

Let's go to court!

Firing costs and dismissal conflicts*

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Abstract

In this paper we analyze court outcomes of dismissal conflicts for several countries. We highlight two facts. First, the patterns found are extremely stable in every country over time. Second, two types of patterns are found: either the workers win most of the cases, or the worker and the firm win half the times each. We build a model of dismissal conflicts that explains these facts. The gap between the severance pay for fair and unfair dismissals is a key factor in the determination of such court outcomes. Those countries with a small gap have outcomes in which the workers win most of the times, and the average cost of firing is higher than in those countries with a higher gap. This suggests that costly dismissals and rigid employment protection legislation are not necessarily synonymous.

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1 Introduction

Firing costs play a key role in the functioning of the labor market and they are often blamed for high unemployment rates. In this paper we investigate the cost of firing by studying court outcomes of dismissal conflicts for several countries. These outcomes determine the upper bound of private settlements and, in turn, the average cost of dismissing a worker.

We build a model of dismissal conflicts with two types of disputes. When a worker is fired for a particular cause, there can be **pure disagreement** among employer and employee due to the ambiguity of the law. The law states a justified cause for dismissal, but it typically leaves room for its interpretation. Worker and firm having opposite interests will confront. Another type of dispute has to do with the **strategic behavior** of the agents. This second type of dispute emerges from the incentive problems that the regulations on dismissals generate. These two types of conflicts are related: the agents can get away with a strategy of dishonesty because of the ambiguity of the law which can play in their favor.

In this paper we analyze the incentive problems that are generated around those legal institutions in virtue of which the firm has to compensate the worker when fired. In the European countries, these institutions are the well-known employment protection legislation (EPL). In the United States, despite the nonexistence of formal employment protection legislation for non-unionized workers, the experience-rated unemployment insurance implies indeed that dismissals are not costless. More interesting, we will study how these two different institutions have similar structure in terms of the incentive problems that generate dismissal conflicts.

We analyze data on court outcomes of dismissal conflicts for several European countries and the United States. We highlight two facts. First, the patterns found are extremely stable in every country over time. Second, two types of patterns are found among the European countries: either the worker wins most of the cases, or the worker and the firm win half the times each. For the United States, the unemployment insurance conflicts that end up in court are mostly won by the firm.

We provide a model that explains these facts. The gap between the severance pay for fair and unfair dismissals is a key factor in the determination of such court outcomes. Those countries with a small gap have outcomes in which the workers win most of the time while the countries with a higher gap have outcomes close to 50 % worker win rates in court. For the United States, a fired worker either gets the unemployment benefits or not, but there are not fair and unfair levels of benefits. Our model applies to this situation, where the fair payment can be thought to be zero and the unfair payment can be thought to be the unemployment benefit. This can be interpreted as the maximum gap between fair and unfair benefits for which the model predicts that the firm will win most of the cases taken to court.

In addition, the model allows to analyze the average cost of dismissal. Firing is more costly in those countries in which there is a lower gap between the severance pay for fair and unfair dismissals. The idea is simple, more cases that are taken to court are won by the worker and therefore more cases are paid at the unfair rate.

There is a rich literature on litigation and settlement.¹ The question of why cases end up in court even though this is costly is at the heart of this literature. In our model, the

¹For a review, see Cooter and Rubinfeld (1989).

reason why agents may not settle is that they can have different priors on the court decisions because the law leaves room for interpretation.² This literature has also highlighted that the cases that end up in court are a non-random sample of the population (see the seminal paper of Priest and Klein, 1984). Our model predicts that when agents behave strategically, the cases that end up in court are those cases that have less convincing evidence. Consequently, agents will lose most of these cases although their strategies will remain profitable.

Finally, Priest and Klein also emphasized the tendency towards 50 % plaintiff win rates at trial. This fact has been criticized both theoretically and empirically (see Shavell, 1996, for instance). Our model provides an explanation of why different win rates are possible depending on the relative costs of fair and unfair dismissals. We also emphasize that in those countries in which the incentive problems are less severe, the worker's win rates in dismissal disputes will tend to 50 %.

The paper is organized as follows. Section 2 describes the dismissal process both in relation to severance payments and unemployment insurance. Section 3 describes the empirical evidence for Italy, Spain, France, United Kingdom and the United States. Section 4 presents the theoretical model and section 5 discusses how the model fits the data. Finally, section 6 concludes.

2 The Process of Individual Dismissal

In this paper, we concentrate on five OECD countries: Italy, Spain, France, United Kingdom (UK) and the United States (US). The order of the countries reflects their strictness of employment protection legislation according to the OECD (1999),³ from the most strict legislation (Italy), to the least strict (US). The reason why we study these specific countries is the availability of the data. However, it is a sample that captures the whole spectrum of strictness, which makes our exercise meaningful.

The regulations affecting the individual dismissal of workers are similar in all Western European countries (see OECD, 1999). Here we are going to describe the general aspects of the process of individual dismissal common to our four European countries. We will also describe the relevant aspects of the experience-rated unemployment insurance system in the US. The characteristics of this system have some similarities with the European dismissal legislation. Despite the inexistence of formal employment protection legislation for non-unionized workers in the US, the experience-rated unemployment insurance implies indeed that dismissals are not costless.⁴

2.1 Severance payments in Western European countries

Depending on the number of workers dismissed, the regulations in Western European countries distinguish between individual and collective dismissals.⁵ Depending on the reasons

²See Waldfogel (1998), among others, for a discussion on different theories of litigation.

³See Employment Outlook 1999, table 2.5, for country specific overall EPL strictness in the late 1990's.

⁴Lazear (1990) points out that despite the inexistence of formal employment protection legislation in the US, experience-rated unemployment insurance erode the employer's ability to dismiss workers without cost.

⁵Collective dismissals are subject to a different legislation (see OECD, 1999).

behind the firing, the regulations distinguish between redundancies (due to economic reasons, layoff or lack of work) and disciplinary dismissals (due to misconduct, absenteeism, repeatedly arriving late to work, negligence, missing many days of work without justification, not obeying, voluntary reduction of productivity, laziness, disrespectfulness or rudeness). In general, employers can dismiss any worker after some days of notice, which varies with the country, with a severance payment related to the worker's seniority.

When a firm dismisses a worker claiming that it is a redundancy, the worker must be compensated with a severance payment. The idea behind this reward is that this situation is something exogenous to the worker and he must be compensated for it. Redundancies are generally considered fair dismissals. The severance payments for fair dismissals vary with countries. When the worker does not respect the contract signed, i.e. when the worker cheats, then the firm can fire the worker without compensating him with a severance pay. In this case the worker faces a disciplinary dismissal.

Dismissed workers may sue employers in the labor courts. In most of the countries there is compulsory conciliation and, in case of failure, the case is settled by a judge. The procedure is as follows. When the worker is dismissed, if he does not agree with the firm's claim, he can take the case to the administrative unit (labor authority) in charge of the mediation, arbitration and/or conciliation.⁶ Conciliation is the most common kind of third party intervention and is of central importance in most Western European countries, particularly in regard to the processing of unfair dismissal claims. Conciliation takes a great variety of forms. In general both the firm and the worker meet with the labor authority in order to reach an agreement. At this stage, legal representation is rarely used by the parties.

If after conciliation no agreement is reached, the case goes to court and it is settled by a judge.⁷ The court or the tribunal is the ultimate mechanism for processing individual employment rights. If the decision favors the worker, that is, if the judge declares the dismissal unfair (or "unwarranted"), severance payments are increased. In the case of disciplinary firings, the judge may also order the reinstatement of the worker. For specific country information on the conciliation process and court systems, see Appendix 1.

2.2 Unemployment insurance in the US

Here we review the main common characteristics of this institution. In the US, there has been a Federal Law regulating unemployment insurance provision since 1935. In addition, every state has a specific state program. Most American workers do not contribute to the Unemployment Insurance Fund (UI hereafter), instead employers and federal governments do. In Europe, to the contrary, employee and employer contributions are generally collected.⁸ In this sense, and from the employer's perspective, American UI are like severance payments

⁶Mediation: hearing the dispute and making formal but not-binding recommendations for resolving it. Arbitration: hearing the dispute and making a binding decision. Conciliation: encouraging the parties to reach their own agreement (see Barnard et al., 1995).

⁷In some countries there is an intermediate stage between conciliation and the final trial. In Spain, for example, after conciliation, if agreement is not reached, the case goes to a higher authority (Social Court). At this stage, parties try to reach conciliation in front of a judge. If there is no agreement, then the case goes to trial. See Appendix 1 for details.

⁸The only state in the US which has an institution similar to those in European countries is New Jersey.

in Europe.

There are two main types of requirements in order to be eligible for UI: monetary and non-monetary. Monetary requirements are related to the wage and tenure in the previous job. Non-monetary requirements depend on separation and non-separation issues. The latter relate to the unemployed willingness to accept suitable work, being able and available for work, etc. That is, UI is thought to be given to workers who are actively seeking a job. The separation issues relate to the reason why the worker was fired. If a worker is involuntarily unemployed, he is eligible for UI. A worker is disqualified for UI if he voluntarily left the firm without a good cause, was dismissed due to misconduct, or participated in a labor dispute (strike).

The appeal process is as follows. When a worker is dismissed, in order to receive the UI benefits he has to make an initial claim. If after this claim the worker is denied the benefits, he can ask for a revision of his case. This revision is made by the Board of Review. If after this step the worker is denied again the UI benefits, and is not convinced by the decision of the board, he can take his case to court (Lower Authority). Whenever a worker is awarded UI, the firm can disagree with that decision and follow the same process described above. Eventually the firm could end up taking the case to court.

This process is very fast and it does not require legal representation for the parties involved (the first step of the process can even be done over the phone). This means that the process is virtually costless.

3 Empirical Evidence

In this section, we analyze the empirical evidence on individual dismissal data for our five countries under consideration. As mentioned in the previous section, there are several steps that a fired worker follows before he decides to take the case to court. For each country, we have collected data on the number of cases at every step of this process. Tables 1 to 5 contain this information.

In table 1 we report some statistics, for every country and every period available, that summarize the data on individual dismissals displayed in tables 2 to 5. The most interesting statistic for our exercise is the average percentage of cases won by the workers in court. As it can be seen, there are two clearly distinctive groups of countries: those in which the percentage of cases won by the worker is around 50%, that is UK and Italy; and those in which the worker wins in the majority of the cases, Spain. France, is an intermediate case of these two set of countries. Our model will provide testable implications for this statistic.

[TABLE 1 HERE]

Tables 2 to 5 show country specific data on individual dismissals for those years available in each country. The important general remark is that for every country the number of dismissal conflicts, the number of cases getting settled and the number of court resolutions in favor of the worker show no trend over time. This suggests that all these variables are determined by structural parameters of the economy. ⁹In fact, our model will predict that

⁹Galdón-Sánchez and Güell (2001b) provide evidence on regional court outcomes within a country. They find that the differences across regions are very small.

the number of cases taken to court and the court outcomes will depend on the firing costs parameters of the economy. The tables are all structured in the same fashion, and the data displayed on them follow the process described in the previous section (number of workers fired, number of cases settled in conciliation, number of cases taken to court and outcomes of the tribunals).

[TABLE 2 to 5 HERE]

Table 2 displays the data for Italy from 1990 to 1998. To our knowledge, data on conciliation are only available prior to 1992. Table 3 displays the data for Spain from 1986 to 1998. Unlike the other countries, in Spain there are two stages of conciliation before a case goes to court. In the last conciliation stage, the Social Court, the data collected correspond to the total number of cases instead of the total number of individuals. In general, one case implies more than one dismissal.¹⁰ And, since there is no rational reason for the worker to give up at this stage, we can safely assume that the total number of cases represents all the individuals that have not reached an agreement at the conciliation stage.

Table 4 displays the data for France from 1982 to 1998. In this country, the data on court decisions are only available for all employee-employer conflicts and not for dismissal conflicts alone. However, the data displayed show, for the average of the period, that 60% of these conflicts are individual dismissals. Therefore, given that the majority of conflicts refer to dismissals, we believe that these data are still valid for our exercise.¹¹

Table 5 displays the data for United Kingdom¹² from 1985/86 to 1994/95 (from April to March of the following year). We report data on every step of the process for the total number of registered individual cases. We also report data on unfair dismissal and redundancy cases proceeding to a tribunal. The reason why we report these two sets of information is that while all unfair dismissal and redundancy cases are individual dismissals, there could be some registered individual cases that are not. Therefore the percentage of unfair dismissal and redundancy cases won by the worker should be interpreted as the lower bound of the total number of individual dismissals won by the worker.

Table 6 displays the data on unemployment insurance related to individual dismissal for the US. We have approximated the number of dismissed workers who are eligible for UI by the number of initial claimants of UI. Data on tribunal decisions are available for non-monetary issues and not for separation issues alone. However, the data displayed show that separation issues represent on average 44 % of all UI second claims. In addition, 65 % of the cases taken to the Lower Authority are related to separation issues. Given that the majority of cases at court involve separation issues, we believe that the data on tribunal's outcome are still valid for our exercise.

[TABLE 6 HERE]

¹⁰On average, each case corresponds approximately to 1.5 dismissals (Briones, 1995).

¹¹Given that dismissals represent 60 % of all conflicts, it is straightforward to see that the minimum percentage of individual dismissal cases won by the worker is at least 57 %.

¹²Data for United Kingdom refer to Great Britain only.

4 The Model

4.1 The Context

We consider two types of dismissals: i) redundancies or layoffs (labelled R), which are generally caused by economic losses of the firm and ii) disciplinary dismissals (labelled D), which are caused by some misconduct of workers, that is firing for cause.¹³

The EPL states that in case of redundancies, firms have to compensate workers with a severance pay F , while no compensation is required in the case of disciplinary dismissals. Any dismissal can be contested by the worker and if considered unfair by court, firms have to pay a severance pay U (where $U \geq F$). In this context, workers are always the plaintiffs and firms are always the defendants.

At any given point in time, a firm is associated with the vector of firing reasons $X = \begin{pmatrix} X_R \\ X_D \end{pmatrix}$, where X_R captures all the possible reasons that can cause a redundancy (for instance, the level of economic loss of firms) and X_D captures all the possible reasons that can cause a disciplinary dismissal (for instance, the level of misconduct of workers). We assume that X_R and X_D are independent. The realization of X_j is \bar{x}_j , where $j = \{R, D\}$.

The timing of events is as follows: X is realized. Firms decide if they fire a worker or not. If they decide to fire a worker, they also have to decide if they are going to claim economic or disciplinary reasons. That is, they decide the dismissal case j . The vector of firing reasons X is observable to all agents (judge, firm, worker). Since the EPL is ambiguous, the agents may interpret the seriousness of a given case differently.

Agents' interpretation of the evidence

i) Judge.

Let P_j be the probability of plaintiff victory (or the probability that the case is considered unfair) if a dismissal case j with characteristics X_j is taken to court, where $P_j = G(X_j)$ and $G(X_j)$ is the interpretation function of the evidence X_j by the judge (not observable by the firm and the worker).

We will refer to $P_j \in [0, 1]$ as the “objective” probability of plaintiff victory associated with the dismissal case j . Any vector $X = (X_R, X_D)$ is associated with the vector of objective probabilities $P = (P_R, P_D)$, where P_j are iid and $P_j \sim U(0, 1)$.

Let \bar{p}_j , a realization of P_j , be the objective probability of plaintiff victory associated with a particular dismissal. The interpretation function is such that $G^0(\bar{x}_j) < 0, \forall \bar{x}_j$.

For instance, a low \bar{x}_R is associated with a high \bar{p}_R . That is, if the firm's economic losses are very low, a redundancy case would be considered unfair in court with high probability. Also, a high \bar{x}_D is associated with a low \bar{p}_D . That is, if the worker's level of misconduct is

¹³When we talk about “economic loss”, we broadly understand any reduction in profits. The economic losses for the firm can be generated by negative demand shocks. Moreover, there are additional causes that could justify a redundancy case. Those causes are technical, organizational and others related to the production process of the firm. It is implicitly understood that these causes exist when the firing of workers for these reasons contributes to overcome the economic situation of the firm and to guarantee its future viability. On the other hand, workers are monitored by firms which can find workers “misbehaving”.

very high, a disciplinary case would be considered fair in court with high probability.

ii) Firm and worker.

Each agent observes \bar{p}_j with error and estimates the probability P_{ij} of plaintiff victory for a particular dismissal j , where $i = \{f, w\}$ refers to firm or worker in the following way:

$$P_{ij} = \bar{p}_j + \varepsilon_i$$

where ε_i is agent's i error. Agents' errors are iid and distributed $\varepsilon_i | P = \bar{p} \sim U(-a, a)$. Therefore, $P_{ij} | P = \bar{p} \sim U(-a + \bar{p}_j, a + \bar{p}_j)$, where

$$a = \begin{cases} 1 - \bar{p}_j & \text{if } \bar{p}_j \geq 0.5 \\ \bar{p}_j & \text{if } \bar{p}_j \leq 0.5 \end{cases}$$

This specification guarantees that agent's estimates are unbiased. Note that under this specification, the agent's error is higher the closer \bar{p}_j is to 0.5 and lower in the extremes of the distribution. This captures the fact that those cases that are not in the extremes of the distribution have a more difficult interpretation.¹⁴

We consider two types of conflicts:

i) Pure disagreement conflicts. Under this type of conflicts, the firm declares a dismissal j and the worker considers that the underlying \bar{x}_j does not justify the dismissal. In other words, the firm and the worker interpret that evidence differently.

ii) Strategic conflicts. These conflicts arise when both $X_R > 0$ and $X_D > 0$, and the firm declares a disciplinary dismissal while the worker considers that there is actually more evidence of a redundancy case. In other words, the firm and the worker disagree on both pieces of evidence.¹⁵

Remark: if the firm declares a redundancy, there can only be a pure disagreement conflict (it is a nonsense that the worker would construct evidence based on X_D). If the firm declares a disciplinary case, the worker may decide to build his defense based on X_R . If so, then the court considers both pieces of evidence separately.

Expected value of each conflict for firms and workers

1. Pure disagreement conflict

1.a. Redundancy case

The maximum that the firm will offer is what it would lose if the case is taken to court. That is

$$(1 - P_{f,R})F + P_{f,R}U + C_f \tag{1}$$

The minimum that the worker will accept is what he would get if the case is taken to court. That is

¹⁴This same idea can be found in Priest and Klein (1984), where cases near the "decision standard" are more likely to end up in court.

¹⁵Galdón-Sánchez and Güell (2001a) analyse strategic conflicts in a model where worker's effort is not observable.

$$(1 - P_{w,R})F + P_{w,R}U - C_w \quad (2)$$

1.b. Disciplinary case

The maximum that the firm will offer is what it would lose if the case is taken to court. That is

$$P_{f,D}U + C_f \quad (3)$$

The minimum that the worker will accept is what he would get if the case is taken to court. That is

$$P_{w,D}U - C_w \quad (4)$$

2. Strategic conflict

In this situation, the case arrives to court and the firm claims a disciplinary dismissal while the worker claims a redundancy conflict. The firm behaves “strategically” because it thinks that there is a positive probability of getting away with its claim, i.e. of convincing the court that the case is a disciplinary dismissal and paying 0 for it. The main reason behind this belief is that the law is ambiguous and the effort is not perfectly observable.

We consider neutral courts who are not biased against the firm or the worker. Under these circumstances, courts make their decisions based on the evidence that it is presented by both the firm (on a disciplinary case) and the worker (on a redundancy).

The maximum that the firm will offer is what it would lose if the case is taken to court. That is

$$0.5U [\text{evidence on redundancies}] + 0.5U [\text{evidence on disciplinaries}] + C_f \quad (5)$$

In this situation, the firm could lose the case for one or both of the following two reasons:

i) The evidence on a redundancy case is overwhelming (i.e. X_R is high). This happens with probability $(1 - P_{f,R})$.

ii) The evidence on a disciplinary case is not convincing enough (i.e. X_D is low). This happens with probability $P_{f,D}$.

Therefore we have

$$0.5U [1 - P_{f,R}] + 0.5U [P_{f,D}] + C_f \quad (6)$$

The minimum that the worker will accept is:

$$0.5U [1 - P_{w,R}] + 0.5U [P_{w,D}] - C_w \quad (7)$$

For simplicity we will assume that $C_f = C_w = C$. From now on, let $\alpha U = F$, that is $\alpha = F/U$.

4.2 Firm’s firing decisions

4.2.1 Conflicts and court

In what follows we describe the necessary condition for a dismissal to end up in court for each of the conflicts described above.

1. Pure disagreement conflict

1.a. Redundancy case

A case goes to court when the firm's maximum offer is smaller than the minimum the worker's is willing to accept. Given equations (1) and (2), a redundancy will go to court if

$$P_{w,R} - P_{f,R} > \frac{2C}{U(1-\alpha)} \quad (8)$$

This condition states whether a case is taken to court in terms of the difference in the priors of the worker and the firm. The higher the difference, i.e. the more optimistic the worker is in comparison to the firm, the more likely is that the case goes to court. It also states that the higher the costs of going to court, *ceteris paribus*, the less likely that a case ends up in court. The higher the severance pay gap between unfair and fair cases, *ceteris paribus*, the more likely the case will end up in court (i.e., there is more to gain from the worker's perspective!). The numerator, $C_f + C_w$, represents the "social" cost of taking a case to court.

Given the above assumptions, we can calculate for which dismissal cases the above condition (8) has a non zero probability. So, we find that the necessary condition for a redundancy case to go to court is given by

$$\frac{C}{U(1-\alpha)} < P_R < 1 - \frac{C}{U(1-\alpha)} \quad (9)$$

where

$$\frac{C}{U(1-\alpha)} < \frac{1}{2}$$

Note that if $\alpha = 1$, then no redundancy cases will end up in court.

1. b. Disciplinary case

Given equations (3) and (4), a disciplinary case will go to court if

$$P_{w,D} - P_{f,D} > \frac{2C}{U}$$

Given the above assumptions, the necessary condition for a disciplinary case to go to court is given by

$$\frac{C}{U} < P_D < 1 - \frac{C}{U} \quad (10)$$

where

$$\frac{C}{U} < \frac{1}{2}$$

2. Strategic conflict

Given equations (6) and (7), a disciplinary case will go to court if

$$0.5(P_{f,R} - P_{w,R}) + 0.5(P_{w,D} - P_{f,D}) > \frac{4C}{U}$$

Given the above assumptions, the necessary conditions for a disciplinary case to go to court is given by

$$\frac{2C}{U} < P_D + P_R < 2 - \frac{2C}{U} \quad (11)$$

and

$$\frac{2C}{U} - 1 < P_D - P_R < 1 - \frac{2C}{U} \quad (12)$$

4.2.2 The game

In what follows we analyze the different strategies of agents in the firing process and endogenize the firm's firing decision as well as each type of conflict explained above.

X is realized $\rightarrow X$ associated with objective probabilities $P \rightarrow$ Firm decides to fire \rightarrow Worker decides if he accepts or not the default indemnity.

				worker's gain firms cost		
•Firm	↗	Redundancy \rightarrow	•Worker ↗	accept	F	F
			•Worker ↘	contest	equation (2)	equation (1)
	↘	Disciplinary \rightarrow	•Worker ↗	accept	0	0
			•Worker \rightarrow	not accept (defend X_D)	equation (4)	equation (3)
			•Worker ↘	not accept (defend X_R)	equation (7)	equation (6)

Worker's optimal strategies

• If the firm declares a redundancy case, then the worker will:

i) accept F if

$$P_R \leq \frac{C}{U(1-\alpha)} \quad (13)$$

ii) not accept F if

$$P_R > \frac{C}{U(1-\alpha)} \quad (14)$$

So, the worker does not accept F when the evidence on a redundancy case is weak enough (i.e., high enough P_R).

• If the firm declares a disciplinary case, then the worker will:

i) accept 0 if

$$P_R > 1 - \frac{C}{U} \text{ and } P_D < \frac{C}{U} \quad (15)$$

ii) not accept 0 and disagree on X_D (pure disagreement) if

$$P_D > 1 - P_R \text{ and } P_D > \frac{C}{U} \quad (16)$$

iii) not accept 0 and disagree on X_R (strategic conflict) if

$$P_D < 1 - P_R \text{ and } P_R < 1 - \frac{C}{U} \quad (17)$$

So, the worker accepts 0 when the evidence on a disciplinary case is strong enough. It does not accept 0, and claims that actually there is more evidence on a redundancy case, when indeed this evidence is stronger than the evidence on a disciplinary case. This is captured by condition $P_D > 1 - P_R$. Otherwise, the worker does not accept 0 and constructs his defense based on the evidence of redundancies.

Firm's optimal strategies

The firm takes into account the worker's optimal decisions and decides on the following firing decisions:

i) When $(P_R > 1 - \frac{C}{U}$ and $P_D < \frac{C}{U})$ the firm declares a disciplinary case. That is, when the evidence on a disciplinary case is strong enough and the evidence on a redundancy case is weak enough, the firm declares a disciplinary case. If the firm declared a redundancy case, the worker would never accept F (see condition (14) above).

ii) When $P_R < \frac{C}{U(1-\alpha)}$ the firm declares a redundancy case. That is, when the evidence on a redundancy case is high enough, the firm declares a redundancy case, for any level of worker's misconduct. Since in this situation the worker always accepts F (see (13) above), it is optimal for the firm to declare always redundancy.

iii) When $(P_R > \frac{C}{U(1-\alpha)}, P_D > 1 - P_R$ and $P_D > \frac{C}{U})$ the firm declares a disciplinary case if $(P_D < (1-\alpha)P_R + \alpha)$ and a redundancy case otherwise. That is, the firm declares a disciplinary case when the evidence on a disciplinary case is strong enough. And it declares a redundancy when the evidence on a disciplinary case is weak enough, since in this case the worker always challenges the case.

iv) When $(P_R > \frac{C}{U(1-\alpha)}, P_D < 1 - P_R$ and $P_R < 1 - \frac{C}{U})$ the firm declares a disciplinary case if

$$P_D < 2(1.5 - \alpha)P_R + 2\alpha - 1 \tag{18}$$

and a redundancy otherwise. Again, the firm declares a disciplinary case when the evidence on this case is strong enough and declares redundancy when the evidence on a disciplinary case is weak enough since the worker always challenges the case. Note that in this case the firm can declare a disciplinary case even though the degree of economic loss is higher than the degree of worker's misconduct. This is the reason why we call this conflicts "strategic".¹⁶ Note that the presence of these conflicts depends crucially on the gap between fair and unfair severance payments (α).

Equilibrium

Given the agent's strategies and the court necessary conditions discussed above, we have that:

i) When $(P_R > 1 - \frac{C}{U}$ and $P_D < \frac{C}{U})$ the firm declares a disciplinary case and the case is settled at 0.

¹⁶In the previous version of this paper, we referred to "lying strategies" of agents.

ii) When $P_R < \frac{C}{U(1-\alpha)}$ the firm declares a redundancy case and the case is settled at F .

iii) When $(P_R > \frac{C}{U(1-\alpha)}, P_D > 1 - P_R \text{ and } P_D > \frac{C}{U})$ the firm declares a disciplinary case if $(P_D < (1-\alpha)P_R + \alpha)$ and a redundancy case otherwise. Disciplinary cases end up in court if condition (10) is satisfied. Redundancy cases end up in court if condition (9) is satisfied.

iv) When $(P_R > \frac{C}{U(1-\alpha)}, P_D < 1 - P_R \text{ and } P_R < 1 - \frac{C}{U})$ the firm declares a disciplinary case if $(P_D < 2(1.5 - \alpha)P_R + 2\alpha - 1)$ and a redundancy otherwise. Disciplinary (strategic) cases end up in court if conditions (11) and (12) are satisfied. Redundancy cases end up in court if condition (9) is satisfied.

4.3 The gap between fair and unfair dismissals severance pay

So, in equilibrium, we have two types of cases that can end up in court. First, pure disagreement cases. These are both redundancies and disciplinary cases in which agents disagree on the interpretation of a given piece of evidence. Basically, the firm interprets that the case justifies the dismissal and the worker interprets the opposite. Secondly, disciplinary cases in which the firm highlights the evidence on a disciplinary case and in which workers highlight the simultaneous evidence on a redundancy. Note that for the first type of cases, a bad economic condition is favorable for firms, the opposite is true for the second type of cases.

The gap between fair and unfair dismissals severance pay ($\alpha = F/U$) plays an important role in the resolution of the proposed game and, therefore, in the presence of different conflicts. On the one hand, it determines the number of redundancies that will be contested in court (see (13) above). More importantly, it determines the existence of “strategic” disciplinary cases (see condition (18)) above. In particular, as this gap goes to its maximum value ($\alpha = 1$), the number of strategic conflicts becomes larger than for lower values of α . The intuition is simple, declaring a redundancy case is more costly than declaring a disciplinary case.

5 Testing the model

In the data, we do not observe the “objective” probability of plaintiff victory associated with the dismissal case j , P_j . We only observe the average probability of a worker winning a dismissal case taken to court. So let P be the average probability of a worker winning a dismissal case taken to court, where:

$$P = \begin{cases} P_R & \text{if A=(firm declares redundancy, case goes to court)} \\ P_D & \text{if B=(firm declares disciplinary, case goes to court, pure disagreement)} \\ 0.5(1 - P_R) + 0.5P_D & \text{if C=(firm declares disciplinary, case goes to court, strategic conflict)} \\ 0 & \text{if otherwise} \end{cases}$$

We are interested in the expected value of P . That is,

$$\begin{aligned}
E[P] &= \sum_y y \Pr(P = y) \\
&= \sum_y y \{ \Pr(P = y | A) \Pr(A) + \Pr(P = y | B) \Pr(B) + \Pr(P = y | C) \Pr(C) \}
\end{aligned}$$

We solve $E[P]$ for the 2 extreme cases: when $\alpha \rightarrow 1$ and when $\alpha \rightarrow 0$.¹⁷ Then we discuss the intermediate case. We find that for different values of α the contribution to $E[P]$ of the pure disagreement cases is quite similar. Instead, the contribution of the strategic cases is very different for different values of α . Therefore, the value of $E[P]$ depends crucially on the outcome strategic cases. We find the following results (see Appendix 3 for the calculations):

When $\alpha \rightarrow 1$, we have:

$$E[P] > \frac{1}{2}$$

The intuition for this result is that in this case, there are no redundancies that go to court. At the same time, there is the maximum number of strategic disciplinary cases, including those in which the evidence for redundancy is stronger, in which the worker tends to win most of the time.

When $\alpha \rightarrow 0$, we have:

$$E[P] < \frac{1}{2}$$

For this result, we focused on the case where U is low.¹⁸ In this situation, redundancy cases are concentrated to the left of $P_R = 0.5$. Moreover, in this situation there are fewer strategic cases and they are mostly concentrated among cases for which the redundancy evidence is weak enough. So the worker tends to lose most of the time. When $\alpha \in (0, 1)$ we deal with an intermediate case. Again, the strategic dismissals are those for which the redundancy evidence is weak enough. But, many more cases are concentrated around $P_R = 0.5$ and $P_D = 0.5$ than when $\alpha = 0$ which increases $E[P]$.

Aggregate court outcome and the cost of firing

[TO BE ADDED]

6 Does the model fit the data?

In the previous section it has been stated that the proportion of cases won by the worker depends on $\alpha = \frac{E}{U}$. In this section we study if our data fit the testable prediction of our model on the proportion of cases won by the worker, for the five countries object of our study.

¹⁷To our knowledge, previous models have not been able to derive closed-form expressions of the probability of plaintiff victory (conditional on trial). See Waldfogel (1995).

¹⁸We think that this case can approximate the case of UI for the US. The level of this UI is generally lower than the European severance pay.

We will concentrate first in the four European countries and analyze the unemployment insurance data for the US afterwards. Table 7 summarizes the country specific institutions for a tenure of 4 years.¹⁹

[TABLE 7 HERE]

6.1 European countries

The parameter F in our model has been calculated adding the notice period and severance pay for no-fault individual dismissal following the OECD (1999). The parameter U in our model has been calculated by the unfair dismissal compensation, again following the OECD (1999). For more details on country-specific calculations, see Appendix 2.

Spain is the country in our sample in which workers win more than half the times, around 70 %. For this country, the ratio α is close to 1. Italy and UK are the two other countries in which workers win around 50 % of the times (55 and 45 % for Italy and UK, respectively). For these two countries the ratio $\frac{E}{U}$ has a positive value. For Italy, it is 0.32 and for the UK it is 0.31. However, the actual value of these last two ratios is in fact lower if we take into account some country specific institutions.

In Italy, for example, reinstatement is mandatory. As Ichino et al. (2000) mention, “Italy is the only country in which, if firing is not sustained by a just cause, the firm is always forced to take back the employee in payroll and to pay the full wage that he has lost during the litigation period plus welfare contributions”. This is going to have an effect on our ratio via increasing the value of U and, therefore reducing $\frac{E}{U}$.

Two additional pieces of relevant information in relation with the United Kingdom should be taken into account when evaluating the value of $\frac{E}{U}$. In this country, if the case is brought to court by the employee and the firm wins, the employer may counter claim for damages or other sums (see Barnard et al., 1995). This institution has an effect in $\frac{E}{U}$ via reducing F . In addition, the severance payment due to unjustified dismissal is “unlimited”, if there is also discrimination grounds of sex, race or disability (see OECD, 1999) . This implies that some of the cases that arrive to the tribunal will be settled at a higher unfair rate, which again will affect $\frac{E}{U}$ via increasing U . Both forces go in the direction of decreasing $\frac{E}{U}$.

In France, is an intermediate case. The calculated α is close to the English and Italian one. As mentioned, the English and Italian values are biased upwards. Even though we do not have the precise proportion of cases won in France for workers, we know it is intermediate the Spanish and English/Italian rates.

6.2 USA

As we have already mentioned, the incentive structure of the experience-rated UI can be thought to be similar to the European firing costs. When a worker is fired for lack of work (i.e. redundancy) he is eligible for UI, while when the worker has been dismissed for misconduct, he is not eligible. Therefore, when a firm faces a redundancy, it will have an incentive to

¹⁹We have chosen this tenure based on the OECD (1999), that reports this tenure as the average between the extremes of 9 months and 20 years. Preliminary calculations for Spain, based on the Labor Force Survey seem to agree with this number as the average tenure of fired workers.

claim that the case was disciplinary. And, similarly, the worker will have an incentive to claim the case is a redundancy when facing a disciplinary case. The same interpretation of the law problems arise here and therefore the same type of conflicts mentioned in our model can be thought to arise for the UI. Even though the size of UI benefits is relatively smaller than the standard severance pay, what is important for our purpose is that the same type of dismissal conflicts arise.

In the UI case, the worker either gets the benefits or not. Our model applies to this situation, where the fair payment can be thought to be zero and the unfair payment can be thought to be the UI benefit. It can be easily shown that with this specification of the model, the only possible court outcome is that the firm wins most of the times. In the US, our data shows that the firm wins 62 % of the times.

7 Conclusions

We have presented a model of dismissal conflicts. The model has numerous implications. In particular, it provides one possible explanation of court outcomes as function of the relative size of fair and unfair dismissal costs. Even though, the model prediction on court outcomes is based only on the gap between fair and unfair severance payments, the data fit the model well. The model also applies to the dismissal conflicts of severance payments of some European countries as well as the experience-rated unemployment insurance of the US.

In addition, the model allows us to analyze the average cost of dismissal. Firing is more costly in those countries in which there is a lower gap between the severance pay for fair and unfair dismissals. The idea is simple, more cases are taken to court are won by the worker and therefore more cases are paid at the unfair rate. This suggests that costly dismissals and rigid employment protection legislation are not necessarily synonymous. In particular, Italy and the UK which are the most and the least regulated countries in terms of firing costs are closer in terms of court outcomes and therefore cost of dismissal than to other countries with similar employment protection legislation strictness (see OECD, 1999).

The results of this paper are based on the data that has been available at present. We believe the evidence we have gathered so far is conclusive, although to the extent that some data for our countries was not available the results are still preliminary. We are looking for more data for our countries and for more data for other countries that allow us to test further the predictions of our model.

APPENDIX 1: Conciliation and court systems in the four European countries

The information in this Appendix is mostly based on Barnard et al. (1995).

A1.1. Conciliation, mediation and arbitration

The different processes can be defined as follows:

* Conciliation: encouraging the parties to reach their own agreement.

* Mediation: hearing the dispute and making formal but not-binding recommendations for resolving it.

* Arbitration: hearing the dispute and making a binding decision.

As it has been said before, conciliation is the most common kind of third party intervention and is of central importance in most Western European countries, particularly in regard to the processing of unfair dismissal claims. Indeed, it is a compulsory part of the unfair dismissal procedure in Portugal, Italy and Spain. And, although not mandatory in the UK, it is certainly the norm in unfair dismissal claims. Conciliation takes a variety of forms in the different countries object of our study.

Tri-partite conciliation commissions exist in each Italian province whose competence includes resolving individual conflicts of rights. Settlements reached via conciliation can be given legal effect if certified by a judge and they may constitute an exception to the general prohibition of waiver of rights by individual workers. In France conciliation is provided under the principle of bi-partisim: it is conducted by a matched pair of *conseillers*, labor court judges drawn from panels of employers and workers, who sit in private.

In Spain a fired worker can make a claim to the units of *Mediacion, Arbitraje y Conciliacion* (MAC) if he does not agree with the firing decision of the firm. The claim to MAC is the first step of the unfair dismissal procedure. The worker may file the complaint before the Social Court only if conciliation has been held or attempted without success. After the claim has been made, the Labor Authority calls both parts to conciliation. In this act the negotiate over the firing conditions. If there is an agreement, it can be implemented without need for ratification in front of a judge. If there is no agreement, the worker can appeal to the Social Court. At the Social Court, there is one last attempt for conciliation between the parts in front of a judge. If there is no agreement, then the differences have to be solved in court.

In the UK conciliation of individual employment disputes is the responsibility of the *Advisory Conciliation and Arbitration Service* (ACAS). It applies to individual disputes over unfair dismissal, discrimination rights, and other areas, but not to some important categories of conflicts of legal rights, notably, disputes over statutory redundancy pay. ACAS exercise its functions independently from the employment tribunals. In fact, information given to a conciliation officer is not admissible in evidence before a tribunal without the consent of the party who communicated it. As we have said before, conciliation is not mandatory in the

UK, in that ACAS may only act at the request of one of the parties or, in the absence of any such request, if the conciliation officer considers that there is a reasonable prospect of success. ACAS conciliation is likely to have played a major role by communicating to the complainant that he was ineligible or likely to lose. The view has been expressed that the number of settlements would be even higher if lawyers were not involved, since they tend to hinder the informal, speedy, inexpensive and amicable settlement of disputes.

In great contrast to the US, arbitration does not appear to be a characteristic mechanism for handling dismissal or other individual dispute issues among our five European countries. In Spain, for example, arbitration for individual complaints is almost unknown. This may be explained in part by the fact that, for a long time, serious doubts existed as to whether arbitration was legally possible because, in the eyes of the courts, it interfered with workers' rights to appear before the labor court without unreasonable delay.

In Italy the possibility of informal arbitration over dismissal was reduced by the legislation of 1990, which strengthened the courts' powers to award reinstatement. However, Italian labor law allows individual labor disputes to be settled by arbitration (following the failure of conciliation) where this is envisaged by collective agreements, provided such arbitration arrangements do not prevent employees or employers from making complaints to the courts. The Italian framework provides something of a parallel with that of the UK, where there is a small volume of voluntary arbitration on individual discipline and dismissal cases, which are referred to ACAS by the collective parties.

A1.2. Court systems

In all the European countries analyzed, provision is made for reference to a court or a tribunal as the ultimate mechanism for processing individual employment rights.

ITALY

In Italy employment disputes are dealt with by the ordinary courts, but many of the advantages of specialist courts are nevertheless achieved. Pretore, ordinary court judges, have general first instance jurisdiction in employment disputes. Where the local judicial office is made up of several divisions, employment disputes are normally assigned to particular judges, who those have the opportunity to develop specialist expertise. Moreover, special procedural rules have been adopted to increase speed and flexibility. In addition, the judges have been empowered to adopt an investigative approach. They may acquire evidence independently of the parties, call new witnesses, interrogate the parties, order direct inspection of the workplace, and ask for the written and oral opinion of union representatives. Oral evidence is allowed to prevail over written evidence, and decisions are given immediately on the conclusion of the hearing. The tribunale, a panel of three judges, hears appeals from the pretore. But appeals against judgements worth less than L50,000 (just over £20) are not permitted. Decisions on the tribunale may be appealed on points of law to a special section of the Supreme Court handling employment disputes. It makes decisions with five as opposed

to the normal seven judges.

SPAIN

In Spain individual employment disputes are processed through a well developed system of labor courts. Following the judicial Powers Act 1985, the system was reorganized in four tiers: the *Juzgados de lo Social* (Social Courts), the social chambers in the *Tribunales Superiores de Justicia* (Higher Regional Courts of Justice), a social chamber of the *Audiencia Nacional* (National Higher Court), and a social chamber in the Supreme Court. These courts are staffed by professional judges who specialize in employment and social security law. The jurisdiction of the labor courts is comprehensive: it covers every dispute that has as its source, directly or indirectly, the labor relationship. It can be submitted to the labor court by either party. The labor courts apply procedural rules distinct from those of the ordinary courts by virtue of the Labor Procedure Act. This allows the judges greater flexibility and provides that access to the labor courts is free of charge. It also ensures that the judge delivers a decision orally. The purpose is to facilitate workers access to the judicial system and to provide a rapid solution to labor problems.

FRANCE

In France different kinds of labor dispute are heard by different courts. However, our main concern is with disputes arising from the individual contract of employment and these are referred exclusively to the *Conseils du Prud'hommes* (CPH). The CPH has a strictly joint composition: half of their members are elected by employees and half by employers. The individual members are accorded special legal protection from dismissal from their regular jobs. Following compulsory conciliation, which is conducted by the *conselliers* themselves, unresolved cases are adjudicated by the court. It is noteworthy that professional judges are conspicuous by their absence, although the expert court clerk or secretary assists in the drafting of decisions. Appeals may be taken to the ordinary Appeal Court and to the Supreme Court.

UNITED KINGDOM

In the UK disputes over statutory employment rights were processed until 1996 by the Industrial Tribunals (IT) and from then on by the Employment Tribunals (ET). In composition and procedure, the IT (and the ET as well) differ from the ordinary courts. A tribunal has a legally qualified chairman -a lawyer of at least seven years' standing, who is a member of the judiciary. The chairman sits with two lay members, who are drawn from two panels appointed by the Secretary of State for Employment after consultation with employer and employee organizations. All three have equal voting rights. Tripartite composition is also a feature of the Employment Appeal Tribunal (EAT), a superior court of record presided over by a judge, which hears appeals on points of law from the tribunals. With leave there may be further appeals on points of law to the Court of Appeal and ultimately to the House of Lords. The Trade Union Reform and Employment Rights Act 1993 extended the powers of

chairs of tribunals to sit alone in many type of case. The tribunals' method of working, organization and procedures are in principle designed to achieve the goals of cheapness, speed, accessibility and informality. Regional offices are distributed across the country; there are no court fees; litigants' (and their witnesses') cost of travel, subsistence, and loss of earnings are recoverable; the parties may represent themselves; and usually losers (unless they have brought or conducted proceedings frivolously, vexatiously or otherwise unreasonably) do not have to bear winners' costs. The process of making a claim through the completion of a standard form is, moreover, relatively straightforward. The tribunals conduct hearings in a manner they consider appropriate and seek to avoid formality in their proceedings. In addition, they are not bound by any enactment or rule of law relating to the admissibility of evidence in proceedings before courts of law. Moreover, the tribunal rules formally encourage an inquisitorial approach by requiring tribunals to make such inquires of parties and witnesses as they consider appropriate and otherwise conduct hearings in such a manner as they consider appropriate for the clarification of issues and generally to the just handling of proceedings. Until very recently, the ordinary civil courts in the UK had exclusive jurisdiction in respect litigation arising out of breach of the employment contract. This was modified with effect from July 1994 with the introduction of an Order giving tribunals a new jurisdiction over claims in contract for the recovery of damages and other sums that arise or are outstanding on the termination of the claimant's employment. Where proceedings have been brought by the employee by virtue of the Order, the employer may in turn be able to make a counter claim arising or outstanding on termination against the employee for damages or other sums. The ceiling on payments that may be ordered is £25,000 in respect of claims by both employees and employers.

APPENDIX 2: Employment protection legislation for a tenure of 4 years

In this appendix we describe the calculations done to build Table 7. The data used are from OECD Employment Outlook of 1999, Tables 2.2, 2.A.5 and 2.A.6. Some basic assumptions were adopted in order to do the calculations: one week equals 7 days, one and a half weeks equal 10 days, and one month equals 30 days. All values are converted into months. The data on notice period and severance pay for a no-fault individual dismissal of a worker with 4 years of tenure is directly provided in Table 2.2 of the OECD Employment Outlook 1999. In what follows, we specify how we obtained the value for the unfair dismissal compensation, U .

* Italy. Workers in companies employing > 60 employees, or > 15 employees in an establishment compensation of 15 months. For establishments not included in the above cases compensation of 2.5 - 6 months, but up to 10 months for > 10 years of tenure. We have estimated that the total unfair dismissal compensation is the average between the

two cases, around 9.5 months ($15+4/2$). Normal severance pay is payable in addition to compensation. For Italy normal severance pay is F (4.6 months). Therefore, the total unfair dismissal compensation is $(9.5+4.6)$, i.e. 14.1 months. Reinstatement can be ordered by a judge and, therefore, it can be mandatory (see Table 2.2).

* Spain. 45 days per year of tenure (6 months).

* France. Compensation of 6 months minimum for employees with at least 2 years of tenure, and 15 months for 20 years tenure. Since we are looking for the equivalent to 4 years tenure, the amount for the difference (2 years) has been calculated proportionally, i.e. if the difference in 18 years (2 to 20) is 9 months of compensation, for 2 years is going to be just one month. Therefore the total compensation is $(6+1)$, i.e. 7 months.

* United Kingdom. £6,000 (4 months of pay) basic award if 2 years tenure, compensatory award up to £12,000 (8 months of pay) if 20 years of tenure (6 months of pay for 10 years tenure); and special awards. Since we are looking for the equivalent to 4 years tenure, the amount for the difference (2 years) has been calculated proportionally, i.e. if the difference in 18 years (2 to 20) is 4 months of compensation, for 2 years is going to be .45. Therefore the total compensation is $(4+.45)$, i.e. 4.45 months.

APPENDIX 3

[TO BE ADDED]

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