ESTONIAN LABOUR MARKET INSTITUTIONS IN INTERNATIONAL COMPARISON

Marit Rõõm

Introduction

Labour market plays an important role in the development of the Estonian economy. Over the last decade, the structure of production has changed considerably in Estonia. These rearrangements became possible due to the relatively fast reallocation of labour between sectors, which indicates that the Estonian labour market is quite flexible.

There are different definitions for the labour market flexibility but, in general, it can be interpreted as the ability of the labour market to react to changes in the economy. The labour market flexibility is expressed through the adjustment of wages and the ability of labour to move from one industry to another. The labour market flexibility depends on laws and other legislation that regulate the market, as well as the actions of the trade unions.

Strict regulative acts and the strong influence of trade unions in the wage bargaining process limit the adjustment on the labour market and thus lead to higher unemployment. The high unemployment in Western European countries is, for example, attributed to the excessive regulation of the labour market and the strong pressure of trade unions to increase wages. The labour market flexibility also affects economic growth: the slower the labour market adjusts to changes, the slower the economic growth. **The flexible labour market is particularly important during major economic changes (in transition countries, for example)** as it enables fast reallocation of workers from one industry to another. **The labour market flexibility is also extremely important for the small open economy like Estonia,** which can easily be affected by external shocks and where changes can often occur due to external factors.

The flexible functioning of the labour market is also one of the prerequisites for the success of the currency board system and single-currency areas[1]. When the exchange rate is fixed, like in Estonia or the euro area countries, the country has no means of pursuing an independent monetary policy. In such a case, the labour market serves as the channel of adjustment for economic changes caused by external factors. **Therefore, it is extremely important now, in the conditions of the currency board system, as well as in the future, when Estonia joins the European Economic and Monetary Union (EMU), that our labour market is flexible and adjustable.**

[1] Mundell, R. A. A Theory of Optimum Currency Areas. American Economic Review, 1961, Vol 51, pp 657–665.

Below we will compare the regulation of the Estonian labour market with that of other countries, in order to evaluate the institutional framework of our labour market and hence its flexibility. **The labour market studies usually analyse the impact of trade unions, minimum wage, dismissal regulations and unemployment benefits on the labour market.** We will take a look at these institutions and factors and compare them with other Central and Eastern European (CEE) countries and OECD member countries. But why do we need to regulate the labour market in the first place?

The Aim of Regulation and Its Impact on the Labour Market

The aim of regulating the labour market is to guarantee equity, first of all, the fair income distribution. Trade unions, acts regulating layoffs, minimum wage and unemployment benefits should guarantee the equal position of employers and employees in the labour market. **Guaranteeing equity can, however, lead to higher unemployment by limiting the freedom of market participants to choose the amount and price of labour.**

The impact of labour market institutions on unemployment has been extensively studied and the general understanding is that due to the existing institutions the labour market is too rigid in many countries. This increases unemployment. It has also been found that not all institutions increase unemployment by the same degree. Conclusions about their impact are sometimes contradictory.

Trade unions should create equal position for employers and employees at wage negotiations, by improving the situation of employees, as it is easier to press for higher wages during collective bargaining. As a result of trade union activity, the increase of wages can exceed the growth of productivity. This leads to higher unemployment. The labour market studies usually stress the need for state-level cooperation among trade unions themselves, as well as cooperation between trade unions and employers. The aim of such cooperation is to guarantee that the wage agreements take into account the general economic development and the impact of the agreed wage level on unemployment[2].

Minimum wage prevents working for pay that society regards as unfairly low. It sets a lower limit to the wage level and therefore reduces the chances of less-productive workers finding employment. In most countries it is believed that although the minimum wage does not affect the employment of men belonging to the medium age group, too high minimum wage can decrease the employment among low-skilled workers, women and the young people[3].

The aim of **legislation regulating layoffs** is to guarantee stability for employees. At the same time, it reduces the possibilities of employers to react to changes in the market,

[2] Nickell, S., Layard, R. Labour Market Institutions and Economic Performance. Handbook of Labour Economics, 1999, Vol 3C, pp 3029–3084.
[3] Brown, C. Minimum Wages, Employment and the Distribution of Income. Handbook of Labour Economics, 1999, Vol 3B, pp 2101–2164.

hindering dismissals in case of economic recession and thus reducing the desire of employers to hire new workers during economic growth. Labour market studies have often found that rigid regulation of layoffs reduces short-term and increases long-term unemployment[4]. It is hard to evaluate which impact is stronger. A positive outcome of strict layoff regulation includes more stable unemployment and employment levels. At the same time, long-term unemployment can have a more negative impact, both for the individual and society, since it increases poverty and reduces the amount of labour and the level of human capital.

The aim of **unemployment benefits** is to provide a sufficient income for the person who has lost his/her job so that he/she could find a new suitable job. However, if benefits are generous and paid for long or unlimited periods of time, they can reduce the desire of the unemployed to find a job. The size of the unemployment benefit determines the minimum wage for which the worker agrees to take a job. Thus, the benefit is a kind of a minimum wage for the individual. Unemployment benefits can facilitate the movement of labour in the labour market and thus accelerate structural changes. The negative impact of the benefits is increased unemployment – mainly long-term unemployment. According to labour market studies of other countries, the short period of benefit payment can hinder the increase of long-term unemployment[5].

In conclusion we can say that many economists agree that **trade unions and unemployment benefits have a significant role in increasing unemployment**[6]**.** In the majority of countries **the minimum wage is thought to be sufficiently low and does not decrease employment.** It is also thought that **firing regulations reduce short-term but increase long-term unemployment.**

Trade Unions and Collective Agreements

The influence of trade unions in the economy depends, first of all, on the number of their members. In many countries the collective agreement concluded by trade union covers not just union members but all the employees of a respective company or sector. **The real power of trade unions is thus indicated by the number of workers covered by the collective agreements concluded on the sectoral or company level.**

The share of trade union members among the employees is very different across the OECD countries (see Figure 1). It is the highest in the Nordic countries (approximately 80%) and the lowest in Southern Europe and the USA (below 20%). In the majority of European countries, except Great Britain and Switzerland, at least 60% of the employees is covered

[4] Bentolila, S., Bertola, G. Firing Costs and Labour Demand: How Bad is Eurosclerosis. Review of Economic Studies, 1990, Vol 57, pp 381–402.
[5] Nickell, S. Unemployment and Labour Market Rigidities: Europe versus North America. Journal of Economic Perspectives, 1997, Vol 11, pp 55–74.
[6] Nickell, S., Layard, R. Labour Market Institutions and Economic Performance. Handbook of Labour Economics, 1999, Vol 3C, pp 3029–3084.

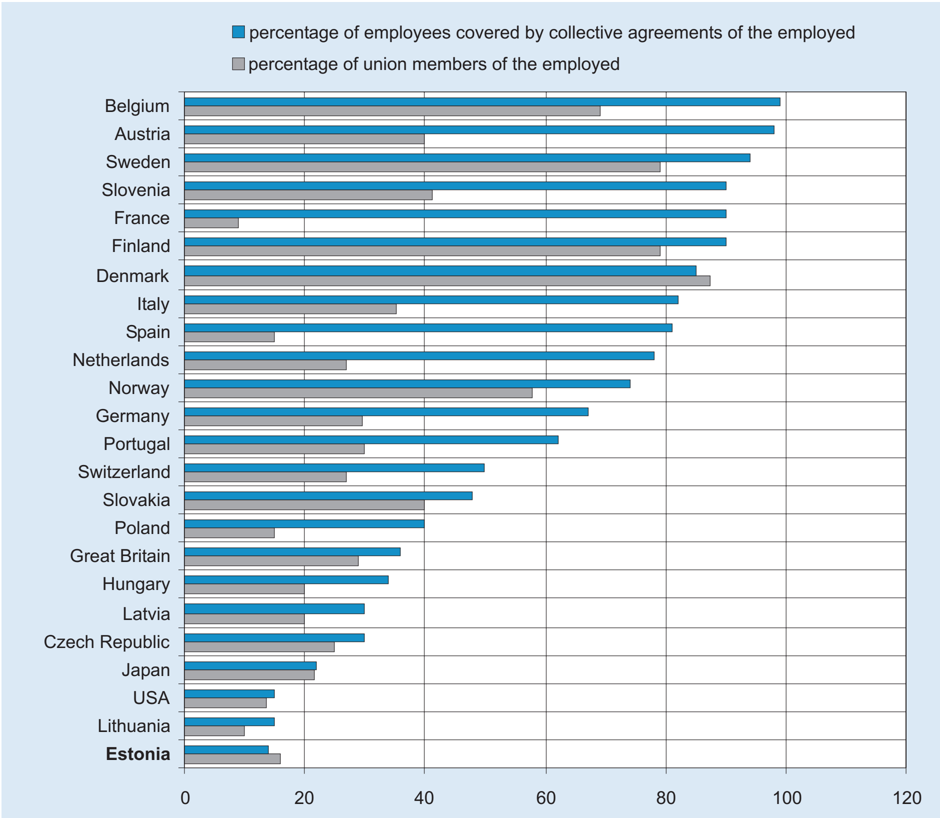

Figure 1. Trade unions (number of members and workers covered by collective agreements as a percentage of the employed)

Sources: Carley, M. Industrial Relations in the EU Member States and Candidate Countries. European Industrial Relations Observatory, 2002; Carley, M. Industrial Relations in the EU, Japan and USA, 2000. European Industrial Relations Observatory, 2001.

by collective agreements, although in France and Spain union members account for less than 20% of the employed. In the OECD countries, collective agreements are concluded parallel at several levels. While in the USA the agreements concluded on the company level are most frequent, in Western Europe agreements are concluded at the industry level. This creates a situation where the share of workers covered by the collective agreements is considerably larger than the share of union members.

In the early 1990s, the majority of the employed were trade union members, but over the transition period the share of union members has decreased everywhere. At the end of the 1990s the share of union members among the employed was below 40% in all the CEE countries except Slovenia. The share of workers covered by collective agreements in the CEE countries is not different from the share of trade union members. As compared to Western European countries this indicator is low – up to 50%. Here, too, the exception is Slovenia. In the CEE countries collective wage agreements are mostly concluded on the state or the company level, collective agreements on the industry level are less common. Therefore, the share of workers covered by collective agreements is small among the employed.

As compared to the OECD and CEE countries, there are few union members among the employed in Estonia (see Figure 2). Like in the majority of other CEE countries, the number of union members has been decreasing since the early 1990s. In 2000 the members of the trade unions belonging to the Estonian Employees' Unions' Confederation (TALO) and the Confederation of Estonian Trade Unions (EAKL) accounted for 16% of the employed, which is approximately the same as the share of union members in Southern Europe and the USA. The share of workers covered by the collective agreements is also small in Estonia: the agreements concluded by member unions of TALO and EAKL covered 14% of the employed in 2000. Collective agreements are concluded on the state, sector and company level in Estonia. As compared to the Western European countries, the sectoral level agreements are rare. Like in other CEE countries, company and sectoral level agreements are mostly concluded in health care and education (state sector) and transport, energy and mining (state and privatised companies). **Still, individual wage agreements dominate in Estonia and the influence of trade unions is small as compared to the majority of the OECD countries.**

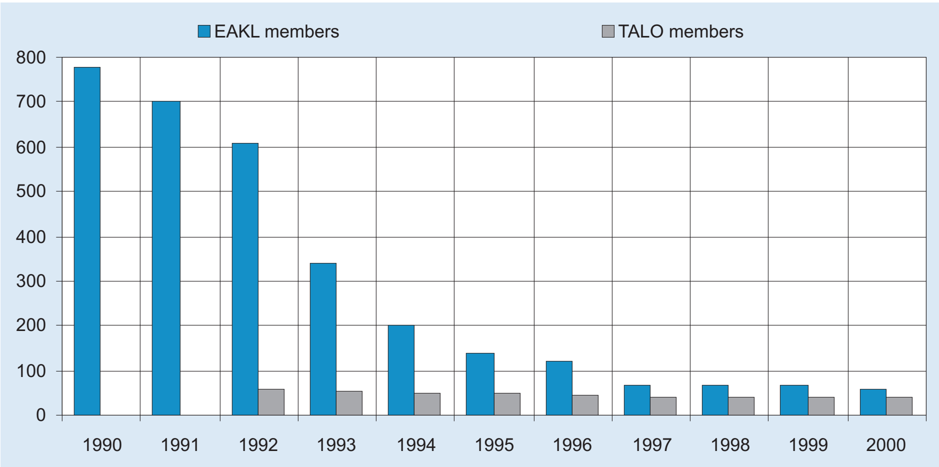

Figure 2. Number of EAKL and TALO members (thousands)

Sources: EAKL, TALO.

Minimum Wage

Across countries, the minimum wage is usually compared using the ratio of the minimum wage to the median wage. An alternative is the ratio of the minimum wage to the average wage, but due to the different distribution of income the latter may not reflect the actual impact of the minimum wage.

The minimum wage exists in the majority of the OECD countries; in the EU the minimum wage has been set in nine countries (Belgium, Great Britain, Luxembourg, Spain, the

Netherlands, France, Ireland, Portugal and Greece). In many OECD countries the minimum wage is differentiated by age groups, in some countries also by regions. Among the OECD countries, the 2000 ratio of the minimum wage and the median wage was the highest in France (60.8%) and the lowest in South Korea (23.8%; see Figure 3). In most EU countries, with the exception of Spain and Portugal, the minimum wage amounted to more than 40% of the median wage in 2000. The average ratio of the minimum wage to the median wage was 47.1% in the EU countries.

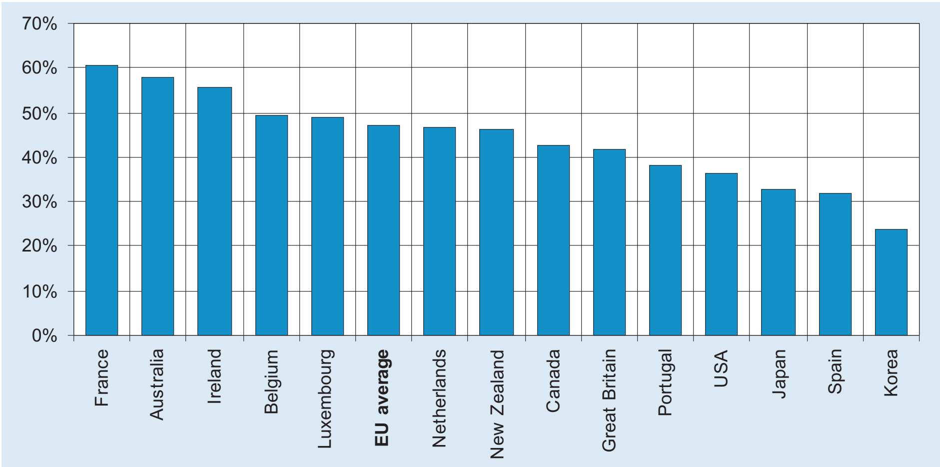

Figure 3. Ratio of the minimum wage to the median wage in OECD countries in 2000

Source: Keese, M., Puymoyen, A. Changes in Earnings Structure: Some International Comparisons Using the OECD Structure of Earnings Database. OECD Labour Market and Social Policy Occasional Papers, 2001.

At the beginning of the transition period, the minimum wage of the CEE countries amounted to 35–50% of the average wage. It was lower in Russia and the Ukraine – 27 and 32%, respectively. This ratio fell in all CEE countries in the following years, as the nominal minimum wage remained unchanged. At the end of the 1990s, the minimum wage was increased considerably in the majority of the CEE countries and therefore it now amounts to approximately 40% of the average wage in these countries. Differences in the minimum wage across labour groups are small.

The minimum wage introduced in Estonia in 1992 had a similar ratio to the average wage as in Western European countries. Later, the minimum wage/average wage ratio decreased (see Table 1). **Since the second half of the 1990s, the minimum wage has increased faster in Estonia than the average wage, just like in other CEE countries.** There is no statistical data on the median wage in Estonia, but according to the wage scale of employees it amounted to 4,000–4,500 kroons in 2001. Thus, the ratio of the minimum wage and the median wage was 36–40%, or smaller than the EU average.

Table 1. Minimum and average wage in Estonia (EEK)

Minimum wage valid from	Minimum wage	Average gross wage	Ratio
01.07.1992	200	549	36.4
01.10.1993	300	1,066	28.1
01.09.1994	450	1,734	26.0
01.01.1996	680	2,985	22.8
01.02.1997	845	3,573	23.6
01.01.1998	1,100	4,125	26.7
01.01.1999	1,250	4,418	28.3
01.01.2000	1,400	4,907	28.5
01.01.2001	1,600	5,510	29.0
01.01.2002	1,850	Forecast 5,781	Forecast 32.0

In 2001, a long-term agreement was concluded between the Estonian Employers' Confederation and the Confederation of Estonian Trade Unions on increasing the minimum wage. According to this agreement, the minimum wage is to increase to 41% of the average wage by the year 2008. Several CEE countries currently have a similar ratio of the minimum wage to the average wage. After the agreed increase, the minimum wage/median wage ratio should exceed the average level of the EU.

Legal Acts Regulating Layoffs

The legal acts regulating layoffs make the employers to inform the employees of pending dismissals in advance and pay them severance. Cross-country comparison of layoff regulations is difficult, as so many different factors have to be considered, for example, the regulation of the use of temporary employment contracts (these make layoffs much easier). Therefore, summary indicators have been worked out for comparing layoff regulations, which take into account various aspects related to layoffs.

In the OECD countries the length of the notice period and the size of severance payment usually depend on the length of service, in some countries also on the age of the employee and some other factors. The shortest minimum notice period – one week – is used in Belgium, the Netherlands, Italy, Ireland, France, Great Britain and Denmark. In Portugal, notice has to be given minimum three months in advance. The longest notice period is applied in Germany, Luxembourg, Norway, Sweden and Finland – 6–7 months. In a number of OECD countries severance payment for individual dismissals is unregulated. In such cases it is usually included in the terms of collective employment agreements (eg, in Finland, Germany and Japan). Severance pay is most generous in Portugal and Spain, amounting to approximately one monthly wage for every year of service. As a rule, **the countries with largest severance payments have the lowest unemployment benefits** (eg, Italy, Spain) **and vice versa.** The indicator elaborated by Nicoletti, Scarpetta and Boylaud[7] takes into

[7] Nicoletti, G., Scarpetta, S., Boylaud, O. Summary Indicators of Product Market Regulation with an Extension to Employment Protection Legislation. OECD ECO/WKP No 220, 2000, p 86.

account various regulations concerning both fixed-term and permanent employment contracts. According to this indicator, the labour market regulation is stricter than average in such OECD countries as Portugal, Greece and Italy, but in the USA, Great Britain, Canada and Ireland labour market regulations are milder than the average.

The CEE countries are characterised by relatively strict layoff regulations. In the majority of the CEE countries the minimum notice for layoffs is 1–2 months, which is longer than in many OECD countries. However, the maximum notice period is four months. Considering that in several OECD countries severance payment is unregulated, the severance payments in the CEE countries are relatively high, ranging from one to four months' pay. Lithuania stands out for its severance payments that can amount to 12 months' pay.

In Estonia, the severance payment (2–4 monthly wages) is on the average level of the CEE countries. Compared to the Southern European countries, where severance payment amounts to approximately one monthly wage per every year of service, the severance payment is small in Estonia but, as already mentioned, payment of compensations is unregulated in many OECD countries. Therefore, the severance payment rules of Estonia and most other CEE countries can be considered strict as compared to the OECD countries. The period of notice is similar to the majority of the CEE countries in Estonia. However, compared to the OECD countries where the maximum notice period can be 6–7 months and the minimum ranges from one week to three months, the notice period of Estonia can be considered average (see Table 2). J. Järve[8] has calculated the value of the indicator worked out by Nicoletti, Scarpetta and Boylaud for Estonia. According to this, the strictness of Estonian regulations is close to the EU average and higher than in such CEE countries as Poland, the Czech Republic and Hungary. Estonian regulations are as strict as those in Sweden, Austria and the Netherlands (see Figure 4). In conclusion we can say that **Estonia is characterised by relatively strict layoff regulations, which compensate for the relatively low unemployment benefits.**

Table 2. Severance payments and notice period for layoffs as prescribed by the law

Continuous length of service with the same employer	Severance payment	Notice period
Up to 5 years	2 month average wage	2 months
5-10 years	3 month average wage	3 months
Over 10 years	4 month average wage	4 months

[*] If the employment contract is terminated due to the employee's unsuitability for the job, the employer is required to pay compensation up to one-month's average salary and the term for advance notice is 1 month. If the employment contract is terminated due to the employee's age, the term for advance notice is 2 months in case the employee's length of service is up to 10 years and 3 months in case it is over 10 years. If the employment contract is terminated due to the agency's liquidation, the term for advance notice is 2 months. In case of bankruptcy, the employment contract may be terminated without an advance notice. Release from service is regulated by the Public Service Act.

[8] Järve, J. '*Tööjõukulude mõju tööjõu nõudlusele Eesti tööstusettevõtetes*' (The Impact of Labour Costs on Labour Demand in Manufacturing in Estonia). PRAXIS, *Poliitikaanalüüs*, No 1, 2002.

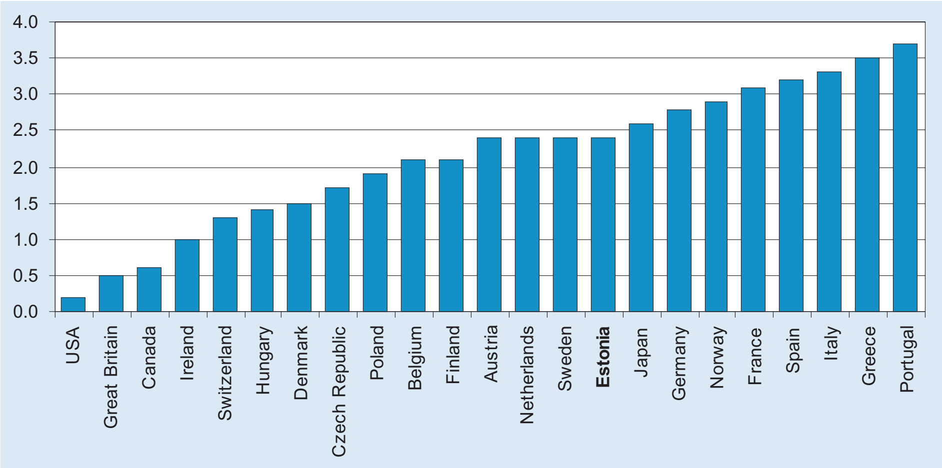

Figure 4. Strickness of layoff regulations in some OECD countries and Estonia in 1998

Sources: Nicoletti, G., Scarpetta, S., Boylaud O. Summary Indicators of Product Market Regulation with an Extension to Employment Protection Legislation. OECD ECO/WKP No 220, 2000; Järve, J. '*Tööjõukulude mõju tööjõu nõudlusele Eesti tööstusettevõtetes*'. PRAXIS, *Poliitikaanalüüs*, No 1, 2002.

Unemployment Benefits

The unemployed are entitled to two types of benefits:

- unemployment insurance benefits the size of which usually depends on the previous wage and for which the person has to have paid premiums to the unemployment insurance fund;
- unemployment benefit the size of which does not depend on previous income. The benefit is usually paid after the termination of the unemployment insurance period or in the absence of unemployment insurance.

The impact of unemployment benefits is determined by their share of the previous wage and the length of the benefit payment period.

In many OECD countries the unemployed are entitled to both types of benefits, the unemployment benefit as well as unemployment insurance benefit. In the majority of the OECD countries unemployment insurance is mandatory for workers (with the exception of Denmark and Finland) and thus the system covers all the workers[9]. The workers who are not entitled to unemployment insurance are paid unemployment benefits. The period of unemployment insurance payment is limited in most countries but the unemployment benefits are paid for an unlimited period of time in many countries. After the end of unemployment benefit payment it is replaced with social benefits, which in most countries have no time limit.

[9] In some countries (Luxembourg, Germany, Denmark) the unemployment insurance does not cover young vocational school leavers. Many countries have separate benefit systems for young people.

The terms of unemployment insurance payment have become stricter in the OECD countries. The period over which the unemployed must have paid premiums into the unemployment insurance fund has become longer. In many countries the payment of unemployment insurance benefits depends on the reason of leaving employment. The ratio of benefit to the earlier gross wage ranges from 30% (Italy) to 90% (Denmark). The longest periods of unemployment insurance payment are in Germany (up to 64 months), the Netherlands and France (up to 60 months).

In most CEE countries unemployment benefits were introduced at the beginning of the transition period and no unemployment insurance system existed in those countries in the mid-1990s. The insurance system was set up to supplement the unemployment benefit system at the end of the 1990s. Several CEE countries are currently reforming their unemployment insurance systems. In Hungary, Slovenia, the Czech Republic, Slovakia and Latvia the unemployment insurance depends on the previous pay. Over the transition period, which has been marked by the increase of unemployment, the terms of qualifying for the unemployment benefit have become tighter. Many countries have also shortened the period of unemployment benefit payment. In the majority of the CEE countries unemployment benefits are paid for a shorter period than in the OECD countries, but this varies from six months in the Czech Republic to 24 months in Slovenia. Slovenia also has the highest ratio of unemployment benefit to the previous wage – 70%.

The unemployment benefit paid in Estonia is small as compared to other countries (see Table 3). Unlike in several other CEE countries, the terms of qualifying for the benefit were rather strict in Estonia at the beginning of the 1990s. By now, these criteria have been liberalised and the period of paying unemployment benefits has been lengthened as well. **This tendency differs from most of the OECD and CEE countries where the terms of paying unemployment benefits have been tightened over the past decade and the length of the payment period has been cut.** In 2003 Estonia began paying unemployment insurance benefits that depend on the size of previous wages[10]. The unemployment insurance should guarantee better welfare of the unemployed and thus encourage the movement of workers in the labour market, giving them the chance to look for a new job without having to worry about their economic situation. Due to the creation of the unemployment insurance system the size of unemployment benefits will increase in Estonia. **Therefore, it is particularly important that the payment period of the benefit is limited.** This should motivate people to actively look for employment.

Table 3. Unemployment benefit (EEK)

Valid from	Amount of the benefit
01.07.1992	160
01.10.1993	180
01.07.1996	240
01.03.1998	300
01.01.1999	400

[10] Unemployment insurance is paid to the unemployed only in case he/she has paid premiums to the unemployment insurance fund; otherwise he/she is entitled to the unemployment benefit.

In Estonia, unemployment insurance amounts to 40–50% of the worker's previous wage, depending on the length of the unemployment period. This is similar to the average level of both the OECD countries and the CEE countries. The period of benefit payment is relatively short in Estonia as compared to the OECD countries. Since the payment period depends on insurance period, the benefits are paid maximum for six months until the end of 2006. This is also one of the shortest periods among the CEE countries. From the year 2013 the maximum period of benefit payment will be extended to 12 months. Among the CEE countries only Slovenia has a longer period of insurance benefit payment – 24 months. In Hungary, like in Estonia, the payment period is 12 months beginning from 2013.

Conclusion

Compared to the OECD countries and other CEE countries, the power of trade unions is weak in Estonia and the share of collective agreements is small. Like in other transition countries, the number of union members has dropped since the early 1990s. In Estonia, 16% of the employed are members of trade unions, which is one of the lowest indicators also among the CEE countries. The number of workers covered by collective agreements is not much larger than the number of union members. Unlike in the Western European countries, collective agreements are mostly concluded on the company and state level in Estonia, just like in most other CEE countries. The majority of wage agreements are individual in Estonia.

Compared to the OECD countries and other CEE countries, the level of minimum wage has been low in Estonia so far. In 2001 it amounted to 29% of the average wage. However, in recent years the minimum wage has increased faster than the average wage. By the year 2008 it should amount to 41% of the average wage, which is similar to the level seen currently in several CEE countries. According to the agreed increase of the minimum wage, the minimum wage to the median wage ratio should exceed the average EU level.

Compared to the OECD countries and other CEE countries, the size of unemployment benefits and period of their payment has been small in Estonia. The terms of qualifying for the unemployment benefit have also been quite strict. From 2003, unemployment insurance benefits were introduced in Estonia, which will increase the sums paid out as unemployment benefits and (in the long run) also the length of the payment period. The ratio of unemployment insurance benefits to previous wage is similar to the average of the OECD and CEE countries, but the payment period is relatively short until 2006.

So far the flexibility of the Estonian labour market has only been reduced by the relatively large severance payments and long notice periods. The size of severance payments in Estonia is similar to those in other CEE countries and considerably lower than in Southern Europe. As many OECD countries have no rules on severance payments, the size of severance payments can be considered large in Estonia and other CEE countries.

The evaluation given to the rigidity of the labour market framework in Estonia depends greatly on the comparison basis. The frameworks are very different in the OECD countries.

In the world context, the institutional framework of the EU labour markets is considered relatively rigid and compared to that the Estonian framework seems liberal. Compared to some OECD countries, the USA and Japan, the institutional framework of the Estonian labour market is relatively rigid.

If we compare the institutional framework of the Estonian labour market to the majority of the OECD and CEE countries, we can say that the legal regulation has not been strict so far and the power of trade unions is weak. **On the whole, the Estonian labour market is still relatively flexible, although the unemployment insurance system introduced in 2003 and the gradual increase of the minimum wage will make it more rigid.**