

# Labor Market Performance in Transition

## The Experience of Central and Eastern European Countries

Jerald Schiff, Philippe Egoumé-Bossogo, Miho Ihara,  
Tetsuya Konuki, and Kornélia Krajnyák



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The following conventions are used in this paper:

- . . . to indicate that data are not available or not applicable;
- to indicate that the figure is zero or less than half the final digit shown;
- between years or months (for example, 2004–05 or January–June) to indicate the years or months covered, including the beginning and ending years or months;
- / between years or months (for example, 2004/05) to indicate a fiscal or financial year.

“Billion” means a thousand million; “trillion” means a thousand billion.

“Basis points” refer to hundredths of 1 percentage point (for example, 25 basis points are equivalent to  $\frac{1}{4}$  of 1 percentage point).

Minor discrepancies between constituent figures and totals are due to rounding.

\* \* \*

As used in this report, the term “country” does not in all cases refer to a territorial entity that is a state as understood by international law and practice. As used here, the term also covers some territorial entities that are not states but for which statistical data are maintained on a separate and independent basis.

## Preface

This Occasional Paper analyzes the labor market experiences of the countries of Central and Eastern Europe during their transition from centrally planned to market-based economies. The paper highlights remaining weaknesses in labor markets in these countries—still-high rates of unemployment and long-term unemployment in many countries, and the concentration of unemployment in selected poor regions—and suggests a broad policy road map for addressing these problems.

The paper was prepared by a team comprising Jerald Schiff, Philippe Egoumé-Bossogo, Miho Ihara, Tetsuya Konuki, and Kornélia Krajnyák. In addition, Nadia Choueiri, Paulo Drummond, and David Moore contributed valuable country case studies, which appear in Appendix II of the paper. The authors would like to thank Carlo Cottarelli, Susan Schadler, and numerous economists in the IMF's European Department for their comments and for help with data at various stages of the process of producing this paper. Anna Unigovskaya provided excellent research assistance, and Sara Salimi and Ana Rosa Reyes ably assisted in preparing the manuscript. James McEuen of the IMF's External Relations Department edited the manuscript and coordinated production of the publication.

The opinions expressed in this paper are solely those of the authors and do not necessarily reflect the views of the International Monetary Fund or its Executive Directors.

## Abbreviations

A-B	Arellano-Bond
ALMP	Active labor market policy
CEE	Central and Eastern European
CIS	Commonwealth of Independent States
EBRD	European Bank for Reconstruction and Development
EPL	Employment protection legislation index
EU	European Union
EU-15	EU pre-2004: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, and the United Kingdom
GDP	Gross domestic product
i.i.d.	Independent and identically distributed
ILO	International Labor Organization
LFS	Labor force survey
OLS	Ordinary least squares
NUTS	Nomenclature of Territorial Units for Statistics (Nomenclature des Units Territoriales Statistiques)



# I Overview

More than a decade after the start of transition, the unemployment rate remains in double digits in a number of Central and Eastern European (CEE) countries. After a period of gradual decline, unemployment has actually increased recently in several transition economies. In addition, in a number of these countries, long-term unemployment rates are high, and regional variations in unemployment large.

The failure of unemployment rates to decline significantly in many countries—including some with good growth performance—is something of a puzzle. At the outset of the transition there were expectations that quick, market-driven reallocation of resources would lead to a rapid decline in unemployment after an initial surge. However, this did not happen, even though labor market institutions in these countries are considered generally flexible and minimum wage and unemployment insurance levels modest. Understanding better this phenomenon may have consequences beyond the transition context, since many countries undergoing market-oriented reforms may need to struggle with initial increases in unemployment.

This Occasional Paper seeks to explain the persistence of high unemployment in transition economies. We focus, in particular, on three interrelated issues:

- How has the process of transition from largely centrally planned to market economies affected labor market performance?
- What part do labor market institutions and policies play in explaining developments over time and across countries? A large literature for industrial countries establishes that rigid labor market institutions correlate positively with unemployment. This paper seeks to fill a gap in the literature by analyzing the impact of institutions on unemployment in CEE countries.
- Why have regional unemployment differences persisted? The paper presents a framework for understanding why regional differences in unemployment have remained, limiting also aggregate declines in unemployment. This requires an understanding of the factors limiting both the movement of labor from high unemployment regions and the movement of capital and jobs to those regions.

Given the complexity of the issues involved and the severe data limitations, the paper takes an eclectic methodological approach to these issues. First, a new database has been compiled from a number of national and international sources on labor market developments and policies. This allows us both to track labor market developments across a number of transition countries and to compare labor market policies in a more systematic way than has to our knowledge been done before. Second, the database is utilized for an econometric analysis focusing on the impact of transition and labor market policies on unemployment and employment. Most econometric studies for transition countries have relied on a snapshot comparison of institutions and labor market performance at a point in time. By using panel data for 11 countries over 10 years, this study seeks to explain the labor market dynamics during transition as well as differences among countries. However, given the limitations of this database (Appendix I), our analysis is supplemented by several case studies of countries with good and poor labor market outcomes. Finally, to look at the issue of labor and capital mobility within countries—for which data are particularly limited—we examine the implications of simple analytical models.

Results suggest that both the transition process and labor market institutions and policies have affected unemployment. Among our key findings are the following:

- Faster-reforming countries have had better unemployment records, notwithstanding initial job losses. Those countries that have been able to move most quickly to an advanced stage of transition have generally proved best placed to experience job-creating growth.<sup>1</sup> This points to the need to complete the structural reform process and remove the remaining bottlenecks that have hindered faster reallocation of resources and decline in unemployment.
- Labor market policies have some, but not a dominant, influence over labor market outcomes. It

<sup>1</sup>However, for some countries, such as Poland, second rounds of restructuring or cyclical downturns have led to increases in unemployment in recent years.

appears that those countries with more flexible policies are better able to take advantage of positive macroeconomic shocks with higher employment and lower unemployment rates. It is plausible, moreover, that data problems have obscured stronger links between labor policies and outcomes.

- Policies not typically viewed as labor market policies can nevertheless have a major impact on labor market outcomes. For example, difficult business climates in some countries appear to have limited the ability for small and medium-sized enterprises to play their role as a key employment generator.
- Market processes cannot be relied on to eliminate regional differences in unemployment. In fact, agglomeration effects may reinforce initial differences in labor market performance. In addition, there are important constraints both on labor mobility to low-unemployment regions and on the movement of jobs to less prosperous areas. For example, housing policies can play a key role in limiting workers' mobility, while the failure to provide decent transportation infrastructure may limit the ability of high-unemployment regions to attract capital.