



## Lobbying and dismissal dispute resolution systems



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### ABSTRACT

Previous studies of dismissal protection have largely been based on the analysis of the rules on the books. However, actual outcomes often rely on the involvement of courts. Our model takes this feature into account and explains how relative lobbying power of unions and employer associations in the legislature and judicial realm, and characteristics of labor court systems shape labor court activity and affect payoffs. Our model predicts that (a) as employer associations become stronger, court activity increases, and firms' costs and workers' payoffs decrease; (b) higher court costs tend to reduce the extent of labor court disputes and may, therefore, actually reduce the cost of judicial involvement; (c) court systems that can be lobbied more effectively make reliance on courts less attractive for the trade union if it is the stronger party.

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### 1. Introduction

The analysis of employment protection has overwhelmingly been based on the assumption that the rules on the books, enshrined in laws or collective contracts, are actually applied. However, evidence from various countries indicates that regulations are often implemented incompletely, that their realization depends on the opportunities to enforce entitlements, or that they are explicitly evaded (see, e.g., Venn, 2009). Even in the U.S. we have seen a stronger reliance on courts. As documented by Autor et al. (2006), federal states have increasingly been adopting wrongful discharge laws. In consequence, court decisions have become more important with respect to the extent of actual employment protection. Against this background, attention has shifted and we have seen calls for a more proper analysis of the law in action, as distinguished from employment protection regulations on the books (Bertola et al., 2000; Skedinger, 2010; OECD, 2013). In fact, striking cross-country differences can be observed in the frequency with which employment protection regulations are enforced via the court system. This raises the question of why different industrial relations systems rely on the enforcement of employment protection rules via labor

courts or comparable institutions to a different extent, and what the consequences of such different approaches are.

In this paper, we address these issues by providing a theoretical analysis of the incentives for employees and firms to establish dismissal protection rules in the legislature, and to settle a dismissal dispute out of court or to file a suit. We investigate how relative lobbying power and features of the legal system affect (1) court activity, (2) the amount of resources spent (unproductively) on such disputes, and (3) expected payoffs.

Our conjecture is that one source of the varying degree of labor court involvement across countries may be the lobbying efforts of the key players in the field, namely the representatives of workers and firms, and how they try to influence the legislature and judiciary that, in turn, differ in their characteristics between countries. To further elaborate on this hypothesis, we set up a theoretical model in which there is a large number of risk-neutral firms and risk-averse workers, represented by a “trade union” and an “employer association”, respectively. Due to an exogenous shock, a fraction of the workforce becomes superfluous and experiences an income reduction. Therefore, workers will want the firm to provide compensation for the decline in income, referred to as dismissal payment. The firm, in contrast, will attempt to pay as little as possible. There is an entitlement to compensation for workers determined by the legislature. It depends on the resources expended by the trade union and the employer association to establish or reduce such a claim. Workers can enforce the

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entitlement only if they file a labor court suit. We assume that resulting costs vary across dismissed employees, but that the firm does not know their magnitude. This asymmetry of information generates the potential for a court's involvement. In order to reduce the likelihood that workers file a costly labor court suit, the firm can offer employees a compensation payment. The acceptance or denial of the firm's offer separates the group of dismissed workers into those who consent to the dismissal and those who file a labor court suit.

The theoretical analysis shows:

(a) Stronger employer associations will lead to more court activity because employees will have fewer chances to obtain a dismissal payment without a court's involvement. Moreover, stronger employer associations reduce dismissal costs incurred by firms and payments received by dismissed workers.

(b) Higher court costs tend to reduce the extent of labor court disputes and may, therefore, actually reduce the amount of resources spent unproductively for judicial conflicts. The intuition is as follows: In our model, court costs increase with the amount of payments awarded by the court. Moreover, they drive a wedge between what a worker gets and the financial burden of the firm. Consequently, higher court fees for workers reduce the incentives of workers to go to court by lowering court-awarded payments. Higher court fees for firms, in turn, incentivize them to make higher voluntary compensation offers. This also reduces the number of workers going to court. Therefore, the overall effect of court costs on resources spent unproductively, which consists of the positive impact via variable costs and the negative effect due to the number of workers going to court, is ambiguous.

(c) Reliance on courts becomes less attractive for the trade union if it has a larger lobbying endowment than the employer association and lobbying expenditures can be spent more effectively in the judiciary. The latter requirement may be fulfilled if judges have more discretion, there are specialized chambers for dismissal disputes or fewer options to appeal, or there is a smaller number of judges including lay judges involved. The result stems from the fact that the worker would get a generous court payment now. In order to avoid the costly dispute in court, however, the firm raises the offer of a voluntary compensation payment. Workers, hence, find it more attractive to accept this offer so that it becomes more likely that they refrain from going to court.

While we focus on employment protection, our analysis is also of wider applicability. There are further types of conflicts between firms and workers which may or may not be settled with a court's involvement. One may think of workplace accidents, the (non)-payment of minimum wages, and consequences of illness-related absences. Moreover, our analysis, which extends a model of litigation by adding a stage, in which two opposing parties may either lobby for laws at the legislative stage or the interpretation of laws at the judicial stage, can in principle also be applied to other areas of law, e.g. antitrust issues where firms and consumer associations are involved. For clarity of exposition, however, we deal with dismissal protection systems only.

In the remainder of the paper we proceed as follows. In Section 2 we present evidence on the relevance of the topic at hand and relate our contribution to the various strands of literature that we build upon. In Section 3 we set up the model, determine optimal choices, and derive our main results via a comparative static analysis. Section 4 concludes.

## 2. Empirical relevance and related literature

### 2.1. Dismissals and court involvement

While codified dismissal law is now fairly well documented (see, e.g., OECD, 2004; Botero et al., 2005; Gwartney et al., 2013;

Holzmann et al., 2011), little information is available on what happens when workers and firms take dismissal cases to court. Bertola et al. (2000) provide some preliminary evidence on the wide variation in the number of dismissal disputes dealt with by labor courts. More recently, Venn (2009) and the OECD (2013) have identified correlations between the specialization of courts and various indicators of their effectiveness. However, to date the most comprehensive information on judicial activity from a cross-country perspective has been assembled by the European Commission for the Efficiency of Justice (European Commission for the Efficiency of Justice (CEPEJ), 2002; European Commission for the Efficiency of Justice (CEPEJ), 2006; European Commission for the Efficiency of Justice (CEPEJ), 2008; European Commission for the Efficiency of Justice (CEPEJ), 2010; European Commission for the Efficiency of Justice (CEPEJ), 2012), with a relatively strong emphasis on transition countries. Drawing on this source, Fig. 1 documents considerable variation in the number of dismissal cases per 100,000 inhabitants dealt with by first instance courts.

To illustrate the quantitative importance of dismissal dispute resolution systems, one may note that the number of dismissal cases dealt with in France and the United Kingdom by Prud'Hommes and Employment Tribunals, respectively, exceed 100,000 per annum. Moreover, in Germany the number of dismissal procedures in labour courts reached 230,000 in 2010.<sup>1</sup> Back-of-the-envelope calculations suggest that the total cost of the courts' involvement may substantially exceed expected dismissal payments.<sup>2</sup> In sum, the intensity with which employment protection regulations are enforced via courts varies substantially across countries. Moreover, the costs to society resulting from such court procedures are likely to be substantial.

### 2.2. Previous analyses

In our theoretical analysis we draw on at least four strands of the literature. First, the investigation is related to contributions which analyse how to divide up resources between litigation and lobbying the legislature. Second, we incorporate various facets of the literature on litigation. Third, our model contains elements originating from the analysis of contests and, finally, we touch upon the political economy of employment protection legislation and the enforcement of such rules.

1) The idea that resources have to be divided up between the legislative and the judicial sphere has, for example, been explored by Rubin et al. (2001) and Osborne (2002). In Rubin et al.'s (2001) model of forum-shopping the level of expenditure used to influence legislative and judicial outcomes is determined endogenously. The interest group will either lobby the legislature or, alternatively, focus entirely on litigation, depending on the relative costs and gains of selecting either of the two fora. Our setting is more similar to the framework analyzed by Osborne (2002) who assumes a fixed

<sup>1</sup> For these exact figures, see Fraisse (2010) (France), [http://www.bmas.de/SharedDocs/Downloads/DE/PDF-Statistiken/Ergebnisse-Statistik-Arbeitsgerichtsbarkeit-2010.pdf?\\_\\_blob=publicationFile](http://www.bmas.de/SharedDocs/Downloads/DE/PDF-Statistiken/Ergebnisse-Statistik-Arbeitsgerichtsbarkeit-2010.pdf?__blob=publicationFile) (Germany, accessed 18.07.12) and <http://www.employmenttribunals.gov.uk/Documents/Publications/ET.EAT.AnnualStats.Apr09.Mar10.pdf> (UK, accessed 18.07.12).

<sup>2</sup> To illustrate this claim, note that there are about 1000 labor court judges and almost 9000 lawyers who specialize in labor law in Germany. Assume, furthermore, that the costs per person, including support staff, overheads, remuneration for lay judges etc., amount to € 200,000 p.a., which is about four times the annual wage of a junior labor court judge and a moderate estimate of total expenditure per professional judge (cf. European Commission for the Efficiency of Justice (CEPEJ), 2010), Tables 2.1 and 7.1). Since about 50% of all labor court suits are related to dismissals, total costs for each case can be calculated as  $[0.5 \times (1000 + 9000) \times \text{€ } 200,000] / 250,000 = \text{€ } 4000$ , while dismissal payments are estimated by Goerke and Pannenberg (2010) to equal on average € 6500. Note, however, that less than a quarter of all dismissed employees obtained such payments.

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