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Ukraine
Ukraine Jobs Study

Fostering Productivity and Job Creation

(In Two Volumes) Volume I: Overview

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ABBREVIATIONS AND ACRONYMS

ALMP	Active Labor Market Programs
BEEPS	EBRD-World Bank Business Environment and Enterprise Performance Surveys
CEE	Central and Eastern Europe
CIS	Commonwealth of Independent States
CPI	Consumer Price Index
EBRD	European Bank for Reconstruction and Development
EPL	Employment Protection Legislation
EU	European Union
EU-8	New EU member states: Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic, and Slovenia
FDI	Foreign Direct Investments
FSU	Former Soviet Union
GDP	Gross Domestic Product
ILO	International Labor Organization
IMF	International Monetary Fund
LFPR	Labor Force Participation Rate
LFS	Labor Force Survey
OECD	Organization for Economic Cooperation and Development
PPP	Purchasing Power Parity
SME	Small and Medium Enterprises
SOE	State-Owned Enterprises
ULMS	Ukrainian Longitudinal Monitoring Survey

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PREFACE

The Ukraine Jobs Study was undertaken following the "Orange Revolution" of 2005. Among the main economic objectives of the new Government are the acceleration of structural reforms, improvement of the investment climate, and the creation of new jobs. The main purpose of the study is to assist Ukrainian policymakers in their efforts to create more and better jobs. It also aims at informing the key stakeholders and wider public on policy reforms necessary to improve the workings of the labor market in Ukraine. The study primarily relies on statistical analysis of recent labor market developments in Ukraine using the Ukrainian Longitudinal Monitoring Survey. It also draws on extensive consultations and discussions with government officials, trade unions, employers' representatives and the research community.

The study builds on earlier work conducted by the World Bank on labor markets in Ukraine, including a *Risk and Vulnerability Study* (World Bank, 2003), a *Country Economic Memorandum* (World Bank, 2004), and the recent *Poverty Assessment* (World Bank, 2005).

This report was prepared by Jan Rutkowski (Task Team Leader, ECSHD) with the assistance of Christian Bodewig (ECSHD). It draws on a commissioned background paper by Hartmut Lehmann, Olga Kupets, and Norberto Pignatti. Imelda Mueller edited the report.

The report comes in two volumes. This volume (Volume I) provides an overview of the study and summarizes its conclusions. Volume II provides more technical and detailed analysis of various aspects of labor market transition in Ukraine. Volume II is available upon request from the Task Team Leader (jrutkowski@worldbank.org).

An earlier version of this report was presented at a World Bank Seminar held in Kyiv on November 2, 2005. The study benefited from discussion following its presentation, and in particular from comments provided by Natailia I. Ivanovna (Deputy Minister of Labor and Social Policy), Grigoriy V. Osoviy (Deputy Chairman, Federation of Trade Unions of Ukraine), Vadym Pischeyko (Department Head, Ministry of Economy and European Integration), and Natalia S. Vlasenko (Deputy Head, State Committee for Statistics).

The team is grateful for the support and guidance of Paul Bermingham, Country Director (ECCU2) and Arup Banerji, Human Development Economics Sector Manager (ECSHD). The team benefited from comments of peer reviewers Wendy Cunningham (LCSHS) and Philip O'Keefe (SASHD). Useful suggestions were provided by Gordon Betcherman, Gerardo Corrochano, Mark Davis, Arvo Kuddo, Zafiris Tzannatos and Dusan Vujovic. The team would also like to thank the Ministry of Economy and European Integration, the Ministry of Labor and Social Policy, and the State Committee for Statistics for their collaboration.

EXECUTIVE SUMMARY

The objective of this study is to assist policymakers in Ukraine in their efforts to create more and better jobs in Ukraine by (i) providing an assessment of labor market performance in Ukraine; (ii) identifying key constraints to job creation; and (iii) suggesting policies that will foster job creation and productivity. The study finds that, despite relatively low unemployment, labor market in Ukraine is depressed and productive job opportunities are scarce. Moreover, unemployment is likely to increase once enterprise restructuring accelerates. The primary cause of poor labor market outcomes in Ukraine is the small size of the "new" private sector, consisting of *de novo* private, usually small firms. This, in turn, is due to the poor investment climate brought about by high risks, costs and barriers associated with dong business in Ukraine. Accordingly, the key to improving labor market outcomes is to remove main impediments to entry of and growth by firms, such as policy uncertainty, corruption, red tape, inefficient regulations and poor access to finance. In the longer term, labor market institutions need to be reformed to create an adaptable labor market and thus support job creation and productivity growth.

I. DOES THE LABOR MARKET IN UKRAINE PERFORM WELL?

The labor market in Ukraine is at a relatively early stage of the transition. Most labor is still employed in the public sector, which implies that the major wave of job and labor reallocation, with an attendant increase in unemployment, lies in the future. At the same time, despite low open unemployment the labor market is depressed and productive job opportunities are few. Labor force participation is low due to the " discouraged worker effect": workers cease looking for work as they no longer believe that jobs are available. Labor market dynamics is limited, as evidenced by low labor and job flows. However, job and labor reallocation needs to be intensified in order to improve economic efficiency, support productivity and, consequently, wage growth. In addition, the wage structure needs to become more flexible to better align wages with productivity differentials and thus support the process of reallocation of labor resources toward their most productive uses. The room to improve the utilization of labor resources is considerable.

Labor is underutilized in Ukraine despite relatively low unemployment. The unemployment rate, at about 8 percent, is relatively low by the standards of transition economics. But the unemployment rate does not tell the whole story. The scarcity of job opportunities in Ukraine manifests itself largely in the low labor force participation rate. Many workers have become discouraged by the futility of their job search and have withdrawn from the labor force. Only about 60 percent of the working age population are either employed or looking for a job. As a result the employment-to-population ratio, which is the most comprehensive indicator of the degree of utilization of labor resources, is low in Ukraine. Less than 60 percent of the working age population is employed, which is both below the OECD average of 65 percent and less than in most successful transition economies.

Low open unemployment may indicate delayed and slow enterprise restructuring. The public sector is still large in Ukraine and many state-owned enterprises (SOEs) are overstaffed, which leads to low labor productivity. Overstaffing is unsustainable in a competitive environment. Once the SOEs become exposed to domestic and international competition, they are forced to shed redundant labor in order to be competitive. This will result, at least temporarily, in an increase in unemployment. Such an increase in unemployment in the wake of accelerated enterprise restructuring is experienced by virtually all transition economies.

Until recently, employment was stagnant despite high rates of economic growth. This phenomenon, known as "jobless growth", is quite common among transition economies and is not specific to Ukraine. One explanation for this phenomenon is so called "defensive restructuring" by

enterprises. This means that many Ukrainian firms improve productivity largely by shedding redundant labor. Productivity gains are then translated into higher wages rather than higher employment. Defensive restructuring is partly the consequence of labor hoarding inherited from the system of central planning. But it also means that firms will find it costly to hire additional labor.

A recent upsurge in job growth is due mainly to the expansion of the informal sector. After the period of jobless growth, employment started to increase in 2002. However, most new jobs – nearly 60 percent – have been created in the informal sector. The hiring rate in the informal sector is roughly five times higher than in the formal sector, while the separation rate in the informal sector is only twice as high as in the formal sector. The growth in the informal sector is a typical response to onerous regulations and high taxation and is indicative of an inhospitable business environment.

The growth in informal sector employment has both positive and negative aspects. On one hand, the informal sector provides jobs and is a source of income, helping many workers to escape poverty. For example, one-third of the jobless escape unemployment by finding jobs in the informal sector. On the other hand, workers employed in the informal sector enjoy little employment security and are deprived of benefits (e.g. pensions) financed by payroll taxes. An immediate cost to the society is the narrowing of the tax base, which leads to higher tax rates paid by formal sector firms, fuelling informality and distorting competition. Moreover, informal sector firms tend to remain sub-optimally small, which results in distorted and insufficient economic growth.

Informal sector offers better earning opportunities. Workers in the informal sector enjoy a wage premium of 10 to 15 percent compared with similar workers in the formal sector. This implies that workers are not only pushed into the informal sector by lack of job opportunities but also pulled into it by better earning prospects. However, it is uncertain whether these higher earnings compensate for the absence of various employment related benefits, which are offered by the formal sector.

Informal sector employment tends to be of low productivity. Young, poorly educated and unskilled blue-collar workers are disproportionately represented among the informal sector workers. For example, unskilled workers account for one-third of informal sector employment compared with less than one-fifth of formal sector employment. In addition, informal jobs are concentrated in industries where productivity is relatively low (trade, agriculture, construction). Majority (close to 80 percent) of the informal sector workers are either self employed, or employed in micro firms.

The unemployed have few opportunities of finding jobs, which results in long periods of unemployment and a high incidence of long-term unemployment. One unemployed worker in two is jobless for longer than one year. By way of comparison, in the United States which epitomizes a dynamic labor market, the incidence of long term unemployment is less than 10 percent. A high incidence of long-term unemployment in Ukraine is thus a symptom of a stagnant labor market. It is also socially costly, as long term unemployment leads to an erosion of skills and a fall in morale which further reduces employment opportunities.

Enterprise restructuring has led to a more efficient use of labor in Ukraine. The type of jobs that are being created are more productive than those that are being destroyed. Labor is thus moving to more productive uses, which improves allocative efficiency and gives rise to earnings gains.

But job reallocation proceeds at a relatively slow pace in Ukraine. Both the job creation rate and the job destruction rate seem to be lower in Ukraine than in the dynamic transition economies, such as Lithuania or Poland. This implies that there is still substantial room for improvement in allocative efficiency in Ukraine; that is, for labor moving to its most productive uses.

Jobs have moved from industry to services, and the services sector has become a major source of employment. Deindustrialization is typical of virtually all transition economies, as industry was overdeveloped under central planning while services were underdeveloped. The employment structure dominated by services, which has evolved in Ukraine during the transition, is characteristic of developing countries with GDP per capita similar to that of Ukraine. However, widespread informality in the services sector means that the challenge to develop a truly modern, productive services sector in Ukraine still lies in the future.

Wage flexibility is limited which might inhibit labor market adjustment. Wages still are determined in a rather centralized way, especially in public and privatized firms. Trade unions play an important role in wage determination and contribute to wage pressures. It is important to note that wage adjustment is critical for attaining labor market equilibrium; however, resulting wage rigidities might contribute to labor market imbalances, particularly to unemployment. Factors pointing to limited wage flexibility include significant wage growth despite unemployment, relatively high minimum wage and modest returns to education.

Wages grew in excess of productivity in recent years, raising unit labor cost. Real wages have grown at an impressive rate of 19 percent per year since 2000, faster than GDP per worker (which is a proxy for productivity). Such a fast growth in real wages reflects insider power in wage determination. However, the resulting increase in unit labor cost dampened labor demand and was one source of jobless growth. Thus, the increase in labor demand associated with output growth benefited the employed insiders rather than the unemployed outsiders.

Relatively high minimum wage may have negative employment effects but lax enforcement limits its "bite". The statutory minimum wage hovers around 40 percent of the average wage in Ukraine. This is high by standards of Central and Eastern Europe (CEE) economies, where in most countries the minimum wage is less than 35 percent of the average wage.[1] Evidence presented in this report shows that a significant fraction of workers earn less than the minimum wage, suggesting that the minimum wage regulation is not enforced. If enforced, however, the minimum wage could have a substantial detrimental effect on unskilled worker employment. Many workers who currently earn less than the minimum wage would lose their jobs because employers would not want to keep workers whose productivity is lower than the wage they are to be paid.

Returns to education have been low in Ukraine. Only very recently (in 2004), wage premia to education increased to levels close to that in other transition economies of CEE. This much delayed increase in returns to education in Ukraine indicates that either the wage structure has adjusted slowly to the changes in demand for skills, or the increase in demand for high skills has been more limited in Ukraine than in other transition economies. The latter reason would be consistent with the slower opening of the Ukrainian economy and a slower pace of technological progress (which is biased towards skilled labor). The modest returns to education are yet another sign that the Ukrainian labor market is at a relatively early stage of transition.

Wage distribution has decompressed during the transition in Ukraine, as it has in other transition economies. However, the actual degree of wage inequality is unclear; estimates range from moderate to high, depending on the data source.[2] It is also not clear whether the increase in wage

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[1] The minimum wage in Ukraine is high in *relative* terms, not in *absolute* terms. While the absolute value of the minimum wage determines workers' consumption level, the relative value (in relation to the average wage) determines its labor market effects: the impact on employment and the wage distribution.

[2] It should be noted that *wage* inequality is only one factor affecting *income* inequality. An important factor contributing to income inequality is non-wage income, e.g. income from entrepreneurial activity.

dispersion is associated with greater economic efficiency. For this to be the case, wage differentials would need to reflect productivity differentials among workers. But this is not necessarily the case. Wage differentials may well reflect various rents (e.g. monopoly rent) which proliferate in a non-competitive environment. Available evidence suggests that such rents indeed do exist in the Ukrainian economy and are partly captured by workers, especially in the unionized sector. But further research is necessary to determine the efficiency of the wage structure in Ukraine.

Trade unions play an important role in shaping industrial relations in Ukraine. The unionization rate is high and so is the union bargaining coverage. At the same time, employers representing the new private sector are only beginning to organize themselves and articulate their interests. In the *formal* sector the unionization rate reaches 70 percent and the union bargaining coverage is still higher at close to 90 percent. These rates are very high by the standards of other transition economies and those of OECD (where on average union density is 20 percent, and bargaining coverage is 35 percent). In virtually all CEE countries, the unionization and bargaining coverage rates have declined sharply along with the growth of the private sector and a move toward decentralized bargaining structures (i.e. from industry to firm level bargaining). The weakness of the employers' representation is reflected in the fact that a majority of industry level collective agreements are signed *not* with the representatives of private business, but instead with line ministries which represent the State as the main employer.

High union density and bargaining coverage reflect a slow development of the new private sector. Expectedly, the trade union stronghold is large in public as well as privatized enterprises. For example, the union density rate is some 80 percent in the public sector and less than 10 percent in the new private sector.

II. WHAT ARE THE KEY CONSTRAINTS TO JOB CREATION IN UKRAINE?

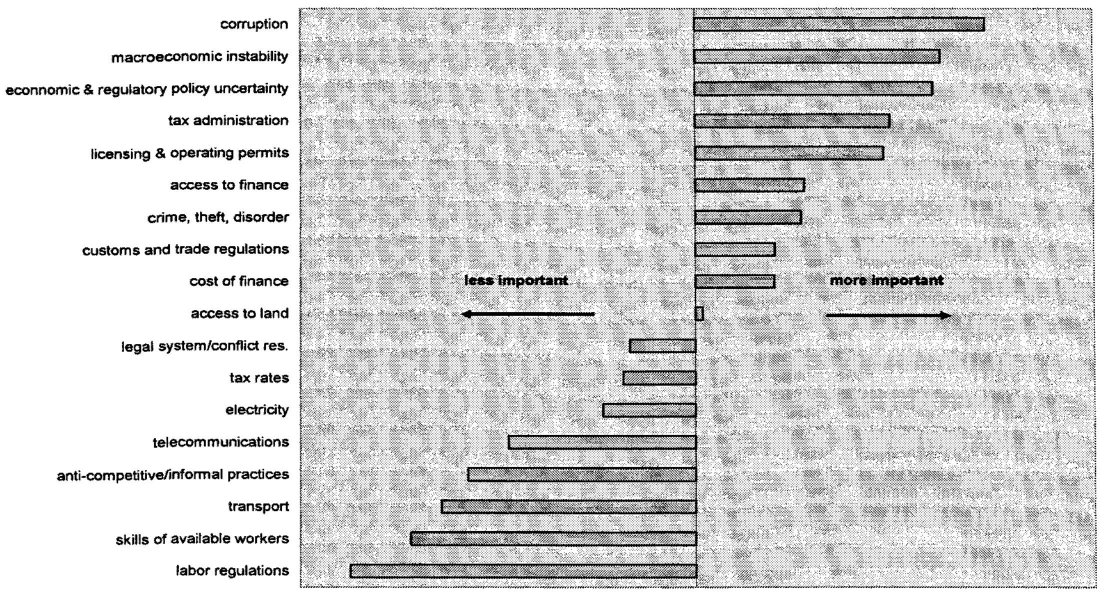
The primary cause of poor labor market outcomes in Ukraine is unfinished structural reforms and an inhospitable investment climate. Policy uncertainty, corruption, bureaucratic harassment, red tape and inefficient regulations inhibit entry of and growth by firms. As a result, the size of the new private sector is small, which in turn limits job creation. Labor market institutions are rigid and ill-suited to the needs of an economy which needs to restructure and grow. However, lax enforcement provides for de facto labor market flexibility. Firms do not comply with labor regulations and often hire labor informally. Thus, labor market institutions do not seem to be a significant barrier to job creation because regulations are evaded.

The major labor market problem in Ukraine is the low employment level, which reflects the scarcity of jobs. Why are there too few jobs in Ukraine? In Ukraine, as in all other transition economies, jobs are created mainly by the private, usually small, firms. However, the size of this job-generating sector in Ukraine is significantly smaller (less than 30 percent of total employment) than in the most successful transition economies. The high costs of doing business in Ukraine deter entry of new firms and growth and profitability of existing ones. Hence, there are too few jobs because there are too few firms. Evidence indicates that the investment climate in Ukraine has indeed been poor, significantly worse than in most CEE countries, and is considered the ultimate cause of the slow pace of job creation.

Poor governance, uncertainty, administrative barriers and poor access to finance are the areas where the Ukrainian economy performs particularly poorly. Figure 1 uses entrepreneurs' perceptions as basis for identifying major obstacles to business operation. It highlights those obstacles which are more severe in Ukraine than in EU-8 countries. The figure makes it clear that Ukraine faces a formidable challenge to reduce corruption, lessen regulatory and economic policy uncertainty, and to remove administrative barriers that constrain business activity. Poor access to finance also limits investment and job creation.

High tax rates are viewed as one of the most important constraints. Some 40 percent of entrepreneurs in Ukraine see high tax rates as a major obstacle to the operation and growth of their firms.[3] In particular, payroll taxes are blamed for raising the labor cost and limiting hiring. However, these results need to be put into perspective. There is no doubt that taxes on business limit economic activity, and taxes on labor are likely to discourage hiring. At the same time, taxes pay for important public services and social benefits and, as such, are part of all modern economic systems. In fact, taxes are seen as less of a constraint in Ukraine than in other CEE countries (Figure I). It must also be noted that payroll taxes are lower in Ukraine than in most CEE countries. Thus, taxes do add to labor costs in Ukraine, but not as much as they do in other countries. The problem is thus not taxes per se, but inefficiencies in the public, including social, expenditure system).

Figure I: Corruption, uncertainty, administrative barriers and poor access to finance are seen by employers as major obstacles to firm operation and growth



Note: the chart shows deviations from the EU-8 and factor average scores.
Source: EBRD-World Bank Business Environment and Enterprise Performance Survey, 2002.

Labor regulations are not seen by entrepreneurs as a major constraint. In fact, as Figure I shows, they are viewed as the least significant obstacle to firms' operation and growth, considerably less important than in other CEE countries.

But on paper, employment protection legislation is extremely stringent in Ukraine. According to the *World Bank Doing Business* indicators, employment protection legislation in Ukraine is significantly stricter than in other CEE countries and much stricter than in most OECD countries. Employment relations are overregulated and firing costs are extremely high.

[3] High tax rates rank as the third most significant obstacle to firm operation and growth in Ukraine (after macroeconomic instability and regulatory and policy uncertainty). However, taxes are perceived as less of an obstacle in Ukraine than in most EU-8 countries, and that is why they are show as less important in Figure I, which shows *relative,* rather than *absolute,* importance of various obstacles.

The draft labor code relaxes some of the constraints on labor adjustment but still over-regulates employment relations. The draft labor code (as of Spring 2005) bears the legacy of communist labor relations. It provides detailed regulations of almost every possible aspect of industrial relations and provides for high procedural costs of labor adjustment. For example, employers would need to notify the relevant trade union of a planned lay-off at least three months prior to its occurrence, discuss with the union possible preventive measures, and carry out the lay-off only in accordance with the trade union's opinion. At the same time the use of fixed-term contracts, which can facilitate labor adjustment, is strictly limited. As such, the draft labor code does not provide regulatory foundations for an adaptable labor market. One additional shortcoming of overregulated labor relations is that they impede the development of social dialogue and collective bargaining. If all aspects of labor relations are already regulated by the labor code and the statutory minima are set at a high level, then there is little scope for direct bargaining between employers and trade unions.

The discrepancy between employers' perceptions and objective indicators of the strictness of employment protection legislation is explained by lax enforcement of labor regulation. **But labor market flexibility through non enforcement is not an optimal outcome.** It undermines the rule of law, exposes firms to costly uncertainty (circumventing regulations involves costs, especially if enforcement is discretionary and selective) and leaves workers without adequate protection. Unduly strict employment protection legislation, even if only weakly enforced, is not conducive to fast and large scale reallocation of labor, which is necessary for successful transition and productivity growth.

Unemployment benefit system was not found to be a factor behind unemployment in Ukraine. There is no evidence that the receipt of unemployment benefit negatively affects job search duration. This is due to the modest generosity of the system: only 40 percent of the unemployed receive benefits and the replacement rate (26 percent of the average wage) is relatively low.

Skill mismatch does not seem to contribute significantly to unemployment in Ukraine. One reason is that there is still considerable demand for low-skilled labor. This is in sharp contrast to other transition economies of CEE where market oriented reforms brought about a marked fall in demand for less skilled manual labor. This is yet another indication that the labor market in Ukraine is at a relatively early stage of transition. Most likely, Ukraine will experience a similar evolution of labor demand away from less skilled manual labor as did other transition economies, which will result in an increase in unemployment among this worker group.

III. HOW TO CREATE MORE AND BETTER JOBS IN UKRAINE?

In order to create more and better jobs, Ukraine needs to pursue a two pronged strategy. First and foremost, it needs to improve the investment climate and lower the cost of doing business to encourage entry of and growth by firms. There is a need to provide adequate incentives for firms to be established and grow, in order to expand for job creation as well as accelerate absorption of workers displaced by structural changes. "Encouragement" policies such as these are particularly important given that the size of the "new" job generating sector is still small in Ukraine. Second, it needs to reform its labor market institutions to create an adaptable labor market, that is, a market where employers have incentives to hire workers, and workers have incentives and skills to take-up available jobs.

While improving the investment climate is the immediate priority, in the mid-term labor market reforms are necessary to lay an institutional foundation for the competitiveness of Ukrainian firms and for job creation. Strict but loosely enforced labor regulations should be replaced by regulations that are more flexible but effectively enforced, so as to protect core worker rights. At the same time, a greater role in setting standards of employment protection should be given to direct bargaining between genuine representation of business and workers.

Labor market reforms should constitute a package consisting of three major elements: (a) the liberalization of employment relations, (b) the development of direct bargaining between employers and workers, and (c) effective enforcement of core worker rights. In particular the following options should be considered:

- *Liberalizing employment protection legislation.* The labor code should regulate a narrower area of employment relations and the regulations should provide for minimum statutory standards of employment protection so as to create room for direct bargaining between social partners. In particular, the *procedural* costs of dismissals should be reduced to facilitate employment adjustment. Provisions governing flexible employment contracts (e.g. fixed term contracts) should be liberalized so as to lower labor adjustment cost and encourage hiring. Working time flexibility should be enhanced by liberalizing rules governing overtime work, and permitting the redistribution of the working hours limit over a longer period of time to facilitate adjustment to seasonal demand fluctuations.
- *Developing efficient bargaining structures.* The collective bargaining system in Ukraine needs to develop so as to meet the criteria for efficiency. Particularly, the interests of employers need to be better balanced with those of employees. Collective agreements concluded with the state acting as an employer will need to be renegotiated to be applied to the private sector. Moreover, the efficiency of industry level bargaining needs to be reassessed. Industry level bargaining can be inefficient since the agreements take into account neither firm specific conditions, nor economy-wide effects of wage increases. Thus, such agreements should be binding only for enterprises which signed the agreement (through their representatives) and should not be extended to firms not represented at the bargaining process. In addition, industry level agreements should include opt-out options for firms which cannot afford to comply (particularly small firms in difficult financial position). An alternative is to strengthen firm level bargaining (which tends to be more efficient) relative to industry level bargaining (which tends to yield inefficient outcomes). Firm level bargaining takes into account firm specific conditions as well as the effects of the agreement on the firm's competitiveness. However, a move toward firm level bargaining assumes that worker interests are adequately represented at the firm level.
- *Improving the enforcement capacity of labor inspections.* While the employment protection legislation should be significantly liberalized and employment relations should be deregulated, the core worker rights should be effectively protected. Firms need to comply with labor regulations to respect the rule of law, and to provide workers with socially acceptable and economically efficient degree of employment protection. But rather than increasing the already high burden of inspections on firms, or increasing the penalties, new modes of inspection services, such as self-reporting or contracting-out, should be tested.
- *Reviewing the minimum wage policy so as to take into account labor market conditions and unemployment among affected workers.* Currently, the minimum wage is high *relative* to the average wage, but not enforced.[4] Enforcement, however, could cause job loss among less productive workers (youth, unskilled workers). Therefore, the government can consider setting minimum wage at a lower proportion of the average wage (e.g. one-third of the average wage) to limit its potential dis-employment effect. This can be coupled with setting a separate minimum base for social insurance contribution to protect social budget revenues. Alternatively, a youth sub-minimum (e.g. 80 percent of the regular minimum) could be instituted to protect employment

[4] This assessment is based on the assumption that official estimates of the average are correct. If however, as sometimes asserted, wages are significantly underreported then the minimum wage to average wage ratio is overestimated and accordingly the "bite" of the minimum wage is less. Therefore it is important that the minimum wage policy is based on reliable data on the wage distribution.

among the most vulnerable group. In addition, social benefits should be delinked from the minimum wage to render the minimum wage policy independent of other social policies.

- *Reducing payroll taxes.* This involves broadening the tax base through providing incentives for firms to move to the formal sector, and improving the cost-effectiveness of social expenditures which are financed by payroll-taxes (mainly pensions). This is a gradual process closely associated with reforming the social insurance system.
- *Putting in place the system of monitoring and evaluation of active labor market programs (ALMP).* ALMP can be a useful tool for improving employment chances of disadvantaged worker groups. However, they do not increase overall employment. Evidence shows that their *net* impact is limited. At the same time, they are costly. Therefore, it is important to improve the cost-effectiveness and targeting efficiency of the programs. To this end, net impact and cost per placement need to be determined for various client groups and under different labor market conditions so as to target programs at groups that benefit most from a given intervention.

FOSTERING PRODUCTIVITY AND JOB CREATION

This report provides an overview of the Ukraine Jobs Study and the summary of its main conclusions. Its purpose is to help policy makers and other stakeholders understand the functioning of the Ukrainian labor market, and to set the agenda for labor market reforms. The report focuses on three issues. First, it analyzes labor market structure and dynamics in Ukraine. Second, it examines factors that impede job creation and reduction in unemployment. Finally, it identifies key policy priorities and sets directions for reforms. The report claims that the Ukrainian labor market is at a relatively early stage of transition and the major restructuring effort still lies ahead. The size of the new sector, consisting of de novo *private firms, is relatively small, effectively limiting job creation and contributing to low labor market dynamics. Job creation is concentrated in the growing informal sector, while employment in the formal sector is low and stagnant despite fast economic growth. This points to the poor investment climate as a main factor constraining entry of and growth by firms and thus job creation. In fact, employers see poor governance, high uncertainty and numerous administrative barriers as major obstacles to operation and growth of their firms. Labor regulations are strict but not enforced. This limits their "bite". However, labor market flexibility through non-enforcement is not an optimal outcome. The report recommends that in order to improve labor market outcomes, the government should adopt a two-pronged strategy. First and foremost, it needs to improve the investment climate so as to encourage formal sector firm creation and growth. Second, it needs to liberalize the labor market which should be accompanied by better enforcement of core worker rights and with greater role being assigned to direct bargaining between employers and trade unions.*

The Ukrainian economy grows at a high rate and unemployment is relatively low. At the same time productive job opportunities are scarce, especially in the formal sector. Many workers have a hard time finding a job, and many become discouraged and withdraw from the labor force. Low unemployment masks a depressed labor market.

This report provides an assessment of labor market performance in Ukraine from an efficiency viewpoint.[5] First, it analyzes labor market structure to see how advanced labor market transition in Ukraine is. Second, it examines determinants of labor market performance to identify factors inhibiting job creation and productivity growth. Finally, it discusses policy options to improve labor market performance.

The report finds that the Ukrainian labor market is at a relatively early stage of transition and that the major restructuring effort is still ahead (see Box 1).[6] The size of the "new" sector, consisting of *de novo* private, usually small, firms is relatively small, substantially less than in more advanced transition economies of CEE. The economy is still dominated by the public sector with non-competitive wage setting. One surprising result is that labor demand is skewed toward less-skilled manual labor, which is in sharp contrast to other transition economies and indicates an early stage of enterprise restructuring. Labor market institutions are rigid and bear the legacy of communist labor relations. However, labor regulations are not enforced and thus have little "bite". The main constraint to job creation is unfavorable investment climate (in particular poor governance and numerous administrative barriers) which limits entry and growth of firms. For example, 20 percent of firms in Ukraine complain about custom and trade regulations, or about licensing and operating permits. In the Baltic states only 10 percent see these as major obstacles. Accordingly, the major means of fostering job creation is to lower the cost of doing

[5] The recent Poverty Assessment looks at labor market policies and outcomes in Ukraine from a point of view of equity, i.e. examines their impact on income distribution and poverty (World Bank, 2005).

[6] This assessment refers to the evolution of labor market outcomes not that of labor market policies and institutions. In particular, the criterion for delimiting the stages of labor market transition is the size of the old, unrestructured sector, where many jobs are of low productivity and not viable in a competitive environment.

business in Ukraine. At the same time, Ukraine should reform its labor market institutions to support an adaptable labor market. The three main components of the labor market reform package are: (a) liberalization and deregulation of employment relations, (b) better enforcement of key worker rights, and (c) the development of decentralized bargaining structures.

This Volume – main report – provides an overview of the report and summarizes its main conclusions. Volume II contains technical chapters. Chapter 1 presents major trends and patterns of labor market transition in Ukraine. Chapter 2 focuses on labor flows, and Chapter 3 looks at job reallocation. Chapter 4 considers the fate of displaced workers, and Chapter 5 analyses wage determination. Finally, Chapter 6 examines investment climate conditions and labor market institutions and policies in Ukraine.

Box 1. The Stages of Labor Market Transition

This box presents a simple model of labor market transition. The model distinguishes between four stages of labor market transition:

First (initial) stage: the dominance of job destruction. The old sector (consisting of state owned enterprises) is large, the new sector (consisting of de novo private firms) is small; job creation (largely in the new sector) falls short of job destruction (largely in the old sector), employment falls and unemployment raises.

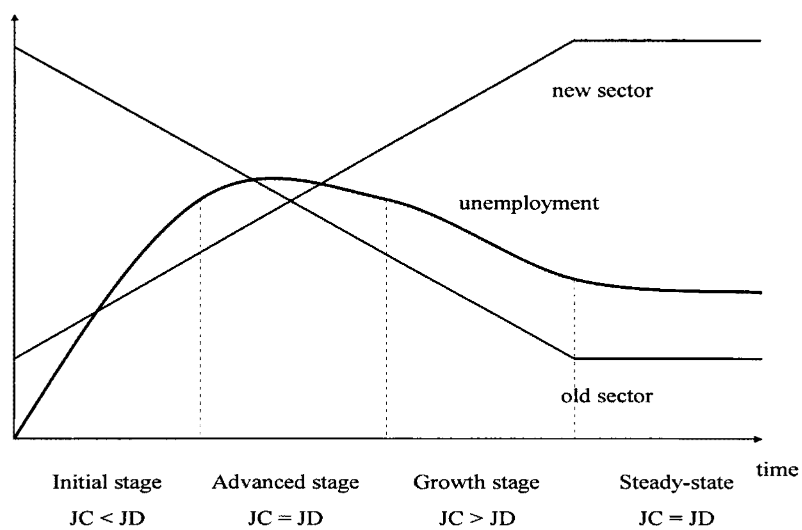
Second (advanced) stage: balanced (synchronized) job flows. The old sector become relatively small and the new sector become relatively large, the rate of job creation catches up with the rate of job destruction, employment stabilizes, but accumulated non-employment does not fall.

Third (growth) stage: the dominance of job creation. The new sector accounts for most of the economy, job creation exceeds job destruction, employment grows and non-employment falls.

Fourth (stability) stage: the steady state. The rate of job creation on average equals that of job destruction. Employment and unemployment cyclically oscillate around the steady state (equilibrium) level.

The model posits that the evolution of employment outcomes during the transition is hump-shaped. For example, low unemployment may indicate either the "initial" stage when enterprise restructuring is at an early phase, or the "growth" stage when the new sector creates jobs on a net basis and absorbs labor released from the old sector. The path of labor market transition is schematically depicted in Figure A.

Figure A: The path of labor market transition

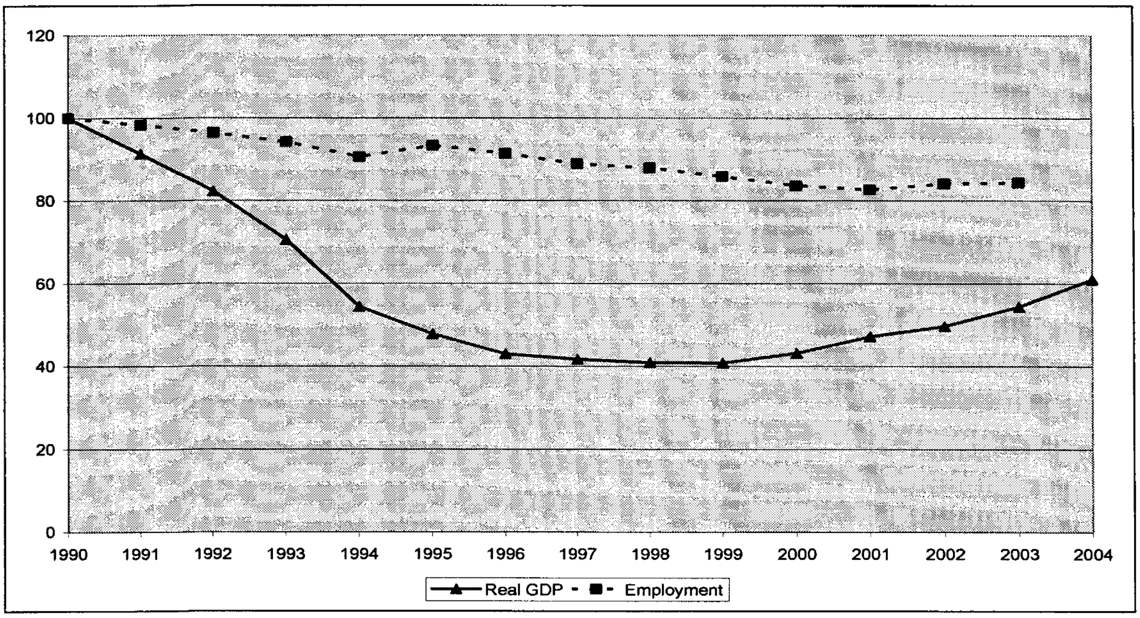


Note: JC stands for the job creation rate, and JD for the job destruction rate. The "unemployment" category covers unemployed and discouraged workers.

I. OPEN UNEMPLOYMENT IS LOW BUT LABOR IS UNDERUTILIZED[7]

The Ukrainian economy has been growing since 2000 at a very high rate of over 8 percent per year. **However, despite substantial output growth, employment growth until recently was negligible** (Figure 1). Such jobless growth is not specific to Ukraine. In fact, it has been experienced by most of the transition economies of CEE. Low elasticity of employment with respect to output is explained by the so called "defensive restructuring" by enterprises. As with other firms in the region, Ukrainian firms improve productivity by eliminating overstaffing and firing redundant labor. They can also easily increase output by improving the utilization of existing factors of production, that is, without firing new workers. The productivity gains are then translated into higher wages (Figure 2). In fact in the recent period a one percent growth in value-added per worker has led to roughly a one percent growth in real wages and to virtually no growth in employment. Thus, enterprise restructuring has benefited the "insiders" (i.e. workers who keep their jobs), at the cost of the "outsiders" (i.e., workers looking for a job). Apparently, few firms have been engaged in "strategic restructuring" where firms use productivity gains to increase production and, consequently, employment.

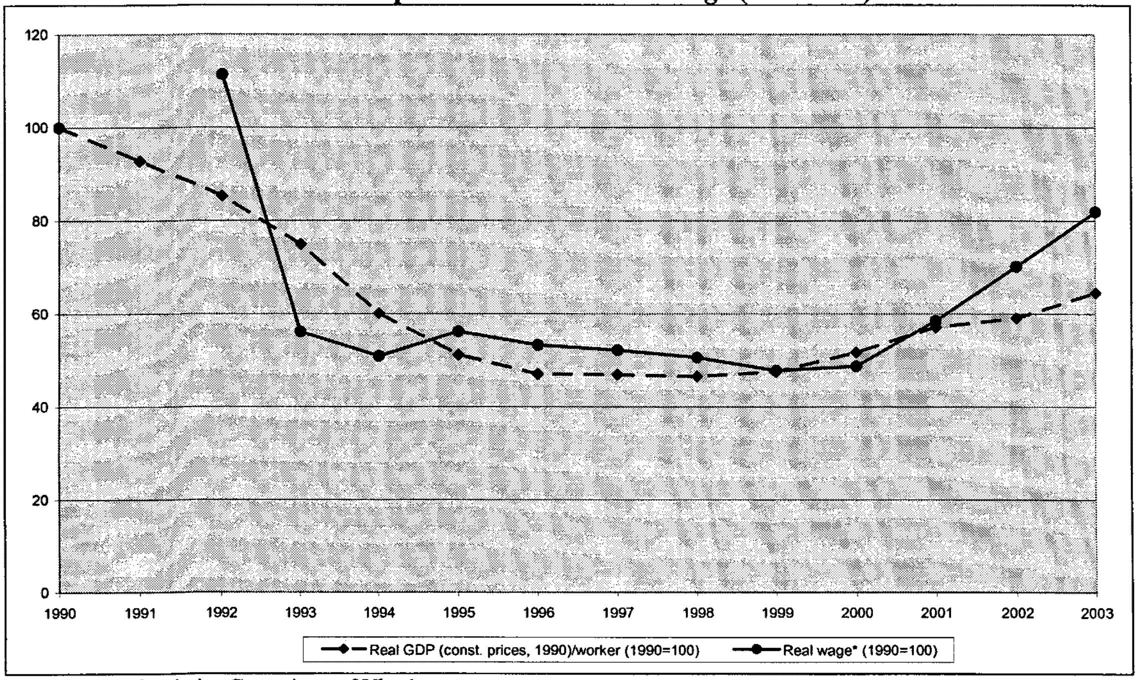
Figure 1: Employment is stagnant despite strong GDP growth
Real GDP, Employment (1990=100)



Source: State Statistics Committee of Ukraine.

[7] The empirical analysis presented in this section of the report draws on Lehmann and others (2005).

Figure 2: Productivity improvements lead to higher wages
Real GDP per Worker and Real Wage (1990=100)

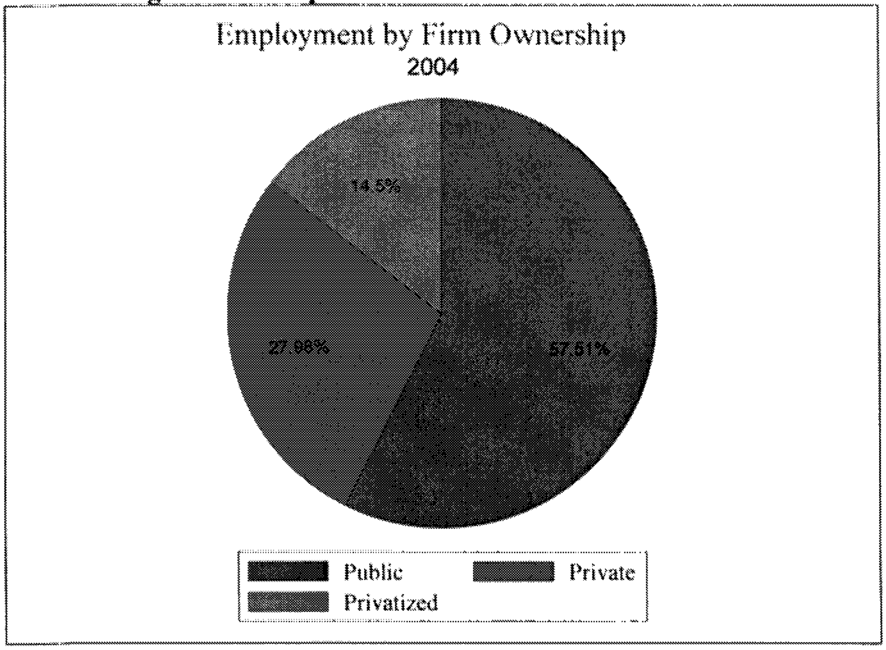


Source: State Statistics Committee of Ukraine.

One reason for the predominance of defensive restructuring by firms is the structure of Ukrainian economy, which is still dominated by large state-owned or privatized enterprises. The size of the "new" sector of the economy, consisting of *de novo* private, usually small, enterprises is relatively small, substantially less than in more advanced transition economies (Figure 3). In Ukraine, the public sector still represents close to 60 percent of total employment. *De novo* private firms account for less than 30 percent of employment (the rest is accounted for by privatized firms). [8] By way of comparison, in Poland, the public sector's share of total employment is only 30 percent. The experience of other transition economies shows that the economy's job creation potential is positively correlated with the size of the new sector: the larger the new sector, the higher the job creation rate. Thus, slow employment growth in Ukraine is in part due to the small size of the new sector.

[8] According to the official Derzhkomstat data, the private sector represented 47 percent of total employment in 2004. However, the private sector includes privatized firms, whose market behavior is often similar to that of state owned firms, and different from that of genuinely (de novo) private firms. For example the job creation rate in genuinely private firms is substantially higher than in the privatized firms (see below). For this reason this study focuses on the "new" private sector.

Figure 3: New private sector is still small in Ukraine



Source: Ukrainian Longitudinal Monitoring Survey, 2004

Although labor productivity has been growing, it is still low by regional standards.[9] The value-added per worker in Ukraine is substantially lower than in other European transition economies. Using GDP per capita (at purchasing power parity) as a rough proxy for productivity, one can see that labor productivity in Ukraine is one-third that in the Czech Republic, less than a half that in Poland and three-quarters that in Romania (Table 1). A similar picture emerges when one compares wages, which are much lower in Ukraine than in the neighboring CEE countries. Thus, the Ukrainian economy needs to converge to these higher productivity levels on its way to EU integration. This requires market friendly institutions and policies as well as investment, restructuring and competition. An efficient labor market is essential for achieving these objectives.

A recent upsurge in job growth is due mainly to the expansion of the informal sector. After the period of jobless growth employment started to increase in 2002. However, the strong job growth in the recent period has been largely driven by the expansion of the informal sector, which created nearly 60 percent of all new jobs between 2003 and 2004. During the same period, the hiring rate in the informal sector was roughly five times higher than in the formal sector, while the separation rate in the informal sector is only twice as high as in the formal sector. Thus, employment in the informal sector has significantly expanded in recent years, while that in the formal sector has roughly stagnated.

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9 Table A1.1 (Annex) provides comparative data on enterprise restructuring in Ukraine and its neighbors: Poland, Romania, Russia and Slovakia.

Table 1: Selected indicators of productivity and competitiveness: Ukraine against CEE Countries

Economy	GDP per capita; 2003 (at PPP)	Average wage, whole economy (2002)	Average wage, manufacturing (2002)	EBRD index of the progress of transition (2001)
	Ukraine = 100			
Bulgaria	143	185	142	3.038
Croatia	204	966	736	3.150
Czech R.	301	686	549	3.575
Estonia	244	524	428	3.538
Hungary	266	671	535	3.738
Latvia	182	369	284	3.150
Lithuania	206	391	323	3.325
Poland	212	728	566	3.563
Romania	132	228	169	2.913
Russia	168	..	..	2.625
Slovakia	246	422	369	3.400
Slovenia	353	1388	986	3.288
Ukraine	100	100	100	2.575

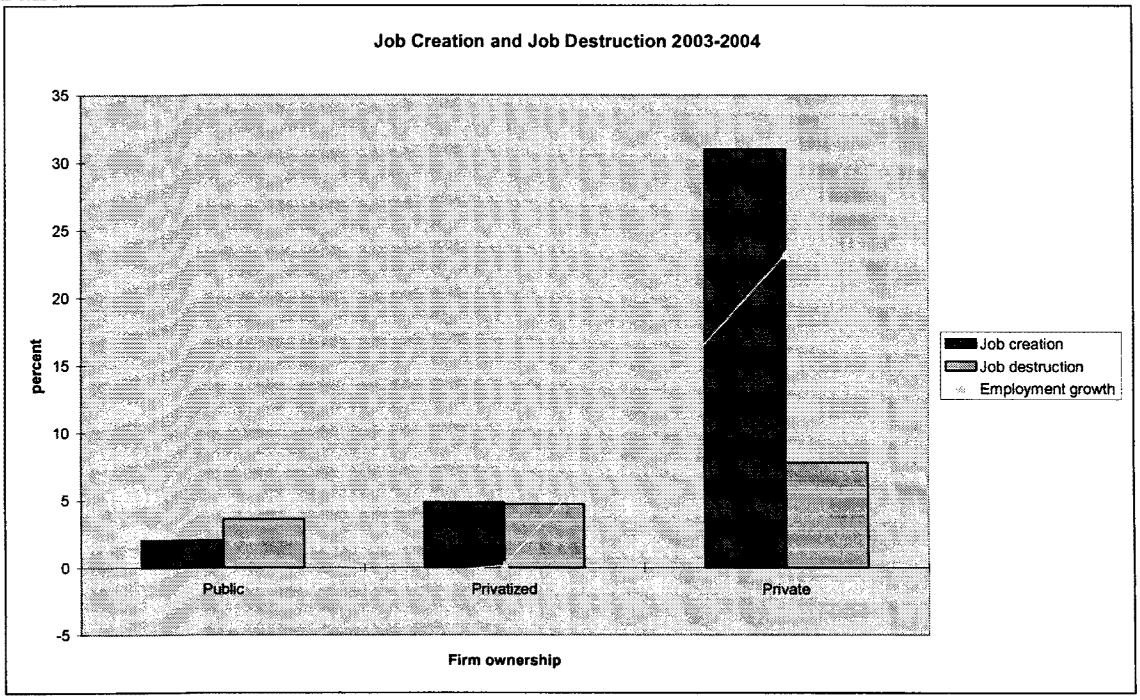
Source: World Development Indicators (2004), ILO Laborsta database, EBRD.

As in other transition economies, job growth in Ukraine takes place largely in small *de novo* private firms in the services sector. In contrast, large state-owned and privatized firms are predominantly downsizing. For example, while in new private firms (including informal ones) employment grew some 20 percent between 2003 and 2004, it fell by about 2 percent in the state owned firms (Figure 4, panel A). Similarly, net job creation falls notably with firm size (Figure 4, panel B). Notably, 40 percent of all newly created jobs were created in the services sector during the 2003-2004 period. However this positive dynamics taking place in small private firms does not translate into a large number of "good" (high-productivity) jobs. First, as it is shown below, the size of the job-generating sector is relatively small in Ukraine. Second, majority of new jobs are created in the informal sector where productivity tends to be lower and jobs are precarious.

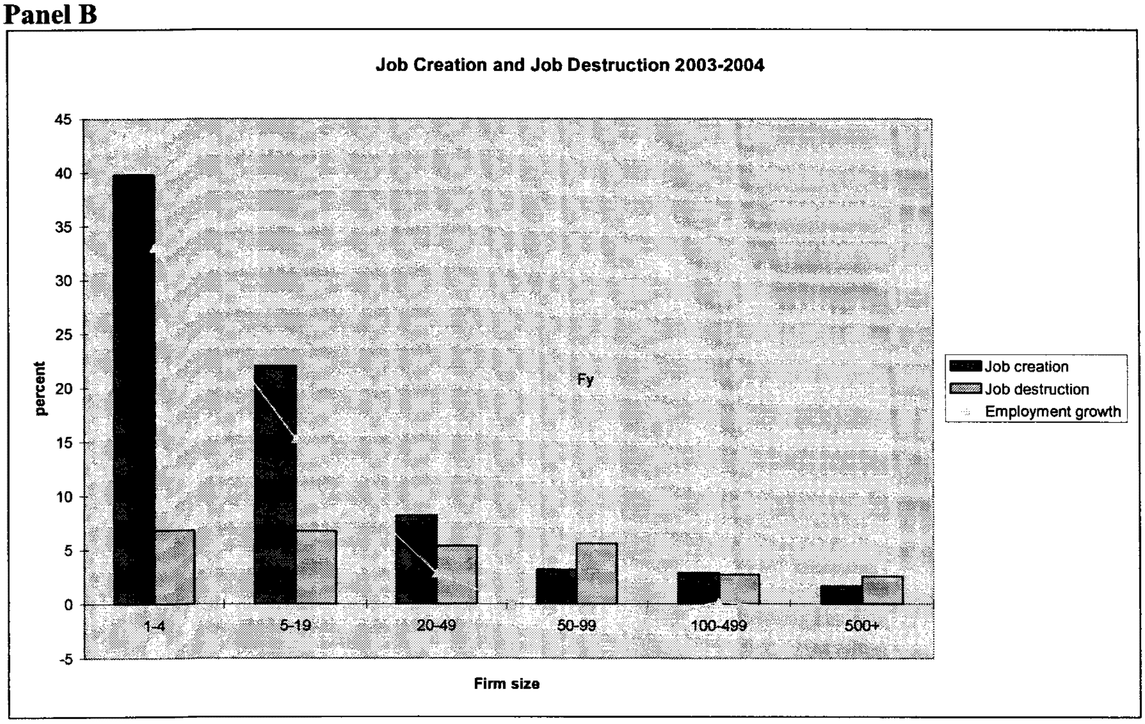
Multivariate regression analysis indicates that **firm ownership and labor productivity are the two most important independent drivers of firm-level employment growth** (Annex Table A2.1). In contrast, firm size by itself is not an important factor. In addition firm employment performance tends to be better in heavily industrialized regions. To illustrate, all else equal, employment in private firms grew on average by 10 percent faster than in the state owned firms during the 2002-2003. Contrary to common perception, higher labor productivity is conducive to faster employment growth in Ukraine. Other things held equal, firms which were more productive increased employment faster. For example, doubling of labor productivity was associated with nearly 6 percent higher employment growth. Given that on average private firms are more productive than state owned firms, their superior job creation performance comes from both better governance associated with private ownership *and* separately from the more efficient use of factors of production. The finding that employment growth is concentrated in heavily industrialized regions is somewhat surprising and indicating the still important role played by traditional industries. In contrast, in most other transition economies, especially in CEE, it is the diversified regions, with a strong services sector, where job creation is the strongest.

Figure 4: Private and small firms are the primary source of new jobs

Panel A



Panel B

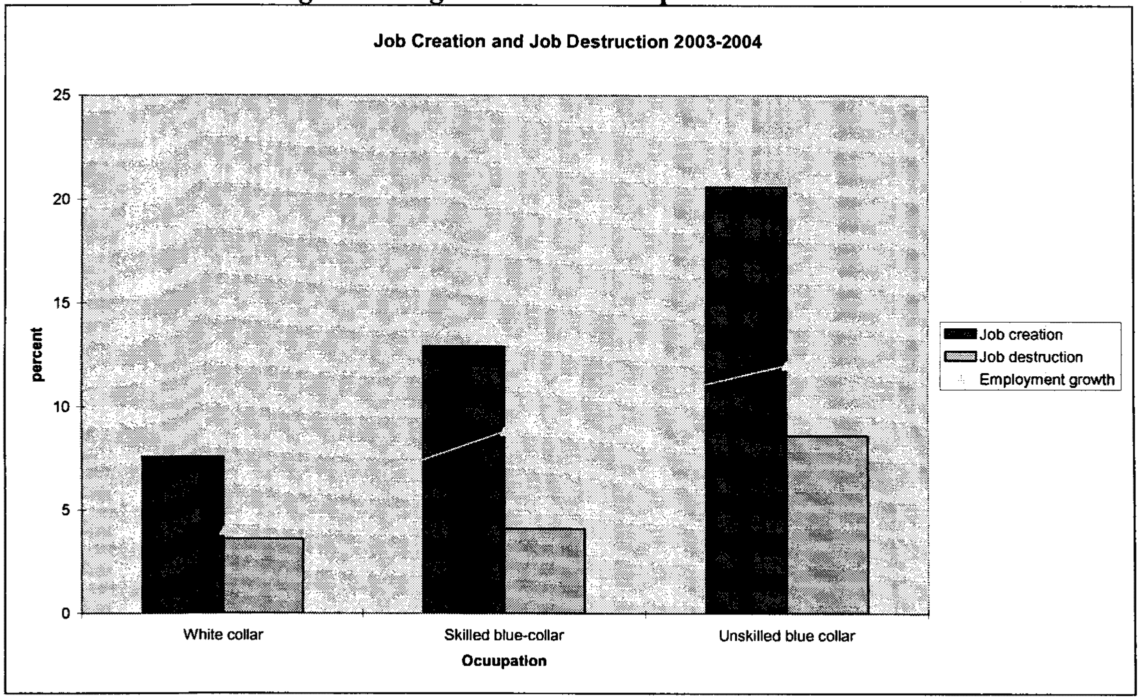


Source: Ukrainian Longitudinal Monitoring Survey, 2003 and 2004.

The job creation rate is the highest for unskilled blue-collar workers in Ukraine. The job creation rates for skilled blue-collar workers and especially white-collar workers are substantially lower (Figure 5) than that for unskilled blue collar workers. This is in contrast to most other transition

economies of CEE, where the demand is biased toward more skilled labor. The dominance of demand for less skilled manual labor suggests that the Ukrainian labor market is at an early stage of transition.

Figure 5: High demand for simple manual skills



Source: Ukrainian Longitudinal Monitoring Survey, 2003 and 2004.

Jobs that are being created are more productive than those that are being destroyed. Job growth occurs in the top third of the productivity distribution whereas job destruction is concentrated in the bottom third (Figure 6).[10] Thus, enterprise restructuring and associated job reallocation lead to a more efficient use of labor. Labor moves from less productive jobs to more productive jobs, with attendant earnings gains.

But the pace of the job reallocation is relatively slow pointing to delayed industrial restructuring. Although job reallocation notably accelerated in 2004 it still is less intensive than in fast restructuring transition economies of CEE.[11] The formal sector job creation rate was around 5 percent and the job destruction rate around 4 percent in 2004. This means that only about 4 percent of all jobs were reallocated away from shrinking (and likely less productive) firms toward expanding (and likely more productive) firms. In Lithuania or Poland the job reallocation rate was twice as high in the late 1990s (Rutkowski, 2003b). Thus the contribution of job reallocation to productivity growth has been rather modest in Ukraine. This implies that there is still substantial room for enterprise restructuring in Ukraine with attendant productivity improvements, but also lay-offs.

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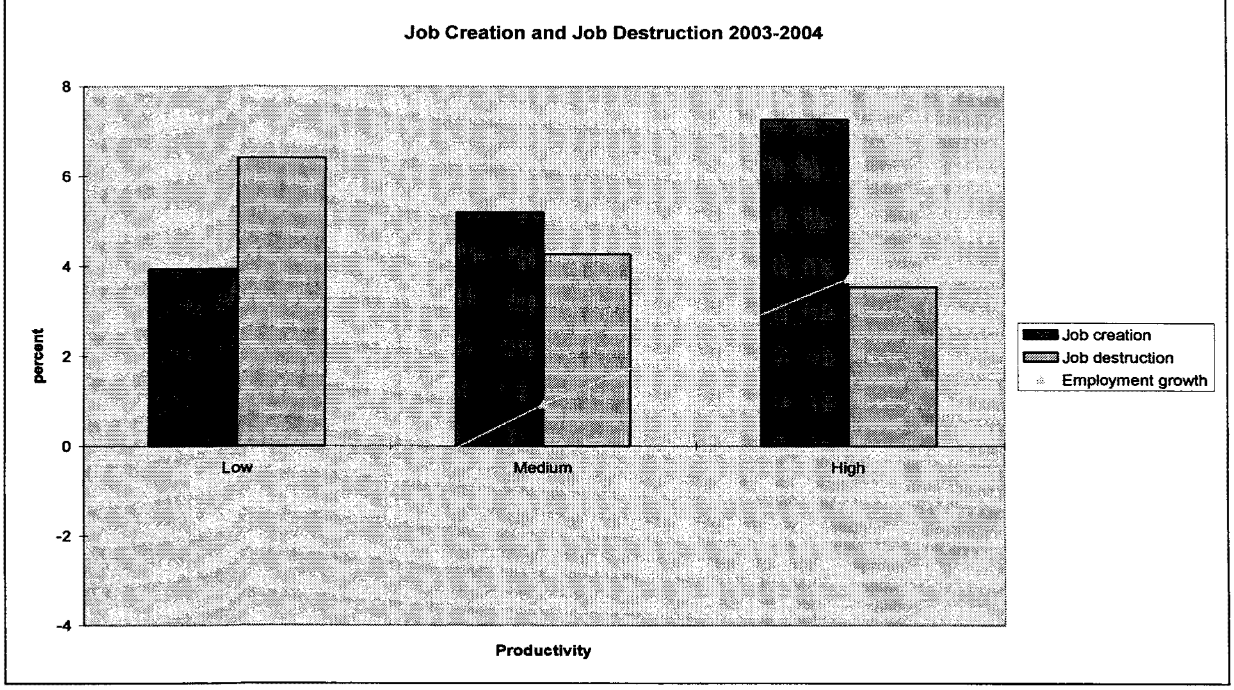
[10] The productivity of a job is proxied by the relative wage level.

[11] Brown and Earle (2004) and Konings and others (2003) provide estimates of job reallocation rates in Ukraine for the earlier period. However, the drawback of these studies is that they do not cover the entire economy since the first cited study only covers medium and large enterprises from industry, while the second looks at firms only above a certain size threshold. This report uses instead the Ukrainian Longitudinal Monitoring Survey data which makes it possible to estimate job flows for the entire Ukrainian economy. See Lehmann and others (2005) for details.

Figure 6: Job reallocation leads to a better use of labor and brings about productivity gains



Source: Ukrainian Longitudinal Monitoring Survey, 2003 and 2004.

Labor is underutilized in Ukraine despite relatively low open unemployment. [12] The unemployment rate was around 8 percent in 2004, which is less than in most transition economies.[13] However, the unemployment rate is not necessarily an adequate indicator of labor market slack. A better measure of the degree of utilization of labor resources is the employment-to-population ratio. By this measure, the labor market performs less well in Ukraine (Figure 7). Less than 60 percent of working age population is employed, which is substantially less than the OECD average of 65 percent, and also less than in more advanced transition economies, for example in the Baltic states. The low level of employment reflects the low labor force participation rate in Ukraine (slightly above 60 percent).[14] Low labor force participation, in turn, tends to be associated with the scarcity of gainful job opportunities. The unemployed become discouraged by the futility of their job search effort and cease looking for a job as they no longer believe that they can find one.

Many workers are underemployed, which is a sign of "hidden" unemployment. For example, one firm in five could produce the same output with fewer workers, pointing to incomplete restructuring (Table 2). And in those firms which report overstaffing, one worker in six could be made

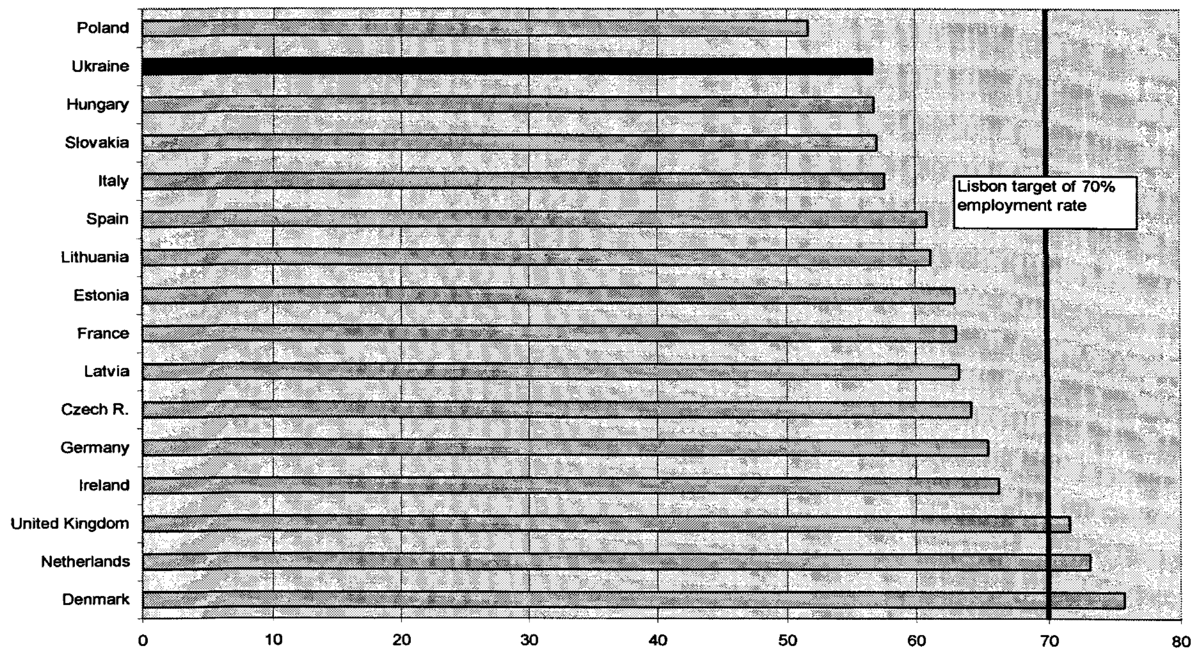
[12] Labor force survey data using the ILO definition of unemployment published by the Dhzerskomstat. It is noteworthy, that according to the Ukraine Labor Market Survey (ULMS) the unemployment rate in 2004 was substantially higher and accounted for 14.2 percent. Both surveys use similar (ILO) definition of unemployment, so the discrepancy is due to different samples. While the ULMS estimate may be biased upwards (e.g. due to under representation of "good" performers), it is also possible that the official estimate exhibits some downward bias.

[13] Table A1.2 (Annex) provides key indicators of labor market conditions for selected OECD countries. Three different benchmarks can be applied to assess labor market outcomes in Ukraine: (a) the OECD or EU-15 average, (b) best performing developed market economies (e.g. the U.K.), or (c) best performing transition economies (e.g. the Czech Republic).

[14] Again, according to the ULMS the labor force participation rate in 2004 was below 60 percent and thus significantly lower than the official one.

redundant without lowering firm's output. That is, many workers – some 3 percent of total employment – hardly contribute to firms' output and will likely be laid-off once enterprise restructuring intensifies, adding to unemployment. However, the scale of underemployment has diminished substantially since the late 1990s, indicating that the enterprise restructuring has accelerated (Table 2).

Figure 7: The employment rate is low in Ukraine
Employment rate in Ukraine and selected transition and EU countries, 2004



Note: The employment rate is the ratio of employment to working age population. The working age is 15-70 for Ukraine and 15 and more for all other countries.
Source: Derzhkomstat (2005)

Table 2: Selected indicators of "hidden" unemployment

	1995	2000	2004
		percentages	
Firms which could produce the same output with fewer workers	37.4	34.1	18.2
Excess employment a)			
Firms reporting over-employment	21.2	23.1	17.2
All firms	7.9	7.9	3.1
Workers on unpaid administrative leave	11.7	13.3	1.3
Involuntary part-time workers	12.9	18.4	7.5
Firms reporting wage arrears	66.5	69.0	30.7

a) Percentage of workforce that could be made redundant without lowering firm's output.
Source: Khan and Zsoldos (2005)

Economic growth brought about an increase in labor market dynamics. **Although relatively few new jobs were being created, unemployment has fallen thanks to a higher labor turnover. Chances to escape unemployment increased more than twofold in 2003-2004 compared to the earlier period (** Table 3). But quite surprisingly, the current unemployed much more frequently stop looking for a new job and withdraw from the labor force, suggesting a stronger discouraged worker effect. At the same time, inactive workers more often decide to enter the labor market in search of a job, indicating a more favorable labor market conditions. Finally, the greater labor market dynamics is associated with a somewhat higher (25 percent) risk of losing a job. But this greater risk is more than offset by better chances to find a job. As a result, the incidence of long-term unemployment has substantially decreased, from close to 70 percent in the early 2000s to somewhat over 40 percent in 2004. Thus, the benefit of economic growth in Ukraine manifested itself in shorter job search duration and thus lower unemployment rather than in new job creation and higher employment.

Table 3: Labor market transition probabilities, 1998-2004

Flows as a percentage of the origin stock

Flows	1998-2002	2003-2004
Employment to unemployment	3.3	4.1
Unemployment to employment	18.1	38.6
Unemployment to inactivity	7.7	27.3
Inactivity to unemployment	2.5	7.6

Source: Ukrainian Longitudinal Monitoring Survey, Bank staff calculations

But the labor market remains stagnant. Although labor force flows increased in recent years along with economic growth, the Ukrainian labor market resembles those in less dynamic, high unemployment transition economies, such as Bulgaria, Poland or Slovakia. For example, compared to the Czech Republic or Russia, transitions across labor force states (employment, unemployment, out of the labor force) are low in Ukraine. Yearly inflows from employment into unemployment (4 percent) are of similar magnitude as in other transition economies (2 to 6 percent). Outflows from unemployment to jobs (39 percent) are moderate, however, compared with 45-50 percent observed in more dynamic transition labor markets, or 65 percent in the U.S. (Boeri and Terrel, 2002).[15] A substantial fraction of the unemployed (27 percent) withdraws from the labor force during a year, which is a sign of a "discouraged worker" effect and points to limited labor market prospects. All in all, the labor market in Ukraine has become notably more dynamic in recent years, but job prospects are still limited and a large fraction of the unemployed (34 percent) is not able to find a job within a year.

One reason for low unemployment is slow and delayed enterprise restructuring. Figure 8 shows that the major wave of public sector restructuring and associated mass lay-offs in Ukraine took place from the mid to late 1990s, and since then has subsided. Inflows into unemployment have decreased and thus unemployment fell (in the early 2000s the unemployment rate was around 12 percent, significantly higher than the current one). But given the large size of the public sector in Ukraine, major restructuring effort still lies ahead. It again will be associated with large-scale job reallocation and lay-offs, which are bound to bring about at least a transient increase in unemployment. Accordingly, the low unemployment rate is unlikely to be sustainable in the medium run. In Figure A in Box 1, the status of the labor market in Ukraine labor market is represented by the area referred to as "the initial stage" where low unemployment indicates an early rather than an advanced stage of transition.

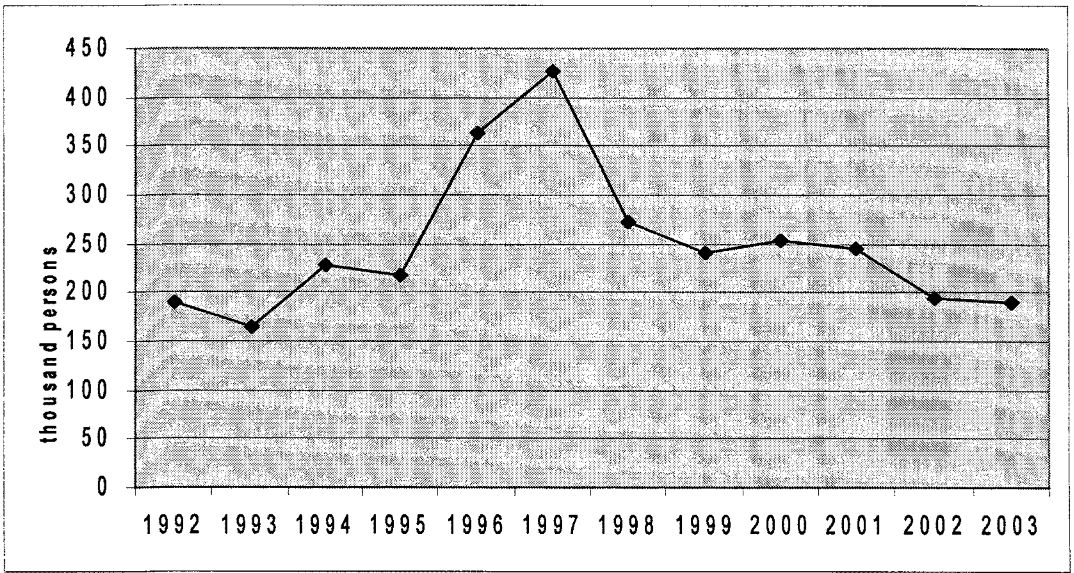
[15] The unemployment-to-employment transition probability was a meager 18 percent before 2003, so doubling of the rate – although from a very low level -- indicates a substantial improvement in labor market conditions in Ukraine in the recent period.

Unemployment in Ukraine is of long duration. About 50 percent of the unemployed remain so for over a year. In particular, displaced workers – those who lost their job due to enterprise restructuring – have a hard time finding a new one. For example, less than a third of the displaced workers found a new job within 3 months after the lay-off during the period of strong economic growth (2000-2003). The long duration of periods of unemployment is characteristic of most of transition economies of CEE and Ukraine is no exception. The contrast with a dynamic labor market, such as that in the U.S. where less than 10 percent of the unemployed are jobless for more than a year, is striking. Long-term unemployment is of particular concern as it is associated with high social cost. Protracted joblessness leads to an erosion of skills and morale and further undermines employment opportunities. Thus, many long-term unemployed eventually withdraw from the labor force. In addition, long-term unemployment is also closely associated with poverty (World Bank, 2005).

The high incidence of long-term unemployment points to structural factors behind unemployment in Ukraine. Specifically, many unemployed lack the skills necessary to find employment. It is estimated that at least 11 percent of the unemployed cannot find a job because his/her skills fall short of those required by employers. It should be noted that this proportion is lower than in most transition economies, where the skill mismatch index usually exceeds 20 percent. This may be a positive sign. However, it may also point to delayed enterprise restructuring. Evidence from other transition economies indicates that the progress of the restructuring is associated with the increase in demand for high, white collar skills and the fall in demand for lower and blue collar skills. In Ukraine this process is still nascent.

Less educated, inexperienced workers in backward regions are hit the strongest by unemployment. The incidence of unemployment varies substantially across worker groups in Ukraine. Young workers (15-24 years old) are about twice as likely to be unemployed as prime age workers (24-49 years old), which is a typical pattern observed in most countries. However, unemployed young workers have much better chances to find a job than their older colleagues, and as a consequence long-term unemployment among young workers is less frequent (34 percent against 52 percent for prime-age workers). As in other transition economies, unemployment among workers with primary and secondary education is much higher than among workers with university education (for the latter group the risk of unemployment is roughly half that for less educated workers). At the same time, workers with primary education find jobs quickly, so the incidence of long-term unemployment is relatively low for this group (36 percent). This is in sharp contrast to experience in other transition economies and supports the claim that the demand for less skilled, manual labor is still strong in Ukraine. Unemployment is negligible (3.2 percent) in the capital region (Kyiv), while it is almost 18 percent in the Central and Northern region. Such large regional disparities in labor market conditions, with strong concentration of job creation around the capital, are not specific to Ukraine and are prevalent also in other transition economies. Finally, there is no difference in the incidence of unemployment between men and women; the risk of losing a job is virtually the same for both genders (slightly higher for men). However, unemployed women have a somewhat worse chance of finding a new job (35 percent for women against 42 percent for men in 2003-2004). In addition, it has been observed that women have a greater tendency to withdraw from the labor force after a period of joblessness, indicating that their labor market attachment is slightly weaker.

Figure 8: The pace of public sector restructuring has slowed down
Mass Lay-offs, 1992-2003



Source: State Statistics Committee of Ukraine; http://www.ukrstat.gov.ua

Productive job opportunities are scarce despite low unemployment. This is because of the small size of the job generating new sector of the economy and of the widespread informality often associated with low productivity. A large fraction of jobs are in the public sector which is downsizing, and barely hiring new workers. Thus, employment opportunities in the public sector are limited and will increasingly be so, once the sector is further restructured and exposed to stronger competitive pressure. While the new private sector is expanding and creating jobs on a net basis, it is still relatively small; thus it hires a relatively small number of workers.

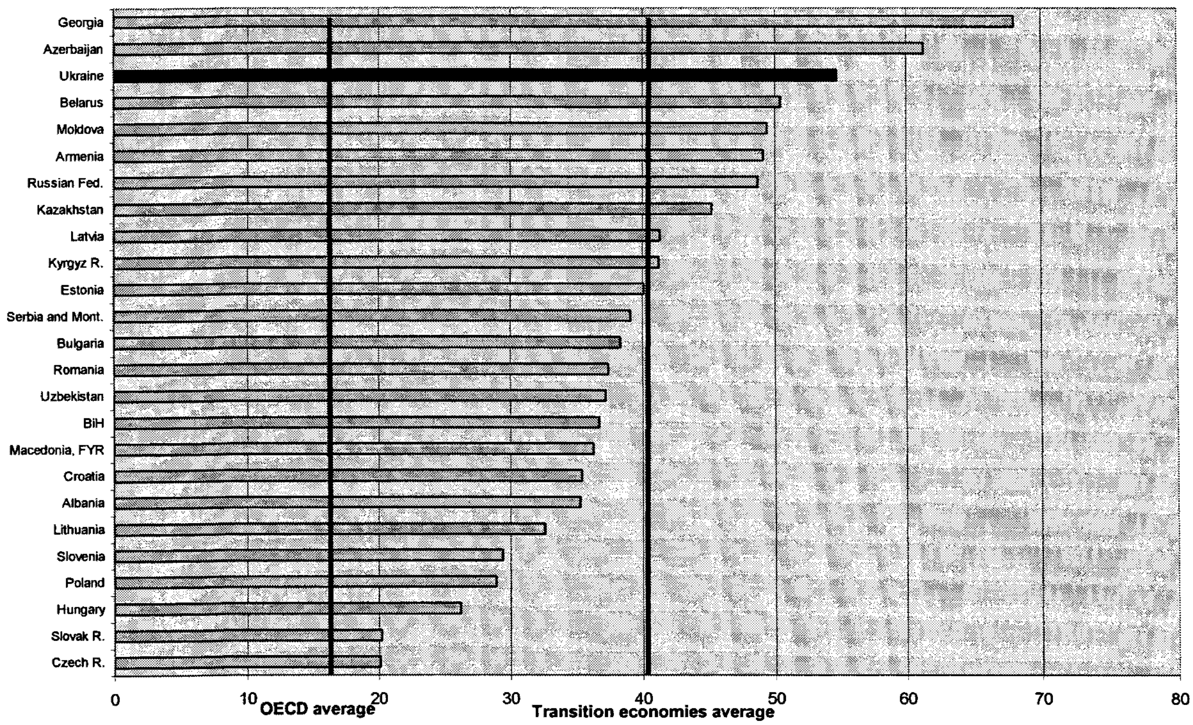
Many jobs are in the informal sector. The informal sector represents a large, according to some estimates even dominant, part of the Ukrainian economy (Figure 9). For example, the informal sector as a share of GDP is estimated at 55 percent (Schneider, 2005). This is much greater than in more advanced transition economies, such as Poland (less than 30 percent), the Czech Republic or Slovakia (about 20 percent). Estimates of informal employment are more modest, but still substantial: one in five workers is employed in an unregistered job.[16]

Informal sector employment tends to be of low productivity. Young, poorly educated and unskilled blue-collar workers are disproportionately represented among the informal sector workers. For example, unskilled workers account for one-third of informal sector employment, compared with less than one-fifth of formal sector employment. About 25 percent of the informal sector workers do not have secondary education, twice as much as in the formal sector. In addition, informal jobs are concentrated in sales (34 percent), agriculture (25 percent), construction (12 percent) and services (8 percent) - industries

[16] According to the ULMS 2004. Derzhkomstat, using the Labor Force Survey, estimates the informal sector represents about 16 percent of total employment. The measurement of the informal sector employment is difficult and depends on the applied methodology and data sources. Results are subject to a wide margin of error. The point that is being made her is that international comparison carried out using a standard methodology indicates that the informal sector in Ukraine is larger than in most neighboring countries. Further research is necessary to obtain more precise estimates of informal sector employment.

where productivity is relatively low. Finally, a majority (close to 80 percent) of the informal sector workers are either self employed, or employed in micro firms.[17]

Figure 9: The informal sector in Ukraine is among the largest in the region
Informal sector as a percentage of GDP in 2002-2003



Note: The size of the informal economy was estimated using DYMIMIC and currency demand methods.
Source: Schneider (2005)

The informal sector offers better earning opportunities than the formal sector. Controlling for individual and firm specific characteristics, informal sector workers receive a wage premium from 10 percent (at the bottom of the wage distribution) to 15 percent (at the top of the wage distribution). This suggests that workers are not only "pushed" into the informal sector by lack of job opportunities in the formal sector, but also "pulled" into it by better earning prospects. However, the incidence of low-pay is somewhat higher in the informal sector than in the formal sector.[18]

The informal sector cushions the impact of unemployment. Casual, temporary jobs in the informal sector seem to be a source of income to many among the (usually) unemployed. Data show that about 30 percent of the unemployed find casual employment in the informal sector. Moreover, one-third of the jobless escape unemployment by finding a job in the informal sector.

The labor market has become segmented but workers move between the formal and the informal sector. Theoretically, labor market segmentation means that there are economic or regulatory

[17] Micro firms are firms employing up to 10 employees.

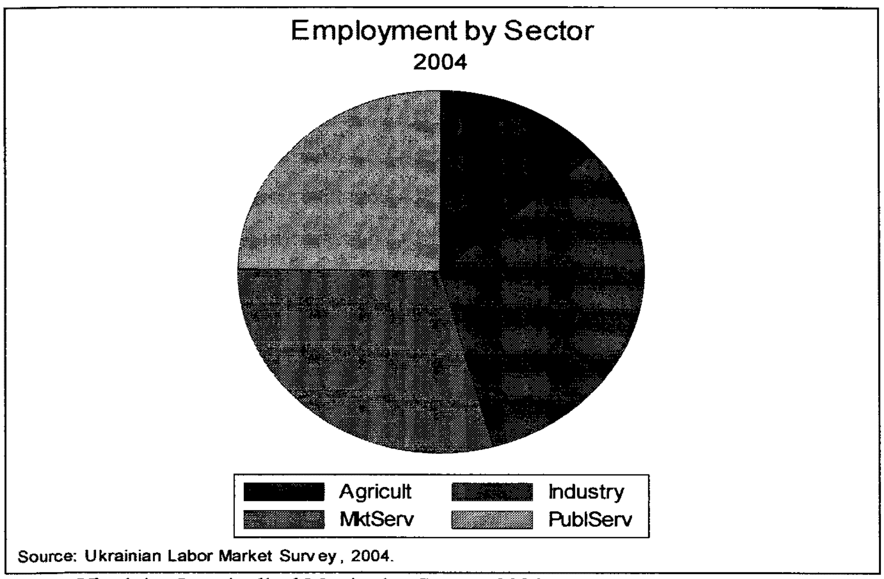
[18] If (as it is customary) low pay is defined as less than two-thirds of the median earnings, then the incidence of low pay (percentage of workers, who are low-paid) is 25 percent in the informal sector and 20 percent in the formal sector.

barriers which prevent workers from moving between sectors. Thus, the larger the flows between sectors, the weaker the cause for the segmentation hypothesis. Naturally, some workers employed in the formal sector move to the informal sector (e.g. due to a job loss); however, this fraction at 3 percent (per year) is very small in Ukraine. More tellingly, some 15 percent of informal sector workers move to the formal sector within a year. This is a significant fraction but it does not seem to invalidate the segmentation hypothesis.

All in all, the data do not support the notion that workers in Ukraine are trapped into "bad" informal sector jobs. The informal sector is an important source of employment and offers relatively high wages. Also for many workers informal sector employment is a transient state and a stepping stone into formal sector employment. However, from the worker welfare standpoint, it is uncertain whether somewhat higher informal sector earnings fully compensate for the lack of employment related benefits and less job security. Without knowing this it is not possible to ascertain whether "push" or "pull" factors are more important in explaining workers' movements into the informal sector.

Jobs have moved from industry to services, and the services sector has become a major source of jobs. The market services sector accounts for some 30 percent of total employment, of which almost one-third is in the informal sector. Public and social services represent an additional 25 percent of total employment, so that over half of all jobs is in the services sector (Figure 10). Thus, there has been considerable movement of labor in Ukraine away from manufacturing (overdeveloped during the central planning era) toward services, which were underdeveloped. As a result of de-industrialization, the industry's share in total employment is presently only about 32 percent. This employment structure, dominated by services, is typical of more advanced transition economies of CEE and of developing countries with GDP per capita level similar to that in Ukraine. However, widespread informality in the services sector means that the challenge to develop a truly modern, productive services sector still lies ahead in Ukraine.

Figure 10: Majority of jobs are in the services sector



Source: Ukrainian Longitudinal Monitoring Survey, 2004.

Wage flexibility is limited which might inhibit labor market adjustment. Wages still are determined in a rather centralized way, especially in public and privatized firms. Trade unions play an important role in wage determination while the role of employers tends to be limited. Resulting wage

rigidities might contribute to labor market imbalances, particularly to unemployment, with wage adjustment being critical for attaining labor market equilibrium. Factors pointing to limited wage flexibility include significant wage growth despite unemployment, relatively high minimum wage, union wage premia, industry wage premia, and finally modest returns to education.

Wages grew in excess of productivity in recent years raising unit labor cost. Real wages have grown at an impressive rate of 19 percent per year since 2000, faster than GDP per worker (which is a proxy for productivity). Such a fast growth in real wages reflects insider power in wage determination. However, the resulting increase in unit labor cost dampened labor demand and was one source of jobless growth. Thus, the increase in labor demand associated with output growth benefited the employed (insiders), rather than the unemployed (outsiders).

The minimum wage is high relative to the average wage but it is not enforced. The statutory minimum wage hovers around 40 percent of the average wage in Ukraine.[19] This is high by standards of CEE economies, where the minimum wage in most countries is less than 35 percent of the average wage (Figure 11). However, as is shown below, the minimum wage often is not enforced. This suggests that trade unions are relatively strong at the national level (where the minimum wage is determined) , but less strong at the firm level, as strong unions would not permit their members to be paid less than the minimum wage. The minimum wage in Ukraine plays a number of functions, and thus its change has not only welfare but also fiscal implications (see Box 2).

Figure 11: The minimum wage in Ukraine is high relative to the average wage by regional standards

Source: UNICEF TransMONEE database; Bank staff calculations.

[19] The minimum wage accounted for 42 percent of the average (mean) national wage in January 2005. However, this estimate may be biased upwards due to the reportedly widespread practice of underreporting of wages as a means of tax evasion. If so, the average wage is underestimated and, consequently the minimum wage-to-average wage ratio is overestimated. Given available data it is no possible to determine how large is the bias, i.e. what is the actual minimum wage-to-average wage ratio. This issue requires further research.

The minimum wage is aimed to protect earnings of those who have jobs; however, it is likely to price less productive workers out of employment. Low skilled, inexperienced (young) workers in economically depressed regions of the country, whose prevailing market wage is substantially lower than the national average, are particularly likely to be negatively affected. Figure 12 shows that **while the minimum wage is hardly binding for skilled manual workers, it cuts deep into the wage distribution of unskilled workers.** This means two things. First, that the minimum wage is not enforced, as many workers earn less than the minimum wage. Second, if enforced, the minimum wage could have a significant detrimental effect on employment of unskilled workers. Many workers who currently earn less than the minimum wage would lose their job because employers would not want to keep workers whose productivity is lower than the wage they are to be paid.

Box 2. The Functions and Effects of the Minimum Wage in Ukraine

The minimum wage in Ukraine plays four main functions. First, it protects workers from exploitation by employers and ensures some socially acceptable minimum consumption level. Second, it provides a base for the wage structure in the public sector, where wages for different occupations and skill levels are expressed as a multiple of the minimum wage. Third, it provides a base for determining some social security benefits (e.g. military pensions). Finally, the minimum wage is intended to prevent tax evasion by determining the minimum income base for social security contributions and taxes. Consequently, an increase in the minimum wage will have a number of effects, which include:

A. Effects on worker welfare

- An increase in nominal wages of low-paid workers.[a)]
- The worsening of employment chances of vulnerable workers (youth, inexperienced, and low-skilled workers) if the minimum wage is set above the market clearing wage for these worker groups.
- A (temporary) reduction in earnings inequality.
- A reduction in poverty if two conditions are met: (a) significant number of the poor are wage earners, and (b) minimum wage earners are predominantly members of poor families.[b)]

B. Fiscal effects

- Increase public expenditures due to an increase in the public sector wage bill.
- Increase public expenditures due to an increase in spending on social benefits.
- Either increase or decrease the revenues of social security funds. The revenues will increase only if there is no significant disemployment or informalization effect.[c)] These effects will be small if (as it is often claimed in Ukraine) the undeclared wage payments represent a significant part of the total wage of vulnerable workers, as the increase in the minimum wage will simply formalize previously undeclared wage payments. However if the disemployment or informalization effects are significant, the revenues can decrease.

Given this multitude of effects, of which some are positive and some are negative, it is hard to predict the net effect of the minimum wage increase on social welfare. This makes the minimum wage policy difficult in Ukraine. One instrument – the minimum wage – is meant to meet too many objectives. The way around is to reduce the number of functions assigned to the minimum wage. The minimum wage should be primarily used as a wage floor to protect earnings of low-paid workers. It should not be used to determine the level of social benefits, or as a minimum base for social security contributions and taxes. The latter function can be played by a separate minimum tax base, which can be set above the minimum wage. Thanks to this the wage structure will be more flexible, while tax revenues will be protected.[d)]

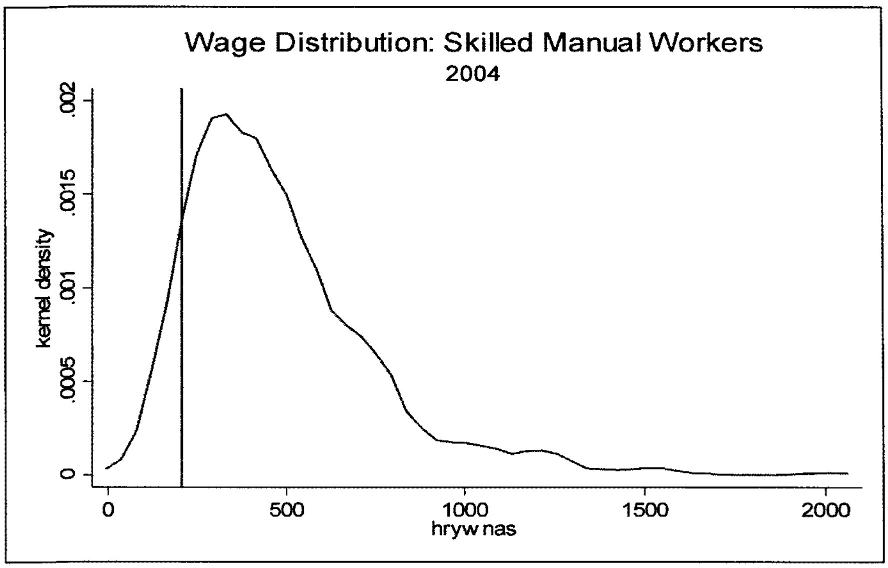
Even if the function of the minimum wage is limited to that of protecting earnings of the low-paid workers, determining the "right" amount of the minimum wage is a difficult balancing act. On the one hand, the minimum wage needs to meet the criterion of fairness and ensure some minimum consumption standard. On the other hand, it should not price low-productivity workers out of employment. Thus, a sound minimum wage policy needs to be based on an analysis of the earnings distribution and should follow some key rules to ensure that the benefits of the minimum wage policy exceed its costs.[e)]

Box 2., cont.

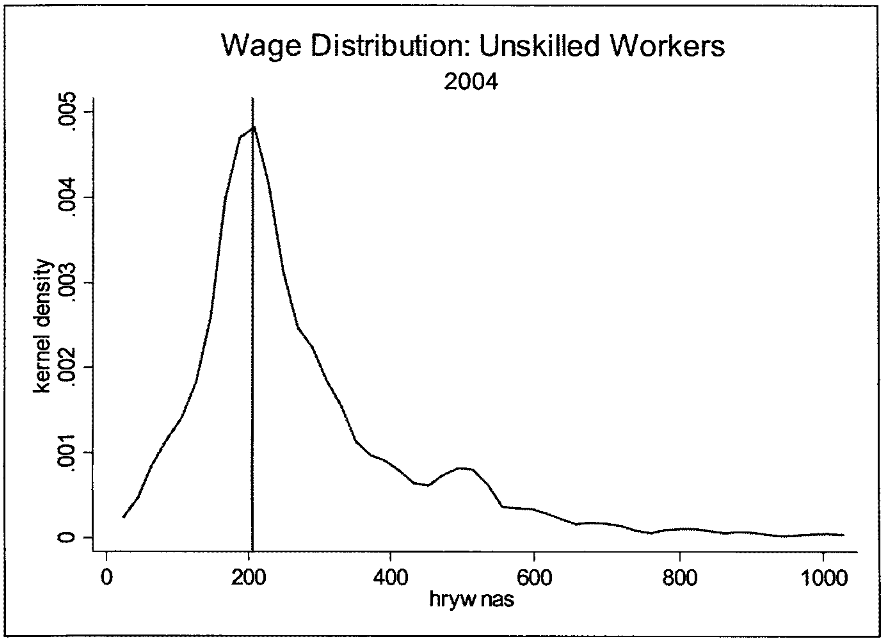
a) If the increase in the minimum wage spills over the entire earnings distribution then it may cause a price increase which lead to a fall in the real value of the minimum wage.
b) In practice (a) most of the poor (the disabled, the retired, the unemployed) do not earn wages and thus do not benefit from the minimum wage increase, and (b) minimum wage workers are secondary earners in non-poor families, so the increase in the minimum wage benefits non-poor families. Accordingly, the minimum wage is not a well-targeted and effective anti-poverty policy, and the positive effect of the minimum wage increase on poverty in most countries has been found to be negligible or at best limited (Rutkowski, 2003a). The effect on poverty can be negative if the disemployment effect of the minimum wage increase is substantial
c) The informalization effect occurs if the increase in the minimum wage leads to a shift of employment away from the formal sector towards the informal sector. The disemployment effect occurs if the increase in the minimum wage causes a fall in employment.
d) The minimum tax base will "formalize" informal (envelope) wage payments, a problem which is currently addressed by means of the minimum wage policy. But the potential disemployment effect of raising the minimum tax base is lower than that of raising the minimum wage.
e) The principles of a rational minimum wage policy are presented in Rutkowski (203a).

Figure 12: The minimum wage accounts for a high percentage of the market wage of low-skilled workers but is not enforced

Panel A



Panel B



Note: The vertical line indicates the minimum wage (205 hrywnas in June 2004).
Source: Ukrainian Longitudinal Monitoring Survey, 2004.

Workers covered by collective agreements and trade union members enjoy a wage premium. Multivariate regression analysis reveals, other things being equal, that formal sector workers who are covered by collective agreements earn higher wages. For example, a worker employed in a firm covered by a collective agreement on average earns almost 10 percent more than a similar worker employed in a firm not covered by a collective agreement (Annex Table A3.1).[20] Thus bargaining agreements raise wages above the competitive level. This lowers employment in the covered sector and forces some workers to move to the uncovered (informal) sector.

Significant industry wage premia are another symptom of non-competitive wage determination in Ukraine. Multivariate regression analysis shows that a worker's wage depends not only on his/her personal traits and on firm characteristics, but also on industry affiliation. For example, workers employed in manufacturing earn significantly more than similar workers employed in the services sector. To a large extent this is a legacy of the communist system, which awarded high wage premia to workers employed in "strategic" industries, such as metal processing, mining, etc. The existence of industry wage premia means that firms share rents with their workers, but again at the expense of those whose higher than competitive wages price them out of employment.

Wage premia to education have been low. Only very recently (in 2004) the rate of return to one year of schooling increased to 6 percent (from around 4 to 5 percent), a rate still significantly less than in other transition economies of CEE. For example, in Poland the rate of return to schooling sharply increased in the early years of the transition and already reached over 7 percent in the mid 1990s (Rutkowski, 1996). With some delay, a similar process has occurred in Russia (Gorodnichenko and Sabirianova, 2004). This much delayed increase in returns to education in Ukraine indicates either that the wage structure only slowly adjusts to the changes in demand for skills, or that the increase in demand

[20] However, the effect of bargaining coverage/union membership is hard to disentangle from that of firm ownership and size. Also the size of the effect depends on the specification of the regression equation.

for high skills has been more limited in Ukraine than in other transition economies. The latter reason would be consistent with slower opening of the Ukrainian economy and a slower pace of technological progress (which is biased towards skilled labor). In either case, the low rate of return to education indicates that the Ukrainian labor market is at a relatively early stage of transition.

Wage distribution has decompressed during the transition in Ukraine, as it has in other transition economies. However, the actual degree of wage inequality is unclear; estimates range from moderate to high, depending on the data source.[21] At face value, the high minimum wage and high union bargaining coverage should act as factors limiting wage dispersion. But as mentioned above, many firms do not comply with minimum wage regulations, and unions cannot enforce compliance even in the unionized sector. It is also not clear whether the increase in wage dispersion is associated with greater economic efficiency. For this to be the case wage differentials would need to reflect productivity differentials among workers. But this is not necessarily the case. Wage differentials might well reflect various rents (e.g. monopoly rent) which proliferate in a non-competitive environment. Evidence presented above suggests that such rents indeed exist in the Ukrainian economy and are partly captured by workers, especially in the unionized sector. But further research is necessary to determine the efficiency of the wage structure in Ukraine.

Trade unions play an important role in shaping industrial relations in Ukraine. The unionization rate is high and so is union bargaining coverage. At the same time, employers representing the new private sector are only beginning to organize themselves and articulate their interests. In the *formal* sector the unionization rate reaches 70 percent and the union bargaining coverage is still higher at close to 90 percent.[22] These rates are very high by the standards of other transition economies and those of OECD. In virtually all CEE countries, the unionization and bargaining coverage rates have declined sharply along with the growth of the private sector and a move toward decentralized bargaining structures (i.e. from industry to firm level bargaining). For example, in Poland union density has fallen to less than 20 percent and union bargaining coverage is around 40 percent. The OECD average is 20 and 35 percent, respectively (O'Keefe, 2005). The weakness of the employers' representation is reflected in the fact that majority industry level collective agreements are reached *not* with representatives of private business, but instead with line ministries which represent the State as the main employer.[23]

High union density and bargaining coverage in Ukraine reflect an underdeveloped private sector. Expectedly, the trade union stronghold is large in public as well as privatized enterprises. For example, the union density rate is some 80 percent in the public sector and less than 10 percent in the new private sector (Figure 13). In the public sector unions tend to be, for historical reasons, linked to the government.[24]

Strong position of trade unions leads to inefficiencies in collective bargaining (Box 3). First, their close ties to the government often give them an upper hand in negotiations with private sector

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[21] According to the ULMS (which is a household based survey), the Gini coefficient (which is a summary measure of income inequality ranging from 0, when all incomes are equal, to 1, when total income is in the hands of one person) amounts to 0.32, which indicates moderate wage inequality (e.g. the same as in Poland and most other European transition economies). However, according to the UNICEF TransMONEE data (coming from the employer based survey) the Gini coefficient is 0.42, which indicates a high degree of wage inequality, characteristic of most CIS countries.

[22] The unionization rate is the percentage of workers who are members of trade unions. The union bargaining coverage rate is the percentage of workers who are covered by collective agreements. For the whole economy these rates are 57 and 70 percent, respectively (according to the ULMS 2004).

[23] Only 13 out of 77 sectoral agreements were concluded with the association of employers. The rest were signed instead by relevant line ministries.

[24] Under communism trade unions played a role of a "transmission belt" of government decisions to workers.

employers. Second, collective bargaining where unions represent public sector workers while employers' organizations represent private business lacks the common object. There is a representation mismatch which can only be addressed by a development of independent, private sector unions and by the decentralization of collective bargaining.

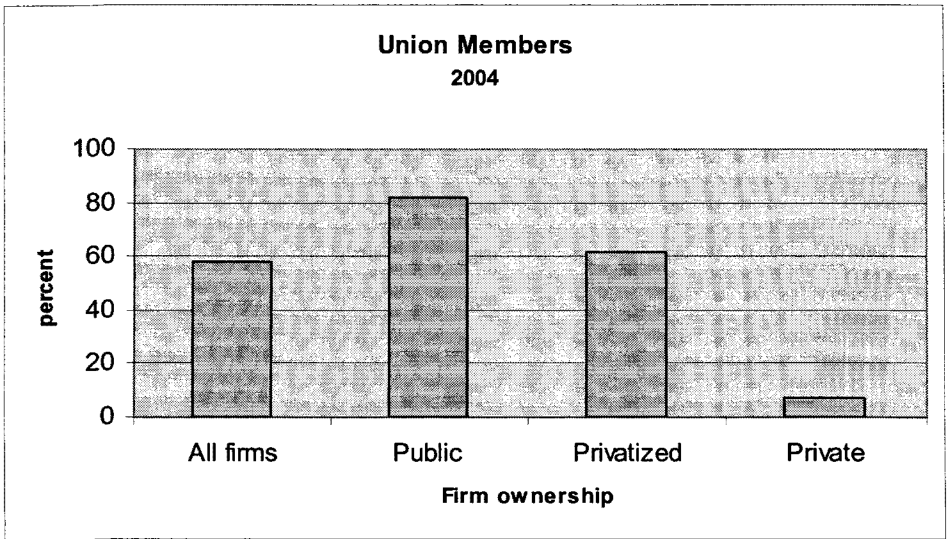
Box 3. Collective bargaining needs to meet some conditions to be efficient, but these conditions are rarely met at an early stage of the transition

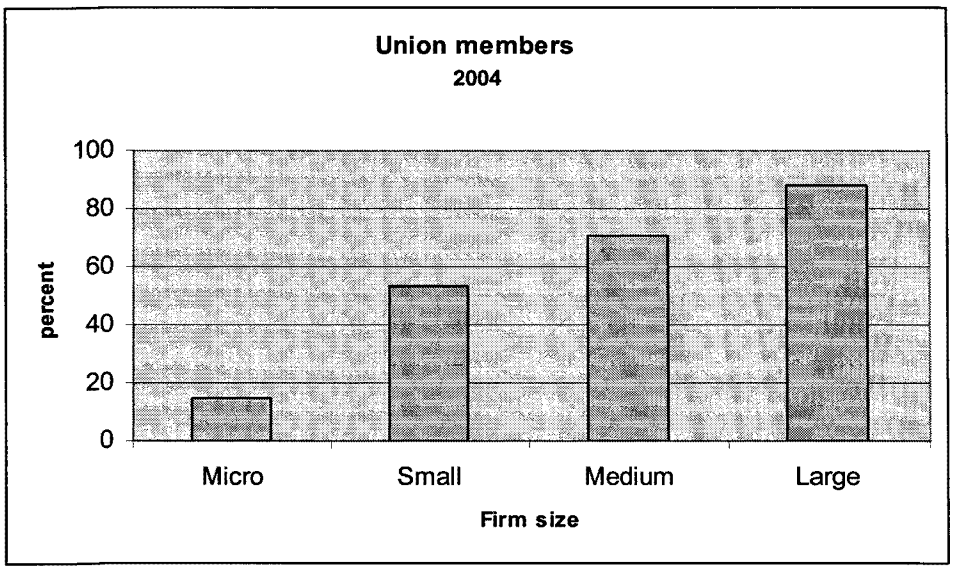
Four conditions need to be met for collective bargaining between trade unions and employers' organizations to yield efficient outcomes.

- **Adequate representation.** At the national and sectoral level the bargaining parties – trade unions and employers' organization -- should represent a significant fraction of the workforce and firms in an identifiable sector of the economy. Criteria for representativeness should be established and representativeness should be periodically verified. Moreover, participation in the bargaining should be voluntary, inter alia to ensure that the interests of bargaining parties are aligned with the interests of workers and firms they represent.
- **Balance of powers.** Bargaining parties should be of approximately equal power, i.e. bargaining to be efficient cannot be dominated by one particular party. This requires that all parties have an adequate institutional representation and the formal of informal bargaining framework does not favor one party. Bargaining should be voluntary in the sense that no party can be compelled to sign an agreement which it does not accept (i.e. each party should have the veto right).
- **Coverage limitation.** Collective bargaining agreements should be binding only to signatories of the agreement, and parties that decide not to enter the negotiations should not be bound by the terms of the agreement. This implies that mandatory extension of bargaining agreements to non-participating employers should be precluded. Also an opt-out option for firms which find it too costly to comply with the agreement should be granted..
- **Right to renegotiate.** Agreements should be signed for a limited period of time so that to enable both parties to renegotiate their provision as economic conditions change. This is particularly important during the transition when firms are exposed to increasing competitive pressures and often no longer can afford paying benefits granted under the old regime.

In many transition economies, including Ukraine, for historical reasons at least one of these conditions is not met, which leads to skewed bargaining outcomes. Existing employer organizations often represent mainly the interests of the large, state owned or privatized firms and not those of small, *de novo* private firms. Public sector trade unions bargain with private sector employers. The bargaining process is often dominated by trade unions, while the interests of employers are poorly articulated and not taken into consideration. Industry-wide agreements are concluded that cover firms, which were not represented at the bargaining table. Finally, agreements are sometimes open-ended (or long-term) and cannot be renegotiated if one party refuses to do so, which deprives the other party (as a rule employers) of the possibility to adjust their content to the changing economic environment. As a result, national and industry-level collective bargaining agreements provide for wage growth and generous work related benefits which are not sustainable once firms face hard budget constraint and become exposed to competition. They raise labor cost and thereby reduce employment in the covered sector. These shortcomings of the bargaining system need to be addressed to make collective bargaining an efficient tool for reconciling interests of labor and capital and to yield socially acceptable and economically efficient outcomes.

Figure 13: Trade unions are mostly present in large public and privatized firms





Note: micro = up to 10 employees, small = 11-50, medium = 51-250, and large = more than 250 employees.
Source: Ukrainian Longitudinal Monitoring Survey, 2004.

The strength of unions manifests itself more in their ability to influence labor legislation than their ability to ensure its enforcement. As shown below, the draft labor code exhibits a pro labor bias placing trade unions on the stronger side. Also, as earlier demonstrated, trade unions' influence is a factor behind strong wage growth capitalizing on the productivity growth in the recent period. On the other hand, unions seem to have less power to control developments within private firms, failing to ensure compliance with labor regulations, (for example minimum wage regulations).

II. What Inhibits Labor Market Performance in Ukraine?

Two broad sets of factors influence labor market performance: the investment climate, and labor market institutions and policies. Investment climate matters because it determines the rates of entry and growth by firms, and thus, the pace of job creation. If the investment climate is poor, few new firms enter the market and existing firms do not expand, which depresses the demand for labor. Labor market institutions and policies – such as employment protection legislation, minimum wage and labor taxation – have a direct bearing on labor demand and labor supply. For example, strict employment protection legislation (EPL) raises the cost of labor adjustment; it discourages employers from hiring workers in the period of economic upturn because they want to avoid future firing costs in the period of downturn (Betcherman and others, 2001). There is substantial room for improvement on both of these dimensions in Ukraine. These factors are further examined below.

Poor governance, uncertainty, administrative barriers and poor access to finance constrain entry of and growth by firms in Ukraine. Figure 14 uses entrepreneurs' perceptions as a basis for identifying major obstacles to business operation. The figure highlights those obstacles that figure more prominently in Ukraine than in other CEE transition economies. The figure makes it clear that Ukraine faces a formidable challenge to reduce corruption, lessen regulatory and economic policy uncertainty, and remove administrative barriers which constrain business activity. Improving access to finance is also critical to spur investment and eventually job creation (World Bank, 2004).

High tax rates are viewed as one of the most important constraints. Some 40 percent of entrepreneurs in Ukraine see high tax rates as a major obstacle to the operation and growth of their firms.[25] In particular, payroll taxes are blamed for raising the labor cost and limiting hiring. However, these results need to be put into perspective. There is no doubt that taxes on business limit economic activity, and taxes on labor are likely to discourage hiring. At the same time, taxes pay for important public services and social benefits and, as such, are part of all modern economic systems. In fact, taxes are seen as less of a constraint in Ukraine than in other CEE countries (see Figure 14). It must also be noted that payroll taxes are lower in Ukraine than in most CEE countries (Figure 15). Thus, taxes do add to labor costs in Ukraine, but not more so than in other countries. The problem is thus not taxes per se, but inefficiencies in the public, including social, expenditure system.

Labor regulations are not seen by entrepreneurs as a significant constraint. In fact, as Figure 14 shows, they are viewed as the least significant obstacle to firms' operation and growth, considerably less important than in other CEE countries. For example, only 22 percent of Ukrainian firms see labor regulations as a significant obstacle, whereas in neighboring Poland the proportion is as high as 50 percent. The fact that labor regulations are not perceived as a major obstacle by employers can mean three things. First, labor regulations might not matter because they are not enforced and widely evaded. Second, they present an obstacle to firm growth, but are less important than other obstacles. Finally, labor regulations might not be seen as a binding constraint because of the dominance of the still unrestructured firms which have not yet gone through downsizing and thus have not incurred dismissal costs. In any case, the implication is that, although labor regulations are presently not viewed as a major obstacle, they are likely to become one as structural reforms progress, as has happened in other, more advanced transition economies (World Bank, 2005). Improvements in business environment, a faster pace of enterprise restructuring and a better enforcement capacity will all cause labor regulations to exert an increasing effect on enterprise performance.

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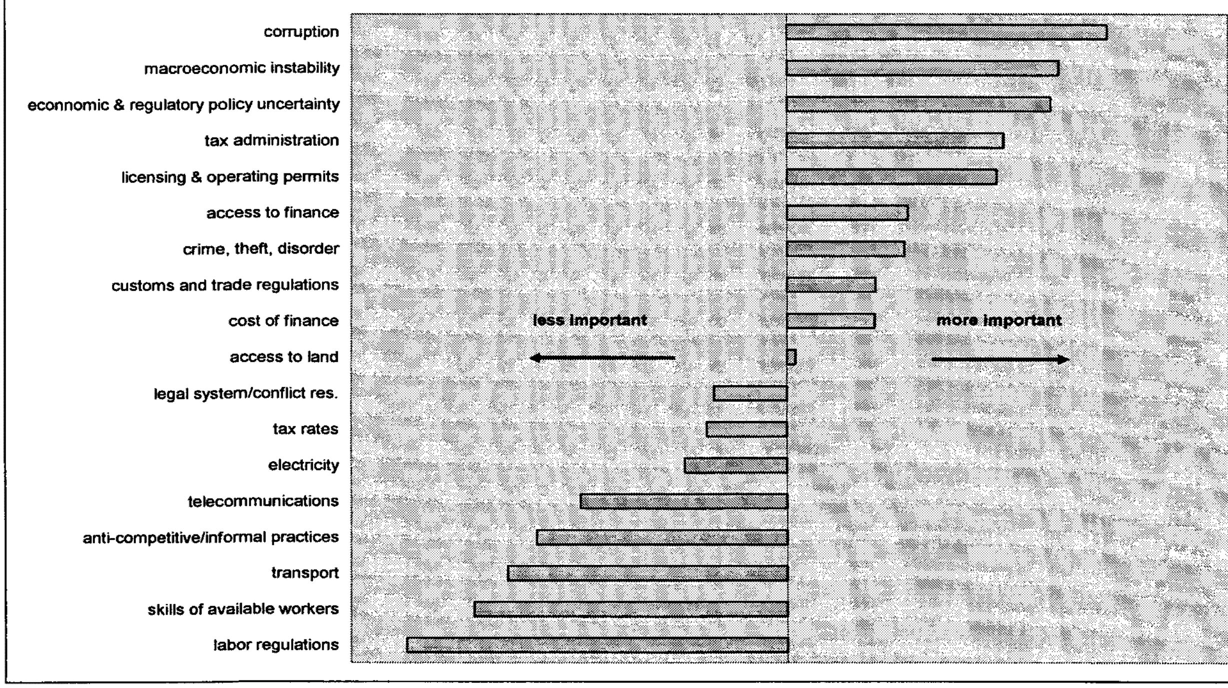
[25] High tax rates rank as a third most important obstacle to firm operation and growth in Ukraine (after macroeconomic instability and regulatory and policy uncertainty). However, taxes are perceived as less of an obstacle in Ukraine than in most EU-8 countries, and that is why they are shown as less important in Figure 3, which shows *relative,* rather than *absolute,* importance of various obstacles.

Figure 14: Corruption, uncertainty, administrative barriers and poor access to finance are seen by employers as major obstacles to firm operation and growth



Note: The chart shows deviations from the EU-8 and factor average scores.
Source: EBRD-World Bank Business Environment and Enterprise Performance Survey, 2002.

However, on paper employment protection legislation is extremely stringent in Ukraine. According to the *Doing Business* indicators, employment protection legislation in Ukraine is significantly stricter than in other CEE countries and much stricter than in most OECD countries. Employment relations are overregulated and firing costs are extremely high (Table 4).

The draft labor code relaxes some of the constraints on labor adjustment but still severely over-regulates employment relations. The draft labor code (of Spring 2005) bears the legacy of communist labor relations. It provides detailed regulations of almost every possible aspect of industrial relations and provides for high procedural costs of labor adjustment.[26] For example, the employers would need to notify the relevant trade union of a planned lay-off at least three months prior to its occurrence, discuss with the union possible preventive measures, and carry out the lay-off only in accordance with the trade union's opinion. At the same time the use of fixed-term contracts, which can facilitate labor adjustment, is strictly limited. As such, the draft labor code does not provide regulatory foundations for an adaptable labor market (leaving aside the issue of enforcement). One additional shortcoming of overregulated labor relations is that they impede the development of social dialogue and collective bargaining. If all aspects of labor relations are already regulated by the labor code and the statutory minima are set at a high level, then there is little scope for direct bargaining between employers and trade unions.

[26] The monetary cost of dismissal is modest and should not be a subject of concern, as firms should partly internalize social cost of unemployment (Blanchard, 2004).

Table 4: Employment protection legislation: Ukraine against selected CEE and OECD countries, 2004

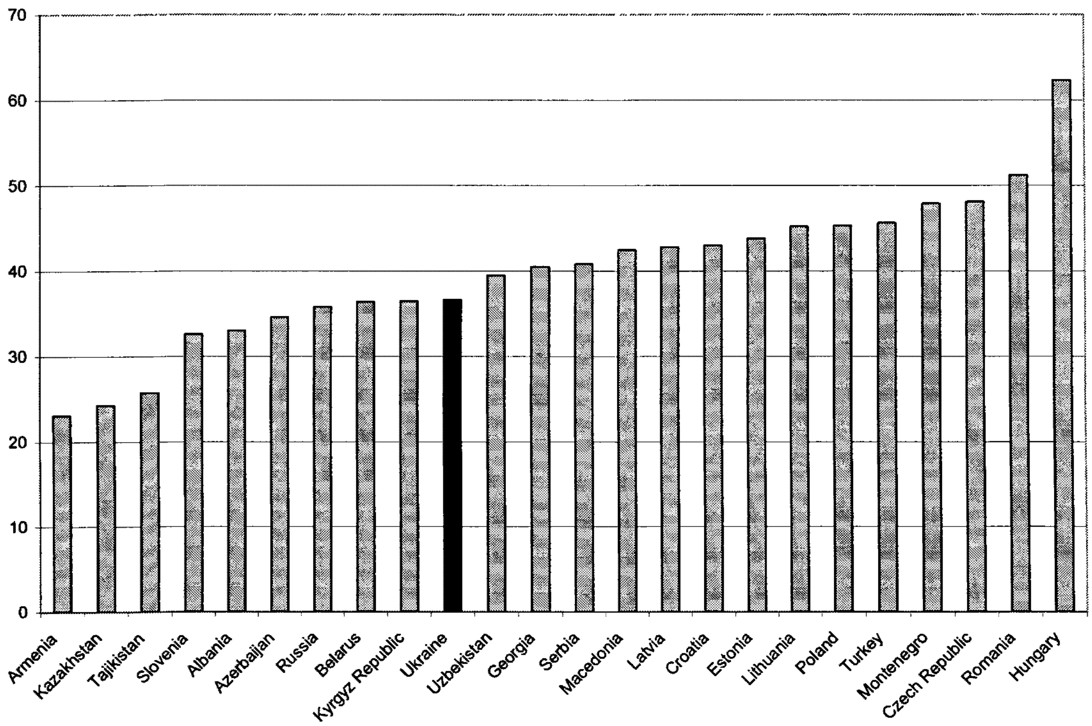
Economy	Difficulty of Hiring Index	Rigidity of Hours Index	Difficulty of Firing Index	Rigidity of Employm ent Index	Firing Costs (weeks)
Bulgaria	33	40	10	28	30
Croatia	61	60	50	57	55
Czech R.	44	20	20	28	22
Estonia	11	80	40	44	33
Hungary	11	80	30	40	34
Latvia	78	20	50	49	42
Lithuania	33	60	30	41	34
Poland	11	60	30	34	25
Romania	78	60	50	63	98
Russia	0	60	20	27	17
Slovakia	0	20	10	10	17
Slovenia	28	80	50	53	47
Ukraine	**33**	**80**	**80**	**64**	**94**
Memorandum					
OECD: High income	26	50	26	34	40
of which low unemployment OECD					
Denmark	0	40	10	17	39
Ireland	28	40	20	29	52
UK	11	40	10	20	25
US	0	0	10	3	8

Source: World Bank Doing Business database, 2004.

The discrepancy between employers' perceptions and objective indicators of the strictness of EPL is explained by lax or selective enforcement of labor regulation. **But labor market flexibility through non-enforcement is not an optimal outcome.** It undermines the rule of law, exposes firms to costly uncertainty (circumventing regulations involves costs, especially if enforcement is discretionary and selective) and leaves workers without adequate protection. Unduly strict EPL, even if only weakly enforced, is not conducive to fast and large scale reallocation of labor, which is necessary for the successful transition and productivity growth (World Bank, 2005). A socially superior solution is to deregulate employment relations so as to focus on the effective (as opposed to on paper) protection of key worker rights and standards, while supporting enterprise restructuring and enhancing labor market adaptability.

Taxes on labor are relatively high in Ukraine, although lower than the CEE average. The tax wedge on labor is high in ECA, higher than in most OECD countries, which might negatively affect both labor demand (by raising labor cost) and labor supply (by reducing take-home pay). In Ukraine the tax wedge on labor, at less than 40 percent, is relatively high, although notably lower than in CEE countries, except Slovakia (Figure 15). Payroll taxes in Ukraine are likely to dampen labor demand by raising labor cost (especially given the relatively high minimum wage, which limits the scope for passing the tax onto labor) as well as to reduce labor supply by reducing the take-home pay. Moreover, they are most probably a major factor behind the growth of the informal sector.

Figure 15: Tax wedge on labor: Ukraine against other ECA countries (2003)
The difference between labor cost to the employer and take-home pay as percentage o labor cost



Source: World Bank (2005b).

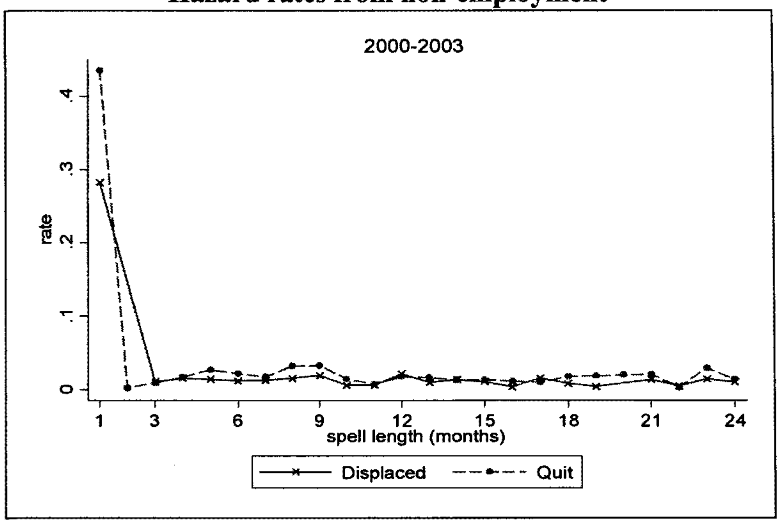
While the minimum wage is relatively high, lax enforcement means that it has little actual "bite". Experience of other transition economies (e.g. Lithuania, Poland) where the minimum wage equally high (relative to the average wage) as in Ukraine indicates that it may contribute to unemployment among less skilled and less experienced workers, especially in economically depressed regions (Rutkowski 2003b; World Bank, 2001). Notably, this does not appear to be the case in Ukraine where there is evidence of widespread noncompliance with minimum wage regulations (see above): A substantial fraction of workers earns less than the minimum wage. However, this is exactly the argument for lowering the minimum wage: Since it cuts deep into the wage distribution, it would become a binding constraint if effectively enforced and, at its current high level, would lead to a job loss among less productive workers.

The generosity of the unemployment benefits system is modest. Unambiguous assessment of the unemployment benefits in Ukraine is difficult because the system is generous in some aspects (coverage, duration) and less generous in others (replacement rate). The *benefit coverage rate* (percentage of the registered unemployed who receive benefit) at 81 percent in 2003 is very high, compared to 20-30 percent in other transition economies. On the other hand, less than 50 percent of the ILO/LFS unemployed are registered with Employment Offices, suggesting that only those unemployed with eligibility for unemployment benefits register. In other words, the unemployment register does not seem to cover workers who are unemployed and ineligible for benefits. Accordingly, the *effective* coverage rate is much lower (40 percent of the unemployed). The *benefit replacement rate* is relatively low. On average, unemployment benefit accounts for 26 percent of the average wage in the economy,

and for 58 percent of the statutory minimum wage.[27] Typical *benefit duration* is one year, which is similar to other European and transition economies. Workers in pre-retirement age (58 years of age for men and 53 for women) can receive the benefit for as long as two years, while new entrants to the labor market (uninsured workers) can receive unemployment benefit for 180 days.

Unemployment benefits seem to have no discernible effect on the outflow rate from unemployment. Estimates of the so called "hazard rates" suggest that unemployment benefits do not create significant adverse labor supply effects (Figure 16). One does not see increased outflows from unemployment to jobs after the exhaustion of benefit entitlement. After all, the vast majority of those who find jobs after displacement (or quit) do so within the first month of non employment. Apparently, unemployment benefit receipt does not prevent displaced workers from actively looking for new employment. In other words, workers do not delay their job search until after unemployment benefits cease. There is thus no evidence that unemployment benefits increase the duration of job search and thereby contribute to unemployment.

Figure 16: Unemployment benefits have no impact on the outflow rate from unemployment
Hazard rates from non-employment



Source: Ukrainian Longitudinal Monitoring Survey, 2002-2003.

Public works and training are the main active labor market programs (ALMP) for the unemployed. About 13 percent of the registered unemployed participated in public works and 6 percent were enrolled in training courses in 2003. In addition, slightly less than one percent was employed in subsidized jobs and close to 2 percent received lump sum grant to start up a business. Little is known of the cost-effectiveness of these programs in Ukraine. Evidence from other transition economies and OECD countries shows that public works should be thought of as an income support scheme rather than as a bridge to regular employment (in fact, the net employment impact of public works is often negative). Training can have a positive net impact if well targeted and tailored to the needs of both employers and the unemployed. Moreover, the efficiency of training closely depends on the availability of job openings. If labor demand is depressed and vacancies are few, training is usually not effective, i.e., it does not improve chances for employment (Betcherman and others, 2004). It is important to realize that while ALMPs may help disadvantaged worker groups (e.g. youth, low skilled workers) find employment, they

[27] But there is some anecdotal evidence (provided by the Ministry of Labor) that unemployment benefits do raise the reservation wages of the unemployed, who reportedly are often not willing to accept low-paid jobs.

do not create new jobs nor do they raise overall employment. Thus, the potential of ALMPs in improving labor market conditions is limited (Rutkowski, 2004).

III. THE POLICY CHALLENGE: PROMOTING JOB CREATION IN UKRAINE

Improving the functioning of the labor market is a key challenge facing Ukraine for two reasons. First, the labor market needs to be flexible to support industrial restructuring and long-term economic growth. Second, the labor market needs to work well to ensure employment and earnings growth, and consequently, to raise the standards of living.

The link between labor market performance and the standard of living is of particular importance given the likely acceleration of enterprise restructuring and the attendant increase in unemployment. An increase in unemployment will cause an increase in poverty and will have a bearing on the entire social protection system. On the expenditure side, it will engender pressures on the unemployment benefit and social assistance systems as well as on the pension system through early retirement and disability schemes (retirement and disability pensions are often used as *de facto* substitutes for unemployment benefit). On the revenue side, higher unemployment, coupled with growth in the informal sector, will result in a narrower tax base. This, in turn, will exert pressure on raising tax rates, and higher tax rates will dampen labor demand. In this context, fostering job creation is critical. If the pace of job creation is sufficiently high, then an increase in job destruction associated with structural reforms will lead to an increase in short-term (transient) unemployment, but not necessarily in long-term unemployment, thus limiting the resulting social cost.

In order to create more and better (more productive and higher paying) jobs, Ukraine needs to pursue a two pronged strategy. **First and foremost, it needs to improve the *investment climate* and lower the cost of doing business to encourage entry of and growth by firms.** There is a need to provide adequate incentives for firms to establish and grow in order to expand job creation as well as accelerate absorption of workers displaced by structural changes. "Encouragement" policies such as these are particularly important given that the size of the "new" and job generating sector is still small in Ukraine.

Second, it needs to reform its *labor market institutions* to create an adaptable labor market. This is a market where employers have incentives to hire workers, and workers have incentives and skills to take-up available jobs.[28] Although currently labor market regulations do not seem to be a significant obstacle to firm growth due to lax enforcement, they might become one in the future. Accordingly, revising labor market regulations so as to improve labor market adaptability is necessary to lay the foundation for job creation and productivity growth in the long-term.

The first step toward improving the investment climate is to identify the key constraints to firm entry and growth. They can be identified using specially designed surveys and, more importantly, through regular consultations with the business community. More broadly, genuine social dialogue can facilitate agreements which would balance the interests of employers with those of workers. For such dialogue to be effective, however, there is a need to balance power between all partners, so that no one side will dominate the process.

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[28] This general policy framework was developed in World Bank (2005b).

Based on the results of the BEEPS survey, **the top priorities for investment climate reform in Ukraine are as follows:**

- *Reducing corruption.* This involves reducing the discretionary power of bureaucrats, simplifying regulations and procedures to reduce scope for arbitrary interpretation and decisions, limiting to a minimum the number of permits, certificates and licenses, and limiting the number and frequency of various inspections.
- *Reducing regulatory and economic policy uncertainty.* By its very nature, transition is associated with uncertainty. Still there is scope for reducing this uncertainty by improving the design of regulations and policies in order to avoid frequent, often erratic changes sometimes introduced under pressure from special interest groups. This involves developing policy analysis, conducting consultations prior to important regulatory and policy changes, and building consensus around reforms.
- *Improving tax administration.* This involves simplifying tax regulations, ensuring their consistent interpretation, cutting red tape, limiting bureaucratic harassment, and controlling tax inspections to curb extortion.
- *Reducing the number of permits and licenses, and simplifying custom and trade regulations.* This should be part of a broader effort to liberalize and deregulate the economy and reduce the extent of state control over business activity. Less cumbersome regulations reduce the cost of operating in the formal sector and thus can entice informal firms to become formal.
- *Improving access to finance.* Access to credit has been proven to be a critical factor affecting firm entry and growth. Key reforms in this area include promoting competition in the banking sector so as to reduce the interest rate spread, and developing micro-finance schemes so as to improve access to finance by small business. Easier access to finance can also improve incentives for firms to register and thus to reduce the size of the informal sector.

Labor market reforms should constitute a package consisting of three major elements: (a) the liberalization of employment relations, (b) the development of direct bargaining between employers and workers, and (c) effective enforcement of core worker rights. In particular:

- *Liberalizing employment protection legislation.* The labor code should regulate a narrower area of employment relations and the regulations should provide for minimum statutory standards of employment protection so as to create room for direct bargaining between social partners. In particular, the procedural *costs of dismissals* should be reduced to facilitate employment adjustment. Provisions governing *flexible employment contracts* (e.g. fixed term contracts) should be liberalized so as to lower labor adjustment cost and encourage hiring. *Working time flexibility* should be enhanced by liberalizing rules governing overtime work, and permitting the redistribution of the working hours over a longer period of time to facilitate adjustment to seasonal demand fluctuations.
- *Developing efficient bargaining structures.* The collective bargaining system in Ukraine needs to develop so as to meet the criteria for efficiency (see Box 1.2). Particularly, the interests of employers need to be better balanced with those of employees. Collective agreements concluded with the state acting as an employer will need to be renegotiated to be applied to the private sector. Moreover, the efficiency of industry level bargaining needs to be reassessed. Industry level bargaining can be inefficient since the agreements take into account neither firm specific conditions nor economy-wide effects of wage increases. Thus, such agreements should be binding only for enterprises which signed the agreement (through their representatives) and should not be extended to firms not represented at the bargaining process. In addition, industry level agreements should include opt-out options for firms which cannot afford to comply (particularly small firms in difficult financial position). An alternative is to strengthen firm level

bargaining (which tends to be more efficient) relative to industry level bargaining (which tends to yield inefficient outcomes). Firm level bargaining takes into account firm specific conditions as well as the effects of the agreement on the firm's competitiveness. However, a move toward firm level bargaining assumes that worker interests are adequately represented at the firm level.

- *Improving the enforcement capacity of labor inspections.* While the employment protection legislation should be significantly liberalized and employment relations should be deregulated, the core worker rights should be effectively protected. Firms need to comply with labor regulations to respect the rule of law, and to provide workers with socially acceptable and economically efficient degree of employment protection. But rather than increasing the already high burden of inspections on firms, or increasing the penalties, new modes of inspection services, such as self-reporting or contracting-out, should be tested.
- *Reviewing the minimum wage policy so as to take into account labor market conditions and unemployment among affected workers.* Currently the minimum wage is high *relative to* the average wage, but not enforced.[29] Enforcement, however, could cause job loss among less productive workers (youth, unskilled workers). Therefore the government can consider setting minimum wage at a lower proportion of the average wage (e.g. one-third of the average wage) to limit its potential dis-employment effect. This can be coupled with setting a separate (higher) minimum base for social insurance contribution to protect social budget revenues. Alternatively, a youth sub-minimum (e.g. 80 percent of the regular minimum) could be instituted to protect employment among the most vulnerable group. In addition, social benefits should be de-linked from the minimum wage to render the minimum wage policy independent of other social policies. However, it is important that the minimum wage policy is based on reliable data on the wage distribution and the correct estimate of the average wage is available.
- *Reducing payroll taxes.* This involves broadening the tax base through providing incentives for firms to move to the formal sector (see above), and improving the cost-effectiveness of social expenditures which are financed by payroll-taxes (mainly pensions). However, this is a gradual process closely associated with reforming the social insurance system.
- *Putting in place the system of monitoring and evaluation of active labor market programs (ALMP).* ALMP can be a useful too for improving employment chances of disadvantaged worker groups. However, they do not increase overall employment. Evidence shows that their *net* impact is limited. At the same time they are costly. Therefore it is important to improve the cost-effectiveness and targeting efficiency of the programs. To this end, net impact and cost per placement need to be determined for various client groups and under different labor market conditions so as to target programs at groups that benefit most from a given intervention.

Labor reforms are politically difficult because they involve trade-offs between interests of various groups: insiders (workers with secure jobs) and outsiders (workers with insecure jobs or the jobless) as well as employers. For example, reforms which limit employment protection weaken the position of those with jobs, but improve the employment chances of the unemployed, and at the same time give employers more flexibility in adapting to changing product demand conditions.

The recent examples of labor market reforms in countries such as Croatia, Poland, Serbia and Montenegro, and Slovakia demonstrate that they can be successfully carried through. The conditions for success include having an agent of change (a government unit, an employer organization, a progressive trade union), an effective dialogue between genuine representation of social partners, and finally a well

[29] This assessment is based on the assumption that the official estimates of the average are correct. If however, as sometimes asserted, wages are significantly underreported then the minimum wage to average wage ratio is overestimated and accordingly the "bite" of the minimum wage is less. Therefore for a sound minimum wage policy better data on the wage distribution and further research are necessary to determine the actual amount of the average wage and the minimum wage-to-average wage ratio.

designed public information campaign to inform the key stakeholders of the costs of existing provisions and the benefits of reforms.

Eventually, reforms need to balance interests of all sides. In the Ukrainian context, the *quid pro quo* consists of deregulating employment relations but improving the enforcement of core worker rights also in the private sector, where unions are weaker.

ANNEX 1
COMPARATIVE DATA ON THE PROGRESS OF TRANSITION AND ON LABOR MARKETS

Table A1.1: Progress of structural reforms: Ukraine against its neighbors, 2004

	Poland	Romania	Russia	Slovakia	Ukraine
Privatization					
Private sector share in GDP (%)	75.0	70.0	70.0	80.0	65.0
Private sector share in employment (%)	72 [a)]	75.0	na	75 [b)]	42 [c)]
EBRD index of small-scale privatization	4.3	3.7	4.0	4.3	4.0
EBRD index of large-scale privatization	3.3	3.7	3.3	4.0	3.0
Enterprise and markets					
EBRD index of enterprise reform	3.3	2.0	2.3	3.0	2.0
EBRD index of competition policy	3.0	2.3	2.3	3.0	2.3
Financial sector					
EBRD index of banking sector reform	3.3	2.7	2.0	3.7	2.3
Memorandum items					
GDP per capita (in US dollars) a)	5402	2624	2987	6045	1024
Agriculture, value added (% of GDP) [a)]	3.1	11.9	5.2	3.7	14.1

a) 2003
b) 2001
c) ULMS

Source: EBRD (2004), Transition report, London; World Development Indicators database 2005.

Table A1.2: Key labor market indicators: Ukraine against the OECD, 2004

(percentages)

	Ukraine	EU-15	OECD	OECD CEE	United Kingdom	Czech Republic
Employment-to-population ratio	56.7	65	65.3	57.5	72.7	64.2
Labor force participation rate	62.0	70.8	70.1	66.1	76.2	70.1
Unemployment rate	8.6	8.2	6.9	13	4.7	8.4
Incidence of long-term unemployment	42.5	42.4	32	51.4	21.4	51.8

Notes:
Persons aged 15-70 for Ukraine and 15-64 for other countries
OECD CEE: Czech Republic, Hungary, Poland and Slovakia.
Long-term unemployed: persons unemployed for 12 months and over
The United Kingdom and the Czech Republic were selected as examples of well-performing labor markets in Western Europe and in Central Europe, respectively.

Sources:
OECD: Employment Outlook, 2005
Ukraine: www.ukrstat.gov.ua

ANNEX 2
RESULTS OF THE REGRESSION ANALYSIS OF FIRM LEVEL EMPLOYMENT GROWTH

Table A2.1: The determinants of firm-level employment growth in industry (manufacturing and mining) during 2002-2003
Dependent variable: employment growth rate

Explanatory variables	Regression equations			
	(1)		(2)	
ln(size)	0.007	(0.005)	-0.006	(0.006)
ln(labor productivity)	-		0.055*	(0.008)
Ownership form (State)				
Liability company	0.097*	(0.024)	0.050*	(0.023)
Joint-stock company	-0.008	(0.016)	-0.020	(0.015)
Private enterprise	0.094*	(0.044)	0.052	(0.045)
Other types of ownership	0.000	(0.024)	-0.004	(0.024)
Industrial sector (Energy industry)				
Fuel industry	-0.095*	(0.024)	-0.068*	(0.022)
Ferrous metallurgy	-0.009	(0.024)	-0.005	(0.027)
Machine building and metals industry	-0.080*	(0.019)	-0.028	(0.022)
Non-ferrous metallurgy	-0.085*	(0.043)	-0.073	(0.038)
Chemical and petrochemical industry	-0.072*	(0.033)	-0.069*	(0.031)
Wood and paper industry	-0.123*	(0.030)	-0.086*	(0.031)
Construction materials industry	-0.006	(0.024)	0.014	(0.026)
Glass and pottery, china industry	-0.107	(0.066)	-0.066	(0.064)
Light industry	-0.141	(0.026)	-0.069*	(0.028)
Food processing industry	-0.059*	(0.019)	-0.063*	(0.021)
Microbiological industry	-0.147*	(0.026)	-0.157*	(0.031)
Bakery, serial and feedstuff industry	-0.081*	(0.036)	-0.046	(0.036)
Medical industry	-0.024	(0.026)	-0.042	(0.032)
Printing industry	-0.084*	(0.032)	-0.075	(0.033)
Other branches of industry	-0.027	(0.037)	-0.016	(0.040)
Type of region (Agricultural)				
Heavily industrialized region	0.039*	(0.017)	0.028	(0.017)
With diversified economy	0.018	(0.015)	0.003	(0.015)
Constant	-0.038	(0.039)	-0.129*	(0.039
Number of observations	2052		2009	
R-squared	0.040		0.081	

Note: Dependent variable is gremp=2(empl2003-empl2002)/ (empl2003+empl2002). Labor productivity is defined as value of sales in 2002 divided by the total number of workers in the end of 2002. Reference (omitted) categories are indicated in parentheses. Robust standard errors are in brackets.

*Indicates 5% significance level.
Source: Ukrainian Labor Market Flexibility Survey. Bank staff calculations.

ANNEX 3
RESULTS OF THE REGRESSION ANALYSIS OF WAGE DETERMINATION

Table A3.1: The determinants of earnings of formal sector workers, 2004
Dependent variable: log monthly earnings

Variable	Coefficient	t-statistics	Significance
Education [a)]			
Vocational training	0.033	0.5	
Secondary	0.134	2.2	*
College	0.258	4.3	**
University	0.493	7.9	**
Age	0.016	2.8	**
Age squared/100	0.022	-3.4	**
Female	-0.303	-13.7	**
Collective agreement	0.101	2.9	**
Regional dummies	yes		Significant
Industry dummies	yes		Significant
Constant	5.193	37.7	**
Number of obs.	2125		
F-statistics	23.54		
R-squared	0.332		
Adj. R-squared	0.318		

** indicates 1% significance level
* indicates 5% significance level
a) Primary education is the reference category)
Source: Ukrainian Longitudinal Monitoring Survey, 2004

ANNEX 4
THE UKRAINIAN LONGITUDINAL MONITORING SURVEY (ULMS)

The Ukrainian Longitudinal Monitoring Survey (ULMS), started in 2003, is a household panel, and was established to monitor the Ukraine's path of transition from Communism to a market-oriented social democracy. Thus far two waves of data have been collected, in March to June of 2003, and May to August of 2004. Access to the micro data is for the moment available only at the IZA-Bonn and the RWI-Essen. The data of the first wave consist of more than 8600 respondents, comparable to the initial samples of the American Panel Study of Income Dynamics (PSID), German Socio-Economic Panel (SOEP), the British Household Panel Studs (BHPS) and the Russian Longitudinal Monitoring Survey (RLMS).

Sample

The ULMS sample is collected by the Kiev International Institute of Sociology (KIIS). The sample is drawn from the December 2001 Ukrainian Census and stratified by age, gender, city/town, and regional structure. The target of the household survey is the working age population. In the original ULMS sample in 2003, the definition of the working-age population comprises of persons between the ages of 15 and 72, who then were administered the individual questionnaire. An additional household questionnaire was administered with the household head (that person most knowledgeable of household matters) responding.

The starting ULMS sample is representative for the working-age population of Ukraine in 2003, with 8641 individuals in 4056 households. The part of that sample (1453 individual interviews, 841 households) was panel, using the sample of the 1995-96 surveys undertaken by KIIS. In each household with persons between the ages of 15 and 72, the household questionnaire was administered. Afterwards, the individual questionnaires were administered to all persons between the ages of 15 and 72. The fieldwork in 2003 lasted 3 months and was carried out by 160 interviewers. See KIIS (2003) for a detailed description of the sample definition.

KIIS (2003) report an initial household response rate of 66% for the ULMS. The wave 1 to wave 2 attrition was in the order of 20%.

Survey Instruments

The original questionnaires are available in English, Russian and Ukrainian. As in many household panel surveys, there are different reference periods addressed in the instruments: (i) retrospective information, where information is gathered about employment changes in 1986, 1991, 1997, 1998–2002 and about changes of residence since 1986, and (ii) concerning the reference-week, where information is gathered about the week preceding the interview. Further, detailed individual characteristics of household members are collected, along with educational attainment and skills section, and finishing with attitudes, health, and ecology issues.
The detail and depth of the ULMS data is similar to that of the well-know German Socio-Economic Panel (GSOEP) and the British Household Panel (BHPS). The first wave of the ULMS, based on the individual questionnaire, includes 1837 variables with an additional 679 variables in the life history chart. The data file based on the household questionnaire includes 240 variables. The average survey duration of the individual survey is 72 minutes and 22 for the household survey.

There are some particularly interesting aspects to the questionnaires. There is particular depth of information with respect to the respondent's own educational attainment and that of his parents. The retrospective questions concerning labor market activity are asked 1986 and 1991. Starting for the year 1997, a complete employment history is recreated up to the date of the interview in 2003. Indeed they are

so complete that hazard rate models can be estimated on labor market. This is unusual as many household panels only collect current month information on employment.

As informal activity in the underground economy also plays an important role in the Ukraine, contingent employment and informal employment is explicitly captured with the survey instrument. During transition to the market economy, there are many large changes in the industrial structure observed in the post-Soviet countries. The questionnaires allow the researcher to observe whether the employee has been simply displaced as opposed to fired (for cause). Together with the identification of informal employment activity, a clearer picture can be taken of the household responses at the micro level.

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