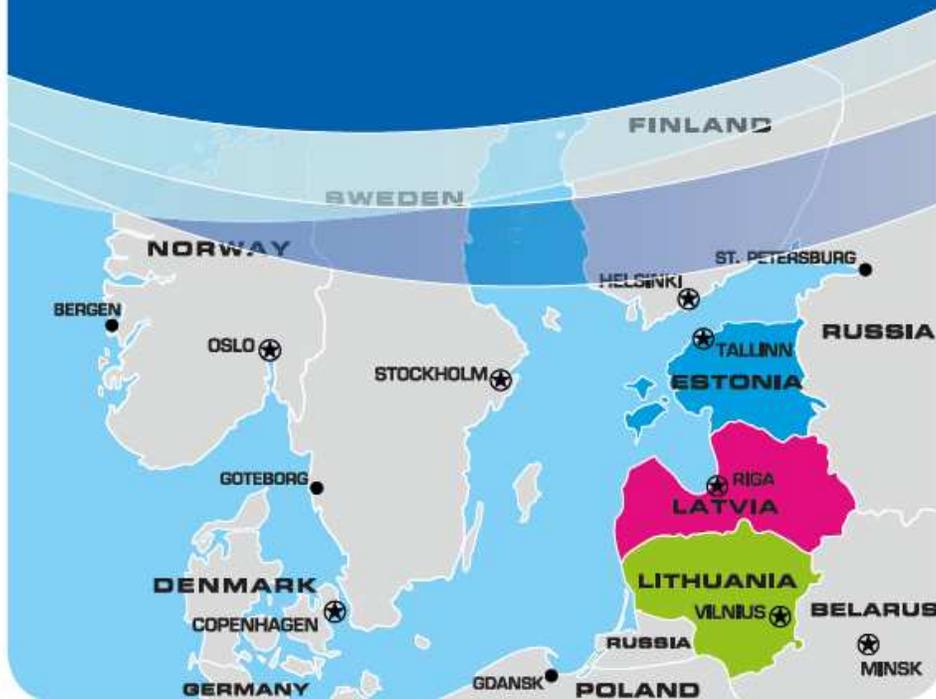




European Economic and Social Committee

# ECONOMIC AND SOCIAL SITUATION IN THE BALTIC STATES

## ESTONIA



# ECONOMIC AND SOCIAL DEVELOPMENT IN THE BALTIC STATES:

## ESTONIA

Alari Purju  
Tallinn Technical University

### Summary

This text discusses trends on the Estonian labour market during the years of rapid economic development and the subsequent economic crisis. The aim of the text is to describe changes in the field of employment and unemployment, as well as the problems facing vulnerable groups (young people, older workers, non-Estonians, people from structurally weak regions) in relation to employment and unemployment. The text includes a description of Estonia labour market institutions as well as the steps that have been taken as part of active and passive employment policies. In particular, we have focused on new labour laws and changes introduced in response to the crisis. We also evaluate the contribution of social partners to framing employment policy. The last part of the text sets out to compile the lessons which can be learned from the framing of Estonian labour market policy responses and adaptation to the economic crisis.

Key words: labour market, employment, unemployment, active and passive labour market policy measures, social partners, social welfare reform, adaptation to the economic crisis

### 1. Introduction

Economic and social development in Estonia since 2000 can be divided into three very different phases. The 2000-2007 period was characterised by very rapid economic growth, in particular due to Estonian accession to the European Union in 2004. During this period real GDP rose by a factor of 1.833, employment indicators improved, and unemployment fell to 4.7% in 2007. To a large extent, Estonian economic growth reflected favourable external conditions. Increasingly, the Estonian economy was becoming integrated into international production networks, at the same time as significant growth in foreign demand. Extensive investments were made: in 2007 the total value of gross asset formation amounted to 35.5% of GDP - a very high percentage by international standards. Nearly one-third of additional capital originated from foreign investments. The influx of foreign capital and rapid growth in credit from private and cooperative banks helped to fuel a credit boom in the property and construction sectors, with rapid growth. Relative to 2000, the number of employees in the building sector had risen by a factor of 2.3 in 2007. This rapid growth was accompanied by rising property prices and more expensive construction services. Such growth was hardly sustainable in the long term, and the international economic slowdown brought economic crisis to Estonia too. From 2008 to 2009 there was a second phase of deep recession, resulting in a GDP decline of 17.5%. In 2009 the unemployment rate reached 13.8%, and continued rising to 16.9% in 2010. The number of people working in the construction sector fell from 82 100 in 2007 to 58 300 in 2009, and 47 900 in 2010. The abrupt recession during the second phase presented the government authorities responsible for labour market issues and social welfare with major challenges. In this context it was questioned whether the principles of Estonian taxation policy remained relevant and appropriate in these new circumstances. As is well known, Estonia had made efforts to operate on the basis of a balanced budget every year. One of the foundations for this policy was the application of a currency board with the Estonian kroon being closely tied to the Deutschmark since 1992 and to the euro since 1999. Given the country's great openness to international capital flows, there was very little scope for an independent monetary policy; as a result the fixed exchange rate forced Estonia to pursue rigid taxation policies to limit the inflationary pressures arising from rising government expenditure. Estonia had the lowest levels of government debt in the whole of the EU - just 6% of GDP in 2011. During the crisis Estonia continued its strict budgetary policies: even though the 2008 budget, which was drawn up during a period of economic growth, was completely

unrealistic, at least the government managed to keep the budget deficit within the limits defined by the Stability and Growth Pact by making significant cuts amounting to 9% of GDP. After two years of severe recession, 2010 saw moderate economic growth again, which gathered momentum in 2011. Total economic growth during these two years was 10.1%. As is well known, unemployment tends to lag behind GDP <sup>(1)</sup>; as a result, unemployment rates peaked in 2011, even though GDP was once again rising. In 2011 unemployment then fell to 12.5% compared to 16.9% on the previous year. Admittedly, policies aiming to achieve a balanced budget do not necessarily mean a relative or absolute decline in social welfare expenditure (as shown by the experience of Scandinavian countries which have succeeded in developing social protection systems while pursuing balanced budgetary policies). However, countries with a young market economy typically face the risk of a higher budgetary deficit when social protection is stepped up. One of the reasons for this could be the weakness of institutions and the growing politicisation of social expenditure; as a result of this, in the event of recession or overly optimistic forecasts, implementation of the cuts needed to achieve a balanced budget are politically very risky for the governing coalition. In view of this there is a mutual interplay between Estonian budgetary policies and the relatively modest level of social protection, which in turn has to do with low income levels. Table 1 shows the main economic indicators for Estonia over the last five years.

Table 1: Estonian economic indicators, 2007-2011

Indicator	2007	2008	2009	2010	2011
GDP, at current prices, in billions of euros	16.1	16.3	13.8	14.3	16.0
GDP, real growth compared to previous year, %	7.5	-3.7	-14.3	2.3	7.6
Gross asset formation, % of GDP	35.6	29.7	21.5	18.8	21.5
Exports (goods and services) as share of GDP, %	67.0	70.8	64.7	79.4	92.7
Growth in exports compared to previous year, %	3.7	0.6	-18.6	22.5	24.9
Consumer price index	6.6	10.4	-0.1	3.0	5.0
Employment, in thousands	655.3	656.5	595.8	570.9	609.1
Unemployment, %	4.7	5.5	13.8	16.9	12.5
Budget surplus (+) or deficit (-) for government expenditure, as % of GDP	2.3	-2.9	-2.0	0.3	1.0
Social welfare expenditure as % of GDP	12.1	14.9	19.2	...	...

Source: Estonian Statistical Office

The following sections of this study focus on this period because we are especially interested in the circumstances surrounding the transition from economic growth to economic crisis and then the recent turnaround, with new growth beginning. Although this is a relatively short period in relation to Estonian economic development over the last 20 years, it is particularly worth examining it more closely, not least because these years saw fundamental changes in labour market and welfare structures and institutions, against the backdrop of these economic trends. At the same time we can evaluate the extent of the problems arising from economic crisis based on the capacity of the relevant institutions to respond to problems and carry out the necessary changes. The following paragraphs set out more detailed information on the specific changes in labour market and welfare systems.

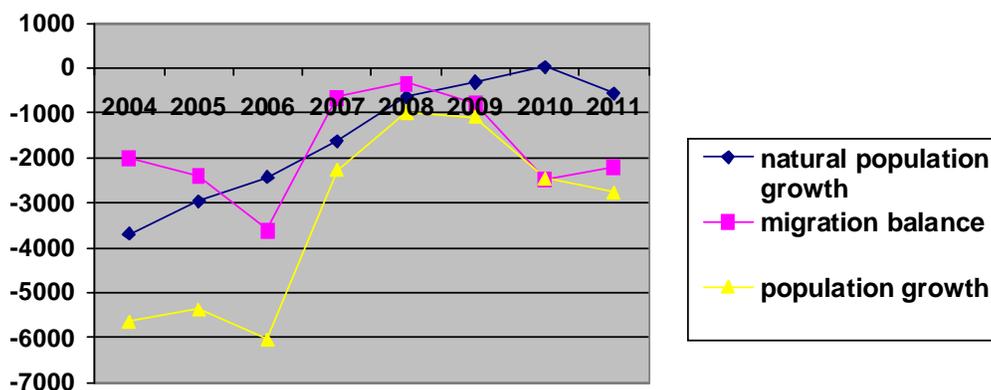
## 2. General economic situation and labour market developments

The changing age structure of the population, and the size of the active population - which is in turn divided into the categories of the employed and unemployed - in relation to the non-active population, determine how the potential of the labour force is used. Natural population growth and migration affect the age structure of the population. In Estonia's case natural population growth has been negative since the beginning of the 1990s; nevertheless, over the

<sup>1</sup>

See Reinhart & Rogoff 2009.

last few years birth rates and death rates have been more or less balanced. Since the beginning of the new millennium, there have always been slightly more emigrants than immigrants. At the same time the use of labour market potential and employment are also affected by similar developments on the labour markets of other countries, even though these developments are not reflected in migration indicators. For example, many Estonians working in the Finnish construction and transport sectors have kept their status as Estonian residents, and some of them commute every week to work in Finland. According to one labour market survey there could be as many as 20 000 such workers, around 3% of Estonia's working population (Viilmann, Soosaar 2012). Diagram 1 shows birth rates in Estonia and the population changes resulting from migration. During the period under review, natural population growth was consistently negative, with the exception of 2010. At the same time, the number of emigrants was in excess of immigrants, with an overall population decline in Estonia. During the economic crisis the migration balance improved a little, before deteriorating again during the last two years due to the high number of emigrants.



Source: Estonian Statistical Office

Diagram 1: natural birth rates, migration balance and change in population, 2004-2011

Diagram 2 shows some basic Estonian labour market statistics. The data clearly show that the number of people in the 15-74 age group has gone down slightly, at a slower rate than the decrease in the non-active population, with the active population remaining relatively stable during the recession. The figures show that during the crisis some of the non-active population joined the active population, as the non-active population shrank at a faster rate than the total population in the 15-74 age group. The number of those in employment decreased significantly with a corresponding rise in the number of unemployed. Before the crisis there was a higher rate of unemployment among men than women; this trend continued during the crisis and the two years of the recent economic recovery.

Compared to other EU Member States Estonia has a relatively high employment rate, second only to the Scandinavian countries. Data showing comparisons with other countries are based on the 15-64 age group (2). In the 15-64 age group in Estonia, the percentage of the active population in 2011 was 74.7% – 78.1% and 71.5% for men and women respectively. These figures are slightly higher than the EU averages for the same period, i.e. 71.2% of the total population in this age group, 77.6% for men and 64.9% for women. At the same time, compared to the EU average the percentage of Estonian women in the active population is relatively high. Finland has similar figures (average 74.9%; 77.2% for men and 72.7% for women).

<sup>2</sup> Data are taken from the <http://epp.eurostat.ec.europa.eu/portal/page/portal/employment> database.

Table 2: the Estonian labour market, 2007-2011

	2007	2008	2009	2010	2011
Size of the 15-74 age group, in thousands	1046.4	1042.8	1038.8	1034.8	1029.8
Size of the non-active population in the 15-74 age group, in thousands	359.0	347.9	348.0	348.0	333.8
men	140.3	136.7	139.7	143.1	136.0
women	218.7	211.2	208.3	204.8	197.8
Active (working) population	687.4	694.3	690.8	686.8	696.0
Employment, in thousands	655.3	656.5	595.8	570.9	609.1
men	330.0	330.9	288.1	275.1	301.4
women	325.4	325.6	307.7	295.8	307.7
Unemployed, in thousands	32.0	38.4	95.1	115.9	86.8
men	18.9	20.2	58.5	66.5	45.6
women	13.1	18.1	36.6	49.4	41.2
Employment rate ( <sup>3</sup> ) in the 15-74 age group, %	65.7	66.6	66.5	66.4	67.6
men	71.3	72.0	71.3	70.5	71.8
women	60.7	61.9	62.3	62.8	63.8
Unemployment rate, %	4.7	5.5	13.8	16.9	12.5
men	5.4	5.8	16.9	19.5	13.1
women	3.9	5.3	10.6	14.3	11.8

Sources: Estonian Statistical Office; *Development of Estonian Working Conditions, 2010-2011*, Tallinn, Estonian Ministry of Social Affairs, 2012.

Estonia still lagged behind countries such as Sweden and Denmark, which with employment rates in the 15-64 age group of 80.2% and 79.3% respectively had the highest percentages in the active population. At the same time, there were larger differences in terms of women's participation in labour markets (the corresponding figures for 2011 in Sweden and Denmark were 77.7% and 76.1% respectively). With regard to unemployment, Estonian unemployment rates rose very fast and by 2010 were among the highest in the EU. At the same time the number of unemployed people who completed the transition to employment in 2011 was relatively high, not least due to a significant drop in the unemployment rate. However, during the same period the number of long-term unemployed rose, reflecting the fact that for certain social groups, once they have left the labour market it can be difficult to get back in again, even if the general economic situation is improving.

Labour market flexibility is reflected in the speed at which people have lost their jobs can find new employment, and how much labour mobility there is between different companies and economic sectors. During the crisis labour mobility decreased significantly. Whereas 9% of employees changed jobs during the years of economic growth, during the crisis this figure fell to 6%. During the period of economic growth 60% of the unemployed found a new job; however, during the first year of the crisis (2009), this figure fell to 40% (Meriküll 2011). Together with the numbers of long-term unemployed, these figures confirm that the labour market only provided weak support for employment.

<sup>3</sup> The employment rate is the working population (employed and unemployed) as a percentage of the total population in the 15-74 age group.

### 3. Vulnerable social groups on the labour market: long-term unemployment, unemployment of young people and older workers, regional differences, and the employment situation of Estonians and non-Estonians

#### 3.1 Long-term unemployment

Long-term unemployment is defined as being outside the labour market for over 12 months. Table 3 shows that nearly half the people who became unemployed during the economic crisis in 2008 and 2009 moved from short-term unemployment to long-term unemployment (with the other half finding a new job within one year). In 2011 the long-term unemployed accounted for 57% of all unemployed people. At the same time, the number of long-term unemployed

Table 3: long-term unemployed, in thousands

	2007	2008	2009	2010	2011
Less than 6 months	13.4	20.3	49.3	38.0	26.5
6-11 months	2.8	6.2	19.7	25.3	11.0
At least 12 months	15.8	11.8	26.1	52.6	49.3
of these, at least 24 months	8.9	6.2	9.0	19.3	27.5
Total	32.0	38.4	95.1	115.9	86.8

Source: Estonian Statistical Office

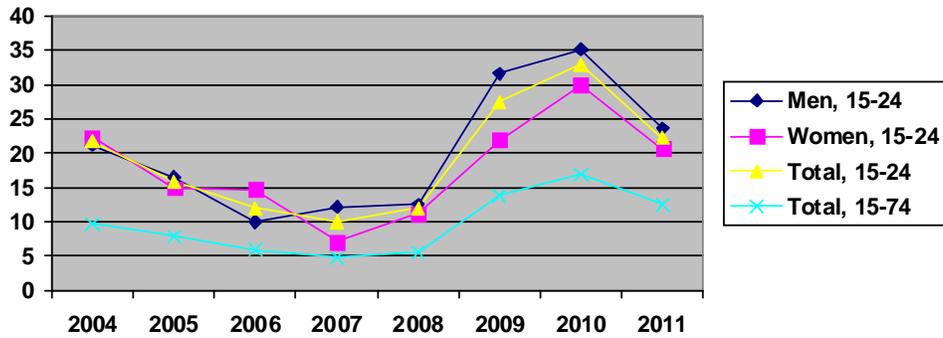
decreased more slowly than the total number of unemployed. The highest percentage of long-term unemployed was in the 50-74 age-group, where they accounted for 67% of the unemployed. In 2011 the percentage of long-term unemployed was over 50% in other age groups, not just in the 15-24 age-group. There was a correlation between long-term unemployment and educational levels of employees. The highest levels of long-term unemployment were found among those who had only completed primary or secondary education (Põldis 2012). This conclusion is borne out by the following analysis of other risk groups.

#### 3.2 Youth unemployment

In 2011 there were 180 000 young people aged from 15 to 24 living in Estonia. 60% of this group was not on the labour market. The main reasons for this were education (87% of the non-active population) followed by pregnancy, maternity or parental leave (4.5%) and military service (2.2%) (4). Throughout the period under review, youth unemployment was higher than general unemployment, and when unemployment peaked in 2010, youth unemployment was twice as high. The fall in unemployment as a result of economic recovery had a particularly strong impact on youth unemployment which fell from 32.9% in 2010 to 22.9% in 2011. During the same period, general unemployment fell from 16.9 to 12.5%. Men were worse affected by youth unemployment, partly because the construction sector, which employs a relatively large number of young men, was particularly hard hit by the economic crisis. Educational levels were one of the key factors determining youth employment: in 2011, 30.9% of young people who had only completed primary education were unemployed, compared to 15% of university graduates. At the same time, unemployment was higher among young non-Estonians than their Estonian counterparts.

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Data from *Development of Estonian Working Conditions, 2010-2011*

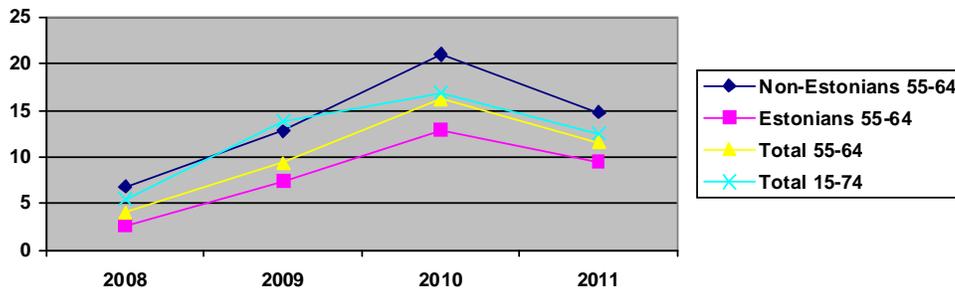


Source: Estonian Statistical Office

Diagram 2: unemployment in the 15-24 age-group and in comparison to general unemployment during the 2004-2011 period, %

### 3.3 Unemployment among older workers

In 2011 the retirement age for Estonian men was 63, compared to 61.5 for women (5). The category of older workers includes the 55-65 age group; as a result the age at which people choose to retire affects the number of older workers (6). In 2011 the 55-64 age group comprised 164 000 people; of these, 57% were in employment, 7.5% were unemployed and 35% were non-active (pensioners and persons who no longer belong to the active population due to illness or disability). In this age group, unemployment was even slightly lower than in the general population. Here too there was a very significant difference between Estonians and non-Estonians. For non-Estonians, unemployment peaked in 2010 at 21%, with the unemployment rate for all people in the same age group at 16.2%, and average unemployment for all age groups at 16.9%.



Source: Estonian Statistical Office

Diagram 3: unemployment in the 55-64 age-group and in comparison to general unemployment during the 2008-2011 period, %

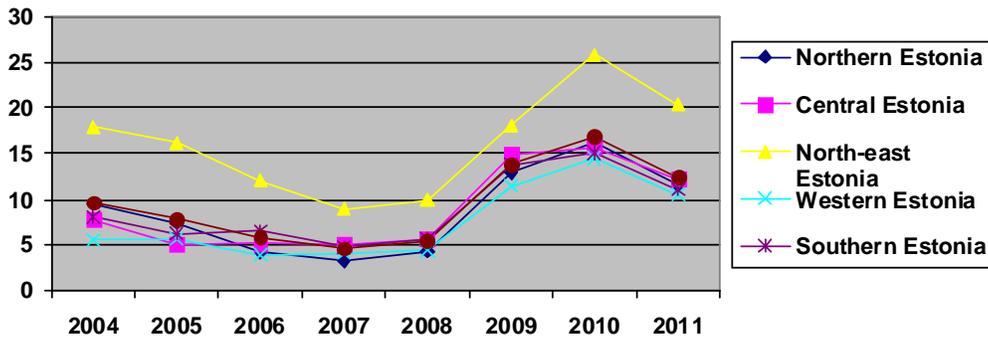
### 3.4 Regional differences

In regional terms north-east Estonia has particularly high unemployment. Even during the years of rapid economic growth, unemployment here was nearly 10%, compared to 4-6% in other parts of the country. In 2010, the unemployment rate in north-east Estonia was 25.8%, falling to 20.3% in 2011 compared to the national average of 12.5%. The reason for this large difference between north-east Estonia and the rest of the country has to do with the high

<sup>5</sup> The retirement age for women will have to be raised to 63 years by 2016.

<sup>6</sup> People can decide to retire before or after they reach retirement age. Monthly pension payments are increased or decreased accordingly. This subject is discussed in greater detail in connection with social security.

percentage of non-Estonians (97% of the population of Narva, the largest city of the region, are non-Estonians).

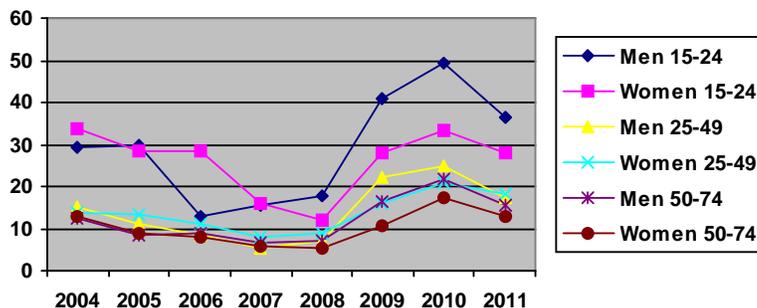


Source: Estonian Statistical Office

Diagram 4: Unemployment by region, 2004-2011

Many non-Estonians can only speak Russian, which makes it difficult for them to find jobs in other parts of Estonia or in international companies. In addition, the share of processing industry in the economy, which employs a relatively large number of non-Estonians, has declined due to structural change.

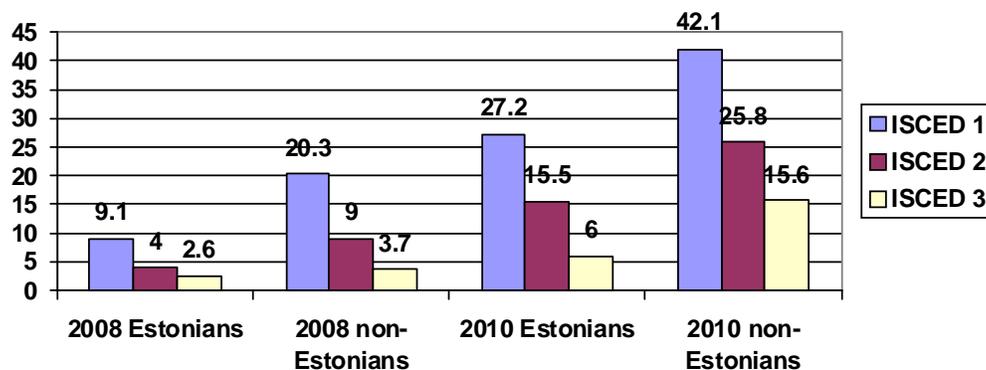
The employment situation of non-Estonians The overall employment situation of non-Estonians is worse than for Estonians, and unemployment is higher. Table 5 shows unemployment rates for non-Estonians according to gender and age, thus identifying the groups most at risk of unemployment. Youth unemployment rates among non-Estonians are particularly striking. We have already presented a general analysis of youth unemployment, noting that unemployment in this age group is higher than for other age groups. Taking into account the figures for Estonians and non-Estonians as well as for men and women, we can conclude that during the years of economic growth following EU accession, unemployment rates among young non-Estonians were almost twice those for Estonians. In 2008 when the crisis was just beginning and had not yet begun to affect employment significantly, in the 15-24 age group unemployment rates for Estonian men and women as well as for non-Estonian women were at similarly high levels (10.1%, 10.9% and 12.2% respectively). Unemployment rates for young non-Estonian men were slightly higher at 17.7%. During the years of economic crisis there was a comparable increase in unemployment rates for the three first groups, peaking at 29.4%, 28.6% and 33.2% respectively in 2010. During the same period, unemployment rates for young non-Estonian men increased to 49.6%. As a result of economic recovery, in 2011 unemployment rates for young Estonian women and men fell to 17.1% and 16.5% respectively. For non-Estonians in 2011 the corresponding values were 28.1% (women) and 36.6% (men). The differences between unemployment rates for Estonians and non-Estonians were not quite as significant - in the 25-49 and 50-74 age groups unemployment rates for non-Estonians (women and men) were lower than for young Estonians, although they were also a few percentage points over the equivalent Estonian age groups. It is interesting to consider the extent to which unemployment among non-Estonians correlates with regional differences in employment.



Source: Estonian Statistical Office

Diagram 5: unemployment among non-Estonians depending on age and gender, 2004-2011, %

There can be no doubt that high unemployment in north-east Estonia is connected with the high percentage of non-Estonians living in the region. At the same time, half the non-Estonians live in the rest of the country, especially in the capital Tallinn, which is in northern Estonia. Here, instead of having to face a combination of unfavourable regional and ethnic factors, non-Estonians can also benefit from more opportunities, thanks to the economic environment. The extent and relevance of resources used to overcome major employment challenges are discussed in the following chapter.



Source: *Development of Estonian Working Conditions, 2010-2011*

Diagram 6: unemployment among an Estonians and non-Estonians depending on educational level, 2008 and 2010, %

Educational levels are closely correlated with unemployment. During the economic boom period and immediately after the beginning of the crisis in 2008, before it had begun to affect employment, it was only in the lowest educational level (ISCED 1) where there were any significant differences in terms of unemployment between Estonians and non-Estonian. At other educational levels unemployment was lower for Estonians, but the difference was not as large. During the crisis there was growing unemployment at all educational levels, with relatively moderate growth being experienced only by persons at the top educational level. Unemployment rates were particularly high during the crisis for persons at the lowest educational level, particularly for non-Estonians. There is a particularly large difference between Estonians and non-Estonians with higher education (ISCED 3); unemployment rates for non-Estonians were 2.5 times higher than for Estonians. One of the reasons for this is that there is a relatively large number of non-Estonian graduates who acquired their skills and knowledge decades ago; their training no longer matches the changing needs of the labour market, which makes it difficult for them to find a job. A relatively large number of these non-Estonians graduated in technical subjects; however, the closure of major industrial companies and the resulting loss of jobs requiring such qualifications has affected their employment situation. In terms of sector, non-Estonians continue to work mainly in processing industry (25.9%), followed by wholesale, retail and vehicle repair (13.6%) and transport and warehousing (10.5%). There are relatively few non-Estonians working in the primary and services sector (Põldis 2012 a).

#### 4. Labour market institutions, legislation, passive and active labour market measures

In order to deal with employment challenges, the Estonian employment insurance scheme (Eesti Töötukassa) has taken over from the former employment office. The scheme has local offices in every county. Labour market issues are also dealt with by some departments of the Ministry for Social Affairs (the labour market, development of working life, and employment policy - information and analysis departments). The employment regulator is responsible for monitoring developments and resolving conflicts. At national level there is also a mediator who can be referred to for example in the case of disputes arising from negotiations on wage

agreements. In addition, there are labour courts, which employees can ask for information or legal support. In addition, these courts can issue recommendations on resolving labour disputes.

The employment insurance scheme pays unemployment and supplementary benefits; it also pays benefits to workers who are laid off or working for insolvent employers. At the same time, the scheme provides various services to assist jobseekers, which are described below. The legislative framework for employment issues was not overhauled and extended till 2009. On 1 July 2009, following years of negotiations between the government, employees and employers, new legislation on employment contracts came into force. This legislation was based on the principle of stable and flexible labour markets ("flexicurity") following the Danish and Dutch model. This happened at a time when the economic crisis had already begun and the government was also struggling to keep its budget deficit within the limits defined by the Stability and Growth Pact. As a result, the governing coalition which submitted the final version of the bill was able to achieve the goal of flexibility, but had to postpone the introduction of social welfare systems to ensure stability (7). Other relevant legislation includes the Labour Market Services and Support Act and the Unemployment Benefit Act.

#### 4.1 Employment contracts, part-time and full-time employment

Employment contracts between employers and employees can either be fixed-term or open-ended. Employment can be terminated either on the basis of the employment contract, through an oral agreement or otherwise (for example in the case of seasonal jobs or persons standing in for other employees). According to figures from the Statistical Office, just 4.5% of employees in 2011 considered themselves to be working on open-ended contracts, with the remainder of employment contracts being fixed term.

Part-time employees usually work shorter hours than other employees. For employees part-time work gives them the option of reconciling work and private life (education, childcare and parenting) more easily. In addition, the option of part-time employment helps to promote female employment. Table 4 shows data on part-time employment in Estonia

Table 4: Part-time employees as a percentage of the active population, 2008-2011, %

	2008	2009	2010	2011
Men	3.3	6.1	6.2	4.3
Women	9.7	13.1	13.8	14.8
15-24	12.4	17	21	16.2
25-49	4.1	7.1	6.5	6.3
50-74	9.4	12.9	14.5	14.6
Total	6.6	9.9	10.2	9.8

Source: Statistical Office, *Development of Estonian Working Conditions, 2010-2011*

During the crisis, percentages of part-time employees grew, especially for women. The largest number of part-time employees were in the 15-24 age group. One reason for the increase in part-time employment was the desire of companies to retain employees despite falling orders. The growth in part-time employment for all workers also has partly to do with the fact that former full-time employees moved to part-time employment during the crisis. During the crisis, there was hardly any decrease in the number of employees, partly due to the fact that as

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In 2010 an OECD report commented as follows: "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 methods, Estonia's strictness of employment protection was previously similar to the European average but a little bit less flexible than the OECD average; it is now more flexible than the OECD average and close to the English-speaking countries. The reform, adopted after a decade of discussions between the government, trade unions and employers, had been conceived as a 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 package was implemented but not the "security" part." (OECD Reviews 2010, p. 14), cf. also Eamets 2010.

in the case of other age groups, people at retirement age preferred to remain in employment, for example by working part-time. This can be explained by the fact that pensions are low.

Another innovative form of employment is teleworking, with employees working outside their employers' premises and in most cases communicating with them using information and telecommunications technology. In 2011 6.1% of the active population chose the option of teleworking, with a slightly higher percentage for management staff (18.9% of all management staff were teleworkers) and highly skilled workers (12.7%). The sectors where telework was most widespread were information communication technologies as well as science and technology (Malk 2012).

Since the new legislation on employment contracts came into force on 1 July 2009, it has become easier and cheaper for companies to lay off workers. The period of notice, previously from two to four months, has been reduced to two to twelve weeks (15 working days for employees working for less than a year in a company, 30 days for employees working from one to five years, 60 days for employees working from five to ten years, and 90 days for employees working over ten years). Under the new legislation redundancy payments have been reduced to just one month's salary. In addition, the employment insurance scheme pays an additional month's salary to employees who can prove that they have been with their employer for from five to ten years, and two months' salary to employees have been in the same company for over 10 years <sup>(8)</sup>. Fixed-term employment contracts are permitted if there are specific reasons, for example the tasks in question are only of limited duration, with a maximum five-year period of employment. However, in this case employers are obliged to continue paying employees their salaries, even if the employment contract is terminated before its expiry. This condition does not apply if the employer goes bankrupt. The new legislation also defines the concept of temporary employment, with employers being obliged to provide employees with relevant information. The new legislation scraps the requirement for various administrative formalities such as the keeping of records on an employee's career and personal files. At the same time the requirement for authorisation by the Labour Protection Inspectorate in the case of recruiting temporary employees and mass redundancies has been scrapped <sup>(9)</sup>.

#### 4.2. Wage policy

The minimum wage also affects labour market flexibility. In 2012 minimum monthly and hourly wages in Estonia were EUR 290 and EUR 1.80 respectively. The purpose of a minimum wage is to prevent exploitative wages and to ensure wages and salaries evolve so as to enable employees to earn a living salary from their work. Minimum wages can hamper employment and flexibility if they exceed the "efficiency wage" determined on the basis of supply and demand. One of the problems with the minimum wage is that "efficiency wages" vary according to sector and region, whereas for political reasons it is practically impossible to have differentiated minimum wages. In Estonia, minimum wages have had practically no impact on the employment situation.

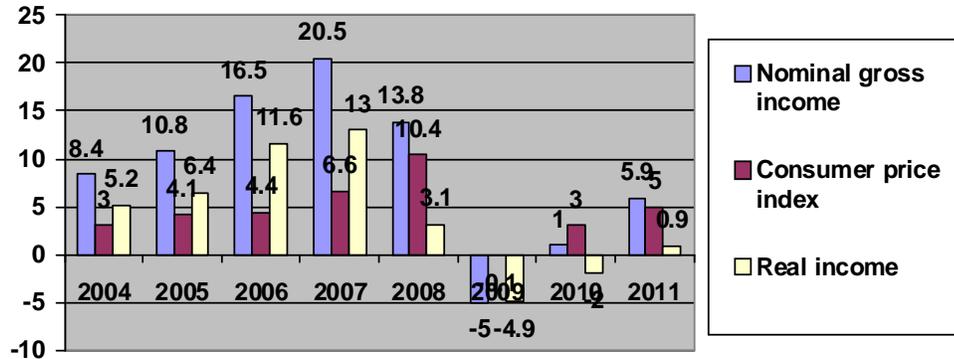
Prior to the economic crisis, till 2008 there was a very rapid increase in Estonian wages and salaries. For example, average nominal wages grew by 16.5% in 2006, 20.5% in 2007 and 13.8% in 2008. In real terms, the corresponding figures were 11.6%, 13.0% and 3.1%. Before the crisis, Estonian economic stability was seriously undermined by the fact that real salaries grew significantly faster than productivity, with the rapid growth in credit leading to a bubble in property prices and fuelling general inflation. Given the fixed exchange rate, the rise in nominal wages led to a corresponding increase in demand for imports which in turn caused a trade balance deficit. In 2007 the balance of payments deficit was 17.4% of GDP. A recurrent question in the Estonian economic policy debate was how to achieve labour market flexibility capable of absorbing economic shocks from external markets. This is of great importance in achieving economic balance given the lack of alternatives (such as currency devaluation) due

<sup>8</sup> For workers with 20 years' employment with the same company, provision under previous legislation for an additional month's salary will continue to apply until 2015 (this means that they are paid four months' salary, compared to three months under the new legislation).

<sup>9</sup> Unemployment Benefit Act (Estonian Official Journal I,21.12.2011, 23).

to a fixed exchange rate and an open capital market. The years of economic crisis have shown that the labour market overall was indeed able to adapt to some extent, however the question arises whether this "internal devaluation" has been enough to ensure Estonian economic competitiveness.

Diagram 7 shows nominal gross salaries in Estonia, together with the consumer price index and real income for the 2004-2011 period. During the crisis price increases slowed down in 2009; at the same time, nominal wages did not start falling until 2009. In 2010 there was a very small increase. Due to rising salaries in 2011, the average nominal income re-gained the pre-crisis level of 2008, but due to the lower number of persons receiving wages and salaries total demand was lower. In real terms, wages also fell in 2010, and in 2009 there was an increase of just 0.9%.



Source: Estonian Statistical Office

Diagram 6: Changes in nominal income, real income and the consumer price index 2004-2011, in %

In 2009, the biggest drops in nominal income were in construction (-13.2%), mining (-7.9%), in public administration and defence (-7.5%) and in the arts and entertainment sector (-7.2%). In this context it should be pointed out that the income index is calculated on the basis of the full-time equivalent of money paid for work. Given the higher number of employees working part-time, the real loss of income is probably larger than shown here. Salaries in the civil service were frozen in 2009, while in other sectors individual agreements between employees and employers resulted in lower incomes.

**4.3. Financing unemployment benefit, supplementary benefit and compensation for the unemployed**

Unemployment benefits are financed from contributions to the employment insurance scheme. In 2012 these contributions amounted to 4.2%, with 1.4% coming from employers and 2.8% coming from employees. Contributions were increased to this rate in 2009, at the beginning of the economic crisis. Later both employees and employers asked the government to cut these rates, a request which was turned down due to the urgent need for budgetary consolidation (until the entry into force of the new Employment Contracts Act in mid-2009, employers' and employees' contributions were 0.5% and 1% respectively).

All persons registered as unemployed are entitled to unemployment or supplementary benefit (10). A comparison of general unemployment rates with the number of registered unemployed shows that around one in every three unemployed persons has not signed up for the unemployment benefit scheme, and is therefore not entitled to compensation or benefits. For example, in the first quarter of 2010, with Estonian unemployment at its peak, the general

<sup>10</sup> Estonian Statistical Office data are based on the ILO definition, according to which an unemployed person is without work, is actively looking for employment and, in the event of finding work, is prepared to begin a new job within two weeks. A registered unemployed person is someone who has no work and is registered in Estonia's unemployment benefit scheme.

unemployment rate was 20.7%, compared to 14.4% registered unemployed. The main reason for not drawing unemployment benefits was having sufficient resources of one's own (34%), not being eligible for unemployment or supplementary benefit (31%), or not being offered a suitable job by the employment insurance scheme (only 20%) (Põldis 2012 b).

Registered unemployed persons are entitled to unemployment or supplementary benefit. The right to unemployment benefits applies to anyone who has been registered unemployed for at least 12 months over the last three years, and who did not leave their last job on their own initiative or by mutual agreement (**11**). During the first hundred days of unemployment, an unemployed person receives 50% of their last salary, followed by 40% of the average income. Unemployment benefits are paid for a maximum 360 days, but only if the person concerned paid contributions for at least 110 months before losing their job. Before the Employment Contracts Act was adopted, the social partners had agreed on 70% of the last salary during the first 100 days, followed by 50%; however, a decision on these levels of benefits has also been postponed till 2013. Furthermore, eligibility to unemployment benefit for persons leaving work on their own initiative or by mutual agreement has also been postponed. Since 1 July 2009, the minimum unemployment benefit has been set at half the minimum wage. In 2011 the average monthly unemployment benefit was EUR 257

Anybody who has had at least 180 days of employment or employment-like activity during the 12 months preceding registration is entitled to supplementary benefit (**12**). Supplementary benefit is EUR 64 a month, equivalent to 8% of the average income and 23% of the minimum wage. It is therefore well below the poverty threshold and needs to be supplemented by additional income in order to ensure a livelihood. Supplementary benefit is paid for a maximum of 270 days. In 2011 an average 12 000 registered unemployed persons received unemployment benefit (22% of the registered unemployed), and 10 300 persons received supplementary benefit (19% of the registered unemployed). Overall, recipients of these two benefits represented 41% of the registered unemployed, and 46% of all unemployed. At the same time, 64 500 persons did not receive any benefits at all, despite not being supported by any active employment policy measures. Anybody who registers as unemployed is also covered by the Estonian health insurance scheme. Under Estonian law, an employee who voluntarily takes out health insurance pays 30% of his average gross salary in health insurance contributions. In 2011, this contribution would have amounted to EUR 103 a month, i.e. 37% of the minimum wage and well in excess of the EUR 64 supplementary benefit. This means a registered unemployed person benefited more from health insurance cover than from the actual value of the supplementary benefit payment. An unemployed person is only entitled to turn down a job which does not match his educational level, work experience and salary expectations during the first five months of unemployment. After five months of unemployment he must accept any job offer remunerated at or above the level of unemployment benefit or the minimum wage.

#### 4.4 Active labour market measures

One of the responsibilities of the employment insurance scheme is to find suitable jobs for jobseekers and to find suitable employees for employers. To this end, the scheme collects information about job vacancies, and on the basis of interviews and advice, it then tries to find suitable work for the unemployed. The system was not very effective, with only 58 550 unemployed people finding work in 2010, just 37.5% of a total of 155 922 persons. The equivalent figures for 2011 were 49 274, or 40% of a total of 122 117 unemployed persons (Põldis 2012 b). This means that less than half of all unemployed persons were able to find a new job within one year. The new database enables unemployed persons to find suitable jobs; employers also have access to the database, enabling them to find suitable persons to fill their vacancies.

Labour market services are provided pursuant to the Labour Market Services and Support Act and the 2007-2013 *Programme on increasing the supply of skilled labour* of the European

<sup>11</sup> Unemployment Benefit Act (Estonian Official Journal I,21.12.2011, 23).

<sup>12</sup> Labour Market Services and Support Act (Estonian Official Journal I,21.12.2011, 23,122011).

Social Fund. Individual plans are drawn up for jobseekers. Services include careers advice, labour market training courses, job search guidance, work experience, and state subsidies for employment. In addition, there is also funding for business start-ups. In 2010 there was an increase in the number of wage cost subsidies paid to companies recruiting unemployed persons. In 2008 labour market policy expenditure amounted to 0.16% of GDP; however, in 2009 it increased to 0.51% and in 2010 to 0.57%. In line with falling unemployment, in 2011 was a slight decrease in this expenditure to 0.485% of GDP. During this period, active labour policy measures and passive labour policy measures accounted for around two thirds and one third of all labour policy measures respectively.

## **5. Role of the social partners and local authorities**

Labour market developments were largely determined by trilateral consultations between employers, employees and the government. The fact that Estonia has been governed by centre-right coalitions for practically all of its 20 years of independence is clearly reflected in the way the labour market is organised. From this it might be concluded that cooperation between the government and employers was relatively smooth, with less extensive representation of employees' interests. To a large extent employment and social policies were market-oriented in the past. However, the economic crisis focused attention on the issue of employees' social welfare, thus disrupting relations between the three parties involved in cooperation.

### **5.1. The social partners**

The most influential employers' organisation is the central Employers' Association (Töoandjate Keskliit), bringing together 24 branch associations and 60 major companies. Altogether 1500 companies employing around 35% of all private-sector employees are linked to this organisation. Other important representative organisations here are the Estonian Chamber of Industry and Commerce and the Association of Estonian Small and Medium Enterprises (EVEA).

Around 10% of all employees are trade union members. The most influential organisations representing employees are the Estonian Trade Union Confederation (AKL) comprising sectoral organisations such as the Transport and Road Construction Workers' Trade Union, as well as the Employee Trade Union (TALO), representing employees in the education and research sector. The main differences between these two organisations have more to do with their coverage in terms of sector than ideology. Low levels of trade union membership among Estonian employees is somewhat surprising as many of the foreign companies operating Estonia are based in Scandinavia where 70-80% of parent company employees belong to trade unions. However, trade unions are better represented in larger companies. For example, in companies with over 250 employees, 48 % of staff are trade union members, compared to 40% of local authority staff and civil servants (Viilmann, Soosar 2012).

This situation is one of the reasons why there is so little collective bargaining, with most salaries being set by mutual agreement between employees and employers. Nevertheless, the number of employees covered by collective bargaining exceeds the number of trade union members. There are two options for concluding collective wage agreements in Estonia. If employees are represented by a trade union, this concludes a wage agreement on their behalf with the employer. Alternatively, in the absence of a trade union, a general assembly of all employees can elect a representative to negotiate a wage agreement. In Estonia around one-third of all employees in companies with over five employees are covered by collective wage agreements. Negotiations also address issues such as work organisation and health and safety at work. With regard to remuneration, around three-quarters of employees feel that conditions should be negotiated individually, whereas only 20% feel that they should be negotiated jointly with other employees (Espenberg, Jaakson, Kallaste, Nurmela 2012).

Prior to 2009, there was extensive cooperation between the Estonian government, employers and employees on drafting the new Employment Contracts Act. However, this act was adopted in early 2009, by which time economic crisis had already reached Estonia and was putting pressure on the government budget. The Estonian government was trying to keep the budget deficit below 3% of GDP in order to join the euro zone. As a result, it was decided to adopt the measures envisaged in the act to enhance labour market flexibility, while postponing measures to guarantee and extend employee security, for example by increasing unemployment and

supplementary benefits. These changes were not easy for employee representatives to agree to, but in the context of the crisis an agreement was still reached. However, in 2011 there was a more serious conflict over a proposal, backed by both employers and employees, to decrease unemployment insurance contributions from 4.2% to 3% (with employees' and employers' contributions of 1.8% and 1.2% respectively). However, the government decided to maintain contributions at the previous level, and pointed out that there was a need to build up reserves. The government also transferred management of funds in the unemployment insurance scheme to the Estonian Treasury, explaining that there was a need to consolidate government expenditure. Given that tax rates are set by the Parliament, and that the governing coalition has a large enough parliamentary majority, suggestions by employers and employees are only recommendations and are by no means binding on the government. During this conflict employers and employees withdrew their representatives from trilateral negotiations; cooperation was not resumed until summer 2012.

## **5.2. Local authorities**

Estonia has a two-tier system of local and regional government, comprising 15 counties and 226 local authorities (33 cities and 193 municipalities). The employment insurance scheme has regional branch offices, where the unemployed can register and benefit from various services. In terms of social services, it is the responsibility of local authorities to organise welfare services and care for the elderly, disabled and other persons in need of help; they also run old people's homes, women's refuges and other social facilities. Local authorities are responsible for paying out maintenance allowances from funds allocated by the state budget. Local authorities have the main responsibility for healthcare services (e.g. GPs). They also reimburse medical costs to persons without health insurance. Most local authorities are small, with half of them representing just 2000 residents, which means they only have limited capacity to provide social services. Their main source of income is income tax levied by the tax and customs authorities; in 2011 11.4% of this went to local authorities, thus accounting for 46% of their revenues (with personal income tax rates of 21%) (Sannik, ... 2011).

## **6. Welfare and adaptation to the economic crisis**

This chapter describes some features of the Estonian welfare system insofar as the relevant services and their funding are connected to labour market development. The following paragraphs give an overview of this area, describing changes in the welfare system in relation to the more general changes decided on during the economic crisis.

### **6.1. Social security and pensions**

Estonia has a three-pillar pensions system. The first pillar is a pay-as-you-go scheme funded by social expenditure, 20% of which is used for pension payments to persons who only have first-pillar pensions. The second pillar is a funded scheme with 4% coming from welfare expenditure for persons paying an additional 2% social security contributions, in which case first-pillar funding is reduced from 20% to 16%. The third pillar is also a funded scheme, with contributions being paid by the person concerned into a pension fund chosen by them, with tax breaks on payments both into and out of the fund. Pension payments are determined both by the number of years worked and the level of income which social security contributions were levied on. Retirement income comprises payments from the three pillars. In addition, there is a basic pension for persons who have paid less than 15 years of pension contributions as employees in Estonia, as well as disability benefits and surviving dependants' pensions. The average pension is 40% of the average net salary. Pensions and practically all other benefits paid to retired persons are exempt from taxation. In addition, pensioners do not have to pay any social security contributions.

### **6.2. The health insurance scheme**

Like in most EU Member States, Estonian health care is based on a health insurance scheme, which covers the cost of services provided by medical institutions. The health insurance scheme is funded from social security contributions, levied at a rate of 33% of earnings, with 13% of earnings going to the health insurance scheme. This funding covers all treatment costs,

as well as subsidies for medicines and compensation for lost earnings in the event of temporary disability. Health insurance is compulsory and covers all residents of the country. In addition to the health insurance scheme, some healthcare expenditure is taxpayer-funded from national and local budgets, for example in the case of medical treatment for a non-insured person. Estonia also has private health insurance schemes, but their share is negligible. Most healthcare costs are covered by the State insurance scheme: in 2008 it covered 66%, compared to 8.5% from the government budget, 20.6% from patient contributions and 1.5% from private health insurance schemes (Tervishoiu kogukulud ["Healthcare expenditure"] ..., 2011). Patient contributions, which were just 14% in 1999, are steadily rising.

The Estonian healthcare system is funded on a similar basis to other European countries, with most costs covered by the health insurance scheme, and most services being categorised. This system worked relatively smoothly so long as the economy grew quickly. A growing tax base ensured a steady flow of funding and smoothed out any discrepancies in the system. However, the crisis saw recession, falling tax revenues and a possible deterioration in services together with longer waiting times. As in the case of pensions systems, rising dependency rates are becoming a problem, with some 40% of users not paying any contribution towards the funding of the health insurance scheme providing services. To overcome this problem, the number of services covered by general tax revenue has been increased together with patient contributions. At the same time the tax base for social security contributions has been expanded, for example pensions are now partially covered by social security contributions. Funding problems are also exacerbated by the growing share of private insurance schemes resulting in the problem of adverse selection in that the viability of the system is being undermined by better-off clients moving to private insurance. Above all, the crisis management programme focuses on deliberate choices in terms of treatments and medicines, together with restrictions on certain services (Eesti Haigekassa ["Estonian health insurance scheme"] ... 2011).

### **6.3. Maintenance allowances and benefits for families with children**

Maintenance allowances are paid to ensure a minimum income. These allowances are calculated on the basis of the income threshold and the income declared by members of the household minus housing costs. Income is supported up to EUR 64 per adult and EUR 51 for each additional household member. Housing costs are deducted when calculating maintenance allowances. At the same time costs arising from housing use and heating can be compensated up to a ceiling set by local authorities. Maintenance allowances can also be paid as an additional benefit to recipients of unemployment or supplementary benefit.

The main benefit is a parental allowance paid by the health insurance scheme for 140 days during pregnancy and maternity, followed by a benefit equivalent to the average income of the previous year, but no more than the average salary for the last three years, paid for 19 months. If the parent concerned was not employed, this benefit is EUR 230 a month.

In addition there is a child benefit of EUR 19 for the first and second child and EUR 58 for each subsequent child up to the age of 16 or until the end of school in the year when the child becomes 19 years old. Childcare benefit of EUR 45 a month is paid until the child's first birthday, followed by EUR 38 a month up to the age of two and then EUR 19 up to the age of eight, if the family has another child less than three years old or if the family has three more children. Furthermore, parents get a one-off payment of EUR 320 on the birth or adoption of a child, and children leaving a children's home receive a payment of EUR 383. At the same time, from the birth of a second child the personal income tax allowance is increased by EUR 144 per child. Compared to other benefits, child benefits and the parental allowance in particular are the only benefits which significantly enhance recipients' living standards. Child benefit are mainly paid during a child's first two years and are intended to compensate for loss of earnings.

### **6.4 Educational system**

In Estonia primary and secondary school education are funded by the State. In tertiary education the State "orders" a set number of graduates for each subject from universities subject to public law. Universities can also choose to take on additional students whose education is not State-funded. In addition, private universities offer courses, particularly in law

and economics, with most costs covered by the students' study fees. The system offers young people a wide range of study options, but there are also problems, e.g. in terms of access to higher education with only a very few students getting scholarships or benefits. A key subject for political debate is the always topical subject of the match between the number of State-funded graduates and labour market needs. Thanks to greater freedom of choice, the number of students studying social sciences, economics and law has grown; at the same time, the demand for engineering and sciences is relatively stable, although there is particularly strong interest in information technologies and medicine.

The second issue of direct relevance to the labour market is the balance between academic education on the one hand, and polytechnics and vocational education on the other. Both universities and vocational educational institutions have invested considerably in infrastructure over the last five years, with much of the funding coming from EU Structural Funds. Businesses have invested more in vocational educational infrastructure, with links between theoretical education and practice becoming closer. During the period of economic growth funding for schools and business increased substantially. The educational system then came under pressure from the economic crisis due to labour market trends. The unemployment figures cited above clearly show a close correlation between educational levels and employment. At the same time, from the perspective of the labour market, educating disadvantaged groups and the number of school dropouts represent challenges for the educational system. Combined with active labour market policy measures, retraining and further education are of great importance. However, funding in Estonia for such measures is limited, not only relative to GDP, but also relative to educational expenditure.

Compared with other EU Member States, Estonian educational indicators are slightly above average. For example, in 2006 82% of persons in the 25-64 age group had completed secondary education, compared to the EU-27 average of 77.8%. In 2010 40% of young people in Estonian had completed higher education (ISCED 3), compared to the EU-27 average of 38% (Estonian Statistical Office). Demographic decline and 25% fewer babies being born per year mean a significantly smaller intake for educational institutions and a need for them to consolidate.

Over the last three years the number of foreign students in Estonia has grown rapidly, at a rate of 15-20% per year. This growth has been supported by funding programs, for example the "DoRa" programme to fund doctoral studies and international education, funded from the 2007-2013 ESF.

### 6.5. Total welfare expenditure

Total welfare expenditure includes expenditure on pensions, healthcare and family benefits. It also includes benefits paid to the unemployed. Diagram 7 shows trends over the last five years in Estonia and some other EU Member States.

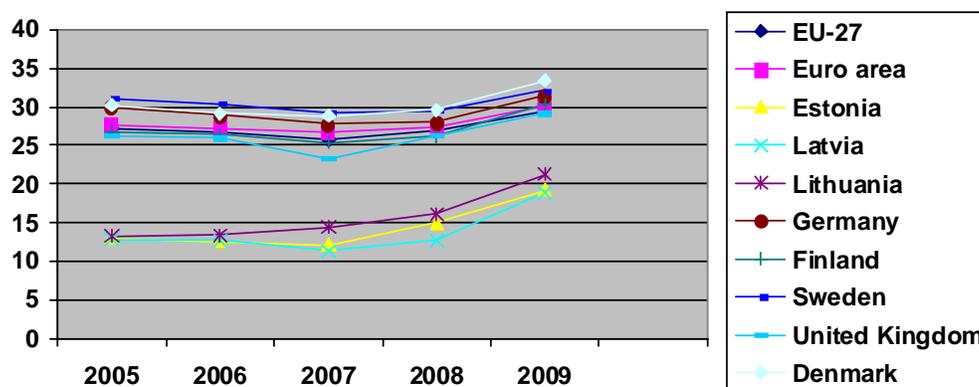


Diagram 7: Total welfare expenditure in the EU-27, Estonia and several other EU Member States, 2005-2009, as % of GDP.

Welfare expenditure in Estonia, Latvia and Lithuania was 19.2%, 18.8% and 21.3% respectively in 2009, significantly under the EU-27 average of 29.5%. The highest levels of expenditure were in Denmark (33.4%), Sweden (32.1%) and Germany (31.4%). In Finland and the United Kingdom the corresponding figures were 30.3% and 29.2% respectively. The relatively low level of welfare expenditure in the Baltic states has mainly to do with low pensions compared to average income.

In 2009 welfare expenditure went up in all Member States, mainly due to the economic slowdown and higher expenditure caused by the crisis (expenditure arising from unemployment). In Estonia these figures mainly reflect a drop in GDP, amounting to -14.3% in 2009. On 1 April of the same year pensions went up by 5% due to indexation, an increase accounting for half of the rise in annual welfare expenditure. Expenditure arising from unemployment also increased significantly. Low levels of welfare expenditure partly have to do with generally lower levels of income, but they also reflect deliberate economic policy choices, with (relatively) low taxes and relatively moderate expenditure. Indeed, in comparison with the EU average and more developed Eastern European countries (such as Slovenia and the Czech Republic), Estonian expenditure is very low.

## **7. Measures taken during the economic crisis, and lessons learned**

### **7.1. Measures**

In 2009, which was a year of crisis, the Estonian government took a series of measures to consolidate the budget. Fiscal policy measures had the largest budgetary impact. VAT was increased from 18% to 20%, with the reduced VAT rate rising from 5% to 9%.

We have already mentioned how implementation of some measures relating to the new Employment Contracts Act was postponed until 2013. There were also some major changes in the pension system. The government changed indexation of pensions so that in 2009 pensions were not increased by 14% as originally planned but only by 5%. In addition, the government suspended its contributions into the second pillar of the pension system till the end of 2012. It was also decided to raise the retirement age for women to 63 by 2016, and to continue raising it up to 65 with the retirement age going up by one year every four years.

With regard to health insurance, the Health Insurance Act was amended - previously, the health insurance scheme had paid 80% of an employee's current salary for the second day of illness, whereas under the amended legislation the health insurance scheme only pays from the ninth day of illness, with no compensation for the first three days of illness and employers paying compensation from the fourth to the eighth day of illness. While these measures undermined the credibility of the social security system, in the medium term they were able to prevent a major budget deficit.

Strict checks were applied to local authority budgets, at the same time as limiting gross debt to 60% of GDP and making public sector investments conditional on co-financing from EU programmes.

### **7.2. Lessons for the future**

Despite the ongoing crisis Estonia achieved an important political goal with accession to the common currency on 1 January 2011. Introduction of the euro has improved the country's financial stability; however in return it has brought additional financial commitments due to involvement in EU aid programmes and funding mechanisms.

The crisis played an important role as a test of the administrative capacity of Estonia's different tiers of government. The government achieved its budget policy goals through decisive measures, although this made cooperation with the social partners more difficult.

Estonian fiscal policy, which is generally pro-cyclical, helped to stimulate growth, but at the same time it exacerbated recession during the crisis due to the almost complete lack of measures to stabilise total demand.

Labour market policies came under severe pressure. For example existing mechanisms and funding proved insufficient in the face of mass unemployment. An analysis of the groups at risk on the labour market highlighted some of the specific problems.

Clearly the labour market was not sufficiently flexible to absorb unemployment. Many Estonians have found work abroad, and this has curbed unemployment, although in the long-term this phenomenon could undermine employment prospects and economic potential in Estonia.

The percentage of the active population is relatively high in Estonia, however additional options in terms of part-time work and retraining could further boost employment and help to integrate problem groups in particular in the labour market.

Both in relative and absolute terms, resources for active and passive labour market policy measures are extremely limited, despite 40% of these resources coming from the EU's European Social Fund. One major problem is that many of the unemployed - 64 000 persons in 2010 - do not get either unemployment benefit or supplementary benefit. Their subsistence is an issue which needs to be addressed. To this end, we need more exact facts about their possible sources of income, including illegal earnings. We also need to consider whether welfare benefits could help to prevent such illegal activities.

Increased long-term unemployment during a period when economic growth was resuming has partly to do with the general tendency of labour market developments to lag behind economic cycles. At the same time, growth in this type of unemployment also shows that active labour market policy measures have only had a limited impact on certain segments of the labour market and risk groups. Furthermore, compared to other EU Member States funding for these measures is limited, both in relative and absolute terms.

The Estonian welfare system has a strong focus on supporting families with children, the aim being to raise birthrates. Clearly support for families needs to be developed and expanded. Older children also need more generous support, not just children under the age of two.

The situation of elderly people must be improved, not just through higher pensions, but also by developing a system offering a wider range of services (old people's homes, nursing homes, day care centres for elderly people).

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***Members of the Workers' Group representing Estonia***

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Carr Liina  
International Secretary, Confederation of Estonian Trade Unions (EAKL)

INT, REX, TEN



Viies Mare  
Researcher, Centre for Economic Research, Tallinn University of Technology; Estonian  
Employee Unions' Confederation (TALO)

ECO, INT, SOC

***European Economic and Social Committee***

***Workers' Group  
Rue Belliard 99  
B – 1040 BRUXELLES***



***Workers' Group secretariat  
Telephone : +32 2 546 99 32  
Fax: +32 2 546 97 55  
E-mail: [gr2@eesc.europa.eu](mailto:gr2@eesc.europa.eu)  
Internet: <http://www.eesc.europa.eu/gr2>***

