

## The Evolution of Employment

Despite the substantial poverty reduction between 1998-99 and 2005-06, many transition countries have failed to create visible and lasting employment for a large swath of the population (figure 1.2). Among advanced reformers, such as Slovak Republic and Poland, the limited use of labor is reflected in unemployment rates, which stood at 13–14 percent of the labor force in 2006. In Hungary it is reflected in declining labor force participation, as many workers have given up their job search and left the labor force, rather than in the unemployment rate, which in 2006 was a (relatively) low 7.5 percent. In the EU8 countries the long-term unemployment rate—the proportion of unemployed without a job for more than one year—ranged from 36 percent in Latvia to 56 percent in Poland, and to an exceptionally high 76 percent in the Slovak Republic in 2006.<sup>1</sup> This was higher than in the cohesion countries, where it ranged from 22 percent in Spain to 54 percent in Portugal. Among the EU8, however, long-term joblessness between 2002 and 2006 fell in the Baltic states, markedly in 2006, and in Slovenia, but rose in the Czech Republic, Hungary, Poland, and the Slovak Republic. In the Southeastern European

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This chapter is based on World Bank (2005b) and Mitra, Muravyev, and Schaffer (2008).

countries long-term unemployment in 2006 was 56 percent in Bulgaria and 58 percent in Romania, but 79 percent in Serbia and 92 percent in Macedonia.<sup>2</sup>

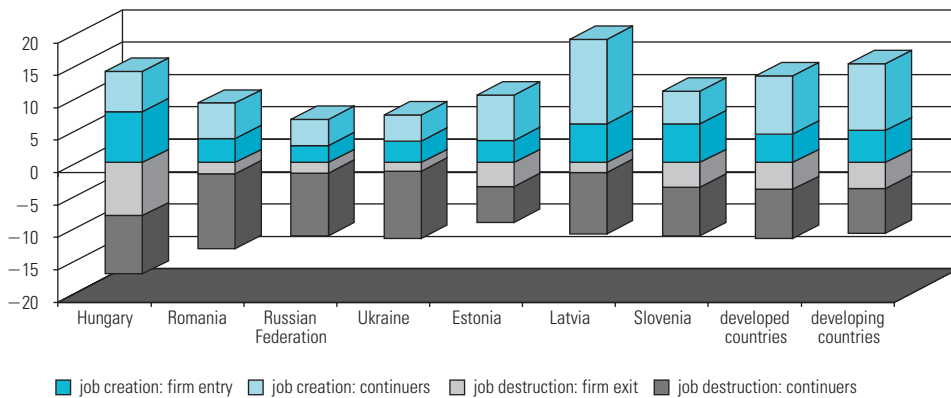
Employment rates tend to be higher in the CIS than in Eastern Europe (figure 1.2). This is in part because open unemployment is less affordable without a strong social safety net. However, this trend is also consistent with having a significant part of the workforce mired in low productivity jobs in unstructured enterprises or in subsistence agriculture, especially in the low income countries. Notwithstanding the absence of strong safety nets, long-term unemployment among the unemployed is also high in the low income CIS countries. In Armenia 40 percent had been unemployed for a year in 2006, while in the Kyrgyz Republic the figure was 43 percent in 2006. The share of self-employment in total employment has grown, ranging from 20 percent in the EU8 and Southeastern Europe and 17 percent in the middle income CIS countries to 50 percent in the low income CIS countries. The self-employed comprise both aspiring entrepreneurs and those for whom it is the last resort in the absence of regular and well-paying jobs, as in subsistence agriculture. The poor are overrepresented among the self-employed because many of the working poor are self-employed, especially in the low income CIS countries.

### Entry, Exit, and Employment

Observed labor market outcomes reflect different stages of the transition and different job dynamics. The sum of job creation<sup>3</sup> and job destruction<sup>4</sup> rates increased dramatically, from less than 10 percent of the labor force in the late 1980s to more than 20–25 percent in the 1990s. The average rates of job reallocation<sup>5</sup> are comparable to those in developed countries but lag somewhat behind those in other developing countries (figure 4.1).

Countries experienced a surge in job destruction in manufacturing at the beginning of the transition as a result of downsizing and liquidation in enterprises made unviable by price and trade liberalization and hardening budget constraints. Job creation was more variable across countries (figure 4.2). In Hungary it caught up with job destruction by 1996–97 and again in 1999–2000. In Romania it surpassed job destruction briefly in 1995–96 before a macroeconomic crisis and a second transitional recession occurred, followed by soaring job destruction and a second catch-up in job creation in 2000–01. And in Ukraine it exceeded job destruction in manufacturing only in 1999–2000. The continued dominance of job destruction over job

**FIGURE 4.1**  
**Large Job Flows in Transition Economies**



Source: Bartelsman and Scarpetta 2007; Brown and Earle 2007.

Note: Data are for 1997–2003 for Estonia, 1989–2003 for Hungary, 1994–99 for Latvia, 1992–2005 for Romania, 1991–2004 for the Russian Federation, 1993–2000 for Slovenia, and 1992–2005 for Ukraine. For developed countries data are for 1978–99 for West Germany, 1989–97 for the United States, 1988–93 for Italy, 1987–98 for the United Kingdom, 1984–94 for Portugal, 1989–98 for Finland, 1991–96 for France, 1985–97 for Canada, 1982–94 for Denmark, and 1994–97 for the Netherlands. For developing countries data are for 1997–2001 for Argentina, 1996–2001 for Brazil, 1979–1999 for Chile, 1982–1998 for Columbia, 1990–95 for Indonesia, 1982–93 for Korea, 1987–2000 for Mexico, 1986–91 for Taiwan, China, and 1995–2000 for Venezuela.

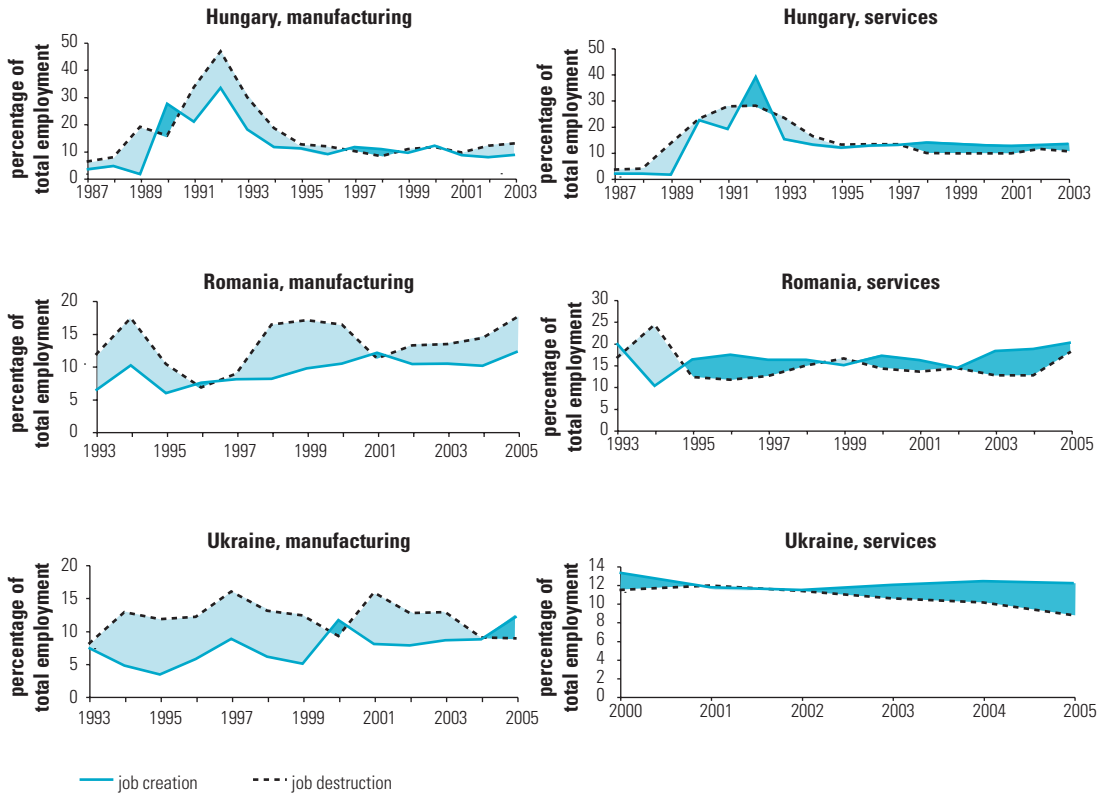
creation in manufacturing in all three countries reflected the downsizing of overly large industrial sectors.

The experience in services was quite different. Job destruction initially soared in Hungary but was overtaken by 1997–98. In Romania job creation, once it had caught up with job destruction in 1994–95, stayed ahead of it in all but one year. And in Ukraine, where data are available only from 1999–2000, job creation stayed ahead of job destruction. This reflects the expansion of services, which had been repressed in the transition economies.

As noted in Chapter 2, firm entry and exit as a proportion of the total number of firms was substantially larger in early reforming transition economies than elsewhere. An essential channel for job creation in transition economies has been the entry of new firms. In pre-transition Russia firm turnover (entry and exit of firms) accounted for less than 20 percent of job turnover. During the transition the contribution of firm turnover to job flows increased greatly. The role of new firms in job creation in the early years of the transition ranged from 70–90 percent in Hungary and Romania, 60–80 percent in Slovenia and Ukraine, and 50–70 percent in the Russian Federation. As the transition unfolded, the share of new firms in job creation fell to around 20–25 percent in Hungary, Romania, and Slovenia, implying that the bulk of job creation in the later years occurred in continuing firms. But the contribution of new firms to job creation in the Russian Federation

FIGURE 4.2

Job Creation and Job Destruction in Manufacturing and Services



Source: Brown and Earle 2007.

and Ukraine increased somewhat when the entry of firms in both countries rose following the 1998 financial crisis in Russia. Over the period since the beginning of transition, firm entry accounted for 38 percent of job creation, higher than that in market economies, where it was slightly more than 30 percent.

Downsizing by continuing firms was more important than firm exit in job destruction in all countries. Its share in Romania, the Russian Federation, and Ukraine was around 88 percent, and around 66 percent in Estonia, Hungary, and Slovenia. The share of firm exit in job destruction was 23 percent, lower than the 30 percent or so in market economies. The role of firm creation and firm destruction in the evolution of employment highlights the importance of the demand side of labor market outcomes.

Thus, to summarize, net entry—the entry of new firms and exit of obsolete firms—has been a key driver of productivity growth in the transition countries (Chapter 2), while the entry of new firms has been important for employment creation as well. And while the

restructuring of existing firms has contributed to productivity growth, it has on average led to job destruction, suggesting defensive restructuring. As transition economies come to resemble market economies, the role of existing firms in productivity growth and job creation likely become more important than firm entry. And firm exit will be more important than downsizing in job destruction.

## Labor Market Outcomes: Converging?

What do the three rounds of the BEEPS surveys show about job creation, destruction, reallocation, and growth (table 4.1 and figure 4.3)? First, job allocation, which is the sum of the job creation rate and the job destruction rate, did not vary much across time or across groups of transition economies. At around 20 percent, it was no higher in the transition economies than in the cohesion countries.

Second, job destruction rates were higher at earlier stages of the transition and either stayed broadly the same or fell, while job creation

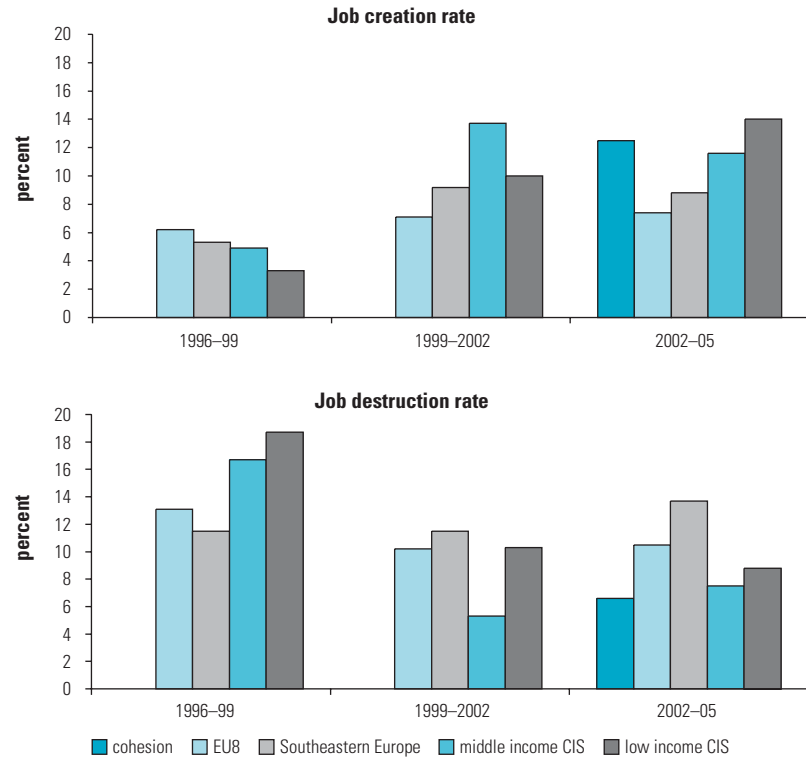
**TABLE 4.1**  
**Job Reallocation, Job Creation, Job Destruction, and Job Growth, by Country Group**

Country group	Job reallocation rate	Job creation rate	Job destruction rate	Job growth rate
<b>Developed market economies (2004–05)</b>				
West Germany	0.138	0.060	0.078	-0.018
Cohesion	0.192	0.125	0.066	0.059
<b>Transition economies (2005)</b>				
EU8	0.180	0.074	0.105	-0.031
Southeastern Europe	0.224	0.088	0.137	-0.049
Middle income CIS	0.191	0.116	0.075	0.041
Low income CIS	0.229	0.140	0.088	0.052
<b>Transition economies (2002)</b>				
EU8	0.173	0.071	0.102	-0.030
Southeastern Europe	0.207	0.092	0.115	-0.023
Middle income CIS	0.190	0.137	0.053	0.084
Low income CIS	0.203	0.100	0.103	-0.003
<b>Transition economies (1999)</b>				
EU8	0.193	0.062	0.131	-0.068
Southeastern Europe	0.167	0.053	0.115	-0.062
Middle income CIS	0.216	0.049	0.167	-0.118
Low income CIS	0.221	0.033	0.187	-0.154

Source: Mitra, Muravyev, and Schaffer 2008.

Note: The job creation rate is the number of jobs created during a year divided by average employment during the year. The job destruction rate is the number of jobs destroyed during the year divided by the average employment during the year. The job reallocation rate is the sum of the job creation rate and the job destruction rate. The job growth rate is the job creation rate less the job destruction rate.

FIGURE 4.3

**Job Creation and Job Destruction, by Country Group**

Source: Mitra, Muravyev, and Schaffer 2008.

rates were lower at earlier stages of the transition and either stayed broadly the same or increased with the transition. Thus, aggregate job growth, which is the difference between job creation and job destruction, was negative during 1996–99, but less so in the EU8 and Southeastern European countries, where job creation was higher and job destruction much lower than in the CIS countries, many still mired in the transitional recession. The situation reversed in 2002–05. Job growth continued to decline in the EU8 and Southeastern European countries, albeit less so than before because of some improvement in job creation and broadly unchanged job destruction. But job growth was faster in the CIS countries because of a marked acceleration in job creation, together with a rapid deceleration in job destruction.

Third, job creation in the CIS economies was considerably higher and job destruction considerably lower than in the EU8 and Southeastern European countries. Job creation was likewise higher and job destruction lower in the cohesion countries than in the EU8 and Southeastern European countries in 2002–05.

Fourth, aggregate job growth was consistently the highest in de novo firms, although it was modestly negative in 1996–99 before

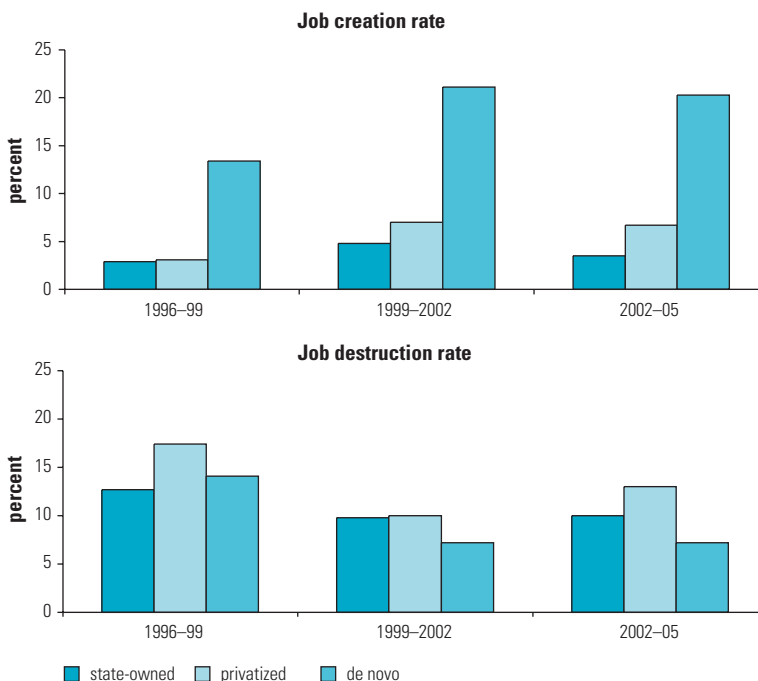
turning strongly positive in the later years (table 4.2 and figure 4.4). Indeed, rates of aggregate job growth in de novo firms were 15–20 percentage points higher than in state-owned and privatized firms. The pattern of positive net job growth in new firms and downsizing in traditional firms is found in all country groups a decade-and-a-half since the start of the transition.

What accounts for the comparatively weak job growth in the EU8 and Southeastern European countries? Indeed, both the cohesion countries and the poorer transition country groups have higher job creation and lower job destruction rates than the EU8 and Southeastern European countries during 2002–05.

### Employment Growth in the EU8 and the Cohesion Countries

Growth in aggregate firm employment was substantially lower in the EU8 than in the cohesion countries during 2002–05.<sup>6</sup> Differences in employment growth between country groups are attributed to differences in three sets of factors: (i) sectoral composition of employment, whether in construction, manufacturing, transport, trade, real estate,

**FIGURE 4.4**  
**Job Creation and Job Destruction in the Transition Economies, by Ownership**



Source: Mitra, Muravyev, and Schaffer 2008.

**TABLE 4.2**  
**Job Reallocation, Job Creation, Job Destruction, and Job Growth in the Transition Economies, by Ownership**

Ownership	Job reallocation rate	Job creation rate	Job destruction rate	Job growth rate	Observations
Transition economies (2005)					
State	0.135	0.035	0.100	-0.066	756
Privatized	0.198	0.067	0.130	-0.063	1,237
De novo	0.275	0.203	0.072	0.132	6,738
Transition economies (2002)					
State	0.146	0.048	0.098	-0.050	820
Privatized	0.171	0.070	0.100	-0.030	915
De novo	0.283	0.211	0.072	0.140	4,086
Transition economies (1999)					
State	0.156	0.029	0.127	-0.098	530
Privatized	0.205	0.031	0.174	-0.144	840
De Novo	0.275	0.134	0.141	-0.007	2,182

Source: Mitra, Muravyev, and Schaffer 2008.

hotels and restaurants; (ii) ownership of firms—whether de novo, state-owned, or privatized; and (iii) firm size. De novo firms grew rapidly in both groups of countries, leading to growth in employment in the EU8 group more than one-and-a-half times higher than in the cohesion countries. This was helped by much faster growth in manufacturing in the EU8 group, as well as a higher share of employment in the EU8 in trade, which grew rapidly in both groups. But the faster growth of employment in rapidly growing de novo firms in the EU8 was more than offset by substantial downsizing in state-owned and privatized firms, especially the larger privatized ones. So, ownership and, to a lesser extent, size accounted for shrinking job growth in the EU8 compared with the cohesion countries. The stronger job growth in de novo firms in the EU8 may be explained by market niches that such firms could continue to fill in the transition countries. The downsizing in state-owned and privatized firms in the EU8 countries is a phenomenon with no analogue in the cohesion countries.<sup>7</sup> Together these trends help account for the relative stagnation of employment growth in the EU8 relative to the cohesion countries over 2002–05.

### **Employment Growth in the EU8 and the Southeastern European Countries**

Growth in aggregate firm employment in the EU8 was substantially higher than in the Southeastern European countries during 2002–05. De novo firms in both groups grew very rapidly, but their contribu-

tion to employment growth in Southeastern European countries was more than one-and-a-half times that in the EU8 countries. This was helped by much faster growth in manufacturing and, to a lesser extent, a higher share of employment in manufacturing in Southeastern European countries. But the rapid growth of employment in de novo firms was more than offset by vigorous downsizing in state-owned and privatized firms, more than twice as large in Southeastern Europe as in the EU8. Hence, the downsizing was predominantly due to ownership, with size playing virtually no role.

This is a catching up story. The new private sector boom is farther advanced but slowing in the EU8 countries, because there are presumably fewer niches for new firms to occupy. This is on account of the EU8's greater progress in the transition in relation to the Southeastern European countries. And the downsizing of state-owned and privatized firms is farther advanced in the EU8 but slowing there because progressively less of the transition legacy is left to be extinguished.

### **Employment Growth in the Southeastern European and the CIS countries**

Growth of aggregate firm employment in Southeastern Europe was substantially lower than in the CIS countries during 2002–05.<sup>8</sup> De novo firms in both country groups contributed enormously to employment growth—and in broadly comparable amounts. But whereas this was more than completely offset by downsizing one-and-a-half times larger in state-owned and privatized firms in the Southeastern European countries, it was only partially offset by downsizing that was two-thirds as large in the CIS countries.

This suggests that the catching up story does not quite apply to the CIS country groups. Since the Southeastern European countries have progressed more in the transition than the CIS countries, catching up would have involved stronger job growth in de novo firms in the CIS countries (more market niches available) and more vigorous downsizing in state-owned and privatized firms in the CIS countries (more of the transition legacy to be extinguished). De novo firms have indeed been generating jobs very strongly. Hence the lack of catch-up is more evident in the weaker than expected downsizing in state-owned and privatized firms.

The absence of catch-up is likely due to inadequate competition. It will be recollected from Chapter 3 that the magnitude of firm entry and exit was, in general, substantially lower in the Russian Federation and Ukraine than in Hungary and Romania. The importance of new firms in job creation was also generally lower in the Russian Fed-

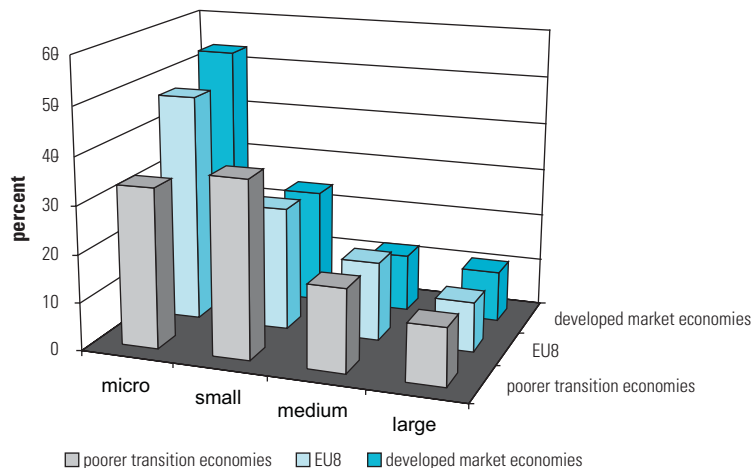
eration and Ukraine than in Hungary and Romania. Chapter 3 also showed that firms in the CIS countries report pressure from foreign competitors as being notably less of a spur to restructuring than do their counterparts in the EU8 and Southeastern European country groups and developed market economies. They also report pressure from domestic competitors, although stronger than from foreign competitors, as being less of a spur to restructuring than do their counterparts.

Stronger competition in the CIS countries would facilitate convergence but also accelerate downsizing. Severance payments, retraining programs, and safety nets should be used to assist displaced workers.<sup>9</sup>

### The Changing Size Distribution of Firms

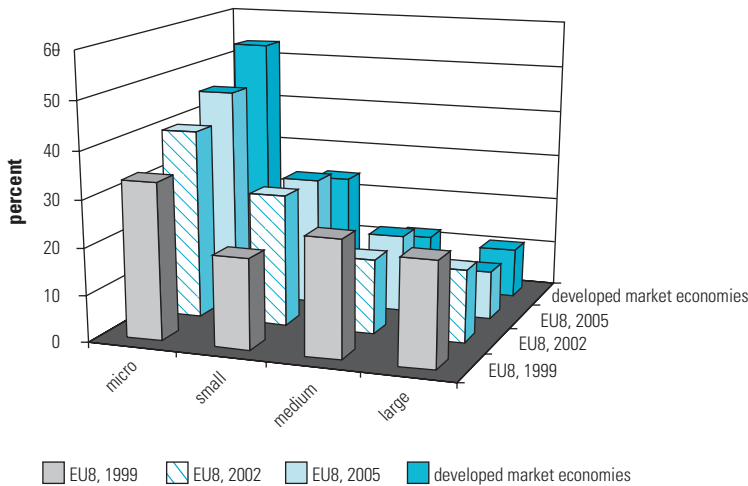
The transition would have been expected to have brought about the growth of small firms because planned economies had so few of them. This expectation is confirmed by figure 4.5, which shows the distribution of firm size in 2004-2005 in the developed market economies (West Germany and the cohesion countries), the EU8 members, and the poorer transition economies (Southeastern Europe and the middle and low income CIS) by four size categories: micro (1–9 employees), small (10–49), medium (50–199), and large (200+). Small and micro firms are most prevalent in the developed market economies of the European Union and least prevalent in the poorer transition economies, with the EU8 in between. The size distribution of firms in

**FIGURE 4.5**  
**Size Distribution of Firms in 2004–05**  
(Percentage of firms)



Source: Mitra, Muravyev, and Schaffer 2008.

**FIGURE 4.6**  
**Evolution of Size Distribution of Firms in EU8 Countries**  
 (Percentage of firms)



Source: Mitra, Muravyev, and Schaffer 2008.

the EU8 moves steadily toward the developed market economy patterns of large numbers of small and micro firms over the three rounds of the BEEPS and, by 2005, is much closer to that in West Germany and the cohesion countries (figure 4.6).

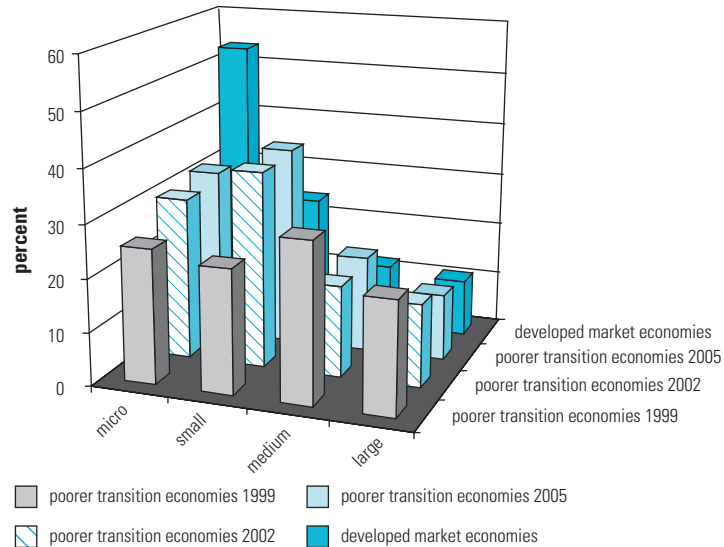
The evolution is similar in the poorer transition economies, but because these countries started in 1999 from a position of even fewer small firms, the size distribution in 2005 is still a considerable distance from the market economy benchmark, even with the growth of small firms between 1999 and 2005 (figure 4.7).

The change in the size distribution of firms brought about by the growth of smaller, typically new, firms and the downsizing of larger state-owned and privatized firms implies that changes in employment in the average firm are not necessarily the same as changes in employment generated by aggregating all firms. The analysis presented so far has focused on aggregate employment. Differences between average and aggregate arise because new firms, which are proliferating and growing rapidly, are typically smaller and thus generate less employment in the aggregate. State-owned and privatized firms, which are fewer in number and shedding labor, are typically larger and thus contribute more to shrinking employment in the aggregate. This implies that the growth in average firm employment is much higher than in aggregate firm employment in the transition countries, where the size distribution is more skewed toward medium and larger firms in relation to that gap in the cohesion countries. But

FIGURE 4.7

**Evolution of Firm Size Distribution in Poorer Transition Economies**

(Percentage of firms)



Source: Mitra, Muravyev, and Schaffer 2008.

comparisons of average firm employment growth by subgroups of countries yields a picture broadly consistent with that presented here for aggregate firm employment.<sup>10</sup>

**Convergence**

In summary, the evolution of employment reflects patterns of convergence similar to those for the business environment. Employment depends on, inter alia, firm ownership (state-owned, privatized, de novo), the sectoral composition of the economy and size. The proportion of de novo firms has been rising and that of state-owned and privatized firms has been falling in all transition country groups over 1999—2005. The size distribution of firms in the transition countries, which was dominated by medium firms (50 to 99 employees) and large firms (200 employees or more), is also converging toward that in West Germany and the cohesion countries, which have many more micro firms (1–9 employees) and small firms (10–49 employees). Employment in small firms is increasing relative to employment in large firms. The process has advanced the most in the EU8, where the size distribution of firms is closest to that in West Germany and the cohesion countries. It has moved the least in the CIS countries which started with fewer smaller firms and, despite their growth, are some distance from the developed market economies.<sup>11</sup>

## Shortages of Skills<sup>12</sup>

Labor market outcomes during much of the transition have been explained by referring to the balance between job creation in *de novo* firms and downsizing in state-owned and privatized firms. Since 2005, however, skills shortages have emerged as a constraint to expanding employment, particularly in the new member states of the European Union.<sup>13</sup> Employers in the Czech Republic, Hungary, Latvia, Lithuania, Poland, and Romania report lack of skilled workers as an important obstacle to business growth. Despite recent improvements, low employment rates and high unemployment coexist with an increase in job vacancy rates and rising labor demand. In Latvia and Lithuania vacancy rates in manufacturing have increased sharply. And in both countries, as well as in Poland, vacancy rates in construction have increased as well. Part of this is due to out-migration associated with the opening of labor markets in the EU15 countries. However, there is an excess supply of unskilled labor, particularly in Bulgaria, the Czech Republic, Hungary, and the Slovak Republic.<sup>14</sup> So, many of the unemployed will not find jobs even if there is an increase in vacancies because they lack the necessary job skills. Making education systems more responsive to labor market needs and encouraging lifelong learning will be important to reduce unemployment and increase labor force participation. In these countries, the constraints to employment growth are shifting from legacy-of-transition factors to those that have to do with the requirements of competition in a globalizing world.

## Endnotes

1. The figure for the Slovak Republic reflects high long term joblessness among the large Roma minority.
2. The figure for Serbia is for 2005.
3. Job creation is the increase in jobs during a year divided by average employment during the year.
4. Job destruction is the loss in jobs during a year divided by average employment during the year.
5. Job reallocation is the sum of job creation and job destruction rates during the year. Job growth is the job creation rate less the job destruction rate.
6. This section is based on Mitra, Muravyev, and Schaffer (2008), which presents the complete analysis.
7. The small number of state-owned and privatized firms in the cohesion country sample are taken out before making the comparison described in the text.

8. The middle-income CIS and low-income CIS groups are combined in this comparison for brevity. The substance of the argument is not qualitatively affected by doing so.
9. Social safety nets are discussed in Chapter 5.
10. The analysis of average firm employment growth is developed in Mitra, Muravyev, and Schaffer (2008).
11. The influence of changing sectoral composition on employment is explored in Mitra, Muravyev, and Schaffer (2008).
12. The discussion is based on World Bank (2007b), which contains a fuller account.
13. The new member states of the European Union refer to the EU8, Bulgaria, and Romania.
14. The difference between the percentage share of the employed with a particular educational attainment and the percentage share of the unemployed with the same educational attainment is taken as an indication of the mismatch in the labor market.