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.

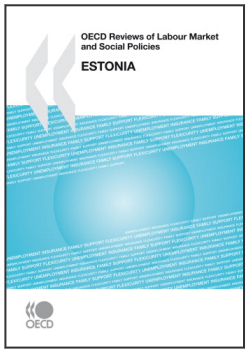
Preventing old-age poverty.

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.



From:

OECD Reviews of Labour Market and Social Policies: Estonia 2010

Access the complete publication at:
https://doi.org/10.1787/9789264082120-en

Please cite this chapter as:

OECD (2010), "Assessment and Recommendations", in *OECD Reviews of Labour Market and Social Policies: Estonia 2010*, OECD Publishing, Paris.

DOI: https://doi.org/10.1787/9789264082120-2-en

This work is published under the responsibility of the Secretary-General of the OECD. The opinions expressed and arguments employed herein do not necessarily reflect the official views of OECD member countries.

This document and any map included herein are without prejudice to the status of or sovereignty over any territory, to the delimitation of international frontiers and boundaries and to the name of any territory, city or area.

You can copy, download or print OECD content for your own use, and you can include excerpts from OECD publications, databases and multimedia products in your own documents, presentations, blogs, websites and teaching materials, provided that suitable acknowledgment of OECD as source and copyright owner is given. All requests for public or commercial use and translation rights should be submitted to rights@oecd.org. Requests for permission to photocopy portions of this material for public or commercial use shall be addressed directly to the Copyright Clearance Center (CCC) at info@copyright.com or the Centre français d'exploitation du droit de copie (CFC) at contact@cfcopies.com.