

The Impact of the German Job Protection Legislation on Job Creation in Small enterprises

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One of the proposals most frequently raised to increase flexibility of the German labour market is the liberalization of the job protection law (Kündigungsschutzgesetz).

It applies only to those firms employing a more than a cut-off number of employees. Thus, firms just above the cut-off face considerably higher adjustment costs in times of lower demand for labour than their competitors with a firm size lower than this number. An argument produced in the discussion is that this step in legal regulation hinders small firms from growing beyond this cut -off number.

It is the aim of the paper to evaluate whether this hypothesis concerning the threshold in job protection laws and its effect on job creation in small enterprises can be confirmed by empirical analysis.

The basis for estimating the treatment effect of being close to the cut-off number in employment protection is a change in the cut-off number in the year 1996. By that time the cut-off number was raised to ten employees releasing small firms between five and ten full-time workers from coverage by the law. The evaluation approach is a Regression Discontinuity Design using the change in legislation as a natural experiment. The local treatment effect can then be estimated non-parametrically. The method used is a local linear regression recently proposed by Hahn, Todd, Van der Klaauw (2001).

The data base used is the 1997 wave of the IAB establishment panel containing some 8 000 firm level observations. The paper is one of the few using micro data to evaluate effects of job protections measures. To my knowledge it is the first one to exploit the policy change named above and controlling thus for self-selection into the treatment job protection using minimal assumptions concerning model specification.