THE IMPACT OF DISMISSAL PROTECTION ON EMPLOYERS' COST OF TERMINATING EMPLOYMENT RELATIONS IN GERMANY: AN OVERVIEW OF EMPIRICAL RESEARCH AND ITS WHITE SPOTS

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I. INTRODUCTION: THE CURRENT DEBATE ON DISMISSAL PROTECTION IN GERMANY AND THE NEED FOR EMPIRICAL RESEARCH

In Germany, the debate about deregulation of employment law, labor market policy, and unemployment has always centered on dismissal protection and its current setting. Until today, dismissal protection law in general, as well as its negative and positive impacts on employment, in particular, are being theoretically analyzed and controversially discussed.

In the political debate, the employment effects of dismissal protection and its potential costs and benefits for workers, firms, and the society as a whole are very prominent, not only in Germany, but in many other countries as well.[1] Supporters argue that the resultant reduction in economic uncertainty for workers enhance job satisfaction, long-term attachment to the job, and thus ease investment in human capital, especially in specific human capital, provide trust, loyalty, and cooperation of workers with and for their firms and thus help to decrease resistance against the introduction of new technologies and to retrain workers.[2] Opponents criticize the significant negative influence of dismissal protection law on firms' recruitment of "risky workers," stating that this law does not only prevent new hires and thus new employment but also results in an increasing rate of structural unemployment in Germany, especially as

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1. *See* ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (OECD), EMPLOYMENT OUTLOOK, CHAPTER 2: EMPLOYMENT PROTECTION AND LABOUR MARKET PERFORMANCE (1999).

2. *See id.* at 68.

groups of applicants with strong dismissal protection are not hired and will thus remain unemployed longer than necessary. Many empirical studies show that there is no overall link between the strictness of employment protection legislation and the level of unemployment, but the structure and dynamics of unemployment seem to be influenced by employment protection legislation.[3] Additionally, personnel managers complain about the resulting restrictions and financial burden on the firm. In times of prosperity, firms therefore try to compensate peak loads by increasing internal functional and/or numerical flexibility, for example by relocations or overtime. In times of economic slowdown, firms use internal numerical flexibility to avoid dismissals and the related cost of dismissal protection law, e.g., changing full-time into part-time contracts. To summarize, one result of the theoretical and political discussions is that dismissal protection law leads firms to refrain from employing additional personnel as well as from dismissing redundant employees, thus stabilizing employment on a medium level during up- and downswings of the economy. Thus, firms develop different HR strategies to achieve the necessary degree of employment flexibility under dismissal protection law and/or to outflank the application of dismissal protection law.[4]

In the theoretical models on which some of the contributions to the discussion are based, employment protection legislation is very often modeled as a tax or a price on employing, hiring, or firing workers.[5] Thus, employment protection legislation is translated into economic prices for certain decisions, and the assumption is that the expected higher cost for terminating employees will lead to fewer recruitment decisions. However, this translation of legal rules into prices is often concentrated on some of the most important aspects of the cost structure, as their focus is on cross country comparisons and the macro level of dismissal protection and effects on unemployment. In effect, the structure of the decisions of workers and firms that the law enhances and the resulting structure of expected cost of dismissals is not fully reflected in the models and in the empirical data.

3. *See id.*

4. *See id.*; Silke Bothfeld & K. Ullmann, *Kündigungsschutz in der betrieblichen Praxis: Nicht Schreckgespenst, sondern Sündenbock*, *in* 5 WSI MITTEILUNGEN (2004); Volker Daiss, *Empirische Ergebnisse zu den Arbeitsrechtsreformen. Das Kündigungsschutzgesetz*, *in* ARBEITSRECHT, PERSONALPOLITIK, WIRKLICHKEIT (Florian Schramm & Ulrich Zachert eds., 2005); Nicole Fischer & Juliane Thiel, *Arbeitsrechtsreformen im Überblick*, *in* ARBEITSRECHT, PERSONALPOLITIK, WIRKLICHKEIT (Florian Schramm & Ulrich Zachert eds., 2005); Elke Jahn, *Der Kündigungsschutz auf dem Prüfstand* (Working Paper No. 138, 2004); P. Janßen, *Arbeitsrecht und unternehmerische Einstellungsbereitschaft*, 2 IW-TRENDS 1 (2004); U. Walwei, *Ökonomische Analyse arbeitsrechtlicher Regelungen*, *in* IAB-KOMPENDIUM ARBEITSMARKT UND BERUFSFORSCHUNG 250 (G. Kleinhenz ed., 2002).

5. For an overview, see, e.g., OECD, *supra* note 1; Sher Verick, *Threshold Effects of Dismissal Protection Legislation in Germany* (IZA Discussion Paper No. 991, 2004).

Many of the cost elements of employment protection rules in Germany do only occur in certain situations, with specific combinations of decisions by employers and employees or for certain types of dismissals. Nevertheless, up to now the knowledge about the probabilities or frequencies of certain cost elements, and their determinants, the typical amount or the range of such costs for firms, the relevance of legal restrictions for concrete decisions and the perception of these rules by decision makers in firms, and thus the empirical relevance of specific cost elements is quite incomplete or very fragmented and scattered in different strands of the literature.

However, during recent years, a couple of large empirical research projects for Germany have aimed at assessing and evaluating the arguments presented in the theoretical discussion and at underpinning the overall theoretical and political arguments with more knowledge about frequencies, amounts, and other details of costs and decisions related to employment protection legislation. Today, the results of these studies are available in many different papers and books, and it is quite difficult to form a coherent picture of all the details. In this paper, we therefore summarize and critically reflect the main empirical results of these studies and point out the "white spots" where more information on dismissal protection would help us to better assess the effects of the current legislation on employers' costs and on employers' HR decisions.

To this end, we review and summarize data from the following research projects:

Figure 1
Research Projects about Dismissal Protection in Germany that are the Main Basis of Our Analysis

Project	Institutional Responsibility/Financing Institution	Project period	Enquiry period	Enquired persons	Enquiry methods	Data source
REGAM Pfarr/Ullmann/ Bradtke/ Schneider/Kimmich /Bothfeld (2005)	"Regulierung des Arbeitsmarkts" (a project on regulation of the labour market) financed by the Institute of Economic and Social Research (WSI) of the Hans Böckler Foundation and conducted by Pfarr and co-workers	07/2002 to 06/2007	2001 to 2003	2.400 persons who finished an employment in the period from September 1999 till November 2000 and still wanted to continue to be employed; 1.997 companies	Quantitative by standardized questionnaires	IAB-Betriebspanel, WSI-enquiry 2001 and WSI-enquiry 2003 (own enquiries)
ARIBA Schramm/Zachert (2005)	"Arbeitsrecht – Personalpolitik – Wirklichkeit" (a project on labour law, personnel policy and reality) conducted by Schramm, Zachert and co-workers at the University of Hamburg, financed by the Hans Böckler Foundation	01/2002 to 2004	12/2002 to 04/2003	54 personnel managers and works councils	Qualitative by interviews with experts	Own enquiry
KÜPRAX Höland/Kahl/Zeibig (2007)	"Kündigungspraxis und Kündigungsschutz im Arbeitsverhältnis" (a project on dismissal practice and dismissal protection in employment relations) conducted by Höland and co-workers from the Martin Luther University Halle-Wittenberg, also financed by the WSI	2003 to 2006	02/2004 to 07/2004	912 judges at 122 labour courts (first level of jurisdiction) and 207 judges at 19 higher labour courts (second level of jurisdiction)	Quantitative by standardized questionnaires ; workshops for judges to discuss the results	Own enquiry
Arbeitsgesetzbuch für eine neue Arbeitswelt Janßen (2004)	A field survey conducted by the "Institut der deutschen Wirtschaft Köln" (IW), which was part of the research project "Arbeitsgesetzbuch für eine neue Arbeitswelt" (labour code for a new world of employment) commissioned by "Initiative Neue Soziale Marktwirtschaft" (INSM)	n.a.	2003	Personnel managers of 859 companies with at least one employee liable for social insurance	Quantitative by standardized questionnaires	Own enquiry

Source: Own design.

The paper is organized as follows: In section II, we present the legal regulations on dismissal protection in Germany. In section III, we summarize and discuss empirical results on dismissal costs related to several steps in the dismissal process, that is, the costs of litigation, the costs of severance payments and the costs of selection by social criteria for redundancy. Section IV concludes and draws some conclusions on research deficits.

II. GERMAN DISMISSAL PROTECTION LAW AND THE ELEMENTS OF COSTS RELATED TO DISMISSAL PROTECTION

The German law on dismissal protection provides for different forms of dismissals that have differing legal preconditions, definitions, and

consequences. It further differentiates between dismissals following a statutory or an extraordinary notice of dismissal:

- By a statutory notice of dismissal, the employer adheres to the contracted period of notice. For these cases, the German law defines three groups of reasons that may be the basis for a legally valid dismissal (see figure 2).
- By an extraordinary notice of dismissal, the employer states a very important reason that makes it unacceptable for him or her to continue the employment any longer.

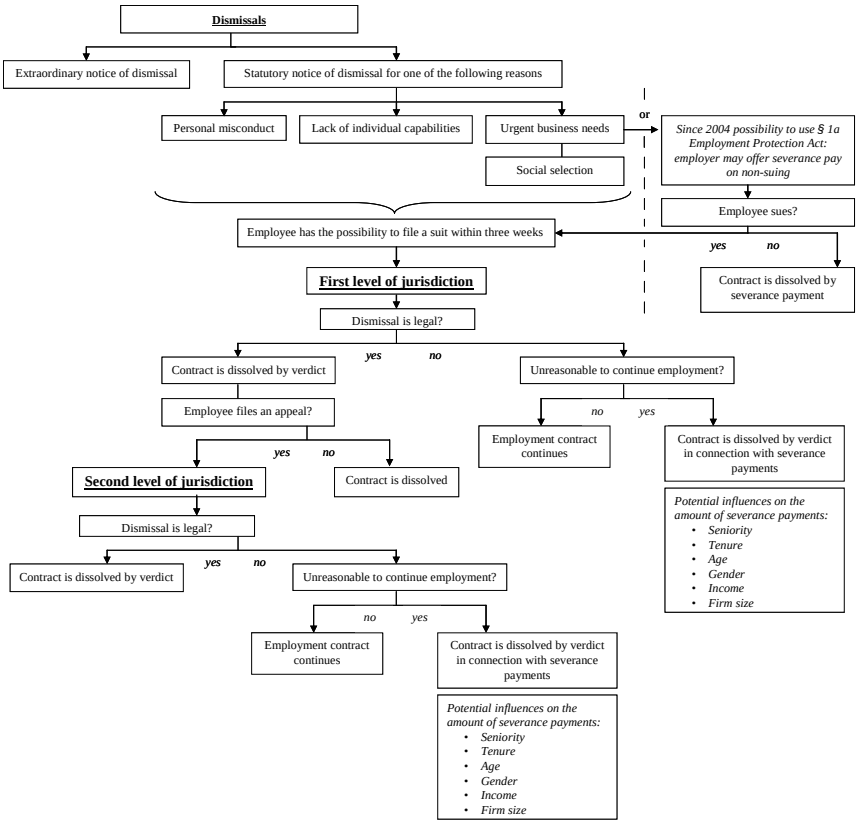
A dismissal is deemed "socially unjust" and thus legally invalid if it was not based on one of the following reasons:[6]

- Personal misconduct (*verhaltensbedingte Kündigung*).
- Lack of individual capability to perform the contracted tasks (including sickness) (*personenbedingte Kündigung*).
- Urgent business needs and compelling operational reasons (*betriebsbedingte Kündigung*).

Thus, there are three groups of reasons that may serve as a basis for a legally valid, statutory dismissal.

6. *See* Laszlo Goerke & Markus Pannenberg, *Severance Pay and the Shadow of the Law: Evidence for West Germany* (DIW Berlin, German Inst. for Econ. Research, Discussion Paper No. 541, 2005).

Figure 2
Decisions and Remedies in German Dismissal Protection Law



Source: Own design.

When employees have been notified of their dismissal and want to take legal action, they may file a suit with the labor court responsible for the respective region within three weeks after notification of the dismissal. During a first hearing, a judge will usually suggest that the conflicting parties reach an agreement prior to judgment. The court may dissolve an otherwise valid employment contract if—given the juridical conflict and its antecedents—continuing the employment would be completely unacceptable, either for the employee or the employer or both. If the contract is dissolved, the court has to award a severance payment. The law only stipulates some basic criteria concerning the amount of severance payment: a maximum amount of twelve months' gross wages in general, increasing up to fifteen months' wages for workers aged at least fifty with a minimum of fifteen years' tenure, and up to eighteen months' wages for

workers aged at least fifty-five years with a minimum of twenty years' tenure.[7]

In fixing the amount of severance pay, courts are expected to take into account the specific aspects of the individual case. However, labor courts often[8] apply a specific rule of thumb (or "formula") according to which severance pay equals the product of a so-called severance pay factor, tenure in years and the last gross monthly wage. This factor is often mentioned to be around 0.5. Severance payments calculated according to this formula would then on average be much lower than the maximum amounts stated in the Dismissal Protection Act.

If the dismissal is based on urgent business needs, there are some special rules and stipulations that are relevant for our topic. First, in these cases there will often be more than one employee who could be dismissed to solve the economic problem underlying the employers' dismissal decision. Employers are required to select the employees to be dismissed from the relevant group in accordance with social criteria—such as age, tenure, alimony obligations, or individual disabilities. Employees out of that group with greater "economic and social strength" on the labor market should be dismissed before those with less "economic and social strength." Whether and how this selection by social criteria affects the personnel structure and performance potential of the employees who stay may constitute an important element of costs for employers.

Second, there exists the right of a works council to negotiate a "social plan" with the employer if the number of dismissals exceeds certain limits in relation to the total number of staff. In the "social plan" compensation for negative impacts of dismissals on employees is defined. A very frequent form of compensation is severance pay for dismissed workers, but other elements, as for example training opportunities or outsourcing workers to other employers, are used as well.

Third, there is another specialty concerning dismissals based on urgent business needs in § 1a Dismissal Protection Act. The employer has the option to offer the employee to be dismissed a severance pay, which is only payable if the latter does not file a suit against the employer within the legally prescribed period of three weeks. The employee can then decide whether to accept this offer or reject it and sue the employer. Thus, the employer can offer to trade off severance pay against the employee's chance to file and win a lawsuit against him or her—which will often result

7. *Id.*

8. Hümmerich finds that 75% of the labor courts use this formula to solve juridical conflicts and calculate severancee pay, while 25% of the courts use other formulas or do not use any formula at all. Klaus Hümmerich, *Die arbeitsgerichtliche Abfindung*, *in* 7 NEUE ZEITSCHRIFT FÜR ARBEITSRECHT 342 (1999).

in a severance pay anyway.[9] For employers, this option may be attractive in order to avoid labor suits, costs in terms of time and effort and uncertainty about the outcome.

Turning to the cost elements of dismissals for employers, it is important to note that German dismissal *law* does *not* stipulate severance pay for any of these forms of dismissals in general, and that dismissals that are not in accordance with the law may become valid nevertheless if employees do not file a suit against them. Therefore, many costs will only arise with a certain probability and depending on certain conditions, but not in general. This has two important consequences. On the one hand, employers will often be uncertain about the effective cost of dismissals and the incidence and result of labor suits, that is, uncertainty and the related negative effects may be a special category of costs. On the other hand, scientists, politicians, and lobbyists may not estimate dismissal costs just by interpreting the law (as is often done), but have to conduct empirical studies to gain knowledge about the frequency of suits and the probability of certain cost elements of dismissals in Germany.

As our description of German dismissal law shows, there are three areas that might be especially interesting to look at. First, the question of how often a labor suit is filed after dismissals is one important element of the probability of several cost elements. Second, the frequency and amount of severance pay constitute important elements of expected costs for employers. Third, restrictions as to which employees or who may be dismissed may have important repercussions on firms and constitute indirect cost regarding the structure and the quality of the remaining personnel.

In the following, we will therefore start by discussing the empirical results on litigation (III.A.), then focus on severance payments and their empirical relevance (III.B.), concluding with empirical results on social selection (III.C.).

III. EMPIRICAL RESULTS ON COST ELEMENTS AND THEIR PROBABILITY

A. Empirical Results on Costs of Litigation

One frequently used argument in the debate about dismissal protection states that the risk of labor suits and their outcomes in terms of severance pay and continuation of employment contracts is very high for firms, that labor suits are very protracted and thus cost intensive and accompanied by

9. *See* IRMGARD KÜFNER-SCHMITT & JOCHEN SCHMITT, KÜNDIGUNGSSCHUTZ. DAS NEUE RECHT NACH DER ARBEITSMARKTREFORM 31 (2004).

considerable uncertainty for employers. Especially small firms would be affected seriously by these aspects.[10]

There are several empirical results on the rate of employees who file a suit after dismissal: In 1978, in a comparatively favorable overall economic situation, the suing rate was approximately 8%. Later on, in much less favorable economic conditions, Höland et al. found a rate of between 10–15%. In the WSI survey (2001) on the termination of employment relations, 11% of all employees filed a suit against dismissal.[11] A second survey a few years later, the WSI survey (2003) on personnel policy, showed an average suing rate of 15%. Although the comparatively small difference between these two results is within the range of statistical errors, it is compatible with an interpretation stating that the suing rate is related negatively with the economic situation and the level of unemployment—the worse the labor market situation for employees and the lower the probability of finding a new job after dismissal, the higher the probability of suits being filed.[12] Accordingly, the order situation of the employing firm and the employment trend with the current employer—as indicators of the general economic situation—have a negative influence on this rate. The existence of a works council is related positively with the suing rate, which may be interpreted as a result of the legal advice given by the works council, e.g., regarding employees' rights, duties, and periods of notice under German labor law or regarding the prospect of success in a potential labor suit.[13]

However, behind these average suing rates differing suing rates for different kinds of dismissals may be found. Results from the REGAM project show that the probability that employees file a suit is higher for dismissal due to reasons related to the person or conduct (11.7%) than for dismissal based on urgent business needs (9.5%).[14] The KÜPRAX project team reports that only 10–14% of all dismissals non-statutory dismissals. However, in 2003, 28% of suits were filed against non-statutory dismissals. Additionally, while 96% of all dismissals were based on urgent business needs and 84% of all those based on reasons related in the person of the

10. *See* Jahn, *supra* note 4.

11. *See* Armin Höland et al., *Recht und Wirklichkeit der Kündigung von Arbeitsverhältnissen - Erst Erkenntnisse aus der Forschung*, *in* 3 WSI MITTEILUNGEN 145 (2004).

12. *See* HEIDE PFARR ET AL., DER KÜNDIGUNGSSCHUTZ ZWISCHEN WAHRNEHMUNG UND WIRKLICHKEIT: BETRIEBLICHE ERFAHRUNGEN MIT DER BEENDIGUNG VON ARBEITSVERHÄLTNISSEN (2005); H. Bielenski & K. Ullmann, *Arbeitgeberkündigungen und Klagequote*, *in* 10 BUNDESARBEITSBLATT 4 (2005); M. Bradtke & H. Pfarr, *Belastet des Arbeitsrecht kleine und mittelgroße Unternehmen?*, *in* 85 WIRTSCHAFTSDIENST, ZEITSCHRIFT FÜR WIRTSCHAFTSPOLITIK 1 (2005).

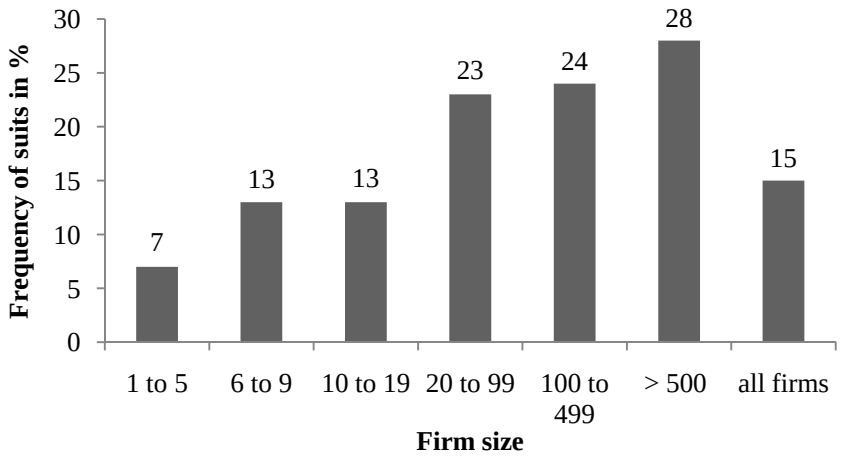
13. *See* PFARR ET AL., *supra* note 12; Heide Pfarr et al., *REGAM-Studie: Die Kündigungs-, Klage- und Abfindungspraxis in den Betrieben*, *in* 2 BETRIEBS-BERATER 106 (2004).

14. *See* Bothfeld & Ullmann, *supra* note 4, at 264.

employee were statutory dismissals, nearly three quarters (74%) of all dismissals based on conduct were non-statutory dismissals. Thus, the probability that employees file a suit seems to be higher after a non-statutory dismissal or one based on reasons related to conduct than after other kinds of dismissals, and these two effects may even interact with each other.[15]

Looking at differing types of firms, some descriptive empirical data on suing rates indicate that the hypothesis that small firms are affected more seriously than larger ones, which figures prominently in the political debate, is not very well supported—at least as long as we talk about suing rates and not about the resulting costs and effects on the firms. Instead, the suing rate increases with firm size (see Chart 1).

Chart 1
Frequency of Suits against Dismissals for differing Firm Sizes (in Per Cent of All Dismissals in the respective category 1998–2003)



Source: Own design; data from Pfarr, Ullmann, Bradtke, Schneider, Kimmich & Bothfeld, *supra* note 11, at 60.

While in firms with twenty or more employees, approximately one quarter of all those dismissed filed a suit against their employer, only 13% or less

15. *See* Armin Höland, Ute Kahl & Nadine Zeibig, *Kündigungspraxis und Kündigungsschutz im Arbeitsverhältnis, Eine empirische Praxisuntersuchung aus Sicht des arbeitsgerichtlichen Verfahrens*, 66 SCHRIFTEN DER HANS-BÖCKLER-STIFTUNG 77 (2007).

of all employees did so in firms with less than twenty employees. However, firm size and the frequency of works councils are related positively with each other.

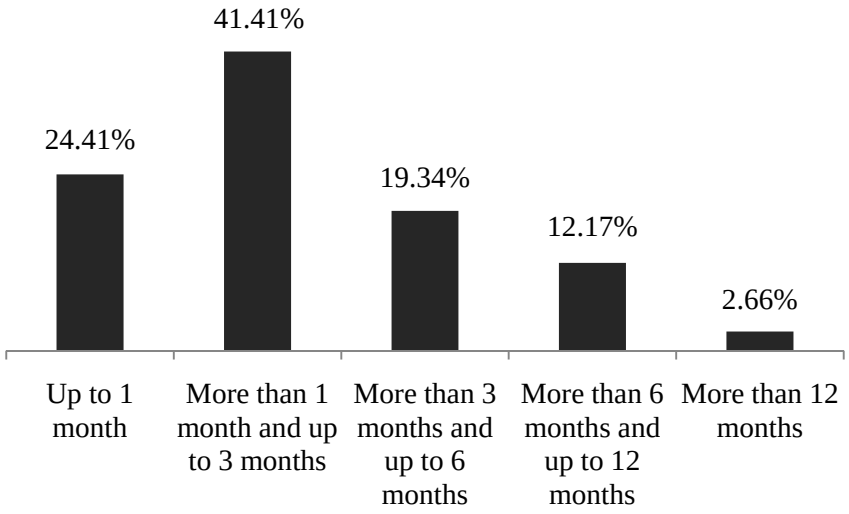
Concerning the length of labor court suits and the risk for firms that they may have to pay retrospective wages should the court decide that a dismissal was invalid, there are some hints from the statistics of labor jurisdiction by the Federal Ministry of Labor and Social Affairs that there is indeed a risk, but that this is not as high as is often argued in the political debate: a few years ago two-thirds of suits were terminated after three months. Only 2% lasted more than one year, and only in 3% of all cases the party that wasn't favored by the verdict turned to the next higher juridical authority.[16] In 2003, nearly two-thirds (64%) of all suits on the first or lowest level of jurisdiction (*Arbeitsgericht*) were terminated within the first three months. Only 3% of the suits were transferred to the next higher level of jurisdiction (*Landesarbeitsgericht*) where nearly one-third of all suits was decided upon within three months. Employers had to pay retrospective wages in around 2–6% of all dismissals.[17]

Our own calculations from the official statistics of the ministry of labor pretty much confirm these findings concerning the duration of labor court files for the recent years 2002 to 2007:

16. *See* PFARR ET AL., *supra* note 12, at 45.

17. *See* Höland, Kahl & Zeibig, *supra* note 15, at 197; Armin Höland, *Ein Beitrag zum inneren Frieden*, 9 BÖCKLERIMPULS 1 (2005).

Figure 3
Duration of Labour Court Files Concerning Dismissal Protection in Germany (2002 to 2007)

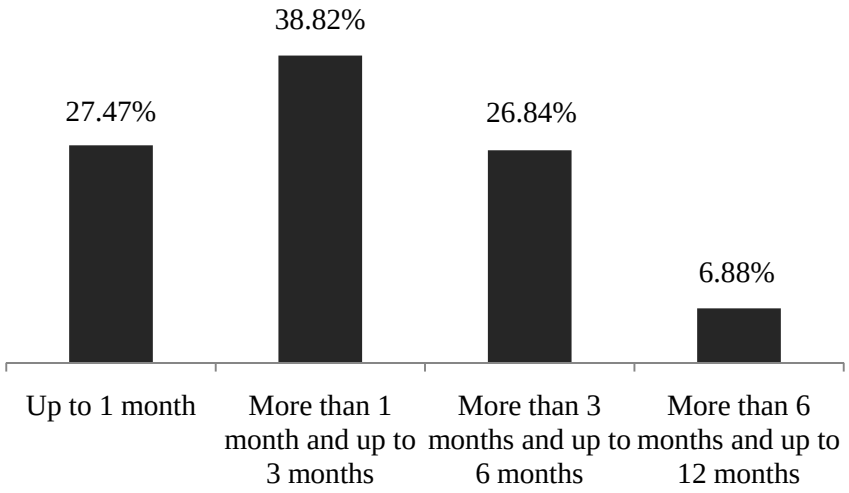


Source: Own Design and Calculation, data from *Ergebnisse der Statistik der Arbeitsgerichtsbarkeit 2002–2007*, BUNDESMINISTERIUM FÜR ARBEIT UND SOZIALES, *available at* http://www.bmas.de/portal/16702/startseite.html.

While 2.66% of all labor court files concerning dismissal protection do indeed endure for more than twelve months, the large majority of cases is finished much faster: nearly one quarter of the files in the years 2002 to 2007 lasted only up to one month, and another 41% were finished in a time span between a one and three month duration. All in all, more than 80% of all the cases have come to an end within half a year.

Looking at the second level of jurisdiction only, we get a similar picture: While nearly 30% of the suits on the second level of jurisdiction are finished within the first three months, and another nearly 40% ended within a time span of between three and up to six months, roughly one quarter ended between six and twelve months and a minority of roughly 7% took more than twelve months.

Figure 4
Duration of Suits on the Second Level of Labour Court Jurisdiction (Landesarbeitsgerichte) in Germany (2002 to 2007)



Source: Own design and calculations; data from *Ergebnisse der Statistik der Arbeitsgerichtsbarkeit 2002–2007*, BUNDESMINISTERIUM FÜR ARBEIT UND SOZIALES, *available at* http://www.bmas.de/portal/16702/startseite.html.

Summing up, the empirical results show quite clearly that the employers' risk to be sued and to be exposed to lengthy and unpredictable suits does indeed exist, but it is obviously much lower than has been suggested by some contributions to the political debate. However, one question that remains unanswered is whether these opinions and statements in the political debates should best be interpreted as indicators of strong lobbyism, or whether—and if so why—decision makers in firms perceive a higher risk than actually exists. As far as we know, none of the empirical research projects has so far produced answers to this question, and it would be difficult to differentiate between these aspects in empirical research anyway. One possible interpretation is that firms that have been sued and were involved in lengthy litigation or high retrospective wage payments remember these negative experiences much more intensely than other firms whose experience was neither particularly good nor bad. If so, negative experiences would affect the public debate much more than average or positive experiences due to distortions in the human capacity to remember.

A second question also remains unanswered. So far, we have only very sparse information on *who* files a suit and who does not. We know that nearly two-thirds (64%) of employees who filed a suit were male; but

this statement is very unspecific as 58% of those who were dismissed were males, too.[18] Frick and Schneider show empirically that the frequency of suing increases with the unemployment rate.[19] Neubäumer argues that besides the labor market situation, union membership, a higher-than-average wage and high seniority increase the suing probability.[20] It would be interesting to know whether employees with high or low performance records with or without strong alimony obligations to support dependent family members, young or old employees, employees after a strong conflict with the employer or employees who have been laid off without such conflict, and so on, are more likely to sue their employer, and how these personal characteristics or structural determinants possibly interact with the kind of dismissal or other aspects that can be influenced—at least partially—by the employer. Such information could help employers to calculate and potentially influence the risk of being sued much better than at present, and it might also help researchers to better understand the probability of juridical conflicts after dismissal. Some tentative qualitative research results by one of the authors of this paper hint at the possibility that underperforming employees may have a much higher probability to sue their employer than those with high potential or good performance records. This effect could be due to fewer chances on the labor market and a lower risk of damaging a good reputation by filing a suit against their employer for the former group.

B. Empirical Results on Costs of Severance Pay

In his 2004 IW study, Janßen reports that 87% of the firms stated that a legal suit about dismissal protection was a financial risk that is difficult to calculate. Therefore, we should look at the cost elements of such suits.[21]

One central cost element of dismissal suits is severance pay. As there is no legally fixed severance pay after any kind of dismissal, but regulations specifying differing conditions under which a dismissal may result in severance pay, the incidence and the amount of severance pay are, in turn, relevant both for the question of how high expected cost of dismissals are and the potential employment effects that result from such costs.

18. *See* PFARR ET AL., *supra* note 12; Bielenski & Ullmann, *supra* note 12; Bradtke & Pfarr, *supra* note 12.

19. *See* Bernd Frick & Martin Schneider, *Zunehmende Konfliktregelung durch Arbeitsgerichte? Eine ökonomische Analyse der Häufigkeit von Kündigungsschutzprozessen, in* ENTLOHNUNG UND ARBEITSZEITGESTALTUNG IM RAHMEN BETRIEBLICHER PERSONALPOLITIK (U. Backes-Gellner, M. Kräkel & C. Grund eds., 1999).

20. *See* Renate Neubäumer, *Mehr Beschäftigung durch weniger Kündigungsschutz?*, 87 WIRTSCHAFTSDIENST 3 (2007).

21. *See* Janßen, *supra* note 4, at 2.

Starting with the incidence of severance pay, there are several results. The REGAM project reports that severance pay was paid in 10% of all terminations of employment contracts.[22] Goerke and Pannenberg calculated that during the period 1991 to 2003, an average of 12% of employees who were dismissed received severance pay.[23]

The probability of receiving severance pay in individual cases may fluctuate around these average data due to several factors: First, the kind of termination of employment relations seems to play an important role. Data from the REGAM project indicate that severance payment occurred in 15% of all dismissals and in more than one-third (34%) of all mutually agreed terminations of employment contracts. As for the types of dismissals, severance payment occurred in 17% of all dismissals based on urgent business needs (which are often accompanied by a social plan), but in less than 10% of dismissals on account of person-related reasons or the conduct of the employee. Forty percent of all incidences of severance payment were linked to a social plan and thus to a dismissal based on urgent business needs.[24]

Second, firm size may also have an influence. In the smallest category of firms, severance payment occurred only in 3% of all terminations of employment contracts, whereas in larger firms with 200 to 500 (firms with more than 500) employees the respective figure was 15% (25%) of all terminations.[25]

Third, firm size may interact with the success of employees who file a suit to obtain severance payment. On average, 47% of all dismissed employees who filed a suit obtained a payment, in contrast to only 15% of all those who filed no suit after dismissal. However, the success of filing a suit in terms of obtaining a severance payment seems to differ with respect to firm size: while only 25% of all employees of the smallest category of firms who filed a suit obtained such a payment, the corresponding figure for employees of firms with up to forty-nine employees (firms with fifty or more employees) was 46% (68%).[26]

Fourth, there are individual factors that may influence the probability of obtaining severance payment. The KÜPRAX project reports that employees with higher seniority and income are more likely to receive such a payment than those with lower seniority.[27] Only 2% of employees who

22. *See* Andreas Peuker & Karen Ullmann, *Kündigungsschutz unter Druck: Zurück zur Realität, Empirische Daten zu Beendigungen von Arbeitsverhältnissen*, 5 ARBEITSRECHT IM BETRIEB 261 (2003).

23. *See* Goerke & Pannenberg, *supra* note 6.

24. *See* PFARR ET AL., *supra* note 12.

25. *Id.*

26. *Id.*

27. *See* Höland, Kahl & Zeibig, *supra* note 15.

were employed for less than two years received severance pay. For employees with more than twenty years of seniority the respective figure was 51%, showing that even for long-term employees severance payment is not a matter of course.[28] Additionally, the gender of the employee influences this probability. The REGAM data show that 11% of dismissed male employees received severance payment, while only 8% of dismissed female employees did. One interpretation—besides plain discrimination—is that female employees often earn less than male employees, have shorter seniority and work part-time or have fixed-term contracts only. As such factors influence the incidence of severance pay, they may (partially) explain the lower probability of severance pay for women.[29]

Turning to the factors that influence the amount of severance payment or the level of jurisdiction on which it was awarded, we can again use results from the REGAM and KÜPRAX projects.

Concerning seniority as a factor affecting the amount of severance pay, the REGAM project reports that in those cases where courts were involved in the negotiation of severance pay, seniority influenced the actual amount more than expected if the rule of thumb was strictly applied.[30] Although on average severance pay seemed to be calculated with respect to the rule of thumb in the majority of the cases, there was a tendency to lower severance pay for employees with short seniority and to higher severance pay for those with long seniority.[31]

Based on the analysis of court records of 2003, the authors of the KÜPRAX project state that on the first level of jurisdiction, severance pay that was negotiated during litigation amounted on average to 0.57 monthly gross wages per year of seniority. Thus, the result on this level of jurisdiction is pretty much in coincidence with the severance pay formulas, although the average amount is slightly higher than the factor 0.5. However, on the second level of jurisdiction, the respective amount is 0.89 monthly gross wages per year of seniority. Thus, both average values exceed the value of 0.5 monthly gross wages that is included in § 1a Dismissal Protection Act. The aim of legislation to stop employees from suing their employers by giving them the right to a severance payment without suing may therefore be thwarted by detrimental incentives for single employees: suing may result in higher average severance payment than non-suing.[32] However, as the difference in the expected amount of payments is quite small on the first level of jurisdiction, and only 3% of all

28. *See* PFARR ET AL., *supra* note 12.
29. *See id.* at 71.
30. *See id.*; Bradtke & Pfarr, *supra* note 12.
31. *See* PFARR ET AL., *supra* note 12, at 74.
32. *See* Höland, Kahl & Zeibig, *supra* note 15, at 161.

cases are transferred to the second level of jurisdiction, and as we do not know how well informed employees are about these differences, it is not clear whether the difference in expected payments is large enough to compensate for the cost of suing the employer.

How the two results relate to each other is an open question. Possibly, there are selection effects, such that a higher proportion of cases with certain characteristics increasing the payment, for example involving high seniority, are transferred to the second level of jurisdiction. However, as we do not have valid information on the individual characteristics of employees who sue their employer and whose suits are transferred to the second level of jurisdiction, we may only speculate about this aspect.

Besides seniority, other factors influence the amount of severance pay as well. The analysis of Fabel, Welzmiller, and Chrubasik shows that in 98% of all social plans severance payment is differentiated by seniority of dismissed employees; in 80%, age is used as one criterion among others, and in 70%, income plays a role.[33] Grund, using SOEP data, reports that the amount of severance pay and the probability of obtaining it increase with seniority and firm size.[34] The KÜPRAX project reports that in 71% (first level of jurisdiction) and 82% (second level of jurisdiction) of cases that went to court the success probability of the parties was decisive for the amount of payment, while gross monthly wages and seniority of employees followed behind but played a major role in between 60–70% of all cases on both levels or jurisdiction. Payments increased significantly with the size of the employer firm.[35]

With respect to other individual factors besides income and seniority, the amount of severance payment differs by gender. Not only do women have a lower probability to receive severance pay, but if they do, the average amount they receive is on average lower than for their male colleagues. Again, this may be due to other factors in correlation with gender or due to discrimination. Without further analysis of individual data this question cannot be answered.

The data do not contain any information on the effect of § 1a Dismissal Protection Act as this paragraph was included in the Act and became valid only in 2004—after the research projects had collected their data.

33. *See* Oliver Fabel, Steffen Welzmiller & Peter Chrubasik, *Severance pay in Germany: A contract perspective*, *in* LAW AND ECONOMICS AND THE LABOUR MARKET 185 (Gerrit De Geest ed., 1999).

34. *See* Christian Grund, *Severance Payments for Dismissed Employees in Germany* (German Econ. Ass'n of Bus. Admin., Discussion Paper No. 04-26, 2004). *See also* STEFAN HARDEGE & EDGAR SCHMITZ, DIE KOSTEN DES KÜNDIGUNGSSCHUTZES IN DEUTSCHLAND 31 (2008).

35. *See* Höland, Kahl & Zeibig, *supra* note 15, at 156, 175.

However, we can deduct some probable effects. Without the employers' offer of severance payment, roughly 10% of the employees file a suit against dismissal based on urgent business needs, and about 50% of them are awarded a severance payment, calculated, on average, by the rule of thumb, that is, half of a monthly wage per year of seniority. Thus, if the employer does not offer severance pay, the expected monetary cost of severance pay is 0.1 x 0.5 x 0.5 x years of seniority x monthly wage, or 0.025 monthly wages per year of seniority, plus the legal cost of the suit for the employer. Instead, if the employer offers severance pay and the employee does not sue, he has to pay a minimum of 0.5 monthly wages per year of seniority. Thus, if the suing probability is zero under the offer, offering severance pay pays for the employer only if the expected cost of the suit (without severance pay) is higher than 0.475 monthly wages per year of seniority—if the offer is accepted by the employees with a 100% probability. For example, a monthly wage of € 4,000 and a five year seniority would indicate that expected legal cost would have to be higher than € 9,500 as otherwise offering severance pay would not be profitable for the employer if the probability of litigation is zero under the offer.

However, so far we do not know how offered severance pay under § 1a Dismissal Protection Act changes the probability that employees sue their employer. On the one hand, many employees may do so to increase their chances to obtain severance pay. In this case, an offer of severance pay should decrease the probability that employees sue their employer. On the other hand, an offer of severance pay could be interpreted as a signal that the employer tries to "buy off" dismissal protection because he or she fears the dismissal might be found invalid if reviewed by a court. If this interpretation prevails among employees, the probability that they sue their employer even though offered severance pay might even increase compared to when no such offer is made. Thus, an offer of severance pay may change the employer's probability of being sued—and thus the probability of having to pay severance pay instead of incurring other costs for legal action—either way, and it remains unclear whether, and under what conditions, it is profitable for the employer to offer severance pay under § 1a of the Dismissal Protection Act. Most probably, this newly added paragraph will therefore increase perceived uncertainty due to the complexity of the decision structure the law enhances.

Thus, to summarize, it can be said that the probability that firms will have to make a severance payment after dismissing employees is not too high. In light of the available data, about one-third of employees whose employment relations are terminated after a mutual agreement receive severance pay, while "only" 15% of all dismissed employees receive some payment at all. Larger firms have a higher probability of being liable to pay

severance payments, while for smaller firms the probability is much lower. Filing a suit increases the employees' prospect of obtaining severance pay to nearly 50%, but it obviously does not necessarily increase its amount. The effect of employers offering severance pay under § 1a of the Dismissal Protection Act on the probability of employees suing the former, and thus on their cost structures after the termination of an employment relation, is not at all clear. Here again, it is obvious that more information on who files a suit under what conditions would also deepen our knowledge on who obtains severance pay. Thus, individual data on the kind of employees who sue their employers and what differentiates these persons from non-suing employees would be most valuable.

C. Empirical Results on Costs of Social Criteria for Redundancy

As already mentioned, for dismissals based on urgent business needs the selection of employees to be dismissed has to follow social criteria such that the employee with the highest social strength has to be dismissed before other employees. At the beginning of 2004, the law specified these criteria as tenure, age, degree of disability, and alimony obligations, while prior to 2004 the law contained only a general clause that "social aspects" had to be considered in making a selection for dismissal.

Two different aspects could be relevant for employers' cost in this respect: First of all, if courts often correct employers' social selection ex post and declare dismissals invalid for reasons of incorrect social selection (which may additionally result in high ex post wage payments by employers), the cost and the uncertainty of employers about the results of lawsuits and the ensuing amount of payments could be negative factors in the perception of dismissal protection law and have negative repercussions on the readiness to recruit and employ new personnel.

Second, if social selection results in dismissals of high-potential employees, while employees with lower potential or motivation to perform stay within the firm, this could negatively affect the firm's personnel structure and become another cost element for employers.

Let us first discuss the question whether social selection causes high uncertainty regarding incorrect dismissals and an ex post revision by the courts. Please note that this problem can only occur after dismissals based on urgent business needs, as the law stipulates social selection only for this type of dismissal. Thus, the number and proportion of dismissals based on urgent business needs hints at the potential magnitude of these problems.

In the WSI study on the termination of employment relations, Pfarr et al. report that 65% of the approximately two million employer dismissals they analyzed were based on urgent business needs, 5% on person-related

reasons, and 7% on reasons related to the employee's conduct.[36] Twenty-three per cent of the dismissals could not be classified into any of the categories, for example, because the employer stated no, or more than one, reason for the dismissal. An earlier WSI study on personnel policy in 2003 produced a related result: two-thirds of the firms that had issued notices of dismissal within the last five years before the study stated they had some experiences with dismissals based on urgent business needs.[37]

The share of dismissals based on urgent business needs decreases with firm size. While firms with up to 200 employees stated that 66% of their dismissals were based on urgent business needs, for firms with more than 200 and up to 500 employees the figures were 57%, and for firms with 500 or more employees 47%, respectively.[38] The higher capacity of large firms to absorb financial shocks as well as the better monitoring capacities of small firms that will decrease the share for other reasons than urgent business needs will have some part in explaining this result.

Another important aspect is whether and what kind of problems firms confront regarding dismissals based on urgent business needs. In the WSI study (2003) on personnel policy, only 24% of the firms stated they had no problems with the implementation of dismissals based on urgent business needs, while the large majority of firms did have problems. Surprisingly, very small and small firms with up to nineteen employees stated more frequently than larger firms that they did not have any problems.[39]

While around one-third of all firms, both small and large, reported having problems with correctly defining and proving the reason of urgent business needs for dismissals, there were some differences mentioned with respect to firm size concerning other aspects. Compared to larger firms, only a smaller fraction of small firms indicated problems with making the correct social selection,[40] but a higher proportion of small firms reported problems following the loss of high-potential employees. In the IW study

36. *See* PFARR ET AL., *supra* note 12, at 51; Hartmut Bielenski et al., *Die Beendigung von Arbeitsverhältnissen: Wahrnehmung und Wirklichkeit, Neue empirische Befunde über Formen, Ablauf und soziale Folgewirkungen*, *in* 3 ARBEIT UND RECHT 81, 86 (2003); Heidi Pfarr et al., *Projekt Regulierung des Arbeitsmarktes (REGAM), Verhindert das Kündigungsschutzgesetz Kündigungen?*, 2004, *available at* http://www.boeckler.de/pdf/wsi_regam_kuendigungen.pdf.

37. *See* H. Pfarr et al., *Projekt Regulierung des Arbeitsmarktes (REGAM), Kündigungen, Abfindungen, Kündigungsschutzklagen – Wie sieht die Praxis aus?*, 2004, at 4, *available at* http://www.boeckler.de/pdf/wsi_regam_kuendigung_praxis.pdf; Hartmut Seifert & Harald Bielenski, *Lebhafte Bewegung am Arbeitsmarkt*, 3 MITBESTIMMUNG 26, 27 (2003).

38. *See* PFARR ET AL., *supra* note 12, at 51; Bielenski et al., *supra* note 36, at 86; Pfarr et al., *supra* note 36.

39. *See* PFARR ET AL., *supra* note 12, at 56.

40. *See id.* at 57.

by Janßen, about 80% of the firms stated that dismissals during an internal economic crisis frequently resulted in the loss of such employees.[41]

The fact that small firms seem to have more problems with the loss of high-performing employees, but fewer problems with social selection, could be a direct result of the smaller number of employees. Losing one high-performing employee out of a total of, say, ten, may have much more serious consequences for the performance level of the firm in general than losing one high-performing employee out of, say, 2,000 employees. On the other hand, as the number of employees from which the person to be dismissed has to be selected is much smaller in small firms—often consisting of only one employee—selection in the sense of comparing employees with respect to the relevant criteria involves fewer persons and will thus be much easier or even superfluous.

Daiss, on the basis of qualitative interviews of the ARIBA project, concluded that social selection is a factor of considerable uncertainty for firms. The experts interviewed stated that dismissals, even if prepared and implemented very carefully, always implied some risk of a "faulty" evaluation of social data and an ex post revision of social selection (and thus of dismissals) by the courts. However, only seventeen of the interviewees had personal experiences with dismissals based on urgent business needs in their current employer firms; therefore, there may be some political bias in these statements.[42]

Authors from the ARIBA project report more results on social selection. Obviously, the case of social selection implemented in the full sense of the law does not prevail in firms. Only five firms stated that they applied the correct social selection intended by the law.[43] Seven experts answered in a way that implied an incorrect social selection, and four HR managers stated that they applied other social criteria besides age, tenure, alimony obligations, and disabilities.

However, results of the KÜPRAX project, in which the court records of a large number of cases were analyzed, point in a somewhat different direction: Höland et al. report that in the majority of cases social selection was applied if it was legally required.[44] While these results may be more reliable due both to the higher number of cases analyzed and the differing method (analysis of court records in contrast to interviews), there may, at the same time, be some distortion owing to the fact that Höland et al. analyzed only cases that went to court, while Schramm et al. did not restrict

41. *See* Janßen, *supra* note 4, at 11.
42. *See* Daiss, *supra* note 4.
43. *See id.* at 137.
44. *See* Höland, Kahl & Zeibig, *supra* note 15, at 118.

their questions to such cases.[45] Maybe firms apply social selection more carefully if they perceive a higher probability of being sued, for example in larger firms.

Thus, summing up what we know so far, it can be stated that a considerable share of dismissals is based on urgent business needs and that firms do report problems with social selection, although proving urgent business needs might be an even higher obstacle to a legally valid dismissal than social selection.

So far we have not discussed the probability that a suit is filed and the employer loses the court case—a factor that also influences the expected costs of employers. There are some relevant data available. Höland et al. of the KÜPRAX project report that suits were filed in 10% of all dismissals based on urgent business needs, and in 12% of all other dismissals.[46] With reference to the suits filed against dismissals based on urgent business needs, employers did not succeed in 55% of the cases on the first level of jurisdiction and in 46% in the second.[47] Thus, weighing the probabilities of being sued and/or of losing the case, we can state that employers have a high probability (about 95%) of success regarding the dismissals based on urgent business needs. They lost their case in only about 5–6% of all dismissals based on urgent business needs.

What are the reasons when employers do not succeed in court? According to the judgment of the judges who analyzed the cases of the KÜPRAX project, the most frequent reason (66%) for not succeeding was the non-existence of urgent business needs, although the dismissal was ostensibly based on such needs. This relates well to statements of the firms, indicating that many of them had problems proving urgent business needs. The second most frequent reason was an invalid or non-existent social selection in cases where it would have been necessary. The third most frequent reason, concerning 19% of the lawsuits lost, was a non-existent or invalid consultation of the works council.[48]

On the positive side, the social selection procedure was confirmed in 41% of the cases on the first level of jurisdiction and upheld in 39% of the cases on the second. Only in 18% of the cases on the first level (12% of the cases on the second level) the courts stated that no social selection had been

45. *See* ARBEITSRECHT – PERSONALPOLITIK – WIRKLICHKEIT. EINE EMPIRISCHE ANALYSE ZUR BETRIEBLICHEN UMSETZUNG VON ARBEITSRECHTSREFORMEN, Schriften der Hans Böckler-Stiftung 58 (Florian Schramm & Ulrich Zachert eds., 2005).

46. *See* Höland, Kahl & Zeibig, *supra* note 15, at 113.

47. *See id.* at 114.

48. *See id.* 114–18.

made where this would have been legally required. Obviously, the majority of the employers sued had correctly implemented social selection.[49]

The judges analyzing these cases found social selection to be invalid in only 22% (19%) of the cases on the first (second) level of jurisdiction. In 63% (68%) of the cases heard on the first (second) level, the criteria applied in social selection did not render invalid the dismissals based on urgent business needs. Only in 8% of the cases on both levels of jurisdiction did an employer lose its case because of an incorrect social selection.[50] Thus, (incorrect) social selection is not a frequent reason for invalid dismissals—an empirical result that is in stark contrast to the political debate, where a frequently made argument concerns the high error-proneness of social selection and the resulting uncertainty about its validity.

Data are also available on the criteria employers applied in social selection. Up to 2004, the law did not stipulate specific criteria but obliged employers to consider "social aspects" in selecting for dismissals. Thus, employers were more flexible as to which criteria they could use than nowadays. Results of the KÜPRAX project show that these criteria were seniority (in 90% of the cases on the first level of jurisdiction, in 87% of the cases on the second), age (88% on the first level, 81% on the second) and alimony obligations (80% on the first level, 77% on the second), reflecting a relatively high compliance with the law as it now stands. However, disability as a criterion was put forward in only 14% of cases on the first and 13% on the second level of jurisdiction, indicating a strong deviation from the law in its present form. Besides the criteria explicitly mentioned in the present law, the marital status influenced social selection in 37% (42%) of the cases on the first (second) level, and income of the spouse in 9% (13%) of the cases on the first (second) level of jurisdiction.[51] Thus, it seems implausible that major problems with social selection result from the specific formulation of the law since 2004 because no big difference exists between employers' actions before the amendment and the situation postulated by the law nowadays. At any rate, an increase in the problems with social selection would deviate from the legislators' aim as the amendment was implemented to reduce the error-proneness and the problems of employers with social selection.

Another, potentially major problem of social selection for employers could be the loss of high-performing employees as a consequence of the Act. Thus, in his study Janßen reports that 80% of the firms state that in some cases high-performing employees had to be dismissed before other

49. *See id.* at 117.
50. *See id.* at 122–23.
51. *See id.* at 119.

employees due to the social selection criteria specified in the law.[52] Whether or not these statements are supported by facts cannot be analyzed because individual empirical data on the performance and innovativeness of the employees selected for dismissal in this way under the Dismissal Protection Act are still lacking. Thus, a very important aspect of the Act and its consequences for firms in this respect cannot be evaluated as yet.

IV. CONCLUSIONS: THE URGENT NEED FOR FURTHER EMPIRICAL RESEARCH

From this overview of the results of some large empirical projects on the German Dismissal Protection Act, it is quite evident that there is a lack of individual data on a number of questions raised by dismissal protection. To a lesser degree, this is also true of some collective data and data on employers and their activities.

The cost of dismissal protection for employers and for the society as a whole cannot be evaluated correctly up to now, because a number of empirical data are still lacking. Thus, the individual employees' decision about filing a suit and the individual characteristics of employees who had to be selected for dismissal under the social selection procedure are white spots on the map of our knowledge about dismissal protection and its cost for the different groups. For many political debates in Germany and for the question of which effects labor law has and how this law could potentially be improved by designing legal rules that result in a lesser amount of cost a valid basis in empirical data is thus still lacking.

This deficit in individual data is especially obvious both with respect to social selection and the probability of suits being filed:

- Who are the high-performing employees in the firms and what are their individual characteristics?
- Who are the employees dismissed as a result of social selection—high-performing employees or other groups? How may employers use the exception clause to keep high-performing employees in their firm?
- Who are the employees who file a suit against their employer?
- Who are the employees whose suit is transferred to the second level of jurisdiction?
- How is the probability of a suit being filed changed by an offer of severance pay under § 1a Dismissal Protection Act?

52. *See* Janßen, *supra* note 4.

Gathering and analyzing data on these aspects would greatly help to disentangle the consequences of dismissal protection for both firms and employees.

In general, our analysis for the specific case of German dismissal protection law shows very clearly that the costs of a specific legal rule or a law cannot be estimated by looking at the respective law in isolation. Instead, many other factors influence these costs, for example the perception of law and the knowledge of individuals about their rights, the individual estimations about success and failure probabilities in court files and incentives as well as the individual characteristics of the groups affected by the respective rule have to be taken into account. Both theoretical and empirical analyses that aim at evaluating consequences of law, e.g. for employers or for society as a whole, should those encompass these elements whenever possible.