



Labor courts, nomination bias, and unemployment in Germany

Helge Berger^a, Michael Neugart^{b,*}

^a Economics Department, Free University of Berlin and CESifo, Germany

^b School of Economics and Management, Free University of Bozen, Italy

ARTICLE INFO

Article history:

Received 17 March 2010

Received in revised form 16 May 2011

Accepted 18 May 2011

Available online 24 May 2011

JEL classification:

J53

K31

K41

E24

Keywords:

Courts

Labor courts

Law production

Nomination bias

Unemployment

Regulation

Germany

ABSTRACT

Labor courts play an important role in determining the effective level of labor market regulation in Germany, but their application of law may not be even-handed. Based on a theoretical model of the legal process and a new panel data set, we identify a nomination bias in labor court activity – that is, court activity varies systematically with the political leaning of the government that has appointed judges. In an extension, we find a significant positive relation between labor court activity and unemployment, even after controlling for the endogeneity of court activity.

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1. Introduction

The activity of German labor courts is interesting from a number of perspectives.¹ From a normative point of view, most would agree on the principle that the application of law should be independent from the specific judge or the appointing authority. The question of a possible nomination (or ideological) bias in the appointment process of judges – that is, a preference for nominating judges with political leanings close to the incumbent government – seems to be most relevant in court or case-law-based legal systems. This is a point underscored by the recurring battle over Supreme Court nominations in the United States and recent evidence that policymakers have an interest in binding the hands of possible successors by appointing life-time judges (Hanssen, 2004). However, the issue is also of considerable importance in German labor law. Labor law is the one domain in the German legal system where the interplay of lower-level and higher-level courts is more or less unrestrained by lawmakers.² As a consequence,

* Corresponding author. Tel.: +39 0471 13250; fax: +39 0471 13009.

E-mail address: Michael.Neugart@unibz.it (M. Neugart).

¹ Throughout the text, we use the terms *court activity* or *court production* to summarize the full range of court actions, including the number of cases filed with courts, settlements, decisions, and appeals.

² For instance, the *Kündigungsschutzgesetz* of 1951, the German Protection Against Dismissal Law relevant for the majority of cases brought in front of labor courts, places few restrictions on court behavior. In principle, courts ask on a case-by-case basis whether dismissals were the “ultima ratio”, based on an “important” reason or “socially justified”, with the burden-of-proof placed on employers. Since most of these tests and terms are a matter of interpretation, the labor courts de facto determine the actual size of firing costs (see, Richardi and Wlotzke, 1992).

judges enjoy an unusually high degree of independence in setting and implementing labor law and standards, leading to some degree of unpredictability even for legal experts (Sachverständigenrat, 2003).³ In particular, judges have an important influence on the discretion of firms to adjust their workforce through dismissals and on wage issues.⁴

The high costs of unemployment also make German labor court activity an object of interest to economists. The OECD (2004b) identifies labor courts as an important factor in the implementation of labor market regulation in general, and employment protection in particular – an area that many economist hold at least partially responsible for structural weaknesses in labor market performance in Germany and elsewhere in Europe.⁵ The literature also suggests that court activity may matter even if only some cases are actually heard simply because of the possibility of employees appealing to labor courts (OECD, 2004b).

As to the German case, there is some evidence that labor courts may indeed play an important and not necessarily positive role in the mostly dismal performance of the German labor market since the 1970s. For instance, based mostly on anecdotal evidence, Soltwedel (1983) and Franz (1994) assert that a new generation of judges appointed to labor courts at all levels starting in the late 1960s moved systematically to strengthen the contractual position of workers, implying that it became significantly more difficult for firms to reduce their workforce. This, in turn, sharply raised labor and firing costs, with negative repercussions for employment.⁶ While information on the actual level of court-induced firing costs is limited, the available evidence suggests it can be substantive. For example, Hümmerich (1999) reports that courts tend to follow a rule of thumb that sets severance pay at roughly half a monthly gross salary per year employed. The more recent literature surveyed by Grund (2006) comes to similar conclusions, stressing the scope of discretion of the courts.⁷

We extend the existing literature in a number of directions. First, we develop a simple model describing the behavior of employees and firms before and during labor court procedures at the lower and the higher level, yielding a number of testable hypotheses that can be used to identify the repercussions of a nomination bias in court activity. The model's key mechanism is the way nomination bias interferes with the trade-offs faced by forward-looking workers and firms along the different stages of the legal process. For instance, before allowing a case to go to the lower-level court, both sides will compare the safe payoff of a pre-court settlement with the uncertain outcome of the legal procedure. If there is nomination bias at the higher labor court level, then a change in the direction of the bias will influence the expected payoffs stemming from their interaction. The nomination-induced ideological leanings of higher-level labor courts may change because of, for instance, an increase in the share of judges biased in a certain direction. Thus, empirically one should be able to trace an effect of nomination bias in the number of filed claims by workers and firms. Working through the same channel, changes in the direction of nomination bias will, in addition, influence the willingness of workers and firms to accept a lower-level court settlement, the share of lower-level court decisions that is appealed, and the willingness of firms and workers to settle their case at the higher-level court.

To take these hypotheses to the data, we construct a new panel data set including information on lower- and higher-level labor court activity (i.e., decisions, settlements, and appeals), higher-level labor courts characteristics, the ideology of the state (*Länder*) governments nominating higher-level court judges, and relevant economic data for the German states starting in the 1970s (for the West German states) until 2004. The empirical analysis uses panel techniques, applying a robust modelling approach that controls for both time and state fixed effects based on feasible generalized least square (FGLS).

A number of interesting results stand out. First, demand for court activity matters. We find, perhaps not surprisingly, that claims filed by workers at lower-level German labor courts (*Arbeitsgerichte*, ArbG) are driven to a large extent by structural and economic variables that can be linked to the demand for contract protection by employees.⁸ Second, however, the production of German labor courts is not driven by demand factors alone. Among the supply-side factors are personal and professional characteristics of the judges and a measure of nomination bias. In particular, there is evidence that the political “color” of the appointing state government affects court production at higher-level labor courts (*Landesarbeitsgerichte*, LArbG), with significant repercussions on court activity at the lower level of the judiciary. This suggests that employers and employees act rationally along the lines suggested by the theoretical model. Last but not least, there is evidence that labor court activity is among the determinants of unemployment in Germany. Using the measure of nomination bias, population size, and state and time fixed effects as instruments to identify exogenous changes in labor court production, we show that an increase in court activity is associated with higher unemployment rates. The effects are both economically and statistically significant.

These results have potentially important policy implications. To the degree that evidence of nomination bias in German labor court activity might be disturbing from a normative perspective, an argument can be made for changes in the nomination process. On a more applied level, our results suggest that labor court activity is an important part of labor market regulation and deserves the attention of policy makers interested in influencing employment conditions in Germany.⁹ Taking the nomination process as

³ As we will argue below, an important part of the uncertainty may be changes in the composition of labor courts through the nomination process.

⁴ Contract disputes over dismissals and, to a somewhat smaller degree, wage issues are behind the vast majority of cases filed with German labor courts. During the period 1970–2004, about 44% of all case filed concerned dismissals (approaching 50% in more recent years) and about 39% wage disputes.

⁵ See, inter alia, (Young, 2003; OECD, 2004a, 2004b; Berger and Danninger, 2006).

⁶ This view has received some support from a macro perspective (Berger, 1998).

⁷ Grund (2006) also suggests that tenure and monthly gross wages are the single most relevant determinants of severance payments captured in the German Socio-Economic Panel (GSOEP).

⁸ This will include wage issues as well as dismissals. Unfortunately, the data does not allow us to differentiate between court activity concerning the one and the other.

⁹ Another implication is that indicators of labor market regulation based on readings of the law (e.g., some OECD indicators) may only give a partial picture of the actual level of regulation pertinent to the German labor market.

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