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I Z A
World of Labor
Evidence-based policy making

New firms entry, labor reallocation, and institutions in transition economies

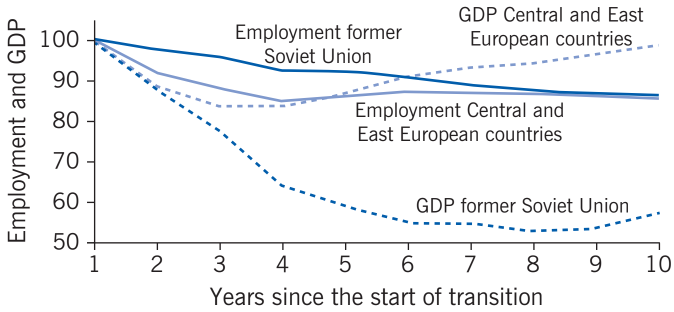
In transition economies, better property rights protection and rule of law enforcement can boost job creation and growth

Keywords: new firms entry, job reallocation, transition, institutions

ELEVATOR PITCH

In the transition from central planning to a market economy in the 1990s, governments focused on privatizing or closing state enterprises, reforming labor markets, compensating laid-off workers, and fostering job creation through new private firms. After privatization, the focus shifted to creating a level playing field in the product market by protecting property rights, enforcing the rule of law, and implementing transparent start-up regulations. A fair, competitive environment with transparent rules supports long-term economic growth and employment creation through the reallocation of jobs in favor of new private firms.

Employment and output adjustment reflect the quality of labor and product market institutions



Note: 100 represents the point at the first year of transition.
Source: [1].

KEY FINDINGS

Pros

- Entry of new firms boosts productivity growth in the transition from a command to a market economy.
- Reallocation of market share from non-productive incumbents to dynamic new private firms may reduce employment in the short term but increases welfare in the longer term.
- Sound labor market institutions enable job creation by new private firms and job destruction in state-owned enterprises.
- By spurring employment in the medium to long term, property rights protection and rule of law enforcement encourage the entrance and survival of more firms and the creation of more jobs.

Cons

- It takes years to formalize and consolidate property rights protection and rule of law.
- In a weak institutional environment, the entry of small firms, which create most new jobs, is impeded by incumbent firms acting in collusion with state and local governments.
- New firms' entry rates in transition economies are comparable to international standards, but survival rates are lower in weak institutional settings.
- Transition economies in the former Soviet Union trail others in labor market institutions, property rights protection, and rule of law enforcement, slowing long-term economic growth.

AUTHOR'S MAIN MESSAGE

In the initial stage of transition, countries adopted labor market policies to tackle the soaring unemployment that accompanied the reallocation of workers and transfer of property rights from the state to the private sector. In the second phase, countries needed to focus on strengthening competition and property rights to enable long-term economic and employment growth. Product market institutions such as fair entry regulations and sound competition laws allow new firms to enter and then to expand. Central and Eastern European economies have scored much better than the economies of the former Soviet Union in shaping both types of institutions.

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