

Economics Department



LABOUR MARKET REVIEW

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MAIN DEVELOPMENTS IN THE SECOND HALF OF 2008

The second half of 2008 differs from recent years by robust corrections on the labour market: unemployment soared and wage growth came to a drastic halt. This review focuses on labour market developments in the second half of 2008, the time of further economic decline in Estonia. In the first half-year the reaction of the labour market was almost indiscernible, whereas in the second half the speed of correction exceeded all expectations. In the final quarter, the developments of the recession and labour market indicators were already so rapid that hesitations regarding the insufficient flexibility of the Estonian labour market faded.

The number of the employed started to decrease already in the second and third quarters of 2008, though relatively modestly. Compared to earlier periods, employment declined around 0.2–0.3% in both quarters, which means that the employment rate did not change, as the total working age population decreased to a similar extent. Since labour supply grew, as numerous school graduates entered the labour market, the number of the economically inactive diminished and unemployment growth surged. In the third quarter, the unemployment rate rose to the highest level of the past two years (6.2%) and the number of the unemployed climbed to 44,000 (see Figure 1). Owing to the economic decline, the labour market entrants experienced greater difficulties with finding employment; the creation of jobs halted as well.

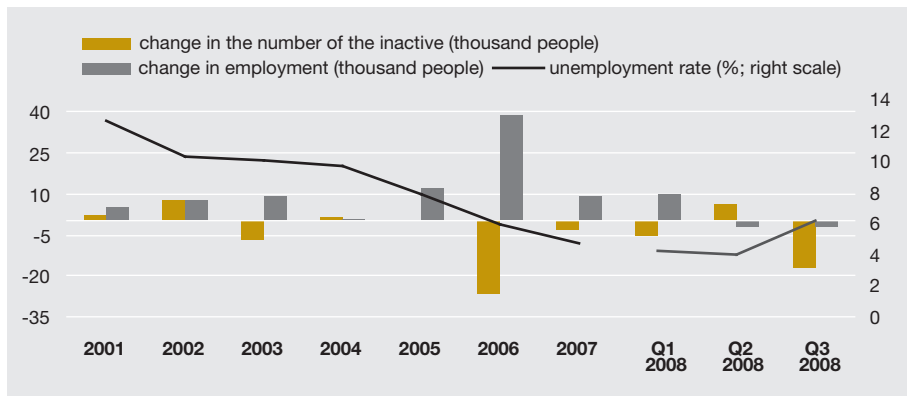


Figure 1. Main labour market indicators

The available data concerning the fourth quarter indicate an even faster unemployment increase and deepening pessimism in the near future. The number of the employed started to react to the economic decline with a two-quarter lag, but ever so more abruptly. At year-end annual growth in registered unemployment had already reached 115%.

At the time of strong economic growth the main goal was to increase labour supply, the inac-

tive mainly being the sole source of additional workforce. The flexibility of the labour market was boosted by active labour market policy: jobs were made more attractive through more flexible working hours, structural (incl. also regional) jobs and additional wage growth. At the time of recession, however, it is the other side of the labour market flexibility that becomes important: the simplicity of lay-offs or wage cuts, the extent of using flexible employment contracts, unemployment insurance and social guarantees.

In the conditions of economic downturn there is no need for the same amount of workforce and with the waning demand the domestic employment will drop further. The robust increase in labour costs and a sharp decrease in orders forces entrepreneurs to seek opportunities to reduce the costs. Some curb the number of employees, others cut wages and some do both.

From the perspective of the state budget the considerably cheaper – and thus possibly preferable – option would be to reduce wages, which would entail a drop in the effective personal income tax rate, but would require no use of unemployment insurance or unemployment and other social benefits. In order to avoid massive unemployment, the first alternative in some fields of activity may be a shortened working week; also the option of eliminating bonuses and additional remunerations (incl. in the public sector) or a solidary wage reduction should be used. Withholding additional remunerations does not require adjustments to employment contracts; solidary wage reduction enables to amend employment contracts as cheaply as possible, it is understandable to the employees and does not offend their sense of justice too much. Structural changes in the economy would thus be slightly slower, but less painful.

The upward wage pressures noted at the beginning of 2008 started to wane gradually in the second half of the year. In the final months of 2008, nominal wage growth halted considerably and real wages shrank. Due to the extent of correction in labour demand, nominal wages are likely to decrease in the near future, which also rapidly eases inflationary pressures.

Owing to the high inertia of wage growth, it abated slower than nominal economic growth. Therefore, the period of strong economic decline is characterised by growth in unit labour costs and the dropping share of profit in GDP. The share of profit will stabilise or begin to rise and the upward trend of unit labour cost growth will reverse only after the recession hits the bottom, stabilises and shows signs of growth again.

At the times of economic turmoil, the labour market and social policy must support the rapid and adequate reaction of the labour market to economic changes. The flexibility of the labour market is the key prerequisite for competitiveness, fostering the relocation of labour force from less productive to more competitive companies along with relevant training. Until now the rapid growth period has disguised the problems in that area, but the bottlenecks emerge as economic growth slows. Amending the Employment Contracts Act was vital and its implementation could be even faster.

LABOUR SUPPLY AND DEMAND

Labour force participation and economic inactivity

The aggravation of the economic decline in the second half of 2008 revealed breaking developments in several labour market indicators. According to the labour force survey, in the third quarter of 2008 the number of the inactive¹ aged 15 to 74 had dropped 5% (by 17,200 persons) compared to a year ago. The number of the inactive decreased especially fast in Northern and Central Estonia (10% and 9%, respectively). Inactivity mainly diminished due to the declining number of students; to a smaller extent, inactivity also decreased among the discouraged, people in retirement age or attending to children (see Figure 2). As employment growth stopped in the third quarter of 2008, the increased economic activity of the population boosted the number of the unemployed.

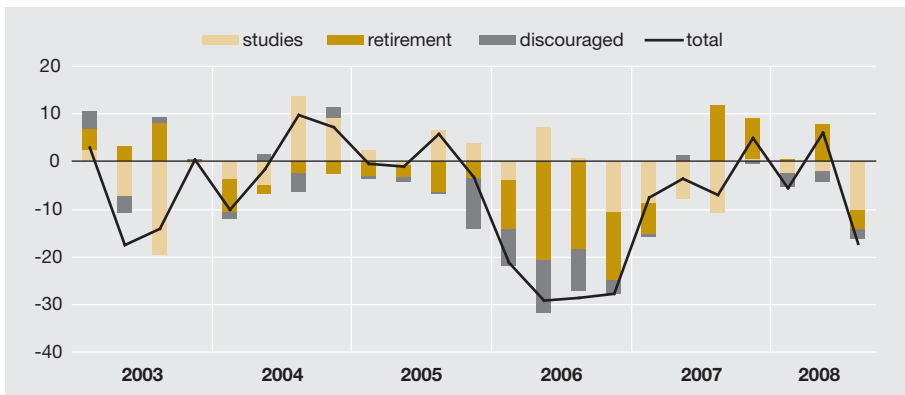


Figure 2. Change in the number of inactive and reasons for inactivity (y-o-y; thousand people)

Along with a drop in inactivity, in the third quarter of 2008 the labour participation rate² of the working age population rose to 67.6%; that is 1.6 percentage points more than a year ago.

Labour force increased mostly owing to the young (aged 15 to 24) and the elderly (50 to 74) (see Figure 3). The number of the young labour force participants exceeded the previous year's figure by 4,900. This was mainly caused by the demographic specifics of Estonia, as the summer of 2008 boasted a relatively large number school graduates (the so-called Singing Revolution generation, i.e. the young born during 1987–1991), who entered the labour

¹ A person is inactive when he/she does not work and is not looking for work either (the retired, students, homemakers and the discouraged).

² The labour participation rate equals the share of the employed and unemployed in the working age population.

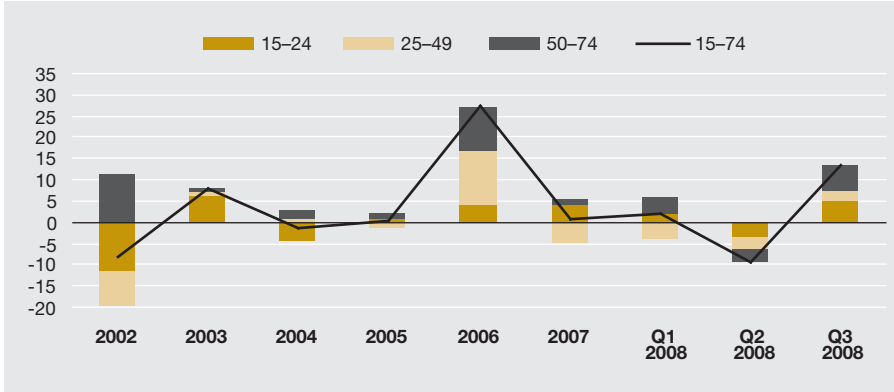


Figure 3. Contribution to employment growth by age groups (thousand people)

market. Thus, the decrease in inactivity and growth in labour force participation among the young was more notable.

Earlier, the increasing share of students has been associated with wider education opportunities and the fact that prolonging studies is an alternative for the young; thus, the educational system has become a reservoir for those who would otherwise remain unemployed. Unfortunately, it has not been the best time for numerous young people to enter the labour market. The state has no means to create additional student places, labour demand is rapidly declining and the global economic crisis renders job seeking abroad also futile. Besides, surveys on economic cycles indicate that in difficult times the labour market risks primarily manifest themselves among the young and ethnic minorities. New labour market entrants have little or no work experience, they are offered jobs with lower qualifications and less pay. The economic crisis damages their outlooks even further.

Apart from age, people's behaviour on the labour market is also affected by their regional mobility. Although the differences between regions have been decreasing in recent years, the development of the Estonian labour market was still quite uneven across regions. In the third quarter of 2008 activity increased in Northern, Central and Southern Estonia, while in North-Eastern Estonia it decreased further (see Figure 4).

Exact data for the fourth quarter of 2008 and the beginning of 2009 are currently unavailable. Most probably, though, employment decrease and unemployment growth picked up considerably and inactivity may have started to increase again because of giving up job-seeking and poorer outlooks to find a job.

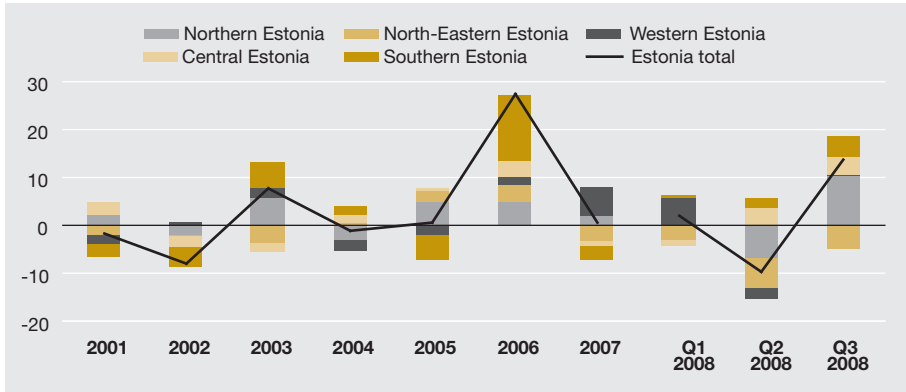


Figure 4. Contribution to employment growth by regions (thousand people)

A reasonable level of unemployment poses no threat to the economy and society, whereas large-scale and prolonged unemployment involves several serious risks. These include the personal problems of the unemployed, social marginalisation of the unemployed, loss of qualification and deterioration of workforce potential. In order to utilise the country's labour resources more effectively and maintain the working capacity and activity of people at the times of economic decline as well as adjust their skills to the required structural changes, the benefits and programmes of the labour market policy should be used more extensively. As employment growth will primarily be hindered by the scarcity of vacancies in the forthcoming years, the availability of active labour market measures should be increased (e.g. in-service training, language studies, retraining and providing enterprise support to the unemployed), using also the structural funds of the European Social Fund.

Employment

The economic decline accelerated in the third quarter of 2008, but employment did not display marked signs of decrease according to Statistics Estonia. Employment dropped only 0.24% year-on-year, whereas GDP decreased 3.3%. At the backdrop of the waning production volume the relatively high employment level continually causes negative productivity growth (calculated per employee). Although no exact data are available on the fourth quarter, the economic recession continued to intensify and the employment rate probably plummeted.

Although the total number of the employed remained relatively stable, extensive structural changes continued in the third quarter of 2008. According to the labour force survey, for

instance, employment grew in manufacturing (by 7.3%, i.e. 9,400 people). In the construction sector, where employment had soared in recent years, a drastic turn occurred in the third quarter and the number of the employed dropped (by 4.8%, i.e. 4,100 persons). The decreasing employment rate in the construction sector was logically related to the shrinking demand and construction volumes, whereas the rise of employment in manufacturing is not confirmed by business statistics. Instead, the latter indicates a gradual decline in the number of the employed in manufacturing throughout the first three quarters of 2008 (see Figure 5).

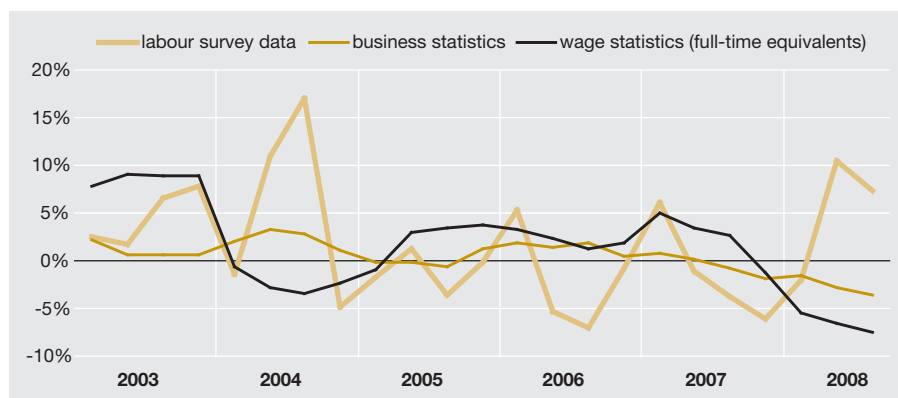


Figure 5. Employment growth in manufacturing based on labour survey, business and wage statistics (y-o-y)

According to business statistics, employment in manufacturing decreased to 3.6% in the third quarter of 2008. According to wage statistics, the average number of full-time employees dropped at an ever faster pace, posting a 7.5% decrease in the third quarter. The great discrepancies between various statistical data were comparable to those of 2004, which (in hindsight) were caused by a significant increase in labour migration following the accession to the European Union. The labour force survey considers Estonian residents as employed regardless of whether the place of employment is in Estonia or abroad. It is difficult to determine whether the year 2008 saw a similar increase in domestic employment rather than an acceleration of net migration, but a gap of 15 percentage points between the employment growth indicators considerably distorts both the productivity data and the conclusions drawn from them.

The Estonian labour market is still very flexible: in difficult times the changes on the labour market occurred relatively fast. As labour demand presumably decreased even faster in the fourth quarter, the changes that occurred then were probably the greatest of the year. It also appears that when encountering difficulties, companies do not start laying off workers at once. Many try to keep their personnel and reduce wage costs by decreasing work hours in order to cope.

To estimate the migration within the European Union, we can use Eurostat's employment data based on the concept of domestic and total employment³. Their difference indicates the net migration, i.e. the number of Estonian residents working abroad less the number of the residents of other countries working in Estonia (see Figure 6).

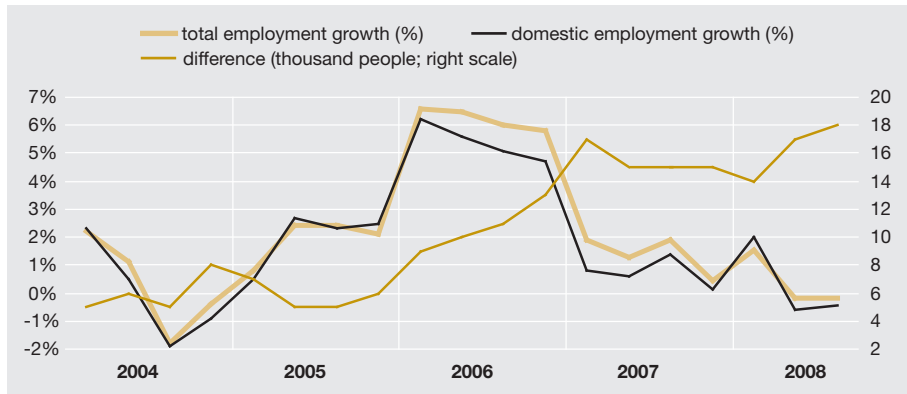


Figure 6. Total and domestic employment

Source: Eurostat and authors' calculations

According to Eurostat, the number of Estonian residents working abroad has been constantly increasing in recent years. Even the inflow of the residents of other countries into Estonia has not been able to offset that. In the third quarter of 2008, net migration climbed even further, and thus domestic employment decreased slightly more than total employment (0.5% vs. 0.2%).

Thus, in the first three quarters employment growth in the Estonian labour market decreased only slightly. The greatest change probably occurred in the fourth quarter, but the exact data are still unavailable. Considering the global extent of the economic crisis, emigration from Estonia may decrease in the near future as finding a job has become more difficult also abroad. After losing their jobs people thus become inactive rather than go to work abroad.

³ Total employment includes domestic employment and also Estonian residents working abroad; it does not include non-resident foreigners working in Estonia.

This, however, constitutes a greater burden for the Estonian unemployment insurance and social benefits system.

Vacancies

Although the statistics on the vacancies of the Labour Market Board are not representative and thus do not apply to the entire Estonian economy, this analysis uses the information as one possible indicator of labour demand. According to these statistics, the growth rate of labour demand has considerably declined recently. In the first months of 2008, the number of valid job announcements in the Labour Market Board was nearly a third lower and the number of new announcements 29% lower compared to last year. In the fourth quarter, the decline of both indicators leaped to 65% and 45%, respectively, implying a sharp downturn in labour demand (see Figure 7).

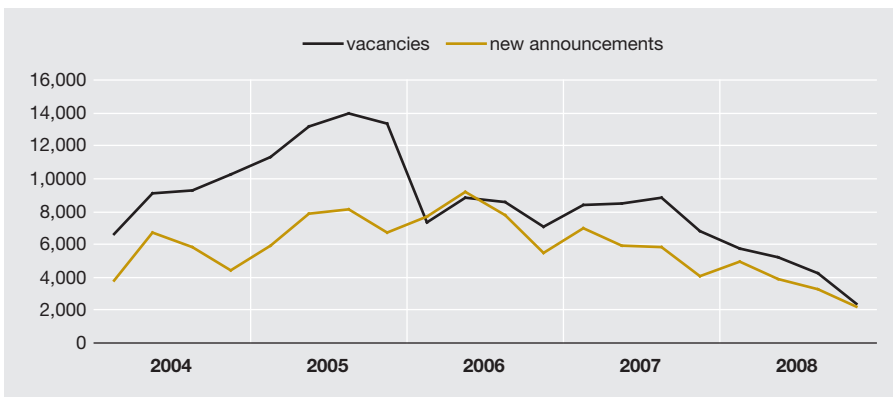


Figure 7. Job announcements submitted to the Labour Market Board

According to CV Keskus, a company specialising in job-seeking, the number of job offers intermediated by them dropped from 2,200 at the beginning of 2008 to 1,500 in autumn. In the second half of September the number of job offers decreased significantly, shrinking to 700 by 31 December 2008. The situation did not improve at the beginning of 2009 either. According to CV Keskus, in the third week of January (the last period on which exact data are available), the portal posted a record number of visits with 101,099 persons searching for a job (this is slightly more than the population of Tartu, the second biggest city in Estonia).

Apart from active job-seeking, also more job offers were available after the expectedly quiet December. Over a 100 job offers were added to the portal in a week and by January 21, their number had risen to 750. CV Keskus also noted that many jobseekers have already made corrections to their wage expectations and a downward wage race is clearly evident: additional remunerations and benefits are disappearing or decreasing and even base wages are reduced.

The economic crisis, pessimistic expectations and uncertainty regarding the future also influence the workers' attitude towards work. In September 2008, the market research company TNS Emor conducted a phone research among salaried employees, which included a total of 400 persons. It appeared that the commitment of Estonian employees aged 15 to 74 has risen by 2 points compared to two years ago, reaching 57 points. However, compared to Europe (59 points on average), this indicator is still slightly lower. The employees surveyed estimated the work environment in companies to be approximately the same as a few years ago, but the commitment of employees has grown. They are willing to contribute more and assume greater responsibility for their work. This also influences the mobility of people, i.e. readiness to change jobs or reactions to win-overs. Although the wage level continues to be important, people now appreciate having a job in the first place. The commitment of employees in the services sector has risen the most: from 57 to 63 points. The surveys of the TRIM centre operating in Munich have indicated that higher commitment of employees also improves the loyalty of customers.

Unemployment

According to the International Labour Organisation (ILO), last year there were 190 million unemployed worldwide. By the end of 2009 ILO expects the number of the unemployed to reach 210 million. Thus, global unemployment will grow at least 10%. According to ILO, the number of jobs will shrink the most in construction and car industry, tourism, services and real estate.

In the second half of 2007 and the first half of 2008, the Estonian unemployment rate remained near 4%, but in the third quarter of 2008 started to increase relatively rapidly, reaching 6.2%. This means that the number of unemployed jobseekers climbed to 44,000. Approximately half of them had become unemployed due to lay-offs, company liquidations or bankruptcies; nearly 11,000 had lost their jobs in the past six months.

In the first half of 2008, the number of the unemployed dropped in terms of both the short-term and long-term unemployment (persons who have been seeking employment for a year or longer), whereas in the third quarter both indicators started to rise. The number of the short-term unemployed increased much faster (by 13,200 quarter-on-quarter, posting a 108% annual growth). The number of the long-term unemployed grew quarter-on-quarter too

(by 3,400), but remained 6.5% smaller in annual terms. The long-term unemployed, who have been inactive for a longer period of time, have bigger difficulties with returning to the labour market at the time of economic decline, which is why many of them become discouraged (see Figure 8).

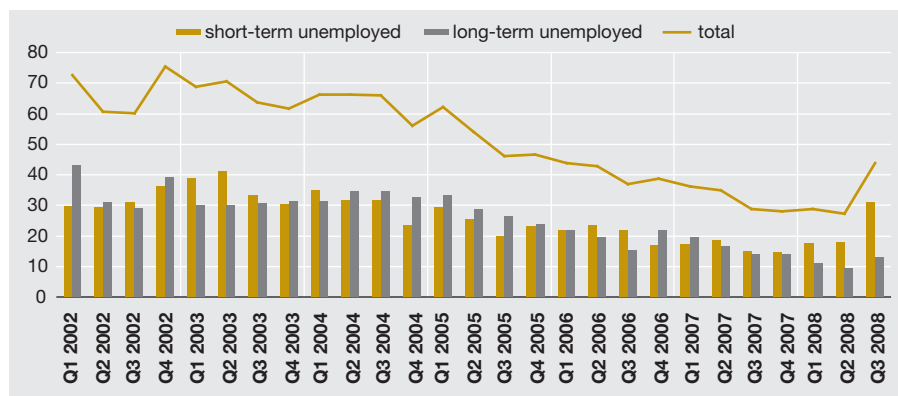


Figure 8. Number of short-term and long-term unemployed (thousand people)

In the final months of 2008, rapid growth in unemployment continued. Employment may have decreased even faster compared to the increase in unemployment, as not everyone who loses their job automatically becomes unemployed. Many become inactive, i.e. give up active job-seeking or go to find employment abroad. Therefore, inactivity (incl. discouragement) as well as labour migration may have increased in the fourth quarter of 2008.

In the third quarter, unemployment grew in all age groups. Growth was especially pronounced among the young, as school graduates aged 15 to 24 started to look for a job and unemployment rose to 14.7%, meaning that almost every seventh young jobseeker remained unemployed. The unemployment rate of people in their prime working age (25 to 49) increased to 5.1% and that of the elderly (50 to 74) to 4.8% in the third quarter.

Unemployment increased in all regions, but mostly in North-Eastern Estonia (to 11.8%). It was the only region where unemployment grew not only due to inactivity but also because of a considerable decrease in employment. In the first three quarters of 2008, collective lay-offs mainly occurred in the textile and clothing industry (45%), followed by the timber and furniture industry and transport, storage and communications.

The number of the employed reacted to the economic decline with an expected lag, but ever so more robustly. At the end of November, the number of the registered unemployed had risen to over 26,000, i.e. by 89% year-on-year. The quarter-on-quarter increase stood at 16%.

According to labour market data, in November the number of the registered unemployed in Ida-Virumaa rose to 6,005. Due to the collective lay-off in the textile company Narva Kreenholm, new unemployed were registered in September, October and November. Personnel cuts have been made also in smaller companies, including Jõhvi Aiand, Repo Vabrikud, Eesti Raudtee (Estonian Railways), and some construction companies. Unemployment was also great in Võrumaa, where problems mainly occurred in timber manufacturing companies. The downward trend continued in December: at year-end the number of the unemployed registered in the Labour Market Board reached 30,374, which is over twice more than a year ago. On 1 January 2009, there were 2,364 job vacancies.

The statistics of unemployment benefits also indicates a rapid increase in unemployment and benefit costs. In 2008, the Estonian Unemployment Insurance Fund paid benefits to 23,576 persons, which is 2.3 times more than in 2007. The majority of applications concerned unemployment benefits, of which 15,476 were approved (nearly a sixth of them in December). Collective lay-off benefits were paid to 5,877 people in 2008 (a fifth of them in December). Nearly a third of benefit recipients had been made redundant by clothes and textile companies (the biggest lay-off took place in AS Kreenholmi Valdus), followed by the timber and furniture industry and transport, storage and communications companies. Employer insolvency benefits were paid to 2,223 people in 2008 (see Figure 9).

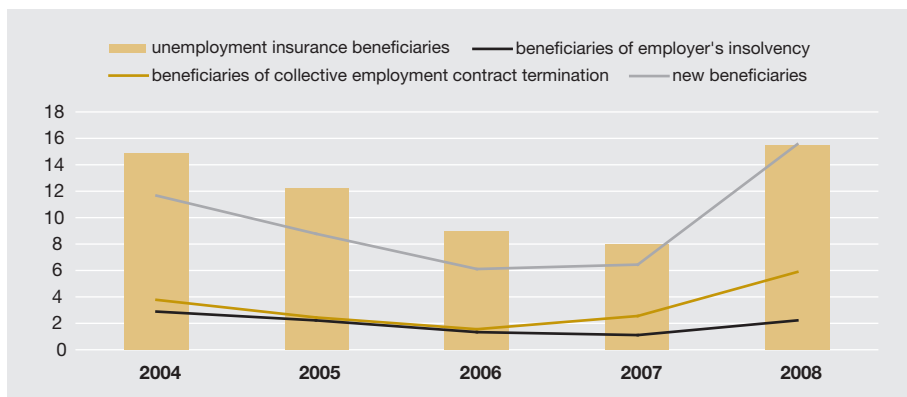


Figure 9. Unemployment insurance beneficiaries (thousand people)

The situation deteriorated constantly during the year and December posted the worst indicators of the year. In the three final months of the year, the cost of benefits exceeded the collection of unemployment insurance payments. Today, employees have to give 0.6% of their salaries and employers 0.3% for unemployment insurance payments. At the end of November, the Government approved the Unemployment Insurance Fund's proposal to adopt new rates as of July 2009 (1% and 0.5%, respectively). Pursuant to the Unemployment Insurance Act,

the Government may increase the tax rate of employees to 2% of their salary and that of employers to 1% of the employees' salary at the proposal of the Unemployment Insurance Fund's council.

According to the Tax and Customs Board, in December 2008 the compensations paid upon terminating employment or service relationship totalled 113.5 million kroons. Such payments were made to 3,155 employees, the average payment being 36,000 kroons. In 2007 compensations for termination of employment were paid to 12,000 people, whereas in 2008 this indicator was one and a half times higher (18,500 people). In 2007 the average compensation stood at 19,000 kroons; in 2008 it rose to 28,600 kroons (by 50.5%). In 2007, compensations for terminating employment or service relationships were paid by an average of 300 employers per month; in the first half of 2008 by 360; in the second half by over 500, and in December by 764.

According to the consumer barometer of the Estonian Institute of Economic Research, the fear of households to become unemployed started to increase in the final months of 2007. In 2008 this fear continued to increase. The pessimistic expectations are in line with the changes in the number of the unemployed, which reached 115% in December 2008 (see Figure 10).

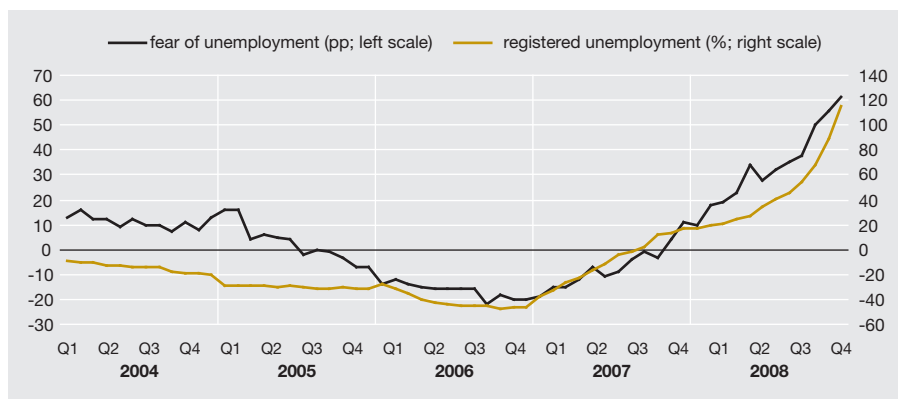


Figure 10. Fear of unemployment and registered unemployment

Source: Estonian Institute of Economic Research

According to the Estonian Institute of Economic Research, 49% of the manufacturing companies and 69% of the construction companies intend to cut the number of employees during the next three months. According to the Institute, in December 63% of the manufacturing companies had fewer orders than usual and the existing orders guaranteed work only for the next 3.4 months; the decrease of export orders was mentioned by 58% of the companies. In the construction market, 81% of the companies anticipated a decrease in workload in the

following three months. The confidence indicator of construction companies reached its historical low. Similar to the industrial sector, also the construction sector outlined insufficient demand as the reason for lay-offs and 51% of the companies also anticipated a drop in construction prices.

In the first three quarters of 2008, growth in the number of the registered unemployed exceeded the change in total unemployment. Thus, the share of the registered unemployed in the total unemployment rate has risen. In 2007 approximately a third of all the unemployed had registered themselves as such, whereas in the third quarter of 2008 nearly a half of them had done that. If finding employment is not very likely, people are more eager to register their unemployment to obtain social guarantees, including health insurance. Therefore, the forecast of budgetary costs should not proceed merely from the expected general unemployment but also consider the increasing registration of unemployment.

LABOUR COSTS AND PRICE PRESSURES

Average wages

The strong wage pressures noted at the beginning of 2008 started to wane gradually in the second half of the year. In the final months of 2008, the nominal wage growth halted considerably and real wages declined.

Owing to the large inertia of wage growth, the growth rate of average gross monthly wages remained high in the first quarter of 2008 (19.5%, year-on-year), whereas the second quarter saw a slowdown to 15.2%, and to 14.8% in the third quarter. The third-quarter wage growth was below average in construction (8.6%), manufacturing (12%) and wholesale and retail trade (12.3%; see Figure 11).

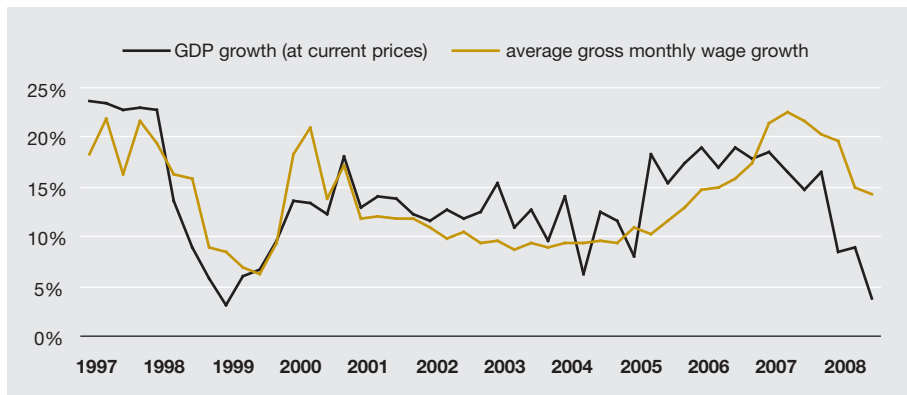


Figure 11. Nominal growth of GDP and average gross monthly wages (y-o-y)

Compared to nominal economic growth, the deceleration of wage growth was slower owing to its large inertia. Therefore, the period of strong economic decline is characterised by an increase in unit labour costs and a drop in profits as a ratio of GDP. Apart from the general inertia, average wage growth may be temporarily higher at the time of economic decline also because of increased payments that arise from lay-offs. In that case, however, wage growth is facing a strong correction in the coming periods.

Real wage growth has been slowing since the second half of 2007. Compared to last year, real wage growth decelerated in the second quarter of 2008 by more than 11 percentage points to 3.5%. The third-quarter growth posted 3.5% as well, but this may have been partly caused by the increased payments related to lay-offs. In the fourth quarter, average gross monthly wage growth slowed even further (exact data are still unavailable) and wage growth expectations decreased considerably. According to the Tax Board, average wage growth decelerated to 10.2% in November 2008 (to 7.6% in the private sector). In other words, real wages in the private sector declined already in November.

The average nominal and real growth of net wages was slightly faster compared to gross wages. Owing to the rise in the non-taxable income threshold in 2008 from 2,000 to 2,250 kroons, the effective tax rate⁴ decreased this year and net wage growth exceeded gross wage growth by 1 percentage point on average (see Figure 12).

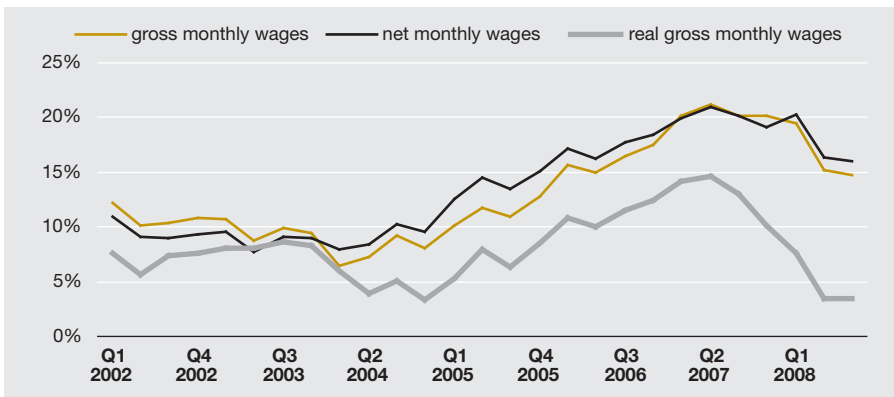


Figure 12. Average wage dynamics (y-o-y)

By fields of activity, average wages grew rapidly (over 20%) in the first three quarters of 2008 in forestry; fishing; mining; electricity, gas and water supply; public administration and defence, and education. The construction sector witnessed the sharpest decline in annual

⁴ The ratio of the tax to the income earned.

wage growth: by over 20 percentage points to 8.6% in the third quarter of 2008. Wage growth decelerated rapidly also in manufacturing; wholesale and retail trade; hotels and restaurants; transport, storage and communications, and financial intermediation (to 12–13%). Due to the plummeting demand and number of new orders, wage growth may start dropping even faster. Nominal wages will probably also diminish on account of additional remunerations and slightly also because of shortened working hours and new employment contracts with lower wages. Although in theoretical literature wages are generally characterised by downward rigidity, the preliminary data on the final months of 2008 confirm that the Estonian wages are relatively flexible downwards too. For instance, in December 2008 the labour cost of typical posts measured for the construction price index dropped by an average of 3.5% month-on-month and by 4.8% year-on-year (see Figure 13).

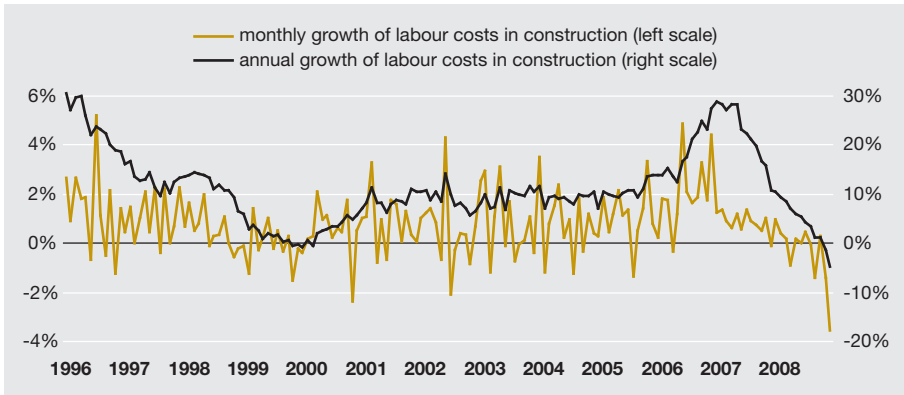


Figure 13. Construction price index data on labour cost growth

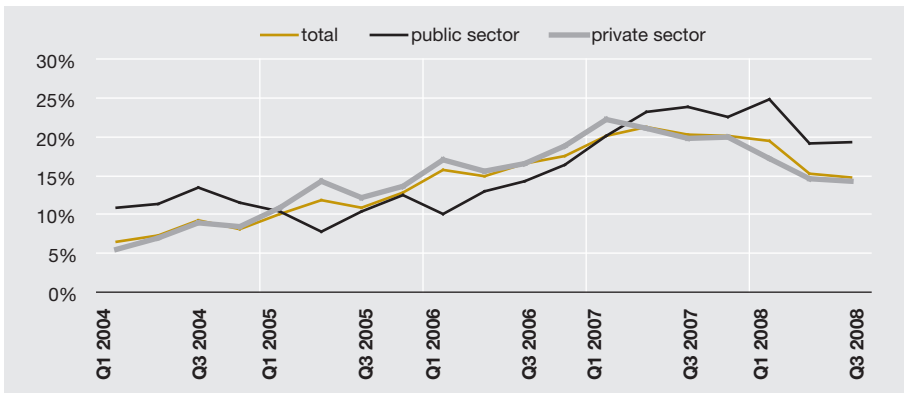


Figure 14. Average wage growth by the owner of the place of employment

Regarding the owner of the place of employment, the developments of wage changes still varied. Private sector wages react to economic changes with a 2–3 quarter lag, whereas in the public sector they respond with a one year lag (see Figure 14).

In 2009, a rapid slowdown in wage growth is expected also in the public sector. Wages are increased rather cautiously and only in a few fields of activity. Wage cuts cannot be ruled out either. At the end of 2008, the Government adopted several regulations on wages, pursuant to which only the wages of state and municipal school teachers were raised (both by 8%), which entails additional budgetary costs of 15.4 and 144 million kroons, respectively. Ministries attempt to reduce their operation costs (mainly staff costs) by 2–3%, but direct wage cuts are not on the agenda yet. However, if revenue collection is as modest as in December 2008, bigger corrections are needed in the public sector.

In conclusion, in 2008 the labour market reacted to the economic downturn with an expected lag, but ever so more robustly. Third-quarter changes in employment were still minimal and average wage growth was still quite strong. In the fourth quarter, the decrease in the number of jobs and the slowdown in wage growth was more pronounced (exact data are still unavailable). Instead of average wage developments it is more important to observe the changes in wage costs, which are affected by changes in full-time gross wages as well as the dropping number of salaried employees and the increasing number of part-time employees.

Unit labour costs

Employment and wage developments always react with a lag to an unexpected economic decline. For that reason, wage growth exceeded economic and productivity growth in every quarter of 2008. Even if we use alternative data instead of the employment statistics of the labour force survey, the productivity growth indicators were still negative for the third quarter of 2008, as the reduction of employees could not prevent the decline of economic growth (see Figure 15). As the labour market is surrounded by uncertainties concerning the depth, duration and trend (V, U or L-shaped) of the decline, there is a risk that more employees are laid off just in case and when the economic situation improves, it may become difficult to find qualified workforce. In order to keep wage developments in line with productivity growth at the time of economic decline, downsizing wages should be preferred to the reduction of the number of employees.

Based on GDP statistics it is also possible to calculate the real and nominal unit labour costs.

The *real unit labour cost* indicator compares the amount of expenditure per employee (mostly wages and taxes on labour) and labour productivity (per employee) in current prices. Practically, the share of the value added spent on wages is calculated. Following the definition, the growth rate of unit labour costs is positive when labour costs per salaried employee grow faster (or drop slower) than labour productivity in nominal terms.

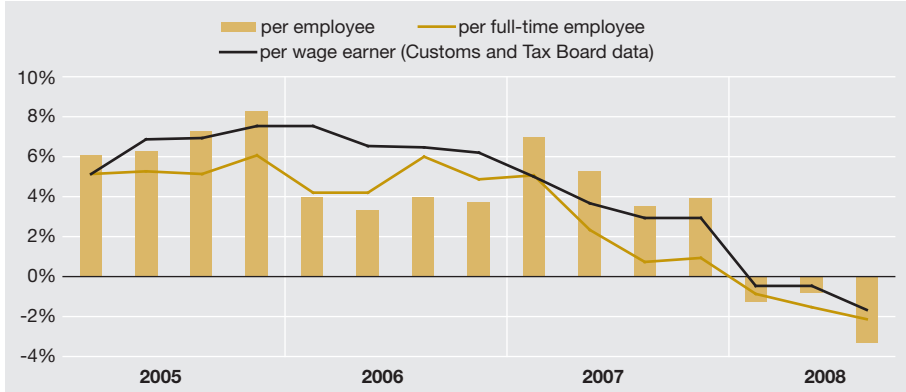


Figure 15. Labour productivity growth (y-o-y)

Nominal unit labour costs compare labour costs per employee with real productivity, not with productivity calculated at current prices. The aim is to analyse inflationary pressures arising from wage growth, as enterprises have to increase prices of their products in order to retain profitability when wage growth exceeds productivity.

As the recession deepened in the third quarter of 2008 and the reduction of labour costs was delayed or they even rose owing to an increase in lay-off payments, growth in unit labour costs picked up considerably in that period. Real unit labour cost growth accelerated to 11.4% from 5.3% in the second quarter and nominal unit labour cost growth increased from 15.9% to 19.9% (see Figure 16).

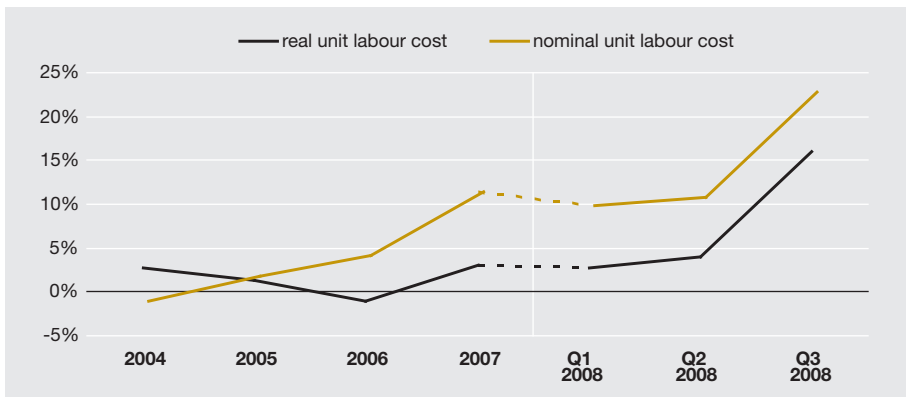


Figure 16. Unit labour cost growth in manufacturing

Such a great difference is not sustainable in the long term. Unit labour cost growth will stabilise after the economic decline comes to an end and growth starts to recover.

In terms of economic sectors, real unit labour costs growth was above average in financial intermediation, real estate, renting and business activities, and construction (see Table 1).

Table 1. Unit labour cost growth by GDP statistics (%)

	2005	2006	2007	Q1 2008	Q2 2008	Q3 2008
Real unit labour cost						
Total economy	-1.6	1.6	9.2	9.9	5.3	11.4
Primary sector	5.7	-0.2	26.4	-0.7	11.8	-10.6
Secondary sector	-1.2	2.4	7.6	4.6	5.7	16.7
Private sector service providers	-2.5	4.8	14.1	8	5.8	10.8
Nominal unit labour cost						
Total economy	3.3	8.1	18.9	19.1	15.9	19.9
Primary sector	16	6.1	45.1	8.7	13.7	-13.2
Secondary sector	3.4	10	17.2	12.5	12.3	22.1
Private sector service providers	0	9.9	20.9	20.1	17.6	20.6

According to Eurostat, nominal unit labour cost growth in Estonia posted 13.1% in the third quarter of 2008. Growth was stronger in Latvia (15.3%), Bulgaria (19.4%), Lithuania (20.5%) and Romania (21.2%). Estonia was followed by Slovenia (11.5%), Poland (9.8%) and other countries. Slower unit labour cost growth was witnessed in Western Europe, including in Germany (2.5%). The average growth in EU Member States was 4.1%; the euro area average stood at 4.0% (see Figure 17).

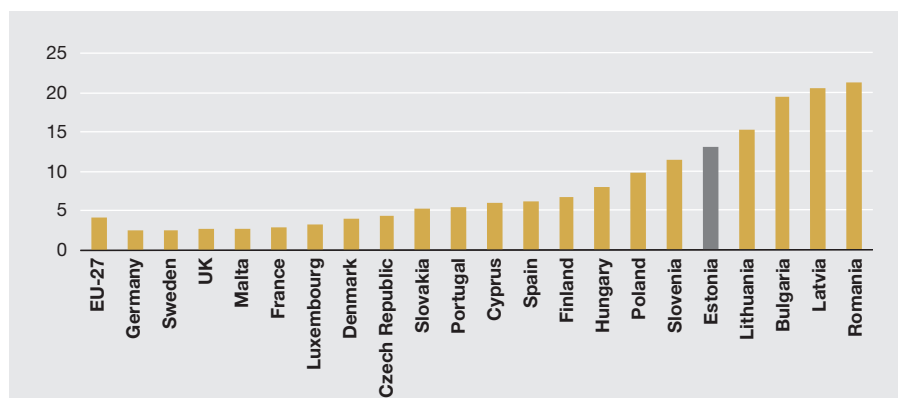


Figure 17. Unit labour costs in EU countries in the third quarter of 2008

Source: Eurostat

INSTITUTIONAL DEVELOPMENTS OF THE LABOUR MARKET

Tax changes

On 1 January 2009, several amendments concerning the procedures of tax payment as well as changes in tax rates entered into force.

- The income tax rate is not reduced and it remains at 21%; the non-taxable income threshold stays at 2,250 kroons per month. The stable income tax rate entails a rise of the personal effective income tax rate in case of gross wage growth and a drop in case of wage decrease.
- The additional non-taxable income per first child is temporarily frozen in 2009 (its impact on the labour market indicators will appear in 2010).
- Paternal leave (ten days within two months before or after childbirth) is not compensated for from the state budget.
- As of 1 July 2009, the unemployment insurance premium for employees will amount to 1.0% and for employers to 0.5% of remuneration. Current rates are valid in the first half of 2009: 0.6% for the employee and 0.3% for the employer.
- The estimated price of the fringe benefit on using the official car for private purposes will increase from 2,000 to 4,000 kroons. If the employee uses the car less and keeps a car diary, the tax may be paid on a smaller sum.
- The limit of the non-taxable compensation for using a personal car for official purposes is raised. The current non-taxable limit of 2,000 kroons increases to 4,000 kroons per month.
- Annualised taxation is not applied to the corporate income tax. Continuing with the current system became possible owing to the so-called Burda case, which allows to conclude that the Estonian corporate income tax may not be regarded as a withheld tax and thus the corporate income tax system complies with EU regulations.
- In addition to the profit distributed as dividends, companies must also start paying income taxes on the reduction of equity capital and repurchase of shares/units. This also applies to payments made from equity capital upon liquidation of companies, which exceed the payments made to equity capital by shareholders. Upon payment of dividends to non-resident shareholders, no additional income tax is required regardless of the size of the holding.

Changes in the Social Tax Act

In 2009, the monthly rate for the minimum social tax liability is at the level of the previous year's minimum monthly wages, meaning that it rises from 2,700 to 4,350 kroons (by 61.1%). Raising the minimum social tax is expected to increase the collection of social taxes.

Minimum wages

Pursuant to the agreement concluded between the Board of the Confederation of Estonian Trade Unions (EAKL) and the Estonian Employers' Confederation (ETKL), the national minimum rate of monthly wages will not be raised in the first half of 2009, i.e. it will remain at 4,350 kroons and the minimum hourly wage rate at 27 kroons. The minimum wage rate may rise as of July, but no specific figures were discussed at the negotiations.

Joining the Labour Market Board and the Unemployment Insurance Fund

On 4 December 2008, the Government approved the draft act, pursuant to which the Labour Market Board and the Unemployment Insurance Fund will become a single public law agency as of 1 May 2009. As a result, all the operations concerning the labour market will be gathered under a single organisation. The new joint agency will continue operating under the name of the Estonian Unemployment Insurance Fund, which will be providing the same labour market services and benefits. The Fund will be run equally by the state as well as the representatives of employers and employees.

New Employment Contracts Act

The new Employment Contracts Act will enter into force on 1 July 2009, except for the sections entailing additional costs to the state budget, which will enter into force on 1 January 2010. The key points of the new Employment Contracts Acts are as follows:

- The Employment Contracts Act will expand the opportunities of concluding fixed-term contracts. A fixed-term contract may be concluded if the job is characterised by a specific term. At the same time, the employer needs to assess thoroughly, whether it is a temporary job or whether the employee is required to work permanently, because the amended Act significantly alters the conditions of the premature termination of fixed-term contracts. Upon premature termination the employer must pay remuneration to the employee, which the employee would have been entitled to upon the timely expiry of the contract.
- Night work will be limited and additional protection is provided to night workers, primarily regarding the obligation of granting rest periods, but also bigger remuneration for night work. The remuneration for night work (22.00–06.00) will be 1.25 times higher.
- An important issue for employees is the advance notice of termination of employment contract. The advance notice term upon lay-offs will be 15 calendar days if the employment relationship is shorter than a year; 30 calendar days in the case of employment relationships of 1 to 5 years; 60 calendar days in the case of employment relationships of 5 to 10 years, and 90 calendar days for employment relationships that has lasted over 10 years. As additional protection, the employer is obligated to provide free time to the employee for job-seeking after giving the advance notice.

- The Act provides the distribution of payment of the lay-off compensation between the employer and the Unemployment Insurance Fund. This allows struggling employers to invest in the sustainability of their companies, continue offering jobs and create new jobs when the situation improves. The employer is directly obligated to pay the employee's monthly wage for all lay-offs; depending on the length of the employment relationship, the rest will be covered by the employers' trust fund of the Unemployment Insurance Fund. The compensation upon lay-offs will be 1 monthly wages in the case of an employment relationship up to 5 years; 2 monthly wages in the case of employment relationships lasting 5 to 10 years, of which one month will be covered by the Unemployment Insurance Fund; 3 monthly wages in the case of employment relationships over 10 years, of which 2 months will be covered by the Unemployment Insurance Fund. In addition, employees with over 20 years of employment will be granted a 5-year transitional period, during which they will maintain a 4-month lay-off compensation.
- If the contract is terminated illegally, the employer will pay the employee a compensation equalling three monthly wages. As an exception, the compensation will equal an employee's six-month remuneration, if the employee is pregnant or acting as the representative of employees at the time of the contract termination. The amended Act provides the opportunity of continuing the employment relationship, but unlike with the current reinstatement system, both the employee and the employer must agree to the continuation of employment relationship. Pregnant employees and representatives of employees, however, are entitled to demand the continuation of their employment relationship.
- The Act provides a rise of the unemployment benefit to 70% of the employee's average wages for the first 100 days after lay-off and to 50% of the average wages since the 101st day of unemployment. In addition, the circle of people entitled to unemployment benefits will grow. For instance, employees who have terminated the employment relationship on their own initiative or by mutual agreement with the employer will also be entitled to unemployment benefits. The amount of the unemployment benefit, however, is smaller in that case. The amount of the benefit will be 40% of the employee's average wages throughout the period of receiving the benefit and the right to benefit is acquired if at least 4 years worth of payments have been made for the employee to the Unemployment Insurance Fund in the past five years. As regards parental leave, the calculation period of unemployment insurance will be extended by the time the employee was on parental leave. The minimum rate of the unemployment benefit will rise 50% compared to the minimum wage rate approved by the Government last year.
- In order to increase competitiveness it is crucial to foster lifelong learning. To this end, study leave regulations will be simplified. Employees will be granted 30 calendar days for study leave per year. It will be possible to take study leave for professional training and academic studies regardless of the form and load of the studies. The period of study leave compensated by average wages will be extended too. In the case of study leave related to academic studies and professional training, the employer will pay the employee average wages for 20 calendar days. In order to complete academic studies the employer will give

the employee 15 days of additional study leave and pay minimum wages laid down by the Government.

- The amounts of financial claims solved by the labour dispute committee will increase. The labour dispute committee will solve disputes with financial claims up to 150,000 kroons. (Pursuant to the current law, the committee solves disputes with financial claims up to 50,000 kroons.)
- Unreasonable obligations and unjustified bureaucracy will be eliminated. No meaningless obligations to keep track of employees will be imposed on the employer; the employment record books and personal cards will be abolished. The Labour Inspectorate will no longer need to provide formal coordinations, for instance upon enforcing internal work procedure rules, in order to be more effective in fulfilling its supervisory tasks and focus on advising employers and employees.

State programmes

In 2009, the European Social Fund will continue to support the five state programmes, which are as follows:

- The objective of the **welfare programme** is to open a counselling centre in Southern Estonia. The centre will provide employment information to the physically, mentally and socially challenged and their family members. In addition, 2,000 social workers will be trained to start working with the new social services database (STAR).
- The **qualified workforce programme** offers various services for target groups who need help and advice in job-seeking. Greater attention is paid to people who have received lay-off notices or have already been laid off.
- The **work-life programme** will arrange an information campaign for employers to introduce electronic tools related to the work environment. The tools are primarily intended for employers to assess the hazards of the work environment of office workers and in order to avoid or reduce health risks.
- The **gender equality programme** started the year with a fatherhood campaign. The conference in February discussed the topic of joining professional and family life, focusing on the importance of the father's role in the family. In 2008 the programme "Promoting gender equality 2008–2010" was approved. The programme is funded by the European Social Fund (ESF) and is implemented by the Ministry of Social Affairs. The budget of the programme is 5.8 million kroons (4.93 million kroons coming from the ESF).
- The **national health programme** promotes health in companies and local governments and provides training for family physicians for the early detection and counselling of alcohol addiction.

SUMMARY

The second half of 2008 differs from recent years by robust corrections on the labour market: unemployment soared and wage growth came to a drastic halt. The greatest change occurred in the final months of the year, but exact data are still unavailable.

At the time of robust economic growth, the key objective was to increase labour supply. At the time of recession, however, it is the other side of the labour market flexibility that becomes important: the simplicity of lay-offs or wage cuts, the extent of using flexible employment contracts, unemployment insurance and social guarantees.

From the perspective of the state budget the considerably cheaper – and thus possibly preferable – option would be to downsize wages. In order to avoid massive unemployment, the first alternative in some fields of activity may be a shortened work week; also the option of eliminating bonuses and additional remunerations (incl. in the public sector) or a solidary wage reduction should be used.

Given the extent of the correction in labour demand, nominal wages are likely to decrease in the near future, which also rapidly relieves inflationary pressures.

Owing to the high inertia of wage growth, it abated slower than nominal economic growth. Therefore, the period of strong economic decline is characterized by growth in unit labour costs and the dropping share of profit in GDP. The share of profit will stabilise or begin to rise and the upward trend of unit labour cost growth will reverse only after the recession hits the bottom, stabilises and shows signs of growth again.

At the times of economic turmoil, the labour market and social policy must support the rapid and adequate reaction of the labour market to economic changes. The flexibility of the labour market is the key prerequisite for competitiveness, fostering the relocation of labour force from less productive to more competitive companies along with relevant training. Until now the rapid growth period has disguised the problems in that area, but the bottlenecks emerge as economic growth slows. Amending the Employment Contracts Act was vital and its implementation could be even faster.