OECD Reviews of Labour Market and Social Policies

ESTONIA

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Foreword

The OECD Council decided to open accession discussions with Estonia in 2007 and an Accession Roadmap, setting out the terms, conditions and process of accession, was adopted on 15 October 2007. In the Roadmap, the OECD Council asked several OECD Committees to provide formal opinions. Accession discussions are currently ongoing.

The Employment, Labour and Social Affairs Committee (ELSAC) was asked to review Estonia's labour market and social policies and to provide a formal opinion on the degree of coherence of these policies with those of OECD member countries and on Estonia's ability to contribute to the work of ELSAC. In light of the opinions received from OECD Committees and other relevant information, the OECD Council will decide whether to invite Estonia to become a member of the Organisation.

This report, prepared as part of ELSAC's accession review, highlights the key labour market and social policy challenges facing Estonia. The above-mentioned formal opinion will be sent separately to the OECD Council, and the findings presented in the present report are without prejudice to the sxubsequent discussions and decision of the Council concerning the accession of Estonia to the Organisation.

After regaining its independence in 1991, Estonia achieved a quick transition to a market economy. Its policies have since then been characterised by a strong commitment to fiscal prudence, flexible markets for products, capital and labour and a social policy stance that emphasises work incentives more than the redistribution of incomes through cash and in-kind transfers. Economic outcomes have vindicated this approach to a large extent, with an average GDP growth of 7.5% per year between 1995 and 2007 and major increases in employment rates and real wages until 2008. Nonetheless, a significant and increasing group of pensioners and others who depend on social benefits were at risk of relative poverty before the current crisis.

The global economic downturn has hit Estonia particularly hard. In this situation, the country has opted for a continued strict fiscal policy stance, while adopting a series of budget-strengthening measures in order to give room for dealing with a rising number of unemployed persons. The unemployment insurance system was merged with the public employment service in 2009 and the latter received additional resources to help cope with the high unemployment. From mid-2009, Estonia also introduced a new labour legislation that is among the most flexible in the world. This legislation had been prepared as part of a flexicurity package of reforms; but a planned "security" part of this package, which would have involved more generous unemployment benefits, was postponed till 2013 because of worsening public finances.

Estonia's public social spending relative to GDP is among the lowest in the OECD area and is not highly redistributive. However, the country has one of the world's most generous parental benefit schemes, designed to promote female labour force participation as well as fertility. The institutional foundations have been laid for a three-tier pension system, which is being gradually phased-in. The relatively high employment rate in older age groups makes the country well-prepared for the expected population ageing, but most pensions are near, if not below, conventional poverty limits.

The review was prepared by Anders Reutersward and Veerle Slootmaekers, assisted by Katherine Latour and Marlène Mohier under the overall supervision of the Head of the Social Policy Division, Monika Queisser. It was written during 2009 and discussed by ELSAC on 23 October 2009.

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Abbreviations

ALMP	Active labour market programme
EAKL	Confederation of Estonian Trade Unions
EEK	Estonian Kroon
ELSAC	Employment, Labour and Social Affairs Committee
EPREL	Estonian Staffing Agency Association
ESF	European Social Fund
ETTK	Estonian Employers' Confederation
EU	European Union
GDP	Gross Domestic Product
LFS	Labour Force Survey
LMB	Labour Market Board
NRR	Net Income Replacement Rate
PISA	Programme for International Student Assessment
SB	Subsistence Benefit
TALO	Estonian Employees' Unions' Confederation
TWA	Temporary work agency
UA	Unemployment assistance
UI	Unemployment insurance
UIF	Unemployment Insurance Fund

ASSESSMENT AND RECOMMENDATIONS

After regaining its independence in 1991, Estonia achieved a quick transition to a market economy through fundamental restructuring. This involved the dismantling of almost all big enterprises, which had accounted for the bulk of employment in the Soviet period, giving way to an emerging SME sector that is now predominant. From the beginning of this transformation, the country's public policies have been characterised by a strong commitment to fiscal prudence, flexible markets for products, capital and labour, and a social policy stance that emphasises work incentives more than the redistribution of incomes through cash transfers.

Estonia's economic progress since 1991 has vindicated this approach to a large extent. Real GDP has grown faster than in most transition economies, up by 7.5% per year between 1995 and 2007 despite a brief recession in 1999. Large strata of the population have experienced great improvements in living standards, but a significant and increasing group of pensioners and others who depend on social benefits are now at risk of relative poverty. This risk increased when the upward trend in labour demand was brutally interrupted in the autumn of 2008 by the onset of the global economic downturn, which hit the Estonian economy particularly hard. Real GDP fell by 3.5% in 2008, followed by a 15% decline year-on-year in the first half of 2009. The abruptness of this plunge was exacerbated by the end of a construction boom that had contributed to a surge in employment and wages during 2006 and 2007.

The overall employment rate, which peaked at 70% in 2008 – higher than the OECD average of 67% – had declined by 6 percentage points by June 2009. Real wages also declined – down by 4 to 5% year-on-year in the first half of this year – with even greater reductions in nominal wages as consumer price inflation declined and turned negative from June and on. Recession notwithstanding, real GDP per capita in mid-2009 was about twice as high as it had been in the mid-1990s and 45% higher than in 2000. By this measure, Estonia is now richer than most central and eastern European countries, though not as advanced as Slovenia and the Czech Republic.

The population is mostly well-educated and about one-third of the workforce has tertiary-level qualifications. However, the relatively small size of such sectors as high-tech industry and highly qualified services limits the job opportunities for specialised job seekers. Combined with the predominance of small firms, this also reduces the potential for employer-sponsored training. But many choose to combine full-time work with formal studies, and the reported participation rate in lifelong learning increased by more than half over the three years to 2008, reaching the EU-25 average of about 10% of employees.

In the years that preceded the recession, employment growth was particularly strong for previously under-represented groups such as women, youth, elderly persons and ethnic non-Estonians (mostly Russians). By mid-2009, this recent increase in employment has been largely reversed for youth, but less so for women, elderly persons and non-Estonians. As many men lost their jobs, notably in the construction and manufacturing sectors, the employment rates become almost identical for women and men (63 and 64%). Non-Estonians experienced a significant increase in unemployment in early 2009, but their relative disadvantage has continued to diminish as measured by employment rates.

Measures of income inequality place Estonia a little higher than the OECD average, with a Gini coefficient of 0.34. Since the 1990s, the risk of poverty has declined strongly in absolute terms. But during most of the 2000s, the risk of relative poverty remained constant or declined only a little in the age classes up to 65 years, in which on average 20% of the population were still poor in 2007 (using a poverty line at 60% of the median income for the whole population). Worse, for the age group of 65 and over, poverty appears to have doubled between 2003 and 2007 and reached 39% by the same measure, reflecting a less-rapid growth of pensions compared with other incomes.

Policy-making in the labour market and social area involves frequent consultations between government, trade unions and business associations. Several key reforms discussed in this report were agreed upon in such discussions, as were a number of painful budget-strengthening measures during the economic downturn. However, the relevant associations have low membership and weak organisational infrastructures, especially on the trade union side. The social partners are represented on the board of the Unemployment Insurance Fund, but consultations about general policy issues usually have an informal *ad hoc* character.

This report reviews Estonia's labour market and social policies, using as a benchmark *Reassessed OECD Jobs Strategy* (*cf.* OECD, 2006) and the OECD's continued monitoring of member countries' labour market and social policies.[1] As developed in the *Reassessed OECD Jobs Strategy*, no single model can be recommended to all countries, but some policy combinations have been found more likely to succeed than others. Among those that seemed to give the best results between the mid-1990s and the mid-2000s, Estonia comes closer to the so-called "market oriented" model (*e.g.* the United States, the United Kingdom and New Zealand) than to the social consensus model (the Nordic countries, Austria, the Netherlands).

The economic downturn required painful policy adjustments.

The social protection system and the public employment service were not well prepared for the deep recession of the past year. The unemployment rate reached 13.5% in the second quarter of 2009 – more than three times as much as a year earlier, when it stood briefly at a historical low point of 4%. The proportion of the labour force that was registered as unemployed rose from 3% to 10% over the same four quarters. Although a significant group among the unemployed did not register at the public employment service, most of the recent job losers are likely to be registered. Practically all employees contribute to unemployment insurance (UI), but its strictly-applied eligibility criteria – requiring 12 contribution months and an involuntary job loss – prevent many from collecting unemployment benefits. In September 2009, UI benefits were paid to 37% of the registered unemployed (corresponding to less than 30% of the survey-based unemployment). In addition, about 25% of the registered unemployed received unemployment assistance (UA), a type of benefit that is much lower than conventional poverty limits; some received social assistance benefits, often as a complement to UA, while a significant proportion received no income support.

1. The *OECD Jobs Strategy* was first formulated in 1994 and aimed to reduce high and persistent unemployment. Since then, empirical research summarised in the *2006 Reassessed OECD Jobs Strategy* has validated its key recommendations. But it also broadened the policy focus and gave more weight to the goals of labour market participation and employment and to concerns about low incomes. It has four main pillars: *i)* set appropriate macroeconomic policy; *ii)* remove impediments to labour market participation and job search; *iii)* tackle labour and product-market obstacles to labour demand; and *iv)* facilitate the development of labour-force skills. Policy makers should ensure that all four pillars are solid, but different policy combinations are possible within each of them. Indeed, the current economic downturn has emphasised the importance of the first pillar and its interactions with the others.

Recognising these institutional shortcomings, the authorities have for several years been preparing a number of policy adjustments. Some long-planned reforms have been speeded up during the recession and accompanied by further measures to cope with the steep rise in unemployment, while others have been postponed or cancelled for budgetary reasons. Reforms of long-term importance that are currently being implemented include a simplified and more flexible set of employment protection regulations and an administrative merger between the UI fund and the public employment service – both introduced in 2009 – along with a continued gradual increase of the statutory pension age for women, which will be 63 from 2016 (a process that began in 2002 and is already complete for men).

In the short term, the chief priority has been to make budgetary room for dealing with the rising number of unemployed while keeping the budget deficit below 3% in 2009. The latter goal is partly related to the EU's strict conditions for Estonia's accession to the euro area, but it is also justified by the general vulnerability of a small open economy in a period of financial turmoil. The adopted budget-strengthening measures include a steep rise in UI contribution rates; deferral till 2013 of already-approved legislation to increase UI and UA benefit amounts and to extend eligibility for unemployment insurance; suspension of a planned 1% cut in the income-tax rate; elimination of a tax-free allowance for the first child; a temporary re-direction of employer contributions from funded to pay-as-you pensions; and abolishing an education allowance for children.

More flexibility than security.

Inspired by the international debate about flexicurity, Estonia introduced a new Employment Contracts Law in mid-2009 that simplified many rules and liberalised the employment protection regulations. As measured by the OECD's scoring method, Estonia's strictness of employment protection was previously similar to the European average but a little less flexible than the OECD average; it is now more flexible than the OECD average and close to the English-speaking countries. This reform, adopted after a decade of discussions between the government, trade unions and employers, had been conceived as part of a flexicurity package together with the above-mentioned planned improvements in the generosity of unemployment benefits, which were postponed till 2013. In effect, the "flexibility" part of the package was implemented but not the "security" part.

As recommended in the *Reassessed OECD Jobs Strategy* – but in contrast to the practice of several OECD countries – the biggest increase in flexibility concerned the termination of open-ended labour contracts. This reduces the potential advantage for employers of using fixed-term contracts, which have been associated with undesirable labour market segmentation in OECD countries. In Estonia, however, temporary contracts accounted for only 3% of employment in 2008 – a lower proportion than in any OECD country – and there is now even less reason to use them. Open-ended contracts can be terminated with shorter notice periods than previously, and employers need not pay more than one monthly wage as a severance benefit. The maximum severance benefit has been cut from four to three monthly wages, of which the UI fund now covers the second and the third, if applicable.

Fixed-term contracts can last up to five years, and the range of situations when they are allowed has been widened. But employers must pay wages for the whole fixed term even if the worker is dismissed earlier – a rule that makes fixed-term contracts less attractive to employers, especially for long contract terms. The need for such a rule is questionable. Temporary-work agencies (TWAs) are allowed, but they are a new phenomenon in Estonia and not yet very common. They need no authorisation and face few legal restrictions, apart from a ban on fees for job seekers and the requirement that all employees must be treated equally.

Working time is also flexible by OECD standards. It should not exceed eight hours per day and 40 hours per week, but employers are free to adapt schedules to reasonable needs within a limit of 48 hours per week over four months. Overtime is allowed at 1.5 times the regular pay and there are no restrictions on weekend work, though higher pay is required on national holidays. In general, "unsocial" working hours are less common in Estonia than in most European countries, and the incidence of long working weeks and overtime has declined.

To promote flexibility for workers as well as for employers – as the *Reassessed OECD Jobs Strategy* recommended with a particular aim to promote family family-friendly policies – Estonian law calls upon employers to consider any request by an employee for a change in working hours. But part-time work is not common by OECD standards and its incidence declined until 2008, when it was only about 7%, reflecting a widespread preference for higher income as well as the buoyant labour demand. When the economic downturn began, enterprises imposed involuntary part-time schedules on about 2% of the labour force. In contrast to some OECD members and Slovenia, Estonia did not subsidise such arrangements: they emerged as a spontaneous cost-cutting reaction.

Trade unions are insignificant in the private sector.

In Estonia, more than in most countries, the rapid shift from manufacturing to private services and from big firms to new small ones has contributed to a collapse of trade union membership. Surveys indicate that under 8% of the employees are union members – a lower figure than in any OECD country – and they are highly concentrated in the public sector. To promote collective bargaining, the law was changed in 2006 to permit elected representatives to bargain for all employees if there is no trade union in an enterprise. Enterprise-level trade unions, by contrast, can only represent their members.

Sector-level agreements exist only in public administration and in the healthcare and transport sectors, where unions are relatively strong. As allowed by law, the bargaining partners in healthcare and road transports have unilaterally decided to extend their agreements to all employers and employees in their sectors. The legality of such extensions does not depend on any definition of representativeness, as it does in several OECD countries. Instead, Estonian law presumes that bargaining partners at sector and higher levels are representative. This situation does not appear to be regarded as problematic in Estonia, although some experts have warned about a possible risk of abuse by small trade unions.

Collective agreements probably cover 11% of the employees directly and about as many more *via* extensions, *i.e.* 20 to 25% in total. But even where they exist, collective agreements mainly set general standards and minimum wage rates. For a large majority of employees, organised or not, pay and working conditions are fixed in individual discussions. This situation can be explained in part by the organisational weakness of potential participants in collective bargaining. But more fundamentally, it signals a widespread lack of interest in collective action on the part of most workers and employers.

As the only national-level collective agreement, the social partners annually determine the minimum wage. The government has not participated in these decisions since 2003 other than by endorsing them by decree. The system has worked well until now, keeping the minimum wage stable at about one-third of the average wage, which appears to represent a suitable compromise with limited negative effects on employment. Before the downturn, less than 5% of the full-time employees were reported to earn only the minimum wage.

Enforcing labour law.

In the absence of strong trade unions, the enforcement of labour contracts depends largely on the Labour Inspectorate, which also monitors occupational health and safety. Its role was changed in 2008 by the removal of some administrative reporting and control functions, *e.g.* on working time, in favour of contractual freedom. This was widely welcomed, but it requires the Inspectorate to step up its role in education and practical assistance to enterprises. To give the staff more time for such functions, all enterprise inspections not motivated by individual complaints have been temporarily suspended in 2009. But the number of complaints was over 6 000 and rising in 2008, mostly concerning unpaid wages, severance pay and holiday compensation.

As in most countries, resources do not permit many inspections in small enterprises. When preventive inspections were last conducted, they only concerned firms with five or more employees for safety issues and those with ten or more employees for issues of labour law. This is a source of concern because there is evidence that violations are most common in small firms. As a further constraint, the sanctions that can be imposed on businesses that violate labour law are subject to much lower limits than in most OECD countries.

Labour-law cases can be brought to civil courts, but this tends to be expensive and time-consuming. To reduce the need for litigation, tripartite individual labour dispute committees have been set up within the Inspectorate. These committees must hear a case and make a pronouncement free of charge in less than six weeks from its submission. In 2008, they treated over 4 000 complaints, and the number is likely to grow from mid-2009 when a legal limit on the financial claims that can be treated was increased substantially, suggesting that additional resources may soon be necessary.

In Estonia as elsewhere, the tax administration plays a key enforcement role by requiring that employment relationships are formalised and reported. The taxation of income is simple, with a flat rate at 21% and significant tax-free allowances, which are higher for families with two or more children. A gradual reduction of the flat rate to 18% had been foreseen, but has been temporarily suspended for budgetary reasons. Mandatory contributions to social insurance are charged at 35 to 39.2% for employers and 2 to 4.8% for employees in 2009 (with several changes during the year as part of the budget-strengthening measures). The total tax wedge – *i.e.* taxes and employer and employee contributions as a percentage of the labour cost – was estimated at 39% in 2007, or close to the EU average of

37% but more than in most non-European OECD countries. The tax wedge has probably increased a little as a net effect of the recent changes.

Undeclared work is not very common in Estonia by international standards, and it showed a declining trend until 2007. Surveys in 2005 and 2006 suggested that 5% of the employees had no written contract; but in addition, 11% of those with labour contracts received "envelope wages" on top of their reported wages. "Envelope wages" are relatively common in low-paid construction and service-sector jobs, and there is evidence about an increasing incidence at the beginning of the economic slowdown, suggesting that they play a role as a way for some firms to cope with a worsening financial situation.

Most of the unemployed are not eligible for unemployment insurance benefits.

As noted above, the effective coverage of UI benefits is lower than in most OECD countries. It was particularly low in the years before the economic downturn, *e.g.* 17% of the registered unemployed in 2006 and 2007. This must be considered in the context of the eligibility rules, which in Estonia cover employees who contributed for 12 of the last 36 months and did not leave a job voluntarily or in agreement with the employer, a rule that appears to exclude many. By comparison, the required number of contribution months is lower in most European countries and in the United States, often around six months, and the general exclusion of "voluntary" unemployment is frequently qualified by various exceptions. Some OECD countries also provide UI for the self-employed. The maximum duration of benefits – 6 to 12 months depending on the work history – is similar to those in most OECD countries, though shorter than in several other EU countries.

The income-replacement rates in UI are adequate but usually modest, amounting to 50% of the previous earnings for 100 days and thereafter 40%. These percentages are applied to earnings of up to three times the average wage – a high ceiling by OECD standards. In the first half of 2009, the average UI benefit was close to the minimum wage and 35% of the average wage. Taking account of taxes and other social benefits, the net income replacement rate during the initial stage of an unemployment spell can be estimated at 40% for a single person, which is close to the OECD average.

Unemployed persons not eligible for UI or having exhausted their entitlements can receive unemployment assistance (UA) for up to nine months. Amounting to only about 8% of the average wage and 23% of the minimum wage, it falls far below conventional poverty limits and is also lower than the income limit for social assistance (subsistence benefits). For most of the 2000s, the number of UA recipients exceeded that of UI, but this is no longer the case after the sudden increase in job losses. In the spring of 2009, UI and UA together covered less than half of the registered unemployed, but the proportion had increased to 62% by the end of September.

The above-mentioned reforms that were postponed for budgetary reasons would, if adopted, have increased the UI replacement rate from 50 to 70% in the first 100 days and from 40 to 50% thereafter. They would also have extended UI eligibility to some cases of voluntary quits, though with reduced amounts. At the same time, the UA benefit would have been more than doubled to 50% of the minimum wage. In many OECD countries, by contrast, the rise in unemployment has motivated policy efforts to extend the coverage or generosity of the benefits.

For the future, once an economic recovery sets in, Estonia needs to reinstate the security part of its new flexicurity bargain. When an improvement of the unemployment compensation proves affordable, the highest priority should be given to an extension of eligibility for UI and to a substantial increase of the UA amount. In UI, a shortening of the required work history from twelve to six months would be justified. To reduce the costs of such a reform, the maximum UI benefit amount could be reduced.

Subsistence benefits should not target the unemployed.

A significant but declining group of unemployed people receive subsistence benefits (means-tested social assistance, hereafter called SB). Administered by municipalities, though financed by the state, SBs guarantee a minimum income of EEK 1 000 per month (EUR 64 or 8% of the average wage) for one person and EEK 800 for each additional family member, plus housing costs up to a limit that is fixed locally. As with the corresponding programmes in many OECD countries, the amount is too low to bring clients out of poverty. Municipalities can top-up with supplementary benefits from their own funds; such top-ups accounted for one-fourth of the total spending in 2008 but much less in 2009, with the result that the typical amounts of the total SB have become smaller. SB spending has shown a downward trend since 2000, being only 0.05% of GDP in 2008 compared with on average about 0.4% in EU countries.

In the average month of 2008, some 1% of the population received SB, and about two-thirds of the recipient households had members registered as unemployed. UA recipients often receive SB as a top-up – notably to cover housing costs – while long-term unemployed persons who have exhausted their UA entitlements receive only SB, if anything. Judging from OECD experience, the involvement of more than one public agency in administering benefits to the unemployed can be inefficient in several ways. Above all, it complicates activation programmes and the enforcement of the requirement that the clients must seek jobs. In most countries, the public employment service tends to give low priority to clients who receive social assistance from a budget that is separate from their own. In Estonia, the fact that the state finances SB can also be expected to reduce the incentives for municipalities to prioritise job placement of such clients.

If and when the UA benefit can be substantially increased, the possibility for individuals to combine UA with SB should be removed. This would reduce the number of SB clients by more than half, and so put municipalities in a better position to focus on the needs of clients with social problems other than unemployment.

The public employment service is far from OECD countries' best practice.

The development of employment services and activation of the unemployed has not been a high priority in Estonia. Existing provisions permit only limited job-matching and the legal job-search requirement for benefit recipients can seldom be enforced. The economic and social risks associated with this situation have been moderate so far, given that the available cash benefits are not generous enough to discourage individual job search (in other words, there is no "inactivity trap"). But if and when these benefits are increased – as is now planned for 2013 – the risk of negative effects on work incentives must be expected to grow unless this is combined with substantial further efforts to enhance the employment service's ability to activate benefit recipients.

To strengthen coordination, the UI fund and the public employment service (which also administers UA) were merged in 2009 to form a single agency with a tripartite board, henceforth called the Unemployment Insurance Fund (UIF). As a temporary solution, the board approved the use of UI contribution funds to finance a 35% increase of the employment service's staff resources. While significant, this could not prevent the caseload per job counsellor from more than doubling to about 260 clients by mid-2009. By OECD standards, this average caseload is relatively heavy but not extreme, especially for a recession year. However, with much of the staff assigned to low-populated regions, the situation is worse in Tallinn, the capital (about 800 clients per counsellor).

The authorities recognise that the matching of vacancies to jobs relies on outdated procedures that will require a substantial development effort. For example, the Unemployment Insurance Fund (UIF) has yet to develop self-service facilities in all offices, to improve the vacancy database and to create a jobseeker database for employers' attention. As an apparent response to these shortcomings, less than half of those classified as unemployed in labour force surveys bothered to register at the employment service until the autumn of 2008. This proportion increased to 60% in the first half of 2009. As in many countries, available indicators also suggest that many registered clients are not actively seeking jobs, while, on the other hand, those who find jobs do so most often without help.

Private employment agencies are registered but need no authorisation, and they are allowed to provide all sorts of employment services. The UIF has hardly used them until now, partly because their reputation has been tainted by reports about abusive practices in some firms. But current plans envisage an increased cooperation with private agencies, for example concerning career counselling for qualified groups. OECD experience indicates that a partial outsourcing of employment services can be cost-effective, but the public agency must then be prepared to monitor the outcomes and to compare with similar cases treated in-house.

The need to prioritise between clients.

Activation strategies can be valuable, but they involve significant costs that may not be necessary for motivated jobseekers. Most OECD countries therefore seek to postpone staff-intensive activities until after an unemployment spell of three months or more. But in Estonia, UIF officers must develop individual action plans with each new client upon registration, after which a second intensive interview is to be held within a month. The authorities are currently reconsidering the need for such a "front-loaded" allocation of staff time, taking account of the rising caseload and the experience that many of the newly-registered can find jobs for themselves. Furthermore, the individual action plans in Estonia are sometimes too standardised, which limits their value as a benchmark against which the job-search can be assessed.

As in many OECD countries, the law gives precise definitions of the "suitable" jobs that cannot be refused without a risk of losing the benefit. These criteria become stricter after six months of unemployment. However, such rules can hardly be enforced without a targeted use of job referrals for low-motivated clients, which should be accompanied by a credible threat of moderate benefit sanctions if suitable jobs are refused. In January to

April 2009, Estonia's employment service made on average six referrals to every vacancy, corresponding to two referrals per job seeker and month, which is much more than is common in OECD countries. But these referrals were not followed up, so the outcomes were unknown and sanctions are rarely used. This situation must also be seen in the context of the above-mentioned shortcomings of the jobseeker and vacancy registers, which limit the scope for effective matching.

Expensive active programmes cannot be afforded.

Estonia implemented active labour market programmes (ALMPs) at a total cost of 0.1% of GDP in 2008, of which EU funds covered almost one-half. More than half of the total concerned the employment service and its counselling and job-search activities, while under 0.05% of GDP was spent on other ALMPs, in which the total participant number was probably a little more than 0.5% of the labour force in average stock terms. By comparison, OECD countries spent on average 0.6% of GDP on ALMPs in 2007, of which 0.15 percentage points for the employment service and 0.4 percentage points for other programmes that enrolled 4% of the labour force. Training was the dominant programme type in Estonia, with perhaps 90% of the participants, followed by start-up incentives and measures for disabled job-seekers. In addition, municipalities and NGOs financed some public works.

The ministry plans the ALMPs, giving the merged UIF some influence on priorities but not on the budget volume. But the regional and local labour offices, facing narrow administrative constraints, lack resources to provide much more than their basic employment services and related in-house activities. They therefore seldom request much money for other ALMPs, and they usually receive what they ask for. To facilitate their administration of training programmes, the authorities are considering a voucher system that would let job seekers choose courses within a spending limit after discussion with a counsellor. To some extent, the merger of the UIF and the presence of the social partners on its board are also expected to facilitate a solution to such administrative problems. Some increase of ALMP spending is foreseen for 2010, to be financed mostly by the European Social Fund.

Judging from OECD experience, it is appropriate to keep ALMP spending at a modest level when the employment service is itself facing tight budgetary and administrative limitations. Without substantial counselling and administrative support, it may not be possible to ensure that ALMPs are effectively targeted on those who need them most. This also makes it difficult to make participation compulsory, *e.g.* in order to test availability for work. Furthermore, if ALMPs are to be efficient in the long run, they need to be systematically monitored and their effects evaluated, which requires further overhead spending. In the present situation, the main priority should therefore be given to counselling and job-search assistance and to short courses and group activities that directly support these functions.

Estonia's social programmes are not highly redistributive.

Taxes and transfers have modest net effects on the overall income equality, as in for example Canada, Ireland, Japan, Korea Switzerland, the United Kingdom and the United States. Compared with a group of Continental European countries with more comprehensive social protection systems – especially Austria, the Czech Republic, France, Germany, the Slovak Republic, Switzerland and the Benelux and Nordic regions – Estonia's tax and transfer system is much less redistributive.

The flat-rate income tax (21%) achieves significant redistribution thanks to a generous set of tax-free allowances. Such allowances make the taxation progressive for low incomes, but the relatively low flat rate limits the scale of the resulting redistribution. Social benefits of all kinds (not counting in-kind services) have recently represented about 8.5% of GDP – less than in the vast majority of OECD countries – and 20-25% of the average household's disposable income. Estonia's social benefits are essential for the living standards of the lowest income groups; but households with above-average incomes also receive substantial proportions of the spending for all benefit types except disability pensions and social assistance. To the extent that more redistribution is found desirable, Estonia may thus have reason to reconsider its tax policy, as well as the design of social programmes.

Family benefits is the only main type of income transfer on which Estonia does not spend significantly less than the OECD or EU averages. Representing 1.5% of GDP and 22% of total benefit spending, Estonia's family benefits are not means-tested, being motivated in part by the desire to encourage young families in all income groups to have children. Child benefits are paid for all children up to age 16, or till the end of upper-secondary school, with higher amounts for the third and subsequent children and an additional child-care allowance up to eight years. A school allowance for all children in education was abolished in 2009.

Estonia implements one of the world's most generous parental-benefit schemes, which came into force in 2004 and was further enhanced in 2006 and 2008. Designed to promote female labour force participation as well as fertility, it replaces the full income (up to three times the average wage) for 18 months, with 70 days reserved for the mother and the rest freely shared between the parents. As an extra incentive to promote the birth of further children, benefits can be based on the same previous income for successive child births with intervals of up to 2.5 years. The policy objectives appear to have been achieved to a considerable extent – between 2004 and 2008, the total fertility rate rose from 1.3 to 1.7 and the employment rate for women aged 25-49 from 75% to 79% – but the causal role of the benefit is hard to assess: strong labour demand and rising living standards were also important. Many parents now stay at home longer than previously, but they usually return to work, while young people planning to have children face a strong incentive to become established in the labour market. As part of the budget-strengthening measures in 2009, a paternal benefit permitting fathers to take ten days of paid leave in connection with child birth was abolished.

Municipalities deliver important programmes with limited resources.

Municipalities administer subsistence benefits and most social services. The state budget covers their expenses for the nationally regulated SB and for social services in certain cases, namely for persons with special mental needs, technical aids for the disabled and social rehabilitation. In addition, municipalities provide a variety of other social benefits and services at their own discretion, using the municipal share of income-tax revenues (11.4%) and local land taxes. Many of the 200 municipalities are too small to organise services effectively unless they cooperate, which is not always the case, while regional authorities try to coordinate and a national authority keeps a list of approved care providers.

In principle, families are responsible for their members and each municipality decides to what extent it should support them with social services and additional benefits. Almost all municipalities pay monthly allowances to care-givers and organise various forms of care. As in most OECD countries, priority is given as far as possible to non-institutional solutions such as adoptions, guardianship and foster care (children) and social care provided in clients' own homes or in day-care centres (the elderly and disabled). But a heritage of institutional care still plays a role for orphans, lone elderly persons, the disabled and the mentally ill, of which the two former categories now fall under municipal responsibility. Such institutions have been increasingly decentralised and modernised.

Most working parents have access to day-care for their children. Municipalities provide this at low cost in most cases, but private day-care centres also exist. The above-mentioned rise in the number of children has caused some shortage of places, but enrolment in 2008 was as high as 90% in the 3-6-year age class and over 60% for 2-year-olds.

Fundamental reforms of the territorial administration have been discussed for a long time, but it has not yet been possible to reach the desirable consensus between different levels of government. In principle, such reforms would be welcome and they should aim, among other things, to ensure that the population in all municipalities have access to a well-administered set of social services within a framework of national quality standards.

Estonia's three-tier pension system has yet to be fully phased-in.

Legislation in 1998, 2002 and 2004 introduced a three-tier pension system that is being gradually phased-in. It is still strongly dominated by the 1st tier, a reformed pay-as-you-go scheme that covers virtually all employed residents and receives most of the contribution revenues. (The mandatory pension contribution rates are 20 to 22%, of which 16 to 20 percentage points are for the 1st tier and 6 percentage points for the 2nd tier, when applicable.) In addition, institutional foundations have been laid for developing fully-funded 2nd- and 3rd-tier programmes. The results until now are promising with regard to the system's financial sustainability and incentives to labour force participation. But the average 1st-tier pension is not far from conventional poverty lines, and the adopted legislation will make individual pensions more and more variable.

In Estonia as in many OECD countries, reforms of the 1st tier have made its pensions more income-related. Apart from a basic amount, they will in future be proportional to the individual contribution histories. But actual contribution amounts are counted only from 1998 and on; any contributions in earlier years are counted as if all workers had earned the same wage and paid the average contribution amount. The poverty risk is therefore now greatest for pensioners with short work histories, but this will change over the next three decades. Both the risk of old-age poverty and the incidence of very high pensions must be expected to increase. Contrary to most OECD countries, Estonia applies no upper limit to the 1st-tier pension amounts. Moreover, as a Soviet heritage that has not been reformed, workers in several occupations can retire earlier and on more favourable terms than others, a situation that concerns 18% of the present pensioners. A fixed minimum pension – less than half of the average pension – is applicable from age 63 and in cases of disability, but it concerns only a small proportion of the pensioners.

The funded 2nd tier paid out some pensions for the first time in 2009. It enrols about two-thirds of the employed, but its capital accumulation has been partly suspended for the period from 2009 to 2011. Previous plans to make it mandatory for all from 2010 have been postponed. But even if the delay in implementation can be compensated for, as the government has promised, it will take many years before the 2nd tier matures. The voluntary 3rd tier consists of tax incentives for individual pension saving, currently used by less than one-fifth of the workforce. Estonia does not promote employer-sponsored supplementary pensions.

The demographic challenge appears manageable.

Population ageing is about as advanced as in the average OECD country, with an old-age dependency ratio of about 25% that may reach 41% in 2050 according to the United Nations' demographic projections. Thanks to the relatively high employment rate for older workers, Estonia appears better-prepared than many OECD countries to meet this demographic challenge, even taking account of the negative effects of the recession. The employment growth has been particularly strong for women: between 2000 and 2008, the employment rates in the 55-64 age-group rose from 36 to 60% for women and from 55 to 65% for men. The statutory pension age is 63 for men, while for women it is 60.5 and will rise to 63 by 2016. With an average life expectancy of only 67 for men and 79 for women, Estonia has not yet envisaged any increase above 63 years.

Less than 5% of the new old-age pensioners have used an option for deferred pensions, despite a generous pension bonus of 0.9% per month of deferment (10.8% per year with no upper limit). Instead, about half of the new old-age pensioners use an option to claim pensions three years early, which leads, as a penalty, to a pension reduction of 0.4% per month of early pensioning (4.8% per year). As in many OECD countries, this penalty is too low to cover the likely cost for the pension system. But not all of them retire early: some draw old-age pensions while working, which is allowed. Full disability pensions are not common, but one-third of the new pensioners only receive low pensions for partial disability until they reach the pension age. According to approximate estimates by ministry officials, the typical age at which Estonians first draw pensions is now about 60 while the most common age of leaving the labour force is around 62.5.

For the future, rising life expectancy will require further steps to push up both the average pension age and the age of labour-force withdrawal. Experience in OECD countries, as well as in Estonia, suggests that a combination of financial incentives and free choice can be effective. In many countries, however, the earliest possible retirement age has had the effect of a signal for many to retire early, so there may be a case for tightening the conditions for early retirement. In Estonia, the present high degree of free choice with respect to the pension age can justify a higher penalty for early retirement, which should, in principle, be calculated by actuarial methods to cover the cost for the pension system. If the average ages of retirement and of drawing a pension continue to increase, it may not be necessary to increase the statutory pension age to 65 or more, as most OECD countries have done. But if it is found necessary, a gradual increase of the statutory pension age could be initiated as soon as the economy recovers. The need to keep special regimes for various occupations should also be reconsidered.

Preventing old-age poverty.

On average, old-age pensions have recently corresponded to a little over 30% of the average wage before tax, and probably about 5 percentage points more after tax, *i.e.* 35 to 40%. (Pensioners benefit from a special tax allowance.) The percentage of pensioners falling below a relative poverty line – 60% of the median income – has increased steadily since the pension reforms were adopted, and it was 39% in 2008. This outcome is worrying, but it must be considered in the context of substantial poverty reductions in absolute terms, and, also, according to a "lagged" measure of relative poverty – using, for each year, the real value of the poverty line that applied three years earlier – which suggests a long-term trend of improvement. Moreover, the government has recently changed the formula used for the annual indexing of pensions, which will henceforth take more account of average-wage growth and less of price inflation. (The ratio of the relative weights given to wages and consumer prices was changed from 50/50 to 80/20.)

In sum, the high and rising incidence of relative old-age poverty merits careful monitoring. The risk of poverty is now highest for elderly women (notably those with survivor pensions) and for disability pensioners. But with gradually more variable pensions, the risk of poverty may well increase for other groups as well. Not all pensioners have the possibility to continue working. Should the trend towards higher relative poverty continue, the government should consider increasing the minimum pension and the fixed part of the 1st-tier pensions.

Box 0.1. Summary of the recommendations

- Once the economic downturn is over, policy makers should consider enhancing the "security" part of the flexicurity approach. Among the above-mentioned plans for improvement of UI and UA, which were deferred till 2013, the greatest urgency should be attached to an extended eligibility for UI benefits and to a substantial increase of the UA benefit amount. Some modifications of the previously-approved package could also be considered:
  - To cover more of the recent labour market entrants, the minimum number of contribution months required for UI benefits could be reduced from 12 to 6 months.
  - UA benefits should, if possible, be at least as high as the SB in typical cases. Once this can be afforded, the possibility for individuals to combine UA and SB should as a rule be eliminated (with possible exceptions for large households).
- On-going efforts to enhance the public employment service in terms of staffing, office space and information systems need to continue and should be followed by further steps. The information systems should be developed both to provide more self-service to workers and employers, to support job-matching activities and to permit better monitoring and evaluation.
- With the present limited funding and administrative capacity, the employment service should concentrate mainly on job counselling and job-search assistance, along with short courses and group activities in connection with these basic functions. More expensive active programmes are not only difficult to afford; they would require additional administrative capacity.
- Job counsellors' time should be devoted with priority to the monitoring of clients who stay on the register for several months without finding jobs. This can justify placing less emphasis on interviews with the newly registered unemployed. Job referrals should be made with discretion, and they should be followed-up when there is reason to suspect that suitable jobs are being refused.
- To promote compliance with labour law, the currently low penalties that can be imposed by the Labour Inspectorate for various violations should be increased.
- The development of absolute and relative poverty should be monitored closely. It may be necessary to reconsider the structure of the tax system as well as social programmes. Various changes in the design of social programmes could then be considered in order to better target low-income groups.
- Some changes of the territorial administration may be required to ensure that the population in all parts of the country have access to well-administered social care services within a framework of national quality standards.
- An increase in the real value of subsistence benefits should be a priority when financial conditions permit it.
- An increase of the minimum pension and the fixed part of 1st-tier pensions is justified as soon as it can be afforded.
- The pension penalty for early retirement should be increased so that it covers the higher cost for the pension system.

CHAPTER 1.

HIGH EMPLOYMENT BUT AN UNEQUAL SOCIETY

Before the present economic downturn, Estonia registered a long period of economic growth which resulted in a rapid increase of employment notably for youth, women and elderly persons. Living standards rose more than in most transition countries, even though they remain significantly lower than the OECD average. During 2006 and 2007, a boom in construction and investment activity led to distortions in resource allocations and relative wages in large parts of the economy.

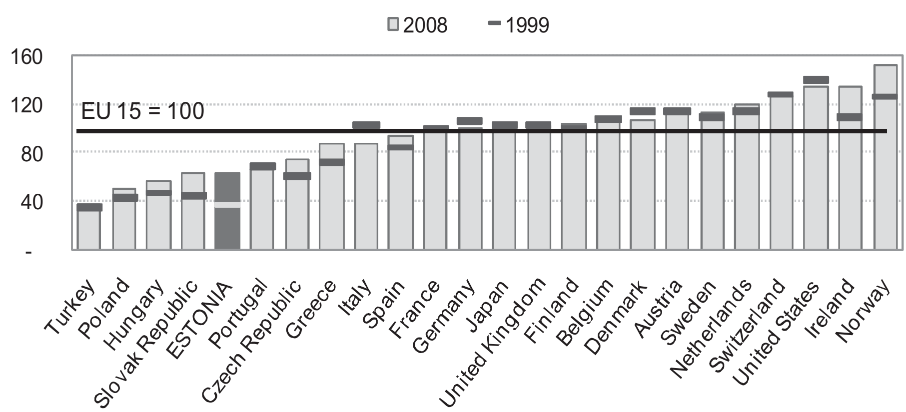
The labour force is mostly well-educated, but employment remains too concentrated in low-skilled activities. Important regional disparities persist and the integration of ethnic non-Estonians continues to be a difficult challenge. Despite the recent long period of rising incomes for almost all groups, the income distribution remains less equal than average for OECD countries and many residents are at risk of relative poverty.

1. A booming economy until 2008, with strong improvements in labour market outcomes

After regaining independence in 1991, Estonia quickly opened its economy to international competition and aligned its economic policies with those of western Europe. For more than a decade until 2008, Estonia's real GDP increased by over 7% per year on average – one of the highest growth rates in transition economies. As a result, the country reduced its income gap with the OECD area and surpassed several other transition economies, including Poland and Hungary as measured in purchasing power parities. Nevertheless, its living standards remain lower than in most OECD countries. With GDP per capita at 63% of the EU-15 average in 2008, Estonia needs to sustain high growth rates for many more years in order to catch up fully with the EU average (Figure 1.1).

Figure 1.1. GDP per capita in Estonia and selected OECD member countries, 1999 and 2008

At purchasing power parities



Source: Eurostat.

Since about 2000, the continued economic growth was driven largely by foreign-financed investments by households and business. Buoyant consumer confidence, supported by rising living standards and the EU accession, entailed a surge in household consumption. But most of the rise in investment concerned residential housing, financed by massive capital inflows through foreign commercial banks (Moreno Badia and

Slootmaekers, 2009). A soaring current account deficit and rising inflation contributed to a hard landing in 2008 and 2009, when Estonia was particularly hard hit by the global recession.

The economic growth prior to the crisis had a strong positive impact on the labour market. Unemployment fell to a historical minimum in early 2008 and employment rose substantially for all age categories and both genders, but especially for women. By 2008, the employment rate among the working-age population reached the EU's Lisbon target of 70%, hereby exceeding the OECD average of 67% (Table 1.1).[2] Estonia was also successful in combating high unemployment. While lingering around 10% or higher from the mid-1990s till 2004, the unemployment rate declined to 5.6% in 2008, a rate slightly lower than the OECD average of 6%. In several regions of Estonia labour shortages started to appear.

High demand for labour encouraged groups who previously were in a disadvantageous situation, including women, youth and older workers as well as ethnic non-Estonians, to seize new opportunities. The rise in the participation rate was particularly strong among older workers (aged 55-64), reflecting the gradually rising pension age for women and the modest levels of pensions (*cf.* Chapter 3).[3] Only for youth (age 15-24) was the labour force participation rate still lower than the OECD average in 2008 (41% compared with about 50%).

The boom-induced labour shortages also reduced the incidence of long-term unemployment from 49% in 2007 to 31% a year later – not far from the OECD average (Figure 1.2). Only within the age groups of 55 and older, the incidence of long-term unemployment remained high (just under 50%).

2. In March 2000, the EU heads of states and governments agreed in Lisbon to make the European Union "the most competitive and dynamic knowledge-driven economy by 2010". As part of the strategy to reach that goal, the employment objectives for 2010 were set at 70% for the employment rate for the working-age population (aged 15-64), 60% for women, and 50% for older workers (aged 55-64).

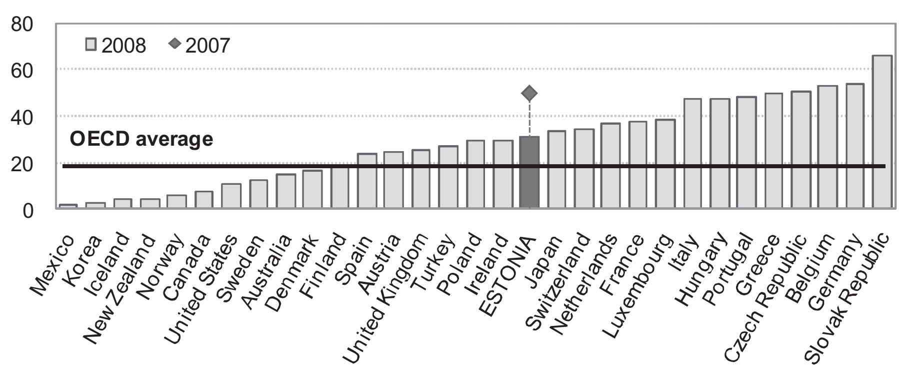
3. The retirement age for women is gradually rising to reach the statutory pension age of 63 years by 2016. For men, this age limit is already applicable, while for women it is currently 60.5.

Table 1.1. Labour force status of the Estonian population, 1997-2009

Age category	Both genders 1997	2002	2008	2009 Q2	Men 1997	2002	2008	2009 Q2	Women 1997	2002	2008	2009 Q2
Labour force/Population												
15-24	45.2	33.8	40.8	39.2	51.5	39.5	44.1	44.5	38.6	27.8	37.5	33.6
25-54	88.9	85.3	88.0	87.5	92.7	90.0	92.6	91.4	85.5	80.9	83.6	83.8
55-64	48.6	55.5	64.9	66.5	62.8	63.3	68.5	67.4	37.9	49.7	62.1	65.8
15-64	72.3	69.0	73.6	73.5	78.5	74.1	77.6	77.0	66.7	64.3	70.0	70.2
OECD average	69.9	69.9	70.8	..	81.3	80.4	80.5	..	58.8	59.6	61.3	..
Employed/Population												
15-24	38.6	27.8	35.9	28.6	43.3	33.9	38.5	29.2	33.8	21.6	33.2	27.9
25-54	80.4	76.7	83.7	76.4	84.0	80.2	88.1	76.7	77.1	73.5	79.5	76.0
55-64	45.6	51.4	62.2	61.2	57.2	58.1	64.9	62.8	36.7	46.4	60.1	60.1
15-64	65.2	61.7	69.5	63.5	70.4	66.0	73.0	63.8	60.5	57.8	66.3	63.2
OECD average	65.0	65.1	66.5	..	76.0	75.0	75.7	..	54.2	55.3	57.5	..
Unemployed/Labour force												
15-24	14.5	17.6	12.0	27.0	16.0	14.3	12.6	34.3	12.4	22.5	11.3	16.9
25-54	9.6	10.0	4.9	12.7	9.4	10.8	4.8	16.0	9.8	9.2	4.9	9.3
55-64	6.2	7.5	4.1	7.9	8.8	8.3	5.2	..	4.3	6.6	3.2	..
15-64	9.8	10.5	5.6	13.6	10.3	11.0	5.9	17.2	9.3	10.1	5.4	9.9
OECD average	7.1	7.0	6.0	..	6.5	6.7	6.0	..	7.9	7.2	6.2	..

Source: Statistics Estonia and OECD Labour Force Surveys for OECD averages.

Figure 1.2. Incidence of long-term unemployment in Estonia and OECD countries, 2008

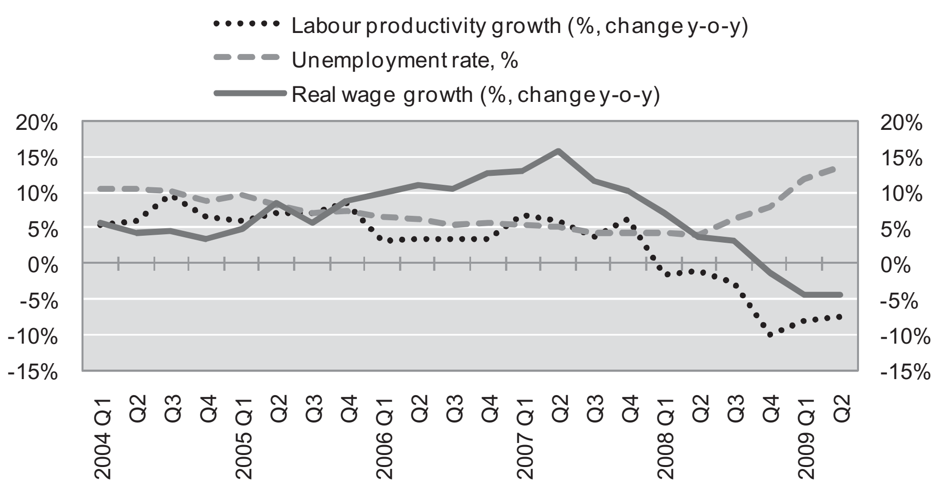


Source: OECD Labour Force Surveys.

2. The current recession poses major challenges

Strong upward pressure on wages and prices signalled overheating since 2006 and the construction boom came to an abrupt end after the summer of 2007, when the turmoil that had struck the global financial markets made investors risk averse. The resulting deceleration in domestic demand and foreign-financed credit caused GDP growth to collapse in 2008. By the second quarter of 2009, employment had declined year-on-year by 10% overall, with a sector-level reduction of 35% recorded for construction and 21% for manufacturing, while the unemployment rate more than tripled to nearly 14% (Figures 1.3 and 1.4). The average real wage declined by 1.3% in the last quarter of 2008 and by 4.5% in the first two quarters of 2009. The recession has especially hit the male population, largely because men are over-represented in the construction sector – which employs 22% of men and 2% of women. The male unemployment rate reached 17% in the second quarter of 2009 compared with 10% for women (Table 1.1 above).

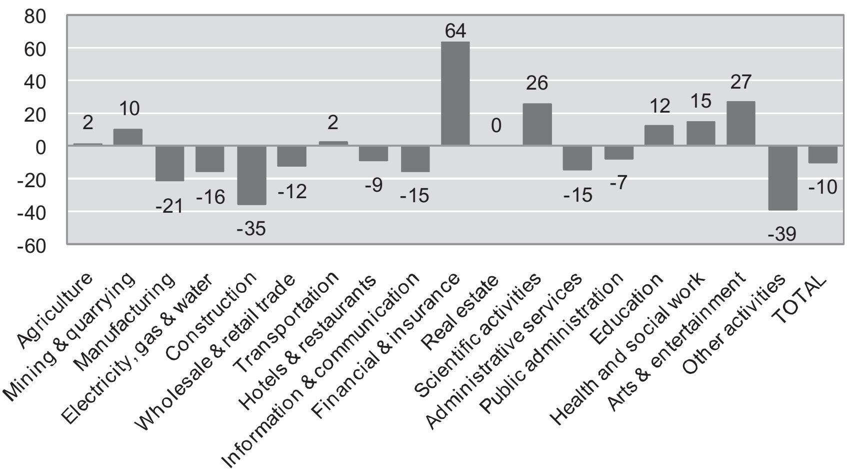
Figure 1.3. Unemployment, real wage growth and labour productivity growth, 2004-09



Source: Statistics Estonia.

Figure 1.4. Changes in employment by economic sector, 2008-09

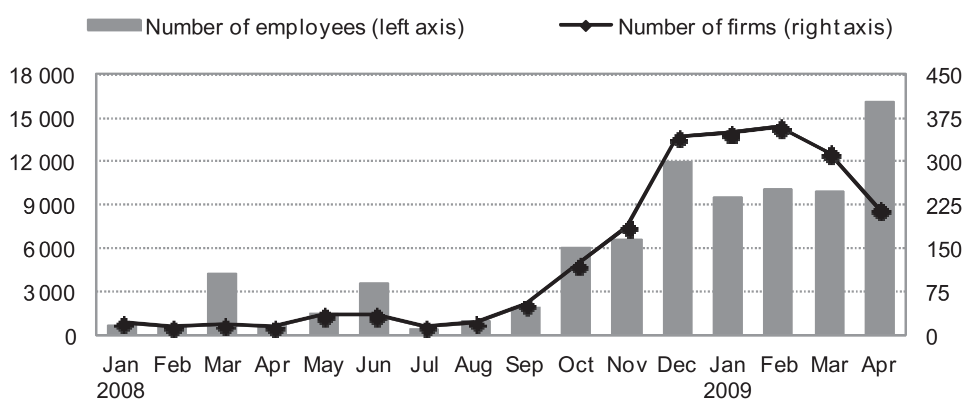
In percentages, 2nd quarter year-on-year changes



Source: Statistics Estonia.

Figure 1.5. Part-time employment and paid holidays, 2008-09

Applications by employers to the Labour Inspectorate



Source: Labour Inspectorate of Estonia.

From October 2008 till May 2009, numerous companies sent employees on partly-paid leave or reduced working time affecting temporarily about 2% of the labour force (Figure 1.5).[4] On the other hand, there is no evidence

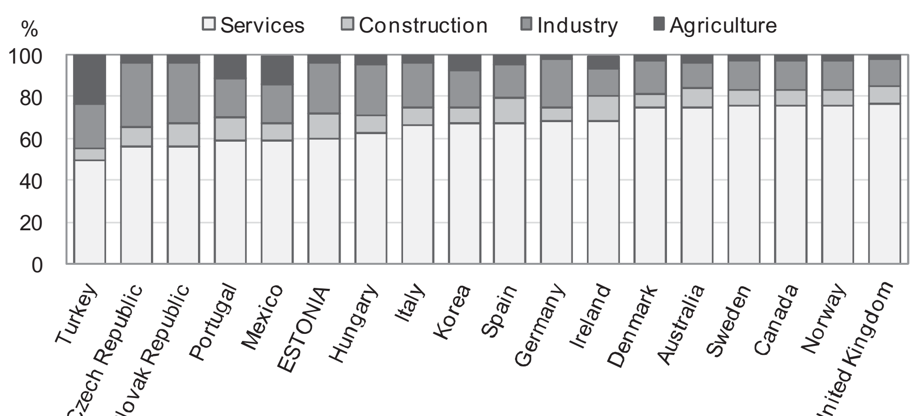
4. Until mid-2009, enterprises had the right to reduce working time or send their workers on partly paid leave for a maximum of three months during a one-year

so far that companies are using early retirement to shed older workers (Nurmela, 2009). The employment rate of older people (aged 55-64) remained more or less constant, with the female participation rate even continuing to rise in this age group (see Table 1.1 above).

3. Employment remains concentrated in low-tech and low-skilled activities

As in other transition countries, the 1990s were characterised by large shifts in the sectoral composition of production and employment, which has become more similar to the situation in OECD countries. Employment has thus been falling in agriculture and industry, while net job creation was concentrated in the service sector and, in more recent years, in the construction sector. By 2008, the service sector accounted for 60% of total employment, a share close to south- and east-European patterns but still lower than in the leading OECD countries. The employment shares of agriculture and industry, respectively 4% and 24% of total employment, were only slightly higher than in OECD member countries (Figure 1.6).

Figure 1.6. Employment by economic sector in Estonia and selected OECD countries, 2008

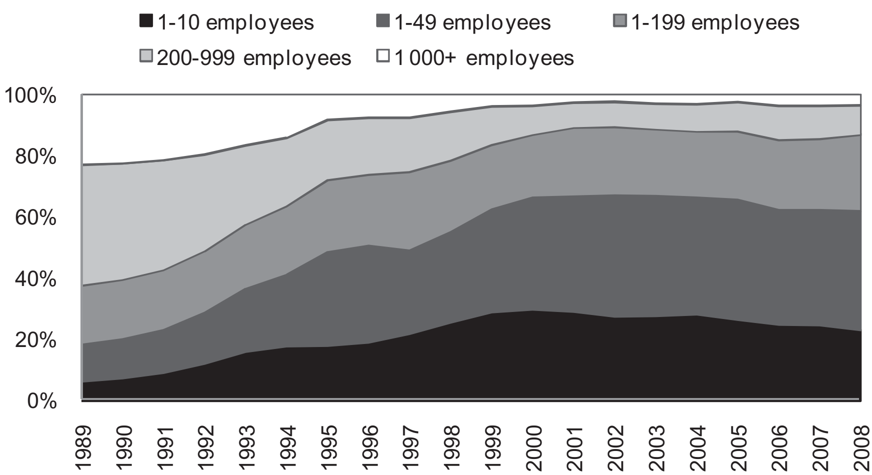


Source: OECD Labour Force Surveys and Eurostat.

period. As part of the anti-crisis packages, the maximum time span has been extended to one year, on the condition that reduced working time is combined with additional training measures (*cf.* Chapter 2). Involuntary part-time was also common in the economic downturn of 1997, when it concerned almost two-thirds of all part-time employees (Cazes and Nesporova, 2004).

In the early 1990s, economic restructuring had also been accompanied by a rapid decline of large companies and the emergence of many small private firms (Figure 1.7). Since 2000, enterprises with less than 50 employees dominate the Estonian economy, accounting for 98% of the number of firms and 61% of employment in 2008.

Figure 1.7. Employment by firm size, 1989-2008



Source: Statistics Estonia.

The investment boom of the late 2000s attracted many firms and workers not only to the construction sector, but also to the partly higher-skilled labour market segments of finance and business services (Table 1.2). Employment in construction almost doubled from 7% of total employment in 2000 to over 12% in 2008, a higher share than any OECD country. The over-heated construction sector not only boosted its employment to an unsustainable level, it also raised its wages much more than its below-average productivity growth justified. The resulting wage inflation spilled over to other sectors, thus eroding Estonia's competitiveness in activities that depend on cheap labour.

Many low-skilled workers have until now been employed in the manufacturing sector, often in export-oriented firms whose profitability depends on low wages (EHDR, 2008). Similarly, much of the private service sector other than finance and business services remains concentrated in low-skill labour market segments, for example trade, catering and transport (Table 1.2). Only 3.6% of the employees in Estonia are working in sectors classified as high-tech and knowledge-intensive, compared with an

EU average of 4.4% (*cf.* Eurostat). With rapidly rising wages prior to the crisis, such an economic structure is hardly sustainable, so a reallocation of labour towards more knowledge-intensive jobs appears necessary.

Table 1.2. Value added per worker, employment and wages by economic sector in Estonia, 2000-08

Sectors are ranked according to their relative change in employment between 2000 and 2008

	Employment		Value added		Wages	
	Share in total ('08)	% change '00-'08	Mean=100 (2008)	% change '00-'08	Mean=100 (2008)	% change '00-'08
Construction	12%	101%	61	91%	109	220%
Financial intermediation	2%	35%	224	86%	185	119%
Education	9%	34%	48	82%	88	170%
Business services, real estate	8%	30%	228	130%	108	180%
Hotels and restaurants	4%	22%	41	125%	64	169%
Wholesale and retail trade	14%	18%	86	144%	95	162%
Public adm. and defence	6%	13%	98	139%	129	164%
Health and social work	5%	11%	68	182%	103	202%
Other services	5%	9%	65	203%	85	163%
Manufacturing	21%	7%	71	128%	92	150%
Transport, storage and comm.	8%	-2%	108	85%	106	127%
Mining and quarrying	1%	-17%	100	169%	116	155%
Forestry	1%	-23%	75	80%	106	212%
Electricity, gas and water	1%	-39%	180	265%	117	154%
Agriculture and hunting	3%	-40%	51	131%	77	252%
Fishing	0%	-62%	95	287%	81	193%
Average/Total	100%	15%	100	125%	100	163%
Estimated coefficients of correlation with:						
– change in employment 2000-2008			*-0.01*	*-0.60*	*0.24*	*-0.08*
– change in wages 2000-2008			*-0.45*	*0.03*		

Source: Statistics Estonia.

Estonia's economic structure is also characterised by a dearth of industrial and technological innovation. Apart from a few highly innovative companies, such as Skype, economic growth in Estonia has been more investment driven than innovation driven (OECD, 2007). R&D spending as a share of GDP is only half that of the OECD average (1.1% in 2006, compared with 2.3%).

The focus on low-tech production and services is reflected in Estonia's trade pattern, with lower shares of high-tech and medium-high-tech exports than on average for OECD members (OECD, 2009a). Trade in goods and services amounts to as much as 80% of GDP – with the European Union, in particular Finland and Sweden, as main trading partners. One-third of the exports are services, especially in transport and tourism but also construction, telecommunication, and financial services. Machinery and electrical equipment account for the largest share in goods exports, often based on subcontracting between local and foreign companies.

4. Regional disparities persist

There are large and persistent disparities in labour market outcomes between regions, with in particular, the Northeast lagging behind. With many Russian-speaking inhabitants, the Northeast has twice as high unemployment as the rest of the country.[5] Despite a great reduction of unemployment after 2000, the three worst-performing of the 15 counties in 2000 still had the highest unemployment rates in 2008.

As in OECD countries, much of the regional inequalities can be explained by differences in sectoral specialisation and educational attainment (OECD, 2005, Chapter 2). Regions with above-average output shares from high-tech sectors and knowledge-intensive services, especially the northern region that includes Tallinn, have relatively high employment rates and low unemployment (Table 1.3).[6] The Northeast, by contrast, has a concentration of low-tech industry and a workforce with mainly secondary or vocational education. This region has been particularly hard hit by the restructuring and downsizing of large industrial enterprises inherited from the Soviet period, but it has seen too little private-sector development.

Table 1.3. Regional disparities, 2008

	Population	Unemployment rate (age group 15-74)	Share of employment in tertiary sector	Average monthly gross wages, EEK	At-risk-at-poverty rate (2007)
Northern Estonia	523 277	4.4	68	14 473	11
Central Estonia	140 267	5.7	51	10 738	23
Northeastern Estonia	170 719	10.0	48	10 263	32
Western Estonia	161 078	4.5	57	10 355	24
Southern Estonia	345 594	5.7	60	10 595	23
Total	1 340 935	5.5	61	12 912	20

Source: Statistics Estonia and OECD calculations.

5. In Northeastern Estonia, 79% of the male population and 81% of the female population have a non-Estonian ethnicity.

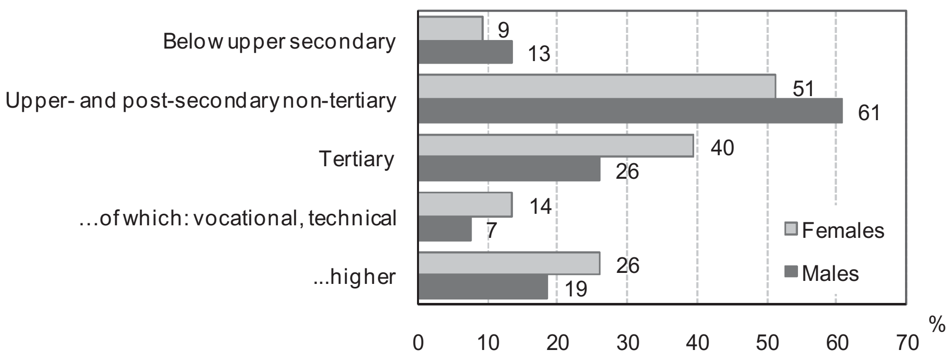
6. In 2008, the tertiary sector accounted for 68% of employment in the northern region and 42% of its workers had tertiary education, in comparison with the national averages of respectively 61 and 34% (*cf.* Statistics Estonia).

5. A well-educated workforce but many blue-collar jobs

Estonia has a well-educated population, with 33% of the 25-64-year population holding a tertiary education degree in 2007 compared with an OECD average of 28%. As in most OECD countries, more women than men completed tertiary education, a gender gap that is particularly large in Estonia (40% for women versus 26% for men; Figure 1.8). Furthermore, Estonian students are among the top performers in the OECD's Programme for International Student Assessment (PISA), ranking third in science and tenth in mathematics.

Figure 1.8. Education attainment of the population aged 25-64, 2007

As a percentage of the relevant population



Source: Statistics Estonia.

Prior to the recession, the labour market easily absorbed the large flows of young tertiary education graduates with an academic orientation, as suggested by their low unemployment rate (*cf.* "Type A" in Table 1.4). Due to strong and continuous demand for skilled labour during the boom period, students were often hired before finishing their studies. In 2007, 46% of the students aged 20-24 combined work and study (OECD, 2009b). However, as there are few part-time jobs (*cf.* Chapter 2), students usually work full-time, which can have negative effects on their education and tends to extend its duration (MSA, 2008).

Table 1.4. Youths (aged 15-24) in the labour market by education attainment, 2008

Educational level	Unemployment rates	Youth labour force by education level
Below upper secondary	18%	26%
Upper- and post-secondary non-tertiary	10%	62%
Tertiary	8%	12%
…Type B (vocational, technical education)	*18%*	*3%*
…Type A (higher education)	*4%*	*9%*
Total	**12%**	**100%**

Source: Statistics Estonia.

Despite this favourable situation with regard to human capital, the country has yet to re-orient its workforce towards a knowledge-based economy. The employment share of white-collar jobs is somewhat lower than the OECD average (Table 1.5), while a relatively high proportion are still in unskilled jobs involving physical work (ISCO 8-9). Many workers in such low-skilled occupations were laid-off in the autumn of 2008; but by the second quarter of 2009, their share of total employment had returned to or even exceeded the level in 2006 (25%). In the long run, such a focus on low-skill production is hardly compatible with the goal of economic catch-up with OECD economies.

Table 1.5. Employment by occupational group (ISCO) in Estonia and OECD, 2006

		Estonia	OECD average
1	Legislators, senior officials, managers	13	9
2	Professionals	15	15
3	Medium-level specialists and technicians	12	16
4	Public servants	5	11
5	Service and sales employees	13	15
6	Skilled agricultural and fishery workers	2	3
7	Skilled and manual workers	16	14
8	Plant and machine operators, assemblers	15	9
9	Elementary occupations	10	9
White-collar workers (ISCO 1-4)		**45**	**50**
Blue-collar workers (ISCO 5-9)		**55**	**50**

Source: OECD (2008) and Statistics Estonia.

Moreover, high unemployment rates for the graduates of some vocationally-specialised tertiary educations (Type B) suggest a mismatch between the education programmes and labour market needs. Such mismatches also affect other vocational schools – *e.g.* at secondary level – whose often low reputation is one reason for the growing interest in pursuing university training (Karu and Roosaar, 2007). Several reforms have been initiated in order to address such mismatches in cooperation with business and industry (EHDR, 2008). Some types of practical training and apprenticeships exist, but they have not been much regulated or coordinated (Loogma, 2008). As part of the reform, the ESF sponsored an apprenticeship programme in 2005-08 and Estonia adopted a Professions Act in 2008, which gives a basis for developing qualifications in correspondence with EU norms.

As a further cause of skill mismatches, older workers' qualifications from the Soviet period – even at advanced levels – are often ill-adapted to the present labour market conditions. Consequently, only 72% of all employed persons with tertiary qualification hold jobs at the corresponding levels, compared with over 80% on average in OECD countries (OECD, 2009b). Older ethnic Russians, in particular, are often over-educated for their jobs (Karu, 2009).

6. Declining and ageing population

With only 1.3 million inhabitants in 2009, Estonia is facing a constraint on employment growth that calls for an optimal use of its labour force. The population has declined by 15% since 1989, a reduction that was most abrupt in the early transition years – when the birth rate declined, the death rate increased and many ethnic non-Estonians emigrated – but the downward trend has continued at a slower pace. According to the United Nations' projections of 2008, the population will decrease by a further 0.1 million by 2050, while population ageing will proceed gradually (Table 1.6). Life expectancy declined in the transition period and it is still only 67 for men and 79 for women, despite some increase since 1995. As a result mainly of low total fertility rates in the recent past – 1.4 or lower for much of the 1990s and 2000s – the overall dependency ratio, which relates the number of children and older persons to the 15-64-year working-age population, reached the low value of 0.5 throughout the 2000s. With some increase in fertility, the dependency ratio is now rising, being expected to reach 0.69 by 2050.

Table 1.6. Main demographic characteristics of the Estonian population, 1989-2050

	1989	2000	2007	2050 (projection)
Population	1 565 662	1 372 071	1 342 409	1 233 000
Fertility rate[1]	2.22	1.39	1.64	..
Life expectancy at birth				
Men	65.6	65.1	67.1	..
Women	74.7	76.0	78.7	..
Age structure (%)				
0-14	22%	18%	15%	17%
15-64	66%	67%	68%	59%
65+	11%	15%	17%	24%
Dependency ratio[2]	..	0.50	..	0.69
Net migration rate[3]	..	-0.13%	-0.05%	..

1. Ratio of the number of life births to the number of women of childbearing age in a calendar year.

2. Ratio of the number of children and older persons to the 15-64-year working-age population.

3. Number of immigrants minus number of emigrants per 1 000 inhabitants.

Source: Statistics Estonia; Projections for 2050 based on World Population Prospects: The 2008 Revision and World Urbanization Prospects (United Nations Secretariat).

The international migration balance has continued to be negative (Table 1.6). It has probably amounted to at least –0.2% per year over the past decade, but available data are unreliable as outward flows often go unreported in the short term. Many emigrants are young, the average age of reported emigrants being 35. Some 72% of them left for Finland, with smaller numbers moving to Russia (5%) and various other countries, essentially in Europe. As experienced in other transition countries, the outward flows have been followed by significant return migration (EHDR, 2009).

Estonia's health conditions are among the worst in the world for a country at its economic development level (EHDR, 2009). Life expectancies for men and women, at about 73 years on average, are around five years lower than the OECD average and the difference between men and women is among the greatest in the world (12 years). This has often been attributed to self-destructive behaviour among men, *e.g.* high alcohol consumption, as well as deficient healthcare provisions.

7. Difficult integration of ethnic non-Estonians

Labour market outcomes have been consistently worse for non-Estonians than for Estonians.[7] The origins of this structural difference date back to the Soviet period, when many workers and engineers were brought in from other parts of the Soviet Union to man large factories and big construction projects after the Second World War. From 1991, the rapid decline of most formerly Soviet-led activities led to high unemployment and poverty in the non-Estonian population, creating a deep socio-economic problem that has yet to be fully resolved.

The biggest minority group is the ethnic Russians, comprising 26% of the population in 2008, followed by Ukrainians, Belarusians and other former Soviet nationalities, accounting for about 5% of the population. An autochthonic Finnish-speaking minority also exists, representing just under 1% of the population. After the restoration of independence in 1991, only citizens of the pre-World War II republic and their descendants automatically received Estonian citizenship. Until now, less than half of the non-Estonians have acquired Estonian citizenship, the rest being most often Russian citizens, while others are stateless – a situation that concerns many ethnic Russians.[8] Most of the non-Estonians are now concentrated in the north-eastern region of Ida-Viru – at the Russian border – and in Tallinn.

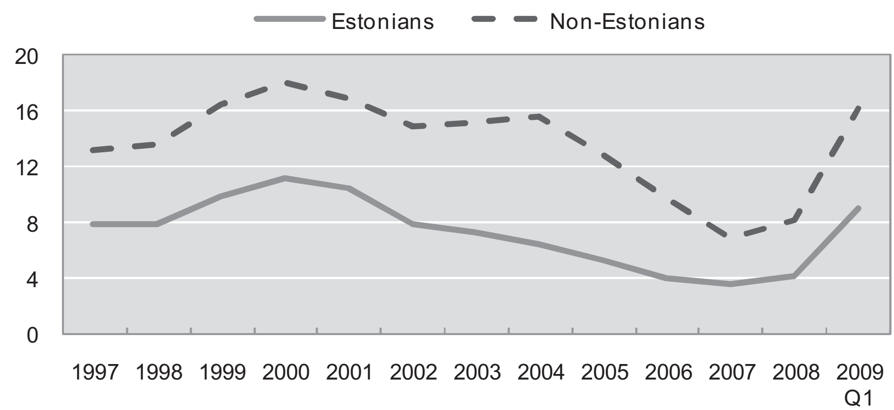
The ethnic difference in unemployment rates is striking, with almost twice as high rates for non-Estonians as for Estonians in most years (Figure 1.9). The recent strong labour demand brought unemployment down for both groups and narrowed the gap to 3.3 percentage points in 2007. Yet, the economic downturn had a slightly above-average impact on non-Estonians' unemployment, while the opposite holds for the employment rate, which in mid-2009 was similar for both groups at aggregate level.

7. Hereafter, "Estonian" and "non-Estonian" refer to the *ethnic origins* (not citizenship), unless otherwise specified. It is self-defined in answers to a question in labour force surveys.

8. In 1995, the conditions for gaining Estonian citizenship became more stringent, requiring applicants to prove their knowledge of the constitution and history, as well as proficiency in the Estonian language. In this situation, many ethnic Russians decided to leave their citizenship undetermined and apply for a permanent residence permit and an alien's passport (EHDR, 2008).

Figure 1.9. Unemployment rate of Estonians and non-Estonians, 1997-2009[1]

In percentage of the relevant labour force (aged 15-74)



1. The terms "Estonian" and "non-Estonian" refer to ethnic origin and not citizenship.

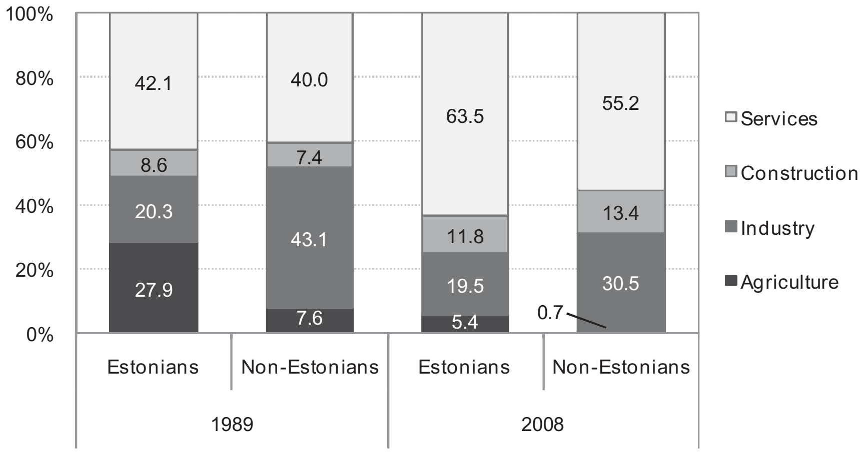
Source: Statistics Estonia.

The situation is partly related to a sectoral and geographic concentration of the Russians in certain areas, combined with an unbalanced economic development over the past two decades. The wave of privatisation and downsizing in the early 1990s hit the Russian population hard, particularly in the Northeast, where many became long-term unemployed or left the labour force. Ethnic Estonians, on the other hand, were mainly active in agriculture and services (Figure 1.10), and, although a similarly sharp drop occurred in agricultural employment, most of those affected found better-paid jobs in the private service sector or public administration (Leping and Toomet, 2008).

An element of ethnic segregation can also be noted when comparing occupational positions across ethnic groups. The percentage of managers and professionals among Estonians is almost twice as high as among non-Estonians, while the opposite holds for most groups of industrial workers (MSA, 2008).

Figure 1.10. Distribution of Estonian and non-Estonian workers by sector, 1989 and 2008[1]

In percentage of total workforce aged 15-74



1. “Estonian” and “non-Estonian” refer to ethnic origin and not citizenship.

Source: Statistics Estonia.

The problems faced by non-Estonians as they seek qualified and white-collar jobs often relate to their insufficient language skills, as well as to their frequent lack of Estonian citizenship (Table 1.7).[9] According to a survey conducted by the Saar Poll research company in 2007, only 39% of the ethnic Russians had active Estonian language skills (EHDR, 2008). Good knowledge of Estonian is essential in many jobs and knowledge of English became also important for higher positions (MSA, 2008). The lack of Estonian citizenship can be a problem even for someone who is proficient in Estonian; but the two obstacles are usually combined because the law requires Estonian language skills as a legal condition for acquiring citizenship. In 2005, some 71% of ethnic Russians with Estonian citizenship had advanced Estonian language skills, compared with only 5% of those with Russian citizenship (Karu and Roosaar, 2006). On the positive side, Russian-speakers’ mastery of Estonian has improved vastly, especially among the younger generations of Russians, who therefore compete more successfully in the labour market (EHDR, 2008).

9. Non-citizens do not have the right to occupy certain state and public positions and are also excluded from a few occupations in the private sector. Other restrictions concern ownership of agricultural land (Van Elsuwege, 2004).

Table 1.7. Unemployment rates by ethnic origin and language skills, 2002-07

In percentage of the relevant labour force (aged 15-74)

	2002	2003	2004	2005	2006	2007
Ethnic Estonians	7.9	7.3	6.4	5.3	4.0	3.6
Ethnic non-Estonians	14.9	15.2	15.6	12.9	9.7	6.9
...knowledge of Estonian language, with citizenship	8.5	9.4	8.6	6.5	4.9	3.9
...knowledge of Estonian language, without citizenship	12.3	15.8	12.4	7.5	8.6	5.2
…no knowledge of Estonian language, with citizenship	13.9	17.3	17.5	23.8	15.0	8.0
…no knowledge of Estonian language, without citizenship	23.6	20.9	20.7	20.3	12.9	11.0

Source: Statistics Estonia.

There is no significant difference in educational attainment between Estonians and non-Estonians. Nevertheless, non-Estonians, and especially non-Estonian women, often have jobs that require less education than they have (Karu, 2009; see Table 1.8). There is also an ethnic wage difference, estimated at 10-15% in the mid-2000s (taking account of such factors as region, sector, occupation, education and language; *cf.* Leping and Toomet, 2007). This wage difference mainly seems to reflect the lower returns to education, but other factors such as insufficient social networks have also been found important.

Table 1.8. Correspondence of education level and job by gender and ethnic origin, 2006

Does your job correspond to your education level?	Estonian		Non-Estonian		All workers
	Male	Female	Male	Female	
Yes	91.5%	89.0%	86.0%	75.7%	87.3%
No, my job requires higher education	2.5%	2.0%	2.5%	1.9%	2.2%
No, my job requires lower education	6.0%	9.0%	11.6%	22.4%	10.5%
Total	100.0%	100.0%	100.1%	100.0%	100.0%

Source: Karu (2009).

Health conditions are worse on average for non-Estonians than for Estonians, a difference that appears to have emerged during the 1990s. The two groups had about the same life expectancy and mortality rates in 1989; but since the mid-1990s, when Estonians' life expectancy began to increase, a gap of several years has separated the two groups. This has been largely attributed to alcohol-related causes of death among non-Estonians (Leinsalu *et al.*, 2004).

Table 1.9. Poverty and inequality indicators, mid-2000s[1]

Gini coefficient of income inequality[2]		Relative poverty rates at 50% of median income		Poverty gap[3]	
Denmark	0.232	Denmark	0.053	Luxembourg	0.201
Sweden	0.234	Sweden	0.053	Finland	0.203
Luxembourg	0.258	Czech Republic	0.058	Belgium	0.204
Austria	0.265	Austria	0.066	Netherlands	0.209
Czech Republic	0.268	Norway	0.068	Hungary	0.234
Slovak Republic	0.268	France	0.071	Australia	0.236
Finland	0.269	Iceland	0.071	Czech Republic	0.236
Netherlands	0.271	Hungary	0.071	Denmark	0.243
Belgium	0.271	Finland	0.073	France	0.244
Switzerland	0.276	Netherlands	0.077	Canada	0.244
Norway	0.276	Luxembourg	0.081	United Kingdom	0.248
Iceland	0.280	Slovak Republic	0.081	Sweden	0.248
France	0.281	United Kingdom	0.083	Slovak Republic	0.255
Hungary	0.291	Switzerland	0.087	Ireland	0.257
Germany	0.298	Belgium	0.088	Greece	0.267
Australia	0.301	New Zealand	0.108	Austria	0.274
Korea	0.312	Germany	0.110	**ESTONIA**	**0.278**
Canada	0.317	Italy	0.114	Portugal	0.290
Spain	0.319	Canada	0.120	Norway	0.294
Japan	0.321	Australia	0.124	Germany	0.297
Greece	0.321	Greece	0.126	Spain	0.320
Ireland	0.328	Portugal	0.129	Turkey	0.329
ESTONIA	**0.335**	**ESTONIA**	**0.135**	Italy	0.333
New Zealand	0.335	Spain	0.141	New Zealand	0.336
United Kingdom	0.335	Poland	0.146	Japan	0.347
Italy	0.352	Korea	0.146	Poland	0.356
Poland	0.372	Ireland	0.148	Iceland	0.359
United States	0.381	Japan	0.149	Korea	0.360
Portugal	0.416	United States	0.171	Mexico	0.379
Turkey	0.430	Turkey	0.175	United States	0.383
Mexico	0.474	Mexico	0.184	Switzerland	0.387
OECD average	**0.312**	**OECD average**	**0.106**	**OECD average**	**0.286**

1. Countries are ranked in increasing order of the respective indicator. The income concept used is that of disposable household income in cash, adjusted for household size with an elasticity of 0.5.

2. The Gini coefficient is defined as the area between the Lorenz curve (which plots cumulative shares of the population, from the poorest to the richest, against the cumulative share of income that they receive) and the 45° line, taken as a ratio of the whole triangle. The values of the Gini coefficient range between 0, for "perfect equality" (*i.e.* each share of the population gets the same share of income), and 1, for "perfect inequality" (*i.e.* all income goes to the individual with the highest income).

3. The poverty gap is calculated as the distance between the poverty threshold (50% of median income) and the mean income of the poor, expressed as a percentage of the poverty threshold. Poverty rates are defined as the share of individuals with equivalised disposable income less than 50% of the median for the entire population.

Source: OECD income distribution questionnaire.

8. An unequal society

With a Gini coefficient of 0.34, the overall income distribution is slightly more unequal than in the average OECD country, and comparable with New Zealand and the United Kingdom (Table 1.9). Although Estonia has a similar distribution of market income as other European countries, it achieves much less redistribution through taxes and social benefits (cf. Chapter 3). Estonia also has a somewhat higher rate of relative poverty than the average OECD country, as 14% of its population fall below 50% of the median income, compared with 11% on average in OECD countries. On the other hand, the poverty gap – measuring the amount by which the mean income of the poor falls below the poverty line – is narrower than in the average OECD country. In other words, relative poverty is more common in Estonia but poverty, when it occurs, is on average less deep than in OECD countries.

The risk of poverty is highest among the unemployed and pensioners, with, respectively, over 60% and over 40% falling below a poverty line at 60% of the median income (Table 1.10). The relative poverty rate among pensioners has risen remarkably over the past five years. By contrast, child poverty has declined in line with the trend observed for the working-age population.

Table 1.10. At-risk-of-poverty-rates by age and labour status, 2000-07

Share of the population with income less than the 60%-median threshold[1]

	2000	2001	2002	2003	2004	2005	2006	2007
Age								
0-15	21	19	18	20	22	20	17	17
16-64	18	18	19	18	17	16	16	15
65 and older	16	18	16	17	20	25	33	39
Labour status								
Employed	9	9	9	9	5	6	6	6
Self-employed	..	..	..	..	31	31	28	30
Unemployed	50	47	48	49	60	60	62	61
Retired	18	21	21	19	23	29	37	43
Other inactive	28	27	28	31	29	29	30	29
Ethnic nationality								
Estonians	..	..	..	..	18	17	19	18
Non-Estonians	..	..	..	..	20	20	21	22
Total	**18**	**18**	**18**	**18**	**18**	**18**	**19**	**20**

1. The income concept used is that of disposable household income in cash, adjusted for household size using the modified OECD adult-equivalence scale. Change in the data source in 2004 should be taken into account when comparing data for 2000-03 with the following years.

Source: Statistics Estonia.

9. Conclusion

The economic crisis has reversed several previous years' improvements in employment and unemployment rates, and it poses major challenges for the country's future development. The surge in unemployment has exposed unresolved structural problems in the labour market and significant parts of the population are facing a risk of relative poverty, although the depth of the observed poverty appears moderate.

Once the recession is over, Estonia's chances of catching up with leading EU and OECD economies will depend largely on how efficiently its human resources can be reallocated to higher-skilled and more productive jobs. It will then be crucial to improve the match between skills supplied by education and lifelong learning systems and the needs of the economy. In this context, a better integration of ethnic non-Estonians could contribute substantially to economic efficiency as well as to social cohesion.

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CHAPTER 2.

FLEXIBILITY WITH LIMITED SECURITY

Estonia's flexible labour market allows companies to rapidly adjust to changing market conditions, but income security for the unemployed and the protection against violations of labour law remain limited. Recent labour market reforms have addressed several institutional problems, but the public employment service still suffers from a number of shortcomings that hinder effective assistance to job seekers. Improved activation measures are needed to ensure that those who become unemployed do not lose contact with the labour market. This chapter reviews Estonia's principal labour market policies against the benchmark of the Reassessed OECD Job Strategy.

1. Introduction

Before the economic downturn, Estonia's flexible labour market had performed very well, with rising productivity and a steady growth of employment notably for youth, women and the elderly since 2000. Unemployment shrank to a historical minimum just before the recession, but the gender-wage gap and the insufficient integration of ethnic non-Estonians remained as structural problems. The current recession has exposed the weaknesses of the country's employment services and the social safety net.

Inspired by the international debate about flexicurity, Estonia drastically reformed its labour market institutions and employment legislation in mid-2009, a decision that followed a decade of discussions between trade unions, employer federations and the government. Chief aims were to encourage the reallocation of labour to more productive jobs and to improve the social protection of the unemployed. However, due to the economic crisis and considerations of fiscal sustainability, the envisaged increase in spending on labour market policy has been largely postponed if not cancelled (*cf.* Box 2.1). The government's commitment to keeping the budget deficit under 3% restrains the provision of income support for the unemployed at a time of rising unemployment. To respond to this, tripartite discussions were held and they led to a number of policy changes, designed to tackle the effects of the crisis while respecting the short-term fiscal constraints.

This chapter reviews Estonia's main labour market policies, focussing on the observed long-term achievements and structural shortcomings. A benchmark is provided by the *Reassessed OECD Jobs Strategy* (see OECD, 2006), which gave detailed recommendations for policies to boost jobs and income while emphasising that there was no single golden road to success. Taking account of Estonia's recent labour market reforms, the country now comes closer to a high-flexibility model (resembling the United States and New Zealand) than to flexicurity (*e.g.* Denmark and the United Kingdom). The following four sections analyse employment regulations, their enforcement, labour taxation and industrial relations. Three subsequent sections consider the unemployment benefit system, employment services and issues about active programmes and lifelong learning. A concluding section summarises the key observations.

Box 2.1. Labour market and social policies to address the crisis

In March 2009, representatives of several ministries, trade unions and employer organisations agreed on a package of policy measures to tackle the recession. The main purpose is to maintain jobs and provide effective help for the registered unemployed, but most of the proposed initiatives are also part of longer-term action plans addressing structural shortcomings in the labour market (Leetma and Nurmela, 2009).

This anti-crisis package, financed mainly from the state budget and the European Social Fund (ESF), has no fixed timetable and the extent of available funding remains unclear. To address budgetary pressures, the government has reversed several potentially expensive labour-market and pension reforms that had just been legislated in a new Employment Contracts Act.

Anti-crisis package

- *Preserving jobs*. Employers can reduce working time in connection with training during a one-year period, but this is not financed by the government.[a] The government has also promised to put pressure on employers to preserve jobs.
- *Job creation*. Local municipalities are encouraged to provide community jobs for the unemployed. The public employment service's subsidy to business start-ups will be extended to unemployed persons who establish non-profit associations.
- *Vocational training.* Unemployed participants in training will be allowed to continue their training even if they find a job before the end of the training programme. The maximum length of the supported training will be extended from one to two years. The Employer Federation will report monthly to the Ministry of Social Affairs about skill needs in enterprises.
- *New financing system for vocational training.* Training vouchers have been proposed as a way to reduce the need for public procurement of courses, considered as too rigid. The unemployed would be offered a voucher with a fixed value that they can use for any training of interest.
- *Job-broking*. More IT assistance is being introduced for registration and monitoring of job seekers and vacancies.

Reversal of previously adopted policy measures in order to address budgetary pressures

- *Suspension until 2013 of the increase in unemployment benefits.* The new Employment Contracts Act included an increase in the unemployment insurance benefit to 70% of the previous wage during the first 100 days and 50% afterwards, and a more than doubling of the unemployment assistance benefit from EEK 1 000 per month to EEK 2 300 per month. Both measures have been suspended by the Parliament until 2013.
- *No widening of the coverage of unemployment benefits*. A decision to extend unemployment insurance benefits to some cases when employees quit jobs or leave them in agreement with employers has been postponed till 2013.

- *Higher unemployment insurance contribution rates.* The new Employment Contract Act increased the contribution rates from 0.6 to 1% for employees and from 0.3 to 0.5% for employers in mid-2009. As a temporary measure, the contribution rates were thereafter increased further to 2.8% for employees and 1.4% for employers, which will apply at least until the end of 2009.
- *No reduced income tax in 2009.* The planned reduction of the flat tax rate from 21 to 20% is delayed for one year, along with a planned rise of the tax-free income allowance from EEK 27 000/year to EEK 30 000 per year. An additional tax-free allowance for the first child is temporarily suspended during 2009.
- *Paternal benefit abolished.* This benefit, giving fathers ten days of paid leave, had been introduced in 2008. (Fathers can still take ten days of extra leave, though without pay. They can also take part of the 18 months of paid parental leave, of which only about 70 days are reserved for the mother. See Chapter 3.)
- An *allowance for children of school age enrolled in education*, at EEK 450 per year, was abolished.
- *Sickness benefits.* The healthcare insurance compensated 80% of the lost wage from the second day of sickness. From July 2009, this benefit is only paid from the 9th day of sickness, while employers are obliged to pay for days 4-8.
- *Reduced indexation of pensions.* The indexation of pensions is reduced from 14 to 5% in 2009.
- *Temporary interruption of contribution towards 2nd-pillar pension saving.* To boost the financing of 1st-pillar pensions, the government will allocate all employer contributions pertaining to the pension system – altogether 20% of wages – to the 1st pillar between June 2009 and the end of 2010. A legislated allocation of 4 percentage points of employer contributions to the funded 2nd pillar is suspended.
- *Suspension of employee contribution to 2nd-pillar pension.* As an exception, workers with up to eight years left to retirement can choose to keep contributing to the 2nd-pillar pension, in which case the government exceptionally pays the 4 percentage points from employer contributions to the 2nd pillar. In 2011-17, employees will have the option to save an additional 2-3% of their wages, and benefit from an additional 6-8 percentage points from employer contributions in 2nd-pillar funds.

a) Under the current system, reduced working time can be implemented for a maximum of three months during a one-year period without requirement for providing training measures.

2. Employment protection

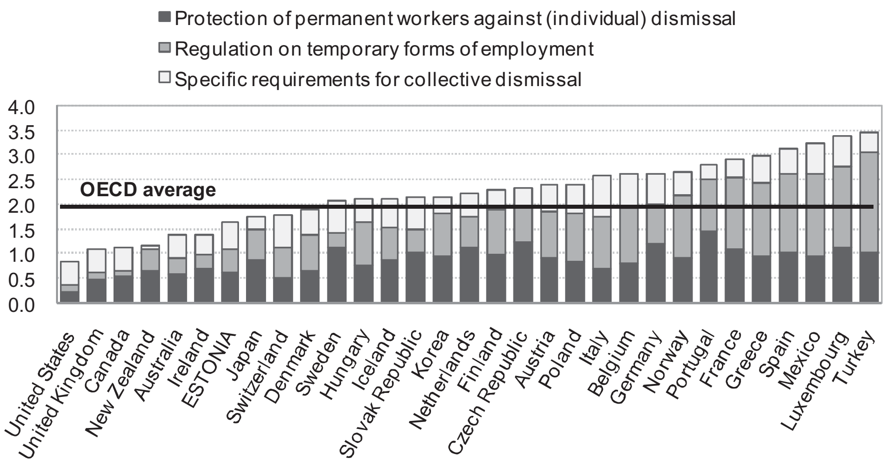
The new Employment Contracts Act introduces more flexibility

With the entering into force of the new Employment Contracts Act in mid-2009, Estonia's employment protection regulations became more flexible than those of any OECD country except the English-speaking ones

(Figure 2.1 and Annex 2.A1). The rules were liberalised on many points, reducing Estonia's overall index of employment protection from 2.4 to 1.65 according to the OECD measure.[10] For example, the previously relatively long notice periods for workers with short tenure were reduced, the possibilities for dismissed workers to obtain re-employment or compensation became more limited, and the use of fixed-term contracts was facilitated (*cf.* Box 2.2).

Figure 2.1. Employment protection in Estonia and OECD, 2008[1]

Average scores 0-6 from lowest to highest strictness



1. Scores for Estonia, France and Portugal refer to 2009.

Source: *OECD Employment Protection database* (*www.oecd.org/employment/protection*), updated for Estonia according to the 2008 Employment Contracts Act, which entered into force on 1 July 2009. See Annex 2.A1 for a discussion of the OECD employment protection indicator.

Whereas employment protection reforms in many OECD countries over the past two decades have focused on the liberalisation of temporary contracts, Estonia's new Act makes permanent contracts much more flexible. As discussed in the *Reassessed OECD Jobs Strategy* (OECD, 2006), this approach is preferable because it reduces the risk of labour market segmentation, a problem often observed in countries where temporary contracts are used to get around strict regulations of regular contracts. Only

10. The employment protection index has been revised slightly downwards in comparison with the *OECD Economic Survey of Estonia* (OECD, 2009a) after rectifications by the Estonian Ministry of Social Affairs.

the rules on collective dismissals remain relatively strict in Estonia. These regulations, which start applying already from five dismissals, oblige employers to notify both employee representatives and the Unemployment Insurance Fund, although the latter's approval is no longer necessary.[11]

Box 2.2. The new Employment Contract Law: key changes from 1 July 2009

The *notice period for dismissal* has been shortened from 2-4 months to 0.5-3 months. It is thus 15 calendar days after one year of employment; 30 days after 1-5 years; 60 days after 5-10 years; and 90 days after ten years or more. On the other hand, the employer must give notified employees free time for job search.

Severance pay has also been cut, and the Unemployment Insurance Fund (UIF) will carry an increased part of the costs. The employer now pays only one monthly wage, while the UIF pays one additional monthly wage to employees with 5-10 years of tenure and two monthly wages for those with at least ten years of tenure.[a]

Fixed-term contracts are now allowed if they are justified by "good reasons" arising from the temporary nature of the job, with a maximum duration of five years. But in cases of premature cancellation of such contracts due to economic difficulties, the employer must compensate the employee for the loss of income till the end of the contract term (except in bankruptcies).

The new Act includes a definition of *temporary agency work* and obliges the employer to inform the employee about the specific characteristics of the employment relationship. In addition, the 2006 Labour Market Services and Benefits Act has been amended to mention temporary work agencies as providers of labour market services.

Remuneration for unsocial working hours. Remuneration for night work – *i.e.* between 10 p.m. and 6 a.m. – is increased from 1.2 to 1.25 times the regular wage, unless the worker's salary already includes additional remuneration for working at night. Evening work – *i.e.* work between 6 p.m. and 10 p.m. – will no longer be distinguished from standard working time and will be paid as regular working hours.

To *reduce the administrative burden* for employers, several outdated register procedures have been abolished, *e.g.* work books and personnel files. The requirement to obtain approval from the Labour Inspectorate for certain procedures, such as temporary part-time work or collective dismissal, has been cancelled.

a) For employees with at least 20 years tenure, the previous redundancy benefit rules will apply until 2015. Those concerned will often be entitled to one monthly wage more than the new rules stipulate.

11. Redundancies are collective if they concern at least five employees in a firm with up to 19 employees, ten employees if total employment is 20-99, 10% if the total is 100-299, and 30 employees if it is 300 or more.

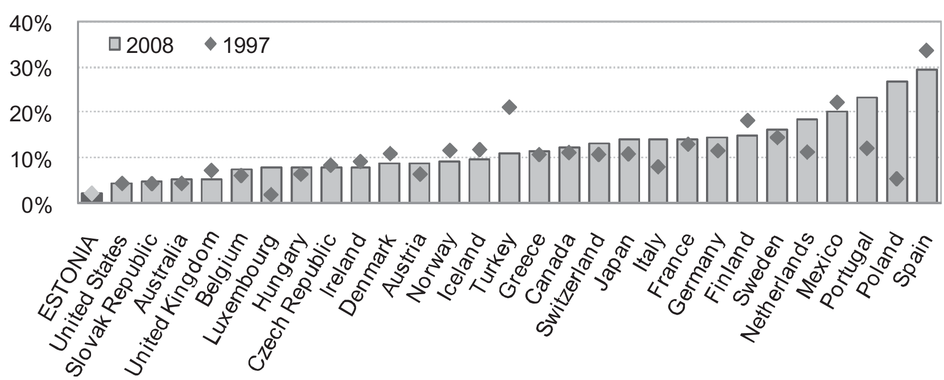
Temporary contracts remain an exception

Almost all employee jobs in Estonia are of indefinite duration, as has traditionally been the case in several other transition countries. But in contrast to some of the latter, Estonia has not seen any significant growth of fixed-term employment since the 1990s (Figure 2.2). Most employers apparently find the open-ended contracts flexible enough, apart from the construction sector (38% of all temporary jobs) and occasional service tasks (35%). While two-thirds of the temporary workers said that they would have preferred open-ended contracts in 2000, this share declined to one-third by 2008 (*cf.* European Labour Force Survey).

Estonia's new labour law makes it easier to conclude fixed-term contracts, but it also obliges employers to pay compensation on premature termination of such contracts (*cf.* Box 2.2). The need for the latter provision is questionable, and it can be expected to further discourage the use of fixed-term contracts, especially for extended contract periods.

Figure 2.2. Temporary employment in Estonia and OECD countries, 1997 and 2008

As a percentage of total dependent employment



Source: OECD Labour Force Surveys and Statistics Estonia.

Temporary work agencies (TWA) are relatively new in Estonia and many potential user companies are not aware of their existence. The first TWA started in 2002 and the sector soon expanded with the entry of international firms. A majority of TWA also provide other labour market services (Klaster and University of Tartu, 2007). No comprehensive statistics exist, but a survey in 2007 found about 50 TWA employing

2 880 workers.[12] Most of these workers used TWA as a channel for local job search, but TWA also sent workers to foreign countries (mainly Finland and Sweden). The main economic sectors of the user companies are manufacturing, construction, and transport (Roosaar and Nurmela, 2007).

As the labour law requires equal treatment of all employees, the same regulations and social security provisions apply to TWA workers and regular employees, including the length of assignments and renewal of contracts. But in practice, the TWA workers may not be eligible for social benefits due to the lack of required length of employment. On the other hand, about a third of the agencies surveyed in 2007 paid higher wages than the user company.

There is no independent quality control, but a group of TWA have introduced a self-regulation mechanism. While until 2005, a license was required and had to be renewed every three years, it is now sufficient for a TWA to be recorded in the business register. In 2005, a couple of TWA formed the Estonian Staffing Agency Association (EPREL) and agreed on a moral code. Nevertheless, the EPREL affiliates only six TWAs and about 500 TWA workers, which is probably around 12% of the TWA and 18% of its employees (Nurmela, 2008).

Working-time rules are flexible, but part-time work is not very common

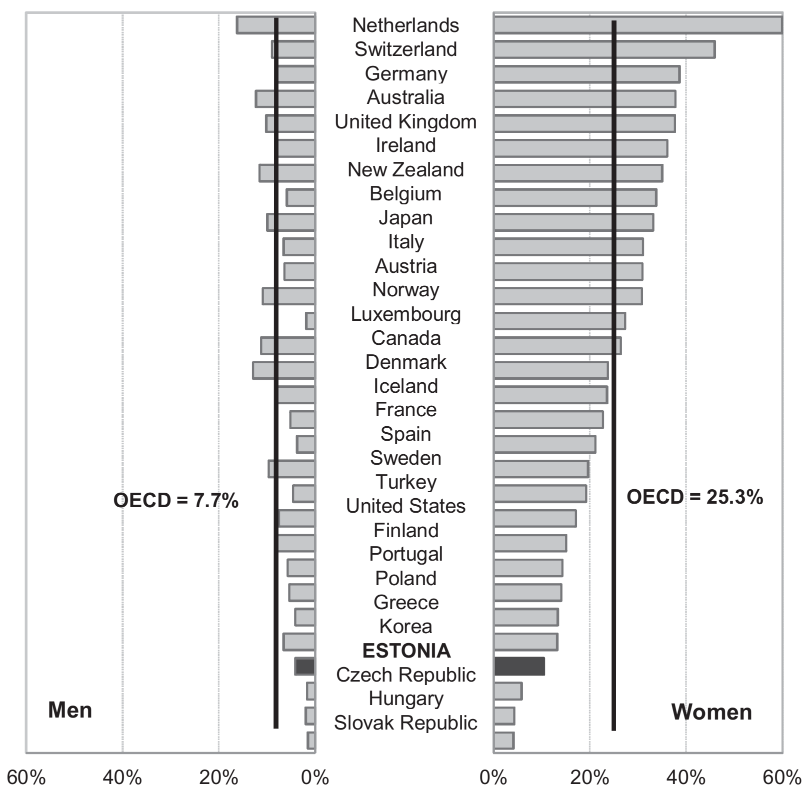
Estonia's rules about allocating weekly working time are flexible by OECD standards. With some exceptions, the standard working time should not exceed eight hours per day and 40 hours per week. Employers can unilaterally adapt the working hours to "reasonable" needs, provided that the total working time does not exceed 48 hours per week on average over four months. For healthcare professionals and workers in agriculture and tourism, working hours can also be averaged over 12 months by means of a collective agreement. Overtime is allowed if the employee agrees, but it must be compensated for by time-off unless the labour contract provides for overtime pay at 1.5 times the regular wage. There are no restrictions on weekend work, but work on national holidays should be remunerated at twice the regular rate. Workers can request a change in working hours for any reason (*e.g.* from full-time to part-time or vice versa) and employers must consider such requests.

12. The standard labour force surveys' samples are too small to measure TWA employment. The cited figures from 2007, drawn from a survey by the Klaster research centre and the University of Tartu, have also been criticised on methodological grounds (Nurmela, 2008). They must therefore be treated with caution.

However, the incidence of part-time work is much lower than in most OECD countries, and it has declined in the past decade. There are no legal limits on part-time work and it gives the same rights and duties as full-time work (in proportion to the working time), but most Estonians seem to reject part-time work for financial reasons. In 2008, only 4% of the employed men and 10% of the women worked less than 30 hours per week, compared with OECD averages of 8% and 25%, respectively (Figure 2.3). Most of them did so for personal reasons including childcare and studies (*cf.* Estonian Labour Force Survey). But when the economic downturn began, enterprises imposed involuntary part-time schedules on about 2% of the labour force. In contrast to some OECD countries and Slovenia, Estonia did not encourage this practice: it emerged as a spontaneous cost-cutting reaction by enterprises.

Figure 2.3. Part-time employment (<30h/week) in Estonia and OECD countries, 2008

Share of part-time employees (men and women) in total employment



Source: *OECD Labour Force Statistics database* and Statistics Estonia.

As noted in the *Reassessed OECD Jobs Strategy*, flexible working arrangements encourage job creation but they can make it more difficult to reconcile work with family life. This holds especially when there is a shortage of childcare, as is sometimes the case in Estonia (*cf.* Chapter 3).[13] Working-time flexibility for employers should therefore be accompanied by some flexibility for employees as well. In general, however, "unsocial" working hours (evenings, nights or weekends) appear less common in Estonia than in most European countries, and the share of employees with long working weeks or overtime has declined in recent years (MSA, 2008).

3. Labour law enforcement

The Labour Inspectorate is intensifying its educative role

Employment protection depends not only on what is written in the law, but also on the extent to which it is respected and enforced. The Labour Inspectorate, which monitors compliance with labour law and occupational safety, was restructured in 2008 to strengthen its preventive and educative role. To raise awareness about the working environment and labour relations, the inspectorate is putting more emphasis on communication with the media and the general public and it has set up an "e-inspectorate". One reason for the restructuring was that the new Employment Contracts Act had removed several administrative reporting requirements and control functions in favour of contractual freedom, for example in matters of working time. While this change was widely welcomed, it has made the Inspectorate's role more demanding as it must now be fulfilled mainly by means of information and practical assistance rather than by use of administrative power. Internal training courses and new guidelines have been developed with the help of the European Social Fund.

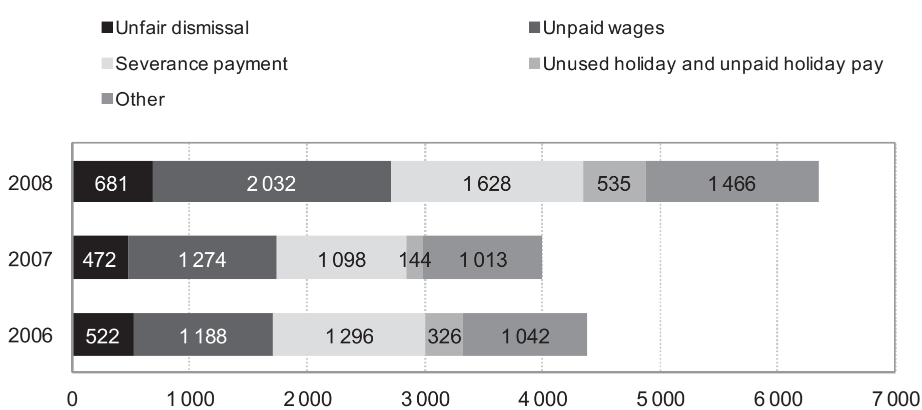
The Inspectorate's previous 14 county offices have been regrouped into four local inspectorates, while the staffing was cut from 153 to 131 positions. The latter figure includes 70 professionals of whom over half are concerned with health and safety, while 20 are lawyers focusing on employment relations. This represents around one inspector per 9 400 employed persons, thus in line with the ILO recommendation of one labour inspector per 10 000 employed persons for advanced countries (OECD, 2008).

13. High employment rates in the 25-49-year age group – 90% for men and 79% for women in 2008 – suggest that most parents can reconcile work and family life. Nevertheless, family responsibilities are a chief reason for inactivity in the aforementioned age class in 2008 (*cf.* Estonian Labour Force Survey).

Preventive inspections were suspended in 2009, but this should only be temporary. With more resources devoted to counselling and information about the new Employment Contracts Act, inspectors currently visit firms only in response to specific complaints. The timing of this temporary suspension of most inspections has proved unfortunate as it coincides with the economic downturn, which triggered a 50% increase in claims by employees already in 2008, often concerning unfair dismissals and unpaid wages (Figure 2.4). On the other hand, complaints about severance pay are likely to diminish as the latter has been reduced and is paid out to a greater extent by the Unemployment Insurance Fund since 1 July 2009 (*cf.* Box 2.2). In addition, the administrative workload should lessen as employers no longer need the Inspectorate's permit for certain procedures, especially involuntary part-time work and collective dismissal.

Many workers remain vulnerable to offences against labour law. In 2008, around 5 000 inspections were conducted, covering 6% of all registered businesses; one-fourth of the inspections concerned labour legislation. In Estonia as in most countries, it is impossible to conduct systematic controls in small firms. Hence, inspections generally target firms with over five employees concerning the working environment and over ten employees concerning labour law, while focussing on firms with a higher risk of violation. This limitation is problematic, considering that small firms seldom have trade unions (*cf.* Section 5, p. 68) and that about 55% of all registered firms have up to five employees. Most of the detected violations of labour law occurred in firms with ten to 20 workers.

Figure 2.4. Complaints submitted by employees to the Labour Inspectorate, 2006-08



Source: Estonian Labour Inspectorate.

The Inspectorate can impose sanctions against violations of labour law, but these are very low. For companies, the maximum sanction is EEK 20 000 or 13% of the average annual wage, compared with one to nine times the average annual wages in other eastern European OECD countries (OECD, 2008). For individual entrepreneurs, the maximum fine is only 4% of the average annual wage. Judging from OECD experience, some increase in these penalties might contribute to a better balance between deterrence and the desire to protect business and jobs (OECD, 2008).

Labour dispute committees limit the cost of resolving conflicts

In the absence of specialised labour courts, claims related to labour rights are often brought to civil courts. To limit the cost and time needed to resolve conflicts, individual and collective labour disputes can also be handled by one of 11 individual labour dispute committees, composed in equal numbers by employee and employer representatives and chaired by the labour inspectorate.[14] Any party who is not satisfied can subsequently bring the case to a court.

In 2008, some 4 100 claims were submitted by employees to labour dispute committees, representing an increase of 57% from the year before. Most conflicts concerned unpaid wages (32%) and severance pay (26%), followed by unfair dismissal (10%; *cf*. Figure 2.4). The number of claims is expected to rise further because the new Employment Contracts Act has increased the limit on the financial claims that can be handled to EEK 150 000 (about EUR 9 600). The previous ceiling at EEK 50 000 excluded many potential cases or obliged the claimants to settle for a lower amount (Kallaste and Roosaar, 2007).

Labour dispute committees charge no fees for reconciliation, and the law obliges them to hear any case within one month (with a possible one-month extension), after which the committee has five working days to communicate a decision. In 2007, the average time of handling cases was 1.3 months compared with nine months in civil courts (Venn, 2009).

14. The representatives are appointed by the Estonian Trade Union Confederation and Estonian Employers' Confederation and receive remuneration from the Inspectorate during the period they participate in the work of a labour dispute committee.

4. Labour taxation and undeclared work

Estonia was the first European country to introduce a flat-rate income tax in 1994. Fixed initially at 26% of taxable income, it has been reduced to 21% by 2008 (*cf.* Box 2.3). The goal is to reach 18% by 2011; but a planned reduction to 20% in 2009 was suspended as part of the package of budget-strengthening measures, as was a foreseen increase of the tax-free allowance.

The flat rate simplifies taxation considerably and reduces compliance costs, a fact that has probably contributed to reduced tax evasion. Such tax reforms can also be motivated by the desire to stimulate work efforts and investment (Hall and Rabushka, 2007). But it also limits the tax-benefit system's capacity to redistribute income (*cf.* Chapter 3).

Box 2.3. The taxation of work income

Income tax was charged at a flat rate of 26% from 1994 until 2004, after which it was cut to 24% in 2005 and then reduced in annual steps down to the present 21%, applicable from 2008. A planned reduction to 20% in 2009 has not been implemented.

Each income earner receives a tax-free allowance of EEK 27 000 per year, or about 17% of the average gross wage, plus the same amount for each child other than the first. (The allowance for the first child, introduced in 2008, was suspended from the beginning of 2009.) A pensioner receives a tax-free allowance of EEK 36 000, which is not much less than the average pension. The tax is individual, but a married couple may file a joint tax return and share tax allowances.

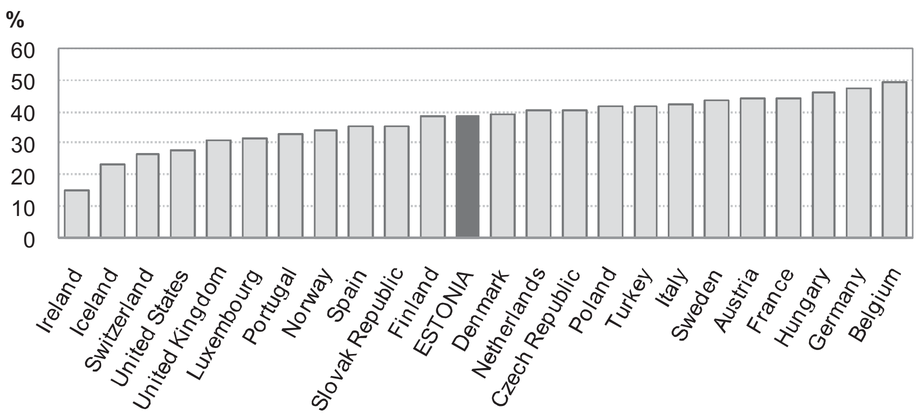
The *social tax,* which finances pension and healthcare insurance, is paid by employers and the self-employed at a rate of 33% of salaries and wages, of which 13 percentage points refer to healthcare insurance and 20 percentage points to the pension system. The social tax is charged only on wages that exceed EEK 1 400 per month (EEK 16 800 per year), but it is not subject to any upper income limit.

Workers participating in the funded 2nd-tier pension must pay a 2% contribution out of their wages, which is allocated to individual accounts along with 4 percentage points of the employer's social tax. The accumulation of 2nd-tier pension funds has been temporarily suspended in 2009 and 2010, except for older workers who opt to continue paying the 2% contribution.

Unemployment insurance is financed by separate contributions. The rates were increased in July 2009, rising from 0.6 to 1% for employers and from 0.9 to 2% for employees, after which a temporary further increase to 1.4% and 2.8%, respectively, was adopted for August-December 2009.

The overall tax wedge on labour costs was estimated at 39% in 2007. This was close to the EU average, but higher than in most non-European OECD countries (Figure 2.5). OECD experience shows that a reduction in the tax wedge is likely to have a positive impact on employment and total hours worked. In the average OECD country, a 10 percentage-points reduction of the tax wedge can be expected to reduce equilibrium unemployment by 2.8 percentage points and increase the employment rate by 3.7 percentage points (OECD, 2006). Surveys also indicate that the tax burden is one of the key factors behind undeclared or under-declared wages in Estonia (Leetmaa and Võrk, 2007). Some further cuts in the income-tax rate would therefore be welcome when the budgetary situation improves.

Figure 2.5. Tax wedge on labour costs in Estonia and selected OECD countries, 2007[1]



1. Income tax plus employees' and employers' social security contributions as a percentage of the total labour costs (including payroll taxes where applicable) for a single person without children earning 67% of the average wage.

Source: *OECD Benefits and Wages database*.

To the extent it can be measured, undeclared work is not very common in Estonia by international standards and has been decreasing. According to one survey, the share of workers without written contract declined from 11% in 1998 to 5% in 2005.[15] In 2001, the size of the informal sector was estimated at 8-9% of GDP (Renooy *et al.*, 2004).[16] While this is slightly

15. The Working Life Barometer surveyed Estonian job conditions in 1998, 2002 and 2005, using a sample of about 1 000 individuals (Philips, 2007b).

16. The size of the informal sector is estimated by the discrepancy between survey-based and administrative employment data.

higher than the EU average of 5%, it is the lowest share of undeclared work among new EU members (ranging from 9-10% of GDP in the Czech Republic to 22-30% of GDP in Bulgaria in 2001).

A common form of tax evasion involves so-called "envelope wages", *i.e.* cash payments to workers on which social security contributions and income tax are not levied. Such payments typically come on top of a declared wage, accounting for 35-50% of the total income (*cf.* Philips, 2007b; and Nurmela and Karu, 2008). According to a survey by the Estonian Institute of Economic Research, the share of employees receiving envelope wages regularly or sometimes declined from 16% in 2003 to 11% in 2006.[17] The practice is most common in the construction and services sectors, where it often seems to concern workers under the age of 30, those with low education and ethnic non-Estonians. The tax loss due to under-declared wages was estimated at about 3% of the tax revenues in 2007 (Leetmaa and Võrk, 2007).

The reasons behind the decline in undeclared work can be found in Estonia's general economic development, European integration and social security reforms (Leetmaa and Võrk, 2007). Joint efforts by the social partners, social security and other public bodies have contributed to the decline by detecting more violations and by increasing awareness in the general public (Kallaste and Nurmela, 2007). Nonetheless, the current economic crisis and the recent increase in the tax burden for employers (with temporarily higher UI contributions, *cf.* Box 2.3 above) are likely to lead to a renewed problem of undeclared and under-declared wages. In 2007, when the Estonian economy started to slow, the incidence of envelope wages already rose by 3 percentage points to 14% (Nurmela and Karu, 2008). But this increase primarily concerned occasional undeclared payments, while the undeclared part accounted for a smaller share of a worker's salary than in previous years. This suggests that the present higher incidence of informality may represent a temporary response strategy by employers to the economic crisis.

17. The survey undertaken by the Estonian Institute of Economic Research is carried out annually since 1999 and covers a representative sample of 1 077 Estonian residents aged 18-74 (Nurmela and Karu, 2008). These figures are confirmed by the Working Life Barometer survey, where 9% of the respondents stated that the received undeclared wages on a regular or occasional basis in 2005 (Philips, 2007b).

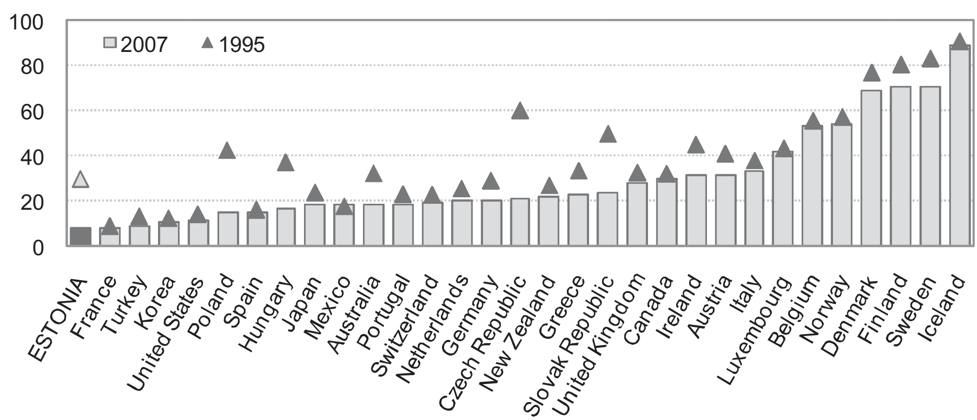
5. Industrial relations

Limited collective bargaining

Estonia's labour market is characterised by the presence of many small firms and low trade union membership (Figure 2.6).[18] Similar to the eastern European OECD countries (the Czech Republic, Hungary, Poland and the Slovak Republic), trade union membership in Estonia has declined steadily over the transition period due to privatisation, the entry of new small enterprises, and a structural shift from manufacturing to private services. There were approximately 45 000 trade union members in 2007 and union density was estimated at 7.6% (MSA, 2008), but recent redundancies in unionised sectors are causing a further decline. There is no reliable estimate of the organisation rate on the employer side, but it is probably similar (Ahlberg and Bruun, 2009). Box 2.4 provides an overview of Estonian labour market associations.

Figure 2.6. Trade union density in Estonia and OECD countries

1995 and 2007 (or latest available year)



Source: *OECD Employment database* and Estonian Ministry of Social Affairs.

18. Almost 90% of the enterprises in Estonia have less than ten employees (*cf.* Statistics Estonia).

Box 2.4. The social partners in Estonia

Trade unions are organised at the industry level and most of them embrace an entire sector or sub-sector. The sector-based organisations are gathered in two trade union confederations, which are both internationally recognised and act as social partners in consultations with the government. The two confederations are separated partly on occupational rather than ideological grounds, being both pluralistic in their general outlook and independent of political parties (Philips, 2006). On the employer side, only one confederation is generally recognised as a social partner.

- The *Confederation of Estonian Trade Unions (EAKL)* is the largest organisation, with 19 affiliated trade union organisations. It covers mostly blue-collar workers in the public sector, transports, industry and some services.
- The *Estonian Employees' Unions' Confederation (TALO),* with 11 branch unions, mainly represents teachers, culture and healthcare professionals and other white-collar groups.
- The *Estonian Employers' Confederation (ETTK)* is the only employers' association recognised by the government and trade unions as a social partner. The Confederation represents 24 branch organisations and 60 single large enterprises, covering more than 1 500 companies with around 35% of the private sector's employees.

Some smaller trade unions that do not belong to any association are acting autonomously in the labour market, but have little political influence. Two other business organisations exist – the Estonian Chamber of Commerce and Industry and the Estonian Association of Small and Medium Enterprises – but they are not primarily regarded as labour market partners.

For the large majority of employees, working and pay conditions are fixed in direct discussions between the employer and the individual worker. When collective bargaining occurs, it takes place mainly at the company level. Apart from an agreement about the minimum wage (*cf.* below), there are currently no national collective agreements and only two sectoral ones (in transports and health care), to which must be added some company-level agreements in sectors or sub-sectors with only one enterprise (energy, post and railways). These collective agreements, renewed every year, mainly cover general working conditions and pay standards, such as sectoral minimum wages.

Only 0.1% of the enterprises and 11.3% of the employees were covered by collective agreements in 2007 (MSA, 2008), but the latter proportion rises to 20-25% if the extension of some collective agreements is taken into account (Philips, 2007a).[19] It is also notable that 90% of the collective agreements are concluded in the public sector. Collective bargaining is most common in the public sector in many countries, but this imbalance appears extreme in Estonia (Parissaki and Vega Vega, 2008).

When there is no trade union, the law allows non-union employee representatives to engage in collective bargaining at the company level, but their role remains minor. Such representatives must be elected by a general assembly and represent all employees, provided that there is no trade union.[20] By contrast, trade unions represent only their members unless the general assembly gives them a mandate to represent all workers. In practice, very few Estonian companies have non-unionised employee representatives, and their role tends to be limited even where they are present (Kallaste *et al.*, 2008).

Various reasons have been mentioned for weak social dialogues in Estonia, including a general unwillingness of branch-level employer associations to sign collective agreements, the lack of such associations in certain sectors and the trade unions' extreme weakness, which effectively prevents them from changing the situation (Philips, 2007a). In many sectors, the trade unions' scarce human and financial resources have prevented the establishment of permanent organisations, while several of the sectoral business organisations have traditionally been more active as political pressure groups (Kerem and Lubenets, 2004).

In road transport and healthcare, the signatory partners have used a possibility – foreseen in law – to extend their collective agreements to all companies in these sectors. In contrast to most other countries where such extension is possible, it requires no decision by public authorities and its legality does not depend on any particular definition of an association's representativeness: the existing sector or higher-level associations are presumed to be representative.[21] Furthermore, Estonia's legislation does not specify any right for the affected non-signatory employers to express

19. Figures on the coverage of collective agreements differ according to the source. In principle, collective agreements should be registered at the Ministry of Social Affairs. But some companies are reluctant to provide the information and there are no sanctions for not reporting.

20. The Employee Trustee Act, which entered into force on 1 February 2009, brought an end to the dual system in which trade unions represented the rights of their members and non-unionised employee representatives represented non-unionised employees.

21. For example, in Germany, Greece and Japan, an agreement can be extended when 50% or more of the employees in the agreement's domain are already covered by it (OECD, 2004, Chapter 3).

their views, nor are the contracting parties obliged to inform outsiders about their negotiations or their plan to extend the agreement. So far, this extension mechanism has not been very controversial in Estonia, and the relevant associations do in fact cover over half of the workers in their sectors. But the mere fact that associations with much lower membership can also seek an extension of their agreements has caused some concern in Estonia. Some clarifications in the law could merit consideration in order to prevent such developments.

The minimum wage

The only national collective agreement in Estonia concerns the minimum wage, which the government has extended by decree to all employees. Introduced in 1992, the minimum wage was first set by tripartite agreements, but the government decided to "step out" of these negotiations in 2002 as a means to stimulate bipartite bargaining. Since then, all collective agreements about the minimum wage have been made applicable to all employees without differentiation by age, sector or region (Carley, 2006).

At the current level, the minimum wage may recently have begun to price-out some low-skilled workers. Its growth was in line with the average wage trend until 2007, after which it has tended to outpace both the average wage and labour productivity (Table 2.1). The ratio of the minimum to the average wage increased from 32% in 2007 to 34% in 2008. It was temporarily at 36% in the first quarter of 2009, when the average wage reached a low point. The social partners agreed not to increase the nominal value of the minimum wage in 2009. However, some low-productive workers might have been priced-out already in 2008 in such sectors such as hotels and restaurants, where the average wage was less than twice the minimum wage.

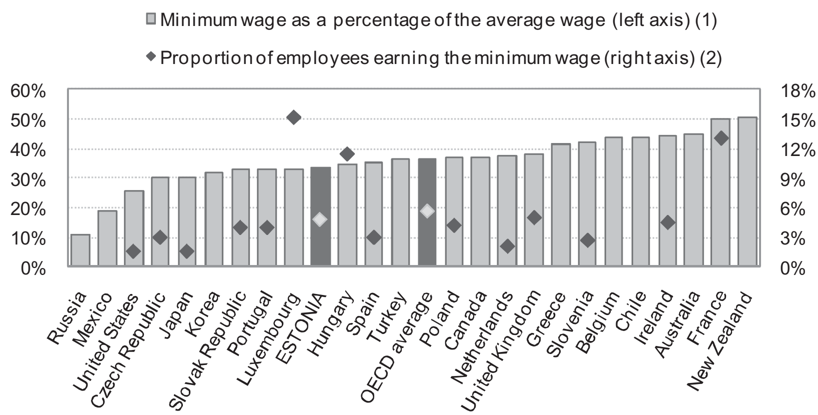
Table 2.1. Evolution of the minimum wage in Estonia, 2002-09

	2002	2003	2004	2005	2006	2007	2008	2009Q1
Monthly minimum wage (EEK)	1 850	2 160	2 480	2 690	3 000	3 600	4 350	4 350
Minimum wage growth		17%	15%	8%	12%	20%	21%	0%
Labour productivity growth	7%	6%	7%	7%	3%	6%	-4%	
Minimum wage / Average wage	30.1%	32.1%	34.0%	33.3%	31.9%	31.8%	33.7%	35.8%
Proportion of full-time employees earning the minimum wage	6.9%	6.3%	3.7%	4.8%	4.7%	4.7%	..	..

Source: Statistics Estonia and Masso and Krillo (2009).

The proportion of employees earning the minimum wage decreased in comparison with 2002 and was under 5% for most of the 2000s (Table 2.1). It still appears higher than in most OECD countries other than France, Luxembourg and Hungary (Figure 2.7, right axis). But the actual share is probably lower, considering the above-mentioned practice of "envelope wages" (*cf.* Section 4, p. 65). On the other hand, the importance of the minimum wage is enhanced by its frequent use as a benchmark for wage scales in both the private and public sector, which makes it likely that any increase of the minimum will "spill over" on other wages (Masso and Krillo, 2009).

Figure 2.7. Minimum wages and coverage in OECD member and accession countries, 2005 and 2008



1. 2008 or latest available year.
2. 2005 or latest available year.

Source: Data on coverage come from Carley (2006); Minimum wages are taken from *OECD Employment database*, Statistics Estonia, Statistical Office of Slovenia, and Russian Federal State Statistics Service.

6. Unemployment compensation

There are two types of unemployment benefit: *1)* earnings-related *unemployment insurance* (UI) benefits available to employees who have contributed to the Unemployment Insurance Fund (UIF) for at least 12 months over the past 36 months, and *2)* a non-contributory flat-rate *unemployment assistance* (UA) benefit covering those who do not qualify for UI or have exhausted their entitlements (Box 2.5). Whereas UI is contribution-financed, UA is funded from the state budget. Finally, unemployed persons who are not eligible or have exhausted their rights to both UI and UA can sometimes receive subsistence benefits from the social assistance system (*cf.* Chapter 3).

Box 2.5. Unemployment benefits

The **unemployment insurance (UI)** was introduced in 2002 by the Unemployment Insurance Act.

Coverage: mandatory for all employees until the retirement age, including public servants.

Contribution rates: the government determines the contribution rates for employers and employees annually, following proposals by the Supervisory Board of the Unemployment Insurance Fund (UIF). The contribution rates (on wages before tax) were 0.6% for employees and 0.3% for employers during 2006-07, but have been increased to 2.8% for employees and 1.4% for employers for the period of 1 August to 31 December 2009.

Conditions for benefit eligibility: involuntary unemployment including cases of unemployment after the end of fixed-term contracts, but not job separations for reasons of discipline or poor performance. A contribution period of at least 12 months over the last 36 months is required (until 2006, over the last 24 months). Claimants must register at the UIF. No supplementary income from work is allowed.

Every new benefit spell requires a new contribution period. Those who take up jobs before the end of an entitlement period can collect the remainder only if they become unemployed again within a year.

The *benefit amount* depends on the average monthly earnings in the last job, with a ceiling of three times the national average wage in the previous year. This income is replaced at a rate of 50% for the first 100 days, thereafter 40%. On 1 July 2009, the minimum UI benefit was increased from EEK 1 000 (equal to UA) to 50% of the previous calendar year's minimum wage (at present EEK 2 175).

Maximum benefit duration:

- 180 days if less than 56 contribution months;
- 270 days between 56 and 110 contribution months;
- 360 days between more than 110 contribution months.

Waiting period: seven days from application.

The **unemployment assistance (UA)** is regulated by the Labour Market Services and Benefits Act.

Coverage: the unemployment assistance benefit is available to registered unemployed persons who are actively looking for work and who do not qualify for UI or have exhausted their UI entitlement.

Conditions for benefit eligibility: unlike UI benefits, UA it is also available in cases of unemployment after voluntary job quits and firings for disciplinary reasons. The UA claimant must have worked as employee, self-employed or on a service contract, or been engaged in daytime or full-time study, for at least 180 days during the 12 months prior to registration as unemployed. UA is also payable in a few other cases, notably to persons who were raising a child or took care of a disabled person. During UA benefit receipt, other incomes are allowed up to the UA amount.

Benefit amount: a flat rate fixed annually in the state budget for each budget. It has been EEK 32.9 per day or around EEK 1 000 (= EUR 64) per month since 2008. It is not means tested.

Benefit duration: up to 270 days; or 210 days after voluntary quits.

Waiting period: usually seven days from application; 60 days after study and after voluntary quits.

Unemployment benefits are modest or low

For those who can claim UI benefits, the initial income replacement rate of 50% appears adequate compared with conventional poverty limits, but it is reduced to 40% after 100 days. The maximum UI benefit period is 6-12 months depending on the individual contribution history.[22] In the first half of 2009, the reported average UI benefit was about EEK 4 400 (= EUR 281) per month or 35% of the average wage. The corresponding average in 2007 (EEK 2 856) represented 39% of the median household income per adult-equivalent (as reported by EU-SILC), *i.e.* it placed a single unemployed person below a poverty line drawn at half of the median income, although it was a little higher than a subsistence minimum defined by Statistics Estonia.

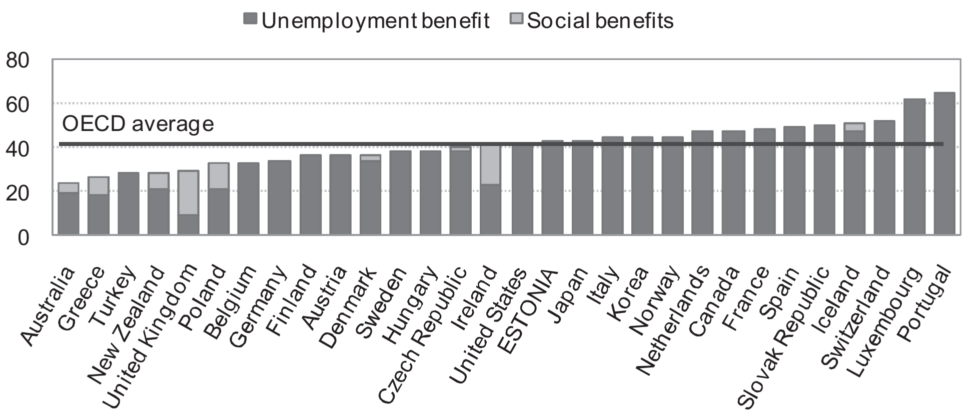
The estimated net income replacement rate at the initial stage of unemployment is close to the OECD average at just over 40%, taking account of taxes and the social benefits that may be available (Figure 2.8, Panel A). But for UA recipients the benefit is barely 23% of the minimum wage, giving an estimated net replacement rate of around 10%, or about 16% if the household receives a social assistance benefit as a complement. This net replacement rate for UA is one of the lowest in the OECD area (Figure 2.8, Panel B).

From mid-2009, UI benefit periods begin only after the one or two months during which the UIF pays severance pay, if applicable. As a result, the payment of the different benefits can now be spread-out over a slightly longer period. This change is expected to improve job-search incentives at the initial stage compared with the previous system (when dismissed persons could receive 150% of their wage during the first few months: 100% as severance pay + 50% as a UI benefit). The total period of severance pay and UI entitlement is still shorter than in many European OECD countries. Given the present moderate rate of income replacement, most beneficiaries are probably eager to take up jobs as soon as possible.

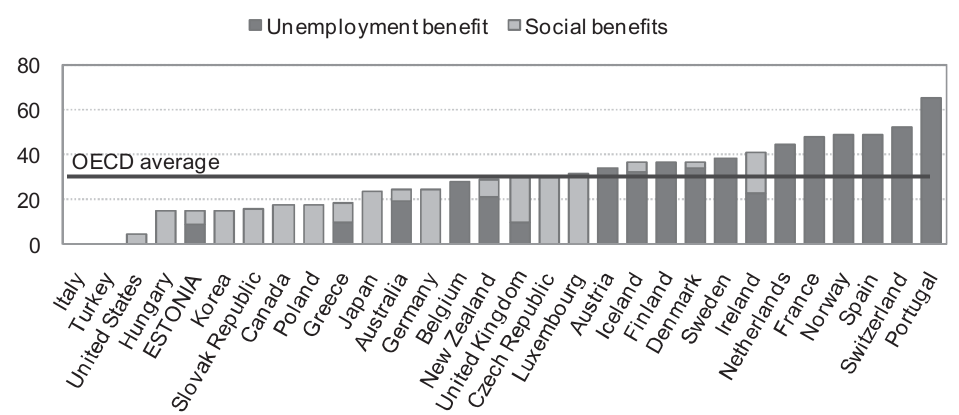
22. Initially, the new Employment Contracts Act included an increase in the UI benefits to 70% of the previous wage during the first 100 days and 50% afterwards, and a more than doubling of the UA benefits from EEK 1 000 (= EUR 64) per month to EEK 2 300 (= EUR 147) per month. However, due to budgetary pressures as a consequence of the current crisis both measures have been suspended until 2013.

Figure 2.8. Net income replacement rates for single persons receiving unemployment benefits, 2008[1]

Panel A. Income replacement rates at the beginning of the employment spell



Panel B. Income replacement rates for long-term unemployed (at the 13th month of unemployment)



1. The replacements rates take into account unemployment benefits as well as other cash benefits (such as social assistance, family benefits, housing benefits, and child-raising allowance), and are calculated for a single unemployed person without children who previously earned the average wage.

Source: *OECD Benefits and Wages database*.

Only a minority receive unemployment benefits

Until 2009, less than half of the registered unemployed received UI or UA benefits, and many were not even eligible for subsistence benefits (SB, *cf.* below). During the present economic crisis, the strong inflow of newly registered unemployed people led to an increase in the number of benefit recipients. Since the introduction of unemployment insurance in 2002, UI and UA together have covered around 40-50% of the registered unemployed in any month, with unemployment assistance being predominant until 2008 (Figure 2.9, Panel A). Even among the newly registered unemployed, who are most likely to receive UI benefits, less than 25% did so before 2008 when the proportion began to rise (Figure 2.9, Panel B). By April 2009, when 65 000 persons were registered as unemployed, some 21 000 or 32% received UI benefits and less than half as many received UA.

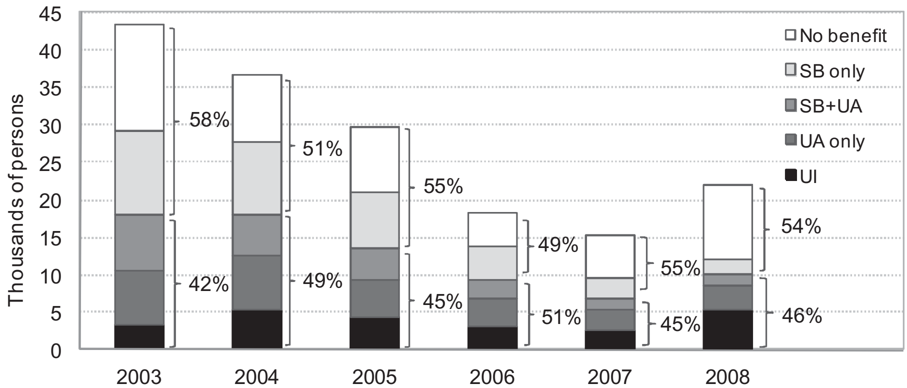
A majority of registered unemployed do not receive unemployment insurance because they have not worked as employees, are not considered as involuntarily unemployed, or have exhausted their benefit rights (see Box 2.3). Persons without the required background as employees have recently accounted for almost 40% of the unemployed (Table 2.2). Among the former employees, almost half of the new clients in early 2009 were excluded from UI because their unemployment was considered as voluntary (Figure 2.10). Many of the long-term unemployed have also exhausted their right to unemployment assistance, so they receive no benefit unless they are entitled to subsistence benefits.

The economic crisis has considerably altered the composition of unemployment. During the first four months of 2009, the share of the newly registered unemployed people who had been dismissed or could not renew fixed-term contracts rose from 37 to 51%, while the share of voluntary quits has been halved (Table 2.2).[23] As a result, the share of UI benefit recipients among the newly registered reached 44% (see Figure 2.9, Panel B). On the other hand, growing numbers of formerly inactive people are appearing at the employment service, a change that may be partly attributable to new rules from 2007 that give unemployed people free healthcare insurance.

23. There is some anecdotal evidence that employers force redundancies to be classified as voluntary terminations to avoid paying severance payments (Eamest and Masso, 2005).

Figure 2.9. Unemployment benefit recipients in Estonia, 2003-09

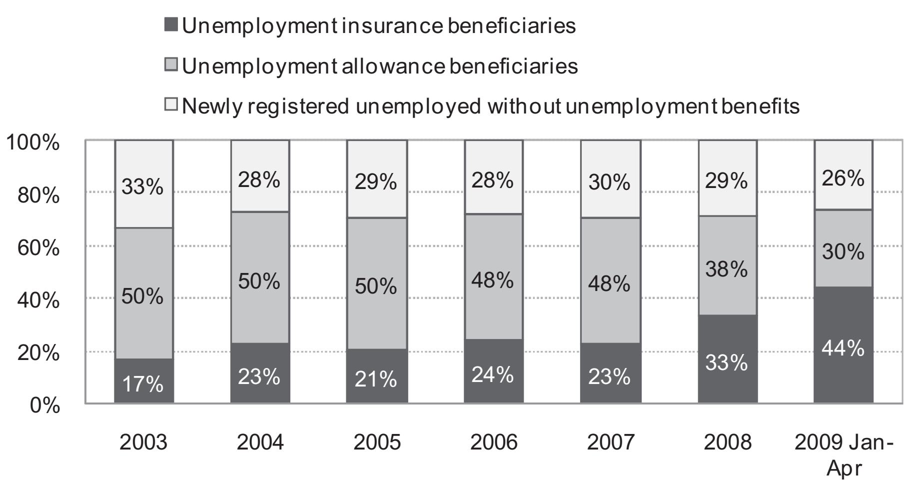
Panel A. Registered unemployed persons by benefit status



Note: The figures for subsistence benefits (SB) refer to the numbers of unemployed persons in SB client households, not the number of applicant households.

Source: OECD calculations based on data provided by the Unemployment Insurance Fund and Statistics Estonia.

Panel B. Share of recipients with different types of benefits among *newly* registered unemployed persons



Source: OECD calculations based on data provided by the Unemployment Insurance Fund and Statistics Estonia.

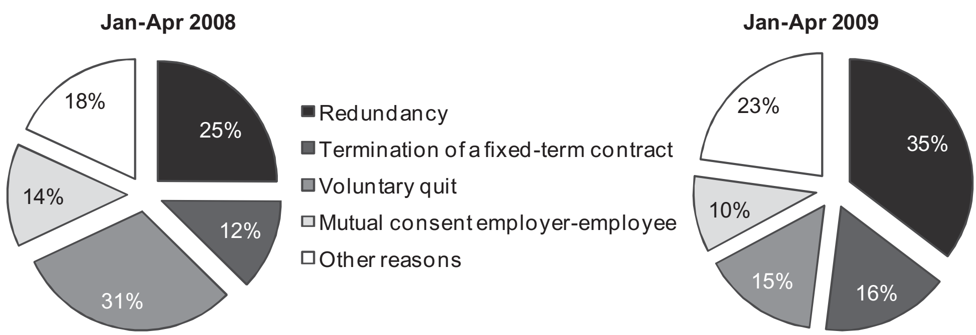
Table 2.2. Main activity of unemployed people prior to their registration, 2008-09

In percentage of the total stock of registered unemployed persons

	End April 2008	End April 2009
Working as an employee or a civil servant	61.5%	72.6%
Self-employment and entrepreneurship	2.3%	2.1%
Studying	3.1%	2.6%
Serving a conscript obligation	0.1%	0.2%
Raising a child	6.7%	4.0%
Taking care of a sick or disabled person	1.8%	1.1%
Serving a sentence in a prison	2.5%	1.2%
Inactive, no specified activity	22.0%	16.1%
TOTAL	100.0%	100.0%

Source: OECD calculations based on data provided by the Unemployment Insurance Fund.

Figure 2.10. Newly registered unemployed persons, by reasons for leaving work, 2008-09



Note: Redundancy also includes employees who lost their job due to insolvency or liquidation of the enterprise. Other reasons include job loss due to unsatisfactory results of a probation period, violation of contractual terms by the employer, loss of trust, breach of duties, and unspecified reasons.

Source: OECD calculations based on data provided by the Unemployment Insurance Fund.

UA recipients often receive subsistence benefits as well

About 65% of the households receiving subsistence benefits (SB) in 2008 had one or more member who was registered as unemployed. This often concerns long-term unemployed persons who have exhausted their rights to both UI and UA, but also others who receive SB as a complement to unemployment assistance (see Figure 2.9, Panel A above). The income limit for SB is usually EEK 1 000 (EUR 64) per month for one person and EEK 800 (EUR 51) for each additional family member, plus approved housing costs and some supplements.

OECD experience suggests that the use of social assistance to compensate large numbers of unemployed job seekers is problematic because it complicates activation programmes, which are necessary in order to prevent clients from losing contact with the labour market (OECD, 2005, Chapter 5). Moreover, it can be difficult to establish an appropriate division of responsibilities when the agency best placed to promote job search does not administer the benefits. In Estonia, the fact that the state finances SB can also be expected to reduce the incentives for municipalities to prioritise the labour-market activation of hard-to-place clients.

It falls on municipalities to motivate job-ready SB recipients to seek employment with the assistance of the UIF, but the extent of such cooperation is limited. Only few municipalities require systematic activation or organise training, public works and activity centres for the long-term unemployed in collaboration with the UIF. The law also allows municipalities to refuse benefits to working-age clients if they repeatedly reject suitable jobs, but such sanctions are seldom applied. On the other hand, the present SB amounts are so low that relatively few households are likely to fall into an “inactivity trap”.[24]

7. Labour market services

Merging the public employment service with the unemployment insurance

Estonia’s public employment service was a separate agency under the Ministry of Social Affairs until April 2009, when it was merged with the Unemployment Insurance Fund (UIF). The latter is a tripartite public institution fully financed from employer and employee contributions. The

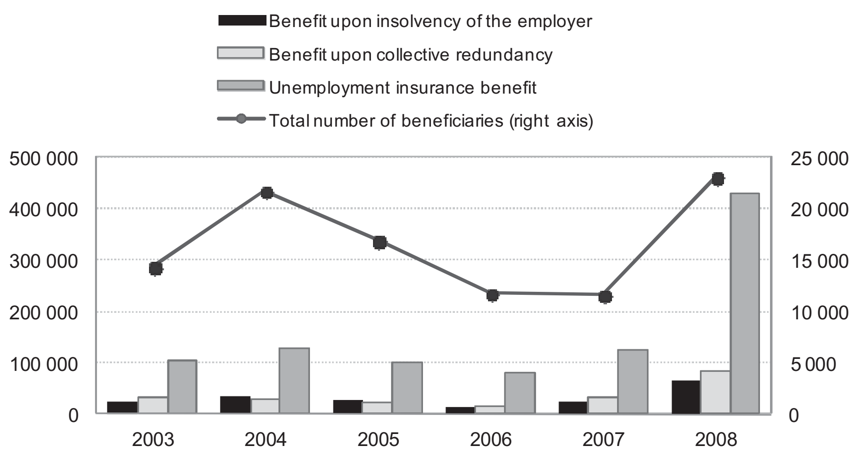
24. Given the generally high work incentives, interviewed policy makers did not regard it as necessary to develop programmes for in-work benefits, as some OECD countries have done.

merged agency, henceforth called the UIF, is governed by a board with equal numbers of representatives of the government, employers and employees, and it is responsible for active and passive labour market measures.

The merger was justified by the need for tighter links between unemployment insurance, unemployment assistance and the employment service in order to put pressure on the latter to reduce the UI caseload. At the same time, it was expected to give UI administrators more insight into the nature of the required employment services and their effects. The employment service and its programmes – including UA – are still financed mainly from the state budget and EU funds, but the UIF accepted in 2009 to contribute money from its own funds to permit a significant increase in the employment-service staff.[25]

Figure 2.11. Expenses of the Unemployment Insurance Fund, 2003-08

In thousands of Estonian kroons; accrual based accounting



Source: OECD calculations based on data provided by the Unemployment Insurance Fund.

The economic crisis has put much pressure on the UIF as it affects contribution revenues as well as expenditures. With rising unemployment, the number of contributors has been declining, while the number of UI beneficiaries doubled already in 2008 (Figure 2.11). In addition, as

25. The advantage of keeping separate budgeting for active and passive labour market programmes is that these budgets are treated as complements rather than substitutes, and increasing benefit payments do not crowd out expenditures on active measures in times of high unemployment rates.

mentioned earlier, the UIF pays severance benefits and benefits to workers affected by employers' insolvency.[26] Despite the temporary increase in contribution rates and the decision to postpone important increases in UI and UA benefits, it remains uncertain to what extent the available funding will prove sufficient in 2009 and 2010.

Employment services under pressure

The merged UIF has retained the 15 regional and 26 local labour offices, as well as 70% of previous staff members – with the plan to increase the number of employees from 345 to 470 posts. However, a shortage of working space in several offices has prevented them from filling all positions. Most UIF staff members are well qualified, with almost half having tertiary education degrees.

Around 80% of the regional and local office staff have front-line functions such as information, job counselling and case management, all in contact with jobseekers and employers. This high proportion is related to the centralisation of important tasks such as benefit administration, procurement of training courses and outsourcing of IT. In addition, the low proportion of administrative staff must be seen in the context of the limited use of active programmes (see below).

Due to the worsening labour market conditions, the employment-service caseload had increased to 263 registered unemployed persons per front-line counsellor by June 2009 – a number that may reach 300 by the end of the year (corresponding to 90 000 registered unemployed persons; *cf.* Table 2.3). In Tallinn, there are already about 800 clients per counsellor, so they can hardly spend more time with each job-seeker than the five minutes it takes to approve a benefit payment.[27] To reduce the workload, clients are currently required to report only once in 60 days instead of 30 days and non-cooperative clients are often removed from the register.

26. The UIF previously paid severance benefits only after collective dismissal. But from July 2009, it pays the second and third monthly benefit whenever an entitlement exceeds one month, *i.e.* for over five years of tenure (*cf.* Box 2.2 above). Upon bankruptcy, the UIF compensates for unpaid wages and holiday pay.

27. Offices whose workload exceeds 400 clients per counsellor are allowed to temporarily hire additional staff.

Table 2.3. Workload indicators for public employment centres in Estonia and selected OECD countries

	Estonia		CZE[2]	FIN	IRL	JPN	NOR[3]	POL	SVK	SVN
	Jun 2009	Dec 2009[1]	2007	2007	2007	2007	2009	2006	2006	2008
Placement staff as a share of total staff (including benefit administration)	64%	65%	22%	61%	36%	59%	62%	..	..	28%
Registered unemployed ('000s) per placement staff	263	296	214	..	168	..	13	691	92	253

1. The expected number of registered unemployed people for 31.12.2009 is 90 000 (*Source*: UIF predictions). All approved staff positions are assumed to be filled in by then.
2. Data are only available at the regional level.
3. Data are for November 2009.

Source: Estonia: Unemployment Insurance Fund and Statistics Estonia; Czech Republic: Kalužná (2008b); Finland and Japan: OECD questionnaire on activation policy; Ireland: Grubb *et al.* (2009); Norway: Duell *et al.* (2009); Poland: Kalužná (2009); Slovak Republic: Kalužná (2008a); Slovenia: OECD (2009c).

Major deficiencies in the office infrastructure are currently being addressed.[28] Some offices are moved and it is recognised that outdated IT systems need to be replaced. To save some time, counsellors are often obliged to deal with two to three clients simultaneously, *e.g.* serving one of them while waiting for the computers to process data about one or two others.

Inefficient job-broking system

About one-third of all vacant jobs in Estonia were reported to the public employment service in 2008, but only 3% of the hires were attributable to its clients.[29] Such measures are influenced by the dearth of information about the outcomes of job referrals, but it nevertheless suggests that the placement function is less effective than in OECD countries. More than 70% of the registered unemployed persons who found jobs in 2008 did so without the employment service's assistance, a share that appears to have risen to 85% in the first four months of 2009.

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28. In one office visited by the OECD team, four job counsellors were delivering interviews in a room of 10m^2. The same office had no wheel-chair access and disabled clients were interviewed in a nearby park; during winter, they were not invited for interviews at all.

29. This percentage relates the average monthly stock of vacancies registered at the employment service to the average monthly stock of vacancies in the economy as reported by Statistics Estonia.

Similarly, only a minority of the unemployed people care to register at the public employment service. Since the 1990s, when around 60% of the unemployed were registered, the share dropped to 47% in the early 2000s and 32% in 2008 (*Source*: Statistics Estonia). The proportion is particularly low for youths (11% in 2007). The majority of those not registering in 2008 claimed that they would manage without help (44%) or that the employment service did not offer suitable jobs (23%; *Source*: Statistics Estonia).

The UIF is aware that its low "market share" must largely be attributed to poor job information and inefficient matching of vacancies to jobs. The relevant procedures will require a substantial development effort.[30] For example, many regional offices lack self-service facilities. Current plans for the near future envisage to make an on-line vacancy database much more user-friendly and to create a similar jobseeker database where employers can look for suitable candidates.

Until now, the UIF has made little or no use of private employment agencies. According to OECD experience, a partial outsourcing can be cost-effective if the public agency monitors the outcomes compared with similar cases treated in-house (OECD, 2005, Chapter 5). Private employment agencies need no authorisation – having only to be listed in the business register – and they can provide labour market information, career counselling and job-broking services, which must be free of charge for the job-seekers. But the UIF does not cooperate with the private employment agencies, partly because their reputation has been tainted by recent cases of violations of the law.[31] As an exception, very hard-to-place clients are sometimes referred to rehabilitation centres run by non-governmental organisations.

Activation measures should focus on clients who cannot or would not help themselves

International experience suggests that activation strategies can be valuable, but they involve significant costs in terms of staff time that may not be necessary for motivated jobseekers, especially not in the first few months

30. In contrast to its counterparts in most OECD countries, Estonia's public employment service has not yet been equipped for automatic matching of vacancies to jobseekers. Employers can notify vacancies through all common means – on-line, phone, e-mail or in person – but office staff must type them manually into the database, where they are listed in an Excel file not suitable for advanced search. Until recently, the online database showed only local vacancies but it should now be nationwide.

31. The Unemployment Insurance Fund provided anecdotal evidence of private agencies asking jobseekers to pay for their services – which is illegal – or asking them to pay for services they never received.

of unemployment. In most OECD countries, the employment service therefore tends to postpone intensive interviews and the development of individual action plans until after three months or more (OECD, 2007, Chapter 5). But in Estonia, UIF officers are expected to develop an individual action plan with each new client upon registration as unemployed. This takes about 40 minutes, after which a second session should follow within 30 days. Such a "front-loaded" allocation of limited staff time at the beginning of unemployment spells appears inefficient because many can find jobs for themselves, for example via self-service systems, newspapers and the Internet. In any case, it is not realistic to require such time-consuming early interventions in a period of high unemployment.

Within the first five months, the unemployed can refuse jobs that do not correspond to their education, previous work experience or salary. After six months, they must accept any job that pays more than the unemployment benefit or the minimum wage, whichever is higher. However, such regulations are difficult to enforce without a targeted use of direct job referrals to low-motivated clients, which should be accompanied by a credible threat of benefit sanctions if suitable jobs are refused.

Estonia's employment service made over 24 000 direct job referrals in January-April 2009 – corresponding to 26 referrals per client and year. This figure is very high compared with OECD countries, where the corresponding number is often between one and eight per year (OECD, 2007, Chapter 5). Yet, with only 4 000 reported vacancies in the mentioned period, this large number of referrals is likely to overwhelm employers. Moreover, employers need not report outcomes of referrals and counsellors rarely contact them for a follow-up. Sanctions appear to be exceptional (*e.g.* two cases in 2007).

The individual action plans are often too formalistic, *e.g.* repeating a standard set of obligations every month without requiring proof of their fulfilment.[32] Much is left to the counsellor's discretion. By contrast, many OECD countries have fixed rules requiring benefit claimants to provide employers' confirmation that job applications were received, and sanctions can be imposed if jobs are refused (OECD, 2007, Chapter 5). These shortcomings in Estonia must also be seen in the context of the jobseeker and vacancy registers, which currently do not permit very careful job-matching.

In sum, the development of employment services and activation measures for the unemployed has not been a high priority until now in

32. The required standard job search obligations are: reporting to the UIF in person on an agreed day; following weekly job offers in the print media, on the Internet and on the UIF's board; contacting employers by phone or sending CVs; contacting friends, relatives and former colleagues.

Estonia. Existing provisions are therefore barely adequate for the most basic functions. Judging from the experience summarised in the *Reassessed OECD Jobs Strategy*, the economic and social risks associated with this situation are possibly moderate as long as the available social benefits are not generous enough to place the unemployed people in an "inactivity trap". But if and when these benefits are increased in the future, the risk of negative effects on work incentives must be expected to grow. To prevent this, a substantial further development of the public employment service would then be required, over and above the significant but modest changes that were initiated by the UIF in 2009.

Active programmes are insignificant

The UIF offers a range of active labour market programmes (ALMPs), similar to those in OECD countries but on a smaller scale. At 0.11% of GDP in 2008, the relevant expenditure is much lower than the OECD average of 0.56% of GDP (Table 2.4); only Mexico spends less (OECD, 2008). Almost half of this total comes from the European Social Fund (ESF), which has a budget for 2007-13 that mainly targets career counselling, training and measures for special groups.[33] Apart from counselling and job-search assistance, less than 1% of the labour force participated in ALMPs – mainly in training – compared with more than 4% on average in the OECD area (OECD, 2009).

The ministry plans ALMPs annually in accordance with formal eligibility criteria, defined in legislation. Two-thirds of registered the unemployed belong to the selected target groups, suggesting that counsellors have room for further targeting based on local or individual criteria (Table 2.5).[34] The social partners can comment on draft budgets and strategies, and the UIF board can henceforth decide how to distribute the budget between pre-defined programmes – but not on its volume. In practice, the regional offices generally receive as much funding for ALMPs as they request and they seldom ask for more: their human resources permit them to do little more than to provide information and job-broking services.

33. Since 2007, Estonia uses funding from the European Social Fund (Measure 1.3 Increasing the Supply of Qualified Labour Force) to provide additional services to registered unemployed people and to pilot new activation measures. A small proportion of the EU funding comes from the Equal programme – for equal opportunities – and EURES (European Employment Services), a cooperation network to facilitate labour mobility in the European Economic Area.

34. The at-risk groups targeted by the Estonian employment services are: young unemployed (age 16-24), older unemployed (aged 55 and above), disabled unemployed, unemployed without sufficient knowledge of the Estonian language, unemployed released from prison, long-term unemployed, and unemployed individuals who have been taking care of children and family members (MSA, 2008).

Table 2.4. Public expenditure on active labour market policies, 2008

As a percentage of GDP

	OECD[1]	Estonia	EU funds as % of total expenditure in Estonia
1. Employment services and administration	**0.15**	**0.06**	**38%**
1.1 Placement and related services	0.06	0.06	43%
1.2 UI benefit administration	0.05	0.01	0%
2. Training	**0.14**	**0.03**	**42%**
3. Employment incentives	**0.10**	**0.00**	**25%**
4. Supported employment and rehabilitation	**0.09**	**0.01**	**77%**
5. Direct job creation[2]	**0.05**	..	..
6. Start-up incentives	**0.01**	**0.01**	**60%**
7. Out-of-work income maintenance and support	**0.64**	**0.23**	**0%**
7.1 Unemployment insurance	0.43	0.18	
Unemployment insurance benefit	0.42	0.10	
Collective redundancy benefit	0.00	0.04	
Employer insolvency benefit	0.01	0.04	
7.2 Unemployment assistance	0.20	0.05	
Total	**1.32**	**0.33**	**14%**
Active measures (1-6)	**0.56**	**0.11**	**43%**
Active measures (categories 2-6 only)	**0.40**	**0.04**	**49%**

1. The data for the OECD area are unweighted averages for 2007.

2. Public works in Estonia are entirely financed by the providers (mainly local governments and NGOs).

Source: OECD (2009b) and OECD calculations based on data provided by the Unemployment Insurance Fund.

Table 2.5. Share of at-risk groups among registered unemployed people, 2007-09

As a percentage of the stock of registered unemployed persons, average over the reported period[1]

	2007	2008	2009 Q1
55+ years	16.0	16.4	12.8
16-24 years	11.6	12.2	17.3
Non-Estonians	26.4	24.6	23.2
Caregivers	1.8	1.3	0.8
Young long-term unemployed	6.4	6.9	8.8
Long-term unemployed	44.7	35.1	28.0
Disabled	8.9	8.0	5.2
Released from prison	3.6	2.4	1.5
Unemployed in at least one at-risk group	**71.9**	**67.1**	**63.4**

1. The UIF defines seven groups of unemployed people who may have stronger difficulties in finding a new job.

Source: OECD calculations based on data provided by the Unemployment Insurance Fund.

The implementation of training programmes has been complicated by lengthy procedures associated with public tenders. With rapidly changing labour market conditions, available courses often fail to match the actual needs of clients. To speed up the process and increase flexibility, the authorities plan to introduce a new voucher system for cases when individual action plans identify training needs. The job counsellor would then propose a list of suitable schools, from which the job seeker can choose training for up to EEK 15 000. This system is implemented as a limited pilot scheme from October 2009, focusing initially on short further education courses in certain occupations.

ALMPs have not been systematically evaluated, partly due to the dearth of suitable data.[35] Transitions to jobs are not consistently tracked and the Ministry of Social Affairs has no access to tax registers. However, the merged UIF will now be able to use UI data – covering all employees – to monitor the labour market performance of its formerly unemployed clients. For this and other reasons, the UIF appears well placed to develop better activation strategies based on documented experience, on the condition that the IT system is restructured to facilitate monitoring and evaluation.

In the present short-term situation, it appears neither possible nor necessary to envisage any large expansion of the more expensive types of ALMPs in Estonia. Judging from OECD experience, it is appropriate to keep such spending at a modest level when the employment service itself is facing tight budgetary and administrative limitations. However, assuming that Estonia will eventually make its benefit programmes more generous as part of the flexicurity bargain, it will also have more reason to enhance its ALMPs, not least as instruments for the UIF to contain the risk of moral hazards and benefit dependency.

At present, participation in ALMPs is not compulsory unless this is agreed in individual action plans, and clients frequently refuse job-search training as there is no risk of sanction.[36] OECD experience suggests that compulsory participation, especially in training, can improve individual job

35. The only micro-level evaluation study has been carried out by Leetmaa and Võrk (2003). They focus on the net impact of active labour market programmes on employment and wages of participants and conclude that programmes carried out in 2000 had a positive impact on future employment probability. The data sample is, however, quite small and there is evidence of cream skimming in the sense that job counsellors tend to select the more promising candidates for labour market training.

36. In 2008, only four persons were de-registered as a result of refusing to participate in ALMPs or other activities specified in their individual action plan.

prospects and limit the moral hazard of staying on benefit, especially after long periods of unsuccessful job search (OECD, 2007, Chapter 5). This would also permit the use of referrals to ALMPs as a test of availability for work (Toomet, 2008).

8. Improved lifelong learning system

In order to keep up with the rapidly evolving economy and to address structural skill shortages, Estonia adopted in 2005 a Lifelong Learning Strategy for 2005-08, which aimed to widen the adult population's opportunities to engage in training activities. Chief objectives were to increase the number of adult education providers, to develop the financing of adult education and to define a set of vocational qualifications (MER, 2005). The new Employment Contracts Act simplifies the rules about study leave and grants employees up to 30 days of such leave per year. Thanks to the European Social Fund, many vocational training courses have also become cheaper or free of charge.

Participation in lifelong learning increased by more than half over three years, reaching the EU-25 average of about 10% of the adult workforce in 2008 (Table 2.6). Almost 70% of the Estonian enterprises provided training to their employees in 2005. But as in many countries, access to training continues to vary greatly depending on individual job positions and the size of the companies (EHDR, 2009). Participation in lifelong learning therefore remains strongly segmented and most participants are well-educated, relatively young, financially secure and living in the biggest cities.

Table 2.6. Participation in lifelong learning in Estonia and the European Union, 2002-08

	2002	2003	2004	2005	2006	2007	2008
Below upper secondary education	0.6	1.2	1.1	1.3	1.5	1.6	2.1
Upper secondary education, post-secondary non-tertiary education	4.6	4.8	4.8	4.7	4.9	5.5	7.5
Tertiary education	8.7	12.3	11.4	9.6	11.0	11.3	15.9
Educational levels total	5.4	6.7	6.5	5.9	6.5	7.0	9.8
EU-25 average	7.8	8.9	10.0	9.8	9.6	9.7	9.8

Source: Statistics Estonia and Eurostat.

Several challenges in the area of lifelong learning require further attention. Above all, the high cost of non-public vocational training makes it hard to afford for the many small businesses (European Employment Observatory, 2008). It is generally difficult for public authorities to assess the potential growth of small firms' demand for qualified labour. This uncertainty makes it appropriate to rely as much as possible on initiatives by individual workers and employers, supported, as far as possible, by a high-quality general education system and a favourable climate for lifelong learning in terms of regulations and taxation.

9. Conclusion

By further liberalising its employment regulations, Estonia has achieved what appears as one of the most flexible labour markets in industrialised countries. Already before this reform, most employers did not regard the regulations as unacceptably rigid, as shown by the limited use of non-standard types of labour contract. The new rules promise to provide an even better climate for creation of new and better jobs. Nevertheless, they have not prevented a steep rise in unemployment during the economic downturn.

The "security" part of the flexibility concept has been given less priority until now. In the present situation, it is crucial to encourage those out of work to stay in contact with the labour market and to enhance their skills so that they can take up new jobs when the job market improves. Moreover, the high unemployment rate involves a risk that relative poverty will spread to an extent that might threaten social cohesion. This risk may turn out to be manageable if the economic growth rate soon returns to its previous level above the OECD average; but under less optimistic assumptions, social disruptions could worsen. OECD experience shows that public support for labour market flexibility cannot be taken for granted if the social risks are too high.

If and when it becomes affordable to improve the unemployment compensation programmes, OECD experience suggests that such reforms should be accompanied by a substantial enhancement of the public employment service and its activation measures. The achieved merger between the employment service and the UIF represents an important step that should allow Estonia to develop a comprehensive, cost effective and more balanced flexicurity approach.

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Annex 2.A1.

Employment protection in Estonia

To compare the rigidity of employment protection regulation across countries and over time, the OECD developed a method for calculating employment protection strictness for 21 basic items on a scale from 0 to 6, with 0 representing total flexibility and 6 the highest possible rigidity (Venn, 2009). Each score is weighted in order to obtain aggregate indices for three main areas: *1)* employment protection for regular workers against individual dismissal; *2)* regulation of temporary forms of employment; and *3)* additional requirements for collective dismissals. Based on these three indices, an overall score can be calculated representing the rigidity of a country's employment protection as a whole. Table 2.A1.1 contains a description of the employment protection scores for Estonia based on the 2008 Employment Contracts Act that entered into force on 1 July 2009.

Table 2.A1.1. Estonia's employment protection scores, 2009

Component	Sub-component	Legislation	Score	EPL index
Procedural inconveniences	1. Notification procedures	A written statement of the reasons for dismissal must be supplied to the employee	1	Regular contracts = 1.66/6
	2. Delay to start notice period	1 day	0	
Notice and severance pay for no-fault individual dismissals	3. Notice period after		1	
	9 months	0.25 months	1	
	4 years	0.5 months	1	
	20 years	1.5 months		
	4. Severance pay after			
	9 months	1 month	2	
	4 years	1 month	2	
	20 years	1 month	1	
Difficulty of dismissal	5. Definition of unfair dismissal	A transfer and/or retraining to adapt the worker to different work must be attempted prior to dismissal	4	
	6. Trial period	4 months	4	
	7. Compensation	3 months	0	
	8. Reinstatement	It is fairly often made available	4	
	9. Maximum time for claim	1 month	1	
Fixed-term contracts	10. Valid cases for use of fixed-term contracts	Fixed-term contracts are allowed if justified by a good reason	0	Temporary contracts = 1.17/6
	11. Maximum number of successive contracts	Two successive contracts	4	
	12. Maximum cumulated duration	No limits if objective reasons for each new contract can be given	0	
Temporary work agency (TWA) employment	13. Types of work for which TWA is legal	Generally allowed, no (or minimal) restrictions	0	
	14. Restrictions on number of renewals	No restrictions	2	
	15. Maximum cumulated duration	No limit	0	
	16. Authorisation and reporting for TWA	No requirements	0	
	17. Equal wages and conditions for TWA	Both wages and working conditions must be equal	6	
Collective dismissals	18. Definition of collective dismissal	Additional regulations apply at five dismissals upward	6	Collective dismissals = 3.25/6
	19. Additional notification requirements	Two more actors need to be notified	6	
	20. Additional delays involved	15 days	1	
	21. Other special costs to employers	No additional requirements	0	

Source: Estonia's Employment Contracts Act as applicable from 1 July 2009.

CHAPTER 3.

CHALLENGES OF SOCIAL POLICY

Estonia's social protection system is well developed but not very generous. It has been designed to keep costs at a moderate level and to preserve work incentives. Social spending relative to GDP is lower than in any OECD country except Korea and Mexico. Some increase in spending has been foreseen for the near future, but several planned reforms were postponed or cancelled in 2009 in order to give budgetary room for supporting the rising numbers of unemployed people during the economic downturn. The latter challenge was considered to exclude improvements of the generosity of various benefits in the short term.

1. Overview

As seen in Chapter 1, the income distribution in Estonia is a little less equal than an OECD average, with Gini-coefficient estimates around 0.34 and a relative poverty rate of 20%. As in, for example, Canada, Japan, Switzerland and the United Kingdom, the tax and transfer system has modest net effects on such measures (Figure 3.1). Thus, Estonia's income inequality after taxes and transfers is substantially higher in than in a number of continental European countries with more comprehensive social protection, including Austria, the Czech Republic, France, the Slovak Republic, Switzerland, and the Benelux and Nordic regions.[37] Compared with this latter group of countries, Estonia has a similar distribution of market incomes but it achieves much less redistribution via taxes and social benefits.

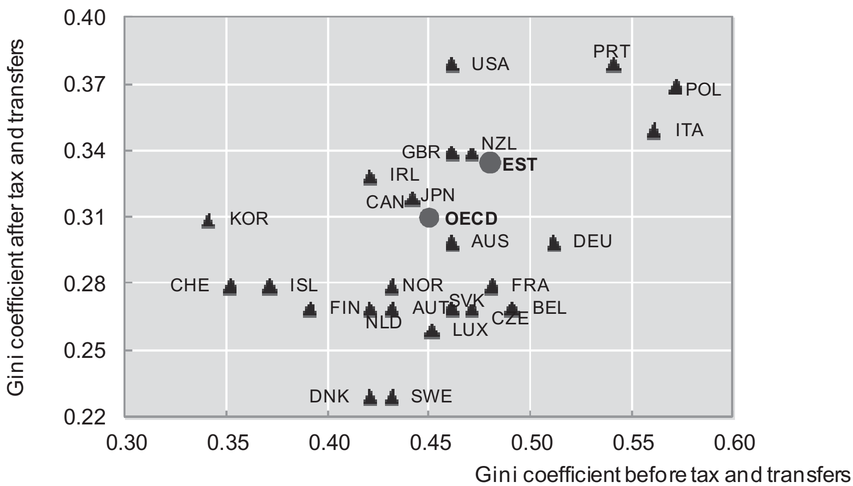
On average, social benefits of all categories have recently represented 20-25% of the average household's disposable income, while the amounts paid as income tax are slightly smaller on average (Figure 3.2 and the Table 3.A1.1). Personal income is taxed at a 21% flat rate, but the tax system has a redistributive effect thanks to a generous set of tax-free allowances (see Chapter 2). Indeed, Estonia's income taxation has more impact on the income distribution than have all its social benefit programmes together (Table 3.A1.1, Panel B). But inevitably, the scale of redistribution that can be achieved via taxation is limited by the flat tax rate and its moderate level. To the extent that more redistribution is found desirable, Estonia should review its tax policy as well as the level of social spending and the design of the social programmes discussed below.

Public social spending has recently accounted for around 12.5% of GDP, which is less than in most OECD countries (Figure 3.3). This total includes about 4% of GDP for services – mainly healthcare – and about 8.5% for cash benefits, with pensions as the largest item. The annual budgets of the Social Insurance Board, which administers social insurance and family benefits, have foreseen annual spending growth of about 1% of GDP for both 2008 and 2009 (Table 3.1). A significant rise in pension spending appears unavoidable in the near future for demographic reasons, and the global economic slowdown is putting additional pressure on most

37. Estimates from Eurostat (2009) based on a relative poverty line at 60% of the median income and the modified OECD adult-equivalence scale. The conclusion that Estonia's welfare system is less redistributive also holds in comparison with other non-OECD transition countries, although the difference is then smaller (Cerami, 2006, p. 203).

social programmes in the short term. However, due to the government's fiscal policy stance – and the country's objective to join the euro zone – a number of recently-approved reforms that envisaged higher spending in 2009 have subsequently been postponed or reversed. As developed in Chapter 2 and below, this notably concerned the generosity of unemployment and family benefits and the development of a funded pension tier.

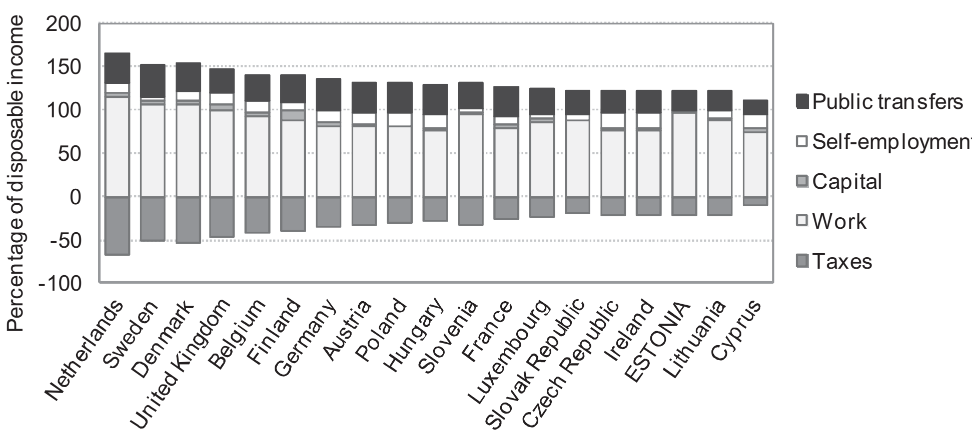
Figure 3.1. Impact of tax and benefit systems on income inequality in selected EU countries in 2006



Source: OECD (2008) and data provided by Statistics Estonia based on SILC-2006.

Figure 3.2. Sources of households' disposable incomes in EU countries in 2005

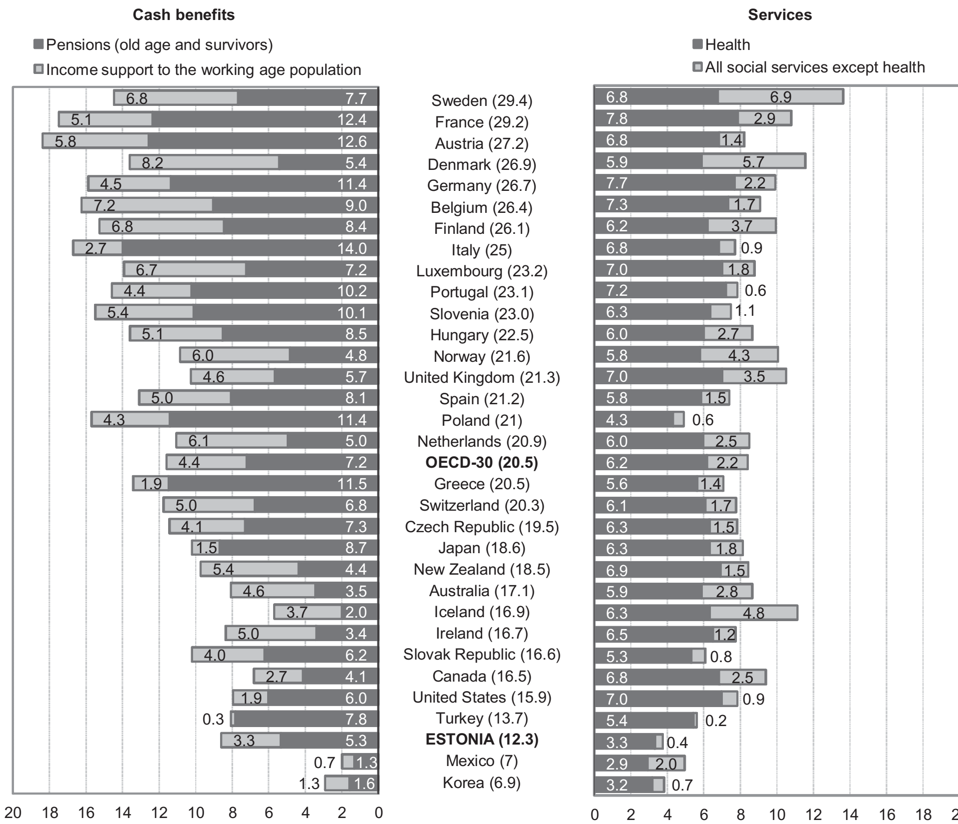
Countries are ranked according to the total of public transfers and taxes



Source: EU-SILC data quoted from TÁRKI (2008).

Figure 3.3. Public social expenditure by broad social policy areas in 2005

Percentage of GDP[1]



1. Countries are ranked by the size of social spending. Totals are indicated within brackets. Active Labour Market Programs (ALMPs) are included only in the totals: its shares in benefits and services are not known.

Source: *OECD Social Expenditure database* and estimate for Estonia based on Eurostat-ESSPROS.

Table 3.1. Composition of the Social Insurance Board's budget

As a percentage of GDP

	2005	2006	2007	2008	2009
Pensions	**6.07**	**6.12**	**6.24**	**7.39**	**7.95**
Financed from the payroll taxes	5.82	5.90	6.03	7.15	7.67
Non-contributory elements	0.18	0.15	0.13	0.14	0.14
Mandatory funded pensions	-	-	-	0.01	0.01
Civil service and defense pensions	0.07	0.08	0.08	0.11	0.14
Other social benefits and allowances	**1.77**	**1.70**	**1.68**	**2.02**	**2.21**
Family benefits	0.97	0.82	0.75	0.70	0.64
Parental benefits	0.31	0.40	0.45	0.74	0.90
Benefits to disabled persons and those with specific needs	0.34	0.31	0.29	0.30	0.29
Miscellaneous	0.14	0.17	0.19	0.29	0.38
Social care (persons with special needs)	**-**	**-**	**-**	**0.09**	**0.10**
Administration	**0.08**	**0.07**	**0.06**	**0.07**	**0.06**
Total	**7.93**	**7.91**	**8.00**	**9.60**	**10.33**

These figures include any additional budgets adopted during a year, except for 2009. They do not cover:

1. Unemployment insurance and labour market programmes; about 0.3% of GDP in 2008.
2. Sickness benefits, paid by the Health Insurance Fund: 0.6 to 0.7% of GDP in 2007.
3. Subsistence benefits and related benefits financed by municipalities: about 0.05% of GDP.
4. Social care financed by municipalities.

Source: Social Board (*www.ensib.ee/frame_eelarve_eng.html*).

Estonia's social transfer system as a whole is not highly redistributive across income groups, and the same holds for most of its components except disability pensions and subsistence and housing benefits. Low-income households receive somewhat more money as income transfers than the average household does, but almost 40% of the total benefit spending in 2006 went to the 50% of households whose incomes exceeded the median (comparing deciles 1-5 to 6-10 in Table 3.A1.2, Panel B). Nevertheless, social benefits are crucial for the living standards of low-income groups, representing over half of the disposable incomes in the three poorest deciles (Panel A).

Old-age pensions have recently accounted for two-thirds of all cash-benefit expenditures, and they also represented over 90% of all reported incomes for the poorest half of the age class of 66 and older in 2006 (Table 3.A1.2, Panel A). By contrast, those in the same age class who belonged to the two highest income deciles depended mainly on work incomes. *Disability pensions* – about 9% of the benefit spending detailed in Table 3.A1.2 – are most often paid to low-income persons of working age (Panel B).

Family benefits including parental benefits are the only main type of income transfer on which Estonia does not spend significantly less than the OECD or EU average in relative terms. Representing about 1.5% of GDP and 22% of total cash-benefit spending, Estonia's family benefits have universal coverage and are not means-tested, being motivated in part by the desire to encourage young families in all income groups to have children. In effect, more than half of the family and parental-benefit spending goes to the richest half of the population (59% in 2006; see Table 3.A1.2, Panel B).[38]

Spending on *unemployment compensation* and *subsistence benefits* (including housing benefits) is much less significant. At least until 2008, these programme categories represented altogether less than 0.5% of GDP and less than 1% of disposable household incomes. As discussed in Chapter 2, the rise in unemployment in 2009 has exposed several shortcomings of Estonia's social protection of the unemployed. The resources involved are modest by OECD standards. To the extent that higher spending can be afforded in future, OECD experience suggests that such programmes could play a more substantial role than they have done until now in preventing relative poverty.

The Estonian social safety net needs to be reinforced to cope with situations of hardship such as the one created by the current severe downturn. Even if higher social spending is unaffordable, given the tight budget constraints, possible ways of strengthening the redistributive role within existing programmes should be considered. To give more budgetary room for unemployment and subsistence benefits, various options for saving could be justified at least as temporary solutions, as for example the introduction of an upper limit on 1st-tier pensions, lower upper limits on unemployment and parental benefits, or an extended use of means-testing in benefit programmes.

2. Supporting families and children

While many family-support programmes in OECD countries have been justified by the need to protect children against poverty, such programmes have also been inspired to a varying extent by other social considerations

38. The cited statistics refer to a distribution of households by income per *adult equivalent*, a method that is preferable and commonly used because it takes account of scale economies in large households. But if the households are distributed according to *per capita* incomes, the opposite result is obtained with around 60% of the child benefits going to the poorest 50% of the population (*cf.* Statistics Estonia's website database). Large families tend to fall in poorer deciles by the per capita method than they do when their incomes are equivalised.

e.g. about the role of the family, gender equality, female labour force participation and low birth rates. The two last-mentioned objectives have been important for recent policy initiatives in Estonia, including the introduction of one of the world's most generous parental-benefit schemes, which came into force in 2004 and was further enhanced in 2006 and 2008. During the same period, a previously-existing package of monthly child benefits – paid for all children up to the age of 16 or till completion of secondary school – has undergone a series of relatively marginal changes, leading to a decline in real terms for most family types and for all family types when compared with the average wage. For example, on certain assumptions, the total benefit to a family with four children fell from over half of the average wage in 2000 to less than one-third in 2008 and 2009.

Box 3.1 details the present rules applying to family and parental benefits. Table 3.2 estimates the trend since 2000 in the amounts of all periodic family benefits available to selected household types, expressed in constant 2009 euros.

Box 3.1. Cash benefits and tax allowances for families with children

Estonia offers a range of cash benefits and tax allowances to families, all designed to support the raising and education of children. The principal programmes are as follows, expressed in constant June 2009 euros.

1. Family benefits

Lump-sum payments

- Birth allowance: EUR 320.
- Adoption allowance: EUR 320.
- Allowance for starting an independent life (when leaving orphanage, guardianship or foster care): EUR 383.

Periodic payments

- Child allowance, paid monthtly up to age 16 or till the end of the school year when the child reaches age 19:
  - EUR 19 for each of the first and second child.
  - EUR 58 for each subsequent child.
- Child-care allowance, paid monthly for each child:
  - EUR 45 up to age 1.
  - EUR 38 in age 1-2.
  - EUR 19 in age 3-8 if the family has *i)* another child aged under 3 or *ii)* three or more children.

- Single-parent allowance, paid monthly in certain situations when the father is unknown or missing: EUR 19.
- Allowance to families with seven or more children, paid monthly: EUR 169.

A previous school allowance at EUR 29, paid at the beginning of each academic year, was abolished in 2009.

2. Parental benefits

The health insurance pays maternity benefits for up to 140 calendar days of pregnancy and maternity leave. After this, the Social Insurance Board pays parental benefits during the subsequent parental leave within a total maximum of 575 days (19 months) as counted from the first day of maternity leave.[a] The father can claim benefits for 14 days of the maternity-leave period, while the parents can freely share the benefit entitlement for parental leave. (A separate benefit permitting fathers to take ten days of paternal leave during child births was introduced in 2008, but suspended from 2009 for budgetary reasons.)

Maternity and parental benefits correspond to the respective claimants' average monthly wages in the previous calendar year (not counting months out of work), as assessed for the purpose of social contributions. The maximum benefit is three times the previous year's national average wage. If the parent did not work, the benefit is EUR 230 per month. If the parent worked but earned less than the minimum wage, the benefit is equal to the minimum wage (EUR 278 since 2008).

If successive child births occur with intervals of up to 2.5 years, the benefit can be based on the same previous income if it was higher than that of the last calendar year.

Benefit recipients can work during the leave, but incomes in excess of EUR 230 per month are partially deducted from the benefit. No parental benefit is paid if the income is EUR 1 150 per month or more.

In addition, benefits corresponding to 80% of the lost income can be paid to parents who stay at home for up to two weeks with sick children under the age of 12. Parents can also take additional holiday leave for three to six days per year with a flat-rate benefit of EUR 4.2 per day.

3. Tax allowance

As mentioned in Chapter 2, parents' taxable income is reduced by EUR 144 per month for each child except the first. This concerns all children up to the age of 17, and the resulting tax reduction can be estimated at EUR 30 per month and eligible child. Parents can make further deductions from taxable income corresponding to their children's education costs up to age 26, including interest on study loans.

a) The Holidays Act gives a right to parental leave until the child is 3 years old, *i.e.* for about twice as long as a parental benefit can be paid.

Table 3.2. General periodic benefits to families in 2000-09

This table shows the sum of all periodic family benefits which a household of a given type is likely to be eligible (see Box 3.2). Birth grants and parental benefits are not included.

Household types (examples)	2000	2002	2004	2006	2008	June 2009
Couple with 1 child, age 0	70	64	82	75	64	64
Couple with 1 child, age 1-2	70	64	73	68	57	58
Couple with 1 child, age 3-6	14	13	24	23	19	19
Couple with 1 child, age 7-19	18	16	28	25	22	19
Couple with 2 children, age 3-6	28	26	49	45	38	38
Couple with 3 children, age 1-2, 3-6 and 9-19	151	157	162	161	156	153
Couple with 4 children, age 0, 3-6, 7-8 and 9-19	238	241	251	261	260	256
Single parent with 1 child, age 1-2*	98	90	98	90	77	77
Single parent with 1 child, age 3-6*	42	38	49	45	38	38
Single parent with 1 child, age 7-19*	46	42	52	48	41	38
Memorandum item:						
Average wage before tax	458	524	595	707	824	813

* Including a single-parent allowance (EUR 19 in 2009), which is paid only in certain situations, *e.g.* if the father is unknown.

Source: Estonian Ministry of Social Affairs.

The generosity of the maternity and parental benefits – replacing up to three times the average wage for 19 months – was justified by the objectives of promoting fertility and labour force participation for women in all income groups including the relatively wealthy. As an extra incentive to the birth of more children, parents can use the same previous income as a basis for benefits in successive periods, provided that the intervals between the births are up to 2.5 years.[39]

These policy objectives were achieved to a considerable extent, although the role played by family benefits is difficult to demonstrate. Rising living standards and strong labour demand until 2008 must also be taken into account. However, Estonia's total fertility rate began rising in 2004 – the first year when parental benefits were paid – and it reached 1.7 in 2008, up from only 1.3 to 1.4 throughout the ten-year period ending in 2003. The employment rate also rose, up from 75% in 2004 to 79% in 2008 for women aged 25-49, with significant growth observed notably for professionals and others in qualified jobs. Interviewed ministry officials underlined that the well-paid and the well-educated are having more children than before, while

39. In Estonia as in Sweden, the use of the same previous income for calculating benefits in successive periods has been associated with a trend towards narrower "spacing" of children (Pettersson-Lidbom and Skogman Thoursie, 2009).

young people planning to have children face a strong incentive to first become established in the labour market. Many parents probably stay at home longer than they would have without the benefit, but they usually return to work.

Municipalities administer important social programmes with limited resources

While the state finances and administers the biggest social programmes such as pensions and family benefits, a variety of smaller programmes are managed by municipalities. The state regulates and finances subsistence benefits, social services for persons with special mental needs, technical aids for the disabled, social rehabilitation and substitute home services. Other social benefits and services are financed by the municipalities themselves, largely at their own discretion, although they often receive additional support from state bodies. The 15 county governors monitor the quality of social services within their jurisdictions, while the Social Insurance Board supervises the provision of social rehabilitation services for the disabled and special care for people with mental disorders.

Municipalities receive 11.4% of the income-tax revenues and they can charge a land tax at a rate that can vary between 0.1% and 2.5%. With falling revenues during the economic crisis, many of them have cut their budgets and any additional social measures that may prove justified in the short term are likely to require financial support from the state.

Fundamental reforms of the territorial administration have been discussed for a long time, but it has not yet been possible to reach the desirable consensus between the different levels of government about such changes. Many of Estonia's over 200 municipalities are so small that they cannot provide many social services unless they cooperate, which they do less often than the central government finds desirable.

As a general principle in Estonia, families are responsible for the care of needy members, with a possibility of public support as decided by each municipality. Monthly allowances to care-givers – *e.g.* for those taking care of disabled or elderly family members – were previously administered by the state, but fall under municipal responsibility since 2005. Almost all municipalities pay such allowances at EUR 13-26 per month and supported person, concerning around 30 000 cases of all categories.

A heritage of institutional care still plays a role for orphans, lone elderly, disabled persons and the mentally ill. About 8 500 persons (0.6% of the population) lived in such institutions in 2006. A majority of them were in municipal homes for the elderly while some 1 600 lived in orphanages and 2 200 in institutions for groups with special needs (Ministry of Social Affairs, 2008). These numbers declined in the 1990s but have later been relatively stable, while the relevant institutions have been largely decentralised and modernised.[40] For the elderly, in particular, a previous network of large state institutions has been replaced by about 100 smaller municipal ones (on average 30 places). As in most OECD countries, non-institutional forms of care are given priority if possible, such as adoption, guardianship and foster care (orphans), and social care provided in clients' own homes (for the elderly and disabled).

Table 3.3. Institutions for childcare and pre-primary education

End-of-year data

	2004	2005	2006	2007	2008
No. of institutions	600	609	620	624	637
Enrolled children (000s)	52,9	54,5	57,0	58,9	62,1
Children per 100 places	103	104	105	104	105
Enrolment rate in age 1-6	0.7	0.71	0.72	0.73	0.74

Total enrolment rates by age in 2008

age 1	13%
age 2	61%
age 3-6	90%
age 7	18%

Source: Statistical Yearbook of Estonia 2009.

Most working parents have access to day-care for their children, organised as baby groups or nursery schools up to age 3 and preschool for children aged 3 to 6. Municipalities provide most of the day care at low cost for the users, but private day-care centres also exist. The number of available places has not fully kept pace with the increasing number of children, of which some 30 000 were waiting for places at the end of 2007. Enrolment reached 62 000 in 2008, corresponding to 90% of the 3-6-year age class and over 60% of 2-year-olds (Table 3.3). Lower proportions were reported for 1-year-olds (covered by parental leave) and for after-school care of 7-year olds.

40. In 2007, the state spent about 0.15% of GDP on orphanages and institutions for people with special needs (*e.g.* the mentally ill). Care of elderly persons and others without special needs is financed mainly by municipalities and individual fees.

Subsistence benefits are too low to prevent poverty

The modest budget devoted to means-tested subsistence benefits (SB) is also used to support housing costs. As in many OECD countries, the benefits are often insufficient to bring beneficiaries above conventional poverty limits, but the incidence of poverty among SB beneficiaries is greater is Estonia than in most member countries other than the United States. In effect, SB can only be expected to prevent extreme poverty. As shown in Chapter 2, the SB administration is currently over-burdened by the need to help large numbers of unemployed persons, who frequently receive no unemployment benefit or only the inadequate unemployment assistance (UA).

The biggest part of the SB programme, which is state-financed, operates as a minimum income guarantee covering the difference between an income limit and the reported household income net of approved housing costs. This income limit, fixed annually in budget laws, has since 2008 been EEK 1 000 per month (EUR 64 or about 23% of the minimum wage and 8% of the average wage) for one person and EEK 800 for each additional household member. Because the guaranteed income applies net of housing costs, many SB clients can be compensated for the entire cost of housing and heating up to a limit determined by each municipality.[41] Municipalities pay supplementary benefits at their discretion from their own budgets, predominantly to top-up the legal entitlement. To a small extent, they also pay social assistance to persons not eligible for a state-funded SB. Municipal benefits have recently represented over one-fourth of total SB spending, but this share declined in 2009 as a result of the municipal budget constraints.

Over the past decade, rising incomes and reduced unemployment have permitted a reduction of social assistance spending as a share of GDP by a factor of ten, down from 0.5% in 1998 to 0.05% in 2008.[42] By comparison, the 27 EU countries spent on average 0.9% of GDP on subsistence and housing benefits in 2006. The number of recipient households in the average month fell from over 30 000 in the early 2000s to just under 5 000 in 2008, corresponding to a decline from over 5% of the population to under 1%. The average benefit duration is about five months. During 2009, several municipalities have asked for additional funding as their initial budgets for the state-financed SB were quickly exhausted. In Tallinn, for example, the number of applications more than doubled, while in Pärnu it was four times higher than a year earlier.

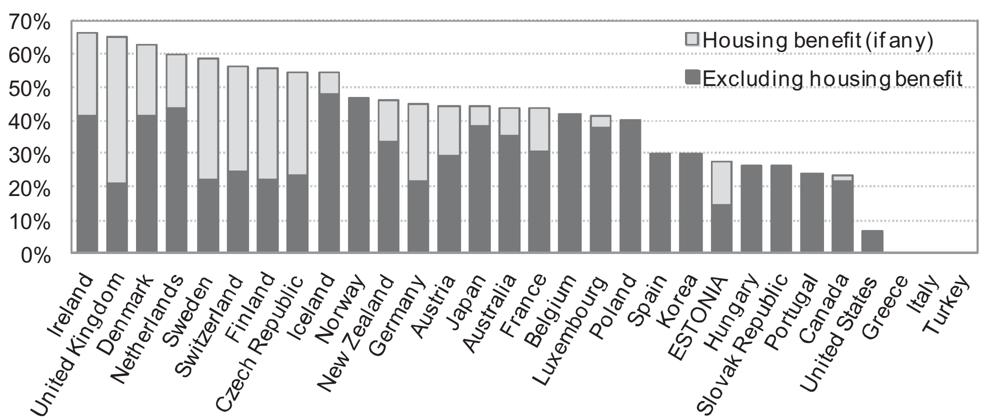
41. The Social Welfare Act (Article 14) obliges municipalities to provide dwellings for those who cannot afford housing, if necessary by means of social housing. Municipally-owned dwellings account for only 3% of the housing stock in 2009.

42. This includes municipal supplementary benefits, which in 2008 represented 0.013% of GDP or one-fourth of the total (*Cf.* Statistics Estonia and Eurostat).

In 2008, the reported average monthly SB payment was just over EEK 2 000 (EUR 130) including housing costs and municipal supplements, corresponding to on average about EEK 1 200 per member of supported households. Analysis for 2007 indicates that a beneficiary family with typical housing costs and no other income except child benefits (if relevant) could expect a disposable income of about 30% of the equivalised median, or 28% for a single person. This is less than in most European countries, though similar to the situation in Spain, Korea, Hungary and the Slovak Republic and more than in the United States. (See Figure 3.4, which compares the benefit outcomes for single persons.) As mentioned earlier, all OECD countries except a few implement social assistance programmes, and the guaranteed income level is between 40 and 60% of the median in a majority of member countries. In Estonia, SB clients' living standards are also lower than an absolute poverty line used by Statistics Estonia, called the subsistence minimum, which in 2007 corresponded to 38% of the equivalised median income.[43] During 2009, the gap between SB amounts and any of these poverty limits has probably widened as municipalities have cut their supplementary benefits.

Figure 3.4. Social assistance and housing benefits for a single person without children in 2007

Percentage of the median household income[1]



1. The figures show net household incomes for a working-age single person with no incomes other than social benefits and no unemployment benefit or pension, expressed as shares of median equivalised household incomes. For OECD countries, it represents the situation around 2005 expressed in 2007 prices. US results include Food Stamps. For housing benefits, it is assumed that the rent corresponds to 20% of average gross full-time wages.

Source: *OECD database on Tax/Benefit Systems* and Statistics Estonia.

43. The subsistence minimum, EEK 2 341 or EUR 150 for one person in 2007, follows the price of a fixed consumption package.

As measured by the net replacement rate (NRR), Estonia's SB appears even less generous compared with most OECD countries (Table 3.4). This indicator compares the household's disposable income during SB receipt with the disposable income it could expect if its "main income earner" had a job at, for example, 67% or 100% of the average wage. Besides the SB, the NRR takes account of income tax and family benefits, but it assumes that the household is not eligible for unemployment benefits or pensions. The NRRs for Estonian households without other incomes are higher for families with children than for those with no children, reflecting the impact of family benefits as well as the SB. But as a result of the low income limit for SB, the effect of having children disappears if one family member has a job.

Table 3.4. Net replacement rates for households receiving social assistance, 2007[1]

	Previous earnings of the main income earner:											
	67% of the average wage						100% of the average wage					
	No children			Two children			No children			Two children		
	Single person	One-earner couple	Two-earner couple	Lone parent	One-earner couple	Two-earner couple	Single person	One-earner couple	Two-earner couple	Lone parent	One-earner couple	Two-earner couple
Norway	67	73	89	105	96	91	64	65	83	86	70	85
Ireland	76	103	52	69	95	67	55	74	44	65	82	57
Denmark	81	76	59	83	91	71	59	56	48	70	75	58
Belgium	64	66	75	81	73	77	47	49	64	63	57	67
Finland	61	84	58	72	92	67	45	61	49	60	77	57
Netherlands	75	90	53	73	88	56	54	66	44	57	68	47
Iceland	60	80	62	71	84	68	44	61	52	57	68	59
Switzerland	70	87	50	80	91	55	48	60	41	59	68	45
Austria	51	65	51	68	80	60	51	52	43	62	64	59
Sweden	64	80	50	62	89	55	45	56	41	50	66	45
Germany	47	60	59	81	82	63	34	45	50	63	64	54
Luxembourg	58	79	52	67	83	56	43	56	43	53	64	48
Czech Republic	55	73	55	69	80	62	38	53	45	55	62	52
United Kingdom	58	58	50	72	78	62	40	40	41	59	66	52
Japan	43	60	51	73	86	53	29	41	41	55	60	44
France	47	58	53	68	77	54	32	40	43	48	54	45
Australia	44	38	53	62	73	70	31	27	44	52	61	60
New Zealand	53	43	58	69	52	64	37	33	47	55	41	56
Hungary	31	56	50	62	71	58	24	44	44	53	62	53
Canada	32	49	55	59	63	69	23	36	46	52	55	60
Poland	37	53	52	67	59	61	25	36	42	51	47	50
Portugal	24	46	52	50	70	55	17	32	43	37	50	46
Spain	33	41	53	49	55	54	23	29	44	36	39	45
Slovak Republic	28	44	53	46	53	57	20	30	44	34	38	48
Korea	25	40	50	54	65	50	17	28	41	37	44	41
ESTONIA	**28**	**37**	**54**	**40**	**50**	**54**	**19**	**26**	**44**	**29**	**37**	**44**
United States	9	15	54	39	46	63	6	11	44	31	37	52

1. The replacement rates take account of social assistance, family and housing benefits and, where relevant, the second earner's work income (assumed to be 67% of the average wage).

Source: OECD database on Tax/Benefit Systems (*www.oecd.org/els/social/workincentives)*.

If and when unemployment assistance (UA) benefits can be substantially increased – as was recently decided, although the decision was subsequently suspended (see Chapter 2) – the number of SB clients could be reduced by half or more. An appropriate increase of both UA benefits and SB would go a long way to reduce the incidence of poverty in Estonia. The present possibility for individuals to combine UA with SB could then be removed. Such a reform would permit the transfer of most unemployed SB clients to the UIF, while municipalities would be in a better position to pay individual attention to the needs of the remaining SB clients.

3. Estonia's three-tier pension system needs to be consolidated

Legislation from 1998, 2002 and 2004 introduced a three-tier pension system that is being gradually phased-in (see Box 3.2). An inherited pay-as-you-go scheme, now the 1st tier, has been reformed to offer more incentives to work and contribute, while the institutional foundations have been laid for developing fully-funded 2nd- and 3rd-tier programmes. The results until now are promising with regard to the system's financial sustainability and economic incentives, which encourage labour force participation in the age group 55-64. The current pensions, which still come almost entirely from the 1st tier, are mostly very modest. In the first quarter of 2009, the average pension was about 40% of the average wage after tax (36% before tax), which was not far from conventional poverty lines. Expected developments in coming years will make pensions more and more variable in the mandatory system as it will take more account of individual contributions. The voluntary 3rd tier has the potential to become important as a complement, but this does not exclude that some modifications to the 1st tier may prove necessary in order to reduce the risk of old-age poverty.

The 1st tier covers virtually all employed residents and it is set to remain predominant, receiving at least 16 percentage points of the pension contributions compared with 6 percentage points for the 2nd tier, when applicable. The 2nd tier enrols about two-thirds of the employed, but its capital accumulation has been suspended during the period 2009-11, except for the oldest workers.[44] Previous plans to make the 2nd tier mandatory for most workers from 2010 have thus been postponed, but the government has underlined that this will be compensated for in subsequent years so that the 2nd tier's long-term development is not jeopardised. But even if this is achieved, it will take many years before the 2nd tier matures. The voluntary

44. The temporary diversion of employer contributions intended for the 2nd tier (4% of payroll) to the 1st tier was motivated by the need to strengthen the consolidated budget balance. This balance encompasses the pay-as-you-go 1st-tier pension but not the 2nd tier, which consists of individual saving.

3rd tier, consisting of individual pension saving encouraged through tax incentives, concerns less than one-fifth of the workforce. The government has not promoted employer-sponsored supplementary pensions of the type that is common in several OECD countries.

Box 3.2. The Estonian pension system

Following reforms adopted in 1997-2000 (1st and 3rd tiers) and 2004 (2nd tier), a three-tier pension system is being phased-in. The 1st tier is mandatory, while the 2nd tier is also expected to become mandatory for most workers after its temporary suspension during the economic downturn. The 3rd tier is voluntary.

1st tier

Persons who reach the pension age after 15 contribution years or more are eligible for a 1st-tier pension, also called state pension. It is financed from employer contributions (called the social tax), charged at a rate of 20% of which at least 16 percentage points are allocated to the 1st tier. The state pays social tax at low amounts in some situations, *e.g.* for persons on parental leave.

The statutory pension age is 63 for men, while for women it is currently 60.5 and will be 63 from 2016. Anyone can retire up to three years early with a pension penalty of 0.4% for each month. Deferred pensioning gives a bonus of 0.9% per month, with no limit to the length of the deferral.

First-tier pensions have three components, with monthly amounts in April 2009 as follows:

a) A basic amount of EEK 1 793 (EUR 115 or about 16% of the average wage before tax).

b) Approximately EEK 68 (EUR 4.35) per contribution year until the end of 1998.

c) An income-related component of EEK 68 multiplied by the sum of "annual factors" accumulated since the beginning of 1999. For each year, the annual factor is the state-pension part of individually registered social tax revenues divided by the average of such taxes recorded for all insured persons in the same year. There is no ceiling on the income-related pensions or on the social tax.

Pensions on favourable terms, permitting earlier retirement, are available to parents with three or more children and several occupational groups (police, military, miners and workers in heavy industry etc.), representing 18% of the current old-age pensioners. These rules, essentially a Soviet heritage, have not been much affected by the recent pension reforms.

Disability pensions follow mostly the same rules as old-age pensions, but the required contribution period is only up to 14 years (depending on the claimant's age). Pensions are calculated from the actual contribution record or as if the claimant had 30 contribution years, whichever is more favourable. Amounts received correspond to the established degree of incapacity to work. When disability pensioners reach the pension age, they receive old-age or national pensions (see below).

Survivor pensions correspond to the old-age pension entitlement at the time of death or are calculated as if the deceased had 30 contribution years, whichever is more favourable, and paid at 50% if there is one eligible survivor, 80% for two and 100% for three or more survivors.

A minimum or national pension of EEK 2 009 per month (EUR 128 or 16% of the average wage before tax) can be paid from the age of 63 to persons not eligible for a state pension, provided that they have legally resided in Estonia for five years. For disability and survivor pensioners, the national pension amount will also depend on the degrees of incapacity to work and the numbers of survivors, respectively.

Awarded pensions are indexed annually according to the previous year's changes in contribution revenues and prices, using a weighting formula that was recently changed from 50/50 to 80/20 (with some exceptions). This change in the formula was aimed to keep the replacement rate between 35 and 40% (including tiers 1 and 2).

The pension index can be reduced if social-tax revenues fall by over 1% during the year, as happened in 2009. But such reductions must be reimbursed within five years and the government must ensure that they do not alter the indexation in the long term.

2nd tier

The schedule for introducing the 2nd tier, temporarily interrupted in 2009-11, would have made it mandatory for all workers from 2010. If, and when, it is in operation, it will be financed by a 2% employee contribution and 4 percentage points of the 20% employer contribution to pensions.

These contribution revenues are invested in government-approved pension funds, operating on market conditions in three risk categories – "growth", "balanced" and "conservative" – for which different proportions of stock-market investments are allowed (up to 50%). Most of these funds are managed by Swedish and Danish banks, while the role of Estonian funds has been small until now. A majority of participants have opted for "growth" funds in which the returns until now have been negative – with losses in the order of 25% in 2008, and large losses even in real terms. There is no guarantee of returns except in cases of fraud, but fund managers face incentives to maximise returns (*e.g.* an obligation to invest). Participants must opt for only one fund at a time, but they can switch new allocations to different funds without having to transfer all pervious savings.

After a minimum contribution period of five years, pensions are payable from the same pension age as in the 1st tier. Monthly pensions are usually maximised at one-fourth of the national pension. The balance is paid out as a lump sum when it is smaller than three monthly national pensions.

3rd tier

To encourage voluntary pension saving, tax incentives are provided on the "free-free-reduced" model, as follows:

- Regular payments to pension insurance with investment risk, made at least once in every quarter, are exempt from income tax up to a limit at 15% of the income. For less regular payments, income tax is charged at a rate of 10%.
- Capital gains staying in pension funds are not taxed.
- Payments from voluntary pension funds are taxed at the reduced rate of 10% if the claimant is over 55 years old or totally disabled. Any sums withdrawn before the age of 55 and not motivated by disability are taxed at the standard 21% rate.

In Estonia as in many OECD countries, the reformed 1st tier incorporates a significant income-related element. All pensions include a fixed amount (currently about one-sixth of the average wage), but more than half of the average pension depends on the individual contribution history. Recorded contribution amounts are counted only for the time after 1998, while any contributions in earlier years are counted as if all workers had earned the average wage. As a result, the differences in pensions are now moderate and the poverty risk is greatest for pensioners with short work histories. But this situation will change as the income-related part becomes more important over the next three decades. Unless the rules are changed, *e.g.* by an increase in the fixed amount or the minimum pension, the proportion of pensioners in relative poverty is likely to rise. At the same time, the proportion with very high pensions is also set to increase: contrary to most OECD countries, Estonia applies no upper limit to the 1st-tier pension amounts or to the social tax. Moreover, as a Soviet heritage that has not been reformed, a number of occupational groups can retire on more favourable terms.

High labour force participation makes Estonia rather well prepared for the demographic challenge

Population ageing is about as advanced in Estonia as in the average OECD country, with an old-age dependency ratio of about 25% in 2010 (Figure 3.5). Judging from the United Nations' projection made in 2008 – after a rise in the total fertility rate from 1.3 in 2003 to 1.6 in 2007 – this dependency ratio may reach 41% in 2050, a development that would also be similar to the OECD average. However, a recent significant increase in employment among the elderly – especially elderly women – suggests that Estonia is better prepared than many OECD countries to meet this demographic challenge. The employment rate of women was far above the OECD average in 2008, while for men it was on a par with the average (Figure 3.6; *cf.* Chapter 1 for international comparisons).

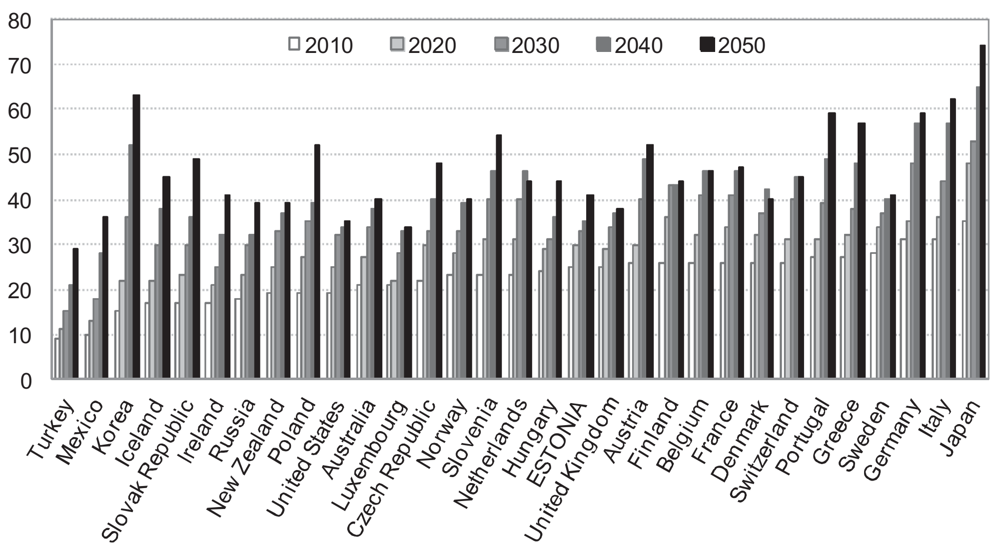
With a life expectancy of only 67 for men and 79 for women, Estonian policy makers have not yet envisaged any increase of the statutory pension age up to the 65 years that currently apply for men and women in many OECD countries. As mentioned in Box 3.2, the present statutory pension age is 63 for men but only 60.5 for women, though gradually rising to 63 by 2016. Anyone can apply for a pension up to three years earlier with a penalty of only 0.4% per month (5% per year), *i.e.* somewhat less than the additional cost to the pension system. This option has recently been used by about half of the new old-age pensioners, including many who choose to draw pensions while still working. The possibility to choose the time of drawing a pension irrespective of retirement, as allowed in Estonia, adds to labour market flexibility and individual choice, but it strengthens the case for imposing reductions for early pensions based on actuarial grounds.

About two-fifths of the new pensioners (18% of all pensioners) first receive disability pensions, and a large majority in this group (over 90%) have some capacity to work and so get reduced disability pensions up to the pension age (from which they get old-age pensions). It is also notable that the option for deferred pensions has recently been used by less than 5% of the new old-age pensioners, albeit this share is increasing. Such deferments are rewarded by a pension bonus as high as 0.9% per month (10.8% per year) with no upper limit. All told, the average age of drawing a pension is probably over two years lower than the average age of leaving the labour force (about 60 compared with 62.5).

In the future, rising life expectancy will require further steps to push up the effective pension age. A gradual increase of the statutory pension age up to 65 could be initiated as soon as the economy recovers. However, a suitable combination of financial incentives and free choice may well be sufficient to achieve this objective. Some increase of the penalty for early retirement should therefore be envisaged, and the special pension regimes for various occupations should be abolished.

Figure 3.5. Old-age dependency ratios (age 65 to 15-64), 2010 to 2050

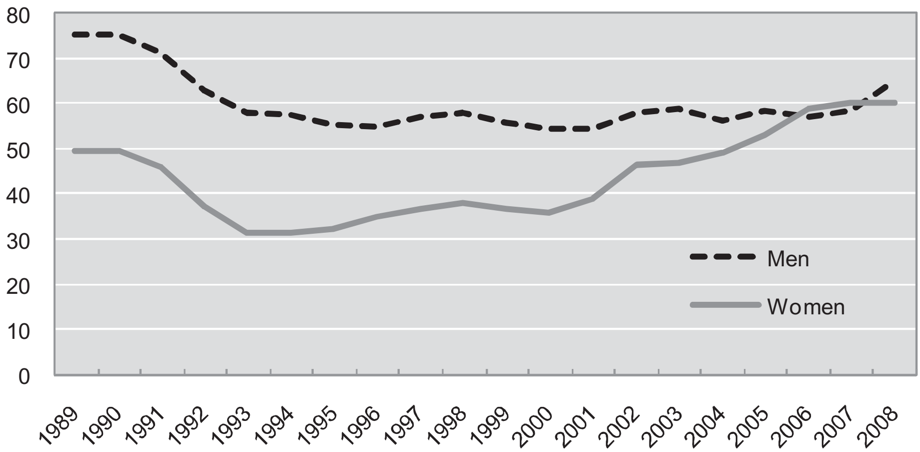
UN projections, medium variant. Countries are ranked according to the value in 2010.



Source: UN World Population Prospects, 2008 revision.

Figure 3.6. Trend in the employment rate of 55-64-year-olds

Percentage of the age-group population



Source: Statistics Estonia.

Preventing old-age poverty

As already mentioned, the predominant 1st-tier pensions are not yet very different across population groups.[45] On average, old-age pensions have recently replaced a little more than 30% of the average wage before tax (Table 3.5). This probably corresponds to about 5 percentage points more after tax, *i.e.* 35 to 40%. (Pensioners benefit from a special tax allowance; see Chapter 2.) At the beginning of 2009, the replacement rate increased suddenly as a result of declining wage incomes, an effect that is unlikely to last.[46]

45. Second-tier pensions, paid out for the first time in 2009, are still quantitatively insignificant and often paid out as a small lump sum. Their importance will hardly increase until after 2011, when it is expected that the suspension of 2nd-tier saving will be lifted.

46. Following the pension law's main indexation rule – which links pensions to economic data for the previous year – pensions were set to rise strongly in 2009, a development that could have pushed up the replacement rate even more as nominal wages declined in the second quarter. This effect has now been reduced by a temporary reduction of the indexation adjustment (as foreseen by the law when revenues decline by over 1%; *cf.* Box 3.2).

Table 3.5. Number of pensioners and average pensions (before tax)

Type of pension	Number of pensioners[1]			Average pension in current EEK per month			Average pension as a percentage of the average wage		
	2004	2008	2009	2004	2008	2009	2004	2008	1Q 2009
Old-age[2]	296 883	293 675	293 650	2 072	3 763	4 356	31	31	36
Disability	55 480	67 459	70 024	1 244	2 241	2 595	18	18	21
Average loss of capacity to work	*73%*	*71%*	*70%*	-	-	-	-	-	-
Survivor	7 924	9 126	8 724	1 001	1 814	n.a.	15	15	n.a.
By the number of household members who cannot work:									
1	*5 410*	*6 734*	*n.a.*	*751*	*1 543*	*n.a.*	*11*	*13*	*n.a.*
2	*1 932*	*1 884*	*n.a.*	*1 374*	*2 440*	*n.a.*	*20*	*20*	*n.a.*
3 or more	*582*	*508*	*n.a.*	*2 092*	*3 086*	*n.a.*	*31*	*25*	*n.a.*
National (minimum)	11 012	7 227	6 708	982	1 285	1 473	15	10	12
Of which old age	*3 382*	*2 605*	*n.a.*	*984*	*1 574*	*n.a.*	*15*	*13*	*n.a.*
Total/Average	371 299	377 487	379 106	1 890	3 395	3 919	28	28	32

n.a. = not available.

1. For survivor and national pensions: number of households.

2. Including pensions for required length of service (1% of the cases).

Source: Ministry of Social Affairs; *Statistical Yearbook of Estonia 2009*. The data refer to the beginning of the years.

The incidence of relative poverty among pensioners has increased steadily since the pension reforms were adopted (Table 3.6).[47] This is a preoccupying development. Some increase of the lowest pensions will merit consideration as soon as it can be afforded, for example by increasing the fixed amount in the 1st tier and the national pension. Moreover, policy makers will need to monitor the development of old-age poverty and living conditions as the total pensions become more dependent on past incomes. Once the economy recovers, the development of the funded 2nd and 3rd tiers should resume. This should relieve pressure on the state budget in the long term, but there will be short-term costs.

47. This does not exclude that many can experience a relative improvement over the longer term, as shown by an alternative measure used in Part B of Table 3.6. In this case, the real value of the poverty line for any year is “anchored in time” three years earlier (*cf.* OECD, 2008, p. 131).

Table 3.6. Indicators of old-age poverty

Percentage of persons earning less than 60% of the equivalised median income

	2000	2001	2002	2003	2004	2005	2006	2007
A. Based on the current poverty line in each year								
All retired persons								
Both genders	18	21	21	19	23	29	37	43
Men	14	16	15	15	11	17	25	31
Women	20	24	23	22	28	34	42	49
People aged 65 and older								
Both genders	16	18	16	17	20	25	33	39
Men	8	9	7	7	10	14	21	25
Women	21	23	21	22	26	31	39	46
B. "Anchored in time" (based on the real value poverty line that applied 3 years earlier)								
Both genders	18	19	10	9	4	3	2	2

Source: Statistics Estonia.

4. Conclusion

Estonia has deliberately chosen to rely on economic growth and labour market incentives as its defence against poverty. Its social spending is therefore modest, although its social protection system includes all the main elements commonly found in industrialised economies. The pension system's financial sustainability appears greater than in many other countries, despite population ageing. But with the notable exception of family benefits, the social transfer programmes are less generous on average than in OECD countries, and they have not been designed to achieve income-distribution goals.

This strategy has been largely successful, as shown by sustained GDP growth rates in the order of 7% per year for nearly a decade and a half before the present economic downturn. Even in mid-2009, the overall employment rate was significantly higher than in 2000 and household incomes were much higher, not only for the employed but also for pensioners and others who depend on social benefits. Nevertheless, measures of relative poverty indicate that a disturbingly large proportion of benefit recipients can be regarded as poor in relative terms. This situation will require more policy attention in the future.

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Annex 3.A1.

Household incomes and social benefits by decile

Table 3.A1.1. Household income by source and equivalised deciles in 2006

A. Disposable income by source for each decile

Total population						
Decile	Wages	Capital income	Self-employm.	Trans-fers	Taxes	Total disp. income
1	34%	3%	6%	65%	-8%	100%
2	46%	1%	3%	59%	-9%	100%
3	54%	2%	2%	52%	-10%	100%
4	72%	1%	2%	37%	-13%	100%
5	92%	1%	2%	24%	-18%	100%
6	100%	1%	2%	17%	-19%	100%
7	104%	0%	2%	14%	-21%	100%
8	108%	0%	1%	12%	-22%	100%
9	114%	1%	1%	9%	-25%	100%
10	109%	2%	12%	5%	-29%	100%
Average	96%	1%	4%	19%	-21%	100%

Age 18-65						
Decile	Wages	Capital income	Self-employm.	Trans-fers	Taxes	Total disp. income
1	43%	4%	7%	55%	-10%	100%
2	71%	2%	3%	37%	-13%	100%
3	85%	1%	2%	26%	-14%	100%
4	96%	1%	2%	19%	-18%	100%
5	102%	1%	2%	15%	-20%	100%
6	103%	0%	3%	13%	-20%	100%
7	110%	0%	1%	10%	-22%	100%
8	111%	1%	1%	10%	-22%	100%
9	118%	0%	1%	6%	-25%	100%
10	106%	2%	17%	4%	-29%	100%
Average	103%	1%	6%	12%	-22%	100%

Age 66+						
Decile	Wages	Capital income	Self-employm.	Trans-fers	Taxes	Total disp. income
1	3%	0%	0%	97%	-1%	100%
2	1%	0%	0%	100%	-1%	100%
3	1%	0%	2%	102%	-5%	100%
4	4%	1%	1%	97%	-3%	100%
5	3%	1%	0%	96%	-1%	100%
6	6%	1%	1%	93%	-1%	100%
7	13%	1%	0%	87%	-2%	100%
8	34%	1%	1%	69%	-5%	100%
9	61%	0%	1%	47%	-10%	100%
10	80%	3%	2%	33%	-18%	100%
Average	33%	1%	1%	71%	-7%	100%

B. Distribution by decile of each income type

Total population						
Decile	Wages	Capital income	Self-employm.	Trans-fers	Taxes	Total disp. income
1	1%	8%	3%	9%	1%	3%
2	2%	4%	3%	14%	2%	4%
3	3%	11%	3%	15%	3%	6%
4	5%	7%	3%	13%	4%	7%
5	8%	4%	3%	10%	7%	8%
6	9%	6%	3%	8%	8%	9%
7	11%	3%	5%	8%	10%	11%
8	14%	5%	3%	8%	13%	12%
9	18%	11%	2%	8%	18%	15%
10	29%	42%	71%	7%	35%	26%
Total	100%	100%	100%	100%	100%	100%

Age 18-65						
Decile	Wages	Capital income	Self-employm.	Trans-fers	Taxes	Total disp. income
1	1%	9%	3%	11%	1%	2%
2	3%	8%	3%	13%	3%	4%
3	5%	8%	2%	12%	4%	6%
4	7%	5%	3%	10%	5%	7%
5	8%	5%	3%	10%	7%	8%
6	9%	4%	4%	10%	8%	9%
7	11%	4%	2%	9%	10%	10%
8	13%	9%	2%	10%	12%	12%
9	17%	6%	2%	7%	17%	15%
10	27%	44%	77%	9%	33%	26%
Total	100%	100%	100%	100%	100%	100%

Age 66+						
Decile	Wages	Capital income	Self-employm.	Trans-fers	Taxes	Total disp. income
1	1%	1%	2%	7%	0%	5%
2	0%	0%	1%	8%	1%	6%
3	0%	1%	8%	9%	4%	6%
4	1%	6%	8%	10%	3%	7%
5	1%	8%	2%	11%	1%	8%
6	2%	9%	7%	12%	2%	9%
7	5%	11%	4%	12%	3%	10%
8	12%	9%	11%	11%	9%	11%
9	28%	5%	16%	10%	20%	15%
10	52%	50%	41%	10%	56%	22%
Total	100%	100%	100%	100%	100%	100%

Source: Calculations based on EU-SILC data provided by Statistics Estonia.

Table 3.A1.2. Public income transfers by type and equivalised income decile in 2006

A. Social benefits as a percentage of disposable income

Whole population

Decile	Old age[1]	Disa-bility	Family	Unem-ployment	Hous-ing	Other	All benefits
1	39%	14%	10%	0.3%	1.3%	0.4%	65%
2	48%	5%	6%	0.2%	0.1%	0.2%	59%
3	40%	4%	6%	0.2%	0.1%	0.3%	52%
4	27%	3%	6%	0.3%	0.0%	0.2%	37%
5	16%	2%	6%	0.2%	0.0%	0.3%	24%
6	10%	1%	5%	0.3%	0.0%	0.6%	17%
7	8%	1%	5%	0.2%	0.0%	0.2%	14%
8	7%	1%	4%	0.1%	0.0%	0.5%	12%
9	5%	1%	3%	0.1%	0.0%	0.5%	9%
10	2%	0%	2%	0.2%	0.0%	0.2%	5%
Average	12%	2%	4%	0.2%	0.1%	0.4%	19%

Age 18-65

Decile	Old age[1]	Disa-bility	Family	Unem-ployment	Hous-ing	Other	All benefits
1	23%	21%	8%	0.6%	1.6%	0.6%	55%
2	22%	7%	7%	0.2%	0.2%	0.5%	37%
3	14%	5%	6%	0.4%	0.1%	0.3%	26%
4	11%	2%	5%	0.2%	0.0%	0.3%	19%
5	8%	2%	4%	0.4%	0.0%	0.6%	15%
6	8%	1%	3%	0.4%	0.0%	0.3%	13%
7	5%	2%	3%	0.1%	0.0%	0.2%	10%
8	6%	1%	3%	0.1%	0.0%	0.6%	10%
9	3%	1%	2%	0.1%	0.0%	0.4%	6%
10	2%	0%	2%	0.2%	0.0%	0.2%	4%
Average	7%	2%	3%	0.2%	0.1%	0.4%	12%

Age 66+

Decile	Old age[1]	Disa-bility	Family	Unem-ployment	Hous-ing	Other	All benefits
1	95%	1%	0.8%	0.0%	0.4%	0.1%	97%
2	99%	1%	0.3%	0.0%	0.0%	0.0%	100%
3	101%	1%	0.3%	0.1%	0.0%	0.0%	102%
4	95%	2%	0.1%	0.0%	0.1%	0.0%	97%
5	94%	2%	0.3%	0.2%	0.0%	0.0%	96%
6	91%	2%	0.4%	0.0%	0.0%	0.0%	93%
7	84%	2%	0.7%	0.0%	0.0%	0.0%	87%
8	67%	1%	0.8%	0.1%	0.0%	0.1%	69%
9	45%	1%	0.6%	0.1%	0.0%	0.1%	47%
10	32%	0%	1.2%	0.0%	0.0%	0.2%	33%
Average	70%	1%	0.6%	0.1%	0.0%	0.1%	71%

B. Distribution by decile of each social benefit type

Whole population

Decile	Old age[1]	Disa-bility	Family	Unem-ployment	Hous-ing	Other	All benefits
1	9%	22%	6%	5%	60%	3%	9%
2	17%	13%	6%	5%	10%	3%	14%
3	18%	14%	8%	6%	12%	5%	15%
4	14%	11%	10%	10%	4%	4%	13%
5	10%	7%	11%	10%	2%	7%	10%
6	7%	8%	11%	13%	1%	15%	8%
7	7%	8%	11%	12%	1%	6%	8%
8	7%	7%	11%	9%	0%	18%	8%
9	6%	7%	11%	6%	11%	23%	8%
10	5%	2%	15%	23%	0%	17%	7%
Total	100%	100%	100%	100%	100%	100%	100%

Age 18-65

Decile	Old age[1]	Disa-bility	Family	Unem-ployment	Hous-ing	Other	All benefits
1	9%	26%	6%	7%	59%	4%	11%
2	15%	16%	9%	4%	16%	6%	13%
3	13%	16%	10%	11%	7%	4%	12%
4	11%	7%	11%	8%	1%	6%	10%
5	10%	7%	11%	15%	2%	14%	10%
6	11%	7%	10%	16%	1%	8%	10%
7	8%	9%	10%	4%	0%	5%	9%
8	11%	5%	10%	8%	9%	21%	10%
9	7%	6%	9%	4%	5%	16%	7%
10	7%	2%	14%	24%	0%	15%	9%
Total	100%	100%	100%	100%	100%	100%	100%

Age 66+

Decile	Old age[1]	Disa-bility	Family	Unem-ployment	Hous-ing	Other	All benefits
1	7%	3%	6%	4%	60%	6%	7%
2	8%	3%	3%	0%	7%	1%	8%
3	10%	4%	3%	10%	4%	2%	9%
4	10%	13%	2%	4%	20%	4%	10%
5	11%	13%	4%	24%	4%	3%	11%
6	12%	14%	5%	0%	1%	3%	12%
7	12%	19%	11%	0%	2%	4%	12%
8	11%	10%	14%	28%	1%	19%	11%
9	9%	13%	14%	18%	0%	16%	10%
10	10%	7%	40%	12%	1%	42%	10%
Total	100%	100%	100%	100%	100%	100%	100%

1. Including survivor pensions.

Source: Calculations based on EU-SILC data provided by Statistics Estonia.

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