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Journal of Comparative Economics 32 (2004) 745–774

Journal of
COMPARATIVE
ECONOMICS

www.elsevier.com/locate/jce

Human capital, market imperfections, and labor reallocation in transition

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Received 30 December 2002; revised 8 August 2004

Rizov, Marian, and Swinnen, Johan F.M.—Human capital, market imperfections, and labor reallocation in transition

In this paper, we investigate the effects of human capital and factor market imperfections on household decisions regarding labor use and reallocation in transition countries. We develop a model that accounts explicitly for heterogeneity in the supply of labor and analyze its impact on the allocation of labor. Furthermore, the effects of imperfections in the capital and labor markets on the reallocation process are modeled. Using a dataset based on a countrywide representative survey of Hungarian rural households, we estimate the effects empirically and find them to be important. *Journal of Comparative Economics* **32** (4) (2004) 745–774. Institute for International Integration Studies, Trinity College Dublin, Ireland; LICOS Center for Transition Economics, Katholieke Universiteit Leuven, Belgium; The World Bank, Washington, DC, USA; LICOS Center for Transition Economics & Department of Economics, Katholieke Universiteit Leuven, Belgium.

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JEL classification: D13; J20; J23; P36; Q12

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doi:10.1016/j.jce.2004.08.002

Keywords: Labor allocation; Self-employment; Human capital; Households; Transition economies; Hungary

1. Introduction

The literature on economic restructuring in transition economies identifies several factors that contribute to the initial decline in output and the growth of unemployment. [Blanchard and Katz \(1997\)](#) model the increase in unemployment by assuming that subsidy cuts led to a reduction in demand for labor by existing restructuring firms at a time when the growth in employment in the emerging private sector was insufficient to absorb displaced workers. In addition, [Blanchard and Kremer \(1997\)](#) argue for the importance of disorganization problems within the supply chain and [Roland and Verdier \(1999\)](#) identify search frictions as a cause for reductions in output and employment. [Konings et al. \(1996\)](#), [Bilsen and Konings \(1998\)](#), [Acquisti and Lehmann \(2000\)](#), [Basu et al. \(2000\)](#), [Dries and Swinnen \(2002\)](#) and [Konings and Lehmann \(2002\)](#) provide empirical evidence on the problems of reallocating labor between firms. These authors find major differences in the effects of disorganization on newly established private firms and on restructuring existing firms and also considerable variation across different types of firms regarding labor market behavior.

Microeconomic studies of labor adjustment processes in transition economies focus primarily on the firms and investigate the effects of their hiring policies and characteristics on the restructuring process. Hence, job creation and destruction in the economy are examined. Although important, these are not the only factors relevant to the labor adjustment process. Human capital and other characteristics of the labor force have an important impact on restructuring processes and growth as [Huffman \(1980\)](#), [Lucas \(1988\)](#) and [Barro and Sala-i-Martin \(1992\)](#) demonstrate in general, and [Fan et al. \(1999\)](#), [Kertesi and Kollo \(2001\)](#) and [de Brauw et al. \(2002\)](#) find in transition countries.

Household characteristics, including human capital, affect not only household wages but also household decisions on labor allocation to various activities according to [Becker \(1965\)](#), [Sahn and Alderman \(1988\)](#) and [Ahituv and Kimhi \(2002\)](#). [Kimhi \(2000\)](#) and [Kertesi and Kollo \(2001\)](#) study these effects on part-time employment and early retirement, while [Zhao \(1999\)](#) and [Germenji and Swinnen \(2003\)](#) examine their impact on migration. [Earle and Sakova \(2000\)](#) highlight the growth of self-employment in transition countries. Self-employment, often in food production, has grown dramatically since the beginning of the transition, especially in rural areas as [Kollo and Vincze \(1999\)](#), [Rizov \(2003\)](#) and [Lerman et al. \(2004\)](#) attest.

In this paper, we develop a model of the impact of human capital on household decisions about labor allocation in transition countries. The model accounts explicitly for household heterogeneity and analyzes its effect on the allocation of labor, both to self-employment in farming and to wage employment off-farm. Moreover, the model investigates the influence of imperfections in the capital and labor market on the reallocation process. Using a dataset containing information on 1618 Hungarian rural households based on a countrywide representative survey, we assess the impact of human capital and factor market imperfections on labor allocation empirically. Self-employment of rural households in farming is very

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