The economic costs of court decisions concerning dismissals in Japan: Identification by judge transfers

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ABSTRACT
Despite its significant influence on the actual enforcement of the law, the economic cost of court discretion has generally been ignored in the literature on employment protection. This paper exploits a distinctive feature of the Japanese judicial system, periodic judge transfers, to identify court discretion. Because judges move across local labor markets, while a single national court system ensures that there are no legal boundaries between regions, it is possible to remove any confounding relationships between current litigation outcomes and local labor markets. A key finding is that an increase in the worker victory ratio in adjustment dismissal litigations reduces the rates of both job creation and destruction. Ignoring the uncertainty inherent in court decisions would lead to misspecification of the actual cost of employment protection, especially in countries with high judicial activism.

1. Introduction
Courts’ discretion can lead to substantial differences in the actual enforcement of the law, especially in countries with high rates of judicial activism. The economic cost of such discretion is often ignored, despite its potentially large influence on behavior. One example is court-enforced employment protection legislation. According to economic theory, an increase in the cost of laying off an employee should unambiguously reduce not only the numbers of layoffs, but also of new hires, due to fears of possible future downsizing (Hopenhayn and Rogerson, 1993; Bentolila and Bertola, 1990). Among other effects, this disincentive to expand hampers a smooth recovery from an economic crisis.

In light of this, recent empirical studies have increasingly focused on quantifying the effect of employment protection laws on job flows (Millán et al., 2013; Kugler and Pica, 2008), employment response to shocks (Adhvaryu et al., 2013), productivity (Autor et al., 2007), and allocative efficiency (Petrin and Sivadasan, 2013), rather than on total employment.1 Nonetheless, few of these studies have considered differences in judicial review processes. While Fraisse et al. (2015) studied the impact of litigation outcomes in French labor courts, their identification variations relied on a mechanism that tracked changes in procedural costs brought about by changes in the density of lawyers, rather than changes in the levels of enforcement as such. Although Autor et al. (2007) examined the impact of U.S. state courts establishing exceptions to at-will doctrine, the relevant legal precedents are still open to a wide range of interpretations and judges retain considerable discretion. Provided that firms—when assessing indirect firing costs—do take into account the enforcement levels that affect the odds of winning a case at trial, ignoring the uncertainty inherent in court discretion will lead to misspecification of the actual cost of employment protection.

However, estimating the impact of court discretion poses an empirical challenge, because judgments are often confounded by unobserved traits in the local labor market. First, given points of dispute, judges’ decisions may be biased by local labor market conditions, leading to reverse causation ( Marinescu, 2011; Ichino et al., 2003). Second, cases are selected into trial according to dispute characteristics (Priest and Klein, 1984), which can create systematic regional patterns in litigation outcomes. Previous studies have managed the endogeneity issue by considering the firing restriction to be exogenous in certain dimensions. In the U.S., for example, differential timing for the acceptance of exceptions to the employment-at-will doctrine generated state-level variations.
in the extent of firing restrictions; researchers then used these variations to identify their impact (Autor et al., 2006; Autor, 2003). Studies in Italy used a discontinuity in legislative firing costs across firms (Leonardi and Pica, 2013; Kugler and Pica, 2008). While these previous studies have considered differences in established case law or written statute as exogenous policy changes, identifying the impact of enforcement action itself requires additional caution; individual court decisions are made at too local a level to ignore the tight connections between them and unobserved local labor market conditions.

This paper aims to identify the causal impact of dismissal-related court discretion on job flows by exploiting a unique feature of the Japanese legal system: the exogenous allocation of judges to prefectures. In Japan, judges are periodically transferred across prefectures in a way that is uncorrelated to local labor market conditions. Because Japan has a single national court system and there are no legal boundaries between prefectures, these judge transfers should provide a nontrivial source of variation, generating differences in the enforcement of employment law across prefectures. Since judges move beyond prefecture borders, it is also possible to exclude the effects of any confounding factors between current litigation outcomes and local labor market characteristics.

Specifically, this paper’s analytical approach first estimates the effect specific to each judge, based on records for litigation heard by that judge, while excluding those litigation records within the prefecture to which the judge is currently assigned. Removing the litigation records from the current prefecture allows us to eliminate possible direct reverse causation from current labor market conditions; it also prevents finding a systematic trend arising from selection in accordance with local dispute traits. The estimated judge effects are then used as instruments to analyze discretion in local courts, in order to examine whether any tendency for pro-worker interpretations to the existing case law decreases employment flows in the local labor market.

To capture new judicial interpretations added to the law, court discretion in dismissal cases is represented by a worker victory ratio constructed from influential litigation records taken from prevalent litigation dataset. Using only influential litigation records also allows us to approximate better the agents’ perceptions of levels of court discretion, because local agents do not usually observe all litigation outcomes filed in courts. As we will see later, the resulting calculation of the worker victory ratio reflects important changes in judicial interpretations of the law, including the confidential guideline issued by the Supreme Court Secretariat in the late 1980s.

The estimation results reveal that court discretion per se has a nontrivial impact. Consistent with theoretical predictions, a 10 percentage point increase in the worker victory ratio over the prior 10 years reduces the prefecture job creation rate by 2.03% and the job destruction rate by 1.39%. Interestingly, the impacts of court discretions are significant only when the worker victory ratios are constructed from litigation records related to dismissals undertaken as a means of employment adjustment due to business necessity. Court discretion in other dismissal cases, such as those dismissals due to worker misconduct, had no significant impact on local labor market flows in any specifications.

Although the main estimates are conservative, in that the identification variation comes only from recent judge transfers, this paper is unable to test explicitly whether the impact of worker victory ratios is driven by current court decisions themselves, or their comparison against past litigation records. This is due to the fact, by focusing on influential decisions, only a limited number of litigation records become available for the analysis. In other words, this paper does not rule out the possibility that local agents have bounded information rationality and processed the current litigation outcomes in comparison with past ones.

In addition to answering a long-asked question in labor economics, this paper makes unique contributions to the literature. First, this paper applies the same method employed in a series of studies considering judge effects in the case of employment protection (Dobbie and Song, 2015; Aizer and Doyle, 2013; French and Song, 2014), but it does so while completely excluding the confounding factors, including judicial bias, pointed out in the literature (Marinescu, 2011; Ieshimo et al., 2002). This is possible here because, unlike in previous studies, Japanese judges move beyond local labor markets, while the same law is still applied nationwide. Second, this paper also differs from a series of within-country studies on employment protection by focusing on the economic consequences of court or judicial discretion per se rather than on written regulations or established case law (Autor et al., 2006; Autor, 2003; Leonardi and Pica, 2013; Kugler and Pica, 2008; Marinescu, 2009; Martins, 2009; Schivardi and Torrini, 2008). Lastly, this work provides the first evidence on the impact of employment protection in Japan, showing that even in the absence of legal boundaries, administrative boundaries may suffice to generate cross-regional policy variations.

The remainder of the paper proceeds as follows. Section 2 offers an overview of Japanese employment protection, while Section 3 presents the estimation methods. Section 4 describes the data, while results are presented and discussed in Section 5. Section 6 concludes.

2. Institutional background

Japan has a unique legal system. Its labor legislation is originally based on German law, but heavily follows precedents as a result of the influence of common law during the United States’ short occupation after the Second World War. This introduction of American law allowed judges to make more liberal and teleological interpretations of existing civil laws (Araki 2002). Examples of such “judge-made law” include the so-called Doctrine of Four Prerequisites in employment protection legislation (referring to the four prerequisites in the Doctrine of Abusive Adjustment Dismissals). Unlike some European countries, Japan had no written statute requiring just cause for dismissing workers. Instead, by establishing the doctrine of four prerequisites, Japanese courts have de facto regulated employers’ firing practices that result from business necessity (adjustment dismissal, or Seiri Kaiko in Japanese).

The four prerequisites have severely limited firms’ ability to adjust the number of employees in response to business shocks and flexibly achieve optimal production levels. The doctrine requires a firm to satisfy the following four prerequisites in order for an adjustment dismissal to be legitimate:

2 Ohtake and Fujikawa (2001) and Ohtake (2004) first compiled statistical information on the doctrine of adjustment dismissal established by the courts. JLPT (2005, 2006, 2007) followed; however, neither work analyzed the relationship of this doctrine to the labor market. Okudaira (2008, in Japanese) presented preliminary evidence on the impact of judgments regarding adjustment dismissals, but did not present the causal estimates, which are of primary interest in the current paper.

3 The power of judicial review is a by-product of the 1947 constitution, which organized the present tripartite system (Itoh, 1991, 1995).

4 The Japanese government codified the Doctrine of Abusive Dismissal in 2003 (Labor Contract Act, Art. 16), although the provision only generalized existing case law and did not stipulate the four prerequisites, which will be discussed below.

5 The doctrine of four prerequisites for adjustment dismissal was derived from the Doctrine of Abusive Dismissal, which was originally a “modification” by the courts to the Civil Code provision. It states that, “if the employment is not for a definite period, either party may make a request to terminate the contract at any time…” (Civil Code, Art. 627, Par. 1). Judges issued the Doctrine to alter this written statute in the face of a serious economic downturn after the Second World War, when the cost to workers of being fired was exceptionally high. See Sugeno (2002, 473–493).

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