The Economic and Social Effects of Trial Periods for Employment Contracts

A Master’s Thesis in Law and Economics
The thesis looks at the economics of trial periods for employment contracts with the purpose of accounting for the effects on economic efficiency and social welfare. The analysis uses a viewpoint based upon classical Law and Economics, while avoiding assumptions related to the perfectness of the free market. Instead, angles from Information Economics are utilized to analyse problems related to asymmetries of information, power and risk on the labour market. In order to avoid problems related to a too narrow, microeconomic scope the thesis uses macroeconomic and social angles in order to not disregard wider social welfare. The aim of the thesis is to provide a set of factors to take into account when looking at the potential costs and benefits of employment protection legislation and risk management through trial periods.

The legal paradigm used in the thesis comes from Finnish law. The thesis presents the content of the Finnish system of labour law and the legal content of the trial period for employment contracts according to the Finnish Employment Contracts Act in order to provide a baseline for analysis. To establish the baseline, the thesis looks at the purpose of the construct, the legal requirements for its use and the legal effects on the employment relationship, as well as the effects at the end of the relationship, should either party cancel it. The Finnish system is compared to models of employment protection used in classical law and economics. The analytical tools are not limited to the Finnish case and can be applied to similar legal constructs.

The findings of the thesis are that a trial period is in line with economic efficiency both in terms of purpose and effect. However, problems associated with market asymmetries, the subjective utility of risk and the significant social risks associated with labour markets mean that improved efficiency can be difficult to achieve without increased social cost. Various regulatory and contractual tools can be used to help prevent social cost. Changes to employment protection legislation can provide positive, albeit uncertain, effects as a macroeconomic tool, which however may come at a social cost. The Finnish trial period for employment contracts is generally efficient, providing various positive effects for labour markets associated with uncertainty, but could be made more efficient by decreasing information costs through clearer legislation, clearer employer responsibilities and by use of information forcing.

Avainsanat – Nyckelord - Keywords
Trial Period; Probationary Period; Employment Contract; Labour; Labor; Contract Law; Labour Law; Labor Law; Law and Economics; Law and Society; Law; Economics; Society; Efficiency; Optimality; Social Welfare; Social Cost; Market Asymmetries; Asymmetry of Information; Asymmetry of Power; Asymmetry of Risk; Employment Protection Legislation; Risk Management; Labour Market Uncertainty; Allocative Efficiency

Säilytyspaikka – Förvaringsställe - Where deposited

Muita tietoja – Övriga uppgifter - Additional information
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**Abbreviations**

EK  Confederation of Finnish Industries  
Fi  Finnish (language)  
HE  Government Proposal  
HHO  Helsinki Court of Appeals  
IHO  Eastern Finland Court of Appeals  
ILO  International Labour Organization  
KKO  Supreme Court of Finland  
SAK  The Central Organisation of Finnish Trade Unions  
THO  Turku Court of Appeals  
TT  Labour Court of Finland  
TyVM  Employment and Equality Committee Report
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Statistics


1. Introduction

1.1 Purpose and Scope

When I started law school I heard that a lawyer is someone who doesn’t understand economics, and that an economist is someone who is oblivious to the intricacies of the law. You could say that the purpose of my thesis is to show how little I know of either one.

The labour market is an interesting crossroad between law, society, politics and economics. It is, in many ways, what binds modern society together, for better and worse. There are vast fields of academic study looking at labour markets and employment contracts from many different angles, but very little that tries to combine these views. Such research has been missing, as academic specialization tends to push research into a somewhat narrow view. Research in labour economics tends to dismiss legal points of view, while legal dogmatic research tends to simply assume that a certain party is weaker or that a certain behavior is unwanted in a way that economists would find unjustified.

The purpose of this thesis is to paint a picture of the factors that determine the efficiency of a certain kind of labour market regulation. My paper has specifically focused on the trial period in employment contracts, as specified by Finnish law and legal practice, but the analysis can be further applied to other areas of employment protection legislation. Due to its scope and methodology the framework provided in my thesis can be applied to other legal cultures and traditions as well. By looking at aspects of legal doctrine, social welfare, microeconomic theory and legislation as a macroeconomic tool I hope to provide a wider picture of what efficiency is and can be.

The aim of this thesis is to determine the economic factors and effects that contribute to the efficiency of the trial period in employment contracts. In short, what are the economic effects of the trial period and how can legislation be designed to promote efficiency? In order to answer that question I will look at how labour markets function, which problems that possibly can occur and at how efficiency can be measured, including the effects on parties outside the
contractual relationship. The analysis will take place within the framework of the Finnish legal paradigm, which in turn requires a specification of what the trial period means legally and economically in Finland.

In order to do so, I have first accounted for the current state of Finnish labour market legislation and practice in chapter 2. After that, I cover the starting points in law and economics, and following that the problems of the labour market. Chapter 5 covers efficiency from a microeconomic point of view, while chapter 6 widens the angle onto social welfare and macroeconomics. Finally, chapter 7 concludes and summarizes the thesis, while bringing forth how the covered areas connect to the current state of the Finnish labour market and the law covering it. In order to keep things at its core, only private sector contracts regulated by the Employment Contracts Act (55/2001) have been considered.

A number of angles that could potentially be interesting have been left out in order to stay true to the narrow version of the subject. These are, for example, bargaining seen through game theory, theories on morality and social choice, growth theory and different views on measurements of value. These could provide interesting subject for further research, and could grant the field of law and economics some well-needed refreshment.

The thesis is inspired by current Finnish political developments, but does not aim to argue for or against any particular position. As with any political situation, there are alternatives to be considered and choices to be made. With this thesis, I hope to have provided a socio-economic framework, through the lens of law and economics, for what the factors and effects of those choices are.

1.2 Methodology

The methodology of the thesis is in its essence a combination of legal dogmatism in the Finnish tradition combined with fairly straightforward Law and Economics.

I have attempted to make as few assumptions as possible, which sometimes has been challenging due to the lack of previous research. However, I have attempted to not assume anything about the relationship of the parties, as is so often done in legal dogmatism, while
also making assumptions about the perfection of markets and rationality, which is so often done in Law and Economics. The methodology is fairly simple, with all research being based upon previous studies in a way that is very common in Finnish legal dogmatism. I have based my legal findings upon legal doctrine, codified law and its underlying documents as well as case law and general legal practice.

The economic aspects are mostly based upon Law and Economics grounded in neoclassical microeconomics. However, perfect markets and rational utility maximizers have not been the starting point. Instead, I have used a vantage point inspired by research in modern information economics, where the focus lies upon market failures and how they can be avoided. For the wider angle I have looked at seminal works in macroeconomics in order to build the general framework, while looking at some more recent work for the effects of unemployment upon the labour force.

In this thesis I have first accounted for the content of the legal paradigm, then the framework for analysis within traditional law and economics, and then I have looked at how the markets, the economy and society at large work when the assumptions of traditional law and economics have been removed. Finally, I have applied the findings to the Finnish version of the trial period in order to see how well it works.

Due to the nature of the thesis empirical analysis has been left out. Such research could be rewarding when it comes to finding out what an optimal level of protection would be or what the perceived problems are. I have unfortunately not had the opportunity to include such work in my thesis, and have had to rely on previous work, which in the Finnish case has focused on other questions than the specifics of the optimal and efficient trial period.
2. The Trial Period for Employment Contracts

2.1 General Principles of Finnish Labour Law

The purpose of the following subchapter is to provide an overview of the principles that are present in Finnish labour law as well as to provide the reader with an understanding of the environment that employment contracts exist in. This includes a short description of the system for collective bargaining.

As with most national systems of governing labour law, Finnish law is essentially based upon contract law. Some principles from contract law thus apply to individual employment contracts, and to contracts within the collective bargaining system. The most important of these principles is the freedom of contract and pacta sunt servanda, or the principle stating that agreements must be kept. The freedom of contract is, however, not completely free when it comes to labour law. Many principles restrict it, and laws and agreements set the minimum standards for many terms. Never the less, the assumption is that each and every one has a right to enter into a contract with whomever one wishes, and that the parties to a contract can decide the terms of the contract, without interference from the state or from third parties. This implies a freedom of labour and a ban on forced labour. Furthermore, contracts entered into must be honored, which includes a certain protection from termination without just cause, as at least certain kinds of terminations can be seen as a breach of the implicit contract. Such protection of employment is in line with the convention of the International Labour Organization.

The restrictions to the freedom of contract exist on different levels, through norms that can be described as mandatory (Fi: pakottava), non-mandatory (Fi: dispositiivinen) or semi-mandatory (Fi: semi-dispositiivinen). Mandatory norms completely restrict the freedom of

1 Bruun & Von Koskull 2012, pp. 21-22.
2 Kairinen 2009, p. 46.
3 This principle, while important throughout the work of the ILO, has been specifically important in the ILO Convention No. 158 on the Termination of Employment from 1982.
contract while parties freely can contract around non-mandatory norms. Semi-mandatory norms exist on several different levels, and can be mandatory in certain regards while it may be possible to contract around them in others. For example, some regulations in the Employment Contracts Act (55/2001) can only be changed in a collective agreement (Fi: työehtosopimus). Some norms can only be changed in an employment contract to the advantage of the employee, but never to the disadvantage of the employee.4

The result is a legal system with several layers, where some of the rules of the labour market are set on the highest level, which would be written law, while others are free to be negotiated on the collective level. The collective agreement then sets further mandatory rules, while leaving others to be negotiated on the local level or in individual employment contracts. The hierarchy for the regulation of labour markets can be described as5

1. Laws and regulations
2. Collective agreements
3. Rules of the workplace and other co-operation agreements between labour and management
4. Employment contracts, including implicit terms
5. Established habits, and
6. The orders of the employer

The fact that the unilateral orders, the right to direct the employee (Fi: direktio-oikeus), of an employer can be seen as a regulation of the employment contract is a reason for one the main principles in Finnish labour law. That is, the law assumes that the relationship between the employer and the employee is asymmetric.6 The ability of the employer to lead the work of the employee is in fact one of the defining factors of an employment relationship. This naturally leads to the employers priority of interpretation (Fi: tulkintaetoikeus), as the employers interpretation of a norm or rule should be followed by the employee, until the dispute has been settled. Work should thus continue according the employer’s orders as long as the situation is

4 Kairinen 2009, pp. 142-143.
5 Kairinen 2009, pp. 139-140.
6 Bruun & Von Koskull 2012, p. 19.
Because of the asymmetric relationship between the employer and the employee, related to the principles and rules detailed above as well as others, Finnish law applies a principle of protection for the weaker party (Fi: työoikeudellinen suojeluperiaate), which restrict the freedom of contract in favor of, mostly, the employee. This principle can in certain situations, where the need for protection is deemed sufficiently small, be removed if the parties are considered equal. For example, employers and labour unions are considered to be equally powerful. This follows the tripartite system, with representatives of workers, employers and government, for labour market dispute resolution. The system is considered an important basis for the Finnish labour law system, but can also be found in other countries as well as in the work of the International Labour Organization and the European Union. The principle of protection applies both during the employment relationship, as well as during the bargaining phase, before the parties have entered into the contract. An example of this is that only the employer has to ensure that the employee is informed of a trial period, if the use of a trial period is based upon a collective agreement and is not included in the individual contract. For the employee, a mere mentioning of the collective agreement without further informational duties is sufficient.

The protection of the weaker party takes many different shapes and forms. On the most foundational level, the unofficial English translation of the Constitution of Finland (731/1999) states that:

8 These are of course not the only situations where the relationship between the employer and the employee can be considered asymmetric when it comes to power, information or risk. The subject will be covered in depth in chapter 4.2.
9 Kairinen 2009, p. 43.
10 Bruun & Von Koskull 2012, pp. 21-22. This is known as the neutrality principle (Fi: neutraliteettiperiaate), which states that the public authorities should not take sides in disputes between employer and employee unions, unless there is a specific reason to do so.
11 Bruun & Von Koskull, p. 23.
12 Employment Contracts Act (55/2001) Chapter 1 Section 4 Subsection 3.
“Section 18 - The right to work and the freedom to engage in commercial activity

Everyone has the right, as provided by an Act, to earn his or her livelihood by the employment, occupation or commercial activity of his or her choice. The public authorities shall take responsibility for the protection of the labour force.

The public authorities shall promote employment and work towards guaranteeing for everyone the right to work. Provisions on the right to receive training that promotes employability are laid down by an Act. No one shall be dismissed from employment without a lawful reason.”

The responsibility of the public authorities can be seen as a manifestation of the principle of protection for the weaker party, and as a sign of the special significance of the labour force to general well-being. One important distinction that needs to be made regarding this paragraph is that the right to work does not imply a right to employment, but a right to the societal factors making up employability. That is, each and every one has a right to education, to employment services and to not be discriminated against.

The protection of the weaker party can further be seen in the mandatory functions of certain regulations. As it is assumed that the employee is the weaker party in negotiations over contractual terms, many limitations are set to employment contracts, examples of which could include minimum wages (as set by collective agreements according to the principle of fair pay), working hours and prerequisites for termination of employment. Another important area of interest when it comes to the protection of the weaker party is in disputes over different interpretations of contractual terms. These can involve terms in both individual employment contracts as well as differences in various collective agreements. In these situations Finnish labour law applies an interpretational rule according to which the interpretation that is most

13 Kairinen 2009, pp. 43-44.
14 Kairinen 2009, pp. 46-47. The right to work is not what is known in Finnish law as a subjective right. This means that there is no obligation to actually provide work, but rather that the public authorities have a general responsibility to ensure that society is able to provide opportunities for work.
favorable to the weaker party should be used (Fi: edullisemmuussääntö).\textsuperscript{15}

As there is always a risk of shirking\textsuperscript{16} present in employment contracts, Finnish labour law applies a principle known as the principle of loyalty (Fi: lojaliteettiperiaate) to labour contracts. This principle obliges both parties to act loyalty, and in the interest of the other party. It is mainly used in the interpretation of contractual obligations, and is generally not sanctioned.\textsuperscript{17} In the context of this paper one should notice that such a principle fulfills an economic function as well, since loyal behavior promotes trust, which saves on information costs, thus promoting efficiency.\textsuperscript{18}

Both parties are also obliged to act in a way which promotes the legal security of the other party. This principle of legal security applies to laws and collective agreements as well, and requires them to be sufficiently clear and understandable. This principle results in the view that no one shall be dismissed from employment without lawful reason, and can be found in section 18 of the Constitution. Related to the principles of loyalty and legal security is the so called co-operation maximum (Fi: yhteistoimintamaksimi) which requires the parties to co-operate in certain situations. An example of this is the right to be heard before the termination of employment.\textsuperscript{19}

Furthermore, Finnish labour law requires that any measures taken should be in accordance with the intent of the right or freedom in question, and that the measures should be justified in

\textsuperscript{15} Kairinen 2009, p. 44. The interpretational rule can be seen in relation to the principle of \textit{In dubio pro labore}, which states that when there is doubt in a legal matter related to employment, the view of the employee should take precedence. An example of this principle is the Supreme Court ruling KKO 2007:65, where an unclear contractual term was interpreted to the advantage of the employee, since it had been written by the employer.

\textsuperscript{16} Shirking is the phenomenon when a party to a contract attempts to withhold their obligation in order to do as little as possible for the given price. In other words, a shirking employee is one who tries to avoid working when he or she can get away with it.

\textsuperscript{17} Kairinen 2009, p. 45. An explicit, general obligation of loyalty for the employer towards the employee is included in the Employment Contracts Act Chapter 2 Section 12, but it is without sanction as well.

\textsuperscript{18} Schäfer & Ott 2004, p 375.

\textsuperscript{19} Kairinen 2009, p. 45.
relation to their purpose. It is thus forbidden to misuse the law, or to circumvent it. For example, an inclusion of a trial period in an employment contract may not be used to lay off an employee for reasons related to production or the economy, as the purpose of the trial period is to evaluate the employee and vice versa.

One of the most important aspects of Finnish labour law is the protection from discrimination, which is included in Section 6 of the Constitution:

“No one shall, without an acceptable reason, be treated differently from other persons on the ground of sex, age, origin, language, religion, conviction, opinion, health, disability or other reason that concerns his or her person."

The protection against discrimination is further defined in the Employment Contracts Act (55/2001), the Act on Equality between Men and Women (609/1986), the Non-Discrimination Act (1325/2014) and in legislation on the EU level. Discrimination has somewhat different definitions in the different acts, but can encompass at the very least discrimination due to the causes stated in the Constitution.

Apart from these, a number of principles apply to labour markets. These include among others the right to life, the right to privacy and the right to safety, freedom of religion, conscience, free speech and the free movement of labour. In the field of collective labour law, the freedom of association is of import, as is the right to industrial action.

The Finnish system for labour law can thus be described as an ecosystem characterized by strong participation from labour, employers and government that assumes asymmetric relationships between employers and employees, and that tries to smooth out and correct the problems associated with it through co-operation, trust and protection of the weaker party.

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20 Kairinen 2009, pp. 45-46.

21 Bruun & Von Koskull 2012, p. 23.

22 Kairinen 2009, pp. 51-54. The right to industrial action is accompanied by restrictions to industrial actions directed towards a collective agreement in force. This is known as the industrial peace obligation (Fi: työrauhavelvollisuus).
2.2 The History and Purpose of the Trial Period

Trial periods for employment contracts exist in many different shapes and forms in various economies and legislative environments. In some, a probationary period may only be an economic contract of sorts, after which the nature of the employment relationship changes into something more stable and valuable, while in others a trial period exists as a legal concept of its own.

In Finland the trial period has a long history as a separate legal concept. Regulation regarding it was included in both the 1922\textsuperscript{23} and 1970\textsuperscript{24} versions of the Employment Contracts Act. In fact, for some forms of employment the trial period stems back all the way to 1865, although the Employment Contracts Act of 1922 was the first to provide a generally applicable trial period\textsuperscript{25}. The Employment Contracts Act of 1970 (320/1970), as well as the version of the law it replaces, allowed for both parties to cancel the contract without the need to provide any ground for the cancellation. During that time, established practice in Finnish courts further galvanized the content of the trial period, and further changes were made in the mid-1980’s. One of these changes were to change the length of the trial period from three months to four months, in order to allow for greater flexibility on a more and more demanding labour market with increasingly complex roles for employees\textsuperscript{26}. The regulation in the latest version of the Employment Contracts Act (55/2001) is in most ways similar to previous versions.

The purpose of the trial period is to allow both parties of the contract to find out how well the reality of the contract corresponds to their expectations before entering into the contract.\textsuperscript{27} This is specifically stated in the government proposal for the Employment Contracts Act (55/2001)\textsuperscript{28}. The government proposal and the law itself does refer multiple times to the

\textsuperscript{23} Employment Contracts Act (141/1922).
\textsuperscript{24} Employment Contracts Act (320/1970).
\textsuperscript{25} Lehtimäki 2009, p. 44.
\textsuperscript{26} Kairinen 2009, p. 206.
\textsuperscript{27} Kairinen 2009, p. 206.
\textsuperscript{28} HE 157/2000 vp., p. 8 and 61.
purpose of the trial period, but does not specify what that purpose is more in depth. This has further been defined by legal practice. Part of the purpose, and one of the main objectives, is to give the parties of the contract a time, during which the barriers to exiting the contract are lower both in terms of requirements and time of notice, in order to provide flexibility to both negotiations over the employment contract and the beginning of the actual employment relationship. 29 As such, an important part and implication of the purpose of the trial period is that it can only be applied in the beginning of the employment relationship, when either the parties or the content of that relationship is unknown.

While it was initially the intent of the government to only regulate the use of the trial period for the employer-side of the contract, the regulation was later made more symmetric 30. This is important for the purpose of the trial period, as it shows that the use of the trial period is mainly designed for the employer, while the employee is considered to have a right to leave the contract quite easily at any point in the contract. 31 The intent, in this sense, is thus to increase employment while allowing labour mobility.

One should notice that the purpose and intent of the trial period is not to allow the parties to cancel the contract for any or no reason. This was one of the changes made to the Employment Contracts Act in 1984 32. Once the contract has been entered, the intent of the parties should be clear. The trial period should thus be applied in a way that does not allow for the contract to be laid aside, unless the actualities of the relationship are different than those in the contract entered into. 33 In this sense, the trial period is a way of protecting the content of that original contract. This does not mean that unreasonable expectations can lead to a lower bar for cancellations during the trial period, and the requirements should be set as objectively as possible. 34 As the employment relationship is based on a contract, those expectations should

29 Koskinen 2011, p. 3.
31 Marttila 2014, pp. 4-6.
32 Koskinen 2011, pp. 11–12.
34 Koskinen 2011, pp. 15–16.
be agreed to as well, either explicitly or implicitly. That a contract should not be allowed to be canceled on grounds that are discriminatory or not in line with the purpose of the trial period was a major point in the report from the Employment and Equality Committee\textsuperscript{35}.

Such a purpose is in fact quite in line with economic efficiency. As the contract is entered into by two parties that in many ways and often choose to do so for economic reasons, namely the surplus of the contract, their expectation should be protected. If their expectations are not fulfilled, that contract may end up not bringing them a surplus. Firms and workers not achieving a surplus during good economic times\textsuperscript{36} implies that they should either enhance their productivity or be pushed out of the market in order for resources to be put to better, more efficient use.

As the purpose of the trial period is to evaluate the other party and the relationship itself, grounds for cancellation that do not pertain to the parties or the contract can naturally be deemed to be against the purpose of the trial period. Such would for example be cancellations on collective and economic grounds, grounds that are not in line with reality, grounds based on factors that are outside the scope of the parties, and grounds based on actions that are legal and valid, such as the use of lawful rights.\textsuperscript{37,38} However, these grounds do not draw the line between what is in line with the purpose and what isn’t. They merely state what is on the side of the line that is not allowed.

In the end, the purpose of the trial period is quite loosely defined in the Employment Contracts Act (55/2001) and in the government proposal (HE 157/2000 vp.). This leads to some open questions, which in part have been defined by legal practice\textsuperscript{39}. In economic terms, the purpose

\textsuperscript{35} TyVM 13/2000 vp., p. 8.
\textsuperscript{36} During recessions it may be good for the economy as a whole to protect employment contracts, despite the employer losing money on it. The reasons for this are grounded in pro-cyclical effects known as the paradox of thrift. Simply said, if everyone lays off their workers there will be no consumers to buy products, and the employer will have to lay off more workers, thus causing a downward spiral.
\textsuperscript{38} Koskinen et al. 2012, pp. 36–43.
\textsuperscript{39} This part of the purpose of the trial period is defined more in depth through a look at the legal grounds for cancellation, which I cover in chapter 2.4.
of the trial period can loosely be defined as a way of increasing labour market flexibility, lowering information costs and protecting the contract entered into by the employer and the employee. The goals are thus to avoid inefficient employment contracts, in the sense that they do not meet the expectations of the parties, while promoting employment and employability. This view on the purpose of the trial period is in many ways compatible with ideas of contractual efficiency.

2.3 Requirements for the Use of Trial Periods

A trial period in an employment contract is a severe limitation of the employment security of the employee and the workplace stability of the employer. Limitations on the use of a trial period have therefore been set in the Employment Contracts Act (55/2001) Chapter 1 Section 4. Subsections 1\(^{40}\) states that

“The employer and the employee may agree on a trial period of a maximum of four months starting from the beginning of the work."

While according to subsection 3:

“If a collective agreement applicable to the employer contains a provision on a trial period, the employer must inform the employee of the application of this provision at the time the contract is concluded.”

The basis is hence limited contractual freedom. The parties can agree to a trial period, which includes the length of the trial period\(^{41}\), through a written or spoken agreement. The party wishing to use the provisions of such an agreement is held with the burden of proof\(^{42}\) when it

\(^{40}\) The Employment Contracts Act (55/2001) applies only to private sector contracts and certain public sector contracts. Public sector contracts that are not regulated by the Employment Contracts Act, and therefore have separate regulations of the trial period, are not covered in this thesis.

\(^{41}\) Kairinen 2009, p. 206. If the length of the trial period has not been agreed upon, but it is clear that both parties have consented to such a term, the length of the trial period is considered to be the longest possible, which is four months.

\(^{42}\) See chapter 2.5.2 for an in-depth discussion on the burden of proof.
comes to the existence of such an agreement, which may prove difficult if the agreement is merely spoken. Furthermore, subsections 3 and 4 requires an employer wanting to use a provision regarding a trial period that can be found in a collective agreement to inform the employee of the provision when the contract is concluded, lest the provision become void.

Although the maximum length of the trial period is four months\(^{43}\), there are limitations and exceptions. If the employment contract is for a specific fixed term, the trial period may not exceed half the length of the employment contract itself\(^{44}\), so that an employment contract of for example two months may only include a trial period of one month at the most, according to the Employment Contracts Act Chapter 1 Section 4 Subsection 3. The only possibility to extend the length of a trial period, without a change of tasks or a significant disruption in the employment relationship, is if the employer provides specific, work-related training for the employee, lasting for a continuous period of more than four months. In that case the maximum trial period possible is six months.\(^{45}\)

Subsection 2 of the same section of the Employment Contracts Act further limits the extent of the trial period if the employee was previously in the service of the employer as a hired worker. In such a case, the time spent as a hired worker will be deducted from the maximum length of the trial period.

The agreement must be made during the conclusion of the employment agreement, and cannot be renewed after the agreed upon time has run out. This is logical, as the purpose of the trial period is to let the parties evaluate each other and the content of the agreement. The trial period starts running when work begins\(^{46}\) and it is not possible to agree to breaks in the trial

\(^{43}\) The four month maximum applies to employment contracts governed by the Employment Contracts Act. Other employment agreements, such as those where the employer is a public authority, are subject to separate regulation that can include other maximums.

\(^{44}\) Koskinen et al. 2012, pp. 31–32.

\(^{45}\) Kairinen 2009, p. 207. What constitutes such training should be interpreted narrowly. It does not include the normal training that a new employee gets, and should be theoretically more demanding. It is also not a traineeship, as the trial period runs normally during such a time.

\(^{46}\) Bruun & Von Koskull 2012, p. 38.
period, nor is it possible to extend it. It may, however, be possible to agree to a new trial period if the employment contract ends, and there is a reasonably extensive amount of time between the two employment contracts. Another possibility for a new trial period is when the nature of the employment contract changes adequately when it comes to the duties of the employee. If, however, the change of duties stems from a change to the contract, and not a new contract, a termination would result in the old version of the same contract coming back into force.

We can thus summarize the requirements for the use of a trial period as follows; the trial period must be agreed upon in the conclusion of the employment contract itself, and the employee must be made aware of the provision, even if it stems from a collective agreement. Only one trial period may be used for each employment relationship involving the same tasks and duties, and efforts to circumvent this are considered invalid. The maximum length of a trial period, unless further limited by law or collective agreements, or extended through training, is four months that starts on the first day of work. Should a party wish to apply the provision, the burden of proof regarding the existence of the provision is on the plaintiff.

2.4 Termination of a Contract during the Trial Period

2.4.1 Legal Grounds and Just Cause

It seems to be a wildly held belief that an employment contract can be terminated by either party, including the employee, at any time and for any reason during the trial period. This view, which essentially corresponds to the Employment-at-Will-doctrine, would imply that

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48 Kairinen 2009, p. 207. In the Supreme Court case KKO 1986 II 52 a time of two months between the employment contracts was considered unreasonably short for a new trial period. In the KKO 1995:103 the Supreme Court considered 11 months to be a reasonable time for a new trial period.

what is known in the U.S. as terminations for good cause, bad cause, or no cause at all are permissible in Finland as well. That is, however, not really the case. The limitations to terminations based upon the trial period are laid out in the Employment Contracts Act Chapter 1 Section 4 Subsection 4, which states the following:

“During the trial period, the employment contract may be cancelled by either party. The employment contract may not, however, be cancelled on the grounds referred to in chapter 2, section 2, subsection 1, or on grounds which are otherwise inappropriate with regard to the purpose of the trial period. The employer may not cancel an employment contract when it has neglected the obligation to inform laid down in subsection 3 of this section.”

The first major difference between terminations based upon the trial period is that the contract is canceled, and not simply laid off. This means that the terminating party does not need to apply any period of notice. It is possible to do this after the trial period as well, but the requirements can be quite difficult to achieve. The second major difference is that the grounds for termination laid out in the Employment Contracts Act do not apply. The possibility for cancellation during a trial period is thus defined negatively, as in when

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50 Beck 1999, p. 102. A classic example of the US system for employment is the so called Wood’s rule, named after Horace Gay Wood, who argued that no term of employment was specified in most employment contracts, and that they as such should be terminable at any time. The application of this rule lead to the case Payne v. Western and Atlantic Railroad from 1884, where a Tennessee court stated that “All may dismiss their employee at-will, be they many or few, for good cause, for no cause, or even for cause morally wrong without being guilty of legal wrong.” Legal practice has changed greatly since then, but the basis of US labour law can still be found in the at-will paradigm.

51 Bruun & Von Koskull 2012, p. 39. The trial period can be likened to such a paradigm, but they are not exactly the same. As with the US system of employment protection legislation, the trial period does provide certain protection for even this kind of cancellation.

52 These periods of notice can be quite substantial, varying from 14 days to 6 months for the employer and from 14 days to one month for the employee, depending on the length of employment. It is possible to contract around this to the benefit of the employee.

53 Koskinen et al. 2012, pp. 65-69. Cancellation after the trial period essentially requires that the contractual breach must be so severe that the other party cannot be expected to honor the contract for the duration of the period of notice.

54 See the Employment Contracts Act Chapter 7 for lay-offs and Chapter 8 for cancellations without a period of notice.
cancellation is not allowed, while it is defined positively outside a trial period. This is probably where a large portion of the lack of clarity stems from.

Subsection 4 does, however, state that employment contracts may not be cancelled on grounds that are discriminatory or inappropriate with regard to the purpose of the trial period. Discriminatory grounds are specified in chapter 2 Section 2 Subsection 1 of the Employment Contracts Act (55/2001), and include among others discrimination based on age, health, disability, national or ethnic origin, nationality, sexual orientation, language, religion, opinion, belief, family ties, trade union activity, political activity or any other comparable circumstance. Further definitions of discrimination are referenced in the Act on Equality between Women and Men (609/1986) and the Non-Discrimination Act (1325/2014). Further discussion regarding the categorization of discrimination fall outside the scope of this dissertation, but one should be aware that the standard view within Law and Economics is that discrimination should not be allowed, as it is irrational behavior in the sense of behavioral economics, and leads to efficiency loss since the merits of the situation are not taken into account. Simply said, an employer who doesn’t want to be pushed out of the market will not choose a less efficient employee for discriminatory reasons.\textsuperscript{55} In practice, discrimination is far from uncommon due to problem of bounded rationality, asymmetric information and signaling.

The view on discrimination in Finnish labour law can be seen as following this economic idea. Finnish law can in some situations allow the cancelation of an employment contract for reasons that otherwise would be considered discriminatory, if it, truly, makes the employee or employer unfit for the position\textsuperscript{56}. According to the Non-Discrimination Act (1325/2014) Section 11 a different treatment due to previously mentioned reasons should not be considered discriminatory if they have a valid reason and if the means are justified.


\textsuperscript{56} Kairinen 2009, p. 210. See also Supreme Court decision KKO 1992:7 regarding pregnancy during the trial period. It is often the case, such as in this case, that the line between inappropriate and discriminatory grounds is somewhat unclear. Both can be applicable. In the Helsinki Court of Appeals decision HHO 25.2.2009 S 08/1782 an employee had been laid off due to an illness that prevented him from performing the main obligations of the employment contract, and the lay-off was thus not discriminatory. See Koskinen et al. 2012, pp. 34–35.
To define which grounds are considered inappropriate with regard to the purpose of the trial period, we must first look at what the purpose of the trial period is. The purpose of the trial period, as well as the inappropriateness of the cancellation, must be considered in casu. However, the main function of the trial period is to let employers and employees evaluate the fulfillment of the terms of the contract, and to let them cancel the contract if the reality of the relationship does not live up to the expectations as they pertain to the other party and the content of the relationship. If we consider the case of cancellation by the employer, one must conclude that grounds related to production, the economy and other collective factors are to be considered inappropriate. The same applies to factors that are outside the control of the employee and for actions that are considered lawful and valid, such as the use of certain rights. The courts have, among other things, considered cancellations due to the employee using the right to sick-leave (THO 14.6.2002 S 01/1475), the right to a minimum wage according to a collective agreement (THO 10.1.2000 S 99/1058) or due to the employee refusing to agree to overtime over the legal limit (HHO 30.12.1999 S 98/1166). Similarly, the right to collective action is such a protected right.

For the same reasons an employer may not cancel an employment contract merely because a candidate that is better suited for the task has emerged, if the employee has not proven to be unfit for the task. The same goes for the employee; a better offer from another employer is not considered an appropriate ground for cancellation unless the current contract does not live up to expectations. The Supreme Court did, for example, consider the cancellation of an employment contract by a professional basketball player due to a better offer from another team to be inappropriate considering the purpose of the trial period in decision KKO 57

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57 Koskinen et al. 2012, p.36.
59 Koskinen et al. 2012, p. 43. Cancellations during the trial period due to collective grounds were previously lawful, but are not part of the Employment Contracts Act of 2001.
60 Koskinen et al. 2012, p. 37. This can sometimes be seen as a misconception of the employer about the abilities of the employee.
61 Health issues can sometimes be a lawful ground for cancellation of the contract, if the sickness or disability causes the employee to be unable to fulfill the expectations of the employer.
It is also considered clear that the grounds for cancellation must be real and factual and that misconceptions regarding the employment relationship do not constitute valid grounds for cancellation of the contract. Supreme Court and Court of Appeals case law includes at least cases where the employer has canceled the employment contract without valid grounds due to misconceptions about stealing (IHO 26.8.1994 S 94/178), missing money (HHO 13.5.1997 S 97/2001) and the effects of the employee on the economic situation of the company (THO 10.9.2008 S 07/2259). Misconceptions about the employee’s health was an early development in this area, and the Supreme Court decision KKO 1980 II 110 showed that an illness, or suspected illness, that does not affect the actual work of the employee does not constitute grounds for cancellation of the employment contract.

The fact that misconceptions are not considered valid ground for cancellations implies that the party canceling the contract has a duty to inform itself of the situation. If either party has not attempted to make an informed decision, the purpose of the trial period cannot be achieved. This means that an employer, and to some extent the employee, actually has to try to find out what the situation is. The Labour Court, a special tribunal handling disputes over collective agreements, found that the cancellation by the employer was done on inappropriate grounds, as there had been different understandings about the sick leave of an employee, and the employer had not attempted to inform itself of the situation (TT 1985-92). In the case in question, the employer had allowed the employee to leave work to see a doctor, but the employee had instead visited a practitioner of alternative medicine, thinking the employer had accepted this.

The prerequisites for cancellation of an employment contract during the trial period apply to both the employer and the employee. However, the employee can fulfill the requirements quite easily, as even a feeling of not being welcome or the environment not being fitting on a subjective basis is enough for legal grounds. It is, in fact, widely considered that the employee

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does not have to provide any reasons for the cancellation at all.

With the unlawful grounds for cancellation somewhat defined, we can now look at the lawful grounds. These are, per definition, non-discriminatory and in accordance with the purpose of the trial period.

The most important cause for cancellation is a lack of results, which can be measured objectively and can be considered to be due to the employee. This lack of results can take the shape of customer complaints, that are required to be real and not just an expression of general discontent from the customer, or through late arrivals or absence. It is, however, possible to cancel an employment contract during the trial period due to the employee being unfit for the position, even if it is not visible in a measurable lack of results. Other ways of observing this lack of suitability is through negative effects on the work of colleagues (IHO 19.10.2006 S 05/1418), through a lack of trust (IHO 18.12.2008 S 08/331) or a lack of flexibility (HHO 30.12.1999 S 99/241). As the purpose, generally speaking, of the trial period is to let the parties evaluate the contract and the other party, it is possible that such a situation could emerge without any fault from the other party. It is thus not necessarily unlawful for an employer to lay off an employee due to a lack of trust, even though the actions of the employee have been impeccable. However, the employer would then, if the actions are questioned by the employee, have to show that the lack of trust is real, that it is not due to actions outside the control of the employee, that it is not discriminatory and that the employer has attempted to inform itself of the situation.

If we define the purpose of the trial period as an opportunity for the parties to measure the reality of the contract against the expectations before the conclusion of the contract, we can see an interesting correlation from a Law and Economics perspective. If we assume a fully

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66 Bruun & Von Koskull 2012, p. 39. The employee is, for example, not required to provide the employer with an opportunity to a hearing in accordance with the Employment Contracts Act Chapter 9 Section 2 Subsection 2 if the cancellation is done during the trial period. The employee is also not required to provide the reasons for the termination of the contract upon the request of the employer, which, vice versa, is required of the employer according to the Employment Contracts Act Chapter 9 Section 5.

specified contract\textsuperscript{68}, which is a fictional contract where the parties have allocated all the risks and where the allocation is represented in the price of the contract, one must assume that an employment contract with a higher price to the employer must imply more demanding obligations for the employee. In fact, the price of a contract is not only the monetary sum paid, as the price must also include the bundle of legal rights awarded to the parties. As Robert Cooter and Melvin Eisenberg put it,

\textit{“The exchange of legal rights is no different than the exchange of ordinary commodities.”}\textsuperscript{69}

Because of this, the expectations of the employer must be lower if the primary price, the wage of the employee, or the secondary price, the bundled rights, are lower as well. One might therefore conclude that the burden of proof for failed expectations should be lower the higher the relative wage and position of the employee is. There is, however, a certain lower bound for the expectations of the employer, as there is a minimum wage that limits the possibilities to conclude a fully specified contract. Therefore, an employee receiving the bare minimum could possibly be subject to even lower expectations than another worker with similar terms to their employment contract.\textsuperscript{70}

This rule may not hold if the labour market is characterized by high information costs, asymmetric information or a weak bargaining position. This might very well be the case, but it does not change the premise, as the relative weakness of one party, often labour, should imply a reason for intervention in the contract due to the Coase Theorem.\textsuperscript{71}

\textsuperscript{68} Schäfer & Ott 2004, pp. 278-280.

\textsuperscript{69} Cooter & Eisenberg 1985, p. 1461.

\textsuperscript{70} However, in many cases the lower expectation does not lead to a lower risk of cancellation. Low-wage employees are often subject to easier cancellations and may find it more difficult to receive the legal support they require, if they suspect that their employment contract has been cancelled unlawfully. This may lead to social issues and increased inequality, if low-wage employees effectively do not have access to justice.

\textsuperscript{71} Deakin & Wilkinson 1999, pp. 5-8. See also chapter 3.3 for further discussion on the Coase Theorem and labour law.
2.4.2 Procedural Requirements

Labour law is, in general, characterized as featuring many procedural requirements. It seems as if many disputes over employment contracts are caused by, or by themselves a cause of, uncertainty. In many cases the party with the lowest information costs might be in a position of moral hazard, where it can transfer the damage due to the lack of information to the other party. One example of this would be an employer that cancels a contract without giving any reason for the cancellation. Providing the information the other party needs could lead to a higher risk of a law suit, thus putting the employer in a position where providing that information would be a strategically bad choice. The right to justice of the employee would in such a case require certain procedures, to ensure that the employee has a real and actual possibility of challenging a wrongful termination. Procedural requirements also exist due to the high social cost related to labour market failures.

As they pertain to the termination of an employment contract, the procedural requirements can roughly be divided into three groups: those for cancellation, those for lay-offs on individual grounds and those for lay-offs on collective grounds. Generally speaking, the requirements for lay-offs on collective grounds are set highest, while the differences between the procedural requirements for lay-offs on individual grounds and cancellations are much smaller. In reality, situations where workers are let go collectively and where workers are let go individually are quite different.

Cancellations occur when the need to have the contract nullified is great and urgent, and the procedural requirements are a result of this need. The right to cancel an employment contract becomes void when 14 days have passed since the time that the party is informed of the existence of cancellation rights. However, if the cancellation right is based upon a premise that is continuing, the right to cancellation is not made void until the premise has ended. In certain situations, such as during criminal investigations, the right can be suspended to allow for the canceling party to make an informed decision, but in most cases the decision to cancel

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72 Employment Contracts Act (55/2001) Chapter 8 Section 2.
has to be made swiftly. During the trial period this 14 day limit does not apply in the same sense, as the existence of the trial period provides continuous grounds for cancellation. However, the last possible day for cancellations based upon the trial period is the last day of the trial period, not 14 days after. One should also note that even during the trial period, cancellations should be made within a reasonable amount of time after the canceling party found out that the other party had acted or performed in a way that made cancellation possible.

One of the most important requirements relates to the receiving party's access to justice. According to the Employment Contracts Act (55/2011) Chapter 9 Section 2 the party wishing to cancel an employment contract must first allow the receiving party to be heard regarding the grounds for cancellation. The reasoning behind this requirement is to clear up any misunderstandings, and to give the receiving party the necessary information to judge whether or not the cancellation has been lawful. When the employment contract is canceled during the trial period, the employee is not bound by law to provide the employer with an opportunity to be heard. During the hearing the receiving party has the right to use an assistant, which can be a union representative, a legal professional or any other assistant. The hearing has to be held, naturally, within the aforementioned 14 days.

There is actually some question about whether or not the procedural requirements in Chapter 9 of the Employment Contracts Act (55/2001) are applicable at all to cancellations during the trial period. In fact, there is no mention of this in the legislative history of the act, nor is there any court practice that definitely would show that this is the case. It does however seem to be legal practice to apply the chapter to trial period cancellations as well.

After the hearing the canceling party must notify the receiving party of the cancellation. The

73 Kairinen 2009, p. 313
74 Kairinen 2009, p. 314
75 An agreement on employment protection entered into in 2001 by two major labour market organizations, TT (these days the Confederation of Finnish Industries EK fills the same role) representing employers and SAK representing employees, does at least state that the regulations of chapter 9 sections 1-2 and 4-5 are to be applied to trial period cancellations. This agreement covers a large part of the Finnish labour market, and is important when considering the actual content of the legal paradigm. Irtisanomissuojasopimus 2001 (TT-SAK). 10.5.2001. Helsinki.
requirements for the cancellation itself are not too strict, and it can be delivered in person, by phone, by mail or by email. Text messaging has, however, not been seen as a valid form of notification. While most forms of notification are allowed, a notification that is not in line with good practice can have an effect on potential damages, should the cancellation be deemed unlawful. The notification should primarily be delivered to the recipient directly, and if that is not possible, to the representative of the recipient.

One of the most important procedural requirements regards to the employees right to the grounds of cancellation. The employer must, if asked for by the employee, deliver the specific grounds for cancellation as well as the time of cancellation to the employee. Such a notification must be made in writing, and should include all real grounds for cancellation as they are known to the employer at the time. Simply mentioning a trial period is not enough in this case, as the purpose of the notification is to allow the employee to make an informed judgment on the lawfulness of the actions of the employer.

What information, exactly, that a cancelling employer has to give his or her employee is an old, contested question in Finnish law. The dominant opinion is that the receiving party’s right to access to justice is not preserved unless the true reasons, not merely the legal grounds, for cancellation have been given. However, some legal scholars have been of the opinion that the legal requirements (which do not put the burden of proof of wrong-doing on the cancelling party) can only mean that simply giving the legal ground (as in, the trial period) is sufficient. This view is often justified by Turku Court of Appeals case THO 07.08.2003 S 02/3051, according to which the employer did not have a legal duty to reveal the grounds for cancellation despite demands from the employee. However, this is not the dominant view. Both before and after this case, the majority view has been that the employer has an obligation to provide information on the reasons for the cancellation. This can be seen in, for example, the case TT 1986-69, where the court saw that as not all cancellations during the trial period are lawful, the

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76 Kairinen 2009, p. 314.
78 Tiitinen & Kröger 2012, p. 689.
employee has a right to receive information about at least those factors that the employee would consider unlawful. Since then, the view on the procedural requirements for trial period cancellations have developed into a broader view, according to which constitutional rights and labour market agreements play a larger role.\(^{80}\)

However, there are no legal sanctions for failing to follow these requirements. The canceling party cannot be held responsible through damages for a cancellation that is not in accordance with the procedural requirements. One kind of soft sanction that is often mentioned in the legal literature is that of a weaker legal case, should the receiving party decide to take legal action against the canceling party. If, for example, the employee has not been heard as is required in the Employment Contracts Act Chapter 9 Section 2, the employer might have a tougher time proving that the grounds for cancellation have been valid. An employer with valid grounds would in most cases want to ensure that the grounds are correct, in order to avoid the search, information and investment costs related to finding and training a new employee\(^{81}\). An employer looking to minimize risk would also like to make sure that there is as little misunderstanding as possible about the correctness of the grounds, as misunderstandings about for example health issues aren’t considered valid, despite such grounds being permissible\(^{82}\).

All in all, there several procedural requirements for cancellations of employment contracts during the trial period. These are, in many ways, information forcing and efficiency enhancing. As the requirements are toothless, poorly defined or associated with high information costs, their effects are not as strong as they could be.

\(^{80}\) Koskinen et al. 2012, pp. 46-51.

\(^{81}\) A separate but relevant point is that according to at least some case law the canceling party can be held responsible for the trial costs of the receiving party even if the cancellation is deemed valid, should the canceling party have withheld the relevant information from the receiving party. An important case in this context is THO 23.3.2015 S04/1961, where the employer was held responsible for the costs due to legal action for the time preceding the notification of the proper grounds for cancellation.

\(^{82}\) See for example Supreme Court decision KKO 1980 II 110.
2.5 Conflicts over Termination

2.5.1 Causes for Conflict

Models for labour market functions can in some ways be divided into two separate categories: those where labour and capital are considered equals and the employment contract is one where both parties negotiate without any party being too dominant, and those where labour is considered to be in a weaker position. The second kind somewhat resembles the primary principles of Finnish labour law, in that labour holds a certain level of protection not available to the employer, at least in comparison to legal systems with more of an employment-at-will paradigm.

While it, at least in the former models, is as possible for the employer to see themselves as hurt in some way when the employment contract is canceled by the employee, it is often the case that the employee is in a weaker position when employment ends than vice versa. In the words of Adam Smith;

"Many workmen could not subsist a week, few could subsist a month, and scarce any a year without employment. In the long run the workman may be as necessary to his master as his master is to him; but the necessity is not so immediate."\(^{83}\)

Due to this lack of necessity a lot of the legal conflicts regarding terminations are ones where the employee is the one that has been hurt and demands compensation. The primary reasons for conflicts are situations where the receiving party considers the cancellation to be unlawful or that the real and true reasons for the cancellation are others than those stated. A further alternative could be that the canceling party simply refuses to give information on the grounds for cancellation. Different interpretations of the quality of, for example, the work done can also be a major source of conflict. When it comes to Finnish law, such situations would generally be handled through termination through an individual lay-off instead of a cancellation.

\(^{83}\) Smith 1776, Book 1 Chapter 8.
In a perfect world, with a perfectly functioning market, such problems caused by a lack of information or asymmetry of information would not exist, and the employment relationship could be handled by the marketplace. However, in a lot of ways we have a problem called the Market for Lemons by George Akerlof in his seminal paper from 1970\textsuperscript{84}. The market mechanism can fail to transfer information regarding the quality of the product (here; labour as well as employment contracts) in advance, and does not allow the buyer to inform the market of problems in retrospect, thus creating an uncertainty that pushes both the price and the quality down. The same kind of problems that can cause a Market for Lemons, along with basic human behavior, can in turn cause conflicts that cause efficiency losses and the inefficient use of resources.

While there are legal and social techniques to solve conflicts that have already erupted, these are not the main focus of this paper. In terms of economic efficiency, it is better to prevent a conflict than to solve it, which is where solutions to information asymmetry become important. As the procedures related to solving a conflict have an effect on the behavior of the parties to that conflict, we must also consider effects of the division of the burden of proof, legal expenses and the relative risk of facing those damages.

2.5.2 The Burden of Proof

When it comes to disagreements on cancellations of employment contracts, information is of great importance. Because of the limitations the parties have, that information can be very valuable. One important way for a court to manage that information asymmetry is through the burden of proof. By tilting the responsibility of providing proof of their position, the court can force the party to provide the information necessary to reach a conclusion as close to the substantive truth as possible.

The main principle in Finnish law as it regards to civil cases, is that the burden of proof is

\textsuperscript{84} Akerlof 1970.
divided between the plaintiff and the defendant\textsuperscript{85}, so that the party that wishes to use a fact to support their action must prove that fact. When it comes to the lawfulness of cancellations of employment contracts, this is not quite as simple.

The requirement for a cancellation of an employment contract during the trial period is negatively stated\textsuperscript{86}, so that the contract may be canceled by either party to the contract, but not in such a way that is considered discriminatory or inappropriate in regards to the purpose of the trial period. Effectively, this means that any ground for cancellation that is not forbidden is permissible.

As it would not be in accordance with the foundational principles of Finnish law to force the defendant to prove his innocence without first having had the plaintiff prove his case, and the plaintiff often has limited information about the reasons and grounds for the cancellation, the burden of proof has been further divided between the two parties. It primarily rests with the plaintiff, who has to first prove that the cancellation likely has been unlawful. This can, for example, be by proving that there has been cause to suspect that the canceling party has acted in a discriminatory way. Once this likelihood has been established, the court then transfers the burden of proof to the defendant, who in turn must prove that the cancellation was founded on permissible grounds.\textsuperscript{87}

The canceling party, therefore, has an obligation to declare the reasons and grounds for cancellation under the threat of court-appointed damages. However, one can question the effectiveness of such a threat, as it is only realized once the receiving party has initiated legal action. At that point, both parties have accrued legal fees and opportunity costs that can be quite substantial. An economically efficient solution would force the parties to share information about the cancellation, so that unnecessary legal action is not initiated.

\textsuperscript{85} Vuorenpiä 2009, chapter 2.2.6.3. This basic division also follows from Code of Judicial Procedure (4/1734) Chapter 17 Section 1, according to which each party has to prove the facts that support their case.

\textsuperscript{86} For a lengthier discussion on the requirements for cancellations during the trial period, see chapter 2.4.

\textsuperscript{87} Koskinen et al 2012, p. 33.
2.5.3 The Division of Legal Expenses

The division of legal expenses is somewhat comparable to the division of the burden of proof. The basic rule in Finnish law is that each party is accountable for their own fees, but that the losing party must pay for the reasonable expenses of the winning party. This principle, which is not uncommon in Western legal traditions, can be found in the Code of Judicial Procedure (4/1734) Chapter 21 Section 1.88

There is, however, some case law supporting the view that a defendant who has not provided the necessary information on the cancellation, and thus has caused an otherwise unfounded legal process, is responsible for the legal costs that could otherwise have been avoided.89 This is, in many ways quite logical. If the canceling party was able to cancel the employment contract without having to reveal the factual or legal grounds for the cancellation, a major opportunity for moral hazard would appear. The canceling party would then transfer the risk that a legal process entails to the receiving party, while keeping the benefits of the information advantage regarding the grounds for cancellation. A rational employer or employee would not discern that information, unless it was very clear that the grounds for cancellation were lawful.

When it comes to avoiding such situations of moral hazard, where the canceling party can use the risk of legal costs in cases where the grounds for cancellation are questionable to their advantage, an alternate division of the legal costs can be beneficial to reaching an efficient solution90.

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89 See for example Turku Court of Appeals decision THO 23.3.2005 S 04/1961. It is not, however, clear at what point and what kind of information the canceling party has to provide to the receiving party in order to be relieved of this obligation.
90 Efficiency here assumes that the underlying legal requirements for cancellations of employment contracts are in accordance with economic efficiency. This is an assumption that often might not hold water.
2.5.4 Damages due to Wrongful Termination

Getting rid of an employee on dubious or unlawful grounds is a risk as long as there are consequences to such unlawful terminations. The fact that an employer, as with any rational player on the open market, would look to minimize that risk is foundational for modern economics. The procedural requirements and legal principles and rules, such as the division of the burden of proof, increase the chances of the realization of that risk. A rational employer could then see the benefits of firing that employee as a kind of income, while seeing the risk as a cost. This, minus the costs, is what is known in economics as opportunity cost, or the difference between the actual situation and another potential situation. That cost could be expressed as a function, where the chances of getting caught would be multiplied by damages awarded to the other party. The expected cost of an unlawful cancellation would thus be defined as:

\[
\text{Expected Cost} = \text{Risk of Loss} \times \text{Damage in the Event of Loss}
\]

If the benefits of firing the worker illegally is greater than the expected costs the rational person would take his chances and cancel the contract, while if the benefits were smaller than the expected loss it would not be worth taking that risk. It would always be possible to win that gamble, but rationality would deem it unwise.

The main way of increasing the expected cost is to award larger damages to the party that has had its employment contract canceled unlawfully. In Finnish law, the main cost to an unlawful cancellation is damages in accordance with the Employment Contracts Act (55/2001) Chapter 12 Section 2. An employee shall, according to that paragraph, be awarded between 3 and 24 month’s salary if the employment contract has been terminated unlawfully. This compensation

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91 It is, also, a foundational aspect of modern economics that the rational choices by that player will be limited. This is known as bounded rationality. In many cases the actual choices made by the market player will be very irrational due to misinformation, emotional reactions, miscalculations of risk, wider market failures and so on. The rationality referred to here is, in many ways, only the opposite of chaos. In other words, there will be some basis for the actions of the player.

is the only one awarded, and it is not possible to demand other kinds of damages based upon, for example, general principles of tort law.\textsuperscript{93} For cancellations during the trial period the lower limit is not applicable according to the Employment Contracts Act (55/2001) Chapter 12 Section 2 Subsection 3.

As there is quite a difference between three months (or less than a month’s) and two years’ worth of salary, there is quite a lot of room for the court to consider different angles when deciding upon the value of the damages. A few things that should be considered are the length of the following unemployment, the amount of income lost, the length of the employment relationship, the age of the employee, the opportunities for new employment, the actions of both parties previous to, during and after the cancellation, the size of the employing firm and other comparable factors. These are not regulated at the level of law, but are part of the established legal practice. If the canceling party has only been guilty of using the wrong form of termination, that is, having the right to lay-off the employee but having canceled the contract, the only compensation is the salary for the period of notice.\textsuperscript{94}

A dominant principle in Finnish tort law is the idea that the party that is rewarded damages should not be compensated more richly than the value of the damage sustained. This stands in stark contrast with the punitive damages that are an established part of some legal systems, such as that of the United States. It is thus quite natural that any other form of compensation, freely provided by the canceling party or even through unemployment benefits, should be taken into account when calculating the compensation for the unlawful cancellation of an employment contract. While the Employment Contracts Act Chapter 12 Section 3 states that a certain portion (depending on the benefit in question) should be deducted from the compensation, it is still up to the court to decide what the compensation and the deduction should be. The final judgment is, as it often is, up to the court.\textsuperscript{95}

One should also note that while the law states that the compensation according to the Employment Contracts Act Chapter 12 Section 2 should be the only compensation for

\textsuperscript{93} Kairinen 2009, p. 319.

\textsuperscript{94} Kairinen 2009, pp. 319-320. See also Supreme Court Case KKO 2002:71

\textsuperscript{95} Kairinen 2009, p. 320.
unlawful cancellations, there are cases where other forms of compensation can come into question for related actions. For example, the cancellation can fulfill the requirements for discrimination or for the loss of income that can be compensated on other grounds, or it might be possible to bring criminal charges against the canceling party, especially if that party is an employer.⁹⁶

Overall, the consequences to canceling an employment contract unlawfully can be quite substantial, if the chance of getting caught is high enough. However, in many cases problems of information asymmetry and a lack of resources for the receiving party can be a bigger problem when it comes to disincentivizing inefficient behavior. Simply increasing the cost of getting caught may not be enough, if the chance of getting caught is small while. Because of the fact that many of the obligations that are put upon the cancelling party are toothless and that the burden of proof during the trial period is not on the cancelling party from the beginning, the risk of loss is quite small. Furthermore, the potential damages for unlawful cancellations during the trial period can often fall between one and three months’ worth of salary, meaning that the asymmetries after a cancellation has taken place often may lead to the legal costs being greater than the awarded damages.

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3. Starting Points in Law and Economics

The validity of a contract can be seen in two ways: from a legal and an economic standpoint. Validity in the legal sense is simply a question of technical realization; if the parties to the contract have used their free will without extortion or pressure and without breaking legal rules the contract must be seen as legally valid. Simply put, it is a binding agreement. From an economic point of view things are a bit more complex, as the validity is based upon function and not form or process. A valid contract is one where the utility of the contracting parties increase due to the contract.\textsuperscript{97}

In the same way, an efficient contract in the microeconomic sense is one where the utility of both parties are maximized. In the simplest of terms it can be seen as the monetary surplus of the employment contract, where the profit of the business is shared by the employer and the employee. However, the utility surplus of the contract can constitute much more than the mere money wage and employer profit, as the terms of the contract not only regulate the wage of the employee, but also responsibilities, working hours, the length of the contract and so on. The rules concerning dismissals are a part of this utility allocation, directly or indirectly.

Efficiency is, overall, a difficult subject. Most analyses start from the idea of utility, which essentially means the usefulness of that certain situation. If something has higher utility we will find that particular allocation or production more useful. But ultimately, as many economists have said, the end goal of any kind of economics is the maximization of human happiness. As economics, especially since the early 20\textsuperscript{th} century, has seen itself as the most scientific of the social sciences such whimsical goals as human happiness have not been desirable. Thus, many have instead chosen the cold and mathematical sounding utility as their yard stick for optimality and efficiency.

In the following chapters we will examine what the starting points of law and economics are, and what they mean for the legislation surrounding trial periods for employment contracts. Once we have established what traditionally has been used, we will look at why they, and the

\textsuperscript{97} Schäfer & Ott 2004, pp. 296-297.
markets they have been applied to, do not work as advertised. Following that we will look at what this means for the labour market and for the economy at large.

### 3.1 Pareto Optimality

Allocative efficiency is a difficult subject. Not only can it be difficult to understand the premises, processes and results, but it is equally difficult to understand and explain how to actually determine which values drive that efficiency. Some may consider cold, hard money as their prime objective in life, while others would take environmental protection or a certain blend of social justice over economic prosperity. Economists have for a long time tried to create a theory or a framework that could put such preferences into objective terms, but have largely failed. That was, however, how one of the most important ideas in the field of allocative economics came into being. An Italian economist, Vilfredo Pareto, attempted to create a value-free theory of social choice. He believed that it was possible to measure different economic alternatives on a unified scale, and to judge two different social alternatives without resorting to individual preferences. It was a good cause, as those decisions enforced by the power of the state undoubtedly will cause one set of values to clash with another, through the enforcement upon third parties. While he mostly failed to provide a model with no fault or problems, the model that I will present did provide an important basic idea; That when faced with decision on a societal level that affect others, we should attempt to not push through our values using force and coercion, but attempt to reach a solution that as few as possible oppose.

The Pareto principle is a forceful, valuable, and sometimes clearly faulty, model for measuring allocative efficiency. In its most basic form it is as follows;

Consider two social states, x and y. If each member of society prefers x to y, or is indifferent

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98 Pareto (1848-1923) was an Italian economist, who became one of the great names of his age. He was of Italian nationality, born in France but died in Switzerland, and worked in the fields of engineering, economics and sociology, among others. Pareto optimality, for which he is perhaps best known, was also something that he later came consider a flawed measurement of happiness.

between x and y and at least one member prefers x to y, then x is preferable to y. One may also construct a weaker version of it, whereas x is preferable to y if every member of society prefers x to y, thus eliminating any indifference.\textsuperscript{100}

The Pareto principle may sound convincing in theory, but it is problematic in many different ways. For example, Amartya Sen provided a sharp criticism of Pareto optimality as a universal measuring tool, as he proved that individual freedom is impossible to combine with Pareto optimality, as long as the preferences of one party had unrestricted domain over third parties\textsuperscript{101}. Other critiques have been based on, for example, the fact that the marginal utility of consumption inevitably causes problems with the allocation of resources and the value of goods.\textsuperscript{102} Pareto optimality is often not as value-free as Pareto had originally intended.

A result of the Pareto principle is what is known as Pareto efficiency. Pareto efficiency is a social state in which all allocations of resources follow the Pareto principle, that is, they are Pareto optimal\textsuperscript{103}. Pareto efficiency can thus be defined as a social state in which if we attempt to make one person better off, then at least one other is made worse. The conditions that affect the efficient allocation can be divided into three components\textsuperscript{104}:

1. Initial endowment of goods
2. The state of technology
3. Preferences

The efficiency itself can also be divided into three aspects:

1. Efficient production

\textsuperscript{100} Schäfer & Ott 2004, pp. 21-22.
\textsuperscript{101} Sen 1970.
\textsuperscript{102} Marginal utility of consumption is one of the foundational ideas of economics. It means that the more one consumes of a good, the less the one values one more of that good. A person that has a hundred loaves of bread would value one more loaf less than a person who is starving. Problems like these will be discussed further under chapter 3.2.
\textsuperscript{103} Pareto optimality and Pareto efficiency are often interchangeable terms. In most cases, efficiency is a better term, as it implies that a state is sound in terms of economic surplus, while optimality would imply that a certain social state is the best option. That is not necessarily the case.
\textsuperscript{104} Schäfer & Ott 2004, pp. 23-24
2. Efficient consumption

3. Efficient structure of production

While mostly used for the product market, the aspects of Pareto efficiency can be adapted for the labour market simply by seeing the employment contract as the production of labour by the employee and the consumption of labour by the employer.\textsuperscript{105} In that case, efficient production would be the efficient production and supply of labour; when labour is produced above or below what is considered efficient (the production possibility frontier) the amount produced leads to redundancies and wasted resources, and thus to inefficiency. Pareto optimality in terms of efficient production would be a state where the factors of production (here for the production of labour) are used to achieve the highest amount of labour overall, regardless of the use of that labour, with the resources available.\textsuperscript{106}

Efficient production in itself does not lead to Pareto optimality. An economy where we produce large amounts of fish for those that prefer beef, while those that prefer beef are left with a redundancy of fish is not efficient. Efficient consumption, in turn, means that the allocation of resources for consumption is in accordance with the preferences of society, so that it is impossible to improve the utility of consumption by exchanges between consumers.\textsuperscript{107} In this way, it may be possible to improve efficiency without increasing production, if one can shuffle the goods around to achieve a situation that is likely to be a Pareto improvement.

Regardless of how well the production and consumption is, it may not be enough to achieve Pareto optimality unless the structure of production is efficient as well. In a society, some forms of goods have high utility while others have low utility, and sometimes we produce either too much or too little of these goods.\textsuperscript{108} That goes for labour as well. An inefficient

\textsuperscript{105} This would, of course, also imply that the employment contract can be seen as a situation where the employee buys the money wage, while the employer produces it in exchange for labour.

\textsuperscript{106} Schäfer & Ott 2004, pp. 24-25.

\textsuperscript{107} Schäfer & Ott 2004, pp. 24-25.

\textsuperscript{108} Schäfer & Ott 2004, pp. 26-28. A practical application of this would be division of labour into so called white collar and blue collar jobs. If there is a surplus of white collar workers, while there is a deficit of blue collar workers one could achieve a Pareto improvement by changing the structure of the production labour.
structure of production can be one where we educate (produce) too many secretaries, while we should be educating more engineers to design computers. This also applies once that labour has been put to use; inefficient production can mean having a good worker in a less demanding position or having a bad worker in a demanding position. Both of these lead to an efficiency loss due to the structure of production. The difference compared to inefficient production is that when the structure is the problem, and production overall is efficient, there are no unused resources to put to use.

The efficient structure of production can therefore be defined as the point where producing a marginal unit of one good results in a reduction in the production of another good.\(^\text{109}\) If all of these conditions are fulfilled, we will end up with a state of society that is considered Pareto efficient. However, there is not one single state that must be Pareto efficient, as there may be several different states that can be simultaneously Pareto efficient depending on the conditions that affect the allocation of resources: the initial endowment of goods, the state of technology and the preferences of those in that society. It is also possible that there is no state that fulfills all of these states, which is the essence of the critique that Amartya Sen put forth.\(^\text{110}\) If our preferences intrude on the preferences of others and we accept liberalism as a foundational value of our society, we may end up in an impossible situation, where there are no possible Pareto efficient situations. Sen’s critique was aimed at Kenneth Arrow and Gerrard Debreu, who tried to prove that under perfect competition, and a few other preconditions, we reach a situation which is Pareto efficient.\(^\text{111}\) However, perfect competition in itself is something that is considered almost impossibly rare in modern economics.

Pareto efficiency is a simple, yet complex thing. It is incredibly rare and a state of society that allows it is almost surely subject to other, unwanted limitations to social justice or democracy. It is a somewhat crude tool for policy recommendations. Without modification Pareto efficiency isn't much more than a naive dream that hardly would be possible. It is, however, a starting point for further analysis.

\[^{109}\text{Schäfer & Ott 2004, pp. 26-27.}\]
\[^{110}\text{Sen 1970, p. 152.}\]
\[^{111}\text{Arrow & Debreu 1954, pp. 265-290.}\]
3.2 The Kaldor-Hicks Criterion

In 1939 two English economists, Nicholas Kaldor and John Hicks, proposed an improvement through a new criterion for the Pareto principle. With the Pareto principle alone, social states can seldom be compared. Often there is one member of society who objects to the change in question, as that member of society well might end up in a worse situation due to the Pareto improvement, even though the receiver of the change in allocation may be a more efficient consumer of that resource. Kaldor and Hicks proposed a collective decision rule that is valid for non-Pareto optimal decisions;

A non-Pareto efficient decision affecting the social state in question is preferable if the party opposing the decision can be fully compensated by the accepting party, so that the accepting party is still in a better position that he or she would be in other social states.\(^\text{112}\)

The implication of this criterion is that a social state can still be efficient, despite lacking unanimity, if the “winner” of that state can compensate the losers for that loss. The aggregated utility of that social state is then higher than the alternative. It is not required, however, that the winner actually compensates the loser; only that it is possible to do so. In some cases it may be inefficient to actually compensate the other party, due to, for example, high information costs.

The Kaldor-Hicks criterion has been criticized on several different grounds. Tibor Scitovsky showed in 1941 that it is possible to end up in a cycle where two alternate states are improvements upon each other\(^\text{113}\), but the perhaps most important critique relates to the compensation itself. The Kaldor-Hicks criterion in and of itself provides no particular rules for the nature of the compensation, which can lead to problems with social justice.\(^\text{114}\) For example, it would be completely in line with the Kaldor-Hicks criterion for a rich man to take water for his swimming pool from a starving village that requires that water for their crops, if that rich man had the resources and the willingness to provide them with the money to buy

\(^{112}\) Schäfer & Ott 2004, p. 30.

\(^{113}\) Scitovsky 1941, pp. 77-88.

\(^{114}\) Schäfer & Ott 2004, pp. 30-31
food. However, he would not actually have to give them that money, but simply value his pool higher than the money the village would need to buy food. As the marginal utility of consumption decreases, the Kaldor-Hicks criterion can create problems related to the distribution of income. Wealth is divided unequally, and some value it more than others. Money is usually the main kind of compensation in an economy, but the utility of that money can vary greatly depending on how much one has.

The problems here are especially large when it comes to decisions that affect the macroeconomy or the environment. For example, lowering the wages or dismissing one employee will decrease the wages of labour in the aggregate, as the supply of labour increases in comparison to demand. Measuring the changes onto third parties from such quasi-Pareto superior decisions can be almost impossible.

So what is the impact of the Kaldor-Hicks criterion when it comes to trial periods for employment contracts? The first thing one must notice is that the decision of setting a standard for the rule-type that is trial period dismissals is a decision over several different social states. Some of these states may be Pareto improvements over others, depending on the conditions and factors covered in the previous chapter. It is possible to arrange these social states and to rank them according to preference. However, unanimity is almost impossible, as a lowering of the standard for the use of trial period dismissals will almost surely be resisted by employers. Likewise, an increase would surely be resisted by employees.

To solve this problem the Kaldor-Hicks criterion can be useful. The losing party could be compensated by the winning party, either through an explicit transfer or through compensation through legal requirements. For example, it may be possible to achieve a Pareto improvement by making the maximum time of the trial period longer while compensating through a higher standard for the use of dismissals during the trial period. Where the efficient line goes would depend on the allocation of resources, the kind of compensation, the acceptance of risk on

\[115\] Schäfer & Ott 2004, pp. 30-34

\[116\] Here; assuming that most trial period dismissals are made by employers. This assumption must be seen as quite reasonable, as the requirements for an employee to cancel an employment contract are very low, and must be so according to a range of legal sources prohibiting slavery-like employment relationships.
both sides as well as the information costs and the symmetries of the employment relationship. However, some scholars have come to the conclusion that the Kaldor-Hicks criterion is only applicable in situations where social justice is not an issue, and where it is likely that compensation will occur within a foreseeable period through an effective redistributive mechanism.\footnote{Schäfer & Ott 2004, p. 46.} The labour market is thus a difficult case for allocative efficiency, as there are many moving parts, many different dynamic effects and various issues related to the inability of potential transfers to become reality.

### 3.3 The Coase Theorem

Allocative efficiency can be seen as having three components; the original distribution, the process of re-allocation and the post-allocation state. The allocation after the process is generally what is interesting to economists, as that determines the optimality of the social state. However, in order to determine how to get to that final allocation one must pass through a process that starts with an initial endowment of goods and utility. A major figure and Nobel laureate within the field of Law and Economics, Ronald Coase, made this the focus of his studies through his 1960 article The Problem of Social Cost.\footnote{Coase 1960.}

The so called Coase Theorem was actually not explicitly spelled out by Coase, but can be defined as follows:

If property rights are clearly specified and transferable, and transaction costs\footnote{Transaction costs are the costs associated with transfer of the property rights.} are zero, the allocation of resources will be Pareto-efficient regardless of the original allocation of property rights.\footnote{Schäfer & Ott 2004, p. 87.}

The implication of the theorem is that in the absence of transaction costs resources will find their way to the usage that has the highest utility. This naturally means that the theorem is applicable only when property rights are transferable by contracting. If there is property that is
used inefficiently free contracting will lead to the property find its way to the highest value, as the new owner can compensate the old owner according to the old value, while still receiving a surplus from the new, higher value.\textsuperscript{121} The legal arrangements thus have no effect on what resources are used for, and instead only have an effect on to whom the total value of those property rights are allocated. However, when transaction costs rise above zero the legal arrangements have an increasingly important role to play, as the transaction costs inhibit efficient contracting.\textsuperscript{122}

There are many different interpretations when it comes to policy implications of the Coase Theorem, and there are many exceptions when it does not lead to Pareto efficiency. Such examples could include the fact that having no transaction costs at all could lead to problems with free-riding and strategic behavior when market actors are aware of the preferences and endowments of others. If so, the Coase Theorem would imply that what follows is not Pareto optimality, but a spiral of utility maximization at the expense of aggregate welfare\textsuperscript{123}. Another critique is that market failures and the distribution of wealth may stop Pareto efficient states from forming, or may lead to states that are Pareto efficient but socially unwanted. However, this critique is not entirely accurate, as the Coase theorem can also be interpreted as justifying legal intervention in situations where Pareto efficiency is not possible through free contracting due to market failures. It is of course not a given that the legal intervention is in itself more efficient than the imperfect market, but it is not given that the market will produce good results. Any given solution must be analyzed on its own merits.

\footnotesize{\textsuperscript{121} Coase 1960, pp. 2-7. Coase himself used the following example; imagine a cornfield that borders on grazing land. Without fences the grazing cattle will wander into the crop field and damage the crop. Consider two property right regimes: the livestock owner is liable for damage to crops or he or she is not liable. In the first case the crop farmer can demand that the livestock farmer builds a fence, but Coase proved that without transaction costs the fence would be built regardless of the regime. If the cost of fencing was lower than the damage to the crops, the crop farmer would pay the livestock farmer to build a fence even if there was no legal obligation to do so for the livestock farmer. Likewise, if the cost of fencing was greater than the damage to the crops under the first regime, the livestock farmer would simply compensate the crop farmer for the damage. Both parties have the option to simply contract around the legal regime if contracting is allowed and there are no or low costs to that transaction.}

\footnotesize{\textsuperscript{122} Schäfer & Ott 2004, pp. 90-92.}

\footnotesize{\textsuperscript{123} Schäfer & Ott 2004, pp. 92-93. This can likened to a "Race to the bottom"-type situation, where parties drive their own self-interest on the expense of others, so that all parties end up worse off in the long run.}
The situations where the Coase theorem is problematic are mainly related to situations where asymmetric information makes opportunistic behaviour worthwhile, when initial investment costs are high, when external effects are not internalized due to transaction costs and when economic instability leads to distorted markets. Almost all of these are problems that arise on the labour market. As discussed in chapter 4.2.1, information is often asymmetric on labour markets. That asymmetry can cause problems of both sides of the contractual relationship, as the employer has little information on the capabilities of the employee prior to the relationship, while the employee knows very little of the employers previous contracts and behaviour. After a dismissal there may be further problems with asymmetry, as it may be advantageous for one party to withhold information about the true reasons for the dismissal. Investment costs are often high for both sides, and as the labour market becomes increasingly dominated by high skill jobs such investment costs increase. The employer is forced to provide more expensive training while employees often are expected to be mobile and flexible, as well as having invested in an education. External effects and instability are so common on the labour market that it, in the form of the unemployment rate, is one of the main factors in determining the state of the economy overall. Unemployment rates are directly tied to the fluctuations of the economy, and that same unemployment rate affects the aggregate wage, which in itself is a factor in the determination of the content of the employment contracts.

What are the implications of the Coase theorem when it comes to the trial period in employment contracts? The first conclusion one must come to is that transaction costs can be quite high in individual labour contracts. Not only is it difficult to get sufficient information about the other party to the contract, but information can be very costly after a dismissal due to the adversarial nature of the situation. Furthermore, instabilities on the macro-level directly affect the transaction costs, as the opportunity cost of delaying or restarting negotiations can be very costly for the employee, thus affecting the terms of the contract.

The implication of the Coase theorem is therefore that a free market will not necessarily produce a Pareto or otherwise efficient allocation and that the employment relationship can

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124 Schäfer & Ott 2004, pp. 94-96.
possibly be made more efficient by legal intervention or by moving the negotiations to a level where information is cheaper and more symmetrical. An implication of the Coase theorem is that a concession, in the form of, for example, an increase in the length of the trial period, should be compensated through an opposite transaction, such as a higher wage, if there are no transaction costs hindering the contracting process. The value of that concession should be more easily measured on the level of collective agreements, where transaction costs are lower and market power is more symmetric. A possible conclusion could be that formal legal intervention through legislation could be necessary to ensure that collective agreements are available and possible, while ensuring a minimum standard in accordance with social justice. The parties to collective negotiations could then negotiate further regulation and the compensations for the weakened party. Dismissals could also be given a spot on the collective level, as the possibility of opportunistic behaviour would decrease when market power is more symmetric. However, this would mostly be favorable to workers, as it would be difficult to imagine a situation where a worker would not be allowed to cancel a contract without consulting his or her union. In fact, that would not be in accordance with principles in many constitutions and international agreements, and would not be in accordance with ideas of liberalism and individual freedom. A negative aspect of giving collective negotiations a larger role to play is that the information costs for courts when applying standards would increase\textsuperscript{125}. The increase would most likely be small, as it would only be a case of information on the differences between standards that most likely are quite similar.

\textsuperscript{125} Schäfer & Ott 2004, p. 102.
4. The Imperfections of the Labour Market

4.1 Dealing with Uncertainty

Uncertainty is part of everyday life on the market. A market defined by certainty is, in fact, not a market, as some uncertainty is required for the forces of the marketplace to work. If all risk was eliminated economic activity would come to a standstill.\textsuperscript{126} This means that uncertainty is something that has value and allows for market power, but it is also something that creates risk. Those risks can be especially high when another party has access to more information than the other.

Because of parties or competitors can either gain or lose an advantage depending on that information, a rational utility-maximizer tends to share information with partners while keeping it from competitors and opponents. When it comes to the relationship between an employer and an employee, it can be easy to simply conclude it is the case of a business transaction; the parties enter into an agreement based upon a mutual understanding and share the surplus from that cooperation. This is the ideal relationship between an employer and an employee, but in reality this is not always the case.

The relationship can be seen as adversarial quite early on. During the job search and bargaining stage the parties are indeed competing for the shares of that surplus. While both parties want to increase the size of the surplus, they are both looking to secure a sizable portion of it for themselves at the expense of the other party. The use of information not available to the other party can be one way to increase the share of the surplus, as may the taking advantage of the other party's situation.\textsuperscript{127}

It is not only during the bargaining process that the relationship can be adversarial. During the employment the employee sells his labour for a price in the form of a wage. In this sense, the

\textsuperscript{126} Stiglitz & Driffill 2000, p. 106.

\textsuperscript{127} Mundlak 1999, pp. 69-70.
employee may wish to withhold work (a phenomenon known in economic terms as “shirking”) and the employer may wish to organize the work in a way that minimizes salaries. If the relationship ends through a dismissal the canceling party may wish to keep information from the receiving party, in order to avoid costs or to avoid potential damages, were the grounds not obvious.

The duality of this simultaneously adversarial and co-operational relationship creates an uncertainty for both parties as well as potential market failures. The problems can be seen as arising from asymmetries related to information, power and risk during the bargaining stage, during the relationship and post-relationship. In the following sub-chapters we will look into possible problems due to the characteristics of employers and employees during these stages.

### 4.1.1 Asymmetric Information

Information is an important part of the market, and the idea of the perfect market with perfect competition is based upon the assumption that the agents involved have unlimited information about the goods bought and sold, and about the other agents acting on that market. This is clearly not the case on nigh on any labour market, which can lead to a multitude of market failures.\(^{128}\) Such problems can be explained through for example adverse selection\(^ {129}\) or higher transaction costs. These may in turn cause a variety of inefficiencies, such as lower wages, lower productivity or inefficient investments and allocation of resources.

Problems of asymmetric information exist on both sides of the employment relationship and vary depending on the position of the employer and the employee. Generally speaking, the more experienced the party is, the likelier he or she is to hold inside information. During the process of job search and bargaining the employer is generally the party that holds more

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\(^{129}\) Begg et al. 2008, p. 260. Adverse selection means that a seller that sets a price that does not depend on the individual customer can attract a large amount of customers that otherwise would push costs up. The customer uses his or her inside information when accepting or rejecting a contract. For example, an all you can eat buffet is more likely to attract customers with a large appetite, which in turn increases the average cost.
information on the characteristics of the job in question, and holds a position where the employee gives all requested information without being able to ask as much in return. In most cases the employee is asked to provide information about previous experience, education and performance while very little is asked about the previous labour relations or wages provided by the employer. In some cases where recruitment has been outsourced the employee may not even know the employer is until the contract is about to be signed. In the most extreme cases the employee may not know who the true employer is until work begins. The bargaining process does, of course, vary a lot, with the employees least in demand having the least amount of information in most cases.

While the average employee of the modern age changes jobs regularly, few of those employees switch jobs as many times during their careers as the average employer hires new employees. This means that in general, the average employer holds an experience advantage over the average employee. In game theory terms, the employer is a repeat-player with better information and sophistication. Because of this, the employer will generally know what a typical employee would ask for, while knowing how the employee in question seems to compare to previous employees. The employee may also have several other potential employers for comparison, but they do tend to be fewer than those of the employer, and information costs are generally higher.

Not all representatives of the labour force have the same amount of experience, just as not all employers have had the same amount of employees. Negotiations over the terms of labour contracts exist on many different levels, from the level of the individual contract to the level of legislation. In many countries, an important part of those negotiations include collective agreements. Such agreements between representatives of unionized (and sometimes other) workers and representatives of employers can to some extent improve problems related to asymmetry. The labour union will have a better position to coordinate and to acquire information on the value of the average worker, while representatives of a group of employers may not be under the financial duress of an individual employer. Such negotiations can avoid

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131 Mundlak 1999, p. 68.
some of the problems that face individual agents, such as signaling, adverse selection and the creation of a market for lemons. It is a continuous relationship where both parties need to cooperate over a longer span of time, so that strategic bargaining will not be as rewarding. Collective bargaining may also create inefficiencies that will be discussed further in the following chapter. When it comes to the cost of information, however, there is no question that collective agreements are more efficient than individual bargaining on the whole. The informational situation can be compared to the concept of economics of scale.

Because of the supply and demand for labour and the asymmetry of information during the bargaining stage (and during re-negotiations) there can be high search costs related to obtaining information. Those high search costs can result in parties simply acting on poor information. For example, a potential employee that asks the employer about relations to previous employees may not stand a chance of getting the job, and may thus choose to enter the contract at an information disadvantage\textsuperscript{132}. Likewise, an employer that asks too specific questions about an employee’s record may end up “showing his cards”, thus showing the employee that the demand for his or her services is higher than expected and hence giving the potential employee more bargaining power. Appropriating the returns is a key problem in the field of information economics.\textsuperscript{133}

Both the employee and the employer generally have quite good information on what their own abilities and characteristics are, and they can both have incentives to keep those from the other party or to make that information available. This relates to signaling, which, depending on the point of view, can be either a solution to problems for the party involved or a problem. If productive efficiency is not observable by the other party, meaning that information costs are high, then other factors may serve as a proxy for that information.\textsuperscript{134} By providing an indication of future value, a party can signal their value to the other party which many times can be cheaper than the actual information costs. The efficiency of signaling depends on how close that signal is to the actual situation, as poor estimation may lead to decisions that are less

\textsuperscript{132} Mundlak 1999, p. 68.

\textsuperscript{133} Stiglitz 2001, pp. 478-479.

\textsuperscript{134} Cahuc & Zylberberg 2004, pp. 79-80.
than optimal. If the signal is correct, it may enhance efficiency as information costs are lowered.

Signaling can be either positive or negative, and can take any number of forms. It can be in the form of the over-education of an employee, who in that way wants to signal competence. It can also be in the form of an employer pointing out high standards when it comes to the treatment of employees, through for example rigorous just-cause standards for dismissals. In the second case the employer may face problems due to this signaling, as adverse selection by shirking employees can occur.

This adverse selection and the fact that information may shift the demand curve can give a party an incentive to withhold information. For example, an employee whose ability is below the average may wish to hide that fact from the potential employer, in order to achieve a contractual position is better than the market equilibrium position. Such situations can lead to inefficiencies and allocations of rights that are Pareto inefficient, and must be considered market failures.\footnote{Stiglitz 2001, pp. 488-489.}

The problems of asymmetric information do not go away once the employment contract has been signed and work has begun. The employee still holds more information about his or her abilities, and the employer generally does not have the opportunity to completely observe how well the employee performs. Information costs are, in most cases, too high. This can in turn give the employee the opportunity to shirk through withheld performance. At the same time, the employer does generally have quite a clear picture of the general productivity of the worker or the workers of that kind, which gives the current employer a direct advantage of potential future employers. With clear productivity, the employer should be able to assess the level of the combined price of labour, so that any offer by another potential employer can be matched by the current employer. The current employer thus holds an information advantage over any potential future employers. This too, can lead to lower labour mobility and to inefficiencies.\footnote{The concepts of adverse selection, and especially the Coase theorem and the market for lemons that will be discussed further in upcoming chapter are useful in explaining these market failures.}
If the relationship ends through a dismissal a new situation appears with new problems related to asymmetry. The canceling party, be it the employer or the employee, may hold information about the dismissal that could lead to costs due to, for example, damages for an unlawful dismissal. Signaling is in this case usually not an issue; a party that refuses to share information and thus signals that the information can be harmful to the holder may not lose his or her position, as simply a signal that holds value on the market usually is not permissible as evidence in a court of law.

If the information concealed by one party was accessible to the other, information costs and thus transaction costs would be lower. As we will discuss in upcoming chapters, lowering such costs can lead to (Pareto) efficiency improvements. If information is expensive it may lead to a situation close to that of moral hazard\textsuperscript{137}, where one party can inflict costs without being held responsible. A potential, partial solution to this problem could be to have a party that has withheld information be responsible for any costs exceeding the costs of the holder of information if the question is ruled on by a court or other judicial body. However, as court proceedings generally are an expensive option, it is better if those costs could be allocated more efficiently by handling the issue through a more cost efficient process.

Signaling may further cause issues with the efficiency of the trial period, as an employee that would be willing to enter into a job with lower compensation through the wage, but with low risk in the form of a shorter trial period, would be unable to do so. Asking for a shorter trial period would be a strong signal regarding the potential for shirking and the performance of the employee, and would almost certainly disqualify that employee from any negotiations. Thus, signaling could cause the maximum length of the trial period to become the de facto obligatory term.

\textsuperscript{137} Moral hazard is a term used to describe a situation where one party has a chance of improving his or her utility while passing on the risk of failure to another party. It is often applicable on insurance policies where one is insured against losses to an extent where a decision will lead to at least a neutral result for the agent, regardless of the actual utility gained or lost from that decision. It can also be applied in situations where a party is a pricegiver, in economic terms a monopolist or monopsonist, so that any potential risk can easily be transferred to the other party.
4.1.2 Asymmetric Power

In most models of a functioning, perfect market the assumption is that no party has too much or too little power. The dominant view in labour economics has traditionally been that small firms face a horizontal labour supply curve, meaning that the firms decisions to hire has very little effect on the price of labour. If a player on the market ends up with too much power we usually call that situation a monopoly if the agent is a seller of goods, or a monopsony if the agent is a buyer of goods. In both cases the situation leads to the agent in power being able to set prices for goods purchased or sold beyond what a competitive market would allow them to. This affects the profitability of the firm in ways that generally lead to lower demand for the factors of production, including labour. This, in turn, leads to lower output for the aggregated economy and a welfare loss.\textsuperscript{138}

Monopoly or monopsony powers used to be considered anomalies, but are now suspected to be much more relevant than previously thought. However, the idea that there are asymmetries between employer and employee is not a new one. Writers in other fields have noticed this before, and even Adam Smith concluded that the urgency of the needs of the workman is much more immediate than for the master\textsuperscript{139}. Most firms can subsist without a certain employee for quite some time, while the loss of steady income can be devastating for many workers. Different kinds of subsidies and social safety nets can aid the worker, but most workers will still wish to find employment within a fairly short period of time. Such social safety nets do in fact decrease the opportunity cost of unemployment to some extent both on the micro- and the macroeconomic level.\textsuperscript{140}

Granted, much of the problems of asymmetry when it comes to the power of the parties are due to differences in information, but a large part is also due to the nature of labour. Labour is not just any other good with shifting supply according to the level of demand. If there is a lack of demand for labour we cannot simply stop producing labour, so that market equilibrium

\textsuperscript{138} Begg et al. 2008, pp. 192-194.
\textsuperscript{139} Smith 1776, Book 1 Chapter 8.
\textsuperscript{140} Boeri & van Ours 2008, pp. 234-237.
could be reached. This, along with the fact that most production ultimately ends up as consumption, is one of the reasons why unemployment is a central factor in considerations of the functioning of an economy. A surplus of labour leads to, in most economies, increased human suffering\textsuperscript{141}.

In most modern economies workers have organized on some level in order to either catch up or get an advantage in terms of bargaining power. Historically, taking on monopsony power by employers have been a major reason for the unionization of workers\textsuperscript{142}. In many of those economies employers have in return done the same. These organizations then negotiate over the terms of employment contracts, with varying scope and precision depending on the economy in question. How well the system works depends to a large extent on which questions representatives of employees and employers can agree to, which kind of labour and firms they represent and how well the market works.

Economists have usually seen unions as having a double effect on efficiency, as being simultaneously efficiency-enhancing and rent-seeking.\textsuperscript{143} The positive side is that unions allow workers with low bargaining power to gain an efficient share of the surplus without having to, for example, change jobs. Unions can make discussions over employment protection easier, since a representative of workers does not face problems related to signaling.\textsuperscript{144} Unions can also lower transaction costs, as bargaining collectively is more resource-efficient than bargaining over every single detail in each individual case.\textsuperscript{145}

\textsuperscript{141} It is, of course, possible to have a system in which unemployment is not associated with suffering. However, such a system would most probably suffer, as production would decrease due to a reservation wage that is higher than equilibrium. This means that a certain degree of lack of utility due to unemployment is necessary, which means that the level and functioning of unemployment protection and insurance is an important question for any economy.

\textsuperscript{142} Boeri & van Ours 2008, p. 72.

\textsuperscript{143} Boeri & van Ours 2008, pp. 72-73. The term “rent” is here used in the economic sense, as a profit gained not by efficient market-driven production but by abusing market failures.

\textsuperscript{144} This means that an employer bargaining with a union representative would not assume that all workers are looking to shirk just because the representative is asking for better protection for employees. If the same proposal was put forward by an employee, the employer may become worried that the worker performs below average.

\textsuperscript{145} Boeri & van Ours 2008, pp. 72-73.
In cases where unions hold great deals of bargaining power they may, however, have an efficiency-decreasing effect. For example, if the employer must make an irreversible investment in an employee due to a collective agreement, that employee holds a position to extract a rent from the employer vis-à-vis an outsider. This may happen if the union bargains extensively to the benefit of members contrary to non-members. In some cases unions may also hinder developments that are otherwise efficient, if that efficiency comes at the expense of members.\textsuperscript{146} However, representatives of employers can have that same effect.

So unions and collective bargaining can make information and power more symmetric, and can lower transaction costs but can also allow rent-seeking behavior. How strong these effects are must be decided in casu. In general, efficient negotiations take place on a level where a large majority of those represented are similar in order to avoid rents by those that are unlike the average, and to minimize transaction costs. In some cases a centralized agreement is efficient, while it in some cases is more efficient to decentralize the negotiations, depending on how industry- or firm-specific the question is.\textsuperscript{147} Generally speaking, the more specific labour is, the more efficient collective bargaining is, while efficiency for highly specialized labour can be found on a more individual level.

When it comes to the length and extent of a trial period for an employment contract there are large issues of signaling on the individual level, meaning that negotiations on the individual level would not be efficient. Differences between industries can also be quite large; a technology company employing mostly highly specialized employees would have quite different requirements for a trial period than a fast food restaurant employing what could be considered quite generic labour. Furthermore, highly specialized workers are in a better position to bargain over the terms of the contract, meaning that there should be fewer problems related to asymmetry. Thus, negotiations on the terms of the trial period are best held on a level below the national level. This conclusion is not quite unlike what can be seen in the Finnish labour market, where negotiations take place on an industry level.

\textsuperscript{146} Boeri & van Ours 2008, p. 74.
\textsuperscript{147} Boeri & van Ours 2008, pp. 74-75.
4.1.3 Asymmetric Risk and the Threat Values

As previously stated, risk is an integral part of any economic activity. One simply cannot do anything on the free market without being subject to some risk. This does not, however, mean that each agent on that market is equally willing to take that risk. Some people enjoy a higher potential reward with a higher risk, some prefer a lower risk with a lower, more certain reward and some are simply interested in what the average outcome is. In economics the kind of person that prefers risk is called a risk-lover, while a person that prefers a minimum of risk is known as risk-averse. A person that does unambiguously to risk is known as risk-neutral.\textsuperscript{148}

Affinity to risk is not only affected by the agent in question, but also by their existing resources. Marginal utility is an important concept here as well, since a person with more resources will be more willing to take on risk than a less affluent person. A lost bet for 100€ will mean a smaller loss of utility for a millionaire than for person who is starving.\textsuperscript{149} This has implications for some quite common situations on the labour market. In general, an employee has fewer resources than an employer. As that one employment contract may only make up a fraction of the total cost of labour to the employer, but the entirety of the income of the employee's family, the risk related to the potential loss of that subjective utility stemming from that employment contract is higher for the employee than for the employer. Losing a job is often more damaging than losing an employee. The opportunity cost may also be higher for the employee, as unemployment may affect the possibilities for future employment as well as the future wage. Furthermore, employers generally have better access to capital markets, and can insure against shocks by diversifying risk in a way that most workers can't. What this means is that workers are generally risk-averse, while employers mostly are risk-neutral.\textsuperscript{150} This has been shown empirically as well, with variations between different kinds of labour. Employees are generally speaking more risk-averse during recessions, when labour markets are frictional or when the employee is less likely to find a new job.

\textsuperscript{148} Begg et al. 2008, pp. 255-257.
\textsuperscript{149} Begg et al. 2008, pp. 256-257.
\textsuperscript{150} Boeri & van Ours 2008, pp. 215-216.
In terms of the trial period, that risk-averseness of the employee means that the longer the trial period becomes, the higher the cost for the employee is. On the other hand, the neutrality of the employer means that the employer will be happier to take on risk for the same amount of reward as the employee. If we were to assume that the optimal length of the trial period would be 4 months in a certain case, this means that the average employee would consider a trial period of 5 months to be worse than an average employer would consider a trial period of 3 months to be. The risk that the extra month would imply is a greater loss of utility for the risk-averse employee than for the risk-neutral employer. However, this does not necessarily mean that the parties cannot contract around this situation, so that the party taking the extra risk is compensated in a way that makes the deal worthwhile. As discussed in previous chapters, asymmetric information and power cause such contracts to not realize or to not become optimal. In other words, people value the employment security more when the potential loss is greater.\(^{151}\)

### 4.2 The Labour Market - A Market for Lemons?

In modern economics, the assumption of perfect competition in certain market models is one with many caveats. In fact, much of modern economics is preoccupied with studying market failures, as there practically are no examples of perfect competition in the real world. One prominent example of a model that takes market failure into consideration can be found in George Akerlof's ground-breaking article The Market for “Lemons”: Quality Uncertainty and the Market Mechanism, published in 1970\(^{152}\). Akerlof was awarded the Nobel Memorial prize in Economics. The model, named after the American slang term for a car that proves to be in bad shape after the purchase, tries to show how the market mechanism breaks down when information is asymmetric.\(^{153}\)

Akerlof considered the problems related to the sale of used cars. The assumption previous to

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\(^{151}\) Swanson 2014, pp. 30-32.


\(^{153}\) Informational asymmetries on the labour market have been covered in chapter 4.1.1.
this was that a competitive market would drive out bad products as well as bad sellers and buyers due to reputational effects. Akerlof then supposed that buyers can't distinguish a quality car from a “lemon”. The buyer would then only be willing to pay a fixed price for a car that averages the value of a quality car and such a “lemon”. The seller, on the other hand, knows the quality of the car. Because of this, a seller looking to make a profit is only willing to sell a car that has a value below the average price between a quality car and a “lemon”. Otherwise, the seller would sell the car for less than its value. If the transaction between the seller and the buyer is a one-time event and the buyer has few options when it comes to spreading information about the seller, the seller will not suffer market sanctions through reputational effects because of the lack of quality. Lowering the lack of quality would hence not lead to a lack of buyers, but to an increase in profits. Other sellers would follow, and the average quality would decrease.

As buyers notice this they would increasingly go for the sellers offering the lowest price, assuming that the quality of the car sold is average due to the lack of information. As the average quality decreases, the expectations of buyers will decrease further. This creates a vicious spiral, due to the rationality of the agents, which pushes goods of better quality than average out of the market. For this effect to take place, two conditions must occur: information on the quality of the good cannot be discernible to buyers, or is too expensive, and there is no way for buyers to push low quality sellers out of the market by transferring information or migrating to a better seller. The result is that the quality of market goods either falls, or that the market itself does not appear if agents are able to foresee the development.\footnote{Schäfer & Ott 2004, pp. 230-232}

What are the implications to employment contracts? First off, asymmetric information exists on both sides of the employment contract\footnote{See chapter 4.1.1 for a discussion on asymmetric information in regards to employment contracts and labour relations in general.}. The employer has less information on the capabilities and experience of the employee, while the employee has less information than the employer when it comes to practices and behaviour within the company. They often have decent information about the explicit details of the contract, but know very little about future
problems that may arise. An employment relationship is not a single purchase scenario, but rather an ongoing affair. However, certain situations that arise during the employment relationship, such as the initial bargaining of the contract and discussion over a potential cancellation may have characteristics of a single purchase scenario. The lack of information can be a real problem, and it is one that is often mentioned in discussion over what is known as “shirking”, or the ability of a party to withhold their side of the contract. In fact, the trial period for employment contracts is precisely meant as a remedy for such problems.

The duality of the employment contract, where a part is known and a part is unknown, also means that some portions of the labour market is clearly not a market for lemons. Consider the necessary conditions: asymmetric information and lack of reputational effects. When it comes to wages, for example, there is no asymmetric information. The wage is often clearly stated in the employment contract, and both parties know what to expect and how to value that part of the contract. This usually goes for the price of a car as well, and does not mean that the market as a whole is not a market for lemons.

However, just as the employee often is a price-taker when it comes to wages, the employer has better information when it comes to the chances of future increases in the wage. The same goes for the productivity of the worker; the responsibilities of the employee are often somewhat clear at the signing of the contract, but how well the employee will perform in his or her tasks is not as clear. The employee has better information on his or her willingness and skill when it comes to fulfilling the responsibilities that have been agreed to. How willing a party is to cancel a contract for reasons that are considered inefficient or discriminatory, or how willing a party is to hold out during temporary inefficiencies, are not known by the other party. Often a party is not willing to discuss previous cancellations with outside parties or possible partners in negotiation. Any information that is available in advance is often not reliable, as a party who has seen his or her employment contract canceled may have an incentive to provide biased information regarding the previous partner.

The fact that the information is asymmetric on both sides does not mean that the information is symmetric. It could turn out that a party that has an information disadvantage in one area is likelier to hold on to an information advantage in another. In fact, it could be argued that a party that is uncertain about the good faith of the other party is even likelier to shirk. What this
means is that we have a new market for lemons, where the payment for the product market good of increasingly lower quality comes in the form of labour of, in turn, increasingly poor quality. The two good product market has been replaced by a three good labour-product market consisting of money (the wage), the labour and the product, which in turn can be subject to the problems of informational asymmetries.

What does this mean for the trial period in employment contracts? The first implication is that it may help create a market that would not otherwise exist due to uncertainty. An employer that is uncertain over the abilities of an employee may choose to employ despite the risks, as he has a way to act out against shirking. The same, naturally, goes for the employee. In this quite obvious way, the trial period has an efficiency-enhancing effect. However, it also increases the risk of moral hazard. The fact that either party may have access to information on the grounds for cancellation that the other hasn’t, or that a party that has seen his or her contract canceled is unlikely to, and sometimes unable to, spread that information may allow the canceling party to act in a way that is otherwise illegal or that decreases social welfare. For example, a situation where lack of information allows employers to cancel contracts on a whim may lead to employees assuming that the average future employer could act in such a manner, and choosing to put a minimal effort into their work. As this problem would spread throughout the market, increasing information spending would at some point become inefficient, thus leading to a lower wage and lower productivity.

There are two major options when it comes to solving this problem: making information cheaper or more symmetric\(^\text{156}\), or increasing the chances of economic retaliation from the receiving party. This could, for example, be done through information forcing. If the canceling party was, through legislated requirements and the threat of economic sanctions, forced to provide information to the other party the other party would get access to cheaper information (as the information is cheaper for the owner than for the other party) and it would be easier for the receiving party to react to the low economic quality of the canceling party's actions. Thus, inefficient behavior could to some extent be lessened.

\(^\text{156}\) Making labour market information symmetric is often impossible, and if it is possible, incredibly expensive. It would require that information was gathered on any and all employees and employers, and that such information was made available to any future partners of theirs.
5. A Look at the Efficiency of Employment Contracts

5.1 Models of Employment Protection Legislation

Economic thought and labour market regulation is undoubtedly intertwined; one can hardly imagine a situation where changes in the laws governing labour markets would not affect the results and output of the economy in some shape, way or form. In most cases the intended result is precisely to affect the results of that work. Whether or not you wish to improve the productivity of the economy as a whole, the welfare of the workforce or to improve marketplace matching, you will have to consider how those changes affect other parts of society. As no part of the economy ultimately can be separated from the others, it is natural that economic arguments become part of the never-ending debate on labour legislation.

These issues are highly political, and different views and solutions can be seen in different political systems. Different legal and political cultures may be more tolerant and accepting towards certain risks or outcomes, while others find it more important to use resources, sometimes through higher opportunity costs, to avoid such risks or outcomes.

The two dominant paradigms of dismissal regulation are known as employment-at-will and just-cause. Employment-at-will is a view of employment contracts where both parties are considered equals, and where the basis of that contract is a shared will. If both parties consider that contract to be good for them, they will enter into it and both will come out with their own share of the profit. This view of employment contracts also mean that the most efficient way to handle dismissals is to allow each party to cancel the contract at any point in time and for any reason. If the contract is profitable and efficient, these reasonable, rational parties will keep to it, but if it proves itself unprofitable and inefficient they will simply cancel it. Forcing a party to stay true to an agreement that is no longer efficient would most probably be bad for society at large. This view is the basis of Anglo-Saxon labour law, and employment-at-will

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contracts are the foundation of the US labour market. In the United Kingdom the case is a bit more nuanced, but it still adheres to the same legal tradition. One could say that the UK tradition of labour law is European with a flavor of Americana.

In most of continental Europe, and in some cases in the US, the protection of employment is much stronger than what a pure employment-at-will regime would entail. Some countries have decided to fiercely protect workers from collective dismissals while accepting mostly any fixed term contracts while others quite freely allow collective dismissals while restricting individual dismissals to the absolute minimum. Still, in most cases the protection given to US labour is quite weak in comparison to its European equivalents. The European model, where the social safety of the worker is considered to have great value, economically or socio-politically, can be described as a just-cause tradition. The just-cause model is one where a party to the contract cannot without good, legally supported reason cancel the contract. In some cases, the principle behind just-cause regulation may just be about ensuring access to justice for the party that has had their employment contract canceled.

Employment-at-will can be considered a rule-type option. The judgment on the validity of the dismissal would be simple; if the party initiating a cancellation or dismissal has been a party of

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158 Beck 1999, pp. 102-104. This idea of the American system has later evolved into something more dynamic. The completely at-will contract, known as Wood's rule after Horace Gay Wood, has changed quite a bit through the ages. In the late 19th century it was considered that a contract could be dismissed for good cause, for no cause, or even for cause morally wrong. It was, for example, considered legally right to dismiss an employee because his wife would not sleep with the employee's supervisor. From the 1930's onwards restrictions were put in place, disallowing for example refusal to commit criminal action, the filing of a compensation claim or refusal to falsify documents as grounds for dismissal.

159 Beck 1999, pp. 92-94.

160 US labour law is generally speaking more varied than European national law. There are large variations depending on for example the state and the sector of the labour market.

161 OECD 2013. One of the most important databases on the subject is the OECD Employment Protection Database, which measures employment protection on a scale of 0-6 for the most economically advanced countries in the world. It is measured using four categories: Protection of permanent workers against individual and collective dismissals, protection of workers against individual dismissals, specific requirements for collective dismissals and regulation on specific fixed term contracts. The unweighted average in the latest report from 2013 was 2.29, 2.04, 2.91 and 2.09 respectively. The United States scored 1.17, 0.49, 2.88 and 0.33 while for example Finland scored 2.17, 2.38, 1.63 and 1.88.

the contract, and nothing else has been agreed to, the party has a right to cancel the contract and the cancellation must thus be valid. If regulated by an employment-at-will type rule, a dismissal can only be unlawful if it breaks an agreement by the two parties. Such a binary situation is what makes up the criteria for a legal rule. Given a starting point within the purely contractual sphere, this must be the case, as both parties have used their free will and rationality in the contracting process to ensure that any such rule within the contract would be in their best interest. Employment-at-will can also be seen as a strong expression of the freedom of contract and the freedom of the individual. Just-cause, on the other hand, is not a rule, but a standard. Ultimately the legislator, the parties or a court must set the point, at which dismissals are allowed. This is efficient for ensuring that dismissals are socially acceptable, but also leads to higher information costs than employment-at-will.

In traditional, neo-classical law and economics market forces are considered to be the best regulator of the terms of a contract. This has, largely, been the view of dominant writers in the field, such as Richard A. Posner in his book The Economic Analysis of Law. There are several arguments why this is the case, most of them based around the idea of shirking. Shirking is related to the problems of incomplete information, and implies that an employee finds the work done unattractive, but performs it because of the compensation received. The higher the safety net of the employee is, the more likely the employee is to attempt to decrease his or her productivity. In other words, people will be lazy if they can. If the employer is able to fire the employee at any time and for any reason, there will be less monitoring required to find out if the employee is shirking or not, and thus there will be lower monitoring costs. This can also be seen as a way of lowering the risk of moral hazard.

A response to this, which does seem quite natural, is that a completely free at-will rule would allow one of the parties to use dismissals for purposes that are not considered in line with

164 It must come as no surprise that one of the stronger defenses of an at-will type rule is not economic but political. A libertarian view on the employment relationship quite naturally leads to such a conclusion due to the anti-authoritarian principles often included.
other societal goods\(^{167}\). It is not difficult to imagine a situation where for example, an employer would threaten an employee with a dismissal unless the employee, say, votes for a certain party. A pure at-will rule would allow such an arrangement. There is, however, a response to this criticism; a market player acting in a way that is considered unwanted by other actors would find it more difficult to conduct his or her business. Other actors on the market would charge a premium to compensate for possible reputational losses. This could take the form of having to pay higher wages in order to attract similar labour as other employers, which would translate into either a decrease in profitability, and thus either a correction of the behaviour or the actor being pushed out by market forces due to prices above the supply-demand equilibrium. A rational employer would thus prefer not to dismiss an employee, unless there is an economic incentive to do so.\(^{168}\)

One could argue that workers entering into employment contracts with firms of less than shining reputation would negotiate for restrictions on dismissals. However, that would assume that there are no asymmetries when it comes to power or information\(^{169}\) and that the parties have unrestricted access to information. These assumptions are quite demanding, and do most probably not hold water.\(^{170}\)

There are other solutions to the problem of shirking as well, such as those implied by efficiency wage theory\(^{171}\). Efficiency wage theory would lead to the conclusion that it would be efficient to avoid shirking by increasing the pay relative to the productivity of the worker throughout the employment relationship as long as the employee fulfills the employer’s expectations defined by the implicit contract. This would, as long as monitoring costs are not too high, keep the employee from shirking in order to not lose the implicitly promised raises.

\(^{167}\) Good is here used as an economic term, meaning something that has positive value.


\(^{169}\) See more on the asymmetries of power and information in chapters 4.2.1 and 4.2.2.

\(^{170}\) Epstein 1984, p. 947. Epstein argues, among other things, that such contracts should be widespread if this kind of opportunism was a major issue, and somewhat circularly concludes that they are not. However, one could, with the same line of reasoning, conclude that the evolution of employment protection is proof that employer opportunism and socially unacceptable behavior are a problem. This only requires that you consider law to a manifestation of a social contract.

\(^{171}\) Akerlof & Yellen 1986.
Another effect of this would be to keep the employee from changing jobs, which in turn would protect the investment into training costs that the employer has made.

All in all, it is difficult to say that one model is more efficient than the other. The just-cause model is simply a standard, where the level of protection has to be regulated, and the regulation itself must then become the object of analysis. It is very likely that there are standards for just-cause dismissals that are very inefficient, while there are standards that can promote efficiency better than an at-will type rule, as it can avoid some of the problems of that model. The at-will model does after all make quite a few assumptions; it does assume, among other things, that there are no problems with asymmetric information or power, that employers and employees are risk-neutral. These do probably not hold, as the history of problematic cases in the US show, where employers have attempted to use freely available dismissals to push their employees towards criminal acts, for political gain or for simply petty reasons. While cases like they are not the norm, the evolution of US legislation shows that an absolute at-will regime hardly can be confined into the limits set by socially acceptable norms.

But why are these models relevant to the efficiency of the trial period often used in Finnish employment contracts? The trial period is, essentially, a combination of these two models. In general, Finnish employment law is clearly within the boundaries of the just-cause regime, in some ways quite strongly so, but during the trial period something that is reminiscent of an at-will type rule applies; The Employment Contracts Act (55/2001) Chapter 1 Section 4 even states that the contract may be canceled by either party during the trial period without the requirements that normally apply. However, it is not a clear rule. The Employment Contracts Act (55/2001) Chapter 1 Section 4 further states that the employment contract may not be canceled on grounds that are discriminatory or that are inappropriate with regard to the purpose of the trial period. This does require the court to set a standard, just as is the case when it comes to prohibited grounds within the US at-will model, such as dismissals contrary to public policy, good faith and fair dealings.\textsuperscript{172} The Finnish trial period is therefore not simply a rule or a standard, but a rule with a standard-like component. The efficiency of the model depends on how well the two parts complement each other, and on how well they

\textsuperscript{172} Beck 1999, pp. 102-104.
negate the shortcomings of each other.

5.2 Inefficiency and Welfare Loss

The efficiency, and particularly the inefficiency, of contracts can be seen through many different lenses. Often the contract is seen as a way of allocating certain rights, and that allocation determines how efficiently the resourcing going into the contract and those resulting from the contract are used. Such allocative efficiency will be discussed in chapter 5.3. First, we will discuss the types of inefficiencies that can be observed in employment contracts. These are the kinds of situations where an inefficient employment contract leads to welfare loss, that is, where the welfare of the parties involved could be higher if not because of a problem with the contract in question.

5.2.1 Unwarranted Dismissals

While there are contracts that are inefficient due to the outcomes of the contractual obligations, there are situations where inefficiency and particularly welfare loss can be observed due to the inefficient dismissal of a contract. Considering the purpose of the trial period, such dismissals may also be seen as inefficient dismissals.

Such inefficient dismissals are cases where the employment contract has been canceled because of reasons that are not economic in nature. These reasons may be related to the legal-technical grounds, or they may be completely irrelevant to the formal reasons. However, if the contract did, in fact, provide an economic surplus to the parties of said contract, the dismissal must be seen as inefficient.

If, however, one assumes that the employer and the employee are both rational the contract in itself must be rationally negotiated. If one of the rational parties chooses to cancel the contract they must therefore have rational reasons for this. If efficiency in this case is seen as the contract providing surplus to the parties, a rational party would not have chosen to have canceled the contract. The efficiency deficit, if one will, can be a result of any kind of factor, and factors that are not directly economic can then be part of an economic rationale.
The argumentation is quite circular, but would lead to the result that any dismissal per definition must be efficient. However, such a view of rationality can hardly withstand criticism. Rationality in economic terms often means little more than the fact that a human being generally will act predictably, so that we will maximize our gains depending on our preferences. But while the idea of a homo economicus is a mainstay especially in neoclassical economics, bounded rationality provides a strong criticism.

This criticism, laid out by Nobel Prize winner Herbert Simon, claims that it is unreasonable to assume that we have the mental capacity and information available to consistently act rationally. Our rationality may be more of an intended rationality than an actual one. This idea of a decision-maker that may not always act economically has been further strengthened by developments in the field of behavioral economics, where psychologists like Amos Tversky and Daniel Kahnemann have shown how seemingly unimportant factors can change our behaviour in surprising ways.

The result of this is that even though one could argue that dismissals for any reason are valid due to social or emotional efficiency, we cannot assume that any and all dismissals are in accordance with such social or emotional efficiency. It is quite possible that an employer will dismiss his or her best employee for reasons that would not have led to a dismissal, had it not been for the employer not having had lunch yet. That arbitrary situation would then, clearly, lead to a welfare loss due to an economically unwarranted dismissal. Such welfare losses can sometimes be avoided through legal requirements.

\[\text{References}\]

175 Danziger et al. 2011. Some of the results have a direct impact on the field of law as well. A quite famous example comes from a study, edited by Daniel Kahneman himself, on judges, hunger and its effect on the outcome of rulings. The results clearly showed that a judge statistically would end up at a very different judgment depending on when he or she had lunch.
5.2.2 Inefficient Employment Contracts

As discussed in both chapter 2 and 3, the main function of the trial period is to allow the parties of the employment contract to assess the reality of the contract vis-à-vis the implied terms of the contract upon signing. If seen from a purely contractual point of view, both parties to the contract have entered into a contract with efficiency in mind. A contract that according to one party is inefficient will not be entered into. Such efficiency is, however, difficult to define. The rationality behind it may be economic, social, historical, moral or any other kind. It is furthermore an adaptive and living situation, where the efficiency of the contract can change without any obvious change to the contract or the contractual environment. If such soft factors are taken into account, the efficiency of a contract entered into by a morally judgmental party would become efficient quicker than if the same party was morally tolerant. As such, a mere definition of an existing contract entered into and stayed in through an expression of free will as efficient is insufficient.

When it comes to employment contracts, an efficient employment contract is one where the contract itself produces a surplus for both parties, compared to a contract-less state. If either party could cancel the contract and be better off the contract is inefficient. A further condition of such a definition of efficiency is one of opportunity cost; a contract is inefficient if either party could cancel the contract in order to enter into a new contract, where the surplus is greater still. In fact, opportunity cost is the deciding factor even in the first case where only the two parties to the contract were considered in a static environment. Opportunity cost here would include all costs related to finding a new contractual partner, costs of training and would take into account the surplus of the new contract. These are often known as labour turnover costs\(^ {176} \). As the canceling party would have to consider the costs of the initial cancellation, an efficient contract could be defined as follows

\[
\text{Contractual Surplus} > \text{Opportunity Cost} - (\text{Cost of Conflict} \times \text{Risk of Cost of Conflict})
\]

\(^{176}\) Lindbeck & Snower 1988.
There are further problems with such a definition, as it only considers the parties of the current contract during the contract and the parties of the new contract. There are many potential externalities to an employment contract. A switch from one contract to another can cause socioeconomic issues for an employee who lost his job and for his or her family, it can cause search and training costs for the previous employer of the new employee and it can cause downward pressure on wages and prices, which can lead to a recessionary spiral. All in all, there are huge potential social costs to the cancellation of an employment contract, and those need to be considered in discussions on the efficiency of contracts and regulation. As such, an efficient contract with social cost taken into account could be defined as

**Contractual Surplus of initial Parties > Opportunity Cost for Cancelling Party – (Cost of Conflict * Risk of Cost of Conflict) – Social Cost + Change in Utility of the New Party**

So what are the hallmarks of an inefficient employment contract? Essentially, it is one that allows rents for one of the parties involved that are not otherwise socially or macroeconomically justified. Such rents can take the form of inflated wages or an unjustified employer surplus, and are usually due to distortions in bargaining power. Inefficiencies can also be seen in lower economic growth due to inefficient production caused by low-productivity labour, or through persistently low demand caused by low bargaining power of consumer-employees in comparison to employers. A further interesting aspect of inefficient contracts, as it relates to the trial period, is that a trial period with a sharp increase in employment protection at the end may cause employees in inefficient contracts to not move to a more efficient contract. The rents that they exert as insiders may cause the opportunity cost to go down due to the increased risk related to canceling one contract and entering into a new one. Hence, rents may not always be profitable to the party exerting them and can carry significant social costs.

The conclusion one must draw from the efficiency of cancellations is that the trial period lowers the labour turnover costs (thus raising the opportunity cost) while also lowering the

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177 Insiders would here be defined as employees that are already in employment contracts that have moved past the trial period, while outsiders are new employees still under the loose regulation of the trial period.
cost and risk of conflict. This allows parties to the conflict to more easily measure and compare the contractual surplus to the comparable situation with another party. This can in turn enhance efficiency. Simultaneously, an increased trial period can cause a higher social cost due to a shift in risk to risk-sensitive parties. The trial period is thus a way to enjoy the benefits of so called efficient breaches without the associated issues of determining the price of breach and the transfer of the cost, in exchange for the price of additional social cost.

5.3 The Allocative Efficiency of Employment Protection

As must be concluded from the previous chapters, the allocation of rights and risk on the labour market can in combination with the importance of the labour market itself play a significant role in determining the overall welfare of the economy. As has been seen in chapter 4, there are cases when a functioning market will not appear, or when the quality of that market will decline due to market imperfections, specifically asymmetric information. If so, the resulting allocation will not approach Pareto efficiency, and regulation of the terms of contract can be motivated due to the implications of the Coase Theorem. But what would a Pareto efficient allocation of risk look like?

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\[178\] Klass 2013, pp. 21-29.
In the graph above, risk is a measurement of the subjective utility of a possibility of loss, while level of employment protection is the amount of protection the law provides for the employment contract. In this case, a higher number for the level of employment protection means, for example, that the trial period is lengthier. Risk, in this case, is simply the value the parties give their side of the risk. A change in the level of employment protection translates to a transfer of risk from one party to the other, so that the risk of either ending up with a shirking employee or having your employment contract cancelled on dubious grounds is moved between the parties. The graph is not based upon actual data, and is meant as a visualization of the implications of subjective evaluations of risk.

The Pareto efficient state is the one in which the total risk is the lowest. In this fictional example, that would mean a trial period of three months. One important assumption in the example below must be highlighted, namely that the increase or decrease in the risk of suffering a loss is linear over time. This is an assumption that is unlikely to hold due to diminishing marginal utility.

Risk is a function of utility, and as with any kind of utility the level is subjective. Just as we do not all value a painting the same, neither do we fear the risk of losing a job as much. If we
assume that employers indeed are risk-neutral and that employees are risk-averse, as discussed in chapter 4.4, a longer trial period than is optimal would mean that the net utility of the contract would decrease more quickly for the employee than it would rise for the employer. If the aim of policy and regulation were to set employment protection at the level that most closely matches a market transaction without market failures, then the level of protection should be set to the point (or here, length) where the transfer of risk matches the transfer of monetary compensation if that transaction was made on a perfect market.

However, such a situation rarely exists. The previously discussed Kaldor-Hicks criterion can be of use in such situations. Even if the monetary transaction from the party receiving increased utility from the transfer of risk never happens, the total utility of the change of state can still lead to an increase in social welfare. However, the utility of that monetary transfer will not be symmetrical due to differences in preferences and the diminishing marginal utility of consumption. Just as with risk, money has different value to different people. This is a major difficulty in the specification of and comparison between different social states.

The graph above could be expressed as two indifference curves as well; one representing the preferences of the employer and one representing the preferences of the employee. The curves would express the relationship between the utility from the contract excluding risk and the security (defined as risk in real terms) awarded to each party so that the party is indifferent to any bundle of goods along that curve. The indifference curve the shows the point, at which the marginal utility cannot be increased, and the party is indifference to the bundle. The intersection of the two lines for the employer and the employee would then show the point at which no Pareto improvements can be made in this two person economy.

This relationship can furthermore be expressed using a Pareto frontier, that is, the relationship between states with different allocations of social resources between employees and employers. If the assumption that employers are risk neutral holds, the net utility from the security offered by the state of employment protection and the compensation in the aggregate wage should be equally large. A risk neutral employer would simply transfer the cost of the risk to the wage, as long as there are no information asymmetries or other market imperfections. Therefore, the net utility of the risk neutral employer would be zero. The risk-averse employee would face high marginal utility of consumption at low levels of
compensation and risk, while seeing diminishing marginal utility and effects of risk aversion on the willingness to take on risk at higher levels of compensation and risk. The result is that the Pareto frontier is largely dependent on improvements in utility for the employee. This, in turn, is largely a result of the relationship between the rate of the diminishing utility and the aversion to risk of the employee. While it has an effect, the diminishing utility of consumption for the money wage is similar to most employees to whom the trial period applies. This means that the main driver of Pareto improvements will be the willingness to take on risk, and so social welfare can be maximized by allocating risk to those who tolerate it best.

In areas where workers are less averse to risk, such as career-oriented businesses, the Pareto optimal state would most probably include a lower protection for employment (and a longer trial period) than areas where workers are more averse to risk, such as education.

There are two major conclusions to draw from this: (1) If policy is to set the level of employment protection on an imperfect market it is likely that too low protection will decrease social welfare more than too high protection will, so that policy-setting with imperfect information should aim for higher end of the spectrum of potentially efficient levels, and (2) If possible, the decision to set the degree of protection should be made on the level between the individual contract and the aggregate economy in order to best estimate the varying utility and risk of the parties to the individual contract without problems related to negative signaling.
6. The Wider Angle – Social and Macroeconomic Factors

6.1 The Economic and Social Importance of Employment

Contracts and Labour Markets

There are many different ways to divide up the different areas, sectors and factors of an economy, but the perhaps most important one is the division of the factors of production. In classical economics that division is quite simple; the production of an economy is seen through the shares of labour, capital and material\footnote{Stiglitz & Driffill 2000, pp. 182-184.}. Since the times of Smith and Ricardo there have been newer, more complex models of the factors of production, but labour seems omnipresent in some shape or form.

This is not all that strange. When it comes to the share of the economy, labour makes up about 2/3 of the gross domestic product (GDP). In most western economies the employed labour force makes up a majority of the working age population. In Finland, the employment rate among the working age population, here defined as ages 15-64, has been close to 70% for most of the period between 2005 and 2015\footnote{Official Statistics of Finland: Labour force survey - Employment rate and trend of employment rate 2005/09-2015/09.}. This number even includes all those that study beyond the age of 15 and those who reach the retirement age before the age of 64. All in all, the labour market is a huge part of the economy and has the largest effect on social welfare of any individual part of the economy, especially as the well-being of the labour force directly affects the lives and livelihoods of the large majority of the population.

Another way to consider this is through the definition of the national income. National income, or essentially the money the economy has to persist on, is most often defined as

\[\text{National income} = \text{Labour income} + \text{Capital income} + \text{Material income}\]
C+I+G+NX\textsuperscript{181}

, where C is consumption, I is investment, G is government (or public) spending and NX is net exports (meaning exports minus imports). Out of these, the majority of the demand for consumption is provided by the fruits of labour, while government spending is mostly financed by taxes on the labour market. If the production by or of labour falls, the national income falls as well. Simply said, when the labour market does poorly, the general economy does as well.

The labour market is not only a large part of the market, but it is also one that has far-reaching effects on both the individual worker and the economy as a whole. In many societies, work is a large portion of our personal identities, and not having work or under-performing on the job market can be detrimental to anything from an individual’s self-perception to their social standing and perceived value to society. Furthermore, the effects of unemployment above the natural rate of unemployment can have long-lasting consequences, sometimes called hysteresis-effects\textsuperscript{182}. According to the most basic neoclassical models of macroeconomics, the unemployment rate should find its way towards equilibrium once the price of labour has adjusted, but in reality prolonged periods of persistently high unemployment has not been uncommon throughout history. According to the views of much of modern labour economics, these prolonged periods can be explained by the fact that the workers that end up unemployed get disenfranchised, and may lose some of their value to employers. Unemployment is a strong signal, and it decreases the expected utility for the employer, thus pushing the price up and leaving a portion of the labour force out of the market. In other words, shocks to demand can have persistent effects on the supply of labour\textsuperscript{183}.

Such persistent effects are more problematic in the labour market than in other markets. If there is an oversupply of tennis shoes and some of those tennis shoes sit unused, or unemployed, the owner is at some point likely to either sell them off at a loss or to throw them away. When it comes to labour, an oversupply can in civilized countries not be solved by

\textsuperscript{181} Blanchard & Amighini & Giavazzi 2010, pp. 123-127.
\textsuperscript{182} Blanchard & Summers 1986.
\textsuperscript{183} Blanchard & Summers 1986, pp. 71-74.
lowering the price until someone is willing to buy, as that may result in an overall utility loss for society. It may be more efficient to let that person be unemployed for a short while, and to secure the livelihood using the surplus of other labour. It is even less accepted to destroy that oversupply of labour, as a large majority of the population ascribes certain inalienable human rights to each individual. At the same time, underutilized labour is often supported by the public sector, and may cause underutilization of future labour, or of other labour due to connected problems of mental health and social stigmatization.

What this means in terms of labour market regulation is that the opportunity cost of an employment contract isn't limited to the cost related to the lack of productivity of the worker, but must also include prolonged unemployment as well as lower wages and future periods of unemployment that could, perhaps, have been avoided had the worker not experienced loss of skill or problems with signaling. The argument could even be extended to the next generation, as the employment situation of a parent can have effects on the ability of the child to sustain gainful employment. In other words, the social cost of a poorly functioning labour market, which includes too weak or too strong employment protection legislation, can be seen for the better part of a century after a contract has been canceled on inefficient grounds.

6.2 Employment Protection Legislation as a Macroeconomic Tool

Policy, politics and legislation tends to stagnate during good economic times, while suddenly being forced to adjust quickly once the shock hits. Few shocks to the modern, global economy have been greater than the American sub-prime crash of 2008. Together with the Eurozone crisis starting in 2010 and the emerging markets crisis of 2015 the crash started what is often known as the Great Recession. As can be expected, policy responses varied greatly from legislature to legislature.

How to avoid and ease recessions, and the best tools to use in such situations is often seen as the primary goal of the field of macroeconomics. Such questions would best be answered in an academic text above and beyond this, and would be better suited for academic macroeconomics than for law and economics. However, one relevant question, where important answers can be found in macroeconomics, must be touched upon here; is
employment protection legislation a suitable alternative in the economic toolbox once a recession strikes?

Simple, classic microeconomics could lead one to such a position; recessions can be seen as a fall in output due to a shock or shocks, that push relative prices up, for various reasons, so that a large portion of the economic activity ends up in a situation where the demand and supply curves do not meet. Because of the shock, buyers are not willing to buy for the lowest price sellers are willing to sell for, and production decreases as consumption and investment are pushed to savings instead. One reason for such a fall in the willingness to pay is that the risk associated with the purchase, of for example labour, suddenly becomes more costly to the buyer, as the likelihood of it being a bad deal increases due to price changes and possible insolvency. Market adjustments simply push the price of labour above what buyers want, and unemployment increases.

Standard models used in classical microeconomics state that if prices were able to adjust instantly to the new equilibrium there would essentially be no increase in unemployment during a recession. If everyone went to work the next day and decided, happily, with their employer that their wage would be 5% lower and that all prices would be lowered equally the economy would immediately return to its trajectory. In reality, that is not the case. Wages and prices are sticky\textsuperscript{184}, as such economy-wide, coordinated price adjustments do exist in a Nash equilibrium. A market player that does not lower his wage would gain an advantage in an economy with lower prices, thus creating a prisoners dilemma of sorts.

Throughout history some economists have suggested price and wage controls to help the economy adjust to the shock and following recession. The dispute over whether such centralized guidance of the economy was a good tool for a government trying to return the economy to normality was one of the great economic debates of the 20th century. Nobel laureate Milton Friedman famously stated in his 1967 presidential address\textsuperscript{185} that the goal of economic policy (here mainly monetary policy) should be to set the level of production and growth for the entire economy, not for a specific sector or by attempting to control prices or

\begin{footnotesize}
\begin{enumerate}
\item Deakin & Wilkinson 1999, pp. 18-19.
\item Friedman 1968, pp. 1-17. The address was later published as an article.
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\end{footnotesize}
wages. Such microeconomic controls affect the allocation of resources in a way that distorts markets and can cause otherwise sounds fiscal and monetary policy to create market inefficiencies and failures. In other words, using employment protection legislation to correct problems in the economy as a whole will most likely create further problems, and the adjustments required due to recessions should be made on the aggregate level, not on the level of individual market transactions.

One could note that intruding into the workings of a perfect market is something that governments do constantly. In fact, restrictions on working hours, contract terms and especially minimum wages are precisely such price and wage controls. It is not uncommon to hear arguments in favor of lowering the price of labour, stating that companies cannot afford the high costs of labour and that legislation must be loosened in order for companies to hire more employees. While this may be true in some cases, it is an argument that one should be wary of. In the long run, it is a dangerous argument, as a wage based upon the capacity of employers to pay would lead to low-wage industries that otherwise should be replaced by new technology. It is dangerous, as well, to assume that an industry that does well has a higher capacity to pay. In the long term, per capita growth depends on innovation and gains in productivity, not upon keeping labour at a certain price point. In turn, having a floor set through legislation can keep the market from failing due to asymmetric relations or rents.

The ideas of Milton Friedman correlate well with the first and second theorems of welfare economics. According to the first theorem, an economy where the markets works will be better off if the market is left free to work. According to the second theorem, a lump sum wealth distribution followed by transfers through market forces will lead one of an array of possible Pareto efficient solutions. This makes the case that the workings of the economy should not be interfered with, unless the market does not provide the prerequisites for market transactions to be efficient and rent-free. As a free labour market rarely leads to Pareto efficient distributions intervention can be justified. However, micro-level controls should not

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186 This also applies to the paradox of thrift, as explained on the following page.
188 Stiglitz 1994, chapters 3-4.
be made for macroeconomic reasons.

A change in the level of employment protection thus has three different effects through the increase in the price of labour. An increase in the requirements for cancellations during the trial period would decrease the rate of job destruction due to market forces, it would increase the barriers for new employment thus decreasing job creation, and it would have an effect on aggregate demand that would depend on the state of the economy.\footnote{Cahuc & Zylberberg 2004, pp. 739-741.} If the economy suffers from a recession, where the rate of job destruction is high, an increase in employment protection can help avoid problems related to the paradox of thrift\footnote{Keynes 1936, chapter 23.}, which is a spiraling situation where market actors respond to the lack of demand by decreasing production and labour demand, thus decreasing aggregate demand further. However, if the economy is at full employment, increasing employment protection may in turn increase the natural rate of unemployment, thus decreasing the potential of the economy.

As understanding the state of the economy and the underlying causes of unemployment is vital to understanding the correct level of employment protection legislation in relation to the current level, a short summary of how wages are set, and how structural and cyclical problems affect them.

\[ W = Pe \cdot F(u, z) \]
\[ (-, +) \]

The equilibrium wage is traditionally defined as the relationship between the expected price level (Pe) a function of the unemployment rate (u) and a catch-all function (z), representing all other variables affecting the wage setting.\footnote{Blanchard & Amighini & Giavazzi 2010, p. 142.} As u rises the equilibrium wage falls, since the bargaining power of labour diminishes along with their alternatives for employment. Similarly, as z rises, the equilibrium wage rises. Pe, the expected price level, is a measurement of the inflation or deflation in the economy. As workers do not truly care about the nominal
wage they receive, but about the utility and purchasing power of that wage, higher expected prices means that workers will expect a higher wage in the future. Unemployment and the expected price level interact through a Phillips curve, so that the relationship is inverted.

The catchall variable, z, is important when it comes to changes in legislation regarding the protection of employment. The variable z is made up of any and all factors affecting the bargaining power of workers, except for unemployment. One critical factor is unemployment protection. The more protected an employee is, the better his bargaining position is. The so called non-cooperation position of the employer is stronger if canceling the contract is a feasible option. The same goes for unemployment benefits; a desperate worker is more likely to accept a lower wage.\(^{192}\)

Whenever an economy suffers from a recession, there will be discussion on whether the problems are cyclical or structural. In many cases that discussion will be difficult, as almost any recession will be due to both cyclical and structural issues. High unemployment is likely to have both a component caused by a lower demand for labour (which is cyclical), and a structural component caused by labour market tightness. In general, the price and wage levels can be used as a proxy for deciding what the major problem is. The catchall variable in the wage setting relationship, z, is essentially a measurement of the structural problems of the economy. Ceteris paribus, an economy with more structural labour market issues should have a higher equilibrium wage. Due to the role of wages in the price-setting relation\(^{193}\), a higher wage likely leads to higher prices. However, higher prices can also be a result of market failures as a result of undue product market power of employers.

What this means is that adjusting the protection during, or the length of, the trial period can be a way to manage structural issues in the economy. By looking at prices and wages can get an idea of how large such issues are. If inflation is high and real wage growth above trend for a set level of unemployment, there may be structural issues that can be corrected. If employees simultaneously report problems with hiring new employees and an unwillingness to take on risk, the structural problems may be solved with a more liberal trial period. However, a low

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\(^{192}\) Blanchard & Amighini & Giavazzi 2010, pp. 145-149.

\(^{193}\) Blanchard & Amighini & Giavazzi 2010, pp. 151-152.
level of inflation or deflation combined with below trend real wage growth would in turn imply that the problems are likely to be cyclical or related to other structural issues than the bargaining power of workers. If so, Friedmanian classical economics would favor aggregated monetary policy above wage controls.

If the recession is due to both structural and cyclical issues changes in legislation can be a part of a solution, but is unlikely to solve the economic problems entirely. As the US economist James Tobin famously pointed out,

“It takes a heap of Harberger triangles to fill one Okun Gap.”

In other words, the difference between the potential and the reality of the economy (the Okun Gap), is often much greater than the problems caused by the deadweight loss due to government intervention in perfect markets or lack of intervention in imperfect ones (Harberger's triangle). This is quite logical, as structural changes work in the margins, and only enhance an already existing micro-economic situation, while policies focused on the output gap affect the entirety of the economy. In the Finnish context, this has been pointed out by, among others, Prof. Pertti Haaparanta.

Lowering the risk of employment in order to decrease unemployment is, ultimately, just another way of lowering the price of labour. Other ways to do so would include, for example, lowering the minimum wage or lowering taxes, such as various social security payments or payroll taxes, for employers. As unemployment generally is more responsive to changes in demand than in the supply of labour, such changes can be problematic. For example, in Sweden, with a labour market quite comparable to Finland’s, a study at the Swedish Ministry of Employment found that tax breaks in 2007-2009 for employers of youth aged 19-25 only managed to create jobs for that age group at a price of $150,000 to $240,00 per job. This estimated cost, which according to the researchers is likely to be an underestimation, must be

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194 Tobin 1977, p. 468.
195 Haaparanta 2015.
196 Lichter, Peichl & Siegloch 2014, p 18. This is due to the wage inelasticity of labour demand, meaning that demand of labour moved slowly in response to changes in the price of labour, at least in the short run.
considered very high. As a lot of the tax break was simply put to other use (such as savings, in the macroeconomic sense) little of the money used to lower the price of labour actually translated into increased employment. It would have been much cheaper and efficient to simply have boosted demand for labour through direct employment.

In other words, even if a recession is caused in part by structural problems, labour market legislation can in general not be the only tool used in order to achieve a recovery. It is often necessary to use downturns to pass legislation that otherwise is required, but one should not expect changes in the margins to solve an economy-wide issue. Liberalization of the labour market by use of an extended or freer trial period can bring benefits, but those benefits should be small in comparison to any demand-side recessionary effects. All in all, making changes in the regulation surrounding the trial period is a very crude and unsubstantial economic tool that should not be overestimated.

197 Egebark & Kaunitz 2013, pp. 33–36.
7. Discussion

The trial period in employment contracts is a contractual mechanism regulated in law aimed at reducing the risk related to employment. The trial period, which for private-sector contracts is limited to a maximum of four months or half of a fixed-term contract, gives both parties an immediate way to terminate the contract should it or the other party prove unsuitable for their needs. The trial period is regulated by mandatory law, and can be further specified in binding collective agreements entered into by representatives of employees and employers. There is no legal requirement for the wage to be increased at the end of the trial period, and the minimum wage set by collective agreements still applies. It is however possible to increase the wage above the minimum, but there is no such established practice on the Finnish labour market.

The aim of this paper has not been to state what the optimal trial period in terms of length and requirements should be, but to provide a framework for what factors to take into account when looking at the efficiency of such a trial period. The presumption of this paper is not that the labour market functions perfectly, and I have attempted to show why the labour market is filled with problems of uncertainty, asymmetric power and asymmetric information as well as other market failures. Just as the regulation on employment contracts assumes that the free market will not produce contracts where both parties act honestly and in the interest of the other, one must assume that the labour market will not produce contracts that in themselves are fully efficient.

It is in itself quite clear that in many situations a trial period can have a positive effect on allocative efficiency and employment. As the legislation in question merely limits the workings of the free market, one can assume that a limited acceptance is more efficient than a total ban on such contracts based on the Coase theorem. However, as labour markets are far from symmetrical and perfect, some limitations need to be set to avoid inefficiencies and socially unwanted results.

During the trial period, the normal requirements for the termination of an employment contract do not apply. However, neither party may cancel the contract on grounds that are discriminatory or otherwise inappropriate with regard to the purpose of the trial period,
according to the Employment Contracts Act (55/2001) Chapter 1 Section 4 Subsection 4. The purpose of the trial period is in many ways economic. It aims to reduce the risk of employment by giving the parties a chance to evaluate each other before the full protection of the contract comes into force. In many ways, the purpose of the contract has been defined negatively in the applicable case law, so that the grounds for cancellation that fall outside the scope of what is accepted have been determined instead of what is permissible. The trial period thus sets a standard with fairly high search costs, which enables certain inefficiencies. By lowering the cost of information, regulation can promote efficiency.

In this sense, the trial period creates a fixed-term legal paradigm close to the Anglo-Saxon employment-at-will contracts, which historically has been motivated by ideas based on the virtues of the free market and contractual efficiency. Finnish codified law and case law also grant further protection for workers as the weaker party, through for example the obligation of the employer to inform the employee of the trial period, procedural requirements before canceling the contract and through a set of principles according to which certain unclear facts and situations can be tipped to the employee's favor. Some of these can promote efficiency, as for example, is the case with the requirement that an employer must inform oneself of the correctness of the suspected grounds for cancellation and the prohibition of cancellations on grounds that are out of the other party's control (at least if the other party is an employee). These may reduce inefficient cancellations of otherwise efficient employment contracts, and may prevent a so called market for lemons, where quality and price keep spiraling, from appearing. Sometimes human nature and its impulsivity need to be restrained.

As for collective agreements, the problems related to asymmetries means that negotiations over the substance of the trial period should be held on the level with the smallest differences between the negotiating parties while simultaneously keeping in mind that portion of the labour force concerned should be as homogeneous as possible. Negotiations covering more workers further lower information costs. This means that collective agreements can be efficiency-enhancing, as long as they only set the socially and economically acceptable minimum when markets fail, so that individual contracts can be negotiated in the areas where equitable negotiations can take place, with lower risk of problems due to signaling.

When considering the efficiency of a certain legal paradigm, one must have a framework for
comparison, in order to measure the efficiency. In many cases, Pareto optimality can be a starting point. However, due to the nature of the labour market and the problems with subjective utility it is not an all-encompassing tool. Employers and employees see risk and reward differently, and the results have great importance for social welfare and the macro-level economy. Efficient production and consumption of labour is difficult to determine without running into grave legal, ethical and social issues, especially as the free market rarely leads to a Pareto optimal outcome. However, the Kaldor-Hicks criterion may in theory give some assistance with the comparison of states that give cause to social cost or where the barriers for transfers of resources are high. In practice, measuring the utilities of different states may be very difficult.

However, a Pareto analysis of the trial period results in one important conclusion; transferring too much risk to the employee will result in a welfare loss. This is due to the employee being risk averse while the employer generally is risk neutral. As the welfare loss of increased risk for the employee increases, that employee would probably be willing to compensate the employer, so that the Kaldor-Hicks criterion would lead to a shorter trial period or higher standard for protection. Due to problems of asymmetry and adverse selection, the Coase theorem would imply that the free market would not produce such a result without proper regulation. This means that a regulator with aggregated social welfare in mind would be careful not to shift too much risk towards the employee, as an inefficient shift towards the employee would cause a larger drop in welfare than vice versa. The cost of such an inefficient shift would be especially large when the large social implications of the state of labour are considered. Pareto improvements can thus be achieved by allocating risk and reward to the party most willing to take on that risk, be it employee or employer.

On the macroeconomic level, changes to the structure of the supply side of the labour market is an often talked about tool for economic policy. It is not uncommon for such structural changes to be put opposite to demand-side, cyclical policy. Considering both neoclassical monetarist views as well as more Keynesian views on cyclical changes, one must come to the conclusion that price and wage controls can lead to inefficiencies and that any gains are likely to be small in comparison to the overreaching issues of an economy in recession. Wage controls, with the allocation of risk through a trial period, are therefore poor and insufficient
tools for an economy attempting to reach the natural rate of growth. Considering the social and economic importance of the labour market and the risk for a paradox of thrift, reducing the price of labour through an increased trial period may in fact have a small negative effect during a recession. Such a negative effect may become persistent due to workers ending up outside the labour market because of what is known as the hysteresis effect. Furthermore, lowering the cost of labour may end up slowing down productivity growth, as cheap labour pushes new technology out of the market through both supply- and demand-side shocks.

Legislators should therefore be careful in using wage controls and employment contract regulation as a macroeconomic tool. Developments in unemployment and wage and price levels should be carefully followed, in order to ensure that the problems are not due to cyclical factors. However, when the problem is due to high rents, structural changes in labour market regulation may be efficiency enhancing. These situations should not be overestimated.

When changes are made to the extent of the trial period in terms of time, but also legal requirements, a number of economic and social effects can be seen. An transfer of risk from the employer to the employee, through for example a one month increase in the length of the trial period will cause an asymmetric loss of utility for the employee while causing a symmetric loss of utility for the employer. Information costs are lowered for the employer, but increased in certain scenarios (mainly in case of cancellations) for the employee. Simultaneously, the lower risk and price of labour should cause a small increase in employment, albeit at a high cost. In turn, the lower price of and increased risk for labour should cause a lower propensity to consume, thus slightly lowering aggregate demand. The greater bargaining power of the employer would in turn be offset by the lower price of the rights, meaning that the employee would in turn demand a higher nominal wage. However, this effect will also depend upon how strongly employees react to the increased risk; a lower wage during the trial period may lower the expectations and thus the risk. Furthermore, an increase in the trial period may cause inefficiencies due to increased insider-outsider behavior and thus lower labour mobility.

If the extent of the trial period is decreased the opposite of many of the previously mentioned effects can be seen. The utility of the contract increased asymmetrically for the employee, which brings along certain lowered social costs. In turn, a smaller risk associated with a new
contract may increase labour mobility, while in turn decreasing employer mobility and flexibility. Information costs would increase for both parties, except for legal costs after cancellations. All of these should be taken into account when considering the optimal length of the trial period. The most crucial aspect, however, is the relative bargaining power of employers and employees, and how well their preferences as well as potential social costs transfer to the incentives related to the negotiations over individual contracts.

### 7.1 Room for Improvement?

One way of decreasing search costs could be to redefine the requirements for the use of a trial period through a rule-type setting, so that the canceling party would have to show that the other party has in some way acted against that rule. This would not eliminate search costs, but could lower them, as it would be easier to assess whether or not the cancellation would be or has been unlawful. Another way to decrease information costs would be to penalize a canceling party that does not share information about the grounds for cancellation. This would remove part of the premium of withholding information. Together, these two measures could make unlawful, inefficient cancellations less attractive. Furthermore, by codifying the responsibility of a canceling party to pay for the legal costs of the other, losing party the risk of moral hazard related to the withholding of information could be lowered.

An empirical study of the opinions on the trial period in Finland has been left outside of this paper. However, there has been some empirical evidence of the situation on the Finnish labour market. While not directly related to the trial period and its usefulness and necessity, the ManPowerGroup Talent Shortage Survey measures the difficulties employers face when trying to fill a position. Out of 42 countries, employers in Finland placed 6th among the countries where employers were the least likely to have trouble filling a position, and were least likely to report that recruitment issues had an impact on their ability to serve clients\(^{198}\). According to a somewhat similar study by the Confederation of Finnish Industries (Elinkeinoelämän Keskusliitto), only about 25% of Finnish companies experienced problems

\(^{198}\) ManPowerGroup 2015, pp. 7 and 29.
with recruitment in 2014. Out of these, only 7% were due to personal aspects of the candidate, which are the main aim of the legislation. However, another 36% were due to problems that potentially could be within the boundaries of the law. The problems here were a lack of experience in 14% of cases, outdated skills in 12% of cases, a lack of job-specific special skills in 6% of cases and unsatisfactory education in 4% of cases. While an extended trial period perhaps could relieve these problems, it is not entirely unclear whether or not it is simply a market failure due to companies not being able to sufficiently invest in their potential employees.

It is possible that the results from the years following the economic crisis starting in 2008 do not paint an accurate picture of the structural issues of the economy. As unemployment increases, a larger portion of the unemployed will consist of decent workers that have ended up as such due to the economy. In such situations, a recruiting company will find good applicant more easily. However, studies from the time before 2008 seem to indicate that problems with recruitment are not that often related to the personal characteristics of the applicant, but are more closely connected to the employer not being attractive enough due to low pay, poor reputation or poor working conditions, or to the applicant effectively having fallen outside the labour market after the quite harsh recession in the 1990's. All in all, problems with finding the right person for the job rarely seems to be a problem in Finland, at least compared to other countries.

A lack of problems related to the skills of the applicants does not necessarily mean that the law regulating employment contracts is efficient. It is possible that the Finnish labour force simply is skilled and that good workers have fewer opportunities than in the other, compared economies. Thus, as the times change it may be necessary to change the legislation regulating employment contracts in order to enhance efficiency at the margin. It may furthermore be efficiency-enhancing if legislation can help decrease problems due to inefficient cancellations that exist after recruitment.

One possible efficiency-promoting option could be to allow collective bargaining use the

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199 Elinkeinoelämän Keskusliitto 2015, p. 16
Coase theorem to its fullest, by allowing a system where the Employment Contracts Act (55/2001) Chapter 1 Section 4 would specify the length of the trial period, but that further would allow parties to collective agreements to agree to a longer trial period in exchange for a wage premium. In order to account for the risk-aversion of the average employee the hourly wage premium should increase along with the length of the extended trial period, in order to stay Pareto-improving. Thus the socially accepted minimum could be achieved, while allowing for bargaining on market terms between somewhat equal parties. Bargaining over the premium paid for the lengthier trial period would not be allowed on the level of the individual contract, as it would cause problems with signaling.

Furthermore, information costs could be lowered by forcing information sharing. For example, the obligation of the employer to provide the employee with an opportunity to be heard in the Employment Contracts Act (55/2001) Chapter 9 Section 2 could be clarified. By attaching a sanction for neglect it would be less risky for a well-meaning employer to provide as much information as possible before canceling the contract. Ill-acting employers would in turn be at a disadvantage compared to their competitors.

Inefficiencies due to moral hazard could and should be reduced by clarifying the division of legal costs due to trials over canceled contracts. The principle, set forth in Finnish case law, that an employer that has withheld information can be held accountable for legal costs even when the outcome is positive for the withholding party is efficiency enhancing and should be codified and applied to both parties. Furthermore, aspects of information sharing and asymmetry should be better taken into account in court practice and in legislation in order to reduce market failures and social welfare loss-causing behavior.

A further aspect that should be taken into account when discussing the economic effects of changes in the legislation surrounding the trial period for employment contracts is that any effects on the aggregated economy are likely to be small. The Finnish economy is currently defined by low growth, low deflation and poor wage growth. Such characteristics would often imply that problems are mostly demand-side, while there may simultaneously be problems related to the structure of production of labour. While making labour markets more flexible can enhance efficiency and promote growth, the expected marginal improvements in an economy with large cyclical issues should be rather small.
7.2 Conclusions

The trial period for employment contracts is both a legal and economic construct, through which the legislator has attempted to create a legal paradigm that promotes efficiency and employment, while simultaneously protecting the employment contract from unjust cancellations. In many ways, the current Finnish regulation promotes economic efficiency through protection from shirking, information-forcing and increased labour market flexibility. It is an important tool and complement to the otherwise somewhat strict Finnish employment protection legislation. Due to various market failures the use of the trial period needs to be regulated in order to function efficiently. While current legislation to a certain extent succeeds in doing this, information-forcing and stronger sanctions for unlawful use could further help in combating misuse and promoting efficient cooperation between parties. When using regulation of employment contracts as a macroeconomic tool, through for example, the regulation of the price of labour through decreased risk, the potential gains in employment should be weighed against potential offsets in social cost and the loss of social welfare. If used irrespective of macroeconomic fluctuations, the trial period, as it exists in Finnish law, could with some modifications be an excellent tool for increasing labour market flexibility.