

The Investment Climate and Job Creation

This chapter analyzes the link between investment climate and job creation. It shows that differences in the investment climate account for a significant part of the variation of employment outcomes in the Region. It thus argues that improvements in the investment climate are critical for the creation of more and better jobs in the Region.

Although the investment climate varies considerably in the transition countries, it is generally worse than in both developing and developed countries with the most hospitable business environments. For example, it takes 11 days to start a business in Latvia and more than 100 days in Azerbaijan. In CEE, the average time to start a business is 50 days, compared with only 4 days in Denmark or the United States. The cost to register a business in low income CIS countries is significantly higher than in Thailand, for example.

In all of the transition countries, there is room for reducing the risks, costs, and barriers associated with business operation, although the nature and intensity of constraints vary across countries. In low income CIS countries, the dominant problem is underdeveloped institutions of a market economy (including security of property rights), economic and regulatory policy uncertainty, arbitrary and selective application of the regulations, corruption, and poor infrastructure. Middle income CIS countries, among them Russia, have a higher economic potential and perform better in some dimensions of the invest-

ment climate than do the poorer low income CIS countries. However, the challenges are still profound. Corruption is widespread. Burdensome regulations and bureaucratic harassment hamper business growth, as do underdeveloped financial markets.

In SEE, the playing field for firms is not level because of various—formal and informal—constraints on competition. The legal system does not function effectively, making contract enforcement difficult. Administrative barriers in some areas (for example, customs and trade) are still high, inhibiting firm growth and fuelling corruption. In CEE, institutions of a market economy are more developed and market-oriented reforms more advanced, easing some of the constraints. Yet, much can be done to lower the cost of doing business. High taxes, including taxes on labor, inhibit investment and hiring. Access to credit, although much easier than in other parts of the Region, is still seen as difficult by entrepreneurs. In some CEE countries, onerous regulations, including labor regulations, are a significant impediment to firm expansion. Finally, in some CEE countries, employers find it difficult to hire workers with necessary skills.

How to foster job creation in the Region? In low income CIS countries, the key issue is to develop institutions of a market economy and lower the risk associated with doing business. Property rights need to become more secure and infrastructure more reliable. In middle income CIS countries and SEE, focus should be placed on lowering the administrative barriers. Deregulation, less discretionary power in the hands of bureaucrats, product market competition, and a more effective legal system would address the most binding constraints. Finally, in CEE, priority should be given to addressing the demand for skilled workers, improving labor market flexibility, and lowering the monetary cost of doing business. One key measure is to reduce taxation, particularly taxes on labor, which are especially high in CEE. This requires carrying through difficult public expenditure reforms, particularly reforms of the pension and health care systems (see chapter 6).

But obviously, investment climate reforms need to consider country-specific obstacles to business growth. These can be identified by using investment climate surveys and focus groups of employers and—most important—by instituting authentic dialogue with the business community, including the newly established small private firms.

The rest of the chapter is organized as follows. Section 1 shows the link between the investment climate and employment. Section 2 presents major obstacles to firm operation and growth in the Region, as perceived by the employers. Section 3 provides empirical evidence

of the investment climate's impact on job creation in the Region and shows that differences in employment outcomes are to a large extent accounted for by differences in the investment climate. Section 4 compares the investment climate in the transition countries to that in other regions and uses benchmarking to identify areas where there is room for improvement. Section 5 summarizes the main investment climate constraints in the Region and its subgroups of countries.

Importance of Investment Climate for Job Creation

As stressed in the previous chapter, the birth of new firms and the expansion of existing firms are prerequisites for employment growth and the reduction in unemployment. The importance of new firm creation as a source of new jobs is particularly large in a situation of massive reallocation of workers and jobs across sectors of the economy. New firms in the expanding sectors need to absorb workers released from firms in the declining sectors.¹ During the past decade, the Region's economies suffered a large displacement of workers (see chapter 4). Many SOEs went out of business once they were exposed to hard budget constraints and competition. Others have downsized. They reduced labor hoarding and shed redundant labor to reach the economically efficient size. As a result, the average firm size decreased and comes closer to that in market economies. For example, presently, the average size of a Polish firm is roughly 40 percent of that at the beginning of the transition. But if many firms downsize, as is the case in the Region, then the number of firms needs to grow for employment to increase.

A Sound Investment Climate Is Essential to Firm Creation and Expansion and Thus Employment Growth

Firm entry depends on the costs of starting a business and also on the expected benefits and costs of operating a business (Klapper, Laeven, and Rajan 2004). Similarly, firm growth depends on the rate of return to investment, which, in turn, is influenced by competitive pressures in the product market, internal governance, and access to new technologies. Institutions, policies, and regulations that affect firm entry, survival, and growth are referred to in this chapter as the "investment climate." The rest of this chapter examines the investment climate factors that hamper job creation in the Region through limiting firm entry and growth.

Employers' Views on the Major Obstacles to Firms' Operation and Growth in the Region

One way to assess the investment climate is to consider the entrepreneurs' opinions about their major constraints in running and expanding their businesses.² Additional valuable insights can be gained from focus group discussions (see box 5.1).

Entrepreneurs See Instability and Uncertainties as Major Obstacles to Business Expansion across the Region

Economic and regulatory policy uncertainty, along with macroeconomic instability, are top business concerns in the Region. One firm in three views these factors as major or severe obstacles to its operation and growth (figure 5.1). To a large extent, high business risk is an inherent feature of the transition, but bad governance often adds to this natural uncertainty. This includes frequent changes in regulations, lack of regulatory consistency and clarity, arbitrary interpretation of regulations and their selective enforcement, and (last, but not least) corruption. Although business is always associated with some

BOX 5.1

Small Entrepreneurs Complain about the Business Environment in Bulgaria

A few quotes from the survey of small entrepreneurs illustrate the problems they face in opening and running a business:

"If I had to start again, I would not even think of opening a business."

"I cannot even remember how many times I went for each permit. It just takes insanely long."

"During the inspections, they pick on every single thing. When they decide to pick up your money, there is no way out. They always find something to pick on."

"You must hold a law degree to be able to open a cafeteria."

"Instead of thinking how to be more efficient, we spend 60 percent of our time thinking how to cope with tax authorities and inspectors."

"There should be rules of the game, but clear ones and equally applicable to all."

Source: World Bank 2002a.

risk, reducing policy-induced uncertainty and improving governance are keys to improving the investment climate in the Region.

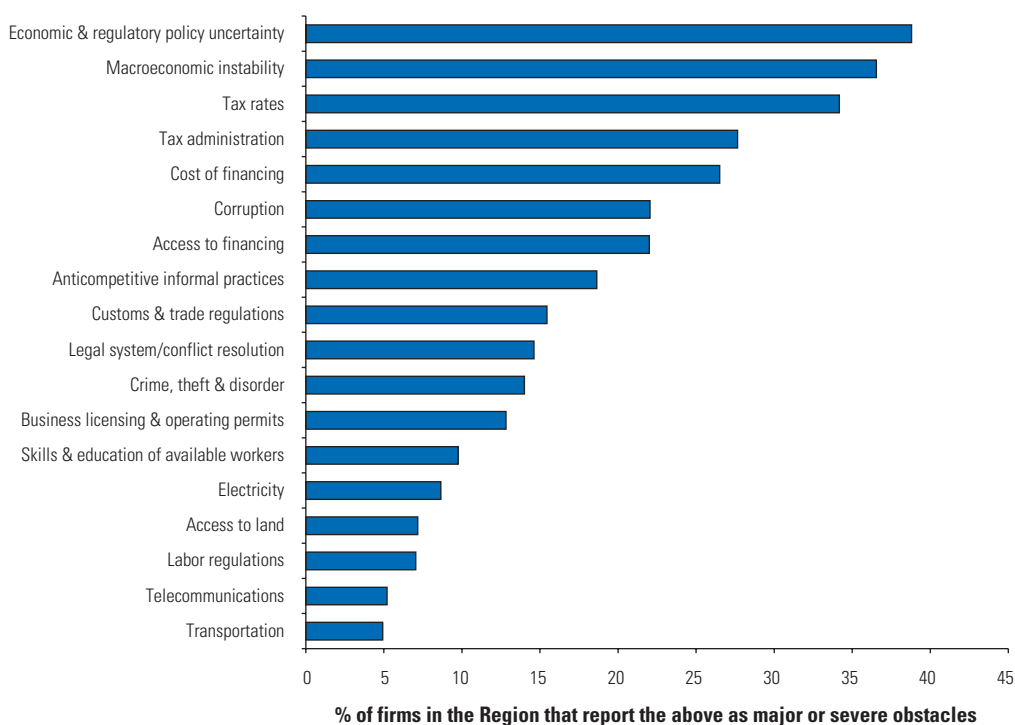
Uncertainty and macroeconomic instability, albeit important in all countries, are—as could be expected—deemed less severe not only in those CEE countries that are members of the EU but also (somewhat surprisingly) in the low income CIS countries. In contrast, uncertainty and instability are very frequently perceived as major constraints in SEE and middle income CIS countries.

Taxation, Access to Finance, and Corruption Also Severely Impede Business Activity

Firms in the Region frequently complain about taxation. This is natural, because taxes raise costs and lower returns on investment. At the same time, taxes are necessary to finance public goods and services. So setting tax rates is a difficult balancing act. However, in the transition countries, taxes are often unduly high because of inefficiencies in ser-

FIGURE 5.1

Most Frequently Reported Major Obstacles to Firm Operation in the Region



Source: 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.

vice delivery, poor tax collection capacity, and a narrow tax base (resulting from a large informal sector), so there is room for reducing tax rates by improving efficiency without compromising important social objectives. One example is to reduce payroll taxes by reforming the pension and health care systems. This pertains especially to CEE and SEE countries, where payroll taxes are particularly high (see chapter 6).

An aspect of taxation that is more amenable to direct policy action is tax administration, which is seen as a major or severe obstacle by close to 30 percent of firms in the Region. Tax administration is a synonym for bureaucratic harassment (for example, disruptive and costly tax inspections), arbitrary interpretation of obscure tax regulations, selective enforcement, and associated extortion. As such, inefficient tax administration—an element of poor governance—contributes to both costs and risks faced by firms and so discourages investment. Tax administration is seen as a particularly severe issue in CIS countries, making it a policy priority.

Another top investment climate issue in the Region, as perceived by employers, is the high cost and difficult access to finance.³ For more than one in four firms in the Region, the cost of credit is a major obstacle to firm growth. For more than one in five, difficult access (for example, high collateral requirements) is a major constraint. Evidence suggests that small firms are particularly hurt by poor access to credit, which limits their growth prospects (Beck, Demircuc-Kunt, and Laeven 2005). Improving access to finance, especially for small firms, is thus a priority in those cases where high real interest rates (or interest rate spreads) reflect an underdeveloped and noncompetitive banking system, which is particularly the case in low income CIS countries (De Nicoló, Geadah, and Rozhkov 2003).

Finally, firm growth in the Region is inhibited by widespread corruption and anticompetitive informal practices. Roughly, one firm in five sees these as major or severe obstacles to their operation and growth. Corruption and government interference are closely associated with numerous administrative barriers, red tape, and discretionary power in the hands of bureaucrats. These governance-related issues are particularly pronounced in SEE, while less so in the new EU-member countries.

Labor Regulations Are Seen as a Less Severe Obstacle in the Region

Labor regulations are not among top business concerns in the Region. According to the investment climate surveys, they are ranked 14 out of 18 obstacles.⁴ They are seldom viewed as a major obstacle, but

many firms see them as a moderate obstacle. Altogether, labor regulations pose a moderate, major, or severe obstacle to one firm in four in the Region, which is by no means a negligible fraction.

Labor Regulations Still Matter

Why are labor regulations perceived as less important in the Region? One reason is lax enforcement, especially in countries with poor administrative capacity. Another reason is that they are less important compared with other constraints. Labor regulations may constrain business operation, but other regulations and conditions may be much more constraining. In less-advanced economies, they are dwarfed by the overall uncertainty and instability, poor access to capital, corruption, and so forth.

Another potential reason may be cultural or historical: in many countries of the Region, employers take historically established labor regulations for granted. This is especially likely in countries where the interests of private businesses have not yet fully taken hold. The comparison between Croatia and Poland is illustrative. In Croatia, employment protection legislation is very strict, yet employers hardly complain about it. In contrast, in Poland, employment protection legislation is significantly more liberal; nonetheless, it ranks high among key business concerns. At the same time, the pace of enterprise restructuring has been much faster in Poland than in Croatia (Rutkowski 2003a). Therefore, the difference in perceptions is likely to reflect the fact that Polish employers are more aware of the role of labor regulations as an impediment to restructuring. This explanation is supported by the fact that restructuring firms (those that actually shed labor) more often report labor regulations as a significant obstacle than do firms that have not gone through downsizing (Pierre and Scarpetta 2004a).

Although labor regulations are not the top business concern, enhancing labor market adaptability is still essential for improving labor market outcomes in the Region. There are at least three reasons why the efficiency of the labor law needs to be improved:⁵

- The fraction of firms adversely affected by labor market regulations is significant in most the Region's subgroups of countries, and in some countries it is high. For example, in Poland, every second firm sees labor regulations as at least a moderate obstacle, and in Serbia and Montenegro and the Slovak Republic, labor regulations are seen as an obstacle by about one firm in three. In addition, as mentioned earlier, labor regulations tend to hurt firms that are most dynamic and are the source of growth and jobs.

- In many countries—mainly in the CIS—labor regulations are not seen as an obstacle only because they are not enforced (see chapter 6). But flexibility through nonenforcement is not an optimal solution; it undermines the rule of law and contributes to the uncertainty faced by both firms and workers.
- The need for greater efficiency of labor regulations is particularly pronounced in the Region, given the paramount challenge of restructuring and productivity catch-up (see chapters 4 and 6).

Worker Skills Can Constrain Firm Strategic Restructuring

Skill deficiencies are a significant obstacle to firm growth, especially in CEE, where restructuring has proceeded at a higher speed and is more advanced. For example, in the Czech Republic, Hungary, Latvia, and Poland, 35 to 40 percent of employers see the skills of the available workforce as a significant obstacle to the growth of their firms. In Estonia, this proportion reaches 65 percent. A special survey of labor demand in an intensively restructuring region of Azerbaijan found that the lack of workers with adequate skills is the third most important reason that prevents firms from hiring more workers (World Bank 2005a). One important source of the skills problem is a strong bias against workers with low educational attainment and skills, associated with enterprise restructuring and technological progress brought about by the transition (Commander and Köllö 2004).

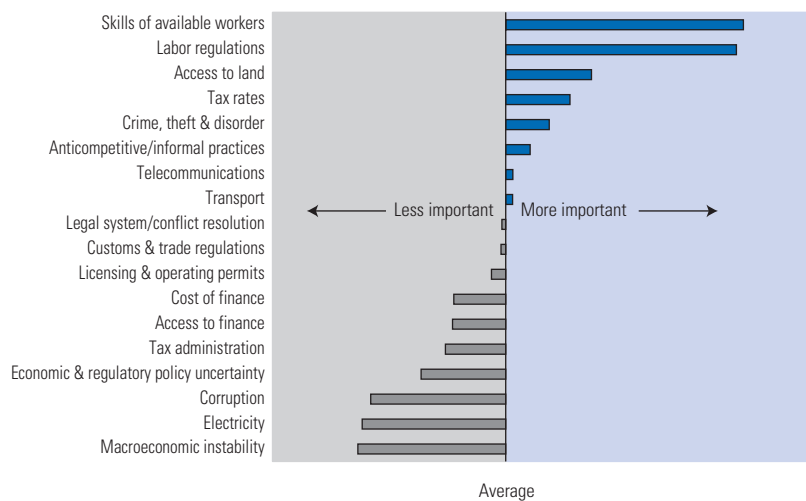
Entrepreneurs' Perceptions of the Most Pressing Problems Vary by Region

Although many investment climate concerns are common across most transition economies, there is also substantial variation in their relative importance by country groups. In the transition economies that recently joined the EU (EU-8), labor-related issues, such as the skills of the available workers, labor regulations, and taxation, figure prominently in the surveys (figure 5.2, panel A). In other European transition economies, entrepreneurs highlight a combination of poorly functioning institutions (for example, ineffective legal system, industrial conflict resolution) and bad governance (for example, anti-competitive and informal practices, corruption) that limit firm growth and job creation (figure 5.2, 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

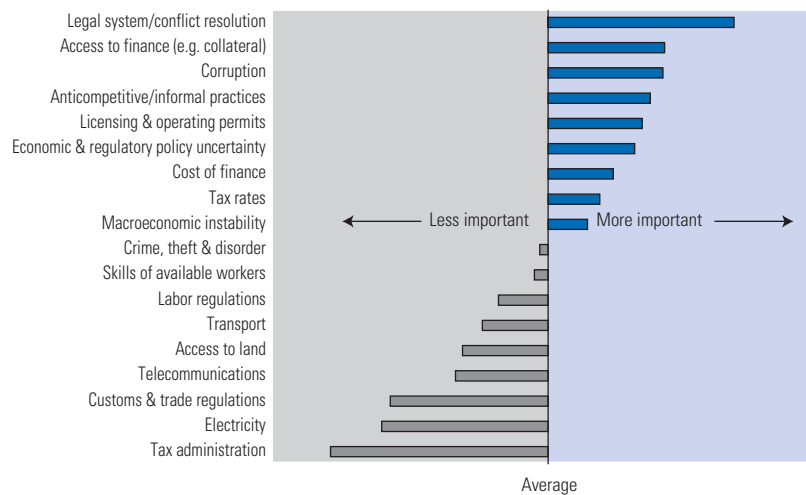
extortion), and inefficient regulations (figure 5.2, panel D). Finally, in the low income CIS countries, the constraints are more basic and range from unreliable infrastructure to underdeveloped institutions of a market economy (figure 5.2, panel E).

It is striking that labor market issues—employment regulations and worker skills—affect firm growth prospects in CEE, while they apparently play a negligible role in the Region’s other subgroups of countries.⁶ One explanation is a faster pace of enterprise restructur-

FIGURE 5.2
Obstacles to Business Operation and Growth Vary by Subgroup
Panel A—CEE EU-Member Countries



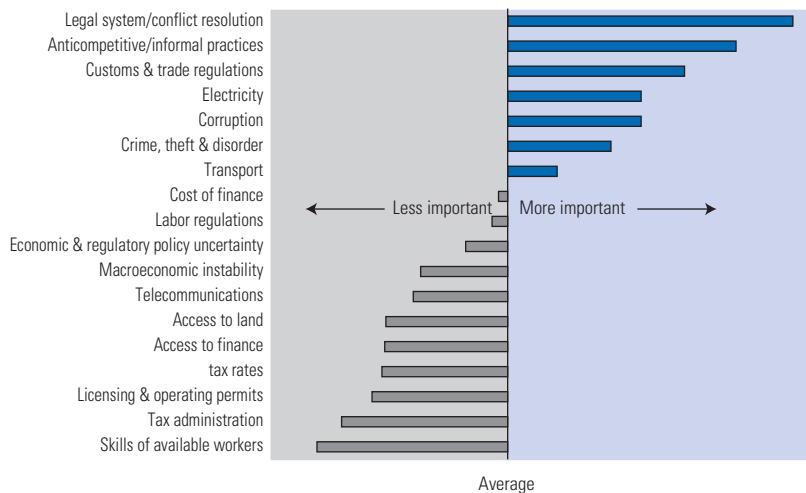
Panel B—CEE EU-Accession Countries: Bulgaria, Croatia, and Romania



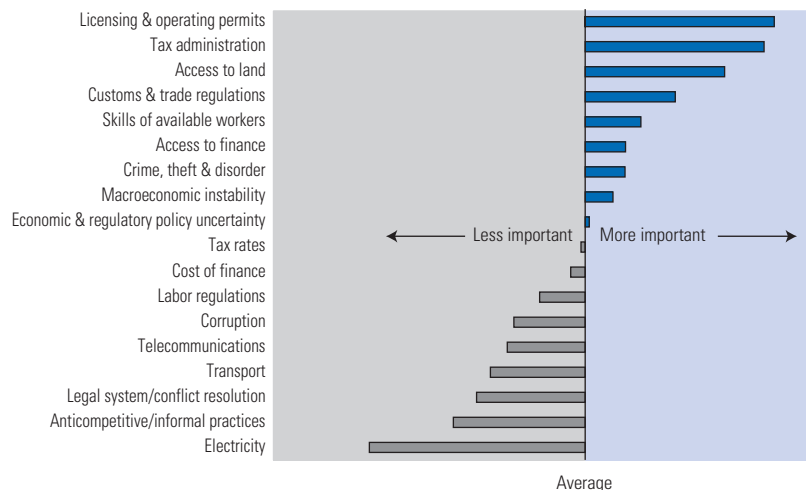
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FIGURE 5.2 (continued)

Panel C—Southeastern European Countries



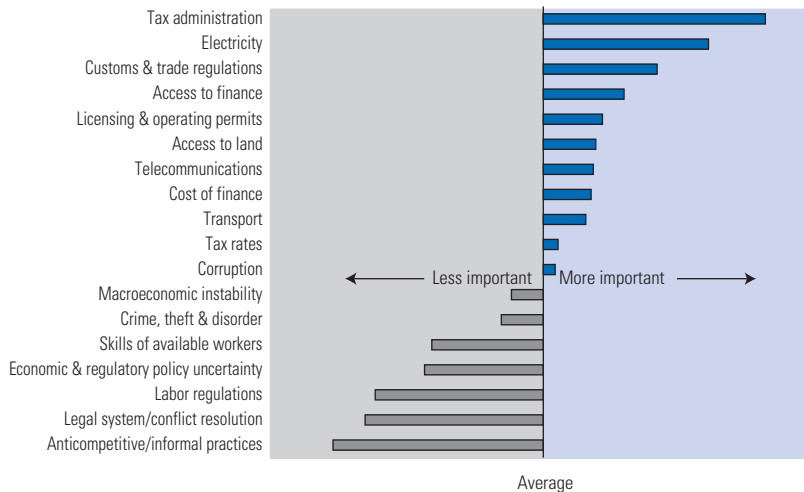
Panel D—Middle Income CIS Countries: Belarus, Kazakhstan, Russia, and Ukraine



ing in CEE than in other parts of the Region, which affects the labor market in two ways. First, widespread job reallocation gives rise to skills mismatch because the newly created jobs differ in skill content from jobs that were destroyed. This explains why employers in CEE more often than in other regions view skills of available workers as a major constraint to firm growth. Second, labor regulations become an effective obstacle only if firms face competitive pressure and have to adjust the size and composition of their workforce to stay profitable. This in turn explains why employers in faster-restructuring CEE countries more often complain about labor regulations, although on the books they are less strict than in other subgroups.

FIGURE 5.2 (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.

Smaller Firms Tend to Be Disproportionately Affected by Investment Climate Obstacles

Small firms are more sensitive to the investment climate than are larger firms. Results of multivariate regression analysis (figure 5.3) show that, controlling for other characteristics such as firms' age, smaller firms tend to be more affected by the main constraints identified above.⁷ Smaller firms also tend to pay more bribes, and to pay bribes more often, than larger ones do (Gray, Hellman, and Ryterman 2004). Because smaller firms are the prime source of job creation, this implies that job growth is sensitive to investment climate changes (see chapter 4).

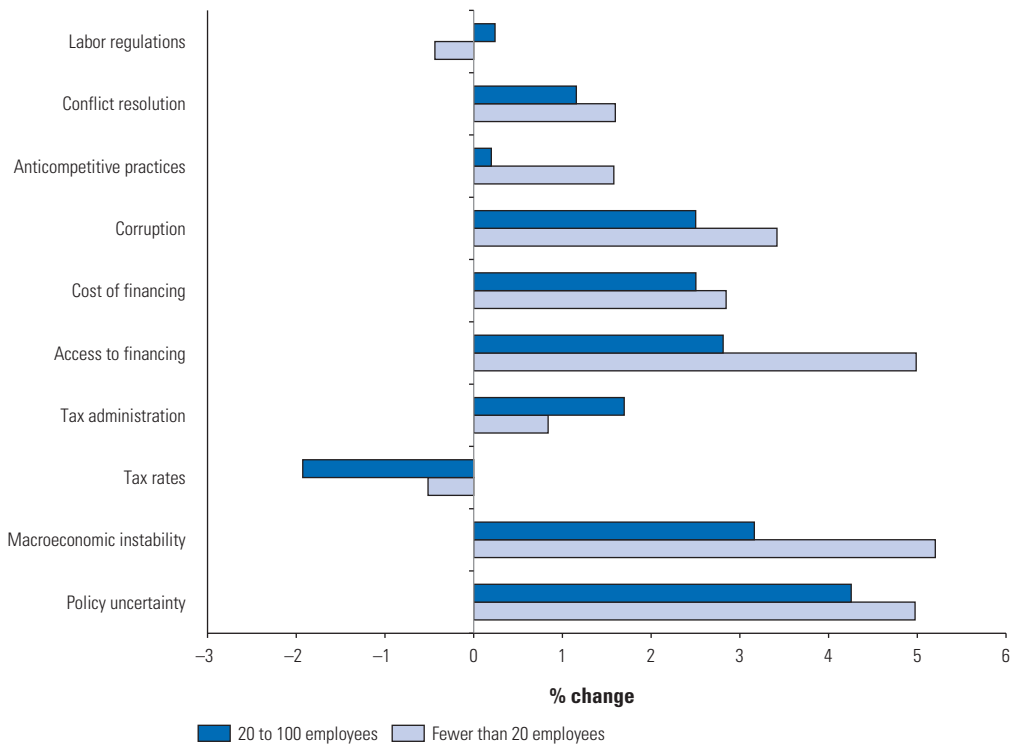
Policies to Foster Job Creation Need to Go beyond the Labor Market

Entrepreneurs' perceptions of the business climate suggest that the main constraints to job creation in the Region currently lie outside the labor market. It could also mean that labor market regulations are just a part of a broader institutional and policy framework that constrains firms' ability to grow and create new jobs. This has important implications for policies to foster employment and reduce unemployment. They cannot be limited to improving the workings of the labor

FIGURE 5.3

Smaller Firms Are More Constrained by the Investment Climate

Probability of reporting the following as major obstacle by size of firm



Source: 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.

market; instead, they should aim at improving the overall investment climate and focus on the most severe obstacles to firm growth. Given the complexity of investment climate reforms, there is a need to set priorities and focus on the most binding constraints.

Macroeconomic instability and economic and regulatory policy uncertainty are seen as major obstacles for businesses across the Region. These two aspects catch various dimensions of the economic environment in which firms operate. In particular, they relate to the quality of institutions and governance. They are likely to encompass such elements as the unpredictability of policy changes, frequent regulatory changes, discretionary interpretation of laws and their selective enforcement, inconsistency in regulations, and discretionary power in the hands of bureaucrats (for example, the power to give permits) and bureaucratic harassment, associated with corruption and extortion.

Therefore, improving labor market outcomes entails a set of comprehensive and complex policy reforms to remove a wide range of constraints to business operation. This involves institutional reforms and changes in governance. Which particular issues should be given priority depends on country-specific circumstances (because key constraints differ by country) and on the extent to which various elements of the investment climate affect labor market outcomes.

The Impact of Investment Climate on Job Creation in the Region

This section attempts to shed light on two questions. Do countries with better investment climates have better labor market performance? Which institutions are most important for a good employment record? In the rest of this chapter, labor market performance is measured mainly through employment generated in the new private sector. The latter is proxied through service sector employment, as explained in box 5.2.

Differences in Investment Climate Explain a Substantial Part of Variation in Employment Outcomes in the Region

The results of a multivariate regression analysis show that differences in market services sector (used as a proxy for the new private sector) employment across the transition countries to a large degree reflect differences in the investment climate.⁸ In other words, knowing various components of the investment climate, one can predict private sector employment reasonably well.⁹ This supports the main claim of this section that a favorable investment climate is critical for job creation and employment growth in the Region. Table 5.1 shows how different components of the investment climate contribute to private sector employment (proxied by service sector employment controlled for GDP per capita¹⁰).¹¹

The first row of table 5.1 reflects the actual change in service sector employment (corrected by GDP per capita). All countries have experienced an increase in service sector employment, above the one implied by economic development.¹²

The second row shows the change in service sector employment predicted by the model, given the impact of the time shock, country-specific effect, and investment climate in the country (see endnote 11). For the new EU member (first column), the model performs quite well, which means that the set of institutions constituting the

BOX 5.2

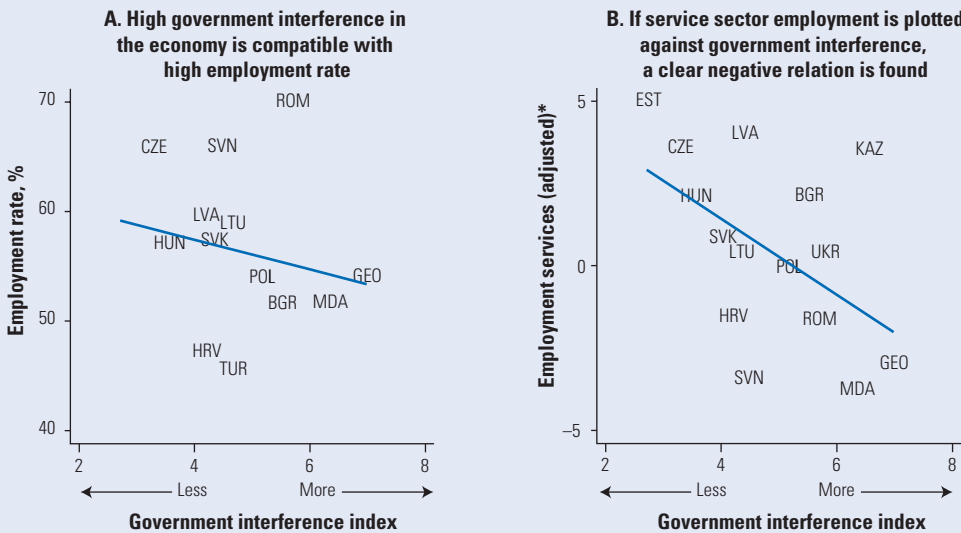
Service Sector Employment Rate as an Indicator of Job Creation Potential

The focus of this report is the employment generated by the new private sector. It might seem obvious to consider a country's total employment as an indicator of job creation potential, but there are difficulties.

Total employment is the sum of employment created by the public and private sectors. Countries with large public sectors have, in general, a large total employment rate, but can still have a bad business environment. In essence, public sector employment does not respond to the state of business environment institutions.

To overcome this difficulty, this report focuses on market service sector employment as a better indicator of an economy's job creation potential because in modern economies—and in transition economies, in particular—most job creation occurs in the market services sector. Therefore, employment opportunities are better in economies where the market services sector is large and expanding.

An index summarizing the government interference in the economy has been plotted against total and market service sector employment rates (figures A and B). As can be seen, the negative impact of the investment climate indicator on market service sector employment is much larger than the impact on the total employment rate.



Source: Lopez-Garcia 2004.

Note: To control for the economic development, a regression of the service employment rate was run against the GDP per capita. The residuals from that regression represent the service employment rate not explained by the development of the economy. The residual is what is called the "service sector employment rate controlled for GDP per capita."

TABLE 5.1

Contribution of Investment Climate Components to Change in Service Sector Employment in the CEE EU Countries over the Past Decade

	Average: CEE, EU- member countries	of which:						Average: CEE, EU- accession countries a)	of which: Romania (94–02)	Aver- age: Russia- Ukraine
		Lithuania (97–02)	Hungary (92–02)	Slovak Republic (94–02)	Poland (94–02)	Latvia (96–02)	Slovenia (93–02)			
Actual change in service sector employment	1.08	-1.83	1.11	0.66	1.33	1.89	0.61	1.06	-0.08	
Predicted change in service sector employment										
Of which:	1.09	0.13	1.92	0.42	1.51	1.26	0.98	0.76	0.30	0.39
Time shock	0.97	0.10	1.42	1.08	1.08	0.44	1.33	0.81	1.08	0.81
Start-up costs	-0.13	0.03	-0.57	-0.16	-0.26	0.17	0.02	0.23	0.53	-0.16
Access to finance	0.44	-0.02	0.70	0.02	0.52	0.39	1.03	-0.50	-1.75	-0.25
Market regulation	0.08	-0.01	1.00	-0.36	0.06	0.14	-0.53	0.15	0.06	-0.35
Tax burden	-0.26	0.04	-0.63	-0.16	0.11	0.12	-0.87	0.06	0.37	0.34

Source: Bank staff calculations.

Note: See annex 5.1 for the presentation of the regression model and definitions of explanatory variables.

Only statistically significant explanatory variables are shown in the table.

On average (considering all countries in the sample), corruption and the quality of the legal system were not significant; hence, they are not included in the table.

The averages for country groups are the unweighted average of the estimated contribution of each explanatory variable to the rise in market service employment within the group.

Low income CIS countries and Estonia were not covered by the regression analysis because of lack of data.

a) Bulgaria, Croatia, and Romania.

business environment is able to explain the employment performance in the private sector. The model is less powerful at predicting the actual service sector employment change in the next wave of accession countries. This results from the fact that corruption and the quality of the legal system play a far more important role in this group of countries than they did for the new EU members.

Poor Access to Finance, Excessive Market Regulations, Administrative Barriers, and High Taxes Are the Most Important Factors Impeding Job Creation in the Region

In CEE EU-member countries (EU-8), the most important driver of private sector employment growth has been by far the relatively good access to finance. To a lesser extent, employment growth has also been facilitated by relatively liberal market regulations.¹³ However, a high tax burden and high administrative barriers (proxied by start-up costs) hindered job creation. For example, a better-than-average access to finance can explain the relatively good private sector employment performance of the Czech Republic, Hungary, and Latvia. Slovenia, another country where the access to finance is quite easy for entrepreneurs, would have performed much better if it had not been for the

strict labor market regulations and high tax burden. The high tax burden has also hampered the employment outcomes in Hungary.

In CEE EU accession countries (EUA-3), the main contributors to the private sector employment growth have been relatively liberal market regulations and relatively low administrative barriers to new business formation. At the same time, private sector employment growth in these countries has been slowed by poor access to finance. For example, Romania saw a service sector employment change smaller than what would be expected, given its GDP per capita. This is mainly the result of poor access to finance. Indeed, Romania scores last in the ranking of the access-to-finance index because of its very high real interest rates, high collateral requirements, and, above all, lack of protection to creditors.

In Russia and Ukraine, growth in private sector employment has been achieved mainly thanks to a relatively low tax burden, but the poor investment climate has impeded job creation. Specifically, heavy market regulations, high administrative barriers to firm formation, and poor access to finance have all slowed the pace of private sector employment growth.

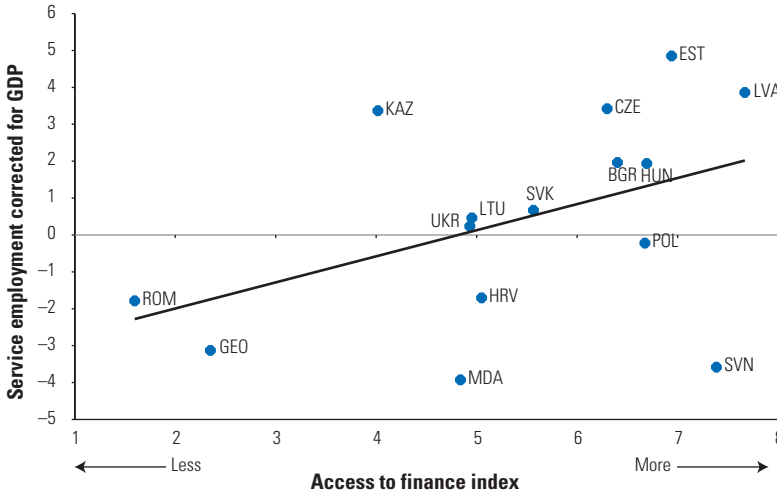
Access to finance stands out as the most important determinant of the growth in private sector employment in the Region. Access to finance alone can explain about 40 percent of the whole increase in service sector employment predicted by the regression model. Improving access to finance—along with other complementary measures to improve the investment climate—therefore carries the potential to foster job creation. Figure 5.4 illustrates this close relationship between access to finance and private sector employment.

However, other components of the investment climate matter too. Stringent market regulations discourage job creation (figure 5.5). Strict employment protection regulations may also discourage job creation, as has been the case in Croatia (box 5.3). Removing one particular constraint may therefore not be enough to engender employment growth. This is especially true, given the complementarities and synergies between various components of the investment climate. It is likely that countries will need to pursue a set of policies to improve the overall investment climate.

Overall, countries with favorable investment climate in the Region enjoy better labor market outcomes. Lower risk and costs of doing business and fewer administrative barriers lead to a faster pace of job creation and employment growth. Using a set of indicators of the investment climate, one can successfully explain much of the variation in private sector employment in the Region. The key determinants are access to finance, the tax burden, administrative barriers to firm creation, and market regulations. The importance of these components varies across subgroups. In European transition economies,

FIGURE 5.4
Market Service Employment Is Higher in Countries with Easier Access to, and Lower Cost of, Credit

Access to finance and service employment*



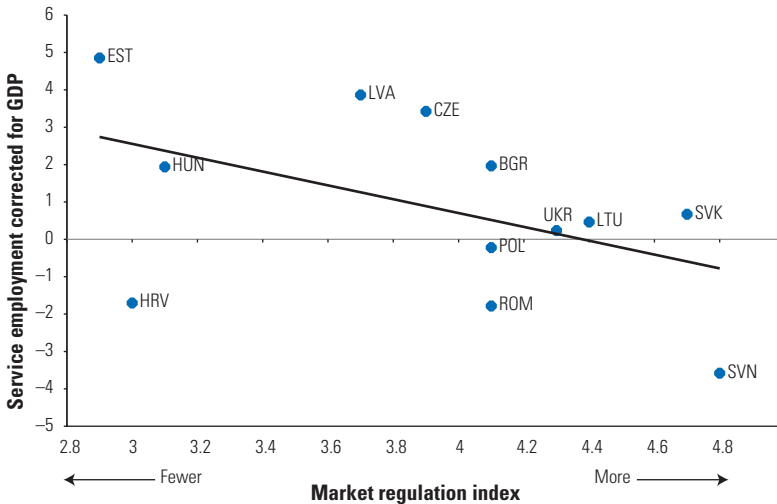
Source: Lopez-Garcia 2004.

Note: The access to finance index is a summary of data on the cost of credit, collateral required, credit to private sector, and protection to creditors (for details, please refer to annex 5.1).

* Controlled for GDP per capita.

FIGURE 5.5
Excessive Market Regulation Hurts Job Creation

Access to finance and service employment



Source: Lopez-Garcia 2004.

Note: Market regulation includes credit and labor market regulations. The former refers to issues such as the percentage of deposits held in privately owned banks, the degree of competition from foreign banks and interest rate controls. Labor market regulation considers hiring and firing practices, impact of minimum wages, unemployment benefits, and union coverage.

* Controlled for GDP per capita

BOX 5.3

Stringent Employment Protection Regulations May Forestall Job Destruction, but at the Same Time They Discourage Job Creation

A simple comparison between Croatia and Poland illustrates the point. Until recently, dismissal costs had been extremely high in Croatia, whereas they are relatively low in Poland. On a scale from 0 to 5, the OECD index of the cost of collective dismissal was 5.0 in Croatia and 3.9 in Poland (late-1990s data). Expectedly, the job destruction rate was much higher in Poland (about 12 percent in 1999) than in Croatia (5 percent in 2001). However, Poland enjoyed a much higher job creation rate than Croatia (10 percent against less than 4 percent, respectively). As a result, the job reallocation rate, which is a measure of industrial restructuring, was significantly lower in Croatia. In Poland, more jobs were reallocated away from declining firms and industries toward expanding ones.

A similar pattern—low rates of both job creation and destruction, reflecting strict EPL—also prevailed in the Slovak Republic. In contrast, high rates of job creation and destruction occurred in countries with relatively flexible EPL, such as Latvia and Lithuania.

As shown in chapter 4, the low job reallocation rate carries a significant cost in forgone productivity gains. Thus, policies to protect low-productivity, unsustainable jobs through high legislated dismissal costs are inefficient. An efficient approach is that of encouragement (that is, fostering job creation through enhancing labor market flexibility and improving the investment climate).

Sources: World Bank 2001, 2002c, 2002d, 2003b, and 2003d.

job creation has been supported by better access to finance (especially in the new EU-member countries) and more efficient market regulations. At the same time, high business and labor taxation and some administrative barriers have impeded job creation. In contrast, in Russia and Ukraine (which are likely to be representative of other CIS countries), taxation is less of a problem, but inefficient market regulations, administrative barriers, and poor access to finance have hindered job creation. Table 5.2 summarizes these differences.

TABLE 5.2

The Importance of Determinants of Job Creation Varies by Subgroup in the Region

	Impact of investment climate components on job creation	
	Foster job creation	Impede job creation
CEE, EU-member countries	Access to finance	Taxation, start-up costs
CEE, EU-accession countries	Start-up cost, market regulations	Access to finance
Russian Fed. and Ukraine	Taxation	Market regulations, access to finance, start-up cost

Source: Bank staff calculations.

Investment Climate: International Comparisons and Variations within the Region

Perceptions from entrepreneurs, which were presented earlier in this chapter, are an important reality check of what matters to firms. However, they are difficult to compare across countries because they closely depend on the environment in which entrepreneurs operate and the standards they use as references (see box 5.4). This section uses selected objective measures of the investment climate to compare the experience of the transition countries relative to other countries.¹⁴

The focus is on those aspects of the investment climate that in the previous section were found to have a strong effect on job creation. Analysis starts by comparing selected elements of the investment climate in the Region to those in other regions. Then differences in the investment climate are examined across the Region's subgroups and across countries. All in all, the investment climate in the Region compares rather favorably to that in other regions, although in some key dimensions there is room for improvement. The study also shows that there are substantial differences in the investment climate among the Region's subgroups, as well as across countries. Generally, the cost of doing business is lowest in CEE and increases as one moves further east. The gap between the investment conditions in CEE and low income CIS countries is considerable.

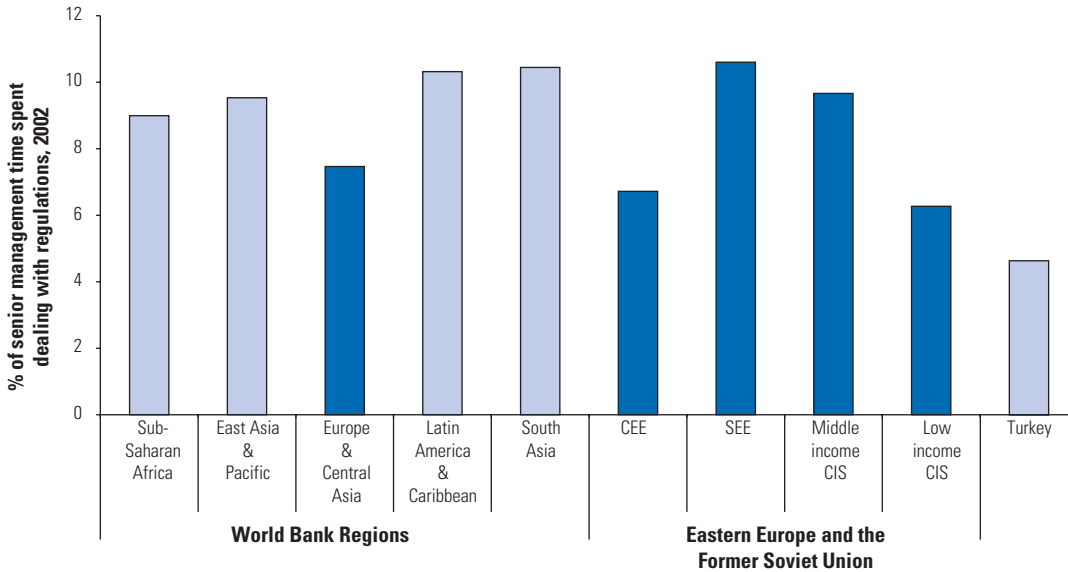
Investment Climate in the Region Compares Favorably to That in Other Regions, but There Is Substantial Room for Improvement

On one hand, several elements of the investment climate in the Region compare well with those in other regions of the developing world. For example, the cost of market regulations (measured in management time spent dealing with them) is less than in other regions (figure 5.6). Unofficial payments to public officials to get things done (as a percentage of total sales) are smaller in the Region than in other regions (less than 2 percent of annual sales against more than 2 percent in all other regions).¹⁵

On the other hand, the comparison is less favorable in other dimensions of the investment climate. For example, property rights—an important element of the investment climate—are less protected in the Region than in some countries, and the costs of providing security are high (figure 5.7). The capital market is also less developed in the Region than in other areas of the world. This inhibits access to credit, which is likely, as shown earlier, to impede job creation (figure 5.8).

FIGURE 5.6

In Some of the Region’s Subgroups, Time Spent Dealing with Government Regulations Is Still Substantial

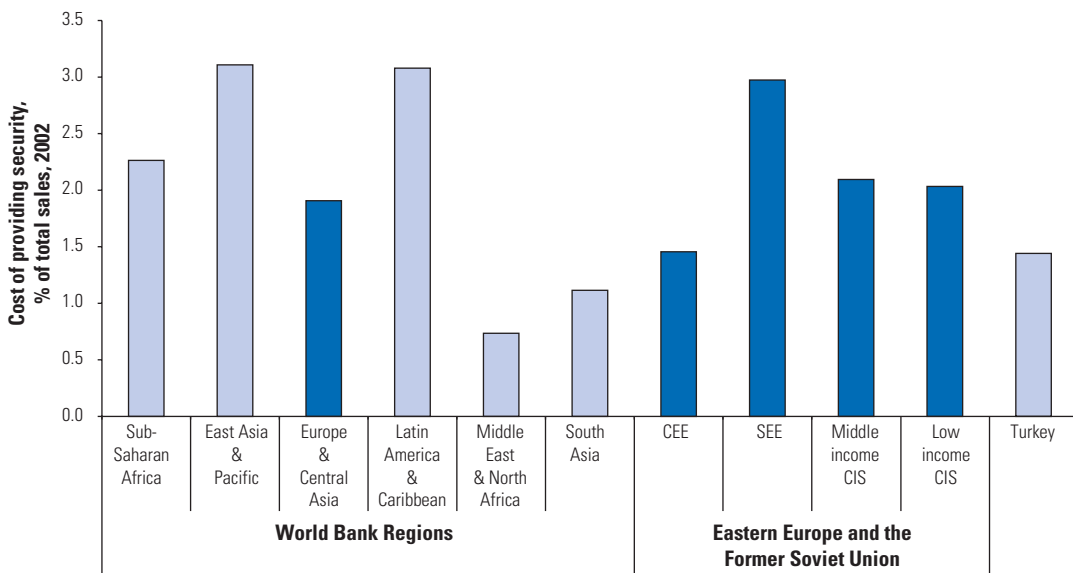


Source: EBRD–World Bank Business Environment and Enterprise Performance Surveys, 2002.

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.

FIGURE 5.7

Protection of Property against Crime Can Be Costly

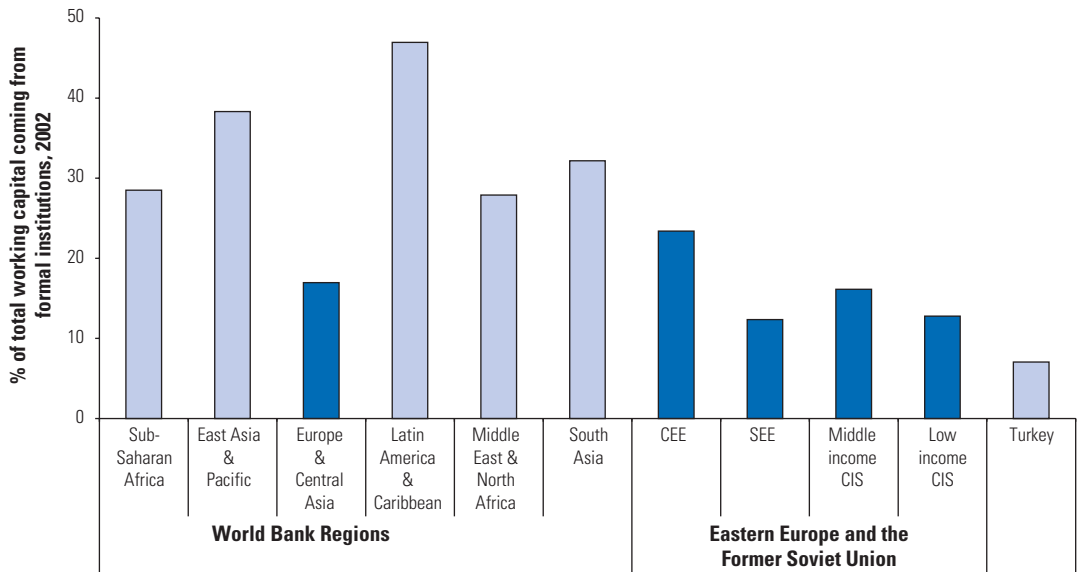


Source: EBRD–World Bank Business Environment and Enterprise Performance Surveys, 2002.

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.

FIGURE 5.8

Firms in the Region Rely to a Lesser Degree on Capital Coming from Formal Institutions than Do Firms in Other Regions



Source: 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.

The Region's Subgroups Differ Substantially in Investment Climate

The comparison of the Region with other areas of the world is illustrative, but should not be taken too far. First, for more-developed countries of the Region, especially in CEE, the right comparators are developed market economies, rather than developing countries. For less-developed countries of the Region, especially the low income CIS countries, the appropriate comparators should be countries representing best practice among low and middle income countries. Second, the Region is heterogeneous, with substantial differences in the investment climate among subgroups and countries. Thus, even if the Region compares favorably to other regions (on average), this is not necessarily the case for some subgroups or countries of the Region. Below, the study looks more closely at variations in the investment climate within the Region and benchmark countries of the Region against investment climate “leaders.”

In general, the investment climate is much better in CEE than in other parts of the Region. Consistent with earlier analysis, the cost of red tape in middle income CIS countries and SEE is much higher than in the rest of the Region and is also high by international standards (fig-

BOX 5.4

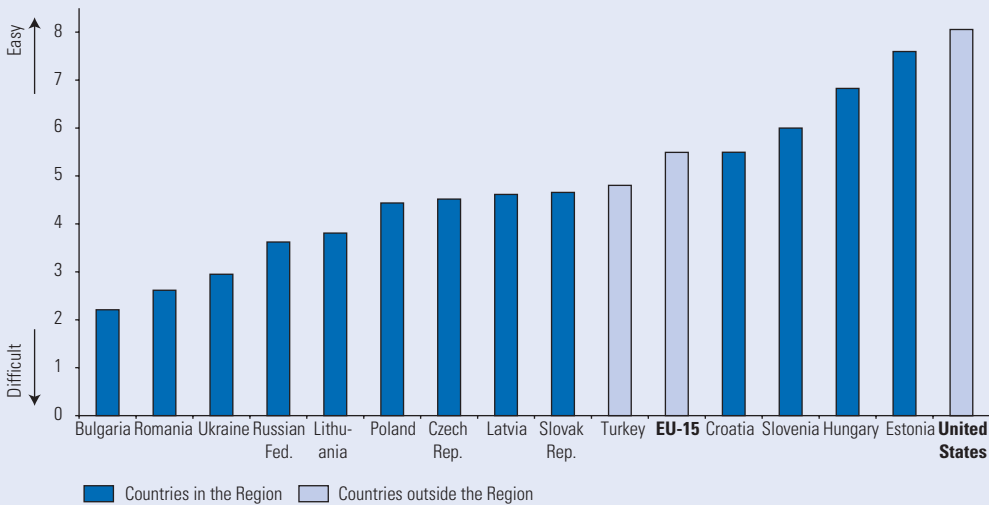
What the Official Data on Entry Barriers Do Not Show: Romania

Measurement matters. Different ways of measuring the same concept can yield different conclusions. The start-up costs in Romania are a good example.

According to *objective* data from the World Bank, opening a business is easy in Romania: no more than six procedures are required to start a business, one can go through the process in less than a month (against 37 days on average in Europe), and the cost of the process and minimum capital requirements are among the lowest in the transition countries.

However, when one looks at similar indicators of start-up costs based on *subjective* opinions, in this case those of managers of large corporations, the situation is quite different. According to the evaluation given to the sentence, "Starting a new business is generally easy," by the *Global Competitiveness Report*, Romania is one of the countries where starting a business is considered the most difficult (figure A).

Figure A: Subjective Perception of How Easy It Is to Start a Business



Source: World Economic Forum 2002.

Note: The index is based on managers' evaluation of the sentence, "Starting a new business is generally easy." The index varies from 0 to 10, with higher values indicating more favorable assessment.

This example shows that indicators based on perceptions in some cases can be preferable to objective indicators, since they reflect de facto rather than de jure conditions. But their inherent subjectivity limits their validity. On the other hand, objective indicators, although not distorted by subjectivity, often give only a partial picture and do not reflect all the dimensions of the problem. Given the limitations of both approaches, it is best to treat them as complementary.

ure 5.6). The cost of providing security (protecting firm property against crime) is especially high—also by international standards—in SEE and in the low income CIS countries (figure 5.7). Access to financing, as measured by proportion of working capital coming from formal institutions, is particularly poor in the low and middle income CIS countries and SEE (figure 5.8).¹⁶ But, interestingly, it is still worse in Turkey—the only nontransition economy in the Region. Finally, corruption is a particular problem in the low income and middle income CIS countries. Countries of the Region that are poorer and less advanced in market reforms still have a long way to go to improve the investment climate to make it more conducive to firm growth and job creation.

On Most Key Dimensions of Investment Climate, the Transition Countries Lag behind World Leaders

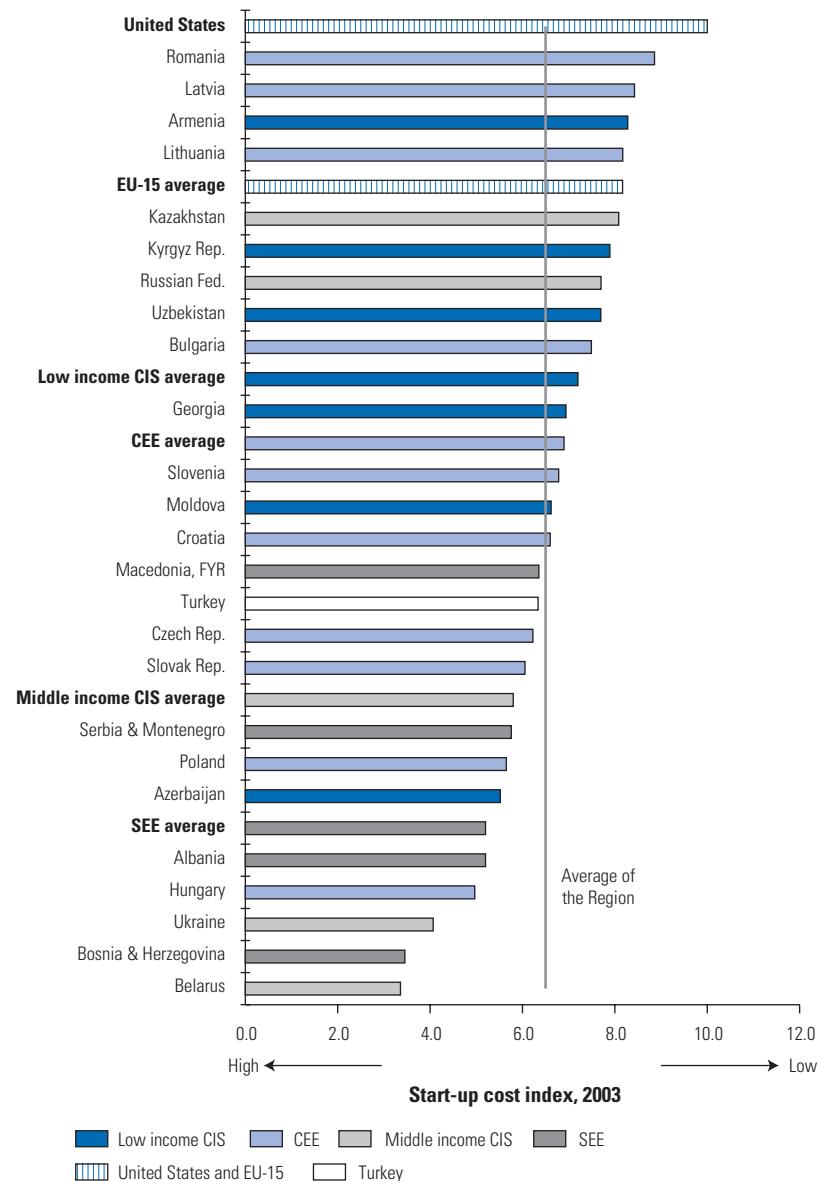
The multivariate analysis presented earlier showed that low business start-up costs; easy access to, and low cost of, finance; and liberal market regulations are keys to the growth of the market services sector, and thus for employment. In all those dimensions of the investment climate, most of the transition countries lag behind world leaders. The gap is relatively small for the best-performing CEE countries, but is wide for most of the CIS and SEE countries. Below, the study benchmarks countries of the Region against selected developed and best-performing developing economies. The former are a natural benchmark for middle income countries of the Region, whereas the latter are a more adequate benchmark for low income countries of the Region.

Opening a Business Is Costly, Especially in SEE and Some CIS Countries

In most of the transition countries, the start-up costs are higher than in the United States (where it is least costly to start a business), the European Union (EU-15), or the dynamic developing countries, such as Korea, Malaysia, or Thailand (see annex table A5.2).¹⁷ Among the transition countries, start-up costs are (on average) lowest in CEE, especially in the Baltic States. Costs of opening a business are also moderate in most CIS countries, although Belarus and Ukraine are clear outliers. Start-up costs are high in SEE by international standards (figure 5.9).¹⁸

The number of start-up procedures is limited to three in industrial countries with a liberal approach to entrepreneurship, such as Ireland or Sweden. In the Region, the most liberal country in this respect is Hungary, where one needs to go through five procedures. But in Belarus, where opening a business is most cumbersome, there are 19 necessary

FIGURE 5.9
Starting a Business Is Not Easy in Many of the Region's Countries



Source: World Bank, Cost of Doing Business Database.

Note: The index goes from 0 to 10, 0 being the most expensive. The start-up cost index was constructed by rescaling the four dimensions of start-up costs provided by the CODB database: number of procedures, total time, cost and minimum capital. Then a simple unweighted average of the four components was calculated.

procedures. Similarly, in many developed and developing countries, there is no minimum capital requirement to start a business. Within the Region, only in Azerbaijan is no start-up capital required. In Ukraine, the minimum required capital is almost five times the gross national income (GNI) per capita, which can effectively limit firm creation.¹⁹

Hungary exemplifies the point that even in countries with overall good investment climate, there is room for improvement. Procedural costs associated with opening a business are the lowest in Hungary, compared with those in other countries of the Region. At the same time, the monetary costs associated with registering a business are the highest. Thus, although (on average) start-up costs are moderate in Hungary, the country would benefit from improving the incentives for firm creation by lowering the registration costs.

To conclude, most of the transition countries can lower administrative barriers to firm entry and thus foster job creation. Opening a business can be made easier even in CEE countries, but the biggest room for improvement is in SEE and in some of the CIS countries.

Access to Finance Is Difficult, Especially in the CIS

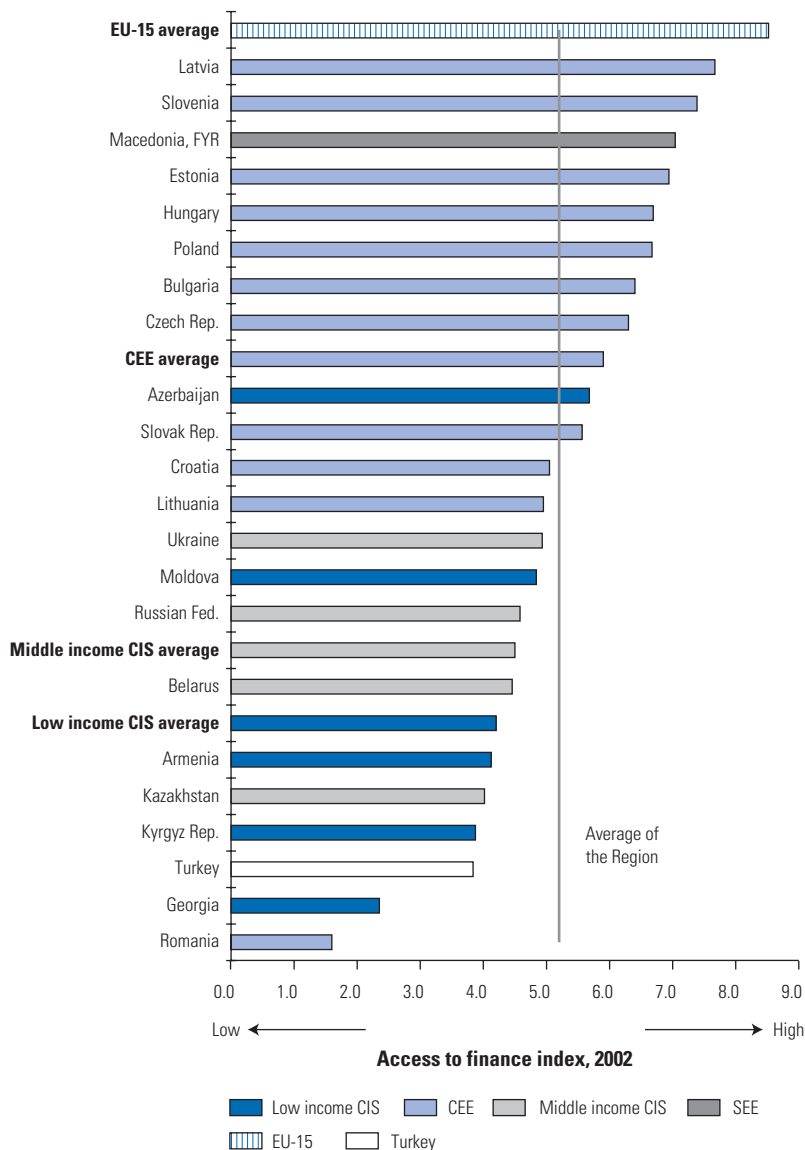
Access to finance is substantially more difficult in the Region than in the EU-15 or in developing countries with developed credit markets, such as Korea or Malaysia, although better than in Turkey. Within the Region, access to finance is easier in European transition economies (especially in CEE) and more difficult in the CIS (especially in the low income CIS countries) (figure 5.10). But even in CEE, the credit market is notably less developed than in the EU-15. Domestic credit to the private sector (relative to GDP) is much less in CEE than in EU-15, and the interest rate spread is significantly larger.²⁰

To illustrate, domestic credit to the private sector represents more than 100 percent of GDP in the European Union and some developing countries, such as Korea and Malaysia, but less than 30 percent in CEE. In middle income CIS countries, the ratio goes down to about 16 percent, and in low income CIS countries, it barely exceeds 10 percent.²¹ This comparison shows that there is substantial room for developing the credit market and improving access to credit in all of the transition countries, but especially those in the CIS. Better access to credit, in turn, is going to support firm entry and growth and, ultimately, job creation. Moreover, better access to credit will provide incentives for firms to move from the informal to the formal sector, which in turn may lead to productivity gains.

Regulations Often Add Heavy Burden to Firms' Operation

There is still much room in the transition countries to make markets more liberal. In all of these countries, markets are more regulated than in the United States, and most of them are more regulated than in the EU-15. Again, European transition economies, especially new EU mem-

FIGURE 5.10
Job Creation in the Region Is Likely to Be Hampered by Difficult Access to Credit

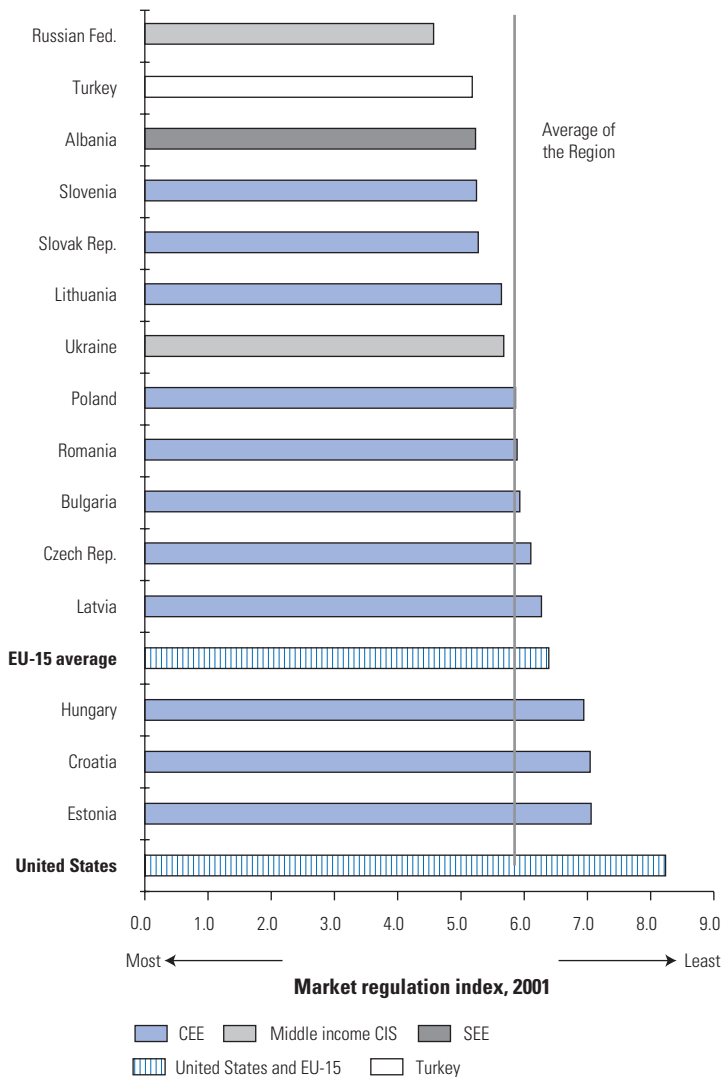


Source: World Development Indicators.

Note: The index goes from 0 to 10, 0 being the worst. The index is the combination of the following variables: ratio of domestic credit provided by deposit money to GDP, interest rate spread and real interest rate, ratio of deposit coverage to GDP and the index of creditors' protection (from the World Bank's Doing Business Database).

bers, tend to have less-regulated markets than the CIS and also Turkey do (figure 5.11). Thus, given that excessive market regulation has been shown to limit job creation, lessening the regulatory burden on business activity in the Region is yet another way to encourage job creation.

FIGURE 5.11
Markets in the Region Tend to Be Overregulated



Source: Economic Freedom of the World 2003.

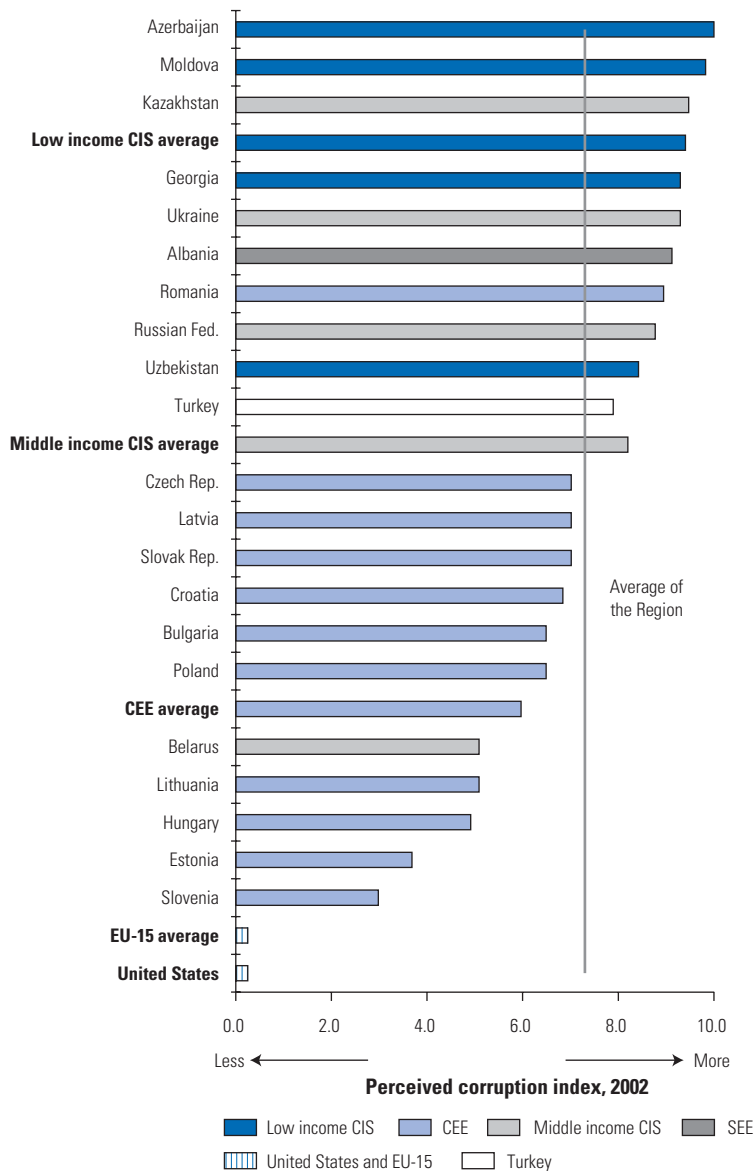
Note: The indexes go from 0 to 10, 0 being the most regulated. The market regulation index is an unweighted average of the credit market and labor market regulation indexes provided by the *Economic Freedom of the World's Annual Report* (Gwartney and Lawson 2003).

Corruption Adds Up to Heavy Regulations to Raise Costs of Doing Business

Corruption is closely related to excessive regulations, and it has been shown to be a severe obstacle to business formation and growth, as well as to job creation. Given that corruption looms large in the Region, its negative impact on employment is likely to be substantial.²² Within the Region,

the least corrupted are the CEE countries that are EU members. But even there, corruption is much more widespread than in the EU-15. In other European transition economies, corruption is a severe problem, and it is apparently rampant in the CIS countries (figure 5.12). But corruption is also a major issue in Turkey, which is a nontransition economy. Fighting corruption and its sources is thus critical to encouraging job creation.

FIGURE 5.12
Corruption Is High in the Region



Sources: Transparency International 2002; Bank staff calculations.

Note: The index goes from 0 (best) to 10 (worst). The country ranking responds to the degree of corruption perceived to exist among public officials and politicians. It draws from 15 different polls and surveys from nine different institutions.

Summing Up: Promoting a Better Investment Climate to Foster Job Creation

Despite major structural reforms, the investment climates in many transition economies still suffer from significant shortcomings that negatively affect firms' incentives to invest and create more and better jobs. Therefore, better employment outcomes in the Region depend on further progress in structural reforms affecting the quality of the investment climate. Many investment climate challenges are common across the Region, although their importance varies by subgroup and country. The three challenges that stand out are the following:

- Strengthening macroeconomic stability and reducing economic and regulatory policy uncertainty.
- Lowering taxes, especially on labor, and simplifying tax administration. This is associated with public expenditure reforms, particularly with reforms to the pensions and health insurance systems. It also includes cutting programs that are not cost-effective and improving the efficiency in the delivery of public services. In addition, tax administration needs to be improved to reduce the burden on firms (for example, the costs associated with tax inspections) and to reduce the scope for corruption.
- Improving access to, and lowering the cost of, credit. This is associated with the reforms of the banking system, such as through enhancing competition.

Investment climate issues are also more pronounced in some regions than in others. The key elements of a reform agenda by subgroup are summarized here.

The Investment Climate Reform Agenda in CEE

Investment climate in the CEE EU-member countries is by far the most favorable among the transition countries. Nonetheless, even the most-advanced CEE countries lag behind world leaders in many dimensions of the investment climate, and there is significant scope for improvement. For example, starting a business in CEE is still considerably more difficult than in the United States or in the EU-15. Three issues are more of a constraint to firm growth in CEE EU-member countries than in other subgroups:

- High tax rates
- Labor regulations

- Skills of available workers

In the EU-accession countries, costs of doing business tend to be higher than in CEE EU-member countries. Additional investment climate issues that need to be addressed include the following:

- Corruption
- The efficiency of the legal system and conflict resolution
- Licenses and operating permits

The Investment Climate Reform Agenda in SEE

SEE countries are less advanced in investment climate reforms than are other European transition economies. There is considerable scope for reducing the risk and costs of doing business, as well as lowering administrative barriers and cutting the red tape. Reform priorities include addressing the following:

- Security of property rights
- High costs of starting a business
- Excessive regulation of business activities, including customs and trade regulations
- Anticompetitive or informal practices
- The quality of the legal system and conflict resolution
- Corruption

The Investment Climate Reform Agenda in the CIS

In most dimensions of the investment climate, the CIS countries, both middle income and low income, lag behind European transition economies. The institutions of a market economy are less developed and market-oriented reforms are less advanced than in European transition economies. Therefore, the risks associated with doing business are substantially higher, as are administrative barriers and associated bureaucratic harassment. Corruption is widespread, adding to the costs of doing business. To bridge this divide and to foster the creation of more-productive, formal sector jobs, the middle income CIS countries need to focus on addressing the following obstacles:

- Excessive market regulations, administrative barriers to business activity (for example, licensing and operating permits), bureau-

cratic harassment (for example, frequent and lengthy inspections), and associated corruption

- Business start-up costs (especially in Belarus and Ukraine)
- Underdeveloped credit market and access to finance

Investment climate constraints in the low income CIS countries are still more profound. In addition to the ones listed above, these countries need to overcome more-fundamental obstacles, such as the following:

- Security of property rights
- Underdeveloped infrastructure, including access to electricity
- Administrative barriers, including cumbersome customs and trade regulations

Reforms to Foster Job Creation Require Identifying Key Constraints to Firm Growth and the Active Involvement of the Business Community

Improving the investment climate is a complex task. Many of the reforms are interlinked and complementary and thus require appropriate sequencing. For example, fighting corruption requires deregulating business activities and lessening the discretionary power given to the bureaucracy. It also requires removing administrative barriers (for example, reducing the number of permits and licenses, simplifying customs procedures, and limiting the number of agencies that have the right to carry out inspections). Moreover, some reforms require substantial investments (for example, improvements in infrastructure, in the efficiency of the legal system, and in the institutions responsible for enforcement). Given the scarcity of resources, governments need to select priorities and focus on addressing the constraints that are the most binding. Improving the investment climate is a continuous process because the environment changes and new challenges emerge. Although investment climate reforms can be difficult and costly, the long-term social costs of abstaining from reforms are likely to be still higher. If firms' entry and growth is inhibited by high costs of doing business, job creation and employment will suffer.

The above-identified subgroup reform priorities define broad areas where the key constraints lie. Country-specific constraints and reform priorities need to be identified, using more-detailed information on the quality of business environment. Such information can be

obtained from specially designed investment climate surveys or from focus groups of employers.²³

The most important channel for identifying obstacles to job creation is ongoing government consultations and dialogue with the genuine representation of the business community, including the small private firms. Such dialogue has already been carried out in a number of the transition countries under different institutional forms. Bosnia and Herzegovina launched its so-called Bulldozer Initiative to involve the private sector in reforms. Latvia established a Steering Committee for Improvements of the Business Environment, which comprises representatives from key ministries and from associations of local firms, as well as foreign investors (World Bank 2003d). In Poland, a dynamic employers' confederation, representing the new private sector, is vocal in publicly articulating business concerns and actively takes part in a dialogue with the government on investment climate issues.

Thus in many of the transition countries, the institutional structure for voicing business concerns has already been created. The challenge is to overcome bureaucratic inertia and to mobilize political support for these necessary reforms that hurt the interests of those who benefit from the status quo.

Annex 5.1: Regression Analysis of the Impact of the Investment Climate on Employment in the Region

To capture the interaction between shocks and institutions, the following simple model (equation 5.1) was estimated:

$$u_{it} = c_i + d_t(1 + \sum_j \gamma_j X_i^j) + \epsilon_{it} \quad (5.1)$$

where u is the unemployment or employment rate in country i at time t , c are the country dummies, d are time dummies (that is, unidentified shocks assumed to be equal across countries²⁴), and X is the time-invariant value over the period of the institution j in country i .

What the model is trying to capture is the way institutions shape the response of countries to a similar shock. All transition economies of the Region have been hit by a similar shock at a similar time, but their labor markets have responded differently. The objective is to

determine whether this is the result of the institutional settings of the countries, and if so, which institutions had the strongest impact. To answer these questions, the model uses as explanatory variables the interactions of various institutions with some proxy to the shock. This is the most general specification, because no specific shocks are imposed; it is only assumed that a number of shocks over time, of equal dimension across countries, have hit the economies. Hence, the model allows one to isolate the impact of the (different) institutions from that of the shocks.

To estimate the coefficients corresponding to each of the institutions in the model, an unbalanced panel of 28 countries of the Region over 14 years (from 1989 to 2002) was used. Unfortunately, only one year of information for most of the institutional variables was available.

The list of institutions (explanatory variables) considered in the regression model is as follows:²⁵

- *Start-up costs*. A composite index, constructed by using the World Bank's Doing Business Database, 2004.
- *Exit costs*. As above.
- *Access to finance*. A composite index, using the following variables: ratio of domestic credit to GDP from *World Development Indicators 2004* (World Bank 2004c), ratio of deposit coverage to GDP (IMF), and creditors protection index (Doing Business Database, 2004).
- *Quality of the legal system*. A composite index, combining indicators of contract enforcement (Doing Business Database 2004) and subjective evaluation of the quality of the legal system provided by the *Economic Freedom of the World 2003 Annual Report* (Gwartney and Lawson 2003).
- *Market regulations*. This is an unweighted average of the credit market and labor market regulation indexes, provided by the *Economic Freedom of the 2003 World's Annual Report* (Gwartney and Lawson 2003).
- *Corruption*. Transparency International Corruption Perception Index 2003 (www.transparency.org).
- *Tax burden*. Tax revenue as a percentage of GDP, from *World Development Indicators, 2004* (World Bank 2004c).

The results of the estimation of the regression are shown in table A5.1.

TABLE A5.1

Estimation Results

Type of regression: Common shocks across countries assumed

Variable	Service employment (corrected)		Unemployment	
	Coefficients	t-statistics	Coefficients	t-statistics
Shocks (given average institutions)	0.8%		0.85%	
Start-up cost index	-0.29*	(-1.45)	0.09	(0.26)
Exit cost index	-0.003	(-0.28)	-0.006	(-0.24)
Finance index	0.41**	(2.95)	-0.18	(-0.42)
Legal system index	-0.04	(-1.13)	-0.05	(-0.86)
Mk. Regulation index	-0.64**	(-2.45)	1.73*	(1.53)
Corruption index	0.06	(0.33)	1.57**	(2.37)
Tax burden	-0.08	(-1.11)	0.43**	(2.35)
Observations	106		104	
Adjusted R-Squared	0.95		0.77	

Source: Bank staff calculations.

Note: Nonlinear least square estimation

*significant at 15%

**significant at 1%

Annex 5.2: Investment Climate Indicators in Selected Transition and Developing Economies

TABLE A5.2

Investment Climate Indicators in Selected Transition and Developing Economies

	GDP per capita at PPP, 2002 (dollars)	Domestic credit/ GDP ratio (2002)	Starting a business			
			Number of procedures	Duration (days)	Cost (% GNI per capita)	Min. capital (% GNI per capita)
Armenia	3,230	6.9	10	25	7	4.5
Brazil	7,450	35.5	17	152	11.7	0
Hungary	13,070	35.3	6	52	22.9	86.4
Korea, Rep. of	16,960	115.6	12	22	17.7	332
Kyrgyz Republic	1,560	4.2	8	21	11.6	0.6
Malaysia	8,500	146.1	9	30	25.1	0
Moldova	1,600	17.6	10	30	18.6	24.6
Poland	10,450	28.8	10	31	20.6	237.9
Romania	6,490	8.3	5	28	7.4	0
Russian Federation	8,080	17.6	9	36	6.7	5.6
Serbia and Montenegro	—	—	11	51	9.5	120.3
Thailand	6,890	102.5	8	33	6.7	0
Ukraine	4,800	18	15	34	17.6	113.9
Vietnam	2,300	43.1	11	56	28.6	0

Sources: World Development Indicators (2004); Cost of Doing Business Database (2005).

Note: — = data not available.

	Hiring and firing workers					
		Difficulty of hiring index	Rigidity of hours index	Difficulty of firing index	Rigidity of employment Index	Firing costs (weeks)
Armenia		17	40	50	36	17
Brazil		67	80	70	72	165
Hungary		11	80	30	40	34
Korea, Rep. of		11	60	30	34	90
Kyrgyz Republic		33	40	40	38	21
Malaysia		0	0	10	3	74
Moldova		33	60	70	54	21
Poland		11	60	30	34	25
Romania		78	60	50	63	98
Russian Federation		0	60	20	27	17
Serbia and Montenegro		28	0	40	23	21
Thailand		67	40	20	42	47
Ukraine		33	80	80	64	94
Vietnam		44	40	70	51	98

Notes

1. Lopez-Garcia (2002) shows that the contribution to unemployment of barriers to entrepreneurship doubled in a sample of OECD countries, when worker reallocation was taken into account.
2. Such information is gathered in the investment climate surveys. These are the result of a partnership between the World Bank and country counterparts for the collection of data from large random samples of firms in more than 50 countries. The surveys collect objective quantitative data on measures of the investment climate, plus information on firm performance. This allows linking the investment climate indicators with performance to understand their impacts on productivity, investment decisions, and employment decisions. The surveys were launched in 2001, with about 20 new surveys conducted each year. So far, more than 26,000 formal firms have been interviewed, half of them with fewer than 50 employees.
3. This is consistent with the results in Pissarides, Singer, and Svejnar (2003), which provides evidence that constraints on obtaining external financing and the high cost of this financing are two of the top five constraints cited by managers of small and medium enterprises in Bulgaria and Russia.
4. Ranking is calculated according to the average score of each constraint.
5. Labor regulations are efficient if they support an efficient allocation of labor resources (see Estreicher and Schwab [2000], especially chapter 5).
6. This is also surprising, because on the books labor regulations are significantly more strict in the CIS and SEE than in CEE; however, the discrepancy between de jure and de facto strictness of employment regulations can be accounted for by differences in enforcement (see chapter 6).
7. Regressions are carried out using generalized ordered logit models. Perceptions for each type of constraint are estimated as a function of firms' characteristics (size, age, sector, innovating history, ownership, exports, imports, and foreign ownership) and country's income level.
8. Multivariate regression analysis was used to estimate the independent contribution of different components of the investment climate to employment. See annex 5.1 for the details, including the regression model, data used, and results.
9. The coefficient of determination (adjusted R²) is 95 percent, meaning that the investment climate variables used in the model explain a large portion of variation in the market service employment rate across the sample of the transition countries.
10. To control for the economic development, a regression of the service employment rate was run against the GDP per capita. The residuals from that regression represent the service employment rate *not* explained by the development of the economy. The residual is what is called the "service sector employment rate controlled for GDP per capita."
11. This analysis is based on the argument that the institutional setting of a country shapes the impact that otherwise-similar shocks have on its labor market performance. The first economists to propose this idea were Michael Bruno and Jeffrey Sachs (1985). But it was only after the publication of the Blanchard and Wolfers (2000) model of equilibrium unem-

- ployment that the interaction of shocks with institutions became a popular explanation among labor economists for the unemployment evolution of developed countries.
12. Lithuania is an exception, but this result needs to be treated with caution: comparisons of employment before and during the transition are inaccurate because of changes in methodology and data sources.
 13. The indicator of market regulations is based on indexes of credit and labor market regulations.
 14. One set of indicators corresponds to employers' answers to "objective" questions as part of the Investment Climate questionnaire (sample question: In a typical week, what percentage of senior management's time is spent dealing with requirements imposed by government regulations, including dealing with officials, completing forms, and so forth?). A second set of indicators reflects de jure conditions.
 15. Based on the World Bank investment climate survey data.
 16. Research on financial developments in the Region points to the poorly developed financial system in low income CIS countries as a major impediment to their sustained growth and emphasizes the "great divide" between the low income CIS countries and other subgroups, especially CEE countries (Nicoló, Geadah, and Rozhkov 2003).
 17. Korea, Malaysia, and Thailand were chosen as comparators for the transition countries because their level of GDP per capita is similar to that in the middle income countries of the Region. For example, Korea has GDP per capita similar to that in Hungary and Poland, Malaysia to that in Bulgaria or Russia, and Thailand to that in Romania or Ukraine (see annex table A5.2 for data on GDP and selected investment climate conditions).
 18. Because of the space constraint, the figures do not show countries outside the Region (except for the EU-15, which is a benchmark). Data for countries referred to in the text come from the same source as those used to construct the charts.
 19. The data come from the World Bank Doing Business Database, 2003.
 20. Interest rate spreads affect the cost of credit and thus investment. The level of spreads is determined by funding, operating and regulatory costs, rents accruing from banks' market power, and credit risk (Nicoló, Geadah, and Rozhkov 2003).
 21. The data come from the World Bank (2004c).
 22. The level of corruption is significantly negatively correlated with employment in the market services sector. However, the level of corruption tends to decrease with the level of economic development, and for this reason, the corruption variable turned insignificant in the employment regression reported in table 5.2. In other words, corruption matters for employment, but its impact is difficult to separate from that of economic development.
 23. World Bank (2005a) provides an example of using focus groups and employer-based surveys for identifying constraints to job creation.
 24. The first period is left out, so it becomes the constant. Therefore, the country dummies can be interpreted as the unemployment rate in the first period.
 25. Detailed information on the construction of composite indices used in the regression is provided in Lopez-Garcia (2004).

