

**Law and Economics of Labor in Japan: Review of
Kaiko Hosei wo Kangaeru: Hogaku to Keizaigaku no Shiten
(Examining Dismissal Law: From the Perspective of Legal and
Economic Studies) Fumio Ohtake, Shinya Ouchi and Ryuichi
Yamakawa, eds.***

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1. Law-and-Economics of Labor

For the labor market to function efficiently, it is necessary for labor resources to be distributed in the most efficient manner. This resource distribution in the labor market is realized through the specific actions of individual economic actors — employers hiring and dismissing, and workers finding and leaving work. Therefore, a social mechanism governing the efficiency of the labor market is tantamount to a social mechanism that regulates the particular activity of employers and workers. Thus, regulating the behavior of employers and workers is generally an important issue, and labor policies in many countries have actually been formulated and implemented from this viewpoint.

When analyzing these policies, we should remember that the issue has two aspects. On the one hand, a nexus of legal devices called labor laws provides public rules which oversee each action in the labor market with the support of third-party enforcement through the courts; that is, the issue has legal aspects.¹ On the other hand, there are also economic aspects

¹ From the economic perspective, it is useful to categorize these social mechanisms if we focus on rule enforcement mechanisms. First, when the economic actors voluntarily obey a set of rules, it is called first-party enforcement. Second-party enforcement refers to mutual enforcement by transactors themselves based on a set of rules. The most crucial is third-party enforcement in which a third party

involved. Since individual actions in the labor market are naturally assumed to be economically motivated, any analysis of the public rules concerning labor should also be based on the presupposition that every actor, to a certain degree, makes rational choices. This is why we need to analyze the legal and economic aspects of labor issues.

The main target of analysis in this field has been dismissals, because dismissals by employers are regarded as particularly important among the various actions that take place in the labor market. It is well-known that being dismissed usually reduces a worker's income, both in the short and long run, making it difficult for him/her to financially maintain his/her pre-dismissal standard of living.² Being dismissed also can result in strong psychological trauma and can negatively impact the worker's life, even in a country such as the United States where dismissals are supposed to be relatively common.³ In contrast, one does not usually think that a worker leaving a job will seriously damage an employer. Thus, among the various economic behaviors that occur in the labor market, it is imperative to first consider how to control dismissals to ensure that labor resource distribution leads to greater social welfare.

As widely recognized, a significant number of studies on the economic effects of dismissal rules have been accumulated in the West. In Japan, scholars, mostly those in legal studies as well as economics, began to research the topic in the 1990s. The book under review in this article, *Kaiko Hosei wo Kangaeru: Hogaku to Keizaigaku no Shiten (Examining Dismissal Law: From the Perspective of Legal and Economic Studies)*, contains articles which have been published in *Nihon Rodo Kenkyu Zasshi*, and it is an excellent tool for grasping the overall direction of current Japanese research on the subject.⁴ To stimulate a dialogue between the

who is not directly involved in the transaction enforces a set of rules. It is generally believed that *private* third-party enforcement was predominant in the early modern era, and *public* third-party enforcement came to occupy an important place after the beginning of the modern era. See, for example, Milgrom, North and Weingast (1990).

² Higuchi (2001) surveys recent trends in employment and unemployment in Japan.

³ See, for example, Darity and Goldsmith (1996).

⁴ In May 2004, the second edition of the book was published. Some articles, mainly legal studies, have been edited in accordance with the passage of two years. New sections include a round-table discussion during which Article 18-2 of the Labour Standards Law was discussed, as was the original version of this article.

scholarships of law and economics, major revisions have been made to some of the articles, allowing the reader to view the history of the debate among the authors of the essays. Additional care has been taken to make the book accessible to non-specialists, and anyone interested in an analysis of dismissal rules or the labor market institution in Japan should find it easy to follow. Following the December 2002 publication of the first edition of this book, the Labour Standards Law was amended, paving the way for Article 18-2 which legislates the judicial principle of “the abusive exercise of dismissal right” which was enacted in January 2004. Since the amendment, statutory grounds to restrict dismissals have been recognized, and conflicts over dismissals no longer seem to be confined to the world of case law. However, according to the author of Chapter 1, “Although the amendment has great importance in that the legislators clarified the general constraint of dismissals, the provision merely copies a sentence in current judicial principle. Therefore, there the dispute over regulations governing dismissals continues.” The 2004 amendment to the Labour Standards Law does not reduce the importance of the discussions contained in this book.

In reviewing this book, I will attempt to survey the field and introduce major issues concerning law-and-economics of Japanese labor.

2. Review of Section I

The book has three sections. Section I is entitled “Introduction,” and the chapter “Nihon no Kaiko Hosei – Rekishi Hikakuho Gendaiteki Kadai (Japanese Dismissal Law: History, Comparative Law and Contemporary Issues)” by Yamakawa introduces basic facts concerning dismissal law and surveys the major issues involved.

According to Yamakawa, what is distinctive about Japanese dismissal law is that “for a long time statutes codifying general regulations about dismissals were virtually non-existent, with case law playing an important role in constituting the judicial principle of ‘the abusive exercise of dismissal right’ in practice.” However, in prewar Japan, both the right to dismiss and the right to resign were treated symmetrically as general civil law problems, and came under the framework of dissolving a contract. It

was only after the first half of the 1950s that court decisions advocating some restrictions on the exercise of the right to dismissal, not the right to resign, became predominant. When viewed internationally, the author continues, the institutional frameworks that regulate dismissals have some similarities, while also containing some differences. For example, few countries have established clear standards even though they may have statutory law provisions regarding dismissals. On the other hand, the court system in each country varies, such as the existence or the lack of a specific institution to handle labor disputes. What these similarities and differences imply is that a dismissal law of a given country — be it the employment-at-will principle of the United States or the judicial principle of “the abusive exercise of dismissal right” — should not be treated as perpetual truth but instead should be analyzed in the particular context of that country’s historical development and in comparison with other countries.

Therefore, it is not surprising that Yamakawa presumes a complementary institutional relationship between the employment system and corporate governance — as assumed in the Comparative Institutional Analysis (CIA) approach — in Japanese dismissal law. In this section, he infers that if the institution of corporate governance changes as a result of international competition or for other reasons, “The employment system and judicial principles, which reflect a social consensus, will be affected by the change.” Based on the speculative understanding that Japanese dismissal law may have been actually affected by such change in recent years, he poses three points on changing judicial decisions concerning “the abusive exercise of dismissal right”: labor contracts limiting job types, notification of dismissal with an option of different work conditions (*henko kaiyaku kokuchi*), and reexamination of the so-called “four requirements” needed to carry out adjustment dismissals in advance.

In fact, Japanese studies on the relationship between the institutions of corporate governance and the practice of employment adjustments have produced certain successful results. For example, studies measuring the quickness in which Japanese corporations carry out employment reductions have provided some empirical support for Koike’s “deficits-in-two-consecutive-periods” hypothesis — meaning a company is more likely

to greatly reduce its work force in the period following two consecutive periods of deficit. These empirical studies are consistent with the theoretical inference of the CIA approach, according to which, when a major event affecting a corporation's future occurs, the balance of power among stakeholders over control of the corporation will be altered, and a major employment reduction will be carried out.⁵ However, in most empirical studies, the term "employment adjustment" can simply mean an adjustment in the number of employees (or work hours). Unfortunately, there is no clear distinction as to the different methods used — such as dismissals, enlisting voluntary retirements, increasing of voluntary resignations, and adjusting overtime hours — which is important from the standpoint of legal studies as well as of social welfare. This lack of detailed information is connected to the understanding that dismissal regulations are a monetary cost for employers, but it does not really address the direct relationship between legal arrangements and actual dismissal behavior (or other employment adjustment behavior). Therefore it should be understood that the relationship between the forms of corporate governance and the dismissal behavior of the employers has not been sufficiently clarified, either empirically or theoretically.

Although chapter 1 certainly offers us an interesting framework to conceptualize overall institutions in the Japanese labor market, we really have less empirical evidences than Yamakawa seems to have. Moreover, the fact that the framework is rarely used in the following chapters indicates that there still exists the gap between understanding overall social mechanism of labor market and analyzing the particular behavior in it. This gap may cause the readers to feel the conclusions of each chapter to be too artificial. It is a helpful message of this chapter that filling this gap is a useful way to practically link the results of each chapter with the actual labor market policies.

⁵ See, for example, Komaki (1998), Abe (1999) and Urasaka, and Noda (2001). Other studies include Tomiyama (2001) which examines the relationship between the so-called "Main-Banks" and employment adjustments, and more recently Noda (2002) who examines the hypothesis in connection to industrial relations. As for the CIA approach, refer to Aoki (2001).

3. Review of Section II

The articles in Section II, “Theoretical Analysis of Dismissal Law,” discuss the justification of dismissal law, more specifically, the justification of the judicial principle of “the abusive exercise of dismissal right” from the perspectives of *pure economic theory and legal dogmatics*.

Chapter 2, “Fukanbi Keiyaku Riron to Kaiko Kisei Hori (Incomplete Contract Theory and the Judicial Principle of Dismissal Regulations),” by Tsuneki examines which theoretical models should be used to undertake an economic analysis of dismissal law. Citing Chuma (1998) and Eguchi (2000), the article rejects analysis based on the theory of incomplete contract and argues that the theory of repeated game, with its stress on the “long-term relationship between the worker and the company,” should be used as the main analytical tool. This negative conclusion about the theory of incomplete contract is drawn by using the following arguments: the theoretical implication of the model relies on the “unrealistic assumption of the ability of the court to correct information and make decisions,” therefore, “the recent argument explaining economic rationality for dismissal regulations using the theory of incomplete contract is not sufficiently persuasive.” (Eguchi responds to this point in Chapter 3.)

However, a good portion of Chapter 2 is dedicated to a discussion of normative standards in legal and economic studies of labor. The conclusion drawn here is that the “main goal of labor law” should be limited to “determining the proper rules and initial conditions for the parties to negotiate and come to an agreement.” To this end, Tsuneki stresses that the concept of (Pareto) efficiency, a commonly accepted normative standard in economics, is “merely a necessary condition [that is, a tentative and intermediate evaluation] for the realization of distributive justice.” In this respect, the concept of efficiency in economics is not different from the normative evaluation in legal studies, that is to say, both employ a tentative standard most likely to receive a social consensus as a normative evaluation. Contrary to the common understanding about standards, he admits that “they have different views over legal schema for realization [of the above tentative standard].” Because economists consider “A contract, which is voluntarily concluded, is by definition meant to improve the

interests of both parties at the same time,” it should be approved naturally not only in terms of efficiency but also in terms of fairness. Therefore, public laws, such as those concerning taxes and social security, should be used as the primary tool to correct wealth inequality, and intervention through private laws, such as civil law and commercial law, should only be used secondarily and as little as possible because it would hinder concluding contracts freely. On the other hand, legal scholars have not made such a clear prioritization, and occasionally argue that “The fairness should be realized at a different level [that is, in the realm of private law] ... other than wealth redistribution through public law [such as tax].” However Tsuneki emphasizes that legal scholarship lacks persuasive arguments as to why private law intervention must take precedent over public law when trying to redistribute wealth. Therefore, contrary to legal scholars who argue in favor of private law intervention, Tsuneki writes that such intervention is an “ad hoc justification for the pre-existing legal practices.”

By applying the same line of argumentation, then, Tsuneki takes a skeptical position toward the views of Uchida. To legally justify the judicial principle of “the abusive exercise of dismissal right,” Uchida attaches importance to the reasoning behind the relational contract theory in legal studies, which has provided empirical support for the development of the theory of incomplete contract in economics in the United States. Uchida also emphasizes the two basic principles underlying that theory — the *continuity principle and flexibility principle* (Chapter 8 includes Uchida’s response to Tsuneki). To a certain extent, Tsuneki understands the rationale behind those who justify private law intervention based on the relational contract theory when he writes, “If the premise of rationality [of individuals] is in doubt, it will be meaningful to provide judicial relief for contractual detriments by placing legal [private law] constraints on the range and possibilities of the contract and/or by developing general provisions concerning civil rights.” When the availability of judicial resources is limited, Tsuneki argues that the interpretation of interfering dismissal rules based on the continuity/flexibility principle can make sense. However, according to Tsuneki, Uchida sees the rationality of the two principles not as limited human rationality, but as residing in “the

protection of the communal value which is in opposition to and in competition with individualistic liberalism,” something the author cannot accept.

Chapter 3 is entitled “Seiri Kaiko Kisei no Keizai Bunseki (Economic Analysis of Adjustment Dismissal Regulations)” by Eguchi. By using the incomplete contract theory which Tsuenki criticized in Chapter 2, this chapter seeks to demonstrate that dismissal regulations might improve social welfare under certain conditions. Eguchi’s model will be discussed in some detail here because it is a clear-cut example of the analysis of the principle of the abusive exercise of dismissal right utilizing the theory of incomplete contract.

The fundamental premise of the model is the incomplete nature of a contract. That is, it is impossible to work out in advance an agreement in which a worker will actually continue to be employed after the training period, although some company-specific training investment will be required beforehand. In this situation, workers can suddenly be dismissed and the money they spent on training will be lost just as they ready themselves for a career and set out to earn wages in that company. Eguchi hypothesizes that dismissal regulations produce an additional (social) cost for terminating employment and presents a comparative statistics for the equilibria with and without regulations.

When a regulation (that is an additional cost) exists, the company can offer a lower wage *ex ante* to the worker instead of incurring costs to adjust employment *ex post*. In this case, there is no incentive for the company to terminate employment *ex post* because it is costly and, therefore, it is easier for the company to tacitly convince the worker that it will curb the number of dismissals which might emerge after the contract has been concluded. On the other hand, when dismissal regulations do not exist, there will be no costs involved in carrying out an employment reduction afterward. Even if the company offers a tacit promise to curb the number of dismissals *ex ante*, it will be difficult for the company to convince the worker. This is because the company has an incentive in ignoring such tacit promises — which is never a clearly written contract obligation — and in carrying out employment reductions at will, depending on the environment. Therefore, the crux of the theory of incomplete contract is about committing

precautionary indirect measures to regulate the *ex post* actions of the parties when the situation cannot be clarified beforehand. An analysis of dismissal rules using the theory of incomplete contract shows that they can be interpreted as precautionary measures.

Since the chapter adopts a Benthamian definition of social welfare, whether a set of dismissal regulations improves social welfare depends on whether or not an increase in production resulting from an increase in employment will exceed the social cost resulting from dismissal regulations. In other words, when the benefit (increased production) resulting from predetermined artificial restrictions outweighs the cost, such restrictions are justified from the perspective of efficiency. This is one way to justify dismissal regulations in terms of economics.

The above discussion, however, rests on an assumption that the company and the worker can work out only one wage level in the contract regardless of economic fluctuations. If it were somehow possible for them to commit an agreement *ex ante* to change the wage level in accordance with *ex post* situations, it would be possible for the company to induce the worker to accept a more efficient promise without resorting to dismissal, which incurs a social cost. The chapter lists some examples such as issuing separate expenses for wage and training costs, establishing regulations concerning retirement allowances, and allowing the labor union and management to negotiate the total sum of wages *ex post* to be shared among the union's members. However, Eguchi finds all of these possibilities infeasible and concludes that creating a social device for commitment in the form of legal regulations of dismissals can improve social welfare.

Chapter 4, "Kaikoken Ranyo Hori no Seitosei (Justification of the Judicial Principle of Dismissal Right Abuse)" by Tsuchida, justifies the judicial principle of "the abusive exercise of dismissal right" with the continuity/flexibility principle as discussed by Tsuneki in Chapter 2.

Tsuchida begins with a discussion of the general theories surrounding the judicial principle. Mainly employing the theory of incomplete contract, he argues that the principle has a certain economic rationality. He continues that at the same time, it is generally necessary for legal studies that the continuity/flexibility principle should regulate contractual

relationships, for example continuous contracts (typified by labor contracts), because of the bounded nature of human rationality. He considers the judicial principle as an embodiment of this general inference, considering “inequality between labor and management” as a problem specific to labor contracts. The principle also functions as a legal norm to meet the ideal of “establishing actual equality between labor and management,” and this is why there is an asymmetry between the right to dismiss and the right to resign. Based on these inferences, he concludes that the principle “should not be immediately relaxed simply because of changes in the market environment” as it is a kind of social norm.

Of course, a social norm in the labor market must be an illustrated expression of the general principle running through the concept of labor law which can be referred to as the “doctrine of employment security.” The norm can take any form as long as it substantially guarantees “employment (maintenance and continuation of the labor contract) and the ideal of actual equality between labor and management.” That is to say, there is no reason that the current judicial principles have to be the only expression of the doctrine of employment security, implying that these judicial principles have some room for reevaluation. Tsuchida actually proposes to reevaluate Japanese labor law as a whole, including judicial principles to ensure that they closely follow the doctrine. For example, decisions allowed in dismissal right abuse cases should be decided more flexibly according to the type of employment, a comprehensive approach to handling adjustment dismissal cases should replace a formal application of the four requirements, and the judicial principle of altering working conditions should be legally reconfigured from the perspective of the doctrine of employment security.

As seen above, Tsuneki’s critique of the interpretations of dismissal rules based on the theory of incomplete contract and relational contract theory in Chapter 2 concerns particular shortcomings in the individual articles he cites and by no means finds a defect in the logic of the interpretation. Therefore, justification of a judicial principle of “the abusive exercise of dismissal right” — in terms of either economic efficiency or legal justice — by the theory of incomplete contract theory in economics and the continuity/flexibility principle in legal studies still

remains a persuasive argument to a certain degree. Of course, there are only a few studies which analyze the theoretical foundations of dismissal rules, similar to the chapters contained in this book, and it is necessary to develop more literature combining a variety of models, such as — for example in economics — the repeated game theory mentioned by Tsuneki and the efficient wage theory used in Ohashi (2004).

4. Review of Section III

As section II proposes some theoretical candidates to understand the working of the dismissal rule in Japanese labor market, then we need the evidences to clarify which of the theories can most reasonably explain the actual dismissal behavior. Section III is entitled “Analysis of the Current Situation concerning Dismissal Law,” and contains three empirical studies on the judicial principle of “the abusive exercise of dismissal right.” Unfortunately, rather than directly test the validity of the theoretical interpretations developed in Section II, these studies only present valuable but peripheral materials concerning this question.

“Seiri Kaiko no Jissho Bunseki (Empirical Analysis of Adjustment Dismissals)” by Ohtake in Chapter 5 is unique for its survey of labor cases and its quantitative analysis. As a matter of fact, there have been few studies which chronologically survey adjustment dismissal and normal dismissal cases, and this is the first study to conduct an econometric quantitative analysis in Japan.⁶

Using the so-called Priest/Klein 50 percent rule as a premise, Ohtake notes that the judicial principle of “the abusive exercise of dismissal right” was established in the mid-1960s while the predictability of the principle

⁶ General surveys of adjustment dismissal cases in legal studies include Liu (1999) who covers the period from 1945 to the 1950s, Hara and Okuno (2004) from 1975 to 1985, and the Hokkaido Daigaku Rodo Hanrei Kenkyukai (2001), which covers the 1989-2000 period. Only a few such studies have been conducted in economics, one of which is Kawaguchi, Kambayashi and Hirasawa (2004). On the other hand, we do not have many empirical studies on general dismissal cases. The lack of empirical data has delayed examining basic facts that would provide the foundation of policy discussion. For example, it is commonly assumed (even in national parliaments where bills are made) that it is difficult for a worker to return to the workplace after receiving a verdict nullifying his/her dismissal during deliberation, but the empirical data about this issue has been addressed only by Maeda (1995) and Yamaguchi (2001).

declined in the 1990s. Then Ohtake proposes the “development of statutes concerning dismissals” in order to “reduce the uncertainty in judicial decisions,” with pointing out that litigation impacts different groups differently, and stresses the importance of deciding “to which group should the rules first apply.” However, because “it is extremely difficult to illustrate each of diverse effects and to establish the most proper standards without precedent, the use of social experiments should be considered.” He prefers the litigation of such standards to experimentally introducing various laws into certain geographical areas and types of corporations and then examining the results.

This chapter adopts a rather unprecedented research strategy for quantifying court rulings and presents a way forward for empirical studies in law-and-economics in labor. However, it is not free of methodological problems. Quantifying court rulings and constructing data for statistical purposes is surely interesting, and in fact econometric studies using such data as codified in court cases have been increasing in the United States recently. But it is first necessary to carefully examine the nature of court rulings when using them for statistical purposes. It is not easy to classify court decisions into several patterns, and it is still more difficult to categorize into finite codes the reasoning behind the decisions. A ruling handed down by a court is not a designed questionnaire using random-sampling, but a private diary with artificial selection. Actually, among the empirical studies on the effects of dismissal law in the United States, for example, it is difficult for researchers to reach consensus even over a question as simple as “In which case did the ruling limit the employment-at-will principle” in a given state, and disagreements lead to opposite conclusions about the effects. We have to keep in mind that this approach always runs the risk of producing widely varying analytical results, and depends on the judgment of individual analysts.⁷

This chapter also takes up the issue of interpretation of data. The Priest/Klein 50 percent rule has been widely used as one of the most

⁷ Epstein and King (2002) is an extensive critique of problems in empirical studies in law-and-economics which includes discussion of this point. Chapter 5 uses the database *Hanrei Taikēi CD-ROM* (Judicial Precedents CD-ROM) published by Daiichi Hoki. The cases and court rulings are categorized by codes which were devised by the publisher and assigned to each court decision.

powerful analytical tools in the field of law-and-economics. Accordingly, a number of theoretical and empirical problems of the hypothesis also have been noted.⁸ In particular, the empirical question involving how much of a stake either the plaintiff or the defendant has in each case or how the attitude toward the risks involved will be reflected in each set of data is perhaps of great relevance to Ohtake's analysis. The more the defendant/plaintiff has a stake in a case, the more likely it is that the defendant/plaintiff will take steps toward litigation even if such action seems to be speculative. Therefore, even if the rate of victory in judicial verdicts deviates from the 50 percent mark (as a trend or not), it may not be because there are deviations among subjective victory rates, but simply because the plaintiff (or the defendant) takes his/her own stake more seriously than the other. Considering Kawaguchi, Kambayashi and Hirasawa (2004) points out the backgrounds of workers who participated in the dismissal cases widely varied, without controlling the relative amount of stake in each case, the deviation from the 50 percent mark does not mean the instability of judgments. We have not yet received a reliable answer when the judicial principle of "the abusive exercise of dismissal right" was established in Japan.

In Chapter 6 "Seiri Kaiko Hori no Saikento – Seiri Kaiko no '4 Yoken' no Minaoshi wo Tsujite (Reexamining the Judicial Principle of Adjustment Dismissals: Review of the 'Four Requirements for Adjustment Dismissals')," Fujiwara provides an overview of trends that can be seen in recent court rulings on dismissals and develops a legal debate with reference not only to general dismissals but also specifically to adjustment dismissals. In Fujiwara's view, a series of decisions by the Labour Division

⁸ In theoretical debate, issues about strategy and/or rationality — that is, how the plaintiff/defendant might predict the probability of winning or the amount of compensation — have been debated. Cooter and Rubinfeld (1989) concisely survey the analysis of judicial processes from the perspective of law –and –economics, including the Priest-Klein hypothesis. Kessler, Meites and Miller (1996) provide a survey of empirical studies on the Priest-Klein hypothesis which notes that the 50 percent rule in its simplest form has not been proven in most of the empirical studies and suggests making some modifications to the rule when using it in empirical studies. As noted in this study, Ramseyer and Nakazato (1989) conducted empirical research and confirmed that the unaltered 50 percent hypothesis does not work in Japanese cases as well. The study by Korobkin and Ulen (2000) is a comprehensive critique of the premise of rationality which is employed in a variety of law-and–economic studies.

of the Tokyo District Court between 1999 and 2000, which are frequently referred to in this volume, seem to have “drastically changed the abuse of the right of dismissal principle and the principle of adjustment dismissals in form as well as substance.” He does not view them as a determined judicial alternation but as “one of prompting discussions toward future reexamination [of the existing judicial principles].” While maintaining the proposition that “the four requirements should be retained,” Fujiwara argues that they need to be theoretically reinforced and he develops the following argument.

At first he argues from the premise that there exists “the employer’s contractual duty (*hairyo gimu*) to endeavor to maintain the employment relationship for as long as possible,” and this duty offers the logical basis for the judicial principle of “the abusive exercise of dismissal right.” The employer’s supposed duty is founded constitutionally on the right to work (*kinro ken*) and the right to life (*seizon ken*) as noted in the Japanese Constitution and legally on the *bona fide principle* of the civil law and the Labour Standards Law. However it is interesting that Fujiwara does not need the help of the continuity/flexibility principle, which the authors of Chapter 4 and Chapter 8 insist on, although he does not clearly explain why.

The duty to endeavor to maintain employment should be “determined through the weighing of the interests between labor and management, that is, carefully balancing both the interests of the employer and the worker,” and the concrete criterion used to determine the employee’s duty in each case should be standards such as the four requirements for adjustment dismissals which we have used until now. In the discussion Fujiwara makes the interesting observation that the term “duty” means that employers only need to make an effort (*doryoku gimu*), they do not need to meet a strict goal. As for his conclusion, he states that, “Realistically we cannot resolve labor disputes without giving up the stability of law and/or the predictability of results, because the court must consider complex circumstances in each individual case.” He therefore casts doubt on the effectiveness of codifying dismissal rules into statutes.

Chapter 7 is “Kaiko Kisei no Keizai Koka (Economic Effects of Dismissal Regulations)” by Kuroda. This is a survey of existing works on

the effect that dismissal law has on the labor market, with its main focus being studies of Europe in the 1990s. Dismissal law usually functions as a uniform rule within a single country, therefore, there are two methods to detect the economic effects of the law on the labor market. One is using a cross-national comparison, and another is a time-series comparison that occurs before and after a law has been passed in a given country. The former has been used predominantly up until now, and as part of its research agenda the OECD has translated the dismissal laws of its member countries into a set of numerical data which has been used in a number of research projects. This chapter discusses the compilation process of the national indexes of dismissal law which have been used in various studies, mainly those of the OECD, and this manual should be useful for readers interested in using these indexes in the future. However, as Kuroda points out, it is important to always recognize that “the indexing of laws generates dispersions among datasets because it is impossible to avoid the arbitrariness of those compiling the indexes, and therefore it is necessary to maintain a great degree of flexibility in interpreting empirical results based on cross-national comparisons and indexes.”

Before surveying results from empirical studies, this chapter summarizes the theoretical models by dividing them between the insider-outsider theory and the job creation and destruction theory. The overall outline of Kuroda’s summary is as follows. The insider-outsider theory emerged in the late 1980s. Based on a hypothesis that dismissal law gives more “bargaining power” to a currently employed worker (the insider) rather than a worker who is not employed (the outsider), the theory posits that dismissal law generates a gap among workers and exacerbates the employment rate. This insider-outsider theory has inspired recent argument in Japan that the judicial principle of “the abusive exercise of dismissal right” only protects the workers currently employed (especially full-time regular workers) and actually aggravates the situation for young and/or future workers. The equilibrium search theory was first put forward in the 1990s, and has successfully generalized the model within the framework of the dynamic partial equilibrium model first and then within the framework of the general equilibrium model. This theoretical extension of the equilibrium search theory allows us to evaluate the welfare effects of the

dismissal law by measuring the performance of the labor market with economic fluctuations, and shows that the above implication derived from the insider-outsider theory merely focuses on a situation in one particular phase of economic fluctuations. At the same time, the theory concludes that the effects of dismissal law — regardless of whether they are positive or negative — are ambiguous when considered over a long period of time. The theory also implies that slightly different models easily produce varying results on how the dismissal law will affect employment/unemployment, and it is difficult to theoretically deduce a robust implication.⁹ When the theory does not put forward a robust implication, economists traditionally reach conclusions by looking at the data. With the gathering of OECD law indexes and the flow data of various countries, a number of empirical studies have been published to settle the issue. Results of these studies are efficiently presented in Figure 7.3. As indicated, unfortunately, existing empirical studies have not yet found solid evidence concerning the effects of dismissal law on employment/unemployment rates. After all, the relationship between dismissal law and employment/unemployment rates has not been clarified either empirically or theoretically. To do away with this ambiguity, some scholars have attempted to find the effects by focusing on indirect indicators, such as wage gaps or frequency of limited-term employment. As pointed out by Kuroda, however, they have not yet developed a sufficient theoretical foundation nor accumulated enough empirical results.

After surveying the existing studies, Kuroda finishes the chapter by commenting on — perhaps with the insider-outsider theory in mind — Japanese dismissal law: “The time has come to explore a more desirable form of dismissal laws while taking into account the possibility that forms of employment will be even more diverse in the future.”

To be sure, as Kuroda argues, “The empirical strategies employed in the existing studies in Europe and the United States are imperative to Japan as well.” However, it is unlikely that we can simply apply these strategies to Japanese cases since Japan has few mutually comparable units of analysis,

⁹ However, it is important to recognize that equilibrium search theories suppose that there is an additional (social) cost for making after-the-fact employment adjustments as Chapter 3 does, and this supposition is slightly different from the supposition of the insider-outsider theory.

such as the neighboring countries in Europe and states in the United States. Moreover, the results of the existing studies suggest that not only the intensity of dismissal regulation is absorbed by changing working conditions, such as wages, but also that there might be a severe limit to the methodology of the so-called “reduced form approach” which tries to demonstrate results of the performance of institutions by supposing an inductive model in an ad hoc manner.¹⁰ To avoid these shortcomings, as Ohtake advocates in Chapter 5, there may be a rather bold method of carrying out social experiments. Also it may be necessary to build an explicit hypothesis about specific social mechanisms through which dismissal law constrains the behavior of economic actors, and examine the deduced proposition by employing such micro data as historical data and court rulings. The intellectual separation between section 2 and section 3 in the book seems to reveal the immaturity of research field.

5. Review of Section 4

Entitled “Future of Dismissal Law: Debate on Legal Policy,” this section wraps up the volume with three essays focusing on policy debate.

Chapter 8 is “Kaiko wo Meguru Ho to Seisaku Kaiko Hosei no Seitosei (Law and Policy concerning Dismissals: Justification of Dismissal Law)” by Uchida. Uchida investigates whether dismissal law hinders desirable policy goals and whether dismissal law generates negative effects. By answering these two questions in the negative, his essay presents a counterattack to those who advocate abandoning the judicial principle of “the abusive exercise of dismissal right.”

¹⁰ First of all, a solid consensus has not been reached on whether institutions affect economic growth. Since North and Thomas (1973) raised the issue, many scholars, particularly the neo-institutionalists, have supported the positive relationship between guaranteeing agents’ incentives by institutions and economic growth and development. More recently, the debate has extended its scope to questions such as the connection between judicial traditions (such as the Continental Law and the Anglo-American Law) and differences in patterns of economic development. Research in this area continues to be conducted vigorously as seen in the works by Acemoglu, Johnson and Robinson (2001), (2002) and Glaeser and Shleifer (2002). As seen in Pritchett (1997), however, there is still strong support for the argument represented by Mankiw, Romer and Weil (1992) that the economic growth rates of nations tend to converge in the end regardless of where they start from and that therefore there is no correlation between institutional arrangements and long-term economic growth.

Regarding the first question, he first adopts the desirable policy goals of “fluidity of employment for newly developing industries” and “workforce reduction in declining industries” as examples. For the first example, Uchida states that it is sufficient to transfer labor from unemployed workers to new industries now that there is a large pool of excess labor [in the form of unemployment]. As for the second example of out-flow from declining industries, he argues that promoting voluntary labor turnover should be the most commonsensical approach. More fundamentally, “The judicial principle of ‘the abusive exercise of dismissal right’ is not a judicial principle that prevents corporations from dismissing workers even when they are faced with bankruptcy.” He concludes that neither abandoning nor relaxing the judicial principle is a proper solution to the above policy goals.

Concerning the second question, he takes on the argument that dismissal law actually increases unemployment among young people and non-regular employees. He wisely refers to the poverty of empirical evidence supporting this argument, and expresses skepticism about the degree to which the judicial principle “can actually affect the hiring activities of Japanese corporations in general.” As for the increase in non-regular employees, wages of non-regular employees would have to be higher than those of regular employees if the increase were caused by the de-regulated dismissal relative to regular workers. Therefore the current increase in the number of non-regular workers cannot be attributed to restrictions placed on the dismissal of regular workers and the argument seeking negative effects of the judicial principle loses its ground. He then concludes that, “The argument for liberalization of dismissals does not seem to have an adequately compelling policy-level foundation.”

If the argument loses its basis on a positive foundation, at least, it has to find a normative foundation. After surveying the normative debate on the justification of the principle, Uchida proposes that the differences among participants in the debate are rooted in their different visions of society. Just imagine “one society in which dismissals can be done efficiently while the distributive inequality is minimized and free dismissals are permitted” and “another society, in addition to fulfilling the above requirements, in which justifiable reasons are required for dismissals and

that corporations seek to maintain employment to the extent possible by using the internal labor market and adjusting working conditions.” He then asks, “Which society does one choose?” His answer is not normative but it is a “matter of one’s social vision.” Uchida believes scholarship should not conclude whether or not to maintain the judicial principle of “the abusive exercise of dismissal right,” because this question is essentially a political issue.

In Chapter 9, “Koyo Hoshō ni Tsuite no Kisei Kaikaku – Keizaigaku no Shiten Kara (Deregulation of Employment Security: A View from Economic Studies),” Yashiro develops a policy discussion from the perspective of economic studies. He attributes the gap concerning deregulation between legal studies and economics to different positions regarding the market principle, differences of opinion about the negative impact of wealth gap correction policies, and different premises about competition in the market. He then discusses the incomplete contract theory and the continuity/flexibility principle, both of which argue for employment security. According to Yashiro, “The company itself rejects opportunistic behavior as a rational actor when it needs human capital,” and “nothing in the four requirements for adjustment dismissals seems to take into consideration the size of investment that has been made in education and training.” Therefore, he concludes that the “matter should be left to free exchange in the market as long as it operates in a rational fashion.”

The final chapter is “Kaiko Hōsei no ‘Pro Veritate’ (‘Pro Veritate’ of Dismissal Law)” by Ouchi which succinctly surveys the general issues discussed in the volume, specifically mentioning the codification of dismissal rules.

Ouchi poses two questions: 1) Can codification of dismissal rules be justified in a normative sense?, and 2) Can it actually accomplish its goals? He answers both in the negative.

Ouchi bases his position on the premise that dismissal right is “a corollary to ‘freedom of contract’ in the Constitution,” and any restrictions placed on that right must be justified. He then identifies three possible justifications: “the right to life, the right to labor ... or it would present a danger to the life of the worker,” the continuity/flexibility principle, and

protection of moral rights. He finds the second justification inadequate as a normative basis for restricting dismissal right because if dismissal right is to be restricted then the right to resign should also be restricted. In addition, “weakening the contractual nature of industrial relations [by recognizing the communal normative standards supporting the two principles]” can discourage workers from working voluntarily. Ouchi goes on to state that “protection of moral rights,” the third justification, “should be handled by making the employer treat the worker with sincerity and care when dismissing the worker,” but concludes that this also is insufficient as a normative ground for restricting dismissal right. Therefore, the restriction on dismissal rights must mainly find its general normative basis in a situation where “a given worker will suffer greatly by being dismissed,” which leads us to evaluate the “degree to which each worker is involved in the company” when applying the restriction to individual cases.

In this respect, even codified dismissal rules will require elastic application because the loss the dismissed worker would suffer depends systematically on many circumstances, such as the outside labor market. As for decisions regarding specific cases, there is a judicial rule that the court’s justice about specific cases must be realized through a judgment based on general provisions. In either case, Ouchi concludes, the idea of codifying dismissal rules is hard to obtain normative justification compared to the judicial principle of abusive right. Of course, three disadvantages that are fundamental to case law are commonly pointed out in discussions about dismissal rules. The first is that the “elastic application [of judicial principles] is mostly left to the decision of individual judges.” The second is the lack of concern about the general impact of the decision because of its preoccupation with realization of individual justice. The third is the lack of uniformity in case law’s recognition or availability. Ouchi comments that the first problem is unavoidable regardless of whether we employ a codified statutory law or case law as long as we rely on the court system. The second problem can be ameliorated to some degree if there is a judicial norm requiring judges to consider the general impact of their decisions, and this requirement can be materialized precisely because of the elastic nature of a given case law. Regarding the third issue, he sees no difference between case law and

statutory law. For these reasons, he concludes, that replacing case law with statutory law to regulate dismissal rights will not benefit anyone.

Based on the above discussion, he infers that the main point is not whether dismissal rules should be codified but rather how to establish precision in the rules. From this perspective, it is useful to introduce two normative concepts, that is “behavioral norms” and “evaluative norms.” First of all, legal norms can be divided into “‘behavioral norms’ that demand [in advance] action from the parties, and ‘evaluative norms’ that provide standards for which to evaluate the actions of parties after the fact.” When this normative categorization of before-and-after is applied to dismissal rules, he suggests, they should meet two sets of demands — one is to clarify the rules as a behavioral norm and the other is to realize individual justice as an evaluative norm. However, there is a tradeoff between these two.

In 2002 when labor and management discussed codification of the judicial principle of “the abusive exercise of dismissal right,” which took effect in January 2004 as Article 18-2 in the Labour Standards Law, both objected to the original proposal, but for different reasons. The disagreement can probably be explained by the above trade-off. Labor perhaps suspected that the codification would narrow the area of decision for dismissal rules as an evaluative standard and hence interpreted the codification as a *relaxation* of dismissal regulations. In contrast, management focused on the expanded area of decision for dismissal rules as a behavioral norm and interpreted the codification as an enhancement of dismissal regulations. To make the argument fruitful, it is necessary for us to consider the tradeoff of norms. As a way to reduce, if not eliminate, the tradeoff, Ouchi proposes that the concept of “primacy of procedural rules” be at the center of labor law. According to Ouchi, the concept has a normative justification legally, “It is desirable to resolve problems through mutual consent between labor and management.” By clarifying procedures surrounding dismissal rules, the concept will allow them to play a role as a behavioral norm (in advance) while not greatly constraining realization of specific justice as an evaluative norm (afterward).

Therefore, Ouchi concludes that we should “establish general procedural rules in labor law and effective requirements specific to

dismissals” while maintaining the judicial principle of “the abusive exercise of dismissal right” as it currently stands. When constructing each requirement, we should consider financial resolutions as an additional way to deal with dismissals in court. Also, because the judicial principle of “the abusive exercise of dismissal right” constitutes the core of various judicial principles concerning labor contracts, he concludes, “The codification of dismissal rules ... is an issue that should be discussed within the context of the future of judicial principles that concern everything about labor contracts.”

6. Issues in Japan

In recent years, dismissals have received increasing attention in Japan, which can be explained by several circumstances that are specific to current Japan. For example, employment adjustments have widely occurred in response to the economic recession that has continued since the 1990s, and many workers face the possibility of being dismissed. In the 1980s, if one thought it was impossible to be discharged, today there is growing concern that the existing dismissal rules are changing.¹¹ In fact, as frequently mentioned in the volume, a series of court decisions concerning dismissal cases between 1999 and 2000 by the Tokyo District Court became the focus of attention and were interpreted as setting a precedent for future decisions. Moreover, as structural reform discourse, with its steadfast belief in the free market, spreads among the general public, a growing number of commentators are arguing that existing dismissal rules actually hinder future economic growth. Consequently, Article 18-2 of the Labour Standards Law codifying the judicial principle of “the abusive exercise of dismissal right” took effect on January 1, 2004. It reads, “A dismissal shall, where it lacks objectively rational grounds and is not considered to be appropriate in general social terms, be treated as a misuse

¹¹ In fact, according to *Koyo Doko Chosa (Survey on Employment Trends)*, in June 2002, the proportion of those who left their jobs due to business reasons (including *shukko*, or transfer to an affiliated firm, and return from *shukko*) reached 14.4%, clearly showing a huge jump compared to 6.8% in 1985 and 4.8% in 1990. Genda (2002) examines the reality of “unemployment due to restructuring” among middle-aged and older workers from a variety of angles.

of that right and invalid.” In the legislative process, it has been repeatedly emphasized that the new Article 18-2 merely codified existing case law, and many do not believe that the codification will cause a major change in the way courts handle cases.¹²

However, the debate during the legislative process was confusing, and it generated speculation about the possible effects of codification. At the root of this confusion is the fact that the judicial principle of “the abusive exercise of dismissal right” — which is the basis of Japanese dismissal rules — is no more than case law. Since it is case law, there are no clear grounds for a decision in each specific case. Rules regarding dismissals should clearly explain what is and what is not permissible based on a given normative principle, but the courts always apply them in an incomplete manner. Since it is case law, the courts are allowed, to a certain degree, to adjust the standards they use to make decisions over time and with changes in the economic structure. If a particular case that was heard 10 years ago was to be tried today, it is possible that an entirely different decision might be reached. Therefore, the extent to which such “vaguely” defined dismissal rules constrain real-world economic activities is not entirely clear, and it will be difficult to reach a consensus as to which part of case law should be codified when codifying dismissal rules.

The discussion above leads to an important point when examining public rules concerning the labor market. Many of the studies on dismissal regulations in the West view dismissal rules as an “act of placing a cost on dismissals.” In this line of thinking, which economic activities constitute dismissals is a self-evident question. The action of dismissing is regarded as “economic goods,” and the main idea is to indirectly control dismissals in the economy by taxing the “price” of dismissals or regulating the “demand size” of dismissals. In other words, it is possible to follow the equilibrium theory in neo-classical economics based on the idea of price/quantity adjustment in this scheme.

However, this approach is limited when applied to the empirical analysis of Japan where dismissal rules take the form of a judicial principle. Some of the essays in this volume adopt the approach that

¹² This issue is featured in *Kikan Rodoho* 203 under the title of “Kaisei Rodo Hosei no Igi to Kadai (Significance and Problems of the Revised Labour Law).”

simply treats dismissal rules as a dismissal cost, but it is difficult to accept that in light of the available studies on labor law and actual court cases. This is because the judicial principle of “the abusive exercise of dismissal right” clearly is not intended to manipulate the number of dismissals, as emphasized in Chapter 8. It becomes easy to see this if we think about how and which part of the principle or which part of Article 18-2 of the Labour Standards Law must be changed in order to place a given cost or quota on dismissals.

Of course, it may be possible to shift from the approach of treating dismissal rules as normative doctrines to the “tax/quota” approach. What is at least clear, however, is that Japanese dismissal rules have never used such an approach before. One challenge for those involved in the study of law –and economics of labor in Japan is to explain this transformation. The question seems to present a great venue for deepening our understanding of the nature of labor-related economic transactions or advancing our thinking about how public rules work in our society and economy.

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