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Employment Dynamics of Newly Established and Traditional Firms: A Comparison of Russia and the Ukraine

Abstract

In this paper we test the effects of ownership, competition and disorganisation on firm level employment dynamics using a unique data set of 150 Russian and 300 Ukrainian firms. Our results, in contrast to findings in Central and East European Countries, suggest that newly established firms do not out perform those that existed under central planning during the transition process. In addition, while competition seems to play no role in employment determination, disorganisation is shown to constrain firm employment in the Ukraine but not in Russia. Such outcomes are explained by the nature and timing of restructuring in these countries.

Keywords: employment, *de novo* firms, traditional firms, Russia, Ukraine

JEL Classification: P0, O0, D0

I. Introduction

The evolution of manufacturing output, employment and unemployment for the Ukraine and Russia is shown in Fig. 1 (a) and (b), respectively. All series are normalised on 1 at the start of transition. The collapse in employment has lagged behind the collapse in output, while unemployment has remained extremely low in both countries. A collapse in output and employment is observed in all Central and East European (CEE) countries in their transition to a market economy. Yet, in most CEE countries the collapse started earlier than in Russia and the Ukraine. By 1997 a substantial number of CEE countries were emerging from their deep recessions, as reflected in the U-shaped pattern of output and employment (Blanchard, 1997). This, is not yet observed in Ukraine, which indicates that recovery has not started and that the initial shocks of transition and restructuring are ongoing. A marginal recovery in Russia shows up in 1997, which may indicate that Russia is in a slightly more advanced stage in the transition process, although the recent financial crisis may be expected to constrain this recovery process.

Fig. 1 (a)

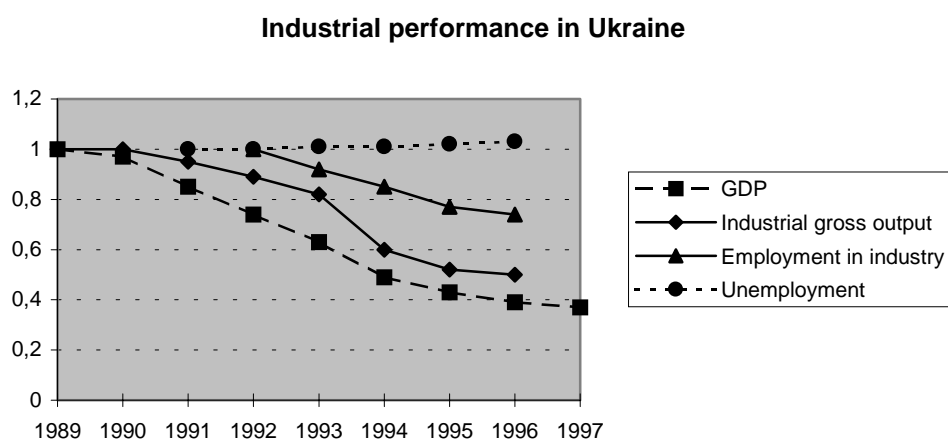


Fig. 1 (b)



As outlined in Blanchard (1997), reallocation and restructuring are the two key elements of the transition process. Reallocation refers to the movement of production away from state to private ownership. Restructuring refers to changing the level and technical composition of labour and capital in search of higher production efficiency. A distinction can be made between initial restructuring and deep or strategic restructuring. Initial restructuring refers to reducing over-manning levels in response to the hardening of budget constraints. The reduction of subsidies to traditional firms should lead to a collapse of labour demand in traditional firms. Initial restructuring would thus be reflected in a high job destruction rate and a low job creation rate. Deep or strategic restructuring requires that fundamental actions be undertaken aimed at improving the long run performance of the firm. This type of restructuring can include various actions such as an increase in investment into new technology, vertical innovations in products and replacement of obsolete capital. Deep restructuring will eventually be reflected in job creation and a slow down in job destruction. This reallocation and restructuring process may be expected to change the sector and regional map of employment. Under Central Planning the manufacturing

sector was large compared to the standards of market economies, so with transition a part of the reallocation takes the form of reallocating activities from manufacturing to services, from large to small firms, from one region to another.

The macroeconomic evolution of employment might hide important turbulence in firm level employment performance during transition. An example can illustrate this. A net aggregate employment growth of -5% might be the result of a gross job creation rate of 1% and a gross job destruction rate of 6%, or alternatively, a gross job creation rate of 10% and a gross job destruction rate of 15%. Obviously, the latter suggests a much more active reallocation process than the former. There has been an increased interest from both labour and industrial organisation economists in the empirical aspects of gross flows of jobs and turbulence (e.g. Davis and Haltiwanger, 1992). However, very little work to date examines job reallocation in transition countries. Konings, Lehmann and Schaffer (1996) study gross job reallocation in the Polish industrial sector at the start of transition, while Bilsen and Konings (1998) and Faggio and Konings (1998) study gross job flows for Romania and Bulgaria. These papers document large job reallocation during the transition process.

In section II of this paper we study gross job flows for the period between 1990 and 1996 as indicators of reallocation and industrial restructuring in Ukraine and Russia. We expect to gain some insights into the timing of transition and the magnitude of reallocation in countries that substantially lag behind the other CEE reforming countries. We use micro data of 300 firms in Ukraine and 150 firms in Russia that were collected by personal interviews with the key manager of state, privatised and newly established (*de novo*) private firms. The data has a regional bias towards St. Petersburg in Russia and Kiev/Dnepropetrovsk in the Ukraine, both

advanced cities in terms of transition within the two countries. Our results suggest that the transition process started much later in the Ukraine. It is only after 1994 that we observe firms creating jobs. Large-scale job destruction was still present in the Ukraine in 1996. In contrast, Russia has undertaken much of its restructuring and reallocation in earlier periods. In both countries firms in the Traded/Retail sector and *de novo* firms are the main job creators during transition while firms in manufacturing and services contribute mostly to job destruction. In contrast to CEE countries, a lack of deep restructuring in manufacturing and the slow emergence of the services is a strong feature of both countries.

A second motivation for this study lies in assessing the effects of ownership, competition and disorganisation on firm level employment dynamics. In section III of the paper, we estimate reduced form firm level employment growth equations. We explain employment growth with ownership, focusing on the difference between *de novo* and traditional firms, competitive pressure, or lack of, in product and input markets, and disorganisation in the vertical links of production.

Evidence from Poland, Bulgaria and Romania suggests that, particularly at the start of transition, *de novo* private firms fuel the job generation process. Traditional firms, privatized and state owned enterprises that existed under central planning, shed labour in the initial stages of transition and modestly contribute to the recovery thereafter (Konings, 1997; Bilsen and Konings, 1998). Industrial restructuring can be expected to lead to the disappearance and shrinking of traditional firms and the emergence of newly established firms in the private sector. Understanding the heterogeneous experience of firms is therefore essential if one wants to understand the details behind industrial restructuring.

Our results, in contrast to findings in Central and East European Countries, suggest that newly established firms do not outperform those that existed under central planning during the transition process. This is explained by the relatively slow emergence of services in these countries, constrained by the lack of restructuring in large manufacturing firms that still manage their own services. Competition, as found in many CEE countries in the initial stages of transition, seems to play no role in employment determination in either country. As documented in Konings and Walsh (1999) for the Ukraine, disorganisation in the vertical links of production is shown to constrain employment. Yet, in this paper this is shown to be absent in Russia. The absence of such supply side constraints in Russia is explained by the fact that Russian firms seem to be more advanced in the transition process by 1996. Finally, section IV summarises and concludes.

II. Data Description and Aggregate Gross Job Flows

II.1 Data Description

The data we have at our disposal is based on enterprise surveys that were organized by LICOS in the fall of 1997. The questionnaire covered various aspects of firm behavior (relating to ownership, production, competition and industrial relations, amongst other things) in the Ukraine and Russia¹. After an initial pilot study, local teams of interviewers undertook the surveys with visits to the companies. The sample framework was set up to cover 50% “traditional” firms, being state owned and privatized firms, and 50% *de novo* private firms. In addition, the sampling was confined mainly to two regions in the Ukraine, Kiev and Dnepropetrovsk, and one region, Saint-Petersburg, in Russia. The sample covers firms in the manufacturing,

trade and service sector. In the Ukraine most of the traditional and *de novo* firms are located in manufacturing, although there are relatively more *de novo* than traditional firms in trade and services. In Russia, most traditional firms are in manufacturing while *de novo* firms are spread across the three sectors in equal proportions. The 50-50 split between the *de novo* firms and the “traditional” ones in these regions does not reflect the distribution of the population of firms. We chose this setup in order to focus on the difference (if any) between these two categories of firms in advanced regions. This is in line with recent evidence showing that *de novo* private firms behave inherently different to SOE’s and privatized ones during transition (Konings, 1997, Richter and Schaffer, 1995).

Our sample consists of 300 Ukrainian firms and 150 Russian firms, with three ownership categories: *de novo* private, one hundred per cent State Owned Enterprises (SOEs) and privatized previously SOEs. The *de novo* firms are those which are private since establishment and for which the date of operation starts after 1989². The second category refers to firms still in state hands, while the third category includes privatized firms that were previously state owned. Table 1 gives the sample structure and summary statistics on size and employment growth for these three categories by country in 1996. The employment characteristics for SOEs and privatized (previously SOEs), are shown to be similar. In the rest of the paper we group these two types under the heading of traditional firms.

The average size of a *de novo* firm is typically small. The average employment growth in *de novo* firms is positive while the average employment growth of traditional firms is negative. This suggests that initial restructuring by traditional firms

¹ The questionnaire is available upon request from the authors.

(reducing overmanning levels) is still going on in 1996. The firms in the Russian sample are much larger compared to the Ukrainian sample. In addition while *de novo* firms have stronger growth rates in Russia, the average employment growth rate in traditional firms, especially privatized firms, is far less negative than that observed for the Ukraine.

Table 1: Summary Statistics 1996

	Ukraine		Russia	
	<i>Employment</i>	<i>Employment growth</i>	<i>Employment</i>	<i>Employment growth</i>
Overall sample,	279	-0.023	421	0.09
de novo firms	29	0.10	42	0.25
State firms	598	-0.12	1005	-0.06
Privatized firms	427	-0.16	808	-0.06

II.2. Job Creation and Destruction

In this sub-section we compute gross job flows for the overall sample, per sector and per ownership class. Following the literature ³, the *gross job creation rate* (Pos) is derived from summing all job gains in expanding firms expressed as a fraction of all jobs in a defined sample (sector or ownership class) a year earlier ⁴. Similarly, the *gross job destruction rate* (Neg) is the sum of all job losses in contracting firms relative to the total number of jobs. The sum of the job creation and destruction rate gives a measure for job reallocation, called the *gross job reallocation rate* (Gross) while the difference gives the *net employment growth rate* (Net) in a defined sample. Another measure for job reallocation often used is the *excess job reallocation rate* (Excess), which is the difference between the gross job reallocation

² There were in fact a few firms which were private since establishment and started to operate before communism early this century. However, these are not considered to be *de novo* firms.

³ Davis and Haltiwanger (1992), Boeri and Cramer (1992).

⁴ Often the denominator has average employment over two years instead of employment a year earlier. This is important if one wants to analyze job gains and losses due to entry and exit of firms. Here we only focus on continuing firms.

rate and the absolute value of the net employment growth rate. In other words, the excess job reallocation rate is a measure of real churning of jobs due to common movements net of employment growth. Alternatively it can be regarded as an index of firm heterogeneity.

Table 2a shows the aggregate gross job creation, destruction and reallocation rates since 1990 for the Ukraine. The gross job reallocation rate increases over time, from 8% in 1991 to 18% in 1996. Thus, we observe increased turbulence over time, which we would expect as we move into the transition to a market economy. This gross job reallocation rate of 18% which is relatively high compared to CEE transition countries, is predominantly driven by a high job destruction rate. While the gross job destruction rate is below 10% before 1994, since 1994, the gross job destruction rate has increased above 10% to reach 15% in 1996. Also the gross job creation rate has increased over time from well below 1% in the early years of transition to almost 3% in 1996. Thus it seems that the real restructuring in the Ukraine started after 1994 when we observed a significant increase in both job destruction and job creation.

Table 2a: Gross Job Flows per year for Ukraine

Year	Pos	Neg	Gross	Net	Excess
1991	0.001	0.078	0.08	-0.07	0.003
1992	0.006	0.049	0.056	-0.043	0.013
1993	0.009	0.094	0.103	-0.085	0.018
1994	0.008	0.101	0.11	-0.092	0.017
1995	0.011	0.144	0.15	-0.122	0.022
1996	0.025	0.153	0.18	-0.12	0.050

As documented in table 2b, the gross job reallocation for Russia increases from 7% in 1991 to 19% in 1994, but goes down to 6% in 1996. The decreasing turbulence is caused by a significant decrease in the job destruction rate. Contrary to the case in Ukraine, it seems that most restructuring in Russia took place before 1995⁵.

Table 2b: Gross Job Flows per year for Russia

Year	Pos	Neg	Gross	Net	Excess
1991	0.001	0.072	0.073	-0.071	0.002
1992	0.009	0.143	0.152	-0.134	0.018
1993	0.003	0.138	0.141	-0.135	0.006
1994	0.025	0.167	0.192	-0.141	0.051
1995	0.018	0.143	0.161	-0.125	0.035
1996	0.012	0.049	0.061	-0.037	0.023

In table 3a and 3b, we show the annual average gross job flows for the manufacturing, trade and service sectors in Ukraine and Russia. Starting with the Ukraine, while job destruction is above 10% in both the manufacturing and service sector with virtually no job creation, job creation in the trade sector is 6.3% and dominates the job destruction rate of 4.5%. Thus, it seems that the booming sector is the trade sector, while the collapsing ones are manufacturing and services. The fact that job creation in the service sector is so low and job destruction so high might come as a surprise since this sector was virtually absent under central planning. One explanation for this is that in the old system services were usually classified within

⁵ Richter and Schaffer (1996), using a comparable survey based firm level data set, report a gross job reallocation rate of 8% for Russia.

jobs in manufacturing. The lack of restructuring and downsizing, or sub-contracting service jobs, in large manufacturing firms ensures the service sector is constrained by the performance of the manufacturing sector.

Table 3a: Annual average gross job flows in sectors for Ukraine

	Pos	Neg	Gross
Manufacturing	0.007	0.10	0.107
Trade	0.063	0.045	0.11
Services	0.013	0.126	0.14

The annual gross job flows in Russia are similar to the Ukraine. The manufacturing and services sectors hardly created jobs, while the job creation rate in the trade sector dominates the job destruction rate.

Table 3b: Annual average gross job flows in sectors for Russia

	Pos	Neg	Gross
Manufacturing	0.01	0.074	0.084
Trade	0.328	0.091	0.419
Services	0.03	0.17	0.20

Finally, in table 4 we examine the gross job flows according to ownership. We distinguish between the *de novo* firms on the one hand and the traditional firms, being SOEs and privatized firms, on the other. We focus on the year 1996 used in our empirical work. The gross job creation rate of *de novo* firms in 1996 is 22% and the gross job destruction rate only 7%. This compares to a gross job creation rate of 2% in traditional firms and a job destruction rate of 16%. In Russia, these figures are lower, but show a similar trend. The job creation rate in *de novo* firms was 10%, while the job destruction rate was 5%. In traditional firms, the job creation rate was only 1%

and the job destruction rate was 5% reflecting there more advanced stage of restructuring compared to traditional firms in the Ukraine.

Thus it seems that the *de novo* firms are fundamentally more dynamic in terms of job creation, and are the main source of growth. There might be a sample selection bias, i.e. we only observe the surviving *de novo* firms while the traditional firms that are non-viable in the market system may still be in the data. In addition there may be a size bias as *de novo* are small and may be expected to grow faster than large firms.

Table 4: Gross Job Flows According to Ownership in 1996

	Ukraine			Russia		
	<i>Pos</i>	<i>Neg</i>	<i>Gross</i>	<i>Pos</i>	<i>Neg</i>	<i>Gross</i>
<i>de novo</i> firms	0.22	0.7	0.29	0.104	0.055	0.159
Traditional firms	0.02	0.16	0.18	0.008	0.048	0.056

The observed pattern of job creation and destruction indicates a substantial process of restructuring in which sector and ownership effects seem to matter. In the next section we investigate how empirically robust these observations are by estimating employment growth regressions.

III. Firm Level Employment Growth

The process of job creation and destruction is ultimately linked to the underlying process of heterogeneous firm performance. We focus on three main factors that can potentially determine the process of firm growth in transition countries: ownership, competition and disorganization.

Ownership Effects: In the previous section we saw that *de novo* firms had higher job creation and lower job destruction rates than traditional ones. We might therefore expect that *de novo* private firms would also show higher growth rates also at the micro level due to their ownership type, while controlling for other variables. However, it is important to recognize that *de novo* firms are also typically smaller than traditional firms. It is a well-known empirical outcome that small firms can have higher growth rates than large firms. To distinguish the ownership effect from a size effect, we take into account firm size in our regressions.

Competitive pressure: Transition economies are endowed with relatively rigid product market structures due to the central planning system. One might expect that increased competitive pressure should enhance restructuring and efficiency and should therefore have a positive effect on firm growth. We measure competitive pressure in the product market by using a firm level indicator as in Nickell (1996). Managers were asked whether they faced more than 5 competitors in their main product market. We use a dummy equal to 1 (comp) if this was the case. Competitive pressure in factor markets is measured on the basis of the number of suppliers. The managers were asked whether they had many suppliers for their inputs, only a few, or one. We use a dummy equal to 1 if the firm has many suppliers. We summarize these dummies in table 5. Firms in the Russian sample are shown to face more competition in both product markets and factor markets.

Table 5: Structure of competition in product and input markets (frequencies)

Competition	De Novo Ukraine	Traditional Ukraine	De Novo Russia	Traditional Russia
More than 5 competitors	0.67	0.50	0.82	0.72
More than 5 suppliers	0.57	0.45	0.55	0.77
Less than 5 competitors	0.33	0.50	0.18	0.28
Less than 5 suppliers	0.43	0.55	0.45	0.23

Disorganization: Blanchard and Kremer (1997) and Roland and Verdier (1997) recently argued that apart from a reallocation and restructuring process in transition countries, there is a third key characteristic of transition, called disorganization. With the collapse of central planning the bilateral relations between suppliers and firms collapsed, leading to a potentially big disruption in production. We use three measures of disorganization. The first disorganization measure relates to import dependence of inputs. In the questionnaire it was asked whether the firm depended heavily on imported inputs. This would be an indication that the firm was successful in avoiding disorganization by importing.

Table 6: Frequency of dependence on imported inputs

	De Novo Ukraine	Traditional Ukraine	De Novo Russia	Traditional Russia
Yes	0.26	0.18	0.49	0.20
No	0.74	0.82	0.51	0.80

De *novo* firms in both countries, particularly in Russia, seem to avoid supply side constraints by importing their inputs. The second control variable measures the number of products the firm has. Traditional firms with many products may be hit

more by disorganization since they are less flexible to adapt their product range to the market system. This variable is summarized in table 7.

Table 7: Product Ranges by Ownership

No. of products	De Novo Ukraine	Traditional Ukraine	De Novo Russia	Traditional Russia
1	0.46	0.44	0.70	0.35
2	0.30	0.27	0.20	0.27
3	0.14	0.11	0.08	0.21
4	0.08	0.09	0.01	0.12
5	0.02	0.09	0.01	0.03

Traditional firms have a tendency to have a greater range of products compared to the smaller *de novo* firms. This is very apparent in the Russian sample. A final disorganisation measure is the level of investment in new equipment in 1996. Firms were asked whether they invested in new equipment in 1996. Roland and Verdier (1997) also model disorganisation in production during the transition process. They prefer not to rely on inefficiencies in the bargaining process between initial buyers and suppliers, but rather focus on the role of search frictions created from the desire to find new partners in the chain of production. The outside option is endogenous in a model of two sided search and matching. In the long-term, more efficient opportunities are available to all. Suppliers and buyers will maintain existing links until one finds a better match. Search by many bad buyers creates congestion and reduces the quality of matches in the short-run. The fall in output is not generated by the breakdown of supplier and buyer relationships that existed in the planning system but rather due to the assumption that investment into capital will not be undertaken in production until a long-term partner is found. No capital investments take place during

search. Aggregate output in the years after liberalisation contracts due to a fall in investment demand and the failure to replace obsolete capital inherited from the planning system. Konings and Walsh (1999) test the theory of disorganisation for the Ukraine by pointing out how employment growth and the evolution in productivity is related to measures of disorganisation. They show that disorganisation matters primarily for traditional firms who are endowed with old equipment inherited from the planning system. In this paper, we test whether, apart from ownership effects and competitive effects, disorganisation matters in employment growth while making a comparison with Russia.

Table 8: Investment in New Equipment in 1996

<i>New equipment in 1996</i>	De Novo Ukraine	Traditional Ukraine	De Novo Russia	Traditional Russia
Yes	0.39	0.32	0.50	0.45
No	0.61	0.68	0.50	0.55

Table 8 suggests that the firms in the Russian sample in 1996 are at a stage where they are undertaking deep restructuring compared to those in the Ukrainian sample.

In summary, the sample of firms in Russia not only generate different trends in gross job flows over time compared to the Ukraine, but in addition competition and supply side structures in 1996 are also quite different. The aggregate job flows and firm level characteristics suggest that Russian firms in 1996, on average, are at a much more advanced stage of restructuring compared to the Ukrainian firms. In table 9 we present our estimated effects of ownership, competition and disorganisation on employment growth for the Ukraine and Russia.

Table 9 : Dependent variable: Firm Level Employment growth in 1996

	Ukraine	Ukraine	Russia	Russia
De novo	0.19* (0.05)	0.03 (0.07)	0.25* (0.06)	0.08 (0.07)
+5 competitors	0.03 (0.05)	0.03 (0.05)	-0.06 (0.06)	-0.07 (0.06)
Import dependence	0.18* (0.06)	0.21* (0.06)	0.20* (0.05)	0.17* (0.05)
+5 suppliers	0.05 (0.05)	0.06 (0.05)	0.01 (0.06)	0.01 (0.06)
# of products	-0.07* (0.05)	-0.05 (0.04)	-0.01 (0.05)	0.05 (0.05)
New equipment	0.12* (0.05)	0.14* (0.05)	0.03 (0.05)	0.07 (0.05)
Ln (employment) _{t-1}		-0.07* (0.02)		-0.06* (0.02)
Adjusted R ²	0.12	0.16	0.28	0.37
No of observations	250	250	110	110

*Note: standard errors in brackets. * denotes statistically significant at the 5% critical level and ** denotes statistically significant at the 10% critical level. All equations include sector, regional dummies and a constant.*

The results suggest that in both the Ukraine and Russia, new private firms are not performing significantly better than traditional firms once we control for firm size. This was not the case in similar studies of CEE countries. Large firms, due to the distortions inherited from the planning system, might not be expected to expand employment during the transition process. Surviving new entrants would be expected to grow rapidly to the minimum efficient scale upon learning their market ex-post entry. Why is this not the case in Russia and the Ukraine? One potential reason why we find that *de novo* firms are not outperforming traditional firms could be related to the linkages the emergence and expansion of *de novo* firms have with the restructuring process undertaken in manufacturing. Restructuring of oversized firms in manufacturing creates the emergence of a service sector and *de novo* activity in manufacturing from the outsourcing of activities that were normally undertaken within

large enterprises before transition. A lack of restructuring, due to credit constraints and existence of a barter market for inputs and outputs, in manufacturing is likely to act as a barrier to entry and growth in *de novo* firms in both services and manufacturing.

Further, we find significant evidence that import dependence has a positive impact on employment growth in both countries. Firms seem more able to grow when using high quality imports and foreign suppliers. The structure of competition in either the product or factor market does not have an impact on employment performance in either Russia or Ukraine.

Contrary to the results of Ukraine, we do not find evidence for disorganization in the vertical links of production in Russia. Investment in new equipment or the inheritance of a large product range does not seem to constrain employment in Russia while having very significant effects in the Ukraine. This outcome is explained by the fact that firms in Russia were at a more advanced stage of restructuring in 1996. The Ukraine was a late starter. Before 1995 Russia may have suffered more from the presence of obsolete equipment and large product ranges.

Conclusions:

This paper uses enterprise level data to examine employment dynamics in advanced regions of Russia and the Ukraine. An analysis of gross job flows created by the firms in the sample suggests that real restructuring in the Ukraine started only after 1994 when we observed a significant increase in both job destruction and job creation. Most of the restructuring in Russia was undertaken before 1995.

The central theme we are interested in is whether we can find any statistically significant effect of ownership on the process of firm growth after taking into account size, sector, competition structures and disorganisation in the vertical chains of production. Our results, in contrast to findings in Central and East European Countries, suggest that newly established firms do not outperform those that existed under central planning during the transition process. This is explained by the relatively slow restructuring of manufacturing that constrains the emergence and growth of *de novo* activity in services/manufacturing. In addition, while competition seems to play no role in employment determination in either country, disorganisation is shown to constrain employment in the Ukraine but not in Russia indicating the more advanced stage in the restructuring process of Russian firms.

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