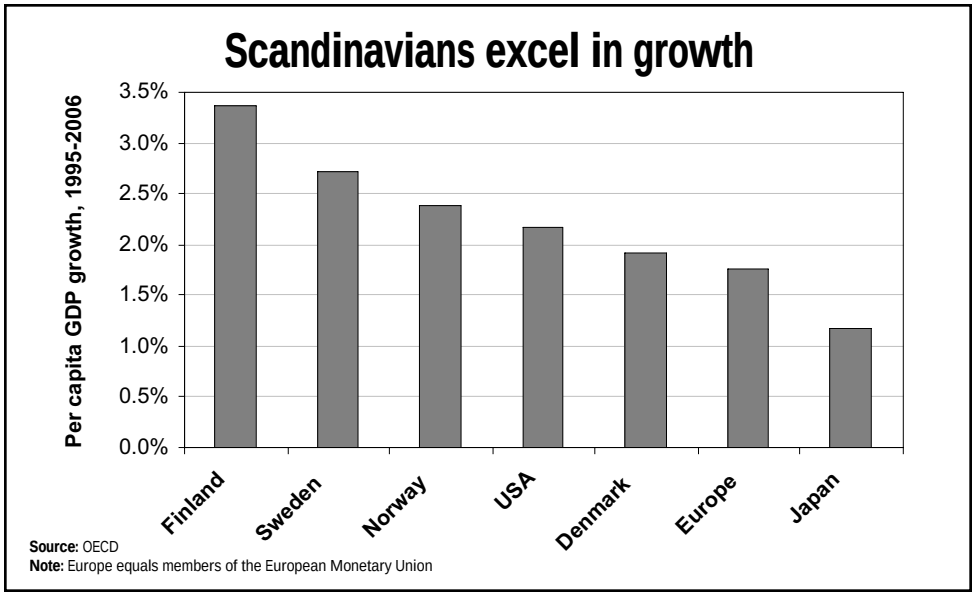
Among the rich capitalist countries, there are three different approaches to this dilemma:

* *The American model.* This model emphasizes market flexibility over personal security. The labor market is very flexible, and there is lots of firm turnover, but a spell of unemployment or a health crisis means disaster for millions.

* *The Japanese/continental European model.* This model emphasizes security over flexibility. There is lots of security for a particular worker at his particular company, but the result is pressure to preserve zombie firms. Japan has one of the lowest rates of firm turnover and longest rates of employment tenure among the rich countries. That system results in less efficiency and growth, and, in the case of Europe, higher unemployment. In Japan, it also means that competition and firm turnover play a negligible role in improving TFP, thereby depressing overall productivity growth and living standards (see figure on pg. 6).

* *The Scandinavian model.* This model uses growth-enhancing flexibility and income security and equality to reinforce each other. The Danes call it "Flexicurity." Rather than trying to protect a worker's particular job at a particular firm, these countries provide a society-wide social safety net: generous unemployment compensation, active help in finding a new job, plus pension and health care plans not tied to any particular job. Jobs come and go. Companies come and go. But workers find new jobs, efficiency rises, and real wages grow for just about everyone.

Undoubtedly, lifetime employment and internal company flexibility provided real advantages to Japan in a time of solid growth—both economic and demographic. Today, the costs are greater than the benefits. Moreover, the traditional Japanese safety net is being eroded without being replaced by something better. Core lifetime workers have all of the traditional safeguards at their firm, while a growing portion of the labor



force—now said to number a third—are irregular part-time and temporary workers. Many of these irregular workers lack both full access to the internal company safety nets as well as sufficient access to society-wide safety nets.

How "flexicurity" works

What makes the system work is a three-legged stool that topples unless all three legs are strong. The three legs are:

1) macroeconomic stability;
2) a globalized market-oriented business and labor system that promotes growth; and
3) income equality and security.

An active labor market policy that quickly retrains and reemploys laid-off workers keeps structural unemployment low. Hence, there is no political demand for either inflationary monetary and fiscal stimulus or the kind of disinflationary monetary policies that kept US unemployment at a 7% average during 1977-1994.

Meanwhile, good growth, efficiency and high employment rates provide the means to finance the welfare state's famous social benefits—from generous unemployment compensation, to free child care, elderly care, health care and education. In turn, those expensive forms of social insurance and benefits—paid for by taxes and spending that take up almost half of GDP—make workers unafraid of creative destruction.

The social security benefits that some neoliberal economists claim will destroy efficiency and growth can do the opposite—as long they are done correctly.

It is cheaper and easier to layoff redundant workers or even close down a plant in Scandinavia than in Germany or France. What is protected is a worker's income and ability to get a new job, perhaps a better one.

Every year, 11% of Danes lose their jobs and another 20% quit to find better jobs. That's the highest turnover rate in the OECD. Job tenure is higher in Sweden than Denmark, but flexibility is still high.

A laid-off Swedish or Danish worker earning 75% of the income of an average production worker gets enough unemployment compensation to replace about 75-80% of his lost income—compared to only 26% in Britain, and 60% in Germany. 20% of American job-losers find they are ineligible for unemployment benefits.

The Japanese system incentivizes both firms and employees to practice long tenure at the same firm, and creates political pressure to keep inferior firms going. Despite high statutory rates for unemployment compensation, the actual effective replacement rate for a typical unemployed worker in Japan is a shockingly low 10%, compared to an OECD-wide average of 30%. A worker under age 44 who has worked for five years can get unemployment benefits for only 90 days, whereas a 45-59 year-old who has worked 20 years gets 300 days of benefits. While insured work does not necessarily mean working at the same firm, this provision, in combination with the dearth of lateral occupational mobility, means that short-tenured workers who lose a job are in big danger of seeing their benefits run out.

Japan's system also punishes irregular workers since eligibility is limited to those who have worked more than 20 hours a week and have done insured work for six of the previous twelve months.

No wonder that in Japan, as in continental Europe, nearly half of all workers have worked at the same firm for more than 10 years. The comparable figures are 26% in the US and 31% in Denmark.

***Kaizen* for workers**

What really makes Denmark and Sweden stand out are their "active labor market programs." They each spend 1.5% of GDP a year on these programs, more than any other rich country besides Holland. At any given time, about 30-40% of Danish unemployed are in programs ranging from subsidized training programs at the technical schools or companies, to subsidies for "Flexjobs," to re-training programs for workers who can no longer find new jobs in their old occupation, to temporary subsidies for firms to hire long unemployed low-skill workers. Strict rules prevent these subsidized workers from undercutting regular workers. Flexicurity is a kind of *kaizen* for both people and the production process.

Most of this money is well spent. In Denmark, only 0.8% of workers have been out of work for more than 12 months. In Sweden it's just 1%.

Not surprisingly, when people were asked if they felt anxious about losing their current job, 80% of Swedes and 75% of Danes said they benefit from switching jobs, compared to only 40% in the rest of the EU.

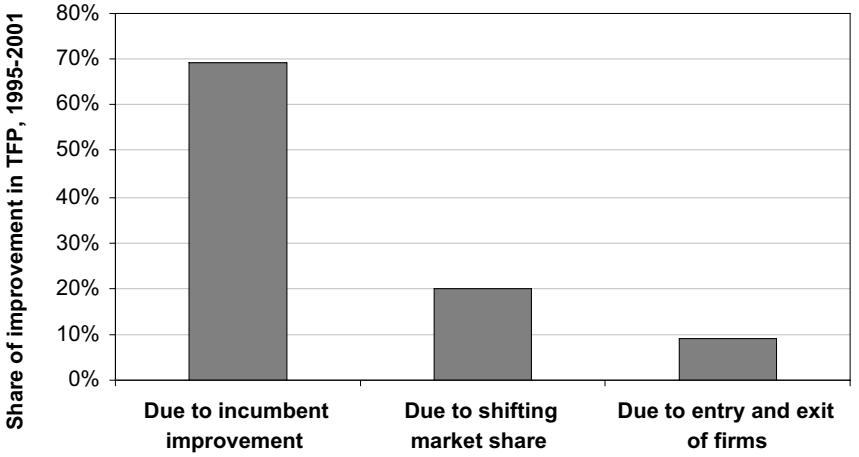
Road to hell and good intentions

By contrast, in Japan and continental Europe, well-meaning laws and practices protecting workers in their current jobs often hurt the very people they aim to help. Firms that are restricted from getting rid of excess workers in tough times are extra careful about hiring them even in good times. In Japan, that leads to protecting zombie firms and to firms switching to low-wage irregular workers. In continental Europe, the long-term (over 12 month) unemployment rate is 4% in France and 5% in Germany.

The system also leads to overwork, so firms can avoid committing themselves to a new employee. In 2002, the proportion of Japanese workers working more than 50 hours a week was 28% compared to 20% in the United States, 15% in the United Kingdom, 5% in Denmark, and 1.4% in the Netherlands. The premium pay for overtime work was lower in Japan than elsewhere.

(*Part 2 next month*).

Too little "creative destruction" in Japan



Source: Kyoji Fukao and Hyeog Ug Kwon. *Why Did Japan's TFP Growth Slow Down in the Lost Decade?*
Note: TFP = Total factor productivity, i.e. units of output per unit of labor plus capital