

Distribution and Welfare Effects of Dismissal Dispute Resolution Systems

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Introduction

We investigate how

- ▶ variation in the relative lobbying expenditure of employer and worker associations,
- ▶ the costs associated with labor court suits,
- ▶ and the effectiveness of lobbying in the political and the legal domain

affect

- ▶ the probability that legal conflicts about dismissals arise,
- ▶ the amount of resources spent (unproductively) on such disputes, and
- ▶ distribution and welfare.

Why we do it.

- ▶ Analysis of dismissal protection regulations has overwhelmingly been based on the assumption that the rules on the book are actually applied.
- ▶ Repeated 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)

Quantitatively important?

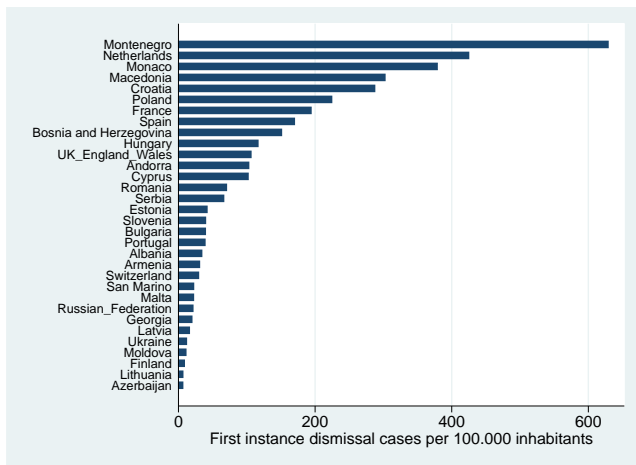


Figure: Dismissal cases brought to first instance courts, averages for years 2002, 2006, 2008, and 2010; source: European Commission for the Efficiency of Justice (CEDEJ)

How many resources are spent?

- ▶ Back-of-the envelope calculations suggest that the total cost of the courts' involvement may substantially exceed expected dismissal payments, at least in Germany.

Total costs for each case can be calculated as

$$[0.5 \times (1,000 + 9,000) \times 200,000] / 250,000 = 4,000$$

- ▶ 1,000 labor court judges
 - ▶ almost 9,000 lawyers specialized in labor law.
 - ▶ cost per person, including support staff, overheads, remuneration for lay judges etc., amount to 200,000 Euros p.a.
 - ▶ 50% of all labor court suits are related to dismissals
- ▶ Goerke and Pannenberg (2010) estimate dismissal payments of 6,500 Euros on average. However, less than a quarter of all dismissed employees obtain such payments.

Literature

- ▶ Voigt (2010) conjectures that **general as opposed to more specialized court systems are less prone to lobbying activities** because judges in general court systems are often only marginally relevant to interest groups (when investigating the determinants of the optimal number of courts.)
- ▶ Evidence that the **judiciary is prone to (political) influence** (George und Epstein, 1992; Posner, 1993; Ashenfelter et al., 1995; Segal und Spaeth, 1996; Stephenson, 2009).
- ▶ **Modeling approach:**
 - ▶ **Contest** success functions, which goes back to Tullock (1980), with recent surveys by Corchón (2007), Congleton et al. (2008), and Konrad (2009).
 - ▶ **Forum shopping** by Rubin et al. (2001)

Model - General set-up

- ▶ Risk neutral firms and (not necessarily) risk-averse workers
- ▶ Firm's are represented by an employer association E , workers by a union U
- ▶ Shock occurs which creates conflict between workers and firms; a fraction $(1 - p)$ of workers is laid off
- ▶ Entitlement to compensation of workers determined in legislature
- ▶ Enforcement through labor court suit

- ▶ Filing a suit is costly:
 - ▶ Workers have individual specific costs k^U with $k^U \in (0, K^U)$, which are unknown to firm
 - ▶ Workers face (known) variable costs of legal representation, taxes, or social security contributions (γ)
 - ▶ Firms face (known) fixed costs k^E and variable legal representation costs (σ)
- ▶ Firm can offer payment to avoid suit, A^O
- ▶ Court awarded payments (A^C)
- ▶ Legislature and judiciary are lobbied
- ▶ Union and employer association have fixed amount of lobbying resources I^U and I^E , respectively

The actors

Workers

- ▶ Expected utility V^U of workers writes

$$V^U = pU(w) + (1 - p)EU(\bullet),$$

where w is the exogenous wage and EU is the aggregate expected utility of dismissed workers.

- ▶ Expected utility EU of dismissed workers is given by

$$EU = \frac{1}{K^U} \int_0^{k_{crit}} U(\omega + A^C(1 - \gamma) - k^U) dk^U \\ + \frac{1}{K^U} \int_{k_{crit}}^{K^U} U(\omega + A^O) dk^U,$$

where ω are unemployment benefits.

Firms:

- ▶ Expected profits of the firm

$$V^E = \pi - (1 - p)T$$

where π are exogenously given profits and T are the expected dismissal costs

- ▶ with

$$T = (1 - r)A^O + r[A^C(1 + \sigma) + k^E],$$

where r is the fraction of dismissed workers going to court.

Legislature:

- ▶ Level of compensation A determined in the legislative process:

$$A = B + \frac{(I_L^U)^\eta - \beta(I_L^E)^\eta}{(I_L^U)^\eta + (I_L^E)^\eta},$$

where B is an exogenously given level of compensation, η is a productivity parameters for the lobbying expenditures, and β measures the relative proneness of the legislature to the lobbying expenditures of the competing groups

Judiciary:

- ▶ Level of compensation A^C determined at court

$$A^C = A + \varepsilon \frac{(I_J^U)^\lambda - (I_J^E)^\lambda}{(I_J^E)^\lambda + (I_J^U)^\lambda},$$

where ε measures to which extent the courts can change the code on the books, and λ is again a productivity parameter for the lobbying expenditures.

Timing of decisions

1. The trade union and the employer association simultaneously decide on how to allocate their resources I^U and I^E in order to influence the judiciary J and the legislature L .
2. The government decides on compensation due to dismissal, A .
3. Fraction $(1 - p)$ of employees loses the job.
4. The firm decides on the voluntary compensation offer A^O .
5. The worker's cost k^U of filing a labor court suit are revealed.
6. Dismissed workers decide on whether to go to court or not which determines the probability r that a court procedure ensues.
7. The labor court awards the payment A^C .

Optimal choices

Model is solved by backward induction:

- ▶ Share of workers going to court:

$$r^* = \frac{K^U - k^E - A^{C*}(\gamma + \sigma)}{2K^U}$$

- ▶ Firm offer:

$$A^{O*} = \frac{A^{C*}(2 - \gamma + \sigma) - K^U + k^E}{2}$$

Important mechanism driving many of our results: Court awarded payments A^C are always subject to γ and σ , whereas A^O is not. Thus, loosely speaking, at the margin A^O changes always by more than A^C which makes going to court for workers more attractive.

- ▶ Lobbying:

$$\frac{I_J^{E*}}{I_J^{U*}} = \frac{I^E}{I^U} \equiv \alpha$$

- ▶ Court payment:

$$A^{C*} = B + \frac{1 - \beta\alpha^\eta}{1 + \alpha^\eta} + \varepsilon \frac{1 - \alpha^\lambda}{1 + \alpha^\lambda}$$

Welfare and distributional measures

- ▶ Recall that expected utility of dismissed workers writes:

$$EU^* = \frac{1}{K^U} \int_0^{k_{crit}} U(\omega + A^{C^*}(1 - \gamma) - k^U) dk^U \\ + \frac{1}{K^U} \int_{k_{crit}}^{K^U} U(\omega + A^{O^*}) dk^U,$$

- ▶ Recall that expected costs of firms write:

$$T^* = (1 - r^*)A^{O^*} + r^*[A^{C^*}(1 + \sigma) + k^E],$$

- ▶ We define waste as:

$$W^* \equiv r^* \left[A^{C^*}(\gamma + \sigma) + k^E + E(k^U) \right],$$

where $E(k^U)$ measures the expected fixed costs of a court procedure to an employee, given that this person files a suit.

Results and conclusions

	Strength of interest groups				Costs				Effectiveness of lobbying expenditure				
		α	β		K^U	k^E	σ	γ		η	λ	ε	
r^*		+	+		+	-	-	-		$\alpha < 1$	-	-	-
										$\alpha = 1$	0	0	0
										$\alpha > 1$	+	+	+
T^*, EU^*		-	-		-	-	+	-		$\alpha < 1$	+	+	+
										$\alpha = 1$	0	0	0
										$\alpha > 1$	-	-	-
W^*	$r^* < \frac{1}{\alpha - \alpha \beta}$	+	+		+	-	-	-	$\alpha < 1$	$r^* < \frac{1}{\alpha - \alpha \beta}$	-	-	-
	$r^* \geq \frac{1}{\alpha - \alpha \beta}$	-	-		+	+	+	+		$r^* \geq \frac{1}{\alpha - \alpha \beta}$	+	+	+
									$\alpha = 1$		0	0	0
									$\alpha > 1$	$r^* < \frac{1}{\alpha - \alpha \beta}$	+	+	+
										$r^* \geq \frac{1}{\alpha - \alpha \beta}$	-	-	-

Do not panic - I will not go into the explanation of every effect!

Important results are:

- ▶ **Stronger employer associations will lead to more court activity** because employees will have less chances of obtaining a dismissal payment without a court's involvement.
- ▶ **Stronger employer associations reduce dismissal costs** incurred by firms and payments received by dismissed workers.
- ▶ **Higher costs of a court procedure tend to reduce the extent of labor court disputes** and may, therefore, actually reduce the welfare loss from a judicial involvement.
- ▶ **More elaborate court systems** with specialized chambers for dismissal disputes, with possibilities of appeal, or with involvement of lay judges **make a reliance on courts more attractive for the stronger party.**

These results are testable (subject to data availability), and may guide data assembling initiatives in the future.