

Overview

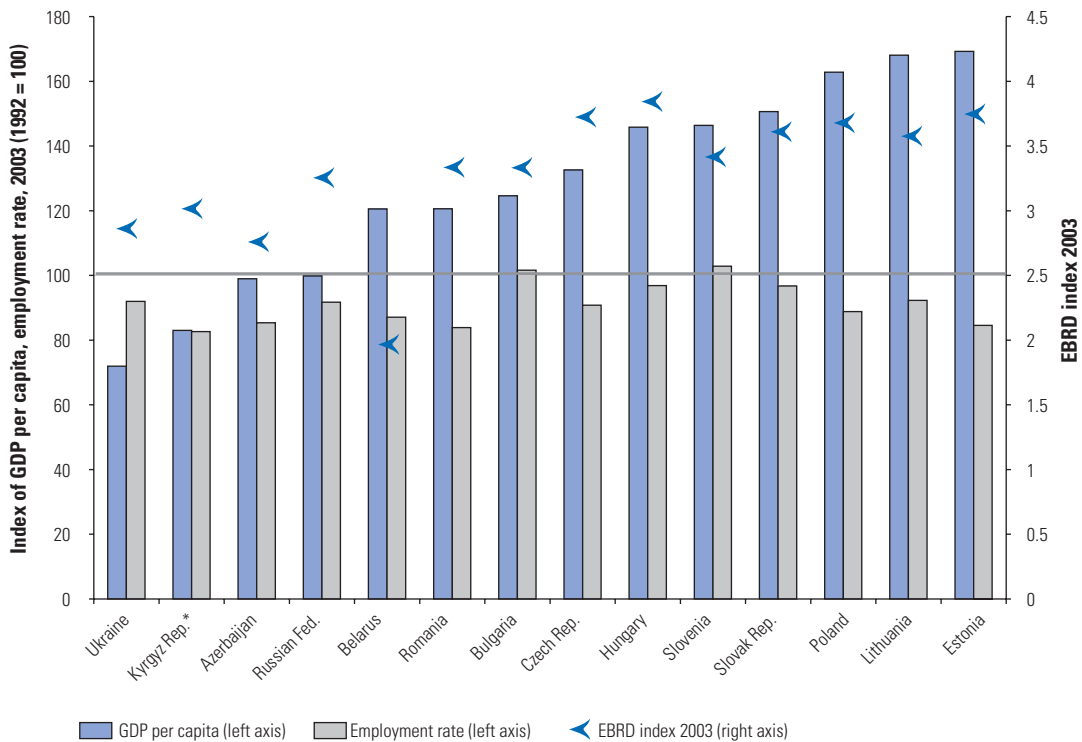
This study examines labor market developments and strategies for enhancing job opportunities in Eastern Europe and the Former Soviet Union during their historic transition from centrally planned to market economies. (This group of countries is called “the Region” in this study.)¹ It addresses three key questions: How has the process of economic transformation associated with the transition affected the labor market, and who are those who have been hardest hit? How far have the different countries progressed in the transformation process, and what are the key constraints against creating more and better jobs? How can public policy help promote job creation?

The transition from centrally planned to market economies has entailed profound institutional reforms and far-reaching structural changes. The countries of Eastern Europe and the Former Soviet Union have achieved impressive results in economic liberalization, privatizing state-owned enterprises (SOEs), and opening up their economies to international trade and capital flows. After a major plunge in the early phases of the transition, gross domestic product (GDP) per capita has recovered in many countries, being at or above the pretransition levels in many. Overall, there is a clear association between the reform effort (proxied by the European Bank for Reconstruction and Development [EBRD] transition index) and the recovery of GDP since the early 1990s (figure 1.1).

Despite some progress in recent years, labor market conditions remain difficult in most countries. For example, the employment-to-working-age-population ratio—a summary measure of the utilization of labor resources—is currently lower than at the beginning of the transition and often below the average of industrial countries (figure 1.1). Slack labor markets assume different dimensions in the Region’s countries: high open unemployment, falling labor force participation, or a low-productivity employment trap.

In faster-restructuring countries such as Poland and the Slovak Republic, unemployment was 19 and 18.2 percent of the labor force in 2004, respectively, despite high rates of economic growth. In Hungary, the unemployment rate is relatively low (around 6 percent), but this rate is partly the result of falling labor participation: many workers have given up their job search and left the labor force.

FIGURE 1.1
The Payoff to Reforms in Transition Economies: Higher Output, but Still Insufficient Jobs, 1992–2003



Sources: World Bank 2004c; ILO LABORSTA database; and EBRD Transition Report 2004.

Note: Data for the Kyrgyz Republic are for 2002. Data for Bulgaria, the Czech Republic, Poland, Slovenia, and the Slovak Republic refer to 1993; for Romania, data refer to 1994. The EBRD transition index is the simple average of the published indicators on Price Liberalization, Forex and Trade Liberalization, Small-Scale Privatization, Large-Scale Privatization, Enterprise Reform, Competition Policy, Banking Sector Reform, and Non-Banking Financial Institutions.

Open unemployment is less of a problem in the slower-reforming countries of the Former Soviet Union, such as Azerbaijan, Moldova, and Ukraine. However, much of their workforce is stuck in low-productivity employment in unstructured and probably nonviable enterprises or has had to move back to subsistence agriculture. The employment levels of the central-plan period, when employment was not only a right but also a duty for most of those of working age, cannot be sustained in a market-based system. However, actual labor market conditions in most countries in the Region clearly indicate significant slack.

This has led to persistent disparities in the labor market. In the Region's economies, especially in Central European (CEE) and Southeastern European (SEE) countries, unemployment is typically of long duration, and many unemployed have difficulties in finding new jobs. The surge in unemployment was largely expected during the transition, given the need for major reallocation of labor across sectors, firms, and locations. But the persistence of unemployment—the share of those without a job for more than a year—is 40 to 50 percent in the EU-8 transition countries (annex 1.1), compared to below 40 percent in advanced market economies. A common assumption at the beginning of the transition was that high unemployment would be transient, declining once the emerging private sector started creating jobs. In reality, workers displaced in the “old” sectors have had limited chances to find jobs in the “new” sectors. In the Commonwealth of Independent States (CIS),² underemployment (low-productivity employment and hidden unemployment) is more prevalent.

Promoting the creation of more and better jobs remains a priority in the Region. Politically, creating viable and lasting employment will strengthen support for further market-oriented reforms. More broad-based employment growth—job opportunities for many workers and not only for the highly skilled and those in large cities—will also reduce social costs. For example, in Poland, a household whose head is unemployed is five times more likely to be poor than a household whose head is employed. In most other countries, such as Georgia, the Kyrgyz Republic, or the Russian Federation, unemployment raises the risk of poverty by at least a factor of two (World Bank 2005b).

The new market economy environment has contributed to the widening of wage disparities.³ Although the increase in wage disparities is consistent with growing productivity differentials, market distortions have also played a role (particularly pronounced in CIS countries). The worst affected have typically been those who are the most vulnerable to shocks and least able to adjust to the new market

paradigms: mostly less skilled and older workers. Thus, low employment and significant earnings inequality have translated into higher poverty and lower social welfare. These outcomes have improved in recent years, but serious problems persist for some of the weakest strata of the population.

What, then, is the way to more and better jobs in the Region? The specific mix of policies that each country needs to adopt varies, depending upon its particular economic and labor market situation. However, for all transition economies, addressing the issue of underutilization of labor requires a two-track strategy: *increasing the pace of job creation* by encouraging firm entry and expansion and *facilitating the reallocation of jobs and workers* away from old, less productive firms toward new, more productive firms.

The first part of this strategy requires further improvements in the investment climate and lowering the costs of doing business. Most countries in the Region have made substantial progress in their investment climate. However, there are remaining constraints. Operating a business in low income CIS countries carries high risks (for example, policy unpredictability, insecure property rights, weak contract enforcement, and unreliable infrastructure). In the middle income CIS countries (Belarus, Kazakhstan, Russia, and Ukraine), businesses face considerable administrative barriers (for example, numerous permits, inefficient regulations, and red tape). Doing business in CEE countries is hampered by high direct costs (for example, high taxation). Although there is substantial subgroup commonality, key constraints to firm entry and growth—and thus priorities for investment climate reform—are country-specific. They have been identified in this report in two ways: by comparing the regulatory and institutional settings in the Region's countries with those of other economies with a vibrant private sector and by exploiting enterprise surveys that directly ask entrepreneurs about the constraints they face in their operation and in their potential for expansion.

The second part of the strategy requires promoting adaptable labor markets and effective social safety nets to protect incomes of workers displaced in the wake of enterprise restructuring. In some countries (mainly in CIS and SEE), employment protection legislation (EPL) is stringent, but enforcement capacity is weak. These countries need to simultaneously liberalize EPL and promote compliance so that core worker rights are protected. In other countries (mainly CEE EU members), enforcement capacity is strong, and EPL is relatively flexible. They need to focus on addressing specific constraints to labor market flexibility. For example, where few regulations on temporary employment exist but regular employment is highly protected, these

countries need to reduce protections granted to permanent workers to avoid creating labor market duality.

The rest of this overview develops these arguments in four parts:

- A summary of the key labor market developments during the transition, highlighting clear country differences in labor market conditions in the Region (see box 1.1 for a discussion on country grouping)
- A review of the process of job creation and destruction that examines enterprise restructuring, privatization, and entry of new ventures
- Highlights of the key constraints in the business environment that curb investment and job creation
- The set of policies still needed to create more and better jobs in the Region

Changing Labor Markets in the Region

The relatively poor record of job creation across the Region, despite the resumption of economic growth, remains the key area of concern for most policy makers. In the early phases of the economic transformation of the Region's countries, employment declined because of the major contraction in output. However, in the subsequent recovery periods, employment has not resumed as much as output has.

This is the case especially in CEE countries, where GDP growth has been sustained but employment has been fairly stagnant. Therefore, as in some EU-15 countries (annex 1.1), certain transition economies have recently experienced "jobless growth," with the number of jobs in the formal sector hardly responding to the growth in output. Poland is a good example: since the late 1990s, employment has been falling and unemployment persisting, despite relatively high rates of economic growth. In Hungary, the relatively weak labor demand has led to a fall in labor force participation. In other countries, such as those in the CIS, the link between output and employment has been stronger. In the early years of transition, this was associated with negative or very small output growth. Even when economic growth resumed in recent years, the strong link with employment has been associated with a generally poor quality of employment, with a rapid increase in the informal sector (including agriculture) as an employer of last resort.

Four main features characterize the labor markets of the Region during the transition:

BOX 1.1

Geopolitical Country Groups Reflect Economic and Institutional Differences among the Region's Countries

The Region is large and economically diversified. Its subgroups of countries differ in their levels of economic development, institutions, industrial structure, and progress in market-oriented reforms. These differences, in turn, influence the characteristics and evolution of their labor markets.

One way to group countries in the Region is to apply a traditional geopolitical grouping (annex 1.1). This approach clearly shows these countries' differences in their levels of economic development, institutional settings, and economic structure:

- The following table shows a close correspondence between geopolitical location and differences in the level of *economic development*, as measured by the GDP per capita. All CEE EU-member countries belong to the group of the richest countries in the Region. All low income CIS countries belong to the group of the Region's poorest countries. Thus, geopolitical location is a good predictor of the level of economic development.

Geopolitical Location and Level of Economic Development Are Closely Related

Geopolitical groups	Income groups: GDP per capita, ^a 2002			Mean value US\$
	Top tercile	Middle	Bottom tercile	
CEE EU members	8			12,984
CEE EU accession	1	2		8,032
SEE		3	1	5,685
Middle income CIS		3	1	6,122
Low income CIS			7	2,428

Sources: World Development Indicators; World Bank database; Bank staff calculations.

Note: Numbers stand for the number of countries within the cell.

a. GDP at PPP (current international dollars).

1. In many countries, job creation still lags behind job destruction, leading to employment decline. Overall, job reallocation (the sum of job creation and destruction) in the Region increased dramatically in response to transition—from less than 10 percent of the workforce in the late 1980s to more than 25 percent in the 1990s. The main differences across countries, however, are in job creation. Although countries lagging behind on reforms, such as those in the CIS, were able to contain job destruction in the early phases of transition, job destruction later rose to high levels but was not accompanied by new private initiatives to create new jobs.

- Similarly, a strong overlap exists between geopolitical location and quality of *institutions and governance*. Government effectiveness varies significantly between geopolitical groups, but variation within groups is relatively small.
- Geopolitical location also reliably corresponds to the progress of *economic transition* (as measured by the International Bank for Reconstruction and Development index). Countries that have either become members of the European Union or are candidates for membership have advanced the most in implementing market reforms. Economic transition is less advanced in the middle income and—especially—the low income CIS countries, while SEE countries occupy the middle position.

Naturally, use of the geopolitical taxonomy occasionally results in a misclassification of some countries from the economic perspective. Bulgaria and Romania, EU accession countries that thus fall into the CEE group, are closer to the SEE group in economic development. The borderline between middle and low income CIS countries is in some cases blurred. For example, in government effectiveness and regulatory quality, Armenia performs better than other low income CIS countries. Georgia, the Kyrgyz Republic, and Moldova, in turn, are more advanced in market-oriented reforms than other CIS countries.

Source: Bank staff analysis.

2. The nature of jobs has changed. The incidence of regular formal sector jobs has fallen, while the incidence of temporary and casual informal sector jobs has increased. This has led to increases in the segmentation of the labor market. There has also been a shift from less skilled, blue-collar manufacturing jobs toward more skilled, white-collar service sector jobs.
3. Wage growth has accelerated in recent years, but wage differentials have also widened substantially. Enterprise restructuring has led to significant improvements in productivity growth, which in turn has led to marked real-wage increases. At the same time,

returns to education and to market-related skills have risen, leading to a greater dispersion in the distribution of wages and a growing share of workers in low-paid jobs.

4. There is strong regional concentration of job creation within countries, which has brought about large regional disparities in labor market conditions.

These features of labor market adjustment to the transition shock have been common, to a varying degree, across the Region's subgroups of countries. At the same time, however, there have been considerable cross-regional differences in the nature of labor market adjustment, depending on region-specific features of the labor market. These four labor market factors are now discussed in turn.

Persistent Unemployment and Lack of Productive Jobs in the Region

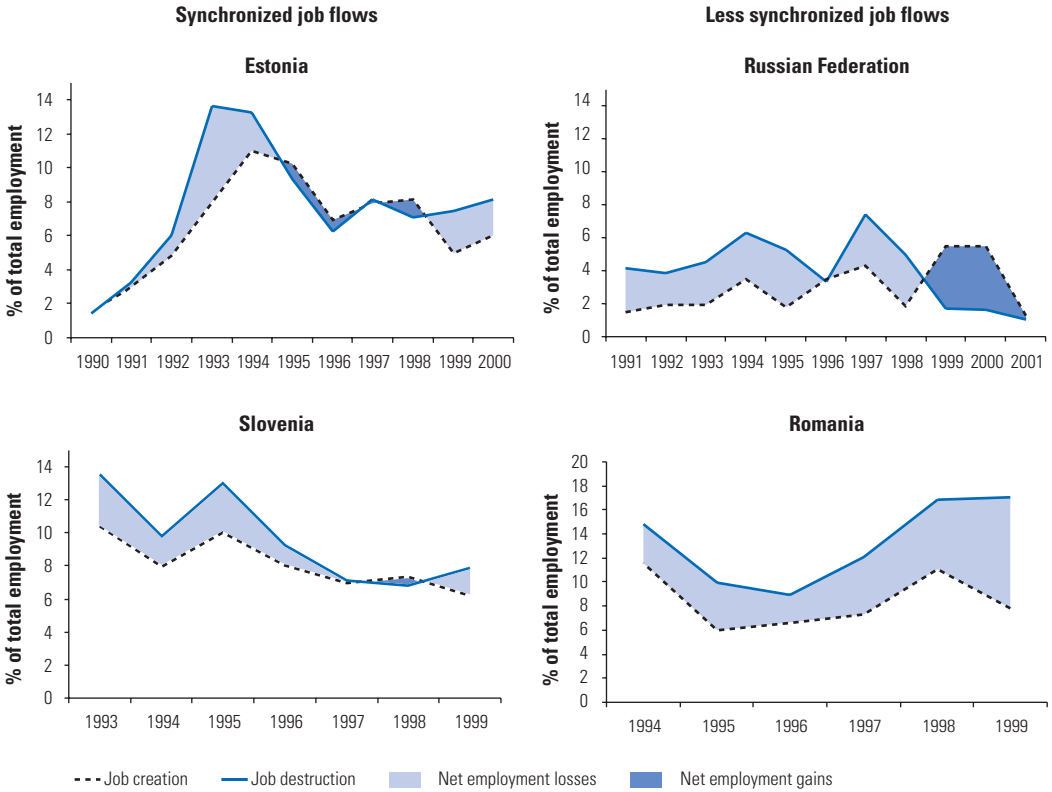
The observed labor market outcomes in the Region's countries reflect different stages of the transition process and differences in underlying job dynamics (figure 1.2). All countries have experienced a surge in job destruction by downsizing and closing businesses. They have also seen job creation by new and expanding firms. However, the size of job creation and destruction, as well as their timing, has varied markedly across countries.

For example, Estonia and Slovenia experienced a short period of large job destruction in the early phase of the transition. This was followed by a period in which job creation and destruction went hand in hand (synchronized flows). More recently, incipient signs in these countries are emerging of job creation exceeding job destruction.

In contrast, many other countries are still struggling with job creation falling short of job destruction (for example, see Romania in figure 1.2). In Russia, job flows have been remarkably low, with job creation lagging behind job destruction for most of the past decade. In those countries where job destruction has been contained by slowing down the restructuring process, larger flows can be expected once the required transformation process has unfolded.

During the initial stage of the transition, high job destruction and low job creation resulted in growing unemployment and falling employment. Today, unemployment rates are in double digits in several CEE economies, in some cases above the Organisation for Economic Co-operation and Development (OECD) or EU-15 averages (figure 1.3). Unemployment rates reach highs of more than 30 percent in the former Yugoslav Republic of (FYR) Macedonia and 19 percent in Poland. In

FIGURE 1.2
Unsynchronized Job Creation and Job Destruction Can Give Rise to Unemployment



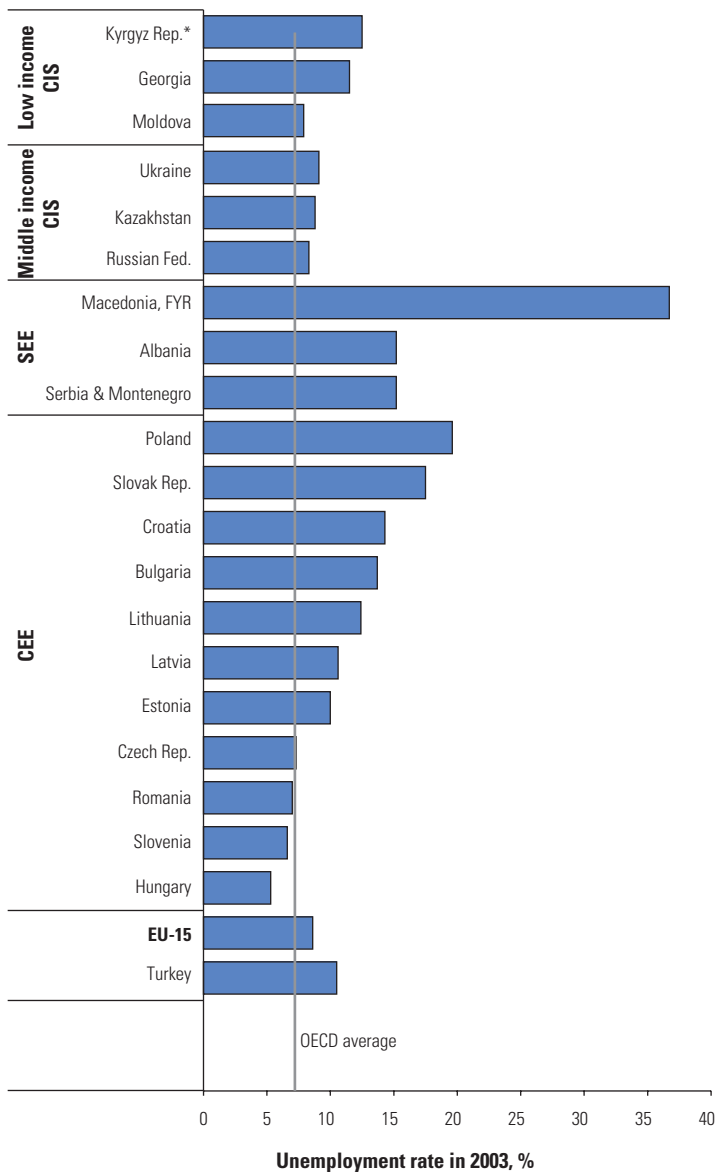
Source: Scarpetta and Vodopivec 2005.

most CIS countries, open unemployment tends to be lower (with Georgia, at more than 12 percent, being an outlier), but many workers are engaged in low-productivity activities or have moved back to subsistence agriculture (see the following discussion).

In CEE countries, high and persistent unemployment has been accompanied by a major fall in labor force participation rates, as workers became discouraged by lack of job opportunities and gave up their job search. In these countries, both open unemployment and low labor force participation have led to a low ratio of employment to working-age population (figure 1.4).⁴ Employment-to-population ratios are below the EU’s average and, for most countries, clearly below the Lisbon target of 70 percent of the working-age population.⁵ However, in recent years there are signs that this negative trend in employment has been reversed in some countries, most notably the Baltic States—raising hopes that employment prospects are finally improving.

In CEE and SEE countries, the salient feature of unemployment is its long duration and prevalence among the young and the less edu-

FIGURE 1.3
Unemployment Continues to Be High in Most Transition Economies
 Unemployment Rate in 2003, Percentage



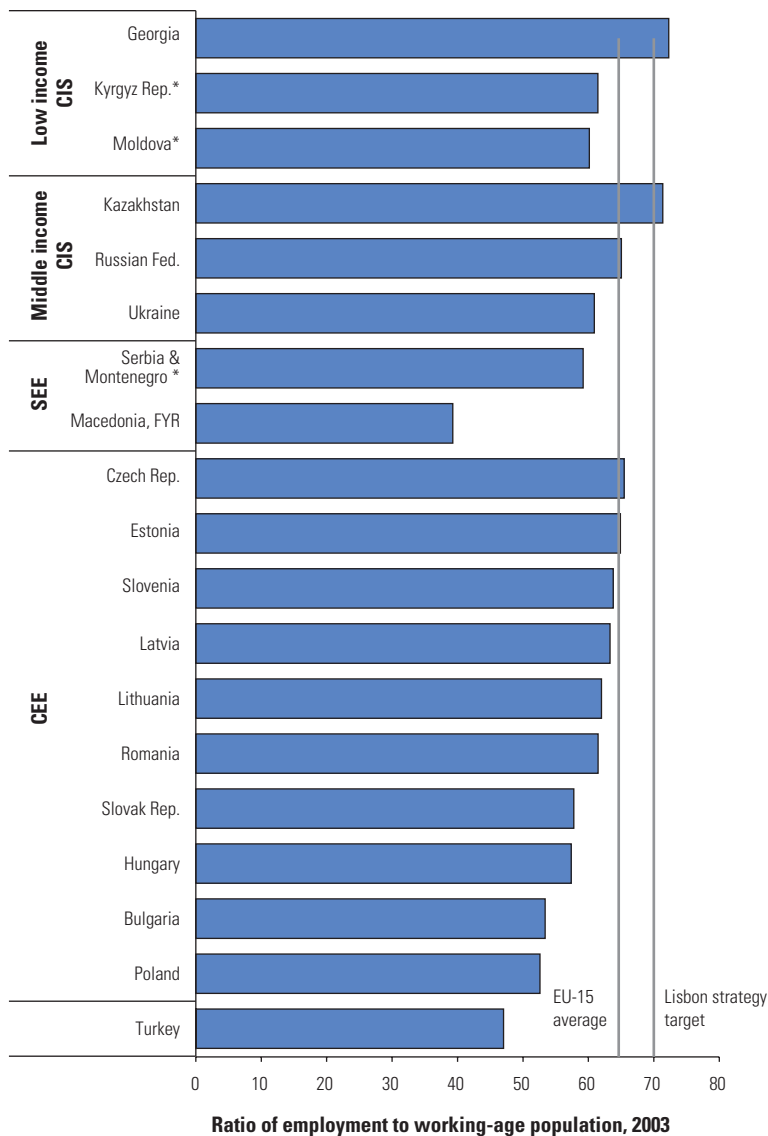
Sources: Labor Force Surveys (ILO [LABORSTA database], OECD); * 2002; and Labour Market in the CIS countries, Statistical Abstract, Interstate Statistical Committee of the CIS, Moscow 2004.

cated. These are problems observed in many EU countries, but assume particular severity in some of the Region's countries. More than 50 percent of the unemployed in many CEE countries have been without a job for more than one year (long-term unemployed), and

FIGURE 1.4

Employment Rates Have Declined and Are below the Lisbon Target of 70 Percent

Employment-to-Working-Age-Population Ratio in 2003



Sources: ILO (LABORSTA database); OECD; Eurostat; and Bank staff calculations.

Note: * = 2002

the proportion is still higher in SEE countries. The chances to escape unemployment are low by the standards of flexible labor markets and are similar to those seen in some EU countries with a stagnant pool of jobless people. Turkey, a nontransition economy, provides a telling

contrast of a more dynamic labor market. Long-term unemployment there accounts for some 30 percent of total unemployment, which is similar to the proportion observed among more flexible EU labor markets.

Unemployment rates in transition economies are particularly high among less educated workers. For example, in Poland, a worker with primary education (eight years) is more than four times more likely to become unemployed than a worker with tertiary education. The employment rate for workers with primary education is less than 20 percent, compared with close to 80 percent for workers with tertiary education (United Nations Development Programme [UNDP] 2004). Youth is another group that suffers from high unemployment: on average, youth unemployment rates are twice as high as overall unemployment rates. In Bulgaria and the Slovak Republic, more than one-third of the youth labor force is unemployed, which also makes them poorer.

In many CIS countries, low open unemployment and high employment rates hide significant problems: delayed enterprise restructuring with persistent overstaffing and, especially in low income CIS countries, the dominance of low-productivity jobs in the informal sector to earn subsistence income. The latter feature is typical of developing countries, where social protection is ineffective and thus unemployment is not an affordable option for most workers. The natural implication is that unemployment in the CIS may worsen as restructuring progresses further. Enterprises will downsize more aggressively to be competitive, as they did in CEE, and unprofitable firms will close. Thus, inflows into unemployment are likely to increase as restructuring progresses. The extent to which this will cause an increase in unemployment will depend on the ease with which the displaced workers will find jobs in the new private sector (or in the informal sector).

The Changing Nature of Jobs

The greatest change since transition has been the shift from secure, though not highly rewarding, employment, to less stable jobs with greater earning potential. But in the low income CIS, casual and less formal jobs have also increased dramatically to levels observed in developing countries. For example, self-employment accounts for about 20 percent of total employment in EU transition economies and for about 50 percent of employment in low income CIS countries. Similarly, informal sector employment as a share of total employment is estimated at around 40–50 percent in the CIS.

Another feature of the changing nature of jobs in transition countries is the rapid increase in fixed-term employment contracts.

The characteristics of the jobs offered under temporary or informal arrangements and those of self-employment vary across individuals and countries. Temporary employment has been largely used by firms to circumvent the often rigid firing regulations for those on open-ended contracts. For example, in Croatia, most workers are hired using fixed-term contracts (World Bank 2003b). Informal jobs loom large among young, poorly educated blue-collar workers. They also seem to be a more frequent destination after a period of unemployment than formal sector jobs are. Informal workers also tend (on average) to have lower wages than formal sector workers do. The observed wage differentials between formal and informal sector jobs are largely the result of selection of workers in the two sectors: low-skilled and less experienced workers tend to be sorted into informal jobs, often in small firms with low-productivity potentials.

The nature of self-employment also varies greatly. For some low-skilled workers, especially in the poorer CIS countries, own-account jobs in retail and agriculture are subsistence activities. But for other, more skilled workers, self-employment is sometimes a preferred alternative to formal sector employment because self-employment offers better earning opportunities and more scope for entrepreneurship, especially in the more dynamic CEE countries.

The nature of jobs has also changed because of sectoral shifts and deindustrialization. Most CEE countries have witnessed a fall in the number of blue-collar manufacturing jobs and an increase in white-collar service sector jobs. In contrast, in most CIS countries, deindustrialization was associated with an increase in agricultural employment. Figure 1.5 illustrates these divergent patterns of job reallocation. In the Czech Republic, market services as a share of total employment increased by about 5 percentage points during the transition, while manufacturing's share fell by about 3 percentage points. In contrast, in the Kyrgyz Republic, market services gained little as a share of total employment. However, there was a dramatic fall in the share of manufacturing (about 17 percentage points) and a huge shift toward agriculture, which increased its share by some 20 percentage points. It is not clear whether the significant increase in the share of agricultural employment in the CIS countries is only temporary or represents a more profound and long-lasting reversion toward employment patterns more typical of countries with relatively low income per capita.

The skill content of jobs has shifted upward, especially in the new sector. The profiles of job creation and destruction during the transition differed in skills, occupations, and experience. Many jobs have

been destroyed in low-skilled activities or in highly specialized manufacturing activities. Many jobs have been created not only in relatively more skilled activities but also in certain service activities that require low- and medium-level skills that are nonetheless different from those of the lost manufacturing jobs. In Estonia, for example, the share of nonmanual workers in total employment increased by 8 percentage points during 1990–2000; at present, nonmanual workers account for 55 percent of total employment. In Russia, the share of workers with tertiary education increased by 6 percentage points during 1992–2000 and currently exceeds 20 percent. A similar increase occurred in Poland and other CEE economies (Peter 2003). This skills mismatch between jobs destroyed in the old sector and those created in the new sector is one of the factors behind unemployment in transition economies. It requires reforms in the education system and efforts of requalification (Commander and Köllö 2004).⁶

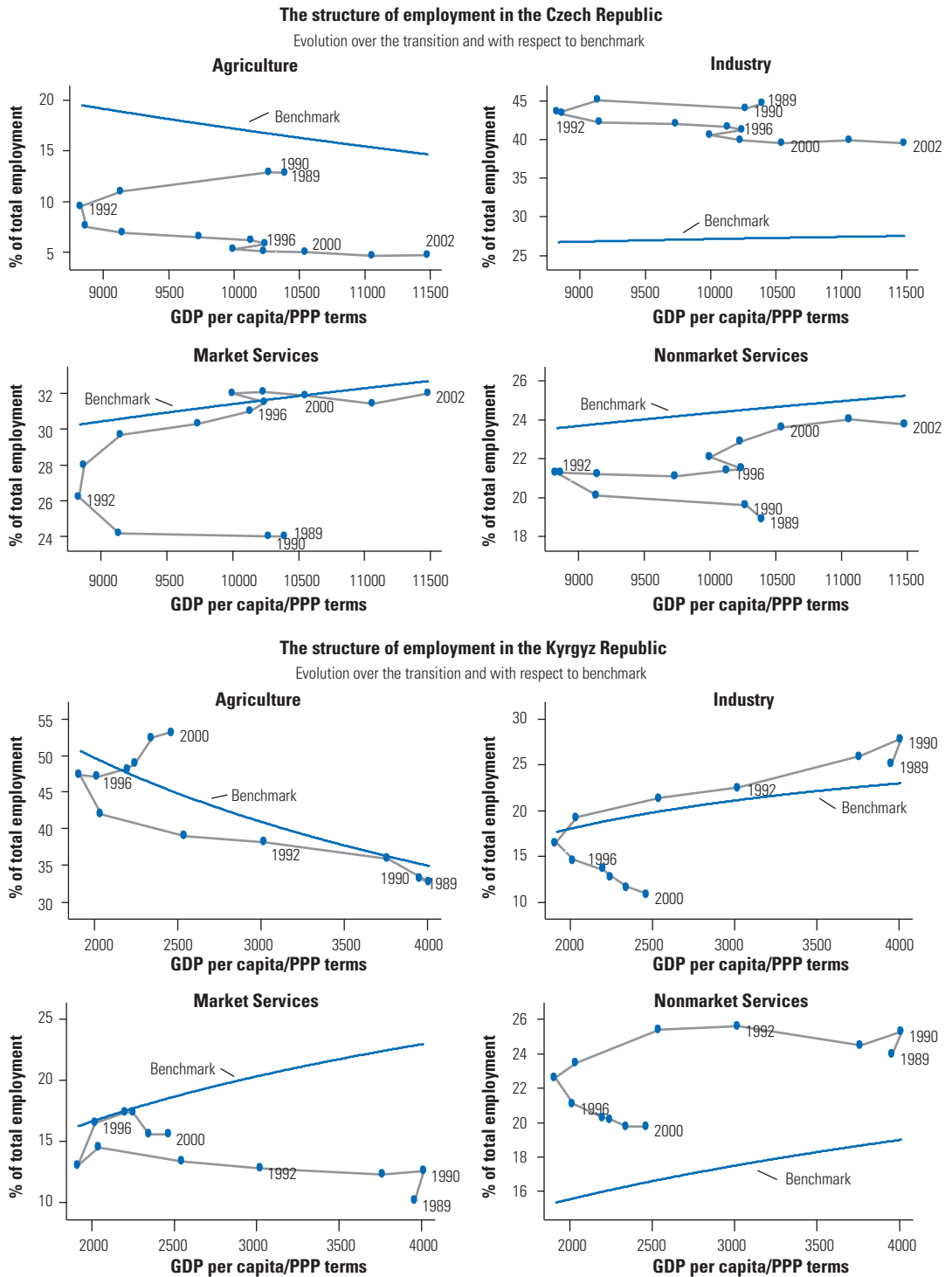
Changes in the nature of jobs have affected men more than women. Many jobs have been lost in sectors dominated by male employment—heavy industry and the extraction industry—while new activities have been created in services where women tend to have easier access. As a result, men have suffered relatively more job losses than women have during the transition. For example, the female-employment-to-population ratio in CEE, at 54 percent, is close to the EU-15 average (56 percent), while the male ratio, at 65 percent, is significantly below the EU-15 average (73 percent).^{7,8}

Wage Growth, Inequality, and Low-Paid Jobs

Wage increases in recent years have been associated with firm restructuring and productivity improvements. Enterprise restructuring benefited the insiders (that is, those workers who kept their jobs and those who managed to find new ones).⁹ Wage growth has been the fastest in the low income CIS countries, where it averaged 2.8 percent annually. It was slightly slower in the CEE and SEE and in middle income CIS economies, where it averaged 2.5–2.6 percent annually during 1996–2002.

The change in the wage-setting mechanism, from administrative to market-based, has led to an increase in wage dispersion. The wage distribution was compressed under central planning because of the egalitarian ideology and the centralized wage-setting mechanism. For example, the wage premium for university workers over those with vocational education was just 20 percent.¹⁰ Changes in the structure of the economy, and thus changes in relative demand for different types of labor, have given rise to various wage premiums to worker

FIGURE 1.5
Different Patterns of Labor Reallocation: The Czech Republic (CEE) vs. the Kyrgyz Republic (CIS)



Source: Bank staff calculations based on the "Industrial Database for Eastern Europe" of the Vienna Institute for International Economic Studies.

Note: The market benchmarks are obtained through regressions of sectoral employment shares on GDP per capita and its square on a sample of 50 countries.

and firm characteristics (such as education and skills, occupation, or industry) that were not widespread in socialist times. A university-educated worker in Poland currently earns (on average) 70 percent more than a worker with basic vocational training. In the private sector, this premium to university education is even higher (160 percent).¹¹ These natural changes not only have contributed to the increase in wage inequality over most of the transition period but also have led to better market efficiency as wages become better aligned with productivity differentials. One should note that, although they remain high by the standards of industrial countries, wage inequalities have shown some decline in recent years (World Bank 2005b).

The gender pay differential has declined in many countries in the Region and is relatively small. On average, women earn some 20 percent less than men in comparable jobs, which is modest by international standards (Paci 2002). Thus, the gender wage differential has not been a factor behind the rise in wage inequality. After all, women in the Region benefited from the increase in returns to schooling more than men because (on average) they are better educated than men.

Though wage inequality is presently high in virtually all transition economies, there are substantial differences among the Region's subgroups of countries (figure 1.6). In European transition economies, wage inequality is high by EU standards, but still within the OECD range (although at its upper end). In contrast, in most of the CIS countries, wage disparities have reached very high levels characteristic of many developing countries. As an illustration, in CEE countries, the top-decile worker usually earns 4 to 5 times as much as the bottom-decile worker. In the Kyrgyz Republic, this ratio rises to 9, in Russia to 11, and in Azerbaijan to 13. In contrast, in the EU, the decile ratio varies between 3 and 4.

In countries where there is high earnings inequality, the labor market is divided into an increasingly large high-wage segment and a correspondingly large low-wage segment. For example, in the Czech Republic and Slovenia (where earnings inequality is relatively low), less than 5 percent of all wage and salary workers earn less than 50 percent of median earnings. In Serbia and Montenegro, this fraction exceeds 20 percent; in Russia, it goes up to 25 percent; and it reaches 30 percent in Azerbaijan.¹² The high incidence of low pay is of particular importance because it may translate into poverty. However, in the Region, consumption inequality tends to be lower than wage inequality because of multiple-earner households and extensive transfer systems in many countries. In the low income CIS countries and some SEE countries, remittances and other private transfers may also boost consumption levels (World Bank 2005b).

The minimum wage serves as a floor in European transition economies, reducing wage dispersion. In CEE and SEE, minimum wages are set at around 40 percent of the average wage. In contrast, in the CIS, minimum wages are much lower in relative terms. As a rule, they account for less than 20 percent of the average wage—often around 10 percent—which means that they are unlikely to be binding. This allows firms to maintain low-paid jobs, and as such it contributes to wage dispersion.

Geographical Labor Market Disparities

Labor market conditions vary substantially across geographical areas of most of the Region's countries, and in many cases such geographical disparities have persisted or even increased over time. For example, in 2003, differences between the regions with the highest unemployment rate and those with the lowest unemployment rate (usually the capital) exceeded a factor of 3 in all countries of the Region except Romania and Slovenia. These disparities in unemployment are also associated with large disparities in wages, with wages being lower in higher-unemployment regions. In Russia, the disparity in regional labor market conditions is much more pronounced, reflecting the immense economic heterogeneity of Russian regions.

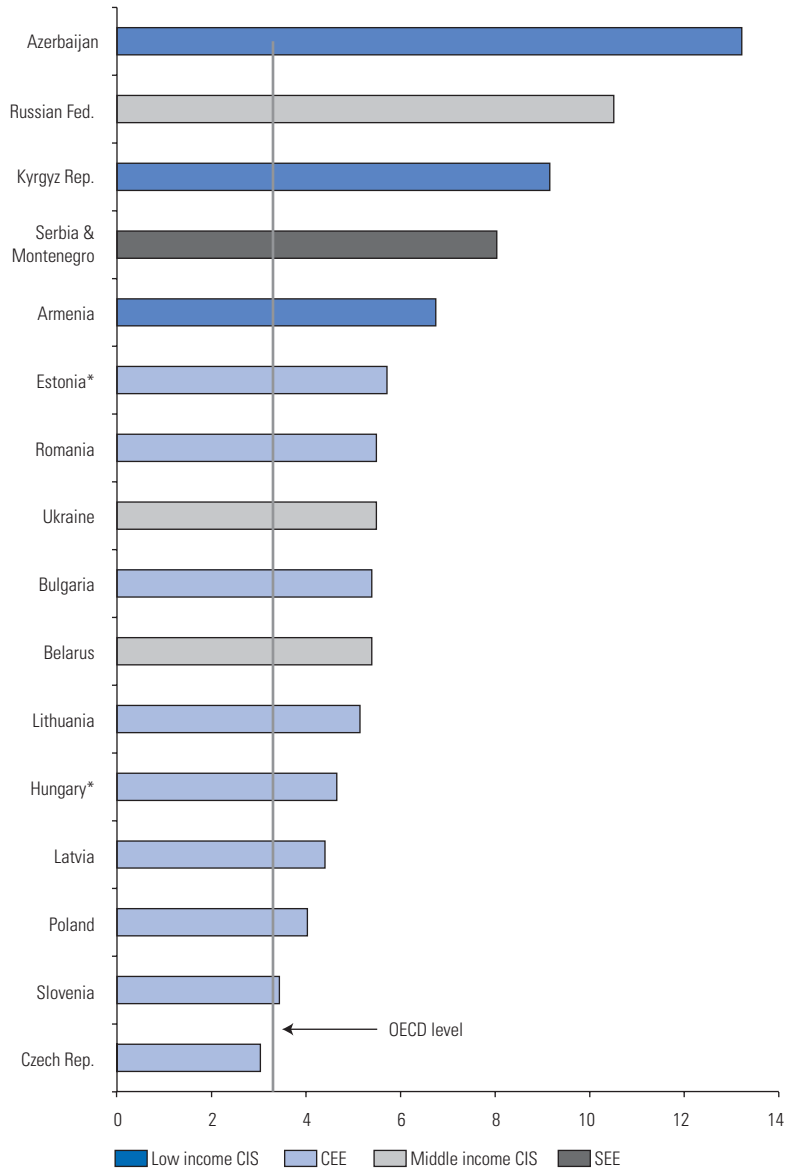
Regional disparities tend to be persistent—regions showing better performance at the outset of the transition also tended to perform better in later phases—suggesting that they may be of a long-term nature, rather than a transitory phenomenon. Job creation and employment opportunities are clustered mainly around large urban agglomerations with diversified industrial structures—particularly with large and expanding service sectors, developed infrastructure, and a skilled workforce. In contrast, employment prospects are dire and unemployment high in monoculture (highly specialized) industrial regions, which suffer from idiosyncratic demand shocks. For example, in Bulgaria and Moldova in the early 2000s, employment was expanding almost exclusively in the capital region. During the same period, employment in Croatia grew in only 4 of 21 regions and in Poland in only 3 of 16 regions. Unemployment in rural agricultural regions is usually lower than that in regions with an industrial monoculture because workers in such regions have recourse to subsistence agriculture and can take temporary and seasonal jobs. In these regions, the problem is underemployment, rather than open unemployment.

The labor market inequalities are sustained by relatively low inter-regional migration. The main factors accounting for low interregional labor migration rates in transition economies include the following:

FIGURE 1.6

Wage Inequality in the CIS Is Higher than in the CEE

Ratios of 9th decile to 1st decile, 2002



Sources: UNICEF TransMONEE database; and Bank staff calculations.

Note: * Signifies 2001.

- *High nationwide unemployment rates* may discourage internal migration because they indicate falling probability of finding employment. For example, in Bulgaria in the early 2000s, the unemployment rates were high in absolute terms, even in rela-

tively low unemployment regions (for example, 14 percent in the capital city). A similar situation occurs in Poland.

- *Skills mismatch.* New jobs are created mainly in the service sector in urban regions, and these jobs may require skills not available to unemployed blue-collar workers in other regions. For example, it is estimated that in Bulgaria and Lithuania, more than 20 percent of the unemployed do not find a job because their skills fall short of employer requirements (World Bank 2002a and 2002c). Related to this is the inefficiency of the spatial matching (that is, the process by which unemployed workers find employment in other regions).
- *Social benefits* might have provided disincentives for migration, especially at an early stage of the transition (they were gradually reduced or abolished). In European transition economies, these were mainly cash benefits, while in CIS economies, they were usually in-kind benefits, such as firm-provided housing.
- *Informal safety nets* from informal sector employment or income from subsistence farming may induce job searchers to stay at home, rather than move elsewhere in the country.
- *Inefficiencies in the housing markets* greatly increase migration costs (for example, through high rents). The cost of renting a studio apartment in Warsaw accounts for around 70 percent of the average monthly net wage of a less skilled worker.
- *Liquidity constraints* may make migration an unaffordable option.

The Drivers of Labor Demand during the Transition

The observed changes in the Region's labor markets during the transition have been strongly influenced by the process of firm restructuring and massive reallocation of resources across firms, sectors, and locations. Faced with radical changes in the institution and market environment, firms in all countries have been forced to adapt their behavior. Some have been able to seize new opportunities, but many others have simply tried to survive in a market environment to which they were unaccustomed. The ensuing process of restructuring has involved major upgrading of technologies and production processes and hiring or (more often) laying off workers. As a result, some firms have managed to boost productivity, but some have been forced to exit the market. The process of economic transformation has been characterized by two interlinked processes:

1. *Within-enterprise reforms*, spurred by higher competitive pressure. These reforms comprise improvements in governance and management; better organization of producing and marketing; and introduction of new, more efficient technologies.
2. *A more efficient allocation of resources*, which also involved reallocation of jobs and workers away from declining, less productive firms, sectors, and regions toward expanding, more productive ones. Resource reallocation is important to promote output and productivity growth in any market economy, but it has assumed an even greater role in transition economies, given their highly distorted industrial structure inherited from the central-planning period. An important role in the process of reallocation of resources has been played by the entry of more productive firms and the exit of obsolete ones.

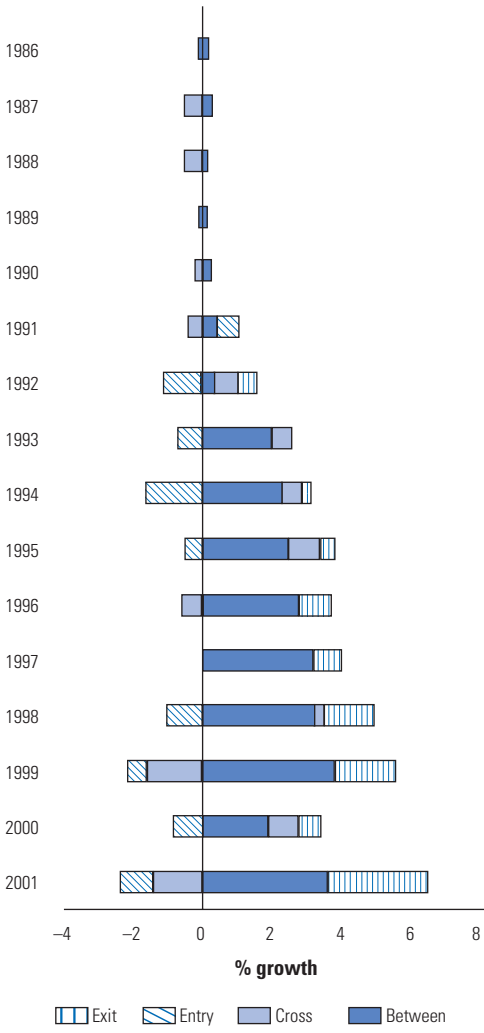
Restructuring of existing firms, reallocation of resources across them, and the entry and exit of firms have all contributed to shape the evolution of productivity and employment. The effects on productivity are massive. For example, figure 1.7 shows that the contribution to productivity growth of the entry and exit of firms and the reallocation of labor across incumbent firms in Russia has increased significantly during the transition period. In addition, there is evidence that more productive firms tend to create new jobs, while inefficient firms are destroying them in a number of countries, including Croatia, Lithuania, and Moldova (figure 1.8 illustrates this pattern for Moldova).

Firm Restructuring

Firm restructuring was a result of imposing market discipline on inherited enterprises and encouraging the creation and expansion of new enterprises. Discipline forced old enterprises to release assets and labor, which were then potentially available to restructured and new enterprises. It did this by hardening budget constraints, introducing competition in product markets, providing exit mechanisms, and monitoring managerial behavior to generate incentives for production and innovation. Encouragement entailed policies to create an attractive and competitive investment climate in which restructured and new enterprises had incentives to hire labor and to invest in expansion (World Bank 2002e, xvii).

Within-enterprise reforms engendered by the imposition of discipline resulted largely in labor shedding and what is called “defensive

FIGURE 1.7
Labor Reallocation Has Played an Increasing Role in Promoting Labor Productivity Growth in Russia



Source: Brown and Earle 2004.

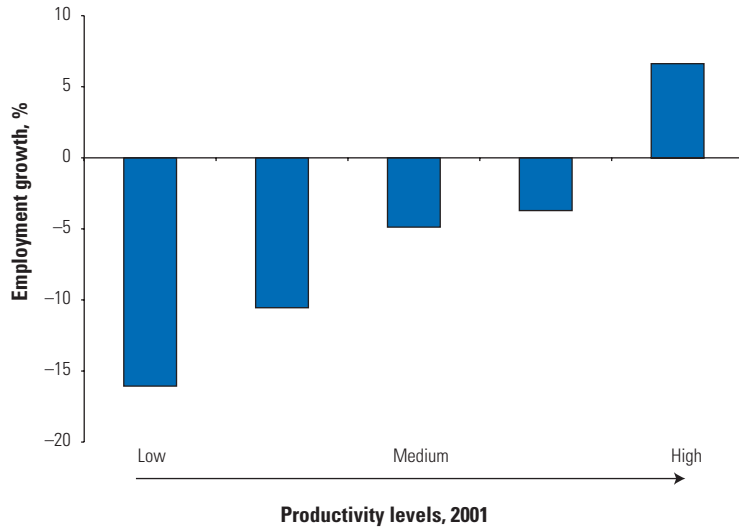
Note: *Entry*: the contribution of new firms to overall labor-productivity growth; *Exit*: the contribution of exiting firms—as they tend to be less productive than the average, their exit contributes to raising productivity growth (on average); *Cross*: the product of changes in productivity and changes in market shares—it is negative if firms with rapidly growing productivity lose market shares; *Between*: captures the gains in aggregate productivity coming from a reallocation of resources from lower to higher productivity firms.

restructuring.” Often, the impetus for defensive restructuring was privatization. In the “old” enterprises, productivity gains have been achieved largely through shedding redundant labor, which allowed the old firms to reduce costs and thus stay in the market. In addition, discipline led to the closure of other old, but inefficient firms, thus

FIGURE 1.8

The Rate of Job Creation Is Higher for More Productive Firms in Moldova

Employment Growth (percentage) by Productivity Level in 2001



Source: Rutkowski 2004a.

raising average productivity. In addition, the entry of new firms further stimulated efficiency enhancements by incumbent firms. In background work to this report, which analyzed the effects of restructuring and reallocation of labor on productivity for a group of CEE countries, Russia, and Ukraine,¹³ productivity growth was found to be clearly led by defensive restructuring and the associated labor shedding.¹⁴ Indeed, those firms that achieved higher-than-average productivity growth during the transition period also experienced significant downsizing, with a fall in their share of total employment. At the same time, many low-productivity industries, sheltered from competitive pressure, have managed to contain job destruction, but may still have to go through a period of downsizing and restructuring, which will likely cause further increases in unemployment.

Strategic restructuring—with new investment and job creation—seems largely confined up until now to foreign-owned firms. For example, evidence for four countries (Hungary, Romania, Russia, and Ukraine) suggests that all privatized firms experienced significant improvements in their productivity performance. The acceleration in productivity was much stronger in foreign privatized firms, possibly because they had better characteristics even before the ownership change but also because of foreigners' advantages in accessing finance, new technologies, the latest managerial techniques, and

world markets, which outweighed any disadvantages resulting from unfamiliarity with local conditions.

But where the differences between foreign and domestic privatization become even more evident is in employment. Foreign privatization is associated with increased employment and wages in all countries. Domestic privatization has been less kind to workers: wages suffered in all four countries, and employment rose in only a few instances. There are also significant differences across types of workers: employment composition and relative wage changes have been significantly biased toward white-collar employees. This is consistent with the idea that foreign privatization, by promoting the upgrading of production processes with new technologies, tends to be skill-biased. It also suggests that although foreign privatization has improved the welfare of workers overall, it has also increased inequality.

Reallocation of Labor and Firm Demographics

In all market economies, many firms enter and exit most markets every year. But in transition countries, the pace of firm creation and destruction during the transition has been phenomenal. In CEE countries, about 20–25 percent of firms were created or destroyed during the transition (compared with an average of 10 percent in OECD countries). Firm entry largely outpaced firm exit, which is obviously related to the process of transition and is not sustainable over the longer run. Yet it points to the fact that new firms not only displaced obsolete incumbents in the transition phase but also filled in new markets that were either nonexistent or poorly populated in the past.

The entry of new firms contributed markedly to job creation. As an example, in Russia, before the transition, firm turnover (entry and exit of firms) accounted for less than 20 percent of overall job turnover. During the transition, the contribution of firm turnover to job flows increased strongly. In the countries for which firm-level data are available, in the initial phases of the transition, the entry of firms contributed to about 40 percent of total job creation in Estonia, Hungary, and Latvia and to more than 70 percent in Romania and Slovenia.¹⁵ Moreover, a stronger (positive) correlation exists in transition countries than in OECD countries between the number of entrant firms in a given country and industry and the overall job creation in that country and industry. By contrast, there is almost no correlation between exit of firms and job destruction, while in OECD countries this correlation is stronger. In other words, the entry of new firms plays a significant role in job creation. However, the exit of obsolete firms, while promoting productivity, does not strongly con-

tribute to job destruction, which largely comes from downsizing of surviving firms.

Not surprisingly, the contribution of firm entry to overall job creation declined over the transition period. After having filled the pre-transition void in certain activities, the characteristics of job flows converged toward those observed in market economies: job creation and destruction come increasingly from within firm adjustment, rather than from the entry and exit of firms. In this context, Russia and Ukraine—two laggard reformers—saw the reverse patterns, with an increasing role of firm entry in total job creation in the second half of the 1990s.

Firm turnover is also important in promoting productivity. Contrary to the evidence in most OECD countries, where the lack of experience and small size often make new firms less productive than the average incumbents, in transition economies new firms have been more productive than existing firms. They have been able to fill in new market niches and adopt new and more efficient technologies. Thus, firm entry is critical not only for job creation but also for productivity growth. Figure 1.9 shows the contribution of the entry of more productive firms and the exit of less-productive ones to aggregate productivity in manufacturing. During the transition, in Estonia, Latvia, and Romania, 30 to 40 percent of overall productivity growth resulted from the creation and destruction of firms.

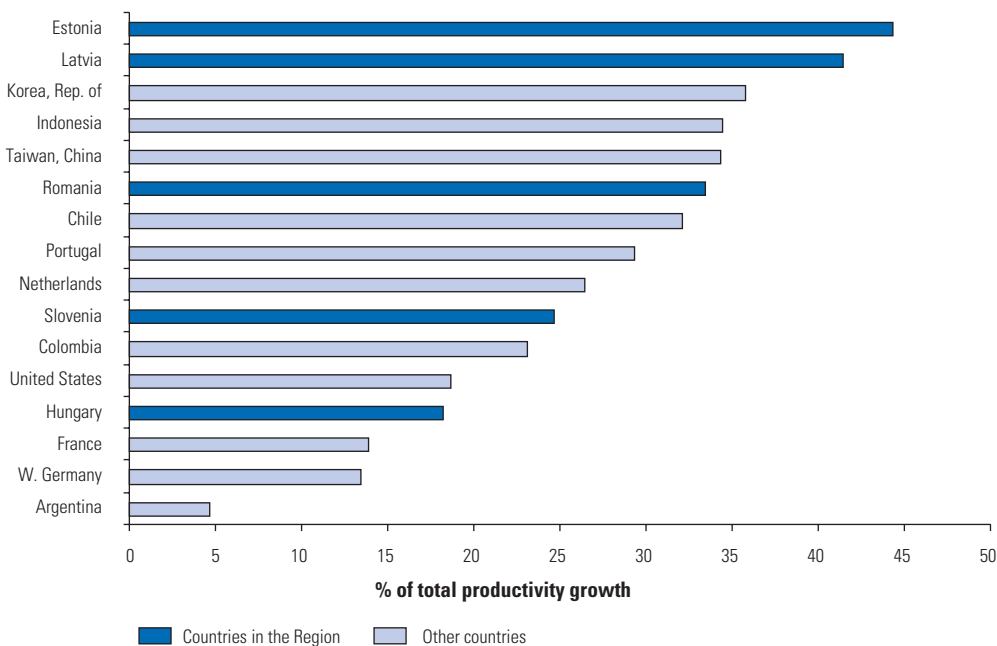
The Role of the Region's Policy and Institutions

All countries in the Region have made major progress in reforming their policy and institutional settings to accommodate the requirements of a market economy. But large differences remain in the investment climate across countries in the Region and, in different ways, all countries still have an ambitious agenda ahead to remove constraints to firms' entry, investment, and job creation. The initial deterioration of labor market conditions in most economies of the Region was the result of the transition shock, which caused a dramatic fall in output and a correspondingly large fall in labor demand. The resulting shedding of redundant labor and closing of loss-making enterprises caused large inflows into unemployment. Yet, the ability of the Region's economies to recover from the transition shock and to reduce unemployment has been largely determined by the rate of creation and expansion of new firms and consequently by the size of the new sector, as well as by the ability of existing firms to restructure to ensure profitability and improve competitiveness.

FIGURE 1.9

Firm Entry and Exit Are Critical for Productivity Growth

The Contribution of Entry and Exit of Firms to Total Labor Productivity Growth



Source: Bartelsman, Haltiwanger, and Scarpetta 2004.

Note: Data show the sum of the contributions from new entrant firms and exiting firms to total labor-productivity growth in manufacturing. Data cover different periods for the countries. For all but three countries, the contributions are calculated on the basis of five-year rolling windows. For Hungary, Indonesia, and Romania, the data refer to three-year rolling windows and tend to underestimate the contribution of new firms to total labor-productivity growth.

The decision of firms to create more, and more productive, jobs and that of workers to stay in the labor market and seek more-rewarding jobs depend on a complex set of factors:

1. *Macroeconomic policy setting.* Macroeconomic instability and financial crises have both contributed to discouraging enterprises from undertaking new investment and creating new jobs. At the same time, the combination of relatively high interest rates and loose fiscal policy may have contributed in some CEE countries to reducing the employment content of growth.
2. *The cost of doing business.* Private investment is often discouraged in the Region's countries by a set of factors that increase the costs of new investment, the risk associated with it, and barriers to competition faced by firms.
3. *Wage flexibility* has increased during the transition in the Region; however, there are still instances in which wage floors or government intervention prevents wages from adjusting.

4. *Employment protection legislation.* Labor reallocation is also influenced by regulations on hiring and firing. Although several countries have reformed these regulations to better conform with market requirements, reforms have often focused on creating flexibility at the margin (for example, temporary contracts in CEE). And in the CIS countries, labor flexibility is often ensured by non-compliance with rigid regulations.
5. *Social benefits* played an important role in smoothing the costs of the transition, but overly generous benefits (as in the early phases of the transition in several CEE countries) weakened job search incentives.¹⁶

Each of these five factors—four on the demand side and one on the supply side—has played a different role across the countries of the Region. But, in general, the dominant role has been played by the demand-side factors, while the supply-side effects were relatively limited. Indeed, in transition economies, the rate of job destruction has been—and, in many cases, still is—higher than the rate of job creation, which has led to a fall in the number of jobs and an increase in unemployment. As a result, the number of unemployed per job vacancy is high in most transition economies. At the same time, the fraction of the jobless who receive unemployment benefits (20–30 percent) is relatively small. This suggests that the outflows from unemployment to jobs are mainly impeded by the lack of job openings, rather than by labor supply disincentives.¹⁷

Macroeconomic Policies

The transition to a market economy has been characterized in some countries by macroeconomic instabilities and financial crises that have had repercussions in the neighboring countries. Since the mid-1990s, there has been a tendency, especially in CEE countries, toward relatively tight monetary policy and loose fiscal policy. This combination is estimated to have contributed to jobless growth.¹⁸ The tightening in monetary policy necessary to reduce inflationary pressures caused high real interest rates in the CEE since 1995. Empirical evidence suggests that high real interest rates tend to reduce capital investment and thus slow down the required adoption of new technologies and production processes, as well as the development of new activities. In turn, a slower pace of capital formation can easily translate into the postponement of defensive restructuring (see below), with less hiring of workers and thus a lower rate of employment growth.

There is also evidence of a loosening in fiscal policy in the aftermath of the 1998 recession, when employment was sharply declining.¹⁹ Because fiscal loosening implied a likely future increase in interest rates, and possibly in the tax burden as well, forward-looking entrepreneurs reduced up-front hiring (Boeri and Garibaldi 2004). In addition, there was a crowding-out effect induced by an increase in labor costs. In the past five years, real wages in the public sector increased at a higher pace than those in the private sector in several CEE countries. In addition to worsening the fiscal balance, the associated high wage growth in the CEE public sector may have crowded out skilled workers from the private sector.

GDP growth also had a strong effect on employment in the second phase of transition, but again macroeconomic policies may have diluted its impact. There is evidence that the rise in real interest rates and the loosening of the fiscal stance contributed to weakening the potential effect of GDP growth on employment and unemployment (Boeri and Garibaldi 2004). In other words, employment and unemployment would have been more responsive to changes in GDP growth had the macroeconomic environment not changed at the same time.

Cost of Doing Business

Improving the investment climate requires further action not only in reducing the costs of investment and the risk associated with it but also in promoting competition in the market (World Bank 2004d). Priorities along these three dimensions differ from one country to another.²⁰

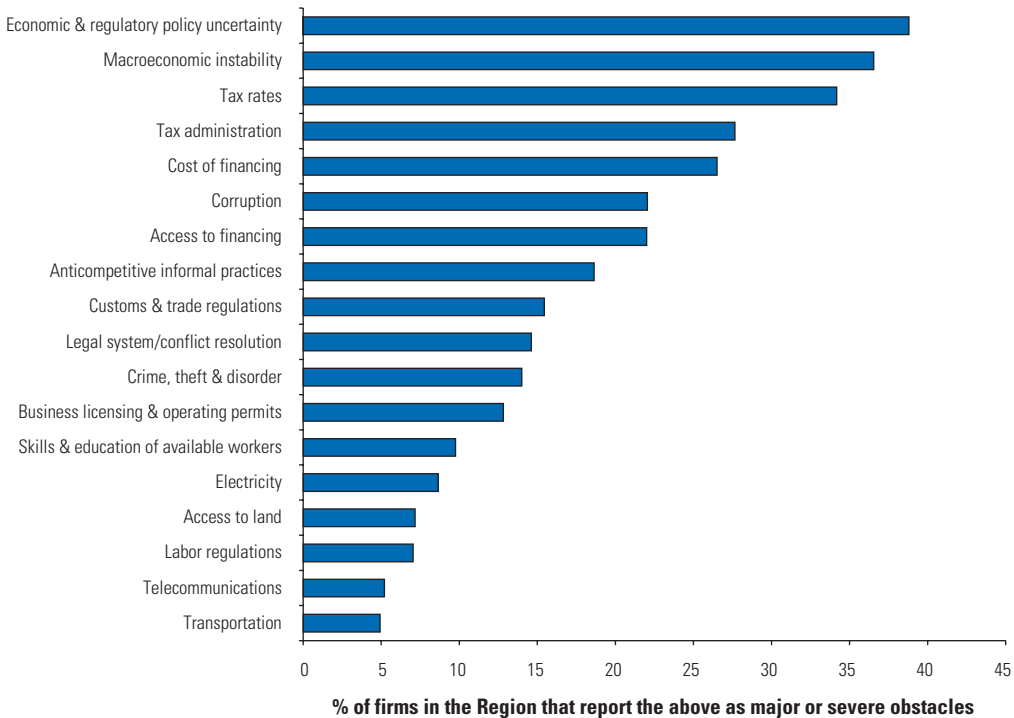
High costs of doing business discouraged the creation of new firms and firm growth, leading to a lower pace of job creation. Objective indicators of the costs of doing business, as well as entrepreneurs' perceptions, indicate that there is substantial room for improving the investment climate in the Region and thus fostering job creation. In most of the subgroups of countries in the Region, economic and regulatory policy uncertainty and macroeconomic instability are seen as major obstacles (figure 1.10). High taxes, burdensome tax administration and associated corruption, and problems with financing access and cost also loom large.

Not surprisingly, most firms in the Region claim that taxes have a major impact on their costs. This is common to most firms around the world, and it is not by itself a source of major concern for policy makers. If properly used, tax revenues contribute to the provision of public goods and mitigate market failures. Two main aspects of the tax system have, however, a specific bearing on firms' costs in the Region.

FIGURE 1.10

Major Obstacles to Firm Activity, 2002

Proportion of Firms That Report the Following as Major or Severe Obstacles in the Region



Source: EBRD–World Bank Business Environment and Enterprise Performance Surveys, 2002.

Note: Preliminary results from the new Business Environment and Enterprise Performance Survey (BEEPS) of 2005 are broadly consistent with those reported in this figure. However, some changes may have occurred for individual countries or subgroups of countries in the Region.

Tax rates—especially payroll taxes—are particularly high in European transition economies, reflecting, to a large extent, inefficiencies in the pension and health care systems. Taxes on labor use are among the highest in the world—in the Czech Republic, Hungary, and Romania, the tax wedge on labor use is around or even above 50 percent, while it is around 40 percent in the OECD countries (figure 1.11). Labor taxes lower labor demand by raising labor costs, but they also lower labor supply by reducing the real consumption wage.²¹ In addition, they contribute to the growth of the informal sector. The result is lower formal sector employment. The employment effect of these taxes is especially strong in CEE economies, which combine high tax rates with effective enforcement.²² Also, tax administration (for example, tax inspections) is particularly burdensome in the CIS countries, being associated with bureaucratic harassment and corruption.

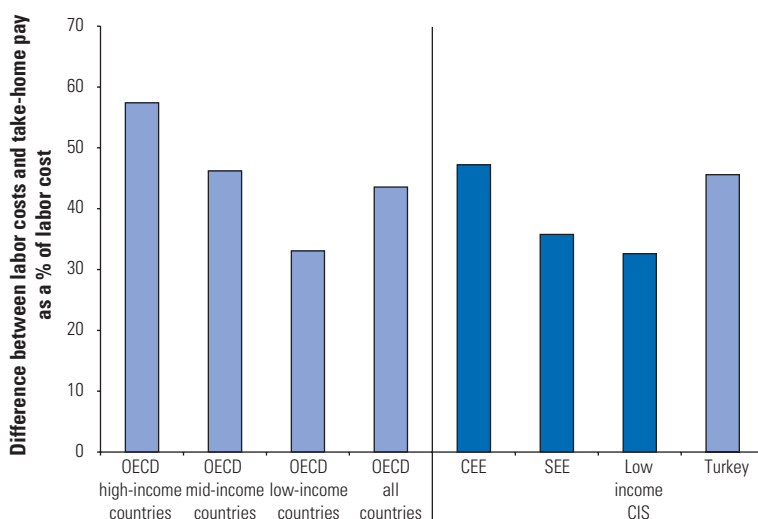
Many firms in the Region also point to the difficulty of accessing finance and the costs of it as major constraints on their ability to invest

and create new jobs. There are large differences in access to finance in the Region. For example, while domestic credit to the private sector accounts for more than 100 percent of GDP in the European Union, it is less than 30 percent in CEE, and it drops to 16 percent (on average) in the middle income CIS countries and to 10 percent in the low income CIS countries. The comparison between Croatia, with one of the most developed credit markets in the Region, and the Kyrgyz Republic, with one of the least developed credit markets in the Region, is stunning: in Croatia, domestic credit to the private sector represents more than 50 percent of GDP, while it represents only 4 percent in the Kyrgyz Republic. But even in Croatia, the credit market is less developed than in some developing countries, such as the Republic of Korea and Malaysia, where credit totals considerably more than 100 percent of GDP.²³

Difficult access to credit is most common for small and newly established firms, which account for a large part of total job creation in most of the Region’s countries. Improving financial markets and easing access to credit may therefore lead to significant improvements in the

FIGURE 1.11
The Tax Wedge on Labor in the Region Is High, Often Higher than in Most OECD Countries

The Difference between Labor Cost and Take-Home Pay as a Percentage of Labor Cost



Sources: OECD 2004b for OECD and CEE OECD, except Slovenia (based on 2001); Bank staff estimates for others (using 2003). Tax wedge calculated with reference to the average worker without dependents. For countries in the Region, average workers do not include those involved in agriculture. OECD groupings exclude CEE OECD: (i) low (less than 40% wedge) includes Australia, Iceland, Ireland, Japan, Korea, Mexico, New Zealand, Portugal, Switzerland, UK, and USA; (ii) mid (40-50%) includes Canada, Denmark, Greece, Luxembourg, Norway, Spain and Sweden; (iii) high (51+ %) includes Austria, Belgium, Finland, France, Germany, Italy, and Netherlands.

labor market. In Latvia, where access to credit is considered one of the best in the Region and comparable to the EU-15 average, successful entrant firms almost double their employment in the first four years of life. By contrast, in Romania, where access to credit is considered one of the worst in the Region, successful new firms increase their employment by a mere 10–20 percent over the same time horizon.

Labor regulations do not rank among top business concerns in the Region, especially in the CIS. In the less-advanced economies of the CIS, they are dwarfed by more important and binding constraints. Although strict on the books, labor regulations are often only weakly or selectively enforced, and firms do not comply with them. Finally, in the slower-reforming transition economies (again, mainly in the CIS), where the restructuring effort still lies ahead, few firms have gone through major downsizing, constrained by high dismissal costs.

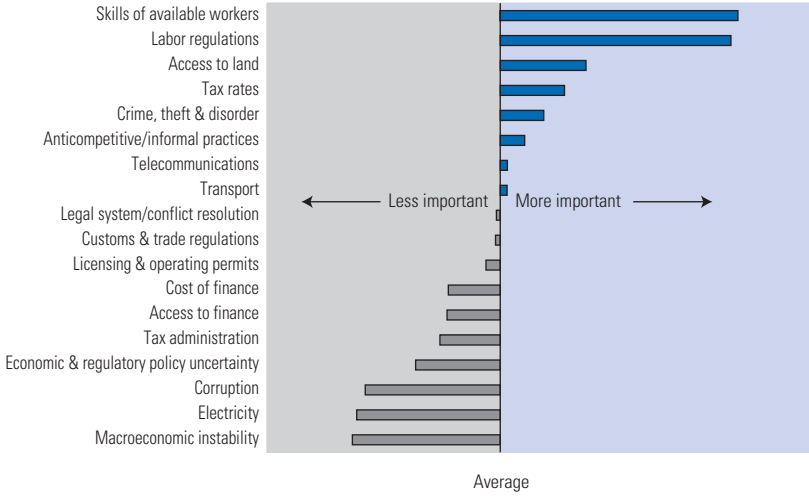
However, in European transition economies, where enforcement is stronger and enterprise restructuring more advanced, firms frequently view labor regulations as a significant obstacle to their operation and growth. In CEE, the proportion of firms complaining about labor regulations reaches as much as 30 percent, and it is only slightly lower in SEE (25 percent). For comparison, in low income CIS countries, this proportion is only 10 percent; it is somewhat more in middle income CIS countries, which reflects in part lax enforcement and in part lower pressures on adjustment.²⁴

Although many investment climate concerns are common for most transition economies, there is also substantial variation in the relative importance of the obstacles. In the transition economies that recently joined the EU, labor-related issues, such as skills of the available workers, labor regulations, and taxation, figure prominently (figure 1.12, panel A). In other European transition economies, a combination of poorly functioning institutions (for example, ineffective legal systems and industrial conflict resolution) and bad governance (for example, anticompetitive and informal practices, as well as corruption) limit firm growth and job creation (figure 1.12, panels B and C). In the middle income CIS countries, the predominant part is played by administrative barriers, such as numerous licenses and operating permits, burdensome tax administration (with associated bureaucratic harassment and extortion), and inefficient regulations (figure 1.12, panel D). In the low income CIS countries, the constraints are more basic, ranging from unreliable infrastructure to underdeveloped institutions of a market economy (figure 1.12, panel E).²⁵

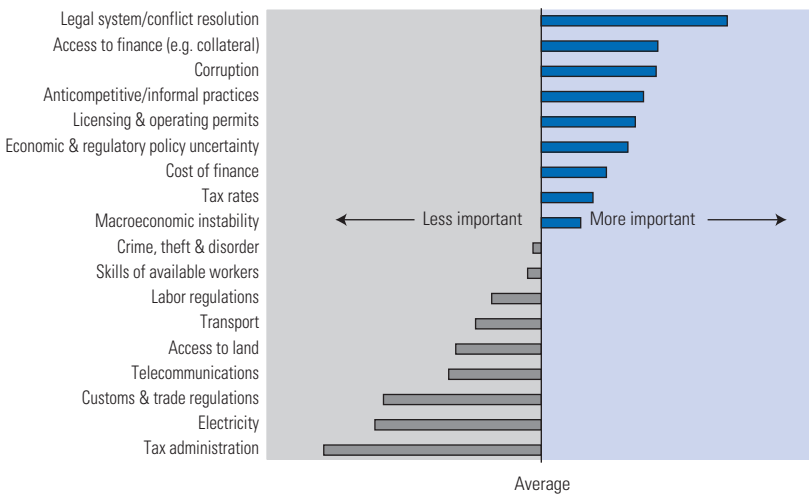
One reason why labor-related issues are more pronounced in CEE, compared with those in other subgroups in the Region, is a faster pace of enterprise restructuring. First, a widespread job reallocation gives rise to a skills mismatch because the newly created jobs differ in

FIGURE 1.12
Obstacles to Business Operation and Growth Vary by Subgroup

Panel A—CEE, EU-Member Countries



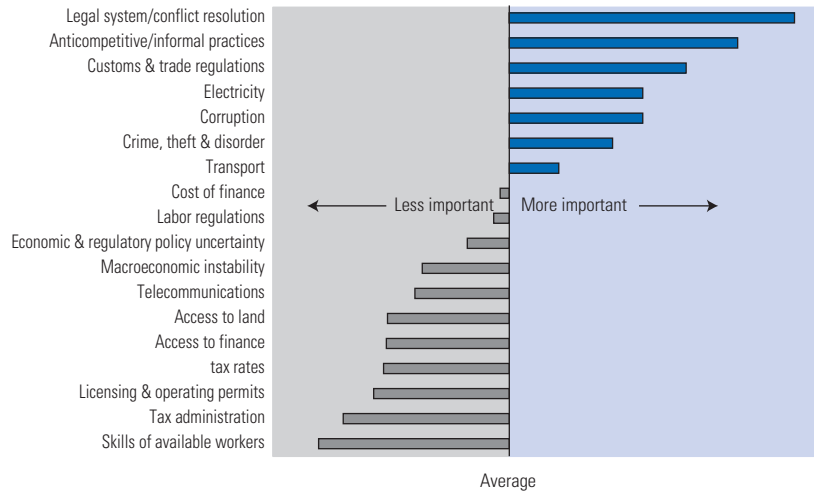
Panel B—CEE, EU-Accession Countries (Bulgaria, Croatia, and Romania)



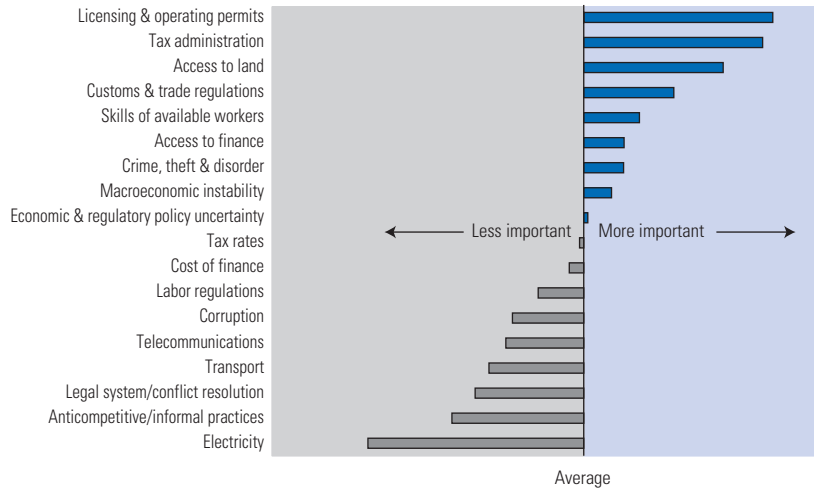
skill content from jobs that were destroyed. Thus, the relatively large job reallocation in CEE explains why employers there see the skills of available workers as a major constraint to firm growth. Second, labor regulations become an effective obstacle only if firms face competitive pressures to adjust the size and the composition of their workforce to stay profitable. This in turn explains why employers in faster-restructuring CEE countries complain more often about labor regulations, although on the books they are less strict than in other subgroups of countries in the Region.

FIGURE 1.12 (continued)

Panel C—Southeastern Europe



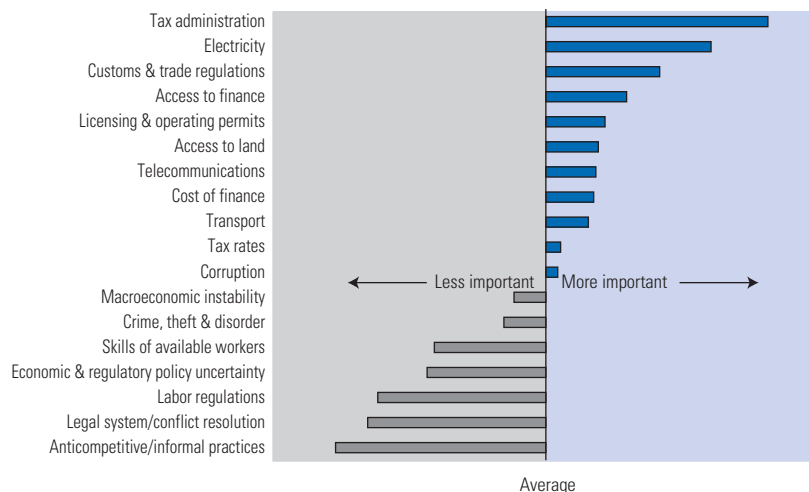
Panel D—Middle Income CIS Countries: Belarus, Kazakhstan, Russia, and Ukraine



Administrative costs of setting up a new business affect the creation of new firms most in the CIS and SEE. Costs for setting up a new business tend to be higher in the Region than in many industrial and emerging Asian economies, being particularly constraining in many of the CIS countries and in the countries of Southeast Europe. By contrast, most Central and Eastern European countries of the Region—most notably the Baltic States—have made significant improvements in reducing start-up costs. For example, the number of

FIGURE 1.12 (continued)

Panel E—Low Income CIS Countries: Armenia, Azerbaijan, Georgia, the Kyrgyz Republic, Moldova, Tajikistan, and Uzbekistan



Source: EBRD—World Bank Business Environment and Enterprise Performance Surveys, 2002.

Note: Bars show the deviation from the regional and factor averages. Preliminary results from the new 2005 BEEPS are broadly consistent with those reported in this figure. However, some changes may have occurred for individual countries or subgroups of countries in the Region.

start-up procedures is just 3 in countries such as Ireland and Sweden and 7 or 8 in the Baltic States, but their number is 14 in Azerbaijan and Ukraine and 19 in Belarus. Thus, reducing business start-up costs in the Region may foster firm entry, facilitate formal sector growth, and as such bring about faster job creation.

Reducing the risks for firms and for workers is also a key challenge because they operate in a milieu of greater uncertainty. Firms in the transition economies have emerged during a period of profound economic and social transformation characterized by major macroeconomic shocks and profound structural changes. All these factors have certainly affected firms' perceptions about risk. Not surprisingly, most countries in the Region point to macroeconomic and political instability as one of the main sources of concern in their operations. But other factors also contribute to the perceived business insecurity: security of property rights and contract enforcement, frequent regulatory changes, arbitrary and selective application of the law, bureaucratic harassment and extortion, and crime are important issues in virtually all countries of the Region, although less so in the new EU members. Thus, strengthening the rule of law, developing effective market institutions, and improving governance are key elements of

reducing risk and uncertainty and thereby fostering investment and job creation.

Workers also have to confront uncertainties in their career prospects and job stability. During rapid transition, in which many jobs are destroyed and others are created in different firms, sectors, and often locations, these uncertainties are high. Government can help workers cope with these rapid changes by insuring against the risk of job and income loss and improving the matching function of the labor market. Better labor market information, job search assistance, training, and facilitation of labor mobility can contribute to achieving this goal. Virtually all transition countries introduced income support schemes and a range of active labor market programs (ALMPs), although they are more generous (in coverage, benefit level, and duration) in CEE than in other subgroups, especially in the low income CIS countries. However, balancing income support to promote reallocation with possible job-search disincentive effects has been, and still is, a challenge in many CEE countries.

Introducing greater competition into markets has helped longer-term job creation in the Region. One of the most visible and pervasive changes during the transition was the introduction of competitive forces into markets for goods and services—by liberalizing prices and trade flows, by imposing harder budget constraints on state firms, and by shifting ownership to the private sector (World Bank 2002e). More-competitive product markets bring easier firm entry, less administrative barriers to firm growth, and greater firm efficiency, including wage adaptability. All these changes are conducive to faster job creation, although productivity gains can lead to job losses in the short term.

There are, however, large differences in the pervasiveness of competitive forces in the markets of the Region's countries, with product markets being most competitive in more-advanced CEE countries and least competitive in the CIS. For example, 90 percent of firms in Poland face significant competitive pressures and thus incentives to improve efficiency, while only 40 percent of firms face similar pressures in Georgia.²⁶ Some of these differences have been the result of different modes of privatization, which have often been the main trigger of firm restructuring and the promotion of efficiency.

The positive effect of privatization on productivity has been stronger in CEE countries than in the CIS countries because the former have placed fewer restrictions on—and sometimes actively encouraged—foreign participation in privatization and concentrated ownership. The defensive restructuring strategy adopted by many domestically privatized firms could go on for a while, given the large overmanning in previously state-owned firms, but further improve-

ments in their performance will soon depend on their ability to invest, adopt new technologies, and hire new staff.²⁷ Promoting competition via easier entry of new firms and leveling the playing field can speed up the transition from defensive restructuring to strategic restructuring and job creation.

Wage Flexibility

The wage determination process in the Region has been decentralized and liberalized during transition and generally resembles that in mature market economies. But liberalization has gone much further in CEE than in SEE and the CIS.²⁸ In CEE countries, where the new private sector plays a bigger role than in other parts of the Region, wages are mostly determined at the enterprise level and linked to worker productivity. Union presence in the new private sector is weak and competition is high, so there is little space for workers to appropriate part of the firms' market rents²⁹ or for wages to be set above the competitive level. Evidence exists that regional wages are sensitive to regional unemployment rates (the so-called wage curve), as they are in mature market economies (Huber 2004). In contrast, wage setting in SEE and the CIS is less competitive, largely because of a still dominant role played by the "old" sector, including public and many privatized enterprises.

In some cases, wage rigidities in the form of binding minimum wages could have contributed to unemployment among disadvantaged groups. In many CEE countries, minimum wages are centrally set at a relatively high level (around 40 percent of the average wage). At this level, minimum wages may produce some disemployment effect among the less-skilled and younger workers, especially in economically depressed regions of the country where underlying market wages are well below the national average. For example, in economically depressed regions of Poland, the minimum wage is roughly 10 percent less than the average wage of low-skilled workers and 25 percent less than that of young workers (Rutkowski and Przybyla 2002). Similarly, the recent substantial minimum wage increase in Hungary was found to adversely affect job retention and job-finding probabilities of low-wage workers (Kertesi and Köllö 2003).

In SEE and especially the CIS, wage determination is more centralized and still influenced by the government. This is related to a higher share of the public sector in employment and the behavior of privatized enterprises, which often mimics that of state-owned firms. In addition, union bargaining power is significantly higher in the public sector than in the new private sector. As a result, the

wage structure in the formal sector in SEE and the CIS is more rigid. Nonetheless, these countries have achieved a considerable degree of de facto wage flexibility through nonpayment or delayed payment of wages.

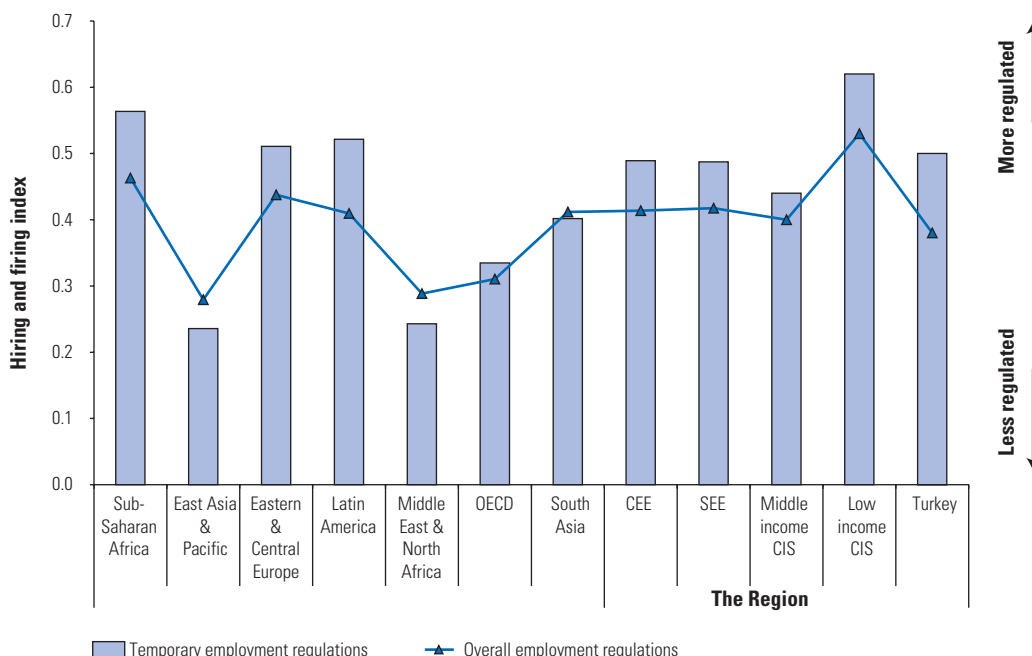
Employment Protection Legislation

Employment protection legislation (EPL) is (on average) stricter in the Region than in OECD economies (figure 1.13). Historically, employment protection has been particularly strict in CIS and SEE countries, and somewhat less strict in most CEE countries.³⁰ This means that employers in the CIS and SEE may face high—mainly procedural—costs of firing redundant labor. This is likely to discourage them from hiring in the period of economic upturn, to avoid future firing costs in some subsequent downturn. Apparently strict EPL in the Region might have contributed to a slow pace of job creation. However, the enforcement capacity in countries with strict EPL—largely in the CIS—is often weak, which means that the actual “bite” of the EPL tends to be less than implied by the law (table 1.1).³¹

In contrast, EPL is more binding in CEE because of stronger enforcement, despite more liberal regulations.³² This assessment is consistent with the perceptions of employers, who deem labor regulations a significant obstacle in the new EU member countries (and also in Turkey), but not in the other parts of the Region (figure 1.14).

Available evidence suggests that the combination of stringent EPL with effective enforcement did indeed slow job creation in the Region. For example, in Croatia and the Slovak Republic, where EPL before the reforms was extremely strict and compliance was high, the rates of job destruction and job creation were much below those in CEE economies with more liberal EPL, such as the Baltic States, Hungary, or Poland (World Bank 2002a and 2003a). Thus, excessive protection of existing jobs comes at a price of slower job creation and also slower enterprise restructuring and productivity improvements. Moldova, where the rate of job turnover is relatively high, shows that strict EPL has little effect on enterprise restructuring if enforcement is weak (World Bank 2004a). All in all, EPL has likely slowed the pace of job creation in those countries of the Region that combined strict regulations with effective enforcement, such as the countries of the former Yugoslavia. In the rest of the Region, high firing costs might have adversely affected job creation in selected firms and had some effects on the composition of employment, but the overall effect on employment has likely been limited.

FIGURE 1.13
The Region’s Countries Have More Stringent Regulations on Hiring and Firing than OECD Countries Do



Source: World Bank, Doing Business Database (2005).

TABLE 1.1
A Typology of Employment Protection Legislation and Enforcement

	Flexible EPL	More restrictive EPL	Very rigid EPL
Weaker enforcement	Albania, Kazakhstan	Armenia, Georgia, Russian Federation, Serbia and Montenegro, Turkey	Azerbaijan, Belarus; Bosnia and Herzegovina; Kyrgyz Republic; Moldova; Ukraine; Uzbekistan
Intermediate enforcement		Bulgaria	Croatia; Macedonia, FYR; Romania
Stronger enforcement	Czech Republic, Estonia, Hungary, Poland, Slovak Republic	Latvia, Lithuania, Slovenia	

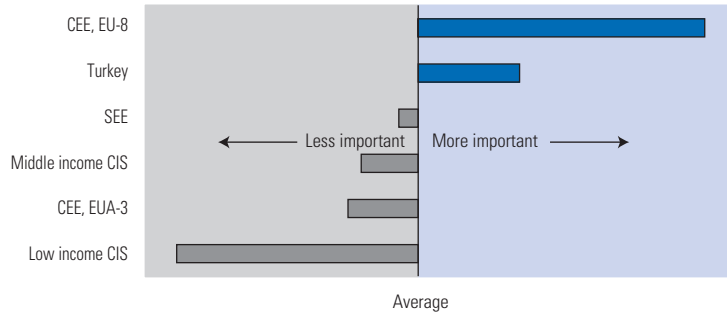
Source: Bank staff calculations.

Note: (a) Strictness is defined as whether country EPL index below world average EPL index in Doing Business 2005 (flexible), up to 20% higher (more restrictive) and more than 20% higher (very rigid). (b) The degree of enforcement is measured by the size of the informal economy—the higher the informal economy, the weaker the estimated degree of enforcement (Schneider and Klinglmair 2004 and country studies, where available). The typology is approximate because the indices are subject to margins of error.

FIGURE 1.14

Labor Regulations Seem to Be a Binding Constraint Only in the New EU Member Countries and Not in the Other Parts of the Region

Relative Importance of Labor Regulations, 2002



Source: EBRD–World Bank Business Environment and Enterprise Performance Surveys, 2002.

Note: Bars show the deviation from the regional and factor averages. Preliminary results from the new 2005 BEEPS are broadly consistent with those reported in this figure. However, some changes may have occurred for individual countries or subgroups of countries in the Region.

Social Benefits

One way to accommodate labor market slack in most of the Region's countries has been through the withdrawal of older workers through the promotion of early retirement schemes and disability pensions. This contributed to raising social expenditures and led to the surge in taxes on labor use. Moreover, social benefits were set at a fairly generous level at the beginning of the transition in many of the Region's countries, creating some disincentive effects on the supply side. The same happened with unemployment insurance benefits that provided income support for a long period of time (18–24 months in some countries) and a high replacement rate. But unemployment insurance benefits have been streamlined in all countries, and their generosity—and, in particular, their coverage—is fairly low nowadays: only 20–30 percent of the unemployed receive unemployment benefits in most of the Region's countries.³³ In CEE, unemployment benefits are more generous than in the CIS, but are still at the lower end of the OECD range. In the CIS, the generosity is so low that few unemployed have an incentive to register, which partly accounts for low registered unemployment in those countries.

Unemployment and other social benefits may have the largest effect in economically depressed regions. Despite their low overall generosity, unemployment benefits and other social benefits in CEE and SEE may create labor-supply disincentives in depressed regions, where they account for a higher proportion of the market wage. Fam-

ily benefits and social assistance benefits are set at a national level and do not consider the large differences in the cost of living across areas of the Region's countries. Although very limited in the capitals and other dynamic regions, they represent a higher proportion of underlying market wages in more depressed areas.

In CEE, social benefits were a factor behind longer job-search duration and labor force withdrawal (especially initially, when their generosity was greater), but they facilitated restructuring and labor reallocation. For example, a study for the Slovak Republic found that workers who received unemployment benefits or social assistance spent more time (about two months longer) unemployed than workers who were not entitled to these benefits. At the same time, however, benefit recipients found new jobs more often, and these jobs turned out to be better matches than the ones obtained by nonrecipients (World Bank 2002d). In contrast, in the CIS, the lack of an effective social safety net made workers extremely reluctant to part with their jobs, contributing to the slower pace of enterprise restructuring. In addition, poor social safety nets in CIS countries caused widespread informal sector employment, including work in subsistence agriculture.

The Policy Challenge: Promoting Job Creation in the Region

The Region's countries face the daunting challenge of fostering the creation of more and better jobs. This challenge is not unique to these countries. Most Western European neighbors have faced high and persistent unemployment for a long time, and only some of them have succeeded in significantly improving labor market conditions. Creating more and better jobs requires improvements in the investment climate, a climate in which firms of all types find the incentives to invest productively, adopt new technologies, and ultimately hire more workers in more-productive, and thus more-rewarding, jobs. In the countries of the Region, this already complex task is part of an even broader process of economic transformation associated with profound institutional and structural changes. Ultimately, structural reforms and improvements in the investment climate are necessary to foster high investment rates and create foundations for sustainable economic growth (box 1.2).

In all of the Region's countries, there is substantial scope for investment climate improvements, although the conditions vary substantially across country groups. Obstacles to firm growth are generally more severe in SEE or low income CIS countries than in the new EU transition countries, where structural reforms have progressed the

BOX 1.2**In Most of the Region's Countries, Higher Investment Rates Are Necessary to Accelerate Economic Growth and Job Creation**

Traditional growth theories emphasize the role of saving and investment in physical capital as important drivers of long-term economic growth. Investment is needed to expand and upgrade physical capital and thus promote output growth and productivity. And if technological progress is also embedded in physical capital, investment is needed to adopt new technologies and again to promote growth. Recent growth theories have also stressed the importance of complementary investment in human capital and the fact that there could be endogenous forces that counteract the traditional decreasing returns in investment in both physical and human capital.

The transition process from a central-plan to a market economy entails a massive investment in physical capital to replace obsolete equipment with new and to expand in new sectors and activities. The experience of some of the rapidly growing countries in East Asia clearly suggests that their extraordinary performance was also promoted by high investment rates, sustained for a prolonged period of time (World Bank 1993). For example, during the 1990s, the investment-to-GDP ratio in East Asian countries, such as Korea, Malaysia, or Thailand, averaged 36 percent. In most transition economies of the Region, the gross-investment-to-GDP ratio was around 20 percent over the past decade (figure A), largely resulting from low domestic savings. Higher investment rates may be necessary to accelerate or sustain economic growth and create new jobs. This in turn requires incentives for domestic savings and an environment in which firms find it profitable to invest and engage in strategic restructuring.

The impact of investment on economic growth and employment is also determined by the structure of investment. A part of gross investment is simply the replacement for depreciated capital and, as such, may not contribute to job creation.^a Moreover, investment can either expand "productive" capital (such as machinery and equipment) and thus contribute to job creation or add to "nonproductive" capital (for example, housing), in which case its effect on employment is negligible. There is a substantial variation across countries of the Region in the proportion of total investment allocated to productive uses. Productive (nonhousing) investment as a share of gross fixed capital formation (GFCF) ranges from less than 60 percent in the Slovak Republic to about 80 percent in Poland and to some 90 percent in the Czech Republic. As a comparison, in Korea, productive investment accounts for 85 percent of GFCF.^b

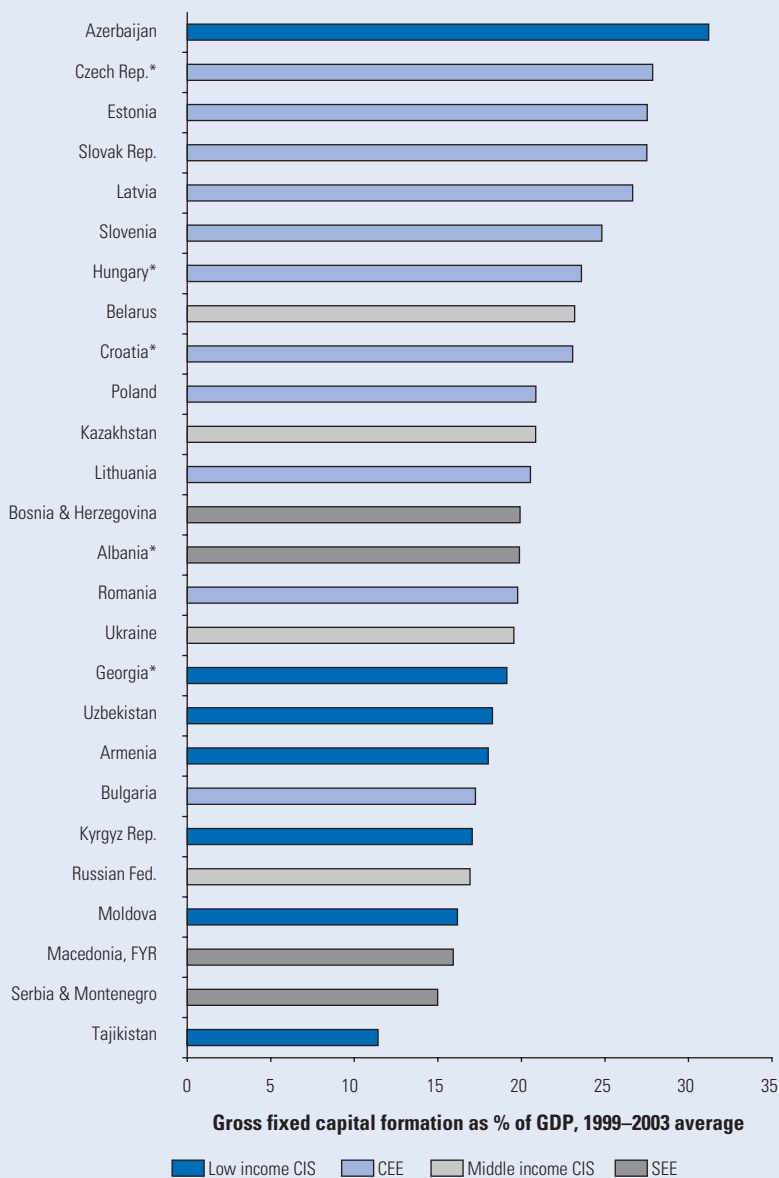
a. Gross investment minus capital depreciation is net investment, which would be a more relevant indicator of the potential for job creation; however, data on net investment are not available on a comparative basis.

b. National accounts of OECD countries (OECD 2003), average share for 1999–2003.

FIGURE A

In Many Transition Economies of the Region, Investment Rates Are below 20 Percent, Weakening Growth Prospects

Gross Fixed Capital Formation as Percentage of GDP (1999–2003 average)



Source: World Development Indicators.

Note: * = 1998–2002.

most. But even in the most-advanced transition economies of CEE, the costs of doing business can be substantially lowered. Entrepreneurs in CEE still complain about high regulatory and economic policy uncertainty, difficult access to finance, poor governance, onerous regulations, and administrative barriers. There is also much to be done to improve infrastructure, from improving road conditions to developing the information and communication technology.³⁴ After all, the experience of developed market economies shows that improving the investment climate is a continuous process that should respond to changing economic conditions, globalization, and technological progress.³⁵

The Region's countries also need to develop an adaptable labor market. Currently, labor codes in the Region, especially in the CIS and in SEE, go well beyond what can be observed in most OECD countries. But the overly generous provisions remain largely on paper because firms find it too costly to comply and thus evade or circumvent rigid labor regulations. A possible solution is two-pronged. First, employment protection regulations need to be revised to remove unduly restrictive and overly detailed provisions. Second, social partners—trade unions and employers—should be given a greater role in determining employment relations. This requires that both sides are adequately represented and that their power is balanced. Employers' organizations, adequately representing the interests of new private firms, should develop and have due voice, especially in the CIS and in SEE. At the same time, workers need to have adequate representation in the private sector—where currently unions are often nonexistent—so that their rights are protected. Deregulation of employment relations, coupled with strengthening the role of collective bargaining, can benefit both sides. Workers would benefit from *de facto* rather than *de jure* employment protection because firms would have less incentive for noncompliance and enforcement would be easier. At the same time, employers would be freed from regulations that are particularly costly to firms but of less value to workers.

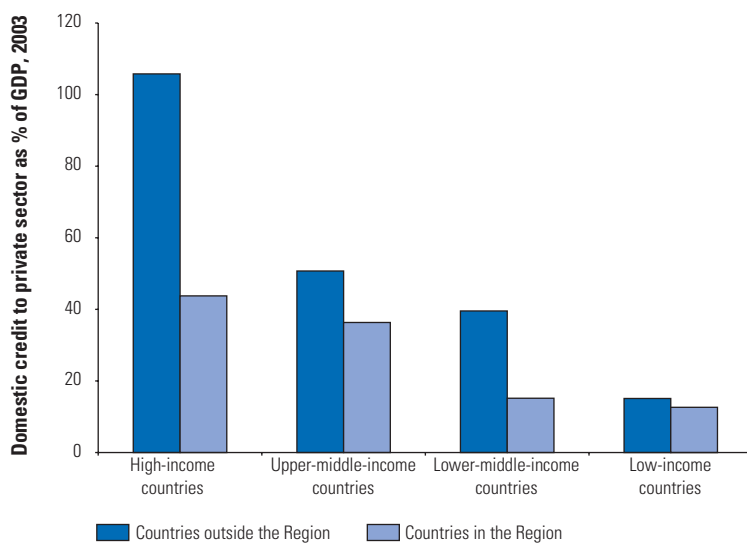
Challenges facing countries of the Region have their source in a combination of the Region's history and its income level. Numerous administrative barriers (for example, permits) or strict employment protection are largely the legacy of central planning, although they are quite typical of developing countries across the world (Turkey is one example). Difficult access to finance or inefficient legal systems reflect institutions of a market economy that are underdeveloped because of both the history of central planning and the stage of economic development. Economic policy uncertainty, corruption, and crime have been engendered by the regime changes, although again

they are typical of much of the developing world. Finally, poor infrastructure is closely associated with relatively low income levels.

How severe are the policy challenges? How far are the Region's subgroups from their natural comparators (that is, countries at a similar level of economic development that have been market economies)? This study focuses on one central dimension of the investment climate—access to finance—which is seen as a major obstacle to firm growth in virtually all countries of the Region. Figure 1.15 indicates that credit markets are underdeveloped in all of the Region's subgroups relative to their income level. For example, Armenia, Georgia, and Ukraine are at an income level similar to Bolivia's. But domestic credit to the private sector (as a share of GDP) is much higher in Bolivia: twice as high as in Ukraine and more than five times as high as in Armenia or Georgia. In the same vein, access to credit in Lithuania or the Slovak Republic is more limited than in Chile or Malaysia, in spite of a similar GDP level. This suggests that historical factors, such as the legacy of central planning, still have a bearing on the Region's economic performance. Evidence provided in this report indicates that access to finance has a significant impact on job creation. This, in turn, suggests that the Region's labor market problems at least partly stem from the uncompleted transition. Thus,

FIGURE 1.15

Access to Finance Is More Difficult in Transition Economies than in Market Economies at Similar Income Levels



Source: World Development Indicators.

Note: * = Slovenia.

further structural reforms are necessary to develop the institutions of a market economy and foster labor demand.

There is no question that the Region's countries have been through major reforms already. The EBRD transition index attests to the many reforms that have been made in the past 15 years in privatization, enhancing competition, developing the financial market, and so forth. Reforms have to be seen, however, as a process through which constraints are identified and continuous improvement and fine-tuning of policies are made. International experience has shown that essential elements of reform processes include setting priorities, managing individual reforms, maintaining momentum, and strengthening government capabilities (World Bank 2004d). Setting priorities and sequencing reforms are of particular importance because too broad a reform agenda is difficult to implement and the impact is likely to be limited because of resource constraints, including "political capital," and opposition from the groups whose interests are likely to be hurt.

The policy priorities need to be set according to country circumstances. Although the transition countries of the Region have gone through similar economic changes over the past 15 years, they differ in their initial conditions, paths, speeds of reform, and consequently in their levels of economic development (figure 1.16). The next part of the overview highlights some of the main policy challenges the report has identified for each of the Region's subgroups: CEE, SEE, the middle income CIS countries (Belarus, Kazakhstan, Russia, and Ukraine), and the low income CIS countries. They focus on the labor market area of policy intervention, although in some subgroups, the improvements in the investment climate and the restoration of sustained growth are the key priorities for job creation, calling for a much broader policy agenda. Main policy priorities for each of the Region's subgroups are summarized in table 1.2.

Central and Eastern European Countries: Reducing the Cost of Labor and Mobilizing Labor Supply

These countries have generally started the macro and structural reform process earlier than other transition countries and have often adopted more aggressive reforms. They have achieved impressive results, with output exceeding its pretransition level. They have also successfully created institutions of a market economy, which has led to their EU accession. But these impressive results should not hide the turbulent phases of this massive transformation and its associated social costs. Moreover, impressive macro and structural reforms have not yet delivered major improvements in labor market conditions.

TABLE 1.2
A Summary of Key Policy Measures to Improve Labor Market Outcomes in Transition Economies of the Region

The Region's subgroups	Policy priorities
Central and Eastern Europe	<ul style="list-style-type: none"> • Reduce taxes on labor through reforming pension and health care systems • Enhance wage adaptability (for example, through reducing/differentiating minimum wages) • Liberalize employment protection regulations for permanent contracts • Improve labor supply incentives in backward, low-wage regions by adjusting benefit levels
Southeastern Europe	<ul style="list-style-type: none"> • Enhance product market competition and reduce administrative barriers • Reduce taxes on labor • Decentralize wage determination • Liberalize employment protection legislation
Middle income CIS	<ul style="list-style-type: none"> • Enhance product market competition and reduce administrative barriers • Decentralize wage determination • Deregulate labor relations and focus on enforcement of key labor standards • Improve the effectiveness of the social safety net to encourage labor reallocation
Low income CIS	<ul style="list-style-type: none"> • Develop key institutions of a market economy and invest in infrastructure • Reduce administrative barriers • Deregulate labor relations and focus on enforcement of key labor standards • Develop social safety net, particularly for those without access to formal insurance mechanisms

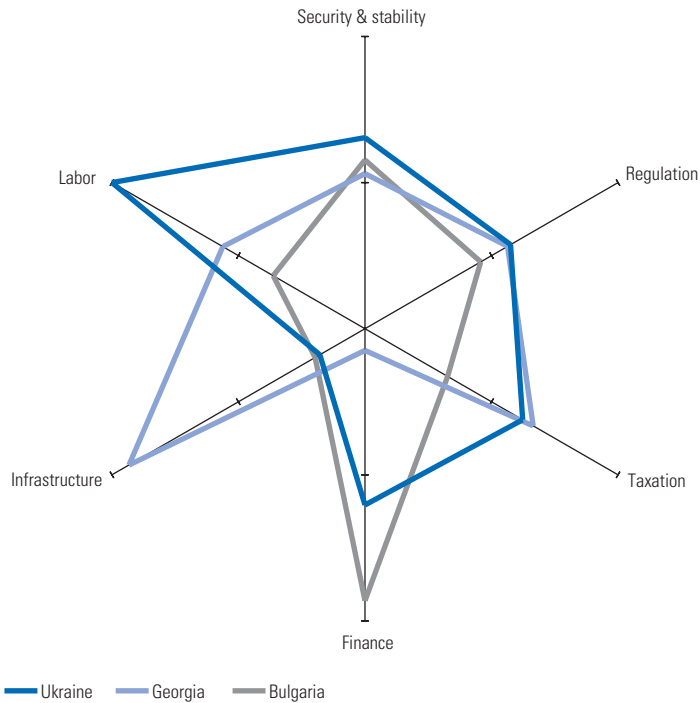
Source: Bank staff calculations.

Job opportunities in the formal sector are scarce, and unemployment is often high and persistent.

There is a substantial potential in CEE to foster job creation through addressing country-specific investment climate constraints. Although the investment climate in CEE is generally hospitable and notably better than in other subgroups of the Region, each CEE country can improve its investment climate along specific dimensions. For example, there is room for lowering start-up costs in Hungary and the Slovak Republic. Registering property is difficult in Croatia, and contract enforcement is extremely time-consuming in Poland. In Bulgaria and Romania, there is substantial room for improving access to finance and the efficiency of the legal system. In many CEE countries, corruption is still a serious problem. In general, the challenges are bigger for the EU accession countries (Bulgaria, Croatia, and Romania), where entrepreneurs identify more obstacles to business operation and more often perceive them as severe as in the new EU member countries.

Reducing taxes on labor is necessary to encourage hiring. To decrease such high rates in a fiscally viable way, reforms of health and pension systems must make the systems more efficient and sustainable. In particular, reviewing early retirement, disability, and sickness benefit policies should be part of the reform agenda, with the aim of tightening the eligibility criteria and eliminating the widespread abuse of the systems.

FIGURE 1.16
Constraints Reported by Firms Vary across the Region's Countries



Source: From WDR 2005, with data from EBRD–World Bank Business Environment and Enterprise Performance Surveys, 2002.

Note: Preliminary results from the new 2005 BEEPS are broadly consistent with those reported in this figure. However, some changes may have occurred for individual countries or subgroups of countries in the Region.

Another way to facilitate job creation in CEE is to provide for greater adaptability of real wages to productivity and local labor market conditions. Decentralized (firm-level) wage setting has developed in most CEE countries, but some countries, such as Slovenia, have kept highly centralized bargaining. Some wage rigidities are also present in the state-owned and privatized firms, as well as in noncompetitive sectors of the economy. Most countries have kept a rigid coefficient system as a basis for wage setting in the public sector. Significantly, wage flexibility is limited by the mandated minimum wages, which tend to be relatively high in CEE.

Creating subminimum wages for young workers or in economically depressed regions, as in many EU countries, would promote job creation for less-productive workers who are hardest hit by unemployment. Poland set the example in CEE by introducing a youth subminimum wage (at 80 percent of the regular minimum wage) in an attempt to alleviate youth unemployment. Reform in this area is also important because social benefit programs are often tied to the minimum wage

(that is, they are relatively high when the minimum wage is relatively high), creating additional disincentive effects on labor supply.

One common strategy to promote flexibility in the labor market in CEE countries has been the liberalization of fixed-term and temporary contracts. In this respect, CEE countries have followed the experience of many Western European countries that, faced with mounting pressure to promote flexibility, liberalized these atypical contracts while maintaining strict regulations for regular contracts. In Western Europe, this strategy has reinforced duality in the labor market, with some workers enjoying high and even increased protection in regular jobs, but others bearing the cost of greater flexibility by moving from one short-term job to another.

In CEE countries, creating jobs, even of short duration, can be beneficial, especially in a context of significant long-term unemployment. Still, it is important in the long term to foster regular employment creation. In this context, employment protection regulations for regular contracts should be liberalized in accordance with the recent relaxation of restrictions on the use of temporary contracts.

More generally, employment relations should be reformed to promote direct agreements between workers and employers.³⁶ For historical reasons, in many countries of the Region, the statutory labor standards are still very high, and detailed regulations cover virtually all aspects of employment conditions (for example, working time, employment protection, wage formation, and in-work benefits). This leaves little room for negotiations and thus impedes the development of genuine collective bargaining systems and stifles social dialogue. Instead, overregulation contributes to noncompliance and a steady drift toward informal arrangements. A greater role given to collective bargaining agreements in determining employment relations is thus a way to instill more flexibility into the labor market while balancing the interests of workers and employers.

Unemployment and related benefits have been reformed several times in most CEE countries, mainly to reduce the initial excessive generosity of the system. Therefore, the system does not currently create major labor supply disincentives. However, it may give rise to the “unemployment trap” in backward regions, where benefits account for a high proportion of the prevailing market wage of low-skilled labor. This is reinforced by the fact that some countries have extended benefit duration in backward areas or apply lax eligibility criteria. Although social assistance benefits are needed to cushion households from falling into persistent poverty, targeting and means testing should be reinforced to improve the effectiveness of these schemes.

Passive labor market programs are not sufficient to deal with the problems of long-term unemployment and discouragement. Stronger job creation by private firms is obviously the main avenue for addressing this serious social and economic issue. But active labor market programs, if properly designed and implemented, can also contribute by providing greater incentives for the unemployed to go back to work and for employers to employ disadvantaged individuals. Evidence suggests that ALMPs can improve the labor market prospects of some groups, although they do not increase aggregate employment and such programs may be costly. It is therefore crucial to pay special attention to their design and efficient targeting. They also need to be accompanied by monitoring and impact evaluation. The former enables the management of programs and fine-tuning, if necessary, while the latter provides feedback for future policies.

Investments in human capital are necessary to keep pace with the growing demand for high skills. Although the workforce in CEE is (on average) well educated, employers have difficulty finding workers with the right skills. The problem of the skills gap and mismatch hits the most advanced reformers in the subgroup. In countries like the Czech Republic, Hungary, Latvia, and Poland, 35–40 percent of employers see the skills of the available workforce as a significant obstacle. (The proportion is even higher in Estonia.) Evidence suggests that a substantial portion of the long-term unemployed in CEE lack the skills required by the employers. In some part, this reflects the failings of the educational system: workers need to be equipped with broad and transferable skills and provided with life-long learning opportunities to be able to meet the challenge of a dynamic labor market and to support firms' strategic restructuring.

Southeastern European Countries: Greater Stability, Law Enforcement, and More Competitive Markets

This subgroup of countries tends to be at an intermediary position between the most advanced CEE countries and the CIS countries. Unemployment is particularly high and persistent in SEE, and informality is pervasive. The reforms in the subgroup have been delayed and slowed by the regional conflict, which has also led to the disruption of regional infrastructure and economic ties. The subgroup of countries fares worse than CEE in product market competitiveness, administrative barriers, effectiveness of the legal system, corruption, crime, and disorder. Substantial investment climate improvements are thus necessary to foster firm growth and formal sector job creation.

Investment climate improvements in SEE require reforming institutions and changing government policies and behavior. One priority is to reduce corruption, which is widespread. Another is to enhance competition, because anticompetitive or informal practices are regarded as a major obstacle by almost 30 percent of firms in the subgroup. The same proportion of firms sees as a major obstacle to their operation the inefficient system of conflict resolution, which points to the need to reform the legal system. Finally, barriers to firm entry need to be removed, because starting a business in SEE can be difficult, time-consuming, and costly.³⁷

The tax wedge on labor is slightly lower in SEE than in CEE countries, but it remains higher than the bottom end of OECD countries. Moreover, tax rates are identified as a major obstacle to operating a business by around 30 percent of firms. SEE countries should aim for a gradual reduction in payroll taxes, with a particular focus on health insurance taxes. This should be accompanied by efforts to improve compliance on tax payments by firms, including SOEs. Moreover, to make the reduction of payroll taxes fiscally viable, public-funded programs should be made more efficient. This entails tightening the eligibility criteria (for example, for early retirement and disability pensions) and reducing the abuse of the benefit system (for example, sickness benefits and disability pensions) by able-bodied individuals.

Wage setting in SEE may hamper achieving labor market equilibrium. Wage pressure arises because unions tend to be influential in these countries (partly because of the history of self-management before 1990). But the role of the government in wage setting also remains strong. Thus decentralized bargaining at the level of the firm should be encouraged to enhance wage flexibility. Sectoral wage negotiations appear to be a particular problem. For example, through the setting of specific minimum wages by sector, such bargaining leads to extremely high levels of wages. For example, in Bosnia and Herzegovina, the minimum wage in the 2004 telecommunications sector collective agreement was double the economywide minimum wage (itself a high 55 percent of the average wage), equivalent to 110 percent of the economywide average wage. The compression of the wage distribution that results leads to high unemployment for vulnerable groups such as youth and for some less developed regions.

Employment protection legislation remains fairly strict in SEE and clearly is not helping workers overall because a great number of “outsiders” are either employed in the informal sector or unemployed (figure 1.13). In fact, the share of formal employment decreases and an informal economy develops where enforcement of these strict reg-

ulations is difficult, especially because of the weak capacity of the administration. The way forward is to deregulate labor relations while protecting core worker rights and to leave the determination of employment conditions to bargaining between employers and workers. This should be coupled with improving the effectiveness of labor inspection in enforcing core labor standards.

Unemployment benefits tend to be at appropriate levels of generosity in SEE countries. However, work test requirements (that is, ensuring that the unemployed is available and willing to take a job, if offered) could be strengthened, especially in regions where labor demand is more robust. Also, employment offices should make a clear distinction between the unemployed who register to find work and those who register to gain eligibility for health care and other benefits. This will help to focus resources on those who need job search assistance and at the same time will provide a clearer picture of unemployment.³⁸

ALMPs are currently insignificant in SEE countries. More fundamental investment climate improvements are needed to encourage job creation and improve labor market outcomes. However, the cost-effectiveness of ALMPs can be improved. ALMPs in SEE should be targeted at vulnerable groups (that is, those running a high risk of long-term unemployment). Given the limited capacity for designing costly programs, the most cost-effective way to improve the matching of unemployed to jobs in these countries is to improve the capacity of employment agencies to identify job vacancies and to provide job search assistance. Finally, to address the mounting issues of long-term unemployment, back-to-work benefits could be useful.

Social assistance performance is mixed across SEE countries. The evidence at the level of the subgroup suggests that the effectiveness of programs has been greater in countries where financing is more centralized, enabling targeting of the poorest areas. The current range of programs could be streamlined into core benefits to provide a decent but sustainable level of social assistance.

Middle Income CIS Countries (Belarus, Kazakhstan, Russia, and Ukraine): Removing Administrative Barriers, Promoting Restructuring, and Improving the Safety Net

These four countries have a high economic potential; however, the challenges are profound. Administrative barriers are still pervasive, and governance is often poor. Corruption is widespread. Competition is limited. Inefficient and burdensome regulations and numerous permits hamper business growth, as do underdeveloped financial markets.

Onerous tax administration and customs and trade regulations are seen as the key constraints to firm operation and growth in this subgroup. However, these are likely to capture a broader spectrum of investment climate issues, which include complex and often unintelligible regulations, their discretionary interpretation, bureaucratic harassment (for example, frequent, lengthy, and disruptive tax inspections), selective enforcement and associated uncertainty, and extortion. Therefore, improving the quality of regulations, reducing the red tape, and limiting the scope for bureaucratic discretion (along with other general improvements in governance) would create a more favorable investment climate and would support the development of the private sector and job growth.

Another important reform concerns wage determination. Even more than in SEE countries, the government has a strong role in wage setting in middle income and other CIS countries. In fact, the formal private sector tends to follow wage increases in the public sector. The role of the government in wage setting should be reduced and replaced with direct bargaining between employer and worker representatives. In most countries, this implies encouraging independent trade unions and employers' associations that are representative of the whole spectrum of firms (including small and newly established private firms).

Although labor codes were revised, labor relations tend to be overregulated, and employment protection remains relatively strict (except in Kazakhstan), but often not enforced (figure 1.12 and table 1.2). This imposes rigidities, leaves little room for collective bargaining, and creates incentives for informal employment. As in other countries of the Region, deregulating labor relations and focusing on a set of core standards of worker protection, which can be effectively enforced, would be more efficient. This would more effectively protect basic worker rights while supporting labor market adaptability and reducing incentives for informality.

Given the low generosity of unemployment benefits in middle income CIS countries, mandatory severance pay for dismissed workers is one way to provide income support and facilitate job search, as well as make firms internalize the costs of dismissal. The mandatory severance pay should be related to job tenure with the terminating employer, with a ceiling so as not to impose excessive and unenforceable costs on firms.³⁹ At the same time, the procedural costs of dismissal (such as preventive measures, advance notice, required notifications, and negotiations) should be considerably reduced to facilitate enterprise restructuring and productivity growth.

The social safety net is underdeveloped in middle income CIS countries, inhibiting enterprise restructuring and locking workers into low-

productivity jobs. To facilitate labor reallocation, middle income CIS countries need to move from the principle of protecting jobs to that of protecting workers. Income-support schemes need to be strengthened to reduce the social cost of worker displacement. Obviously, such schemes are costly and can create adverse labor-supply incentives. One option that addresses these concerns is workfare or public works. In essence, such schemes provide the unemployed with income, conditional on performing some socially useful work. The wage rate under such programs needs to be low to ensure self-selection of the neediest and to avoid competition with regular jobs. The participants should be encouraged to look for regular jobs, which may mean that work is less than full-time.

Countries that have not already done so should also consider using alternative approaches to targeting social transfers, such as proxy means testing or community identification of beneficiaries within national guidelines. In social insurance, middle income CIS countries should continue reforms of the pension system: this will adjust the system's dependency ratio to changing demographics and encourage other reforms that will stimulate formal sector labor supply to improve the contributions base for a given size of the working-age population.

Given the large share of informal employment, a significant proportion of people are not covered by social protection; therefore, a move to universalize social protection could be considered. Decoupling minimum pension schemes and health insurance from the labor market status of people (for example, through creating a universal minimum pension or expanding health insurance coverage to informal workers) are options currently considered for implementation in other countries outside the Region, such as Mexico. As with any of the measures proposed above, fiscal considerations would limit the menu of feasible options.

Low Income CIS Countries: Developing Institutions to Support the Formal Sector

This group of countries has drifted closer to the situation of low-income developing countries. They have great difficulties in creating jobs in the formal sector and have among the largest shares of informal economy (for example, in Azerbaijan and Georgia, the informal economy is estimated to account for more than 60 percent of GDP).⁴⁰ This situation means that large parts of the population are essentially unprotected against economic risk and receive no help from the state.

One key factor behind the low pace of job creation in the formal sector in the low income CIS countries is underdeveloped institutions of a market economy. This includes lack of enforcement of rules and regu-

lations, economic and regulatory policy uncertainty, underdeveloped financial markets, inefficient regulations, bureaucratic harassment and corruption, and (last, but not least) poor and unreliable infrastructure. In particular, the unreliability of public infrastructure is a significant hurdle for firms in the low income CIS countries. It places them at a competitive disadvantage in relation to both their near neighbors in the middle income CIS group and their more-distant competitors in CEE (Steves, Fankhauser, and Rousso 2004). Thus, to meet the challenge of job creation, low income CIS countries need to strengthen the institutional underpinnings of a market economy to lessen the risks associated with doing business. They also need to reform their regulatory framework to increase its efficiency and remove administrative barriers (for example, customs and trade regulations rank high as a significant impediment to business operation in entrepreneurs' perceptions). An important component of the progrowth strategy is also the development and proper maintenance of the infrastructure.

Employment protection legislation tends to be strict in low income CIS countries, compared with the average for the entire Region (figure 1.12). At the same time, enforcement is lax or selective, meaning that the seemingly rigid regulations seldom are a binding constraint on firms. However, flexibility through nonenforcement is not an efficient combination because it undermines the rule of law, increases uncertainty, deprives workers of protection, and is not conducive to long-term productivity growth. Therefore, low income CIS countries, even more than other countries of the Region, need to focus employment legislation on core and enforceable labor standards. As in the middle income CIS countries, mandatory severance pay can be a way of providing workers with income protection (see above), but this option should be coupled with a substantial reduction in administrative procedures associated with layoffs.

In addition, low income CIS countries need to review the wage determination system and encourage direct bargaining between independent employers' associations and labor unions. This entails lessening the role of government and the development of genuine representation of labor and business, representing all segments of the economy (including the new private sector).

The restricted administrative capacity, large underreporting of earnings, and limited financial resources reduce the efficiency of current social protection programs, which end up protecting a few. Although these constraints limit the range of options available to these countries, a minimum level of protection for some basic risks could be provided to all, financed through general revenues. For example, a move to a flat-rate unemployment benefit system could be considered, financed through general revenues rather than payroll taxes. Moreover, given

widespread informality, the need to reinforce social protection for those without access to formal insurance mechanisms should be considered. As in the middle income CIS countries, this could include greater use of public works (or workfare) schemes that are open to all those willing to work. However, the program wage rate should be set below the market level to ensure self-targeting of the most needy. In addition, social funds can serve to improve opportunities in poor areas.

Finally, given the large share of agriculture, policies should aim at improving employment opportunities in rural areas and raising the productivity of agricultural employment (World Bank 2005b). Investment in infrastructure and in human capital in agricultural regions can encourage the development of agribusiness and the creation of off-farm employment.

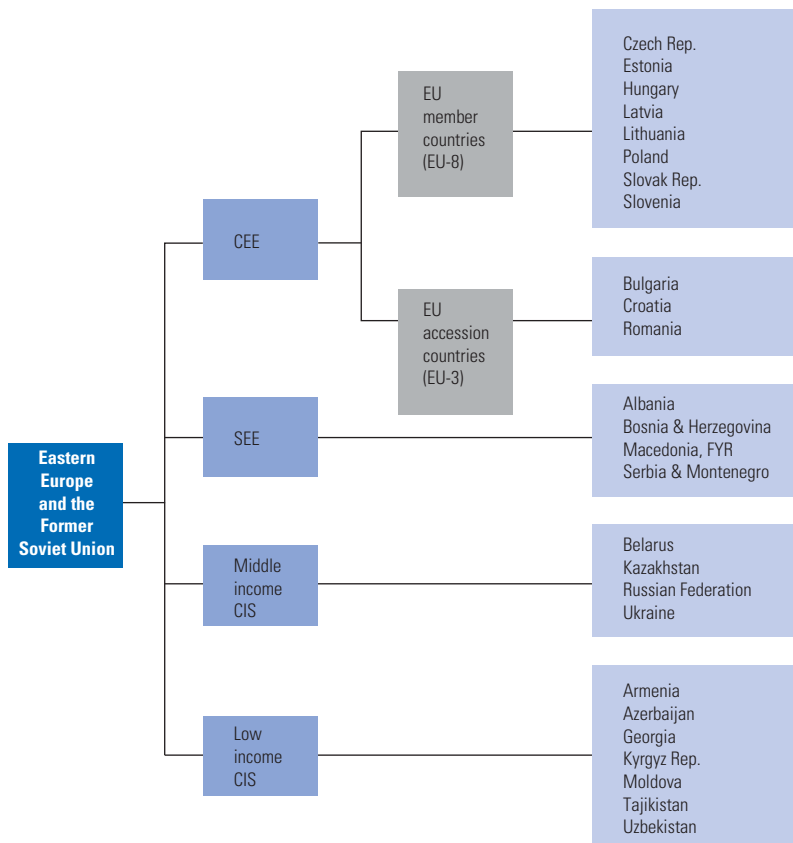
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Productive job opportunities in the countries of Eastern Europe and the Former Soviet Union have to increase substantially to improve the growth prospect in the Region and reduce poverty. Workers who lost their jobs in the declining regions, industries, and firms often find it difficult to find a new, gainful job in the formal sector of the economy because, for most of the transition so far, fewer regions, industries, and firms expanded than declined. As a result, an accumulated pool of unemployment has developed especially in CEE and SEE. In the low-income CIS, by contrast, many laid off workers resorted to low-productivity jobs in the informal sector and in agriculture, because unemployment was not an affordable option. To meet the challenge of job creation, the Region needs to have more productive, competitive, and expanding firms. Lowering the costs of doing business and removing key constraints to firm operation and growth are the main routes to more and better jobs.

Many of the constraints differ across subgroups of countries in the Region, but there is also a common thread. The investment climate can be improved and job creation spurred by reducing economic and policy uncertainty, easing access to credit, lowering the burden of taxation, and removing administrative barriers to firm entry and growth. But the process of moving from the old jobs to the new ones also needs to be supported. This requires an adaptable labor market where employers have incentives to hire workers—incentives that are not weakened by unduly stringent employment regulations. At the same time, workers should have incentives to look for new jobs, even in other regions of the country or in other occupations. This requires lowering the cost of mobility (for example, by developing the housing and mortgage markets) and improving access to lifelong learning opportunities.

ANNEX 1.1

Geopolitical Taxonomy of the Region's Countries



Note: The study focuses on the transition economies of Eastern Europe and the Former Soviet Union. Turkey is also included in some of the comparative analyses. The transition economies of Eastern Europe and the Former Soviet Union, plus Turkey, are all part of the World Bank's Europe and Central Asia (ECA) Region. Turkmenistan is not included in this Overview due to a lack of reliable country data.

ANNEX 1.2

Summary of Key Differences between Labor Markets in the Middle-Income European and the Low-Income CIS Economies

Labor market characteristics	Middle-income European transition economies	Low-income CIS transition economies
Main labor market issue	<i>Unemployment</i>	<i>Underemployment</i>
Adjustment to transition shock	<i>Quantity (employment); labor moving to expanding services sector</i>	<i>Price (wages); labor shifting back to subsistence agriculture</i>
Investment climate	<i>Generally favorable</i>	<i>Less favorable</i>
Market-oriented reforms and enterprise restructuring	<i>Advanced</i>	<i>Less advanced</i>
Employment protection legislation	<i>Relatively liberal</i>	<i>Strict</i>
Enforcement of labor market regulations	<i>Relatively strong</i>	<i>Weak</i>
Unemployment insurance system	<i>Developed</i>	<i>Largely ineffective</i>
Economic structure	<i>Dominance of services and industry</i>	<i>Dominance of agriculture</i>
Informal sector	<i>Marginal, driven by tax evasion and avoidance of regulations</i>	<i>Large, driven by lack of job opportunities in the formal sector</i>
Labor force location	<i>Largely urban</i>	<i>Largely rural</i>
Labor force skills	<i>High</i>	<i>Mostly low</i>
Productivity (wages)	<i>High</i>	<i>Low</i>
Earnings inequality	<i>Modest</i>	<i>High</i>

Source: Bank staff analysis.

Endnotes

1. See annex 1.1 for the taxonomy of the countries of this Region. The study focuses on the transition economies of Eastern Europe and the Former Soviet Union. Turkey is also included in some of the comparative analyses. The transition economies of Eastern Europe and the Former Soviet Union, plus Turkey, are all part of the World Bank's Europe and Central Asia (ECA) Region. Turkmenistan is not included in this Overview because of a lack of reliable country data.
2. The Former Soviet Union, except the Baltics.
3. These inequalities largely reflect differences in workers' productivity. However, in some cases wage differentials may be the result of the lack of more productive jobs for workers rather than their low-productivity potential.
4. Unless indicated otherwise, data on the Region's employment and unemployment presented in this report come from the ILO LABORSTA database, which contains national labor force survey (LFS) results. The data may differ from national sources and may not be strictly comparable across countries.
5. In March 2000, the EU heads of state and governments agreed on a strategy to promote competitiveness and a dynamic, knowledge-driven economy in Europe. The main issues for the realization of the Lisbon agenda for 2010 were the necessary investment in research and development, reduction of red tape to promote entrepreneurship, and achieving an employment rate of 70 per cent (60 per cent for women). The actual employment-to-working-age-population ratio in the EU-15 was about 65 percent in 2004.

6. In principle, the skills mismatch problem can be addressed by training programs. However, in practice, the potential of training programs to successfully address large skills mismatches is limited for at least two reasons. First, if the skill profile of displaced workers is much different from the skill profile of new jobs, successful retraining can be extremely, if not prohibitively, costly. Second, for retraining to be successful, unfilled vacancies must exist for which the training participants can apply. If, however, job openings are few, as is often the case in transition economies, then training is of little help in finding a new job. Existing evaluation of training programs indeed confirms that training is often not very effective in addressing the mass unemployment resulting from large-scale industrial restructuring (Betcherman, Olivas, and Dar 2004).
7. 2002 data.
8. In virtually all modern societies, the female labor force participation rate is significantly less than the male one, which accounts for the higher male-employment-to-population ratio.
9. One reason why productivity gains have been translated into higher wages rather than employment is that they have been largely achieved through defensive restructuring by firms (that is, by eliminating overstaffing and shedding redundant labor). High hiring and firing costs may have contributed to discouraging firms from engaging in strategic restructuring and adopting new technologies and new workers (see the firm restructuring section in this chapter). The substantial real-wage growth, despite high unemployment, reflects a combination of market and institutional forces: employers maximizing profits by using efficiency wages (that is, wages set above the market-clearing level to motivate workers), union pressures, and government wage policies.
10. Rutkowski 1996.
11. Background calculations for World Bank (2001), using data from the firm-based 1998 Survey of Earnings.
12. Earnings dispersion—and thus the incidence of low pay—may be overestimated because of the practice of underreporting wages to avoid taxes on labor.
13. See Scarpetta and Vodopivec (2005) for the detailed analysis. See Grosfeld and Roland (1996) for a discussion of defensive versus strategic restructuring.
14. It should be stressed that, from a sectoral or macro perspective, defensive and strategic restructuring can be complementary—rather than opposing—strategies. Without a strategic reallocation of resources toward more productive use and the entry and expansion of a job-creating new private sector, it would not be politically feasible to engage in downsizing and defensive restructuring. Correspondingly, without hard budget constraints on state and unstructured privatized firms, there is too much leakage of resources into the least efficient parts of the economy, crowding out the new private sector.
15. Scarpetta and Vodopivec 2005.
16. Generous social benefit schemes, including early retirement, were used (especially at the early phase of the transition) in CEE countries to facilitate enterprise restructuring and to move difficult-to-reemploy displaced workers (especially the older ones) out of the labor force.

Obviously, these schemes created adverse labor supply effects and contributed to low employment rates among older workers in CEE. However, they were deemed necessary to maintain political support for reforms. Moreover, the alternative to outflows to economic inactivity was either higher open unemployment or higher hidden unemployment, as in most of the CIS countries.

17. For example, in the early 2000s, there was only 1 vacancy in Poland for every 200 filled positions, which is four to five times less than in the United States, indicating the weakness of labor demand. At the same time, there were about 50 job seekers per vacancy. For comparison, in the United States, the unemployment-to-vacancies ratio is in the 2 to 3 range. The data on vacancies for Poland come from a special establishment-based survey of labor demand and in principle cover all available vacancies, not just those registered with employment offices (GUS 2003).
18. A caveat is necessary: conventional measures of the deficit may not fully capture changes in the fiscal policy stance. Many governments in the Region have reined in quasi-fiscal deficits, reduced arrears, and begun to get a grip on contingent liabilities since the financial crisis in Russia, which does not necessarily show in the fiscal deficit data.
19. It should be stressed that from an analytical standpoint, the association between fiscal loosening, output growth, and job creation is ambiguous.
20. This report uses primarily two sources of information to identify obstacles to business operation and growth: the EBRD–World Bank Business Environment and Enterprise Performance Surveys (also known as the investment climate surveys) and the World Bank Doing Business Database. For countries, the main route to identifying bottlenecks to firm growth and job creation is regular dialogue with the representatives of employers, including those representing newly established small firms. Additional insights can be gained through focus groups of employers and specialized surveys.
21. A growing body of evidence suggests that high levels of taxes on labor use can have detrimental effects on growth and on employment. This is particularly the case when taxes—in particular, social security contributions to pay for social benefits—are not transferred onto lower wages and thus raise labor costs for firms. If workers fully valued these benefits and were willing to trade them off for lower wages or greater effort, high taxes on labor use might not constrain firms’ performance and job creation. The pass-through of taxes on wages, however, depends also on the existence of wage floors (for example, the minimum wage) and wage-bargaining systems. Evidence suggests that in countries with sectoral wage bargaining—as opposed to those with decentralized wage bargaining or fully centralized wage bargaining—the pass-through is more limited because workers have less incentive to internalize the effects of their bargaining on overall employment and unemployment. For evidence on the OECD countries, see Daveri and Tabellini (1997); also Elmeskov, Martin, and Scarpetta (1998). For evidence of the impact of the tax wedge on employment and unemployment in the Region during the transition, see Haltiwanger, Scarpetta, and Vodopivec (2004).
22. Employers in the Region often describe these taxes as substantially raising labor costs and having a strong negative impact on their hiring deci-

- sions. For example, high taxes on labor were identified as the most important barrier to firm growth in a 2003 survey of small and medium-size enterprises in Poland (PKPP 2003).
23. The data come from the World Bank (2004c).
 24. EBRD–World Bank Business Environment and Enterprise Performance Survey (BEEPS) data.
 25. The conventional view is that low income CIS countries inherited well-developed infrastructure for their level of income. However, the public services infrastructure is unreliable, and the level of maintenance is low, which creates sizable obstacles to business. For example, power outages occur almost two-and-a-half times more frequently in low income CIS countries than in middle income CIS countries and almost 13 times more frequently than in CEE countries. The supply of water and the availability of mainline phone systems follow a similar pattern (Steves, Fankhauser, and Rousso 2004).
 26. See World Bank (2004d), *World Development Report 2005*, based on data from BEEPS II.
 27. Domestic privatization has usually been associated with management and employee buyouts and dispersed ownership. Foreign privatization, in contrast, has been associated with outsider control and more concentrated ownership.
 28. This is not to deny that wages may be above the market-clearing level because of efficiency wages and other reasons, reflecting profit-maximizing behavior by firms. The point is that (except for minimum wages) there is no clear indication of institutionally induced wage rigidity in CEE.
 29. “Rent” is extra profit that firms earn if there is little competition. Workers can share in part of this rent and raise their wages (appropriate it) if their bargaining power is high.
 30. Most countries of the Region have reformed their EPL to reduce employment adjustment costs. Recently, substantial reforms were carried out in Bosnia and Herzegovina, Croatia, Poland, Serbia and Montenegro, and the Slovak Republic.
 31. Enforcement is often selective and targeted at larger firms, where there is greater potential for extortion. So, even if compliance with EPL is low in general, some, mainly larger, firms may still be adversely affected by strict EPL.
 32. Strong trade unions are an important part of the enforcement mechanism, so in countries where they are stronger (mainly in CEE and SEE), employment protection regulations tend to be more binding than in countries where unions are weaker (for example, in the CIS). Also, larger firms, where unions tend to be stronger, more often see EPL as a constraint than do small firms, where unions are weak.
 33. For example, in Poland, unemployment benefit coverage was reduced from about 80 percent in the early 1990s to less than 20 percent in the early 2000s, largely by tightening the eligibility criteria (by introducing a requirement of 180 days of covered employment within the last 12 months). Benefit duration, initially indefinite, was reduced to 12 months in 1991. In addition, a flat-rate benefit (36 percent of the average wage) replaced an earnings-related benefit (up to 70 percent of one’s previous

- earnings). In Hungary, revisions to unemployment benefit regulations focused on reducing benefit duration: from two years in 1990 to three months to one year (depending on length of employment over the last four years) in 1993 (Dorenbos 1999).
34. For example, a recent investment climate assessment for Poland identified improving the quality of physical infrastructure as one of top priorities (World Bank 2004b).
 35. OECD (2005) data suggest that foreign direct investment moves away from economies with more-regulated markets (for example, France and Germany) toward economies with less-regulated markets (for example, the United Kingdom and the United States).
 36. Naturally, employment protection regulations need to be consistent with the ratified ILO conventions and, for the EU-member countries, relevant EU directives.
 37. For example, in Serbia and Montenegro—the largest country in SEE—starting a business requires going through 11 procedures and takes 51 days. In Albania, the cost of starting a business represents one-third of the gross national income (GNI) per capita.
 38. Croatia (which in this report is considered a CEE country, but has shared the problem of inflated unemployment registers with other former Yugoslav republics) provides an example of such an approach. It recently revised its unemployment statistics to distinguish between active job seekers and the passive unemployed.
 39. In most OECD countries, the maximum mandatory severance pay does not exceed three months of salary (OECD 1999).
 40. Schneider and Klinglmair 2004.