ESTONIAN STRATEGY FOR COMPETITIVENESS 2009–2011

OVERVIEW AND UPDATES TO THE ESTONIAN

ACTION PLAN FOR GROWTH AND JOBS 2008–2011

5 November 2009

INTRODUCTION

The Estonian Government adopted the Strategy for Growth and Jobs 2008–2011 in September 2008. In less than a year the economic environment in Estonia and Europe has changed remarkably. Taking into account the challenges the Estonian economy faces, its economic policies will need to be adapted to the changing circumstances. However, in light of the short-term challenges, it is important to maintain the primary focus on medium and long-term objectives. Consistency in economic policy is an important prerequisite for further economic growth.

The Government has therefore implemented economic stimulus measures, which according to estimates, will lead to increased competitiveness also in the longer term. In particular, the measures are designed so that they will not hinder the long-term competitiveness or options for the Government in the future. The measures adopted in 2009 have been described in the current update of the strategy.

Based on the analysis carried out in 2008, the strategy for growth and jobs identified four key challenges for the longer term:

1) to develop education based on the needs of companies, and modernise work relations in order to increase the safe flexibility of the labour market;

2) to increase the ability of research and development activities, and direct these to be more commercial;

3) to develop an economic and investment environment that supports innovation and the international competitiveness of enterprises operating in Estonia;

4) to increase the use of environmentally friendly energy, and at the same time ensure the security of the energy supply and the competitiveness of the energy sector.

These challenges remain valid, although the new situation requires that the Government's approach be adjusted and a number of new measures be implemented – in particular in the case of employment policies, where the long awaited employment regulation reform was carried out, the new situation requires further new steps to be taken. Primarily the volumes of active labour market measures and adult training in general have been increased. The Government continues to prioritise R&D policies, directing increased funding to intensify cooperation between R&D institutions and enterprises.

During the past year the situation has changed remarkably both in export demand and in domestic consumption, and this means that employment but also public revenues are decreasing. Confidence in the economies of Central and Eastern Europe is much lower than it was in 2007 and 2008, which also means that Estonia is less attractive to new investments. Consequently, in addition to the long-term challenges, the Government has prioritised medium-term objectives.

Taking into account the changed economic environment and considering the new opportunities and challenges, the following objectives are top priority:

1. **conservative macroeconomic policy** with the aim of keeping the public deficit within the limit of 3% of GDP, joining the Euro area in 2011 and maintaining low public debt levels in order to be able to sustain high investment levels and a favourable level of taxes in the medium and long-term perspective;
2. **raising the export potential of enterprises** primarily by improving the general business environment in order to increase investment and productivity. The aim is to maintain the share of export compared to GDP at its 2008 level. To achieve this, a number of measures are being taken to support export companies. The previous high

levels in foreign investment can only be achieved through systematic and sector-based work with potential investors;

3. **skills development** by increasing the financing of life-long learning, ensuring more resources for continuing education and retraining activities and using the period of lower employment to raise the skills of 50 000 people by at least one level;
4. **maintaining employment levels** by improving the business environment and stimulating job creation, increasing public investments and providing additional subsidies with the aim of preventing long-term unemployment. The aim is to hold the general rate of employment in 2011 at 63.5% (aged 15–64).

The aim of the Government is to come out of the economic crisis as rapidly and strongly as possible. Therefore, there are less general measures for boosting internal consumption and maintaining the current economic structure and more specifically targeted measures to support public investment and employment, develop export potential among Estonian enterprises and keep the public balance within reasonable margins.

The Estonian Strategy for Competitiveness 2009–2011 is an update to the Estonian Strategy for Growth and Jobs 2008–2011. It links the latest decisions of the Government with the strategy for growth and jobs and describes the latest plans for the new measures and priorities of the Government.

MACROECONOMIC POLICY

RECENT DEVELOPMENTS

The growth of the Estonian economy already started to slow in 2007. Until mid 2008 this was considered a natural adjustment process, which would improve competitiveness in the medium term. However, at the end of 2008 the natural downturn in the economic cycle was complemented by international economic instability, which led to negative economic growth. In 2008, Estonian GDP declined 3.6%. In the first half of 2009, the drop in GDP has been even steeper. According to estimates by the Estonian Statistics Office, GDP fell 15.6% compared to the first 6 months of 2008.

While production and services fell in 2008 in those sectors that had experienced extraordinary growth during the years 2006–2008 (including real-estate, financial services, construction, retail sales), all sectors experienced a decline in 2009. The Ministry of Finance has estimated as a final figure that GDP will fall by 14.5% in 2009. Different institutions have estimated zero growth or a modest decline in GDP for 2010.

In parallel with the economic slowdown, lending by financial institutions has also fallen. At the end of 2008, the volume of repayments from households exceeded the volume of new lending for the first time. Estimates say that the total volume that households transfer to financial institutions will be around 10 billion kroons in 2009, which is close to 5% of GDP. The total salary income for Estonian residents has decreased by a similar amount. Taking these two developments into account, it is unquestionable that domestic consumption has fallen and will continue to fall in the coming months.

Demand from Estonia's main export markets also fell sharply at the beginning of 2009. In summer 2008, the governments of these main export markets on average estimated modest economic growth for 2009, but today we know that economic growth in Finland, Sweden, Germany and Latvia was already negative at the end of 2008. The first positive signs are surfacing in some markets and consumer confidence in Estonia is also stabilising; however, it is too early to talk of recovery.

Larger changes became visible in the labour market at the end of 2008. The average employment rate in 2008 was even higher than in 2007, but the unemployment rate already started to grow in the third quarter of 2008. In 2009, the unemployment rate will be around 14%. The employment rate has also fallen sharply – from 69.5% in 2008 to 63.5% in the second quarter of 2009. The extent of unemployment and the drop in the employment rate is far deeper than expected in early autumn 2008, when the strategy for growth and jobs was finalised.

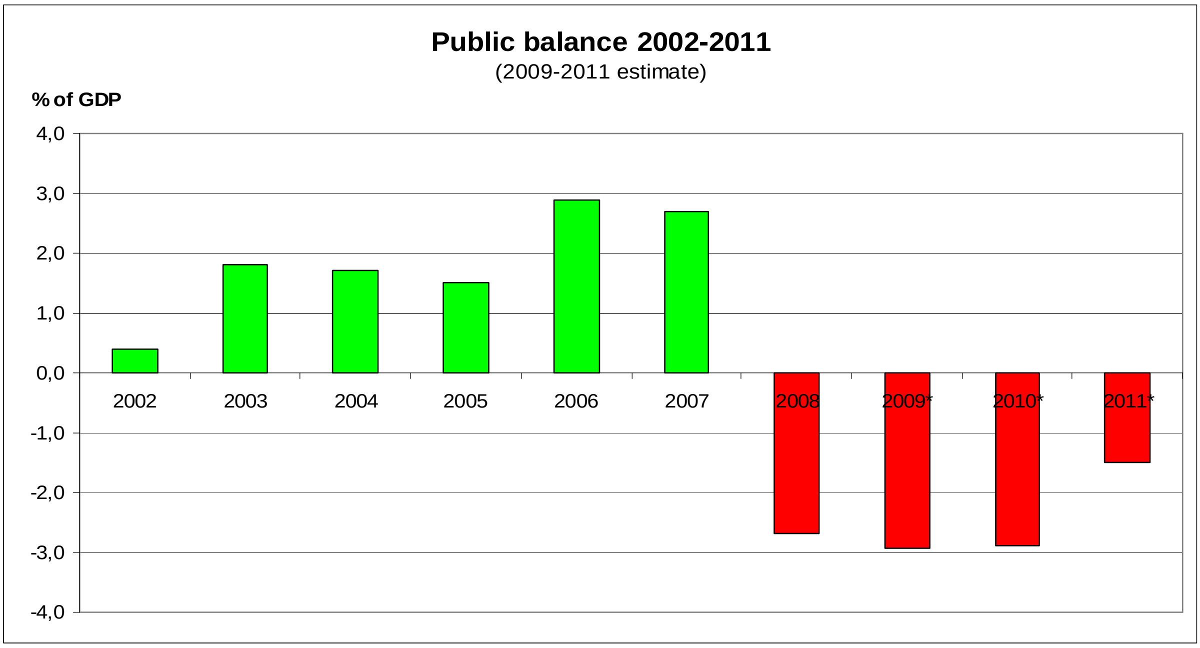
In the context of this overall negative economic situation there are also more positive trends. The export-import balance of goods and services has improved remarkably, which also means that the need for foreign financing of domestic consumption has disappeared. It is also important to note that resources are moving from non-tradable sectors relatively more towards the tradable sectors (where the drop in lending is not as steep). These developments support the common expectation that economic growth in the coming years can come primarily from increasing export volumes.

There are three broader objectives set in the strategy – to ensure a stable macroeconomic environment, to develop a tax system that promotes economic growth and to ensure long-term sustainability of public finances.

During the last year the first objective – **ensuring a stable macroeconomic environment** – has become the top priority objective for the Government. Adoption of the euro has become the cornerstone of all fiscal policies. Joining the euro area is seen as a critical step in increasing macroeconomic stability and confidence in the Estonian economy.

The decline in economic activity has had a significant impact on public revenues. Therefore, public expenditure has already exceeded revenues since 2008. So far the Government has been able to keep the public sector deficit within the margins of the Maastricht criteria (-3% of GDP). In 2008, the public sector deficit was -2.7% of GDP.

Graph 1: Public balance 2002–2011 (*2009–2011 are estimates)



Source: Statistics Estonia, State Budget Strategy 2010–2013

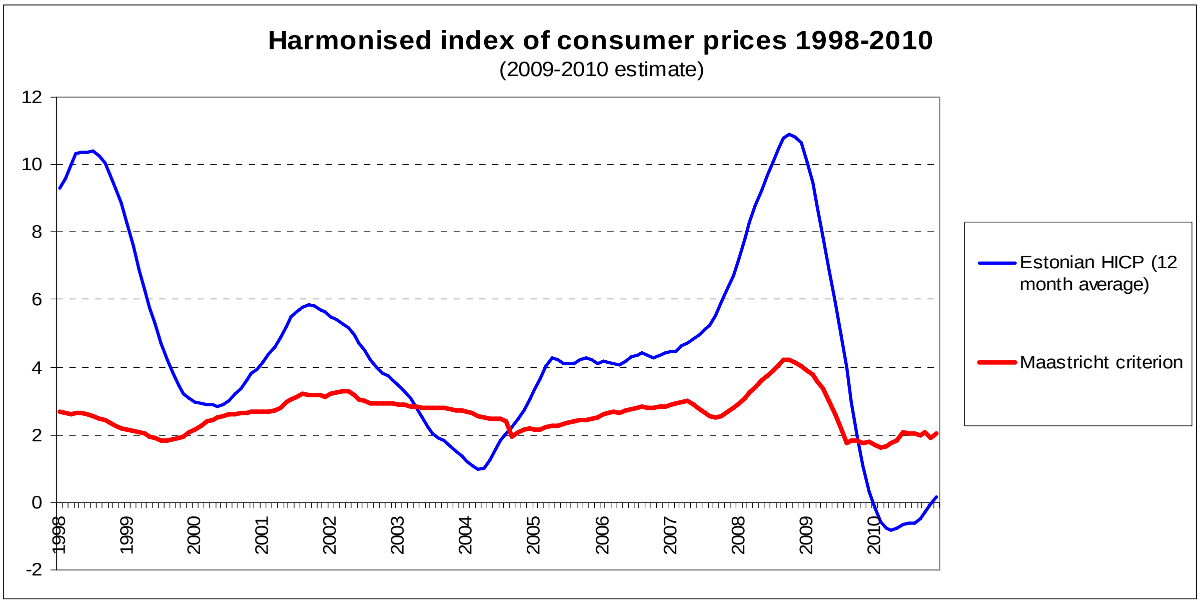
The objective of the Government is to keep public deficit lower than 3% of GDP for the years 2009–2011, and to return to a balanced position in the medium term. **The objective of the Government is to have a surplus in the public balance in 2012**.

The expenditure that exceeds revenues in 2008–2011 will be financed both from existing reserves and new loans. Public sector debt will increase to around 11% of GDP in 2010. Public sector debt will be increased mainly by the central government, but also by local governments in 2009 and 2010. Despite the increasing debt level, Estonia will come out of the economic downturn with a very low public debt. This will enable the Government to support economic growth more via favourable tax policies or the ability to continue with a relatively high share of public investments.

Another objective is to avoid spending all government reserves during the years 2008–2011. If the total amount of government reserves in 2007 was around 10% of GDP, then by the end of 2010 the reserves as a share of GDP will not have decreased significantly.

In addition to the public balance, another critical criterion for joining the euro area is price stability. High inflation has been the main obstacle for Estonia in its aspirations to join the euro area. During the last year the growth of prices has fallen sharply. This has created the realistic likelihood of meeting all the Maastricht criteria by the end of 2009.

Graph 2: Price stability between the years 1998–2010 (2009 and 2010 are estimates)



Source: Eurostat, Ministry of Finance, European Commission

Inflation has also fallen in other EU countries; however, in Estonia the decline has been much sharper than the EU average. The reasons for these developments include decreasing consumption, which reduces price pressures, but even more importantly the drop in the price of agricultural products and oil. In addition, many increases in prices as a result of tax policy decisions in 2007 are now disappearing. Taking these developments into account, the Government has set more ambitious inflation targets than planned a year ago when adopting the strategy for growth and jobs.

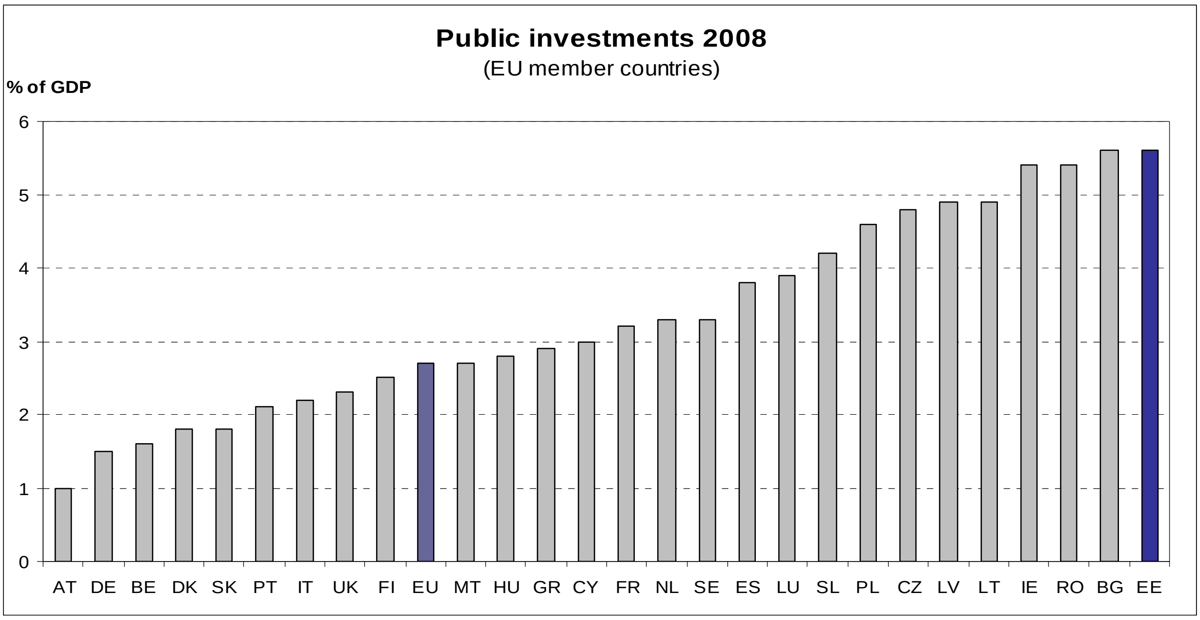
In terms of tax policy, the Government's general objective remains shifting the tax burden from labour and work to consumption and use of environmental resources. The system should continue to be stable, simple and transparent and without too many exceptions.

In 2009 the total tax rate will be 35.1% and in 2010 36.4% of GDP. The tax rate is increasing because GDP is decreasing more sharply than the decline in tax revenues. The largest share of tax revenues are formed by **labour related taxes**, which formed 17.7% of GDP in 2008 and estimates say, 18.7% in 2009. The tax burden on labour is increasing, which makes it even more important to find opportunities to continue with the aim of shifting the tax burden from labour to consumption.

The share of **consumption related taxes** in 2008 was 11.7% of GDP. According to estimates from the Ministry of Finance the figure will increase to 13.7% of GDP in 2009.

In the context of decreasing budgetary revenues, maintaining a high level of infrastructure investments and other productive expenditure in the state budget has become an increasing challenge. Despite the reduction of the total budget, the Estonian Government aims to increase the share of public investments even further.

Graph 3: Public investments in EU member countries (2008)



Source: Eurostat

In the 2010 budget, submitted as a proposal to the Parliament, there is a 14% increase in investments compared to the 2009 budget. These increases should be understood in light of several decisions the Government made at the end of 2008 to frontload the EU structural funds and Cohesion Fund. It is estimated that the share of public investments will be 6.4% of GDP in 2010.

OVERVIEW OF THE PRINCIPAL MEASURES

While implementing the strategy for growth and jobs, the focus of the Government in macroeconomic policy has been on measures that lead to increasing macroeconomic stability and in that context it has been important to keep the public sector expenditure under control. To this end:

- the operational expenditure of the central government has been reduced from EEK 17.4 billion in 2008 to EEK 15.7 billion in 2009. The 2010 budget proposal, which has been submitted to the Parliament, reduces operational costs further to around EEK 14.7 billion. Within two years the operational expenditure has been reduced by 16%. These changes are also important in order to achieve the objectives set in the strategy for growth and jobs, as the strategy foresees a reduction of operational expenditure in comparison to GDP;
- there are new measures limiting expenditure by local governments, in particular through stricter limits on new loans. In addition there is a new law in Parliament establishing clearer rules for the financial management of municipalities. This is in line with the strategy for growth and jobs where these measures were foreseen;
- changes in the health insurance regime as foreseen in the strategy for growth and jobs – the system for health insurance benefits has been amended and the incapacity benefits covered by the Health Insurance Fund have been reduced so that now employers (companies are now responsible for 5 days) and employees (now responsible for 3 days) bear a larger share. In addition, the incapacity benefit was decreased from 80% to 70% of the employee's salary. These changes contribute greatly to the long-term sustainability of the health insurance system.

Taking into account the changed macroeconomic environment, a number of measures have been adopted that were not foreseen in the strategy for growth and jobs:

- lowering the annual pension increase from 14% (that was foreseen by the relevant regulation before) to 5%. This change also has a great impact on the sustainability of the pension insurance fund in the long-term perspective;
- in order to ensure financial sustainability of the Unemployment Insurance Fund, unemployment insurance fees have been increased to the level of 4.2% of salaries;
- suspending contributions to the second pillar pension system until the end of 2010;
- an increase in the value added tax (from 18% to 20%) from July 2009;
- an increase of 10% in fuel excise taxes from July 2009;
- an increase of 5% in cigarettes and tobacco excise taxes from the beginning of 2010 and a further 20% from the beginning of 2011;
- an increase of 10% in alcohol excise taxes from the beginning of 2010;
- doubling taxes on natural gas;
- considerable increases in different environmental duties (mostly related to the use of natural resources, mining in particular).

Along with increased revenues, the total improvement of the position of the public balance is around 9% of GDP. The Government has cut planned expenditure to around 5% of GDP and another 4% of GDP comes from increasing revenues – both tax revenues and non-tax revenues. While planning and implementing tax increases the Government has broadly followed the objective of shifting the tax burden from labour to consumption and the use of environmental resources.

New initiatives

1. Socio-economic analysis on alternatives to establishing **limits** (incl. ceilings) **on social tax** in Estonia.
2. Raising the level of public investments as a share of GDP through the implementation of 2009 and 2010 state budgets.
3. In order to **increase public sector efficiency**:
   - the centralisation of the support functions (i.e. back office) for central government organisations;
   - streamlining the organisational structures of ministries;
   - carrying out an analysis of the delivery of existing public services with the aim of reducing red tape and excessive bureaucratic rules for citizens and enterprises;
   - conducting a revision in state foundations and other public organisations in order to find opportunities for merging institutions with similar and duplicate functions.
4. In order to improve the long-term sustainability of public finances by **raising the general retirement age to 65 years by 2024**. The retirement age for both men and women would be raised three months annually starting from 2017.

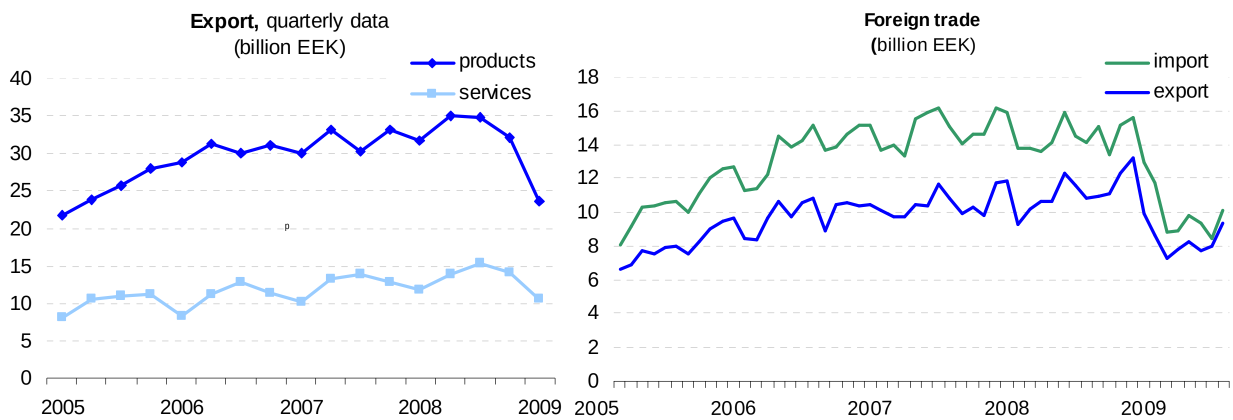
COMPETITIVE BUSINESS ENVIRONMENT

RECENT DEVELOPMENTS

Most of the measures for improving the business environment are inclined towards the central goal of the Action Plan for Growth and Jobs, which is to increase productivity. In previous years, growth in productivity has been rapid in Estonia compared to other Member States of the European Union. At the end of 2008, the downturn in the world economy and weakening of the internal market have clearly pointed out that in the long run the core challenges have nevertheless remained the same: the need for changes in the structure of the economy, moving toward higher value-added activities and sectors, and improving efficiency in all sectors.

Estonia has a small and open economy with a large share of exports in both goods and services compared to GDP – more than 70%. The recovery of the loans market that serves as a prerequisite for growth in internal consumption takes time. Therefore, the future of the Estonian economy is mostly dependent on its exports. In the first half of 2009, the export of goods fell by 26.8% compared to the previous year. The largest contraction took place in exports of metallic products and transport equipment. Largely due to high levels of transit in June, the export of mineral fuels has been the only field showing some growth statistically. The production levels of manufacturing companies have fallen by almost 30% on average every month in 2009 compared to the previous year, which for many sectors means that capacities are equal to those in 2005. The second quarter brought some recovery for electrical equipment and chemicals, but the overall trend has not changed yet. The exports of services encountered a somewhat less dramatic contraction – 9.8% in the first half of 2009.

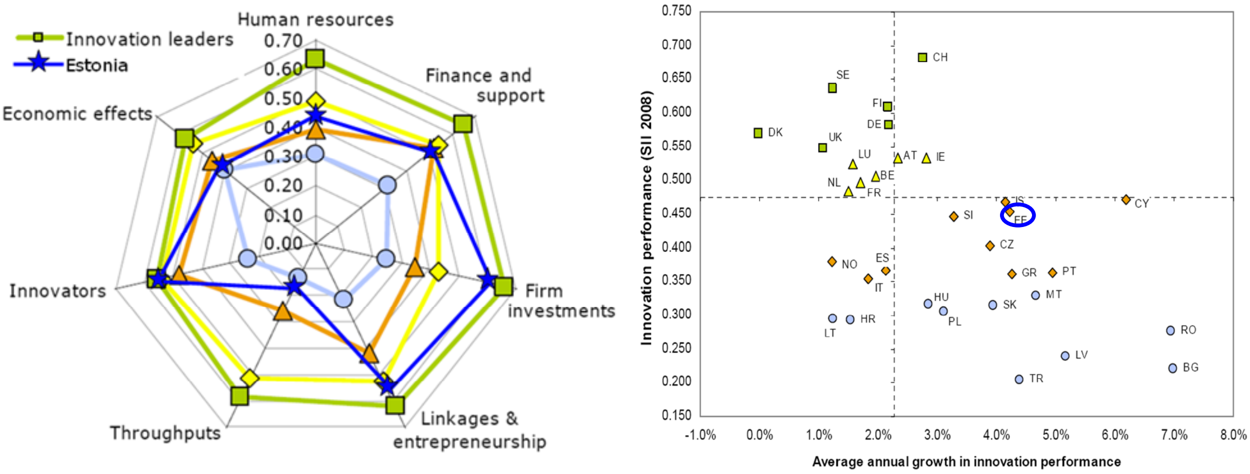
Graph 4: Export of products and services



Source: Bank of Estonia, Statistics Estonia

In the long run, the higher value-added sectors depend on the success of research and development and innovation policies to a great extent. On the European Innovation Scoreboard for 2008, Estonia, with a score better than the previous year, was placed 15th out of 32 European countries for its R&D and innovation capacities. Positive trends have mostly been driven by inputs. Since 2000, public sector contributions have grown by more than 19% on a yearly basis. This was followed by twice that in growth in the private sector, partially due to available credit and financing for investments, which led to a private sector share of 41.6% of all R&D costs in Estonia in 2007. International comparison shows some weaknesses in human resources: lack of graduates, doctoral graduates and overall youth education attainment levels. Concerning the output and impact indicators, Estonia is well below the average in Europe due to lower employment and exports in medium-tech and high-tech manufacturing and knowledge intensive services.

Graph 5: Estonia's position on the European Innovation Scoreboard



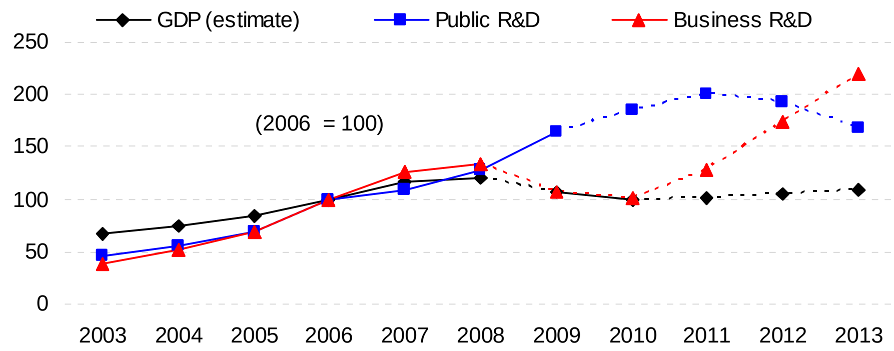
Source: European Innovation Scoreboard

<u>International competitiveness of research and development</u>

Despite budget constraints, improving R&D and innovation policies is a priority for the Estonian Government. In recent years the investments in R&D activities have increased rapidly – faster in the private sector than in the public sector. Overall, R&D spending was 1.11% of GDP in 2007 and in 2008 already 1.29% of GDP. In a changed economic situation the state contribution is of increasing importance for improving R&D competitiveness, as the experience of OECD countries over the last 30 years shows that a fall in GDP will be followed by an even sharper decline in private R&D spending.

Therefore, the Government aims to increase growth in public R&D spending to reach 1.3% of GDP by 2011, which is more than was foreseen in the Action Plan for Growth and Jobs approved in 2008 and the strategy "Knowledge based Estonia 2007–2013". **As a result, the Government will reach the target set for 2011 – overall R&D spending will be 2% of GDP.** Increasing public sector R&D spending (improving the R&D infrastructure, bringing highly qualified specialists and academics from abroad) will serve as the basis for faster growth in the private sector contribution once financing improves and demand recovers.

Graph 6: Forecast of public and private R&D spending compared to GDP

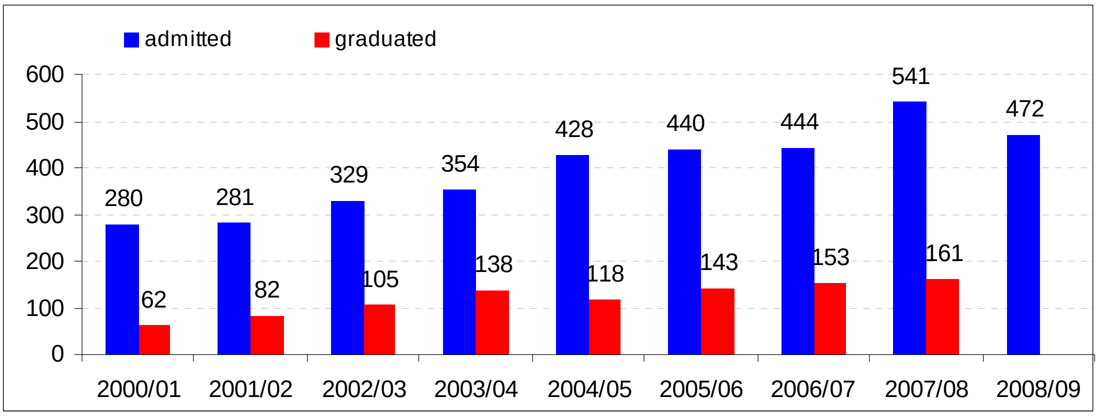


Source: Statistics Estonia, Strategy Office

The efficiency of using financing is characterized by results in two directions: sufficient human resources and good quality infrastructure. The number of full-time scientists and engineers per 1000 employees has been rising constantly and was 6.06 in 2008. In the private sector the number rose by a quarter in one year. The goal in the Action Plan is 7.0, which is still realistic considering the relative growth in R&D spending. In terms of the results of the scientific research, the growth in the number of academic articles in peer-reviewed publications has been rapid; reaching 1 161 articles in 2008 (the goal for 2011 is 1250). This means Estonia has reached the average level among EU Member States.

The objective of the Action Plan was to increase the number of people earning a doctoral degree to 250 by 2011. This is not likely to be met, considering that in the 2007/08 academic year the number was 161. In recent years, successful doctoral graduations have become more frequent, partially aided by the financing system for doctoral studies, but by less than 10 more graduates per year. In 2008/09 the number of people admitted to doctoral studies also decreased, mainly in humanities and non-state subsidized places. The budget constraints somewhat halted the respective measures in the Action Plan, the social guarantees system for doctoral students and increasing the state demand for students preferring the natural and exact sciences and technology. At the same time, the priority of improving human resources is still there, because compared to other fields financing for doctoral studies has not been cut during the budget amendments.

Graph 7: Doctoral students



Source: Ministry of Education and Research

The increase in public sector financing is mainly targeted towards the quality of infrastructure and development of the human resources that will be using it. The goal is to provide the prerequisites for creating a good working environment. Therefore, all of the initially planned investments in infrastructure and equipment will be carried out, as well as the programmes for engaging competent (foreign) scientists to start challenging research groups in priority fields.

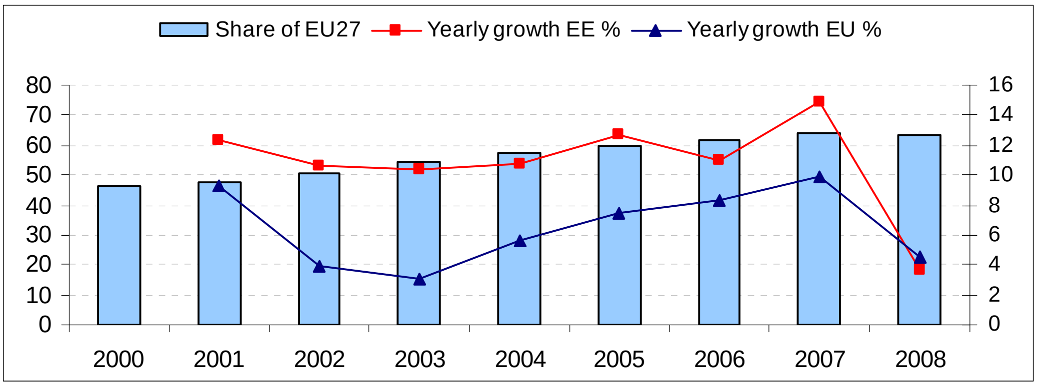
The salaries for R&D workers, especially young scientists, did not increase in harmony with the general trend in the last couple of years; therefore, the attractiveness of R&D institutions as employers suffered. In order to improve the situation, social guarantees must also be improved for scientific careers. For this purpose, amendments to legislation are being prepared that will foresee a position of junior research fellow, and options for partially carrying out doctoral studies on the basis of work agreements are also being analyzed. As a result, young scientists could be considered scientific workers and they would be covered by the social guarantees provided for all employees in Estonia.

An important indicator of the potential for development in companies is the number of full-time researchers and engineers in the business sector per 1000 employees. This has grown remarkably faster than the overall employment in the private sector, reaching 1.93 in 2007 and should at least remain at the same level in 2008. Considering the decrease in overall employment and the prioritization of R&D and innovation measures, the Action Plan objective of 3.3 in 2011 is still accurate.

Productivity and the international competitiveness of enterprises

The contraction of the economy has been much sharper than foreseen during the compilation of the Action Plan in summer and autumn 2008. Productivity per employee in Estonia compared to the EU average has actually started to decline in spite of recent growth. **Therefore, the Government's goal is a quick recovery of growth in productivity with the specific target of bringing productivity to 65% of the EU average with the help of new and existing measures.** Productivity per hour worked has also grown rapidly in recent years compared to the EU average because of its low starting position, but in light of recent developments, the government has set a target of 50% of the EU average.

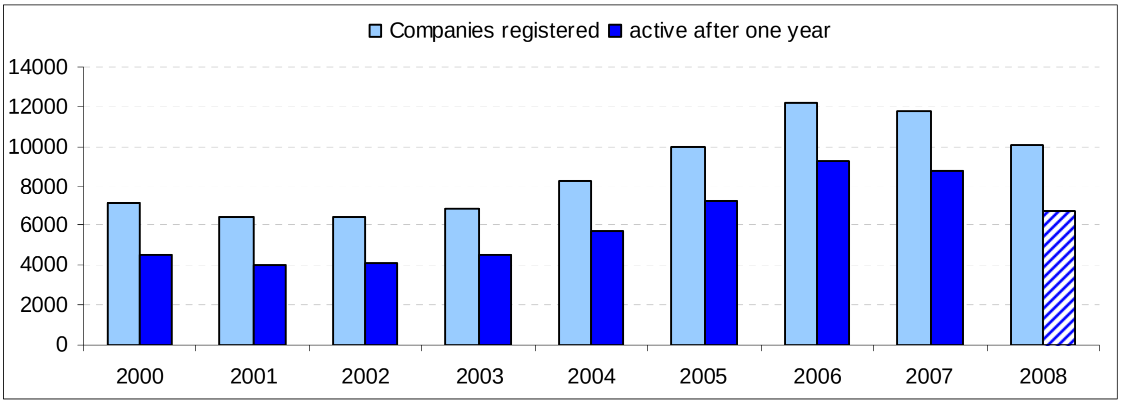
Graph 8: Productivity per employee in Estonia compared to the EU27 average



Source: Eurostat, Statistics Estonia

The fulfilment of the goals of the Action Plan concerning a good business environment can be seen according to the number of established and active companies per 1000 inhabitants and the survival rate of these companies. The number of companies per 1000 inhabitants has grown constantly, and in 2007 and 2008 it was 40.5 and 42.5 respectively, which is already higher than the targeted 39 set for 2011. At the same time, the number of companies that were active a year or more after establishment has also increased. The main reason was an increase in overall economic activity and good financing opportunities, but also the government support schemes. Despite the worsening of the business climate in the second half of 2008, the survival rate after 3 years of activity rose last year. With the negative economic growth, more cases of bankruptcy can be expected. Therefore, measures for improving access to capital and export capacity will become even more important. The Government's goal, with the help of business environment measures, is to maintain the achieved levels of entrepreneurial activity and the share of exports in the economy.

Graph 9: Active companies one year after establishment



Source: Estonian Tax and Customs Board, Strategy Office

In 2008, foreign direct investments to Estonia made up 71.4% of GDP, which means a small decrease compared to previous years due to the loss of one third of the gains in foreign investment compared to last year. The Government's goal is to keep Estonia in the top 3 in Europe for this indicator.

Estonia's position in the World Bank "Doing Business" table for 2010 has fallen from 22nd to 24th. The weakest point for Estonia is still in the category *employing workers* (161st among 181 analyzed states), but as the new Labour Act, which should improve the situation, only came into force on 1 July, it does not impact the period under consideration. Even though the indicators have not worsened, Estonia has fallen from 23rd to 37th place in the category *starting a business* because several countries have removed their minimum capital requirements. Analysis of this issue has been commenced in Estonia as well.

Competitiveness in terms of energy and green economic growth

Compared to the general economic environment there have been no remarkable changes in the security of Estonia's energy supply and the competitiveness of the energy sector compared to last year. One positive aspect is that many of the measures foreseen a year ago have in fact been implemented faster than predicted. The construction of several new electricity plants using renewable energy sources has led to a situation where Estonia will already meet its 2010 objectives for the share of renewable electricity by the end of 2009.

Another positive development is the gradual opening up of the electricity market in the Baltic States. The Government will soon implement several important measures to open the Estonian electricity market. The main power grid will be separated from the Estonian Energy structure, and the legislation concerning the open section of the electricity market will be amended. These steps are being taken to prepare for the complete opening up of the electricity market in 2013 and connecting with the Nordic electricity market.

Progress has not been as expected in all aspects of the market in the Baltic region. Regarding the second electricity cable between Estonia and Finland (Estlink 2), progress has been satisfactory and there is agreement concerning the NordBalt cable between Sweden and Lithuania. At the same time, there is no visible progress in creating an electricity link between Lithuania and Poland. The plans for a new nuclear power plant in Lithuania have also not been moving at the scheduled speed.

Generally, awareness of the need for an economy that carries less environmental burden has been improving. This is supported by more active Government policies for investing in renewable energy and improved energy efficiency. In 2009, in cooperation with the Parliament, the Government has focused on improving the policy to support energy efficiency and renewable energy. The Government has started to prepare an action plan for renewable energy. In the coming years, the Government plans to design a broader **policy of green economic growth.** In addition to energy efficiency and renewable energy, an important part of this plan will be improving innovation in the field of environmental technology and higher value-added activities in the use of renewable natural resources.

OVERVIEW OF THE PRINCIPAL MEASURES

The main long-term goal of the Action Plan for Growth and Jobs is still to **increase productivity** and the related challenges concerning structural changes in the economy and moving towards higher value added activities and sectors. Therefore, **long-term impact R&D and Innovation policy measures** are intended to be implemented as planned:

- R&D infrastructure improvement measures to invest 166 m EUR in higher education and research establishments and 114 m EUR in equipment for R&D institutions and international institutions;
- Financing Technology Development Centres (TAK) increased to 64 m EUR to enable three centres to be funded in addition to the previous five;

- Supporting companies with a programme for R&D projects worth 69 m EUR, a programme for technology investments worth 38 m EUR and a new innovation voucher scheme enabling companies to pay for the work done by R&D institutions;
- Science mobility programme “Mobilitas” (19 m EUR) enabling top scientists to set up research groups in priority areas and post-doctorates to continue their career in Estonian R&D institutions.

With the contraction of domestic demand and reduced inflow of loans, the most important measures in the Action Plan in the mid-term perspective have turned out to be those aimed at the **internationalization of companies and foreign investment:**

- Expanding the target group of the Marketing support scheme to companies that have just begun exporting;
- Increasing the limits to export guarantees from 64 m EUR to 192 m EUR, in order to create stability for the exporters and enable KredEx (Estonian Credit and Export Guarantee Fund) to be more risk averse;
- Centralising enquiries to investor and related information services and linking these to a unified contact solution;
- Re-organization of the network of Enterprise Estonia representatives abroad in order to provide adequate services to exporters and attracting foreign investors in target sectors;
- Opening calls for applications concerning cluster development and collective marketing events and participation in trade fairs, including opportunities for the sectoral business associations to apply.

In response to the worsening economic situation, **business support measures have been frontloaded, increasing their financing amounts for 2009 and 2010**, when the annual amounts paid out to beneficiaries will double compared to previous years:

- Supporting technology investments for manufacturing companies with 35 m EUR by the end of July 2009, instead of the end of 2010;
- More than doubling the maximum amount of support to start-up companies: start-scheme 6.4 thousand EUR and growth-scheme 32 thousand EUR per company;
- Bring forward EU supported infrastructure investment projects (energy saving in housing, water management constructions, vocational education buildings) from decisions made in the second half of 2008 and beginning of 2009.

Considering macro-economic changes, **additional measures to improve the financing of export companies** have been implemented to a total of 390 m EUR:

- Increasing the limits on loan guarantees from 51 to 96 m EUR, at the same time allowing smaller minimum amounts and fewer special controls;
- Allocating state contributed 25 m EUR as long-term resources to companies in co-operation with banks in order to finance projects that meet specific criteria;
- Allocating 25 m EUR as success-based loans subordinate to a bank loan, which provide additional equity capital and improve accountability;
- Providing an additional resource-scheme for banks that makes it possible to combine EU support and EIB loan funds at good interest rates in order to provide these loans to export companies.

The long-term improvement of the **competitive and environmentally friendly** energy sector has direct links to economic stimulus. Schemes for renovation loans and loan-guarantees for the energy efficiency of housing have started:

- First round of applications for boiler house and long-distance heating network investment support has been carried out;
- First round of applications for investment support for extending the use of bio-energy has been carried out.

New initiatives

Supporting exports and business investments

1. **Sector-based programme to attract and support investors** implemented via sector specific offers.
2. **Flexible and comprehensive support schemes for large-scale investors**:

   - **provision of land** for establishing large production units via a simplification of the land offering procedures and consultations on locations with the required qualities;

   - improving the development and use of industrial parks suitable for investments and an **infrastructure investment support scheme** for large scale investors;

   - commence a just-in-time programme for the **flexible provision of labour-force,** which creates the potential to carry out demand-based retraining or additional training via training programmes adjusted to suit companies' needs.
3. **Establishment of regional competence centres** with sectoral specialisation in order to facilitate cooperation between enterprises and education and research institutions outside the two larger centres, Tallinn and Tartu.
4. **Development of an export management programme** in institutions of higher education as both separate modules at Masters level and specific courses, providing access to students from non-economic faculties and students with work experience.

Improvement of the business environment and entrepreneurship

5. **Inclusion of business studies** as an elective subject in the curricula of all secondary schools and institutions of higher education.
6. **Abolition of the minimum holdings** for starting a company and cutting down on the reporting obligations for SMEs, including more efficient use of data.
7. **Development of a broad-band internet network covering Estonia** in order to create and provide services to people and companies in rural areas.

Steps in energy policy

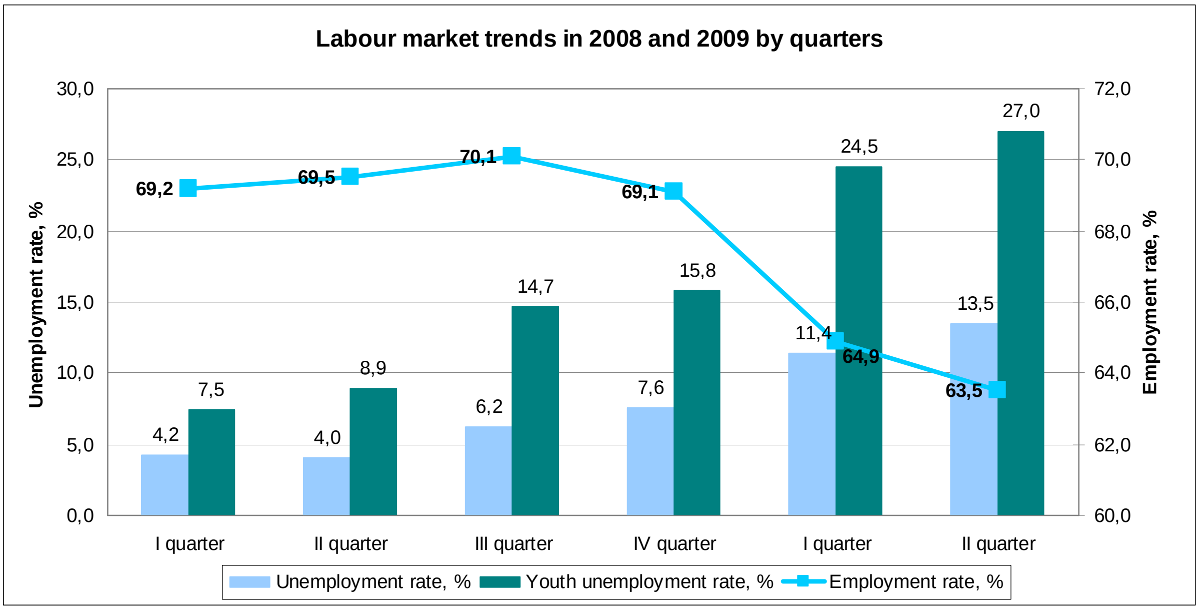
8. **Adopting the necessary legislation for developing nuclear energy**.
9. **Increasing the amount of financial support to renewable energy production.**
10. **Separating Elering OÜ (main power grid) as the natural monopoly of the company** from the structure of Estonian Energy.
11. **Opening 35% of the electricity market.** As a result large consumers will lose the right to buy electricity at fixed prices and a basis for active competition is established.
12. Developing options that enable investments in the security of Estonia’s energy supply by including additional resources to the equity of Estonian Energy.
13. **Establishing an Energy and Climate Agency** in order to improve the co-ordination of energy saving and renewable energy programmes and to provide options for additional measures.

EDUCATION AND LABOUR MARKET

RECENT DEVELOPMENTS

In the context of the severe economic downturn, the labour market situation started to worsen rapidly in the second half of 2008. The unemployment rate stands at an 8-year high reaching 13.5% in the second quarter of 2009. Since the recession has more strongly affected sectors with a male dominated labour force, the unemployment rate for men has increased more than average standing at 16.9% in the second quarter of 2009. Youth unemployment has also increased rapidly. Since the beginning of 2009 the employment rate has decreased to 63.5% in the second quarter of 2009.

Graph 10: Labour market trends in 2008 and 2009 by quarters



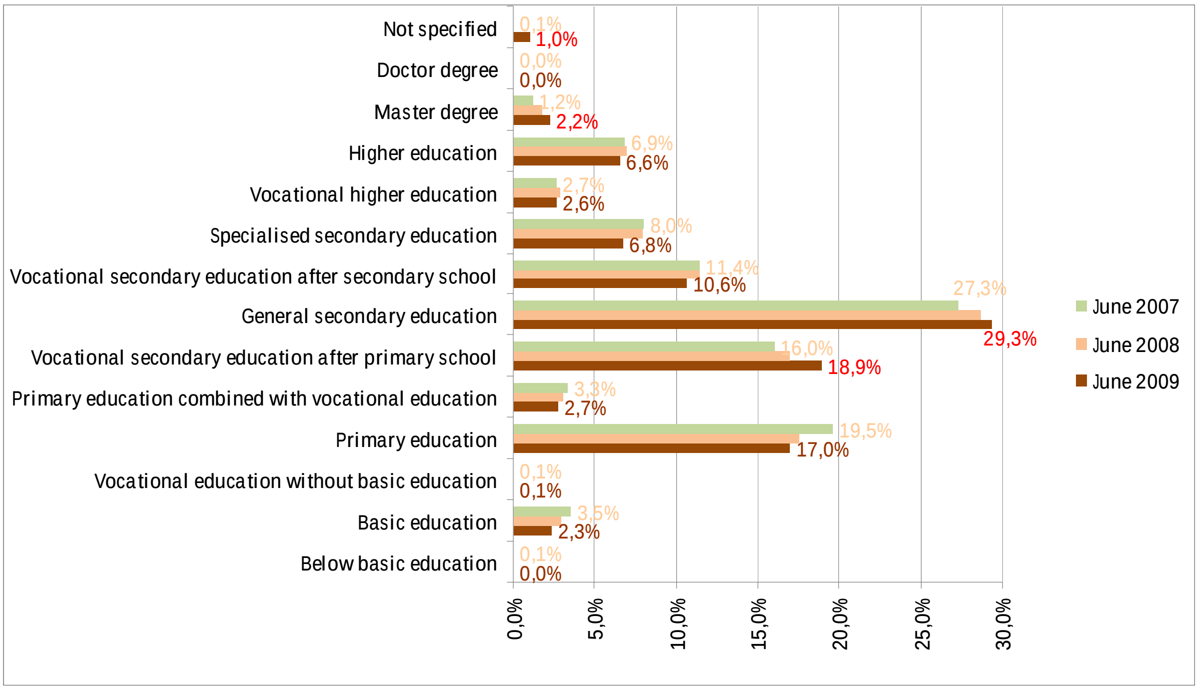
Source: Statistics Estonia

With rapidly increasing unemployment more people are also registering as unemployed. According to recent data, approximately 70% of all unemployed are also registered as unemployed at the Unemployment Insurance Fund. This enables the public employment services to offer active labour market measures to relatively more people than before.

At the same time the educational background of unemployed people has not changed considerably. People with secondary education (29.3%) and vocational education after primary school formed the largest part of those registered as unemployed in the first half of 2009 (see Graph 11). They were followed by people with only primary education (17% of registered unemployed). In total, 46.3% of registered unemployed do not have any vocational or professional education.

Every tenth registered unemployed had a higher educational background. The employment rate of people with higher education has decreased at a slower pace than average, from 89.6% in 2007 to 87.1% in 2008.

Graph 11: Registered unemployed by educational level (first half of 2007-2009)



Source: Unemployment Insurance Fund, Ministry of Education and Research

Due to the changes in the labour market, the current challenges to employment policy are considerably broader and more diverse compared to those of a year ago. The previous narrow focus on supporting risk groups has been mainly replaced by concentrating on wider target groups and particularly on people that have recently been laid-off taking into account the current labour market situation.

In the new economic situation, the target of an employment rate of 70% for 2011 as set in the existing Strategy for Growth and Jobs 2008–2011 is no longer realistic. According to recent forecasts, the labour market situation will not improve considerably in 2010 and the overall employment rate is expected to fall to 60%. Therefore, the Government has set a new target to raise the employment rate among 16-64 year-olds to 63.5% by 2011 taking into account economic development as well as the potential impact of labour market measures taken to improve the employment situation.

Due to the rapid increase in unemployment and the decrease in the number of vacancies, the Government has refocused employment policy measures and revised labour market related targets. The Government aims to support the recovery of the labour market through two main areas of activity:

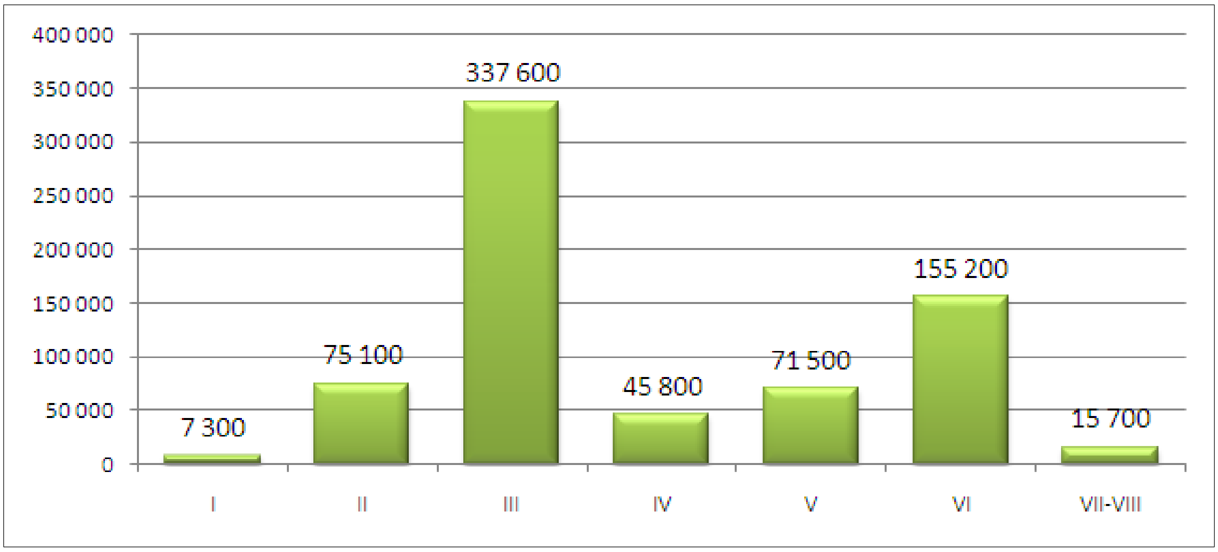
1. Increasing the competitiveness of the labour force by raising skills and qualification levels for at least 50 000 people;

2. Retaining employment through supporting the creation of 5000 new jobs by means of extending the wage subsidy scheme.

Increasing the competitiveness of the labour force

Motivating people to raise their skill levels in line with changing labour market needs and their willingness to do so is one of the most important factors for preparing for the next economic upswing. In this context, the main focus is on increasing the qualification and skills level of as many people as possible. This will be done through both raising the educational level as well as qualification level of people active on the labour market. According to 2008 data, 41% of 25–64 year-olds have a vocational secondary or higher education.

Graph 12: Number of 15-64 year-olds on the basis of the highest educational level they have attained according to the 8-level framework of qualifications (2008)

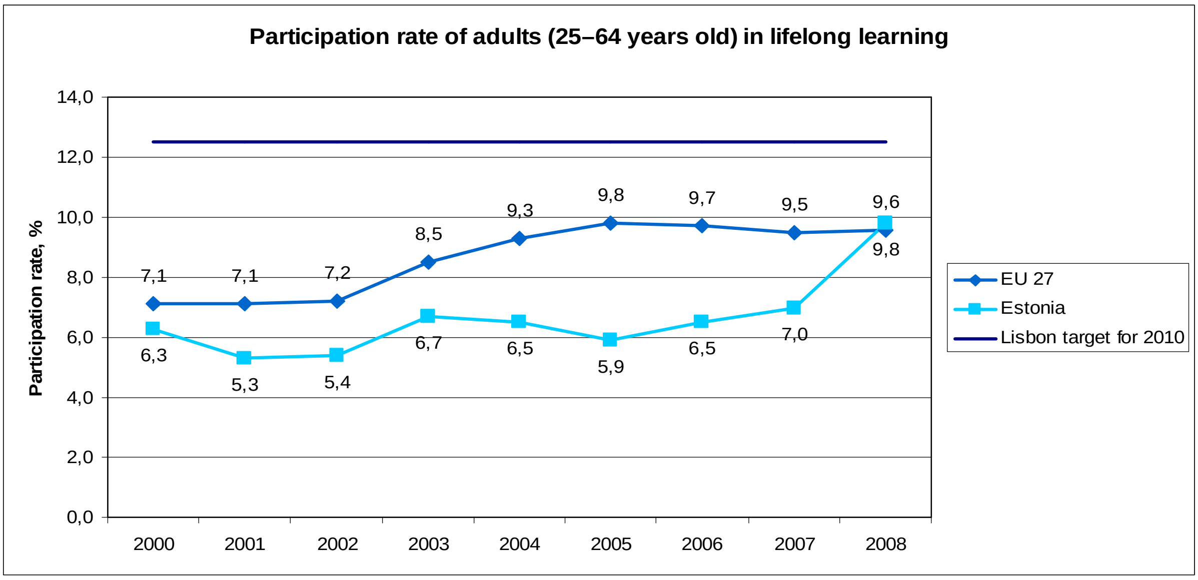


Source: Statistics Estonia

The Government has set the goal to increase the share of 25-64 year-olds on qualification level IV-VIII1 – up to 48% by 2013, which means raising the skills level of 50 000 people.

Lifelong learning schemes and extended provision of learning opportunities for adults are becoming more important in the difficult labour market situation. The lifelong learning policies implemented so far are returning positive results and the participation rate of adults in lifelong learning is constantly increasing. In 2008, the participation rate of adults was 9.8% (see graph 13). Recent positive developments have given a good reason to raise the target value of this indicator. **The Government has set a new target to increase the participation rate of adults in lifelong learning up to 13.5% by 2013**.

Graph 13: Participation rate of adults (25–64 years old) in education and training



Source: Eurostat

[1] The qualification levels are based on the following classification: level I : below basic education; level II : basic education; level III : vocational education after basic school, general secondary education, vocational secondary education after basic school; level IV : vocational secondary education after secondary school; level V : specialised vocational secondary education; VI level: higher education; levels VII - VIII : master and doctoral degrees.

According to the statistical data, the participation rate in lifelong learning activities is higher for people with higher education (15.9% in 2008) compared to people with secondary (7.5%) or lower educational levels (2.1%). Therefore, the main focus is on attracting people with a lower educational background and people who have dropped out of school to return to the education and training system.

The focus and structure of the training provided by vocational education centres has been changed. Besides additional training, more attention will be put on retraining measures and more flexible learning opportunities. **The core of these activities concentrates on attracting people who have dropped out of school to return to the adult education system** to finish their studies. Participation in training and raising skill levels also helps to better prevent unemployment. To facilitate adult learning, several new initiatives will be launched: individual study plans will be introduced, the diversity of learning formats will be enhanced and studies will be interlinked with different counselling and support services throughout the study period.

In September 2009, the new *Development Plan for Adult Education 2009–2013* was approved. The strategy foresees considerable extension of learning opportunities for adults and initiatives for attracting more people to the education and training system. The main aims of adult education include overall improvement of skills and educational levels and an increase in participation in lifelong learning. The reduction of the share of people without any vocational education or professional specialisation and the creation of opportunities for raising the qualification level via a high-quality training system are also high on the agenda.

Active labour market measures

A precondition for higher employment levels is a well functioning and favourable business environment. Besides a number of support schemes for companies, there is a plan **to considerably increase the financial means for the wage subsidy scheme**. Under the wage subsidy scheme the employer can apply for a reimbursement of a maximum of 50% of the salary paid to an employee when hiring a person who has been unemployed for 6 months or more. The ceiling of reimbursement is equal to the national minimum wage. The scheme aims to support the retention of and/or creation of 5000 new jobs. At the same time the scheme also has a preventive effect preventing long-term unemployment and keeping people active on the labour market.

Prevention of unemployment and anticipative support to people at risk of being made redundant or unemployed (including short-time and part-time workers) are high on the agenda. All people at risk of unemployment are preventively entitled to career and labour market counselling in order to avoid unemployment and shorten potential periods of unemployment.

A large challenge is the presumed increase in long-term unemployment in 2010. In the 2nd quarter of 2009 the long-term unemployment rate increased to 3.2% and has doubled in comparison to the rate a year ago. In light of existing economic forecasts, long-term unemployment will most likely reach its maximum level in 2011. Taking this into account **the Government aims to keep the long-term unemployment rate below 8% by 2011.** In addition, the share of long-term unemployed among all unemployed will be closely monitored and it is expected not to exceed the 50% level.

In the context of increasing unemployment, youth (15–24 years) unemployment has increased more rapidly. During the past year youth unemployment has tripled, standing at 27% in the 2nd quarter of 2009. Youth unemployment is dominated by young men with a low educational level and without any vocational specialisation. Most of the unemployed young people do not have any work experience having recently graduated from school or dropped out of school. **To better integrate young people into the labour market the apprenticeship training scheme has been implemented more extensively** to combine vocational training with real work experience in a company.

The process of entering the labour market for young people will be supported by a work practice scheme in companies, which enables young people to gain practical work experience. On the other hand, it allows the employer to train a potential employee according to company-specific needs in a quick and flexible way. Supporting the job search process for young unemployed is facilitated by job-clubs where information about the labour market in general, but also about application procedures, professions and career opportunities will be disseminated. In addition, young unemployed are entitled to the wage subsidy scheme under more favourable conditions. They can be hired with a wage subsidy after only 3 months of unemployment.

As a result of the merger of public employment services the number of people participating in active labour market measures has increased considerably over the past 6 months. There were 2.6 times more active labour market measures offered in the first half of 2009 in comparison to the first half of 2008. The improvements in the provision of labour market measures will be continued in 2009 and 2010 with the aim of making the public employment service function more quickly and ensure a needs-based service.

In order to better tackle the impact of the economic crisis, the Government has decided to considerably increase the budget for both adult training and active labour market measures for the coming years. To better support the recovery of the labour market, the Government adopted the *Action Plan for Reducing Unemployment* in September 2009. The action plan foresees the extension of active labour market measures as well as increases in the financing of employment programmes in the years 2009–2010. Among other activities the action plan includes support for the creation of new jobs, measures for preventing inactivity, and enhancement of additional training and retraining opportunities. Also the availability and flexibility of career counselling will be increased. In total, active labour market measures will be financed in the amount of 459 million EEK in 2009 and 618 million EEK in 2010 within the framework of the programme “Increasing the supply of qualified labour force”. According to the current prognosis, **the total expenditure on active labour market policy will be expected to rise** up to 0.42% of GDP in 2010, which is comparable with the average expenditure level in the EU-27 (0.47% in 2007).

Developments in the higher education system

In higher education, the main focus is on continuously ensuring the competitive quality of higher education institutions while retaining their autonomy. Strengthening the role of universities and higher education institutions as leaders of innovation for Estonian development and **increasing the internationalisation of higher education** are also of special importance. More attention will be given to attracting students of Estonian origin who are studying abroad to return to Estonia after their graduation. According to the OECD, approximately 700-800 young people leave Estonia every year. Thus, it can be estimated that there are approximately 5000 people studying abroad at every moment and attracting them back to Estonia is important. Currently, there are no comprehensive statistics about the people who have left Estonia to study and who potentially would be interested in returning.

To raise the quality of higher education, the Quality Assurance Agency for Higher Education (QAAHE) has been established. The main task of this newly established agency is to develop an independent quality assessment system in line with *European Standards and Guidelines for Quality Assurance in the Higher Education Area*. In the years 2009–2011, the agency will carry out a transition assessment, which aims to reach the situation where all Estonian universities and higher educational institutions will have the right to issue nationally approved diplomas. Until now the accreditation, which is a precondition for national acknowledgement, has only been voluntary for universities.

Increasing the **popularity of studies in the field of natural and exact sciences** is permanently important. In the current worsened economic situation more young people opt to continue their studies. Most of them prefer to study in fields where there are state commissioned study places. As the Government has considerably increased the number of study places in the field of natural and exact sciences over the past years, the structure in higher education is developing in line with the needs of an innovation based economy.

There are also special measures being implemented to further support cooperation between universities and enterprises.

OVERVIEW OF THE PRINCIPAL MEASURES

In the changed labour market situation, the expectations of the employment policy and the quality and volume of labour market measures has considerably increased. The European Council recommended Estonia increase the efficiency of public employment services and to speed up the modernisation of the labour law. In response to this recommendation, two important reforms have been accomplished in 2009:

- **Merger of public employment services** (Labour Market Board and Unemployment Insurance Fund) in May 2009, which concentrated the provision of both active and passive labour market measures in one institution. The supervisory board of the new institution (Unemployment Insurance Fund) includes representatives of the employers' union, trade unions and the Government, which creates a good basis for more efficient implementation of employment policy. During the first months after the merger the new institution started to systematically develop its customer service and has increased its analytical capacity. The recent changes have also focused on extending active labour market services to allow more people to benefit from these services.
- **Implementation of the new labour law from July 2009.** The new labour law is driven by the flexicurity principle. The law was enforced half a year earlier than initially planned in order to better support the adjustment of the labour market to the changed economic situation. The implementation of the new labour law is one of the most important labour market reforms in recent years, and brings the labour law in accordance with real labour market needs. The new regulation stipulates more flexible conditions for collective dismissals and reduces the financial burden for employers in cases of lay-offs. Despite the more relaxed conditions, the new law did not result in any rapid increase in dismissals after coming into force. It is expected that the increased flexibility of the labour law will support the creation of new jobs during periods of economic growth.

  The increased labour market flexibility is counterbalanced by measures to increase employment security. Active labour market policies have been strengthened by extending the target group for employment services. The volume and budget of additional training and retraining measures as well as of the active labour market policy has been increased. Support for participating in active labour market programmes such as training grants and transport compensations have also been increased.

  In addition, the Government has submitted the new draft public service law to the Parliament, which brings the employment regulation of civil servants in line with the main principles set out by the labour law.

Motivation among people to raise their skill levels and qualifications according to the changing needs of employers is one of the crucial factors for the next economic upswing. To increase people's overall skills, several measures have been implemented in vocational and higher education:

- Modernisation of higher and vocational education curricula and matching higher education learning outcomes with labour market needs. The principles of the APEL system (accrediting prior experiential learning) have been introduced;
- Financial support measures to educational institutions to enable them to better attract foreign students at Master and PhD level to study in Estonia; encourage them

to stay longer and forge ties with the Estonian labour market (especially in research and development work) after they finish their studies;

- Launching the DoRa programme (programme for doctoral studies and internationalisation) to increase the quality and competitiveness of higher education. Within the framework of the programme, up to 50% of the wage costs of foreign professors working at regular posts in Estonian universities will be financed. Foreign professors are expected to start their activities in Estonia in 2011;
- Support for studies abroad for Estonian Master level students in order to ensure the availability of highly qualified people;
- Modernisation of the infrastructure (classrooms, learning equipment) of higher and vocational education institutions;
- Raising the qualification of teachers in vocational and general education by developing a needs-based additional training system for teachers;
- Separation of basic schools and secondary schools in order to increase the efficiency and sustainability of the education institutional network. The Government has submitted a corresponding draft law to Parliament, which foresees the separation to take place in 2012;
- Promoting science and technology study fields by increasing the importance of science subjects at basic and secondary school levels and by increasing the freedom of choice for secondary school and vocational education students; developing curricula in technology and the natural sciences for non-formal education institutions;
- Extension of additional training and retraining opportunities for adults through vocational education, higher vocational education and non-formal education institutions;
- Further development of the system for career services based on the needs of society and the labour force.

In addition to existing planned measures as described in the Strategy for Growth and Jobs 2008–2011, the following initiatives have been implemented to improve the availability of additional training and retraining:

- Introducing a personalised training voucher system for the unemployed as an additional option for labour market training. Training vouchers enable the unemployed person to quickly find a suitable additional training course based on individual needs. The system was launched in September 2009;
- Introducing training vouchers for employers with the aim to raise the skills level of managers and employees;
- Simplifying and shortening procedures for organising labour market training to increase the availability of labour market measures.

New measures

1. **Launching a talent programme**. The aim of the programme is to encourage young specialists to return to Estonia after graduating abroad by offering them job opportunities in the private and public sector.
2. **Attracting school dropouts and early school leavers back to vocational and higher education.** More flexible opportunities will be created for school dropouts to allow them to finish their studies. The target group are people who were successful in their studies, but dropped out due to economic reasons during the economic boom. The studies will be combined with counselling and a study grant.
3. **State-commissioned adult training in higher education institutions.** The idea is to enable adults to participate in additional higher education training in state-

commissioned study places.

4. **The continuing training measure** is targeted at students who ceased studies during the economic boom period and entered the labour market before graduation. The measure aims to support those people who were successful in their studies and dropped out mainly for economic reasons.
5. **Launching career information centres and developing career services.** Career counselling will also be extended to employed people. Career information centres will be opened at regional offices of the Unemployment Insurance Fund.
6. **Business start-up package. To** create new jobs, a package for business start-ups will be launched. The package comprises entrepreneurship training, counselling, mentoring new entrepreneurs and providing additional training over two years after the creation of the enterprise.
7. **Relaxation of conditions for the wage subsidy and increasing the respective budget.** The conditions for the wage subsidy will be temporarily relaxed in 2010.
8. **Retaining the employability of unemployed people by organising job clubs and offering opportunities for voluntary work.**
9. **Increasing the quality and availability of labour market services** via more extensive use of modern information technology**.** It is planned to further develop e-services and mobile counselling.