

## **Non-Technical Summary**

### **Labor Markets in Transition: Micro Evidence from the Czech Republic and Estonia GDN Research Competition Project GRCII+22**

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#### *Firm-Size Convergence as a Driving force of Reallocation in Early Transition*

"Transition" of the productive structure in the countries of Central and Eastern Europe (CEE) and the former Soviet Union was a process aimed at achieving efficiency through (1) restructuring of enterprises that were created during central planning (e.g., by privatization), and (2) reallocating capital and labor from these post-communist firms to new start-up private ones. While much research has analyzed the process of privatization and whether it has resulted in efficiency-inducing restructuring, relatively little work has focused on new start-up firms.

In the first paper of our project we analyze the growth of the new sector in two countries whose paths of transition have been very different: the Czech Republic and Estonia. Our earlier research demonstrated that the new sector was an impressive sole engine of job creation in both countries at the start of transition: In only three to five years more jobs were provided by de novo (start-up) firms than by the firms inherited (and potentially transformed) from communism. This massive new-sector growth occurred on different policy backgrounds. While early transition in Estonia was characterized by massive job destruction of the old firms in the absence of an effective social security net, Czech reallocation proceeded at a more gradual pace, involved relatively generous social support, and featured extensive voluntary moves from the old firms to the new sector.

We study the industrial structure of new-sector growth and old-sector decline and find that not only was the growth of the new sector somewhat similar in our two countries at the aggregate level, but the importance of start-up firms within industries was almost identical. We also find that start-ups grow in importance not only in expanding, but also in declining industries.

Why is it that new jobs were created not only in the niches left open by central planning (e.g. in services) but within all branches of the economy? And why is it that the

share of new jobs on industry employment is so similar across two different macroeconomic scenarios? It is a well-known fact that one of the main distortions of central planning was to do away with small firms. Given that almost all new job creation in early transition occurs in small firms, one natural interpretation of these reallocation patterns is that they are driven by convergence to "normal" industry-specific firm-size distribution.

While different open economies specialize in different industries given their comparative advantage, it is more natural to expect the firm-size distribution within an industry to be similar across countries. For example, Kumar et al. (1999) analyze European data on average firm size by country and industry, and find that 63% of variation in firm size is attributable to industry identity and only 2.5% to country identity. We confirm this finding by looking at the firm-size distribution over broad groups of industries from Austria in 1998 and East and West Germany in 1995. These distributions provide one possible benchmark against which one can measure transition reallocation.

Next, we study the industry firm-size distributions in the Czech Republic and Estonia at the start of transition and then again in mid-transition. The initial distortion towards large firms is clear, especially in manufacturing, construction, and services. It is also equally clear that there was a substantial shift toward western distributions and this shift roughly "explains" the growth of the share of the new-sector employment within each industry. Correlating the share of the new sector on an industry employment in the Czech Republic with the corresponding employment share of firms with less than 100 workers across our categorization of industries in 1996 results in a correlation of 0.93. This suggests that natural "evolutionary" forces are largely responsible for the growth of the new small firms in early transition.

### *Labour Market Flows and the Adjustment to Macroeconomic Shocks in the Baltic States*

While there has been much research on the labour markets of transition economies, including Estonia, the other two Baltic economies have been largely left out so far. In the second paper of our project we offer a comparison of worker flows in all three Baltic labour markets before and after the Russian crisis of 1998. Our evidence helps us to understand the micro impacts of macroeconomic shocks in the late-transition countries and sheds light on the labour market flexibility of the Baltic states. Our task is to find out how the Baltic labour

markets reacted to the Russian crisis, i.e., whether and how labour market flexibility helped to adjust the labour markets to the changing market conditions. We capture flexibility with the help of labour-market-state flow analysis.

We find that the Russian crisis had different effects on labour markets of the three Baltic states. In the Estonia, the unemployment pool became more stagnant and outflow from unemployment declined. In Latvia, the probability of staying in unemployment was relatively low, but at the same time inflow to inactivity increased significantly. This is an interesting and unexpected fact. One reason could be that, in Latvia, where unemployment had been substantially higher than in Estonia, “the discouraged worker effect” predominated, many people lost hope in seeking work and became inactive. Differences in participation rates, however, are not that large. The discouraged workers effect probably also predominated in Lithuania, although we have only one year data for analyzing this phenomenon.

We also calculated the probabilities for outflows from employment and inflows to employment. From the analyses of inflows to employment, we can see that in most of the cases people change their jobs (or keep their job) within industries. This could be evidence of the slowdown of labour reallocation between three main sectors. A look at the general structure of employment by three sectors verifies this view in the case of Estonia; however, it is hard to believe that reallocation is over in Lithuania where around 18% of employees are still working in agriculture.