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Multiple equilibria in a firing game with impartial justice

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ABSTRACT

In this paper, we argue that firms' firing strategies and the judicial strategy of dismissed employees depend to a large extent on labor judges' ability to shed light on the various cases. The model is cast as a sequential game with imperfect information featuring firms, employees and labor judges. The judges' error margin increases with the congestion of the judicial system. The game presents multiple equilibria which differ in the frequency of good workers fired for unfair motives and the frequency of unreliable workers who abusively sue firms for unfair dismissal. The probability that the judge sits with the employee appears to be positively related to the ratio between the severance payment for economic dismissal and the company fine for abusive dismissal.

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1. Introduction

Building on the basic principle according to which labour market institutions have a substantial impact on the labor market performance (Blanchard and Wolfers, 2000; Phelps and Zoega, 2001), in the recent years economists begun to pay special attention to the relationship between the employment performance of a given economy and the strictness of its employment protection legislation (EPL). In a broad sense, EPL can be defined as the set of rules that govern the hiring and firing of employees, rules that include regulation on temporary contracts, specific requirements for collective dismissal and protection of regular workers against individual dismissal (OECD, 2006; Cahuc and Koeniger, 2007). Yet rules might have little impact on the labor market if they are not properly enforced. As pointed out by Bertola et al. (2000), when trying to assess the overall strictness of the EPL system, judicial enforcement of a given set of rules and judges' behavior matter as much as the rules themselves.[1]

In general, a firm would separate from an employee if at one moment in time the optimal organization of the production process requires less labor, often referred to as the "economic or objective" motive, or because the worker does no longer fulfill his tasks in an adequate manner, referred to as the "personal or subjective" motive. In all the industrialized world the law protects employees against discriminatory behavior on behalf of the employer (because of gender, age, race and so on). Yet many European countries took workers' rights one step further and ruled that fired workers can take the employer's decision to court even if the motive of the dismissal involves no discriminatory practice. Furthermore, in some countries, mostly belonging to Southern Europe, when the firm opts for the economic motive it must pay the worker a substantial severance payment, or the law defines in a very narrow way what can be accepted as a valid economic motive.[2] The conjunction of these two elements seems to have entailed an extensive recourse to justice in labor affairs. For instance, Bertola et al. (2000) emphasize that, in 1995, in France, Germany of Spain, more than 0.5% of the employees brought a case before the court, as compared with less than 0.1% in Austria or Denmark. They claim that "rather vague legal

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[1] See OECD (2006), European Commission (2006) or the June special issue of the *Economic Journal* (Cahuc and Koeniger, 2007) for a review of recent empirical evidence on the relationship between employment performance and EPL. See Ljungqvist (2002) or Cahuc and Zylberberg (2004) for a survey of the main models, including pioneering work by Bentolila and Bertola (1990) and Bertola (1990).

[2] For instance, in Spain the severance payment for economic dismissal amounts to 33 (45 for older contracts) days of salary per year of employment. The severance payment is also substantial in Portugal and Germany (for large .rms). In Italy there is no mandatory severance payment, but, like in France, the range of valid economic motives is rather narrow.

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definitions of unfair dismissal, which give courts broad discretion in interpreting regulations, may indeed be an important reason for the impressive case loads of the French, German and Spanish courts" (Bertola et al., 2000, p. 68).

France provides for an interesting case study. In this country, 90% of the employed persons are hired under a well-defined "open-ended labor contract".[3] The firm that fires a worker hired under a such a contract must pay him a severance indemnity. This severance payment is relatively small, between 1/10th and 1/6th of the monthly wage per year of experience, when the personal motive is invoked (no payment is due for a "serious professional fault"). The employer must pay the worker twice as much when he resorts to the economic motive. The law (*Code du Travail*) defines in a rather narrow way those situations where the firm can resort to the economic motive. To the opposite, the law provides no formal definition for the personal motive (it only states that the cause must be "real and serious"), and what can be accepted or not as a valid motive emerged from judicial practice over time (Blanchard and Tirole, 2004; Pigoni and Zouary, 2003; Cahuc and Kramarz, 2004). All fired employees can take the firm's decision to a labour court. If the labour judge rules that the motive is not valid, he can ask the firm to pay to the worker a large compensation for unfair dismissal of at least 6 months of salary. The judge can even rule that the firm must reintegrate the employee; in this case, the firm must pay the fine and the wage over the whole not worked period. While the legislation and jurisprudence on firing for personal motives has been quite stable since 1973, starting with the early nineties it became more and more difficult to fire someone for economic motives, not least because courts tend to give a narrower interpretation of the valid motives (Blanchard and Tirole, 2004; Lagarenne and Le Roux, 2006). According to Ministry of Labor data, the frequency of employees fired for personal motives increased in the last 10 years (from 1.6% of total employment in 1997, to 2.1% in 2007), while that of employees fired for economic motives declined (from 1.2% of total employment in 1997, to 0.5% in 2007).[4] Several economists (Cahuc and Kramarz, 2004; Blanchard and Tirole, 2004) surmise that firms probably tend to invoke faked personal motives, while the true motive is economic. Turning now to the role of justice, the majority of cases are brought to court by workers fired for personal motives. For instance, in 2004, 26% of the workers fired for a personal motive sued the employer. In 64.5% of the cases, the outcome of the trial was favorable to the employees (Munoz Perez and Serverin, 2005).

This paper provides a theoretical analysis of the judicial strategies of firing firms and dismissed workers within an institutional setup inspired by the Southern European experience, mainly France. Its original contribution to existing EPL literature is to show that the existing labor–justice interaction is consistent with multiple equilibria. Hence, policies aiming at improving the employment performance of a given economy should pay due consideration not only to the impact of small variations in legal firing costs, but also to the possibility to shift from one equilibrium to another.

The model is cast as a game with imperfect information between firms – that must fire a predetermined number of workers, workers – who can sue their former employers, and labor judges – who must shed light on the cases taken before the court by dismissed workers. In the total population of workers to be fired, on plain legal considerations, only a fraction of them would qualify for the personal motive; the other are "good" workers who, should the firm decide to dismiss them, must be fired only for the economic motive. If the firm decides to fire a worker for an economic motive, it must pay him a substantial severance payment, whose amount is exogenously given; no severance payment is due to a worker fired for a personal motive. All workers fired for a personal motive can sue the firm for abusive dismissal. If the verdict is favorable to the worker, the firm must pay him a substantial compensation.

This game presents a separating equilibrium where the outcome corresponds to the perfect information case: firms fire for personal motive only the unreliable workers, and no worker takes his case to court. The judicial system performs well the role of deterring abuses. Yet if judges can make errors in detecting a worker's type, a firm might fire a good worker for personal motives only in order to economize on the severance payment. It will be shown that the game also presents a pooling and two hybrid equilibria, where at least some good workers are fired for personal motives and some unreliable workers, rightly fired for personal motives, sue the firm as well; the judicial system is subject to congestion and judges, who have only an imperfect information about the type of worker, take the wrong decision with a positive probability. To close the loop, it is the very possibility that the judge makes errors that makes optimal the decision of the firms to fire all (some) good workers for a personal motive and that all (some) unreliable workers sue the firm for abusive dismissal. The judge holds a central role in our analysis, given that he is the only force able to oppose the tendency of both firms and employees to issue unfair claims.

Theoretical analyses of the complex relationship between firms' firing strategies and the judicial system are rather scarce (Deffains, forthcoming).[5] Our work can be related to two existing studies. The paper by Ichino et al. (2003) takes stock of the Italian experience to analyze the relationship between aggregate labor market conditions and courts' decisions. They provide a model of the judge's behavior, who must decide whether a given misconduct is sufficient for firing someone. Judges sit with the worker if his misconduct is milder than the "representative" misconduct. In turn, the representative misconduct depends on the average misconduct of all fired persons. When many workers are fired, the average misconduct is lighter, so judges tend to sit with workers more often. Hence firing costs are countercyclical. Galdón-Sánchez and Güell (2000, 2003) develop a variant of the Shapiro and Stiglitz (1984) shirking model, where shirkers can take their case to court, knowing that judges make errors with an exogenously given probability. Hence, in case of a downturn, firms may resort to disciplinary firing (what we call "personal" motive). One main conclusion of their model, substantiated with empirical evidence on Germany, Italy, France, the UK and the United States in the nineties, is that workers' chances to win in court are inversely related to the gap between the severance pay for fair and unfair dismissal.

At difference with the paper by Ichino et al. (2003) where the incidence of firing is endogenous but there is a single firing motive, in our setup the firm's decision is not about whether to fire a worker, but how. This problem has already been raised by Galdón-Sánchez and Güell (2000, 2003), but in their paper the judge's error margin is exogenous. In our paper, the error margin is endogenous: it depends on the frequency of cases brought to court within an invariant macroeconomic environment. Our analysis builds on an original hypothesis of impartial justice, according to which, under imperfect information, the equilibrium probability that the judge gives a verdict favorable to the worker should match the frequency of good workers in the population of suing workers. For sure, any more sophisticated model should fulfill this criterion, if else justice appears to be biased in favor of either workers or firms.

The assumption of an invariant macroeconomic environment is one limitation of our model and represents an essential contribution

[3] The other 10% are hired under various forms of temporary contracts that imply a much lighter EPL. See Cahuc and Postel-Vinay (2002), Blanchard and Landier (2002) for an analysis of "dual labor markets", and Amira and De Stefano (2005) for recent data on temporary contracts in France.

[4] See DARES, *Premières Synthèses, Premières Informations*, 16, 3, 2008 and www.travail-solidarite.gouv.fr.

[5] Following the pioneering work of Posner (1993), there were several empirical attempts to estimate variables that have a bearing on the quality of a judge decision. A theoretical model describing the judge's behavior in a judicial framework with imperfect information and judges' career concerns was worked out by Levy (2005). See Kaplow and Shavell (2002) for a survey of the literature on law and economics, including litigation.

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