Main Focus of the Recently Announced Labor Market Reform in Japan

A view from the Chairman of the Labor Market Reform Working Group of the Regulatory Reform Council to the Prime Minister

Author Kotaro Tsuru

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Introduction

Since the second administration of Prime Minister Shinzo Abe began and the Regulatory Reform Council, an advisory board to the Prime Minister's Office, was founded, I have been working as a member of the council and also as chairman of the Working Group on Labor Market Reform. We have been working on a few proposals on labor market reform these past couple of years. In this article I would like to present the principal points of the most crucial part of this reform, the reform on permanent employees, namely the new rules for employing permanent workers with restrictions on workplace or job or working time, and how those workers' labor contracts should be terminated in a way that both employers and employees can agree upon.

Rule-Making for Permanent Employees

In our council meetings, we thought rule-making for permanent employees with restrictions on workplace or job or working time would be a crucial issue. Such permanent workers with restrictions are mostly those with restricted jobs in Japan and we call them permanent employees with restricted job responsibility. Today, around half of the large firms in Japan employ them and we have no legal requirements in recruiting them. According to a Ministry of Health, Labour and Welfare statistical report, around one-third of the total employees in a Japanese company are such permanent workers with restrictions, meaning this employment system is widely adopted in Japan *(Table 1)*.

TABLE 1

Job segments set by firms & number of employees in each segment

	No. of firms	No. of job segments	No. of employees
Total	1,987 (100.0%)	3,245 (100.0%)	1,576,996 (100.0%)
Permanent employees with restrictions	1,031 (51.9%)	1,547 (47.7%)	519,152 (32.9%)
restrictions on jobs	878	1,314	442,020
restrictions on working time	146	200	53,148
restrictions on working place	382	505	140,191
Permanent employees without restrictions	1,379 (69.4%)	1,602 (49.4%)	1,011,952 (64.2%)

Note: There are some cases where types of restrictions are combined.
Source: Ministry of Health, Labour and Welfare in Japan

"Infinite Nature" of Permanent Employees in Japan

We picked this issue of permanent employees with restrictions as our first discussion item in our council meetings because we thought that the wider utilization of permanent employees with restrictions would be a starting point for all the labor market reforms. In other words, I believe that "the infinite nature of Japan's permanent workers" could be vital in addressing the wide range of issues related to the working methods of Japanese.

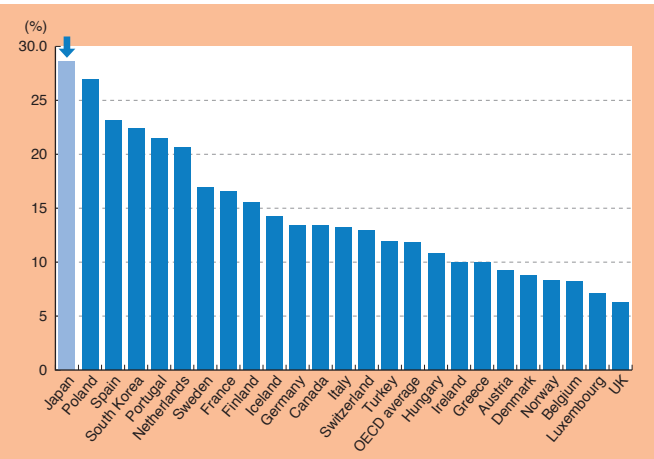
What is the "nature of infiniteness" of the work of permanent employees? Permanent workers in general anywhere in the world have the following three characteristics: labor contracts with limitless terms, full-time work and working directly for their employers. In addition to these, in the case of Japan, compared with the United States and Europe, the workplace, job assignment and working hours are not restricted. Japanese permanent employees are generally not able to refuse any change of job location or assignment or request to work extra hours. Employers are thus considered to have a broader discretion concerning personnel management in Japan.

What has this "nature of infiniteness" brought us in Japan? Firstly, since employers have to ensure that such employees have job security, high salaries and fringe benefits to realize such work, Japanese companies have been increasingly hesitant to employ permanent workers since the economy of Japan began slowing down in the 1990s. Therefore, finite-term labor contracts providing workers with only unstable job opportunities have increased drastically. The percentage of these finite-term workers among total employees has reached 28%, one of the highest levels among OECD nations *(Chart 1)*. Their conversion to permanent workers is insignificant as well in Japan, which has made the working environment harder for Japanese laborers.

Secondly, this has prevented women in Japan from getting permanent jobs. Their husbands, in most cases the principal income earners of households, are generally working as permanent workers bound by unlimited working requirements and thus have to go wherever they are told to work, and to work longer hours if instructed. In such situations, the wives are inevitably obliged to stay at home and do housework and raise children. Given such work at home, such as caring for their children or elderly parents, women in Japan find it extremely difficult to continue their jobs as permanent employees with infinite working requirements even though they were once employed. Thus this works to lower the rate of participation in the labor force by Japanese women in their thirties and forties, a phenomenon called the M-shaped curve.

CHART 1

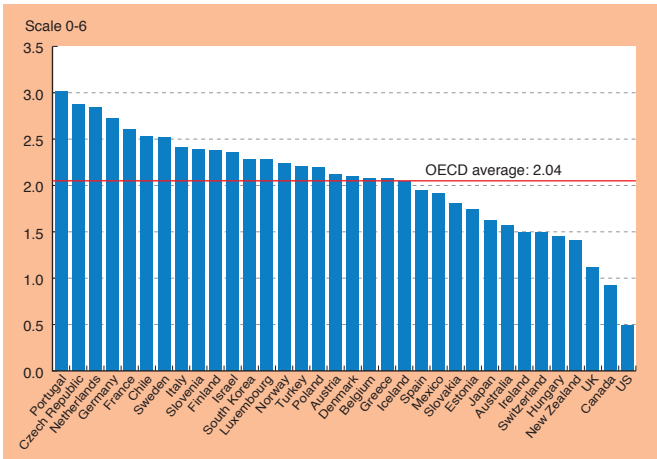
Percentage of temporary workers in OECD nations (2013)



Source: OECD statistics (for Japan: Labor Force Survey)

CHART 2

Protection of permanent workers against individual dismissal



Note: Data refer to 2013 for OECD countries and Latvia, 2012 for other countries. The figure presents the contribution of different subcomponents to the indicator for employment protection for regular workers against individual dismissal (EPR). The height of the par represents the value of the EPR indicator.

Source: OECD Employment Outlook 2013

Thirdly, in some extreme cases, such infinite work by permanent employees has ended up destroying the work-life balance and even in various kinds of harassment in the workplace, death from overwork or mental instability among employees at companies on the "black list". In the past, Japanese labor unions worked well in preventing such extreme cases as a deterrent power by ensuring a balance between the powers of personnel management among employers and comprehensive protection of the employees' welfare. However, today, the labor unions do not work well anymore.

Lastly, since permanent workers with infinite working requirements would have to meet any job requirement, they tend to be all-round players and find it difficult to gain any specific skill or competency by themselves. This may be fine with them, if they continue to work in the same company their whole life, but it could possibly be an impediment to labor mobility and reallocation of human resources in accordance with market mechanisms and thus have a negative impact upon economic growth.

Regulations on Dismissals

We were misunderstood in proposing a wider utilization of permanent employees with restrictions on working conditions as an attempt to modify restrictive regulations on dismissals. It was probably because regulatory reform as a whole was discussed in terms of growth strategy and the concept of "enhancement of labor mobility without raising the employment rate" was considered as an idea for revitalizing the economy. Labor mobility would be a symbol of a revitalized economy for many and for them modification of dismissal rules would be a key to achieving labor market reform.

However, I do not share the view that modification of those rules would be vital in achieving labor market reform. On the question of protection of permanent workers against individual dismissal, Japan is among the group of nations with lower protection than average among OECD nations *(Chart 2)*.

It has also been pointed out that dismissals can be more easily done at small and medium-sized enterprises (SMEs) than at large companies in Japan. The legal logic to prevent abusive use of an employer's right of dismissal adopted by Article 16 of the Labor Contract Law requires an objective rationality and social acceptability of individual dismissal in order to make it effective, and this is reasonable. There have been requests for further clarification of dismissal rules, but in Europe as well the principles are written into law as in Japan, and each specific case would be argued in a court. Japanese law has adopted four basic criteria for dismissals for economic reasons and recently they agreed to consider the procedural aspects of dismissal, namely whether the employers did their best and fully explained dismissals to the employees. This proves that the practice of the law has been flexibly changed in accordance with changed economic situations.

Law to Prevent Dismissal Abusive

There are still some managers of large Japanese companies who feel these rules are too rigorous. Such a perception, I believe, comes from the fact that the legal theory applied to prevention of arbitrary dismissal has been developed only for the interest of permanent workers without any restriction on working conditions who are indigenous to the Japanese labor market. We can look at Japanese dismissal rules from a new angle, keeping in mind the characteristics of Japanese permanent employees.

For example, following one of the four criteria to judge the legal relevancy of a dismissal, it must be proved that the best efforts to avoid dismissal on the part of the employers were made before the dismissal, such as asking the employee to relocate, transfer to another

company or voluntarily retire. A court would examine whether such efforts were sufficient or not. This certainly assumes the employee would be a permanent one without any restriction on working conditions, since this legal principle is supposed to protect job opportunities for those permanent workers even with a change of workplace or job assignment. Even at the end of a trial working period, this principle is occasionally applied to employees on a trial period in Japan, which would make it difficult to dismiss them, assuming they are recruited as permanent workers and they cannot be fired only because they cannot do any specific job well, since they can be transferred to some other job. More generally, in many cases a court may ask that dismissal for the reason of an employee's lack of competency or qualification be reconsidered in the light of the possibility of their transfer to other job assignments for which the dismissed employees could be well qualified.

In contrast, if permanent workers in Japan do not observe the requirements for such permanent workers, this principle preventing arbitrary dismissal would not protect their interests. There are some cases where a disciplinary dismissal of a permanent employee who refused a job transfer or overtime work was considered legally relevant by a court. This tells us clearly that Japanese labor law assumes the workers are permanent.

Rules for Terminating Employment Contracts

In order to cope with the abovementioned demerits of the existing Japanese labor market regulations, I believe it is important to expand the number of permanent workers with restrictions on working conditions and reform the existing system. However, many people are concerned about the possibility of such permanent workers with restrictions being easily fired in cases where their workplace or job assignment has gone, and thus any increase in such workers would merely result in an increase in the numbers being fired.

However, the legal principle of preventing abusive use of dismissal action by employers would be applied to such permanent workers with restrictions as well as to those without any restrictions. Objective rationality and social acceptability of a dismissal would have to be examined in both cases. On the other hand, it is certainly true that there have been many cases where a court's decisions differed depending on whether the permanent workers had restrictions or not.

For example, in the case of dismissal for an economic reason, the employer's efforts to avoid dismissal as one of the conditions to justify it were often easily acknowledged by a court in the case of permanent workers with restrictions, since there would be only limited options for a transfer to another job etc. as a means to avoid a dismissal in their case. Another condition to justify it, namely a well-reasoned rationale for choosing a specific employee to be dismissed, could also often be acknowledged by a court in a case where all employees must be dismissed because of the abolition of the posts or job assignments.

As for the other conditions necessary for justification of dismissal, such as the need for rationalization of personnel or the employer's obligation to fully explain the reason for a dismissal to the labor union and the employees to persuade them to accept it, the decision would have to be equally examined for both types of permanent workers. In particular, the latter example — "the procedural relevancy" — seems to be increasingly considered crucial in judging whether a dismissal is justified or not.

Therefore, employers would need to show employees explicitly the type of contract to be applied to permanent workers with restrictions in their introduction of working regulations and explain in detail the nature of this new type of category of workers and acquire sufficient understanding and agreement from the employees' side.

Termination of Employment Contracts

Termination of an employment contract is the most sensitive issue in "labor market reform". In the light of protection of an employee's rights, this is not to be interpreted as "modification of regulations to prevent a dismissal" or "measures to ease a dismissal".

Meanwhile, enhancing labor mobility would lower mismatches in the labor market and raise an employee's motivation to work by assigning the best workers to relevant positions and also by achieving the most efficient labor resource allocation. High macroeconomic growth could then be expected.

Thus fruitful economic benefits could be achieved by a termination of employment contracts that both the employers and the employees could agree upon.

Diversifying Solutions to Dismissal Disputes

According to the existing labor law in Japan, if a court judgment nullifies a dismissal as "abusive" (not objectively rational and not socially acceptable), continuation of the labor contract is confirmed. However, this solution is occasionally inconsistent with the interests of both employers and employees. For example, in a case where trust between both sides is completely broken by a lawsuit about a dismissal, employees would be reluctant to go back to the same job. In these cases, employees often sue a company for back pay during the period of temporary dismissal as well, assuming that the work contract has continued to be valid. Some point out that employees would have an incentive to prolong the judicial procedures in court to get more back pay from the company.

In these cases, there would be little possibility of their returning to their workplace and in many cases a compromise solution involving financial compensation would be pursued. The level of such compensation varies greatly, depending upon the case. We should aim to diversify solutions for such dismissal disputes and study how to accommodate both sides' interests without continuing the work contract.

Financial Compensation System for Dismissals

A financial compensation system for dismissals is one way of terminating a labor contract, with the employer paying a certain amount as defined by law to the dismissed employee in the case of undue dismissal. This would be enacted after a court decision has

been made and would not be a way of justifying the dismissal. In the US and Europe, such a system is commonly used and the estimated amount of compensation is to be explicitly defined in the law in accordance with the number of working years.

I believe this system should be introduced in Japan as well in order to increase the options for solutions in dismissal disputes and also enhance the predictability of the amount of compensation. Some think the utility of this system would be low in Japan as there would be fewer lawsuits over dismissals than in the US and Europe. But I believe the adoption of this system would be instrumental in determining the amount of compensation in other cases such as conciliation in courts or industrial tribunals, or with the mediation of local government labor departments, since it could work as a benchmark for these. Thus, I believe this system would prompt a decision-making process at such dispute-settlement venues and increase the predictability of compensation.

Determining the Amount of Compensation

One of the difficulties in introducing such a system would be how to determine the amount of compensation. In the US and European nations, the amount varies depending on the country, but almost all have adopted a way of determining the level of compensation in accordance with the number of working years. However, in introducing this system to Japan we should not follow this method.

First, we need to recognize that the US and Europe follow a practice of first dismissing employees who have fewer working years. In other words, while the young people can be more easily discharged, older people are rarely dismissed. It is commonly observed in the US and Europe that the youth unemployment problem is the most serious economic issue during a recession.

That is an enormous difference from Japan where older people would be targeted for dismissal during a recession. In Japan "seniority" may be applied to the level of wages but not necessarily to job security. In Europe and the US, job security is thus assured in accordance with the number of working years. In this light, it would be logically consistent that the compensation money is fixed in accordance with the working years. Both systems complement each other.

In Japan, however, assuming the lifetime employment system is still dominant, we should be aware of the employee's loss caused by dismissal. There may be a wage premium to be earned by continuing to work until retirement age over the possible wage earned in another job after dismissal. In this case, it would be better to fix the compensation amount in accordance with the difference in years between the retirement age and the age at dismissal.

In Japan, in cases of conciliation in court, which account for about 70% of all cases, the compensation amount is a little more than 1 million yen, according to a Ministry of Health, Labour and Welfare report. In many cases, the court chooses six months' salary as the amount of compensation without any particular theoretical reasoning.

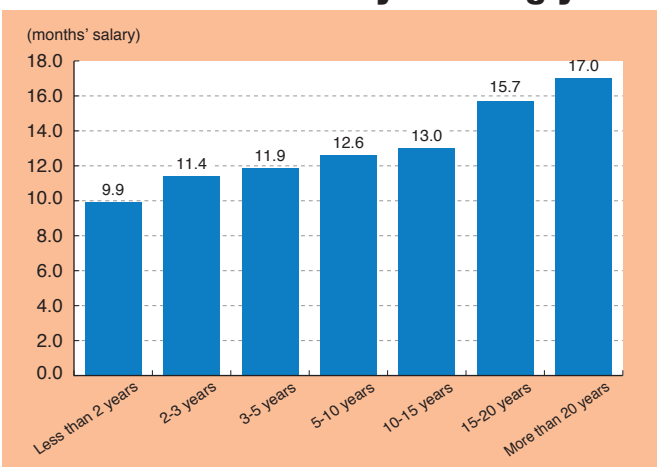
According to the Research Institute of Economy, Trade and Industry in Japan's (RIETI) report on such compensation, the median amount is 16 months' salary among large enterprises with more than 2,000 permanent employees in Japan covered by their questionnaire, and the amount varies from 10 months to 17 months in accordance with the employee's working years *(Chart 3)*.

Looking at other nations, according to the OECD, in the case of an employee with 20 working years, the compensation amount corresponds to one to two years' salary among Continental European nations, whereas among the Anglophone countries and the Netherlands with weaker job security protection, it corresponds to six months' salary *(Table 2)*.

There is a need for Japan to start making rules on fixing these compensation amounts, and we should be as flexible as possible in creating these rules so that both employers and employees can agree on them in a way that will suit their own practical interests. JS

CHART 3

Pecuniary compensation to be paid for undue dismissal by working years



Source: RIETI Policy Discussion Paper Series 14-P-003

TABLE 2

International comparison of compensation for undue dismissal (months' salary)

Belgium	3
UK	5.5
New Zealand	6
Austria	6
Denmark	6.6
Netherlands	7
Norway	12
Finland	14
Portugal	15
France	16
Germany	18
Italy	21
Spain	22
Sweden	32

Notes:
**1. In most cases, 20 working years are assumed. In the US, there is no compensation fixed in advance.*
**2. Plus NZ$ 5,000 (around 6.2 weeks' awards)*
**3. Retirement allowance to be subtracted*
**4. More than 10 working years*
Source:
OECD (2013) Detailed Description of Employment Protection Legislation 2012-2013

Kotaro Tsuru is a professor of economics at the Graduate School of Business and Commerce at Keio University. He was previously a senior fellow at the Research Institute of Economy, Trade and Industry (RIETI) (2001-2012), an economist at the Bank of Japan (2000-2001), and a member of the Economics Department of the OECD in Paris (1995-2000). His research includes comparative institutional analysis and labor market institutions.