

Economic Policy Reform under Political Constraints: Labor Reallocation and Compensatory Redistribution*

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Abstract

This paper examines the positive issue of how political exigencies shape the implementation of large-scale economic policy reforms, such as those in the process of transition from central planning to a market economy. These reforms invariably have a ‘non-neutral’ effect - some workers/citizens benefit (disproportionately), while others face dislocation and the loss of employment or wages. If governments can compensate the losers by redistributing some of the winners’ gains, then any ‘potentially Pareto-improving’ reform should be implemented. However, there is now a burgeoning literature that shows that even redistributive promises by the government may be insufficient to ensure the passage of majority-benefiting, efficiency-enhancing economic reform.

In this paper, we extend this research agenda by considering the effect that various redistribution mechanisms might have on voters’ incentives, and whether the political feasibility of reform is in fact enhanced by these redistributive mechanisms. To what extent can the political resistance of workers who expect to lose from a reform be overcome by promises of compensation? We examine the (often perverse) incentives created by redistributive compensation, the difficulties in identifying the extent of gains and losses of individual winners and losers, and in targeting the redistributive compensation accurately. Recent research has considered alternative ways by which governments can compensate newly unemployed workers - e.g., governments can (and do) use wage subsidies, unemployment insurance, or retraining subsidies. In contrast to this literature, we examine labor reallocation caused by large-scale economic reform, for example, in the process of transition, where job losses may not be concentrated in particular sectors. Further, we examine how the political exigencies of the compensation process shape the incentives of affected workers, and thereby affect the political feasibility of the compensation mechanism and the policy reform.

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1 Introduction

Policy makers in transition economies face a difficult task. Not only are they asked to oversee the implementation of policies that will inevitably cause economic dislocation and the destruction of jobs, they are also expected to ensure that such policies do not result in a drastic erosion of political support. Not surprisingly, of central importance to policymakers, is the challenge of designing policies and institutions to ensure their political viability.¹ In this paper we examine the positive issue of how political exigencies shape the implementation of large-scale economic policy reforms, especially in the context of transition economies.

Economic reforms invariably have distributional consequences. Some citizens benefit, while others face dislocation and the loss of employment or wages. The issue of interest is why these distributional consequences become political issues in some instances and not others. To see this most sharply, consider a policy that is not only ‘efficiency-enhancing’, but also benefits a majority of the population. We might expect that such efficiency-enhancing policies would garner the support of a political majority. In fact, this need not always be the case - as demonstrated by an influential paper by Fernandez and Rodrik (1991). However, in their framework, by assumption, the government lacked the instruments of taxing the ‘winners’ to compensate the ‘losers’. At first blush, it may appear that if governments can compensate the ‘losers’ by redistributing some of the winners’ gains, then any ‘potentially Pareto-improving’ reform should be implemented. However, as we show in a series of recent papers (Jain and Mukand (2003a, b, c)), even redistributive promises by the government may be insufficient to ensure the passage of majority-benefiting, efficiency-enhancing economic reform.

Why is redistribution so hard to implement? One problem is that redistributive promises have to be credible, and it is by no means clear that

¹This point is made most forcefully in the context of not only the transition economies, but also the new democracies of Latin America, by Bresser Pereira, Maravall and Przeworski(1993).

the credibility of governments is any greater than that of private agents.² Second, even if the promises of redistribution are credible, if voters are not fully informed of the outcome of the reform, then the government may use redistributive compensation to make disguised transfers to its favored constituents. Voters, correctly anticipating this possibility, may therefore find the prospect of redistributive compensation to be less attractive in persuading them to support the policy being considered. We discuss these issues in greater detail in the next section.

In this paper, we offer a complementary explanation for why, even in the absence of the problems described above, voters might resist the adoption of economic reform. The actual implementation of redistribution can be a difficult process, characterized by problems in identifying the extent of gains and losses of individual winners and losers, in targeting redistribution accurately, and in avoiding the creation of perverse incentives. Not only is there an asymmetry of information (about winners and losers) between voters and the government (as in Jain and Mukand, 2003c), but also, governments are typically imperfectly informed about, for example, the magnitude of the gains and losses to the individuals affected by the reform.³

Further, we consider the effect that various redistribution mechanisms might have on voters' incentives, and whether the political feasibility of reform is in fact enhanced by these redistributive mechanisms. To what extent can the political resistance of workers who expect to lose from a reform be overcome by promises of compensation? We argue that the very existence of the redistributive mechanisms may in fact distort the incentives of the affected parties, for example, to undertake costly retraining in order to mitigate the effects of the reform. This tension, between the safety-net aspect of the compensation program on the one hand, and the disincentive effects of compensation programs on the other hand, is well understood in the liter-

²The importance of the lack of credibility in ensuring the failure of economic reform, has been discussed by Roland (2002). See also Jain and Mukand (2003a).

³Dewatripont and Roland (1992) emphasize the importance of informational asymmetries of a similar kind in arguing that gradualist reform may be politically feasible, where a big-bang reform need not be

ature. The contribution of this research is its consideration of the political implications for the adoption of economic reform policies, and the extent to which these redistributive mechanisms are politically and economically feasible.

Recent research considers alternative ways by which governments can compensate newly unemployed workers (see, for example, Davidson and Matusz, 2002). For example, in the case of workers adversely affected by trade liberalization, governments can (and do) use wage subsidies, unemployment insurance, or retraining subsidies. However, most of this recent literature has focused on job losses caused by trade liberalization in rich market economies. By contrast, we examine labor reallocation caused by large-scale economic reform, for example, in the process of transition, where job losses may not be concentrated in particular sectors. Further, these papers focus on the economic efficiency of the various compensation mechanisms, while ignoring their political aspects. By contrast, we examine how the political exigencies of the compensation process shape the incentives of affected workers, and thereby affect the political feasibility both of the various compensation mechanisms, as well as of the reform whose passage is being sought by these compensatory mechanisms.

These issues are of more than just theoretical interest. The political feasibility of economic reforms is an issue of abiding interest not just to political scientists and economists, but especially to policy-makers. These issues are especially germane to countries in the process of transition or accession to an economic union, a process accompanied by large-scale reallocation of labor.

The paper is organized as follows. In the next section, we offer a brief and selective survey of the literature on the political economy of policy reform. Our focus in that section is on individual-specific uncertainty, and in particular, whether the promise of redistributive compensation can ensure the passage of such reforms. One key problem with redistributive promises is that they may not be credible, for the reasons discussed in that section. But even absent credibility problems, we argue that the effect of redistributive promises on voters' incentives is not at all straightforward. In each of

the next three sections, which comprise the heart of the paper, we construct an example in which an efficiency-enhancing, majority-benefiting policy is to be considered by voters. In each case, it is common knowledge *ex ante* among voters and government that the policy will increase national income, i.e., the ‘national pie’ expands, and that a majority of the population will emerge as winners (before any redistribution is carried out) from the policy. We then ask, in each instance, whether an accompanying government promise of redistribution increases or decreases the likelihood of political passage of the policy. In section 6, we extend the discussion to take into account labor mobility, both geographic as well as across sectors, consider the stylized facts about differences between labor mobility in the U.S. versus Europe, and develop some intuition for how the compensation mechanisms for displaced labor might differ across environments with different degrees of labor mobility. The last section concludes with some discussion of further research possibilities.

2 Efficiency-enhancing policies under uncertainty

Governments in all societies enact policies that have an impact on national welfare. Some policies result in a Pareto improvement - at least some members of society are better off, and no one is hurt, as a result of the policy. The argument for adopting these policies is easy. A harder case to make is the one where the adoption of a policy under consideration will result in winners and losers. Even though the gains might outweigh the losses, so that the policy is ‘potentially Pareto improving’ (Besley and Coate, 1998), the passage of such a policy may be opposed, successfully, by the potential losers.

We consider, in this paper, “efficiency-improving” or “potentially Pareto improving” policies - while their implementation creates losers as well as winners, society as a whole ends up better off. In other words, if winners could (and would) costlessly compensate the losers, then there would be a Pareto improvement. Most economic policy reforms, especially in the

area of trade policy, fit this description. For example, trade liberalization benefits workers and employers in those sectors of the economy that have a comparative advantage, while hurting workers in others sectors which are unable to compete with imports. One argument often made for the passage of such policies is that, in the long run, after the short-run adjustment and reallocation costs have been paid by the losers, the gains will eventually be realized by all individuals in the economy. Coupled with this, there are usually promises of some kind of compensation to be paid to the losers out of the common pool, funded largely (or wholly) by the winners.

But, as Fernandez and Rodrik (1991) point out, the presence of individual-specific uncertainty (i.e., not all voters know in advance whether they will be winners or losers) can be sufficient for voters to reject an efficiency-enhancing reform policy, even when it is common knowledge that the reform will benefit a majority of the population (and would therefore be an obvious candidate for passage). However, their model is not impervious to the modification that the reform be accompanied by redistributive compensation from the winners to the losers. In that case, all efficiency-enhancing reform policies should pass.⁴

So the key question is: why is redistribution so hard to implement? One obvious reason is that promises of *ex post* compensation may not be enforceable, especially when the groups affected are large and diffuse, and the size of the gains and losses relatively small, so that the ‘representatives’ of the affected groups may be hard to identify.⁵ Further, *ex ante* compensation, in the form of advance payments to support a particular project, run up against the opposite problem - that payees might ‘take the money and run’, i.e., that they are unable to credibly commit to vote for reform when the time comes.

The key issue, often, is credibility. If the credibility of promises by private individuals is the stumbling block in the path of efficiency-enhancing

⁴We discuss the effect of redistribution in the context of the Fernandez and Rodrik (1991) model in greater detail in section 3 below.

⁵This is closely related to the idea of Olson (1965) that small groups might find it easier to organize in support of their interests.

reforms, why can the government not intervene, by making a promise to compensate losers by taxing and transferring income from the winners? After all, such a promise would result in a Pareto improvement and, *ex ante*, would be supported by voters. The problem is one that is well-known to students of political economy: it is by no means clear that the credibility of governments is any greater than that of individuals. If governments are interested not just in the welfare of their citizens, but also in retaining power, (a not unreasonable assumption), then they may be willing to trade off socially beneficial policies, redistributive or otherwise, in favor of those that increase their chances of re-election. Since voters know this, all government promises will have to be filtered through the prism of credibility. As Jain and Mukand (2003a) argue, the government might have a “time inconsistency” problem - its idea of what the ‘best’ policy is might change (even in the absence of new information) from one period to the next, driven by concerns about its own re-election. And since voters know this, the government’s apparent inconsistency in preferences over time will adversely affect its credibility in making promises of redistributive compensation. So, even when the results of a reform are realized during the incumbency of the government, the shift in the balance of political power caused by the reform might be enough to deter incumbents from undertaking reform in spite of the fact that they have the power to tax and redistribute. Dixit and Londregan (1995) argue that influential voter groups can avoid costly adjustment costs, secure in the knowledge that the government will bail them out when the time comes, and that government promises/threats not to compensate them are not credible. This class of ‘political failures’ (to use the terminology of Besley and Coate, 1998) is a wide one, and there is now a large literature that deals with the incentive problems of government, and the credibility issues engendered by voters’ knowledge of this.

One consequence of considering the potential impact of the economic changes wrought by the reform, which we explore in Jain and Mukand (2003b), is that we are able to offer some insight into the often puzzling dynamics of public opinion over the course of adoption of economic re-

form. Why do economic reforms that are proceeding successfully often run aground? We use a theoretical framework similar to that in Jain and Mukand (2003a) to suggest that, if initially successful reforms change the balance of political power in such a way as to make future redistribution less likely, then public opinion may turn against reform. Thus, in some sense, an initially successful reform may well end up sowing the seeds of its own destruction.

However, credibility (or its lack) is not the only stumbling block in the path of economic reform. In Jain and Mukand (2003c), we develop a model of policy choice in which government decision-making might be biased toward policies that benefit those ‘special interest groups’ that are crucial to re-election. The idea that governments might choose ‘pork barrel’ projects to bribe key voters is hardly new. But the recognition, in the political economy literature, of the importance of asymmetric information (between voters and incumbents) is relatively recent. Coate and Morris (1995) show that, in the presence of an asymmetry in information about the true worth of projects between incumbents and voters, governments might use socially wasteful projects to disguise the transfer to the special interest. Jain and Mukand (2003c) makes a slightly different argument. If voters are not fully informed *ex post* about the effects of the reform, then they will (correctly) view with suspicion any redistributive promises made by the government. Voters recognize that the government, in identifying the individual winners and losers, has an incentive to use this redistributive mechanism to make disguised transfers to its political supporters. And one consequence of this (well-founded) voter suspicion might be that redistributive promises by the government may be insufficient to guarantee the political passage of efficiency-improving economic policies.

Our focus in this paper is on a slightly different problem from the one that is examined in the political economy literature discussed above. We focus not on the credibility of government promises of redistribution, but rather on the possible consequences of tying the implementation of reform policies to compensatory redistribution. We assume that the government

is perfectly credible (at least insofar as the implementation of the policy, and any accompanying redistribution, is concerned), and that voters take as given that a package of announced policies and redistribution will in fact be implemented by the government, to the best of its ability. Our concerns here have to do with the effect that redistribution might have on voters' incentives, and how the *ex ante* and *ex post* information structure about the identity of winners and losers can affect voter preferences over outcomes.

3 Identifying winners

We begin by considering the effect of credible redistributive promises on the possibility of passage of reforms in a context characterized by individual-specific uncertainty. The model we use is a modification of the one proposed by Fernandez and Rodrik (1991), who show that if a (large enough) number of voters are uncertain about how they personally will be affected by a proposed reform, then the reform may not pass, even though it is known *ex ante* that a majority will be winners. The essence of their model can be conveyed in a simple example. Suppose a proposed reform, in a society of 100 individuals, will create 60 winners and 40 losers. Each winner gains \$2, and each loser loses \$1. But suppose there is some individual-specific uncertainty: of the 60 winners, only 45 are known in advance. The remaining 55 members do not know if they will be winners or losers, but only that they have a 15 in 55 chance of being a winner, and a 40 in 55 chance of being a loser.⁶ As a simple calculation shows, the expected payoff from the reform to these 55 'unknowns' is negative, and hence they would vote against the

⁶This individual-specific uncertainty might stem, for example, from the fact that workers in the sectors adversely affected by the reform will have to retrain and move to the growing sectors. While the number of relocating workers would depend on the extent of the reform, initially the movement to the growing sectors will only be of the workers best suited to work there (in terms of having low relocation costs). And suppose that individual workers' aptitudes for work (or relocation costs) in the new sector are not known in advance, but the distribution of this aptitude across the working population is known. In that case, workers can estimate, depending on the size of the reform, the probability that they will be able to move to the other sector and be winners.

reform. Thus, even a reform that is known *ex ante* to be efficiency-enhancing and majority benefiting might fail if put to a majority vote.

However, as mentioned earlier, this example depends crucially on the assumption that redistributive promises are not possible, or that they are not credible. If the 45 known winners could credibly promise to give up \$1 from their winnings to compensate the losers once the reform is implemented, then the expected payoff net of redistribution to the 55 unknowns would be positive, the reform would pass, and after redistribution, a Pareto improvement would result. As discussed above, a key question is whether these redistributive promises, whether made by individuals or by the government on their behalf, are credible.

But even if these redistributive promises are credible, we show below that this still may not be enough to ensure the passage of an efficiency-enhancing, majority benefiting reform. Our first example shows that, if we retain the assumption of individual-specific uncertainty, then the difficulty of identifying winners *ex post* might be so great as to doom reform even when redistribution is possible.

Example 1

We modify the example discussed above somewhat. Suppose the reform under consideration will create two classes of winners, Big (B) and Small (S), and a set of Losers (L). Big winners, of whom there are 30, gain \$2 each. Small winners, of whom also there are 30, gain \$.50, while the losers, the remaining 40 workers, lose \$1.50 each. This information can be summarized in an N -element vector (where N is the population size, 100 in this case), each element of which denotes the size of the gain or loss accruing to the individual. Individuals are numbered in ascending order, according to the size of their losses, so that, in the example above, the first 30 elements would correspond to the Big winners. For brevity, we denote the reform results described above as R_1 , i.e., R_1 is a vector whose first thirty elements are 2, the next thirty are .50, and the remaining forty are -1.50.

The information structure is as follows: Big winners know in advance

that they will be Big winners.⁷ The remaining 60 workers, however, do not know *ex ante* whether they are going to be in the group S or group L.⁸ In the absence of a government redistributive program to accompany the reform, these 60 ‘unknowns’ would expect to lose from the reform. The question is: can a credible commitment to compensate the losers, *ex post*, by taxing and transferring from the winners be enough to ensure the passage of the reform?⁹

Before we consider this question, it is useful to impose some restrictions on the amount that governments can reasonably tax and transfer.¹⁰ An intuitive limit, which uses the idea that taxation should not be regressive, is to require that, post-redistribution, losers should not end up better off than winners. For short, we refer to this restriction as a *CCR* (for ‘constitutional constraint on redistribution’) and define CCR_1 as the set of all budget-balancing tax vectors, t , that satisfy this constraint.¹¹ The tax vector, t , consists of N elements, each element of which denotes the tax to be paid by that individual. A negative value of an element in the taxation vector indicates that a transfer is paid to that individual. Budget balance requires that the elements sum to zero.

Finally, the post-reform information structure is as follows: The government cannot distinguish, *ex post*, between Big and Small winners. The Small winners can be thought of as being like the Big winners, but with higher unobserved adjustment costs (or perhaps they incur a disutility from adjust-

⁷In the case of a trade policy reform that changes relative prices of traded goods, these might be the workers working in the sectors expected to grow, who expect to gain from the shift in the relative price of their product.

⁸Recall our earlier discussion about the ‘aptitude’ of workers in the declining sectors to move to the growing sectors. An individual worker does not know his own relocation cost in advance, but only has some sense of the distribution of abilities in the population.

⁹Obviously, a minimal restriction that any such tax-and-transfer redistributive program should have to satisfy is that it be budget-balancing (or generate a surplus).

¹⁰See, for example, Besley and Coate (1998) and Brennan and Buchanan (1980).

¹¹An alternative is to require that the amount taken from a winner not exceed the amount of her winnings. We label the set of tax vectors that satisfy this alternative *CCR* as CCR_2 . In this example, this means that the maximum tax on winners would be \$0.50.

ment to the new regime). If this disutility or effort cost is unobserved, then the government is restricted to taxing them only on the observed portion of their winnings, which is the same as that of Big winners. The analogy here is that with public finance - taxation must be based on income, rather than utility, or income net of disutility costs. This formulation is also standard in the political economy literature (see, e.g., Dixit and Londregan, 1995). *Ex ante*, the government knows only the distribution of gains and losses from the reform, but not the precise identity of the prospective winners and losers.

The information structure can be summarized as follows. Let I_0^i and I_1^i denote the *ex ante* and *ex post* (or pre-reform and post-reform) individual information sets respectively, and I_0^g and I_1^g denote the corresponding government information sets. Let $I_0^i = \{[B], [S,L]\}$ signify that the pre-reform information set for individual i is partitioned into two disjoint sets, indicated by the square brackets - a particular voter knows only whether he belongs to the set [B] or [S,L] but does not know whether he belongs to group S or group L within the set [S,L]. The government does not know, *ex ante*, to which set a particular voter belongs, i.e., $I_0^g = \{[B, S, L]\}$. *Ex post*, however, the partitioning is slightly different, as described above: $I_1^g = \{[B,S], [L]\}$. All the losers are known, but it is not observable by the government whether a particular individual is a member of the group B or group S. Of course, *ex post*, each individual knows which group he or she is in, so $I_1^i = \{[B], [S], [L]\}$.

Given the reform results as described by R_1 , and the constitutional constraints on redistribution, (either CCR_1 or CCR_2), it is easy to see that there is no feasible redistributive promise that the government can make in order to win the support of the 70 ‘unknowns’. The key is that, because the distinction between B and S winners is unobservable, the limits on taxation are set by the extent of the gains of the S winners. Let t_w denote the amount of tax that the winners pay, t_l be the amount that losers receive as a transfer, s the amount of small winners’ gains, and l the amount of losers’ losses. CCR_1 requires that $s - t_w \geq l + t_l$ and the budget balance constraint

requires that, in this example, $40 * t_l - 60 * t_w = 0$. Taking both these conditions together, it is easy to see that, in this example, the maximum feasible redistribution is for $t_w = \$0.80$ and $t_l = \$1.20$. But the net effect of even this maximum feasible redistribution is that, in expected terms, the *ex ante* ‘unknowns’ would still expect the reform to yield a negative payoff (of $-\$0.30$).¹²

Alternatively, this can also be seen as follows: essentially, what is required *ex ante* is a promise to the 70 *ex ante* ‘unknowns’ that there will be a post-reform transfer of (at least) \$45 to them collectively (this is the size of the expected collective loss to the 70 *ex ante* ‘unknowns’). However, there is no feasible way of making such a transfer *ex post* without violating our *CCRs*, which limit the government’s ability to tax and transfer, the binding constraint being the fact that the government cannot distinguish B from S.

Formally, we summarize this discussion as follows, where the function H is an indicator function whose value is 1 if the expression in its argument is true, and 0 if it is false, and $V_i(reform, t)$ denotes the expected post-redistribution value of the reform to the voter i when the redistribution vector is set at t .

Proposition 1 *For a proposed reform R_1 , $\nexists t \in \{CCR_1, CCR_2\}$ such that $\frac{1}{N} \cdot \sum_{i=1}^N H(V_i(reform, t) > 0) > \frac{1}{2}$*

One last point deserves to be made: If the government could distinguish B and S, the above problem would go away, and all efficiency-enhancing reforms could pass with an accompanying redistributive promise. As has been pointed out frequently in the literature on developing country credit markets, and on LDC public finance, asymmetries in information, and the

¹²Under *CCR₂*, even if the government taxed the winners so as to take away all the S winners’ gains, the total amount it gathers from these 60 winners ($60 * \$0.50 = \30) would still be insufficient to compensate all the losers. The calculation is simple: the maximum feasible redistribution is one in which the 60 winners are each taxed \$0.50, and this \$30 tax revenue is divided among the 40 losers so that each receives \$0.75. The expected value of the reform, post-redistribution, to each of the 70 *ex ante* ‘unknowns’ would thus be: $30 * \$0 + 40 * (\$0.75 - \$1.50)$ which is negative.

cost of overcoming them, are most significant in LDCs. A frequent policy recommendation for smoothening the workings of these markets (or for creating a market where none exists, e.g., for agricultural insurance) is that governments should invest in developing the information infrastructure, and in reducing the transactions cost of acquiring information. The problem here is not dissimilar: one distinction between rich and poor countries, (and to some extent, the transition countries), and one that translates into the frequency with which compensatory redistribution is promised in support of reform relatively frequently in rich countries, is that the implementation (and therefore the credibility of the promise) of redistribution is easier in societies where the government is able to measure outcomes accurately.

4 Might redistribution hinder reform?

Our first example showed that even credible redistributive promises may be insufficient to guarantee passage of majority-benefiting, efficiency-enhancing reform, when government ability to accurately identify the outcomes is limited. Our next example builds on the previous one to demonstrate that even more perverse outcomes are possible. With a small modification in the structure of the information sets that voters and government possess, we show that the existence of a redistributive program might actually botch the passage of a reform that would have been approved in its absence! As before, we assume that the government is unable to distinguish B and S, even *ex post*. The key difference in this example is that there is no individual-specific uncertainty - in other words, all individuals know, *ex ante*, which group they will belong to, if the reform is passed.

Example 2

Formally, we retain the same reform outcome structure, R_1 , and the *CCRs* on the taxation vector t , and modify only the information sets. A little notation: Let t_1 denote the maximum feasible transfer under CCR_1 , and let t_0 be a null vector, denoting a no-redistribution program. The government

information sets, *ex ante* and *ex post*, are the same as in the previous example, i.e., $I_0^g = \{[B, S, L]\}$ and $I_1^g = \{[B,S], [L]\}$. Unlike the previous example, however, here we do away with individual-specific uncertainty, i.e., $I_0 = I_1 = \{[B], [S], [L]\}$. Then, it is straightforward to see that:

Proposition 2 (a) *For a proposed reform R_1 , with a redistribution vector t_1 , reform does not pass, i.e.,*

$$\frac{1}{N} \cdot \sum_{i=1}^N H(V_i(\text{reform}, t_1) > 0) < \frac{1}{2}$$

(b) *For a proposed reform R_1 , with a redistribution vector t_0 , reform does pass, i.e.,*

$$\frac{1}{N} \cdot \sum_{i=1}^N H(V_i(\text{reform}, t_0) > 0) > \frac{1}{2}$$

It is useful to point out that the only distinction between this example and the earlier example has to do with the amount of knowledge that individuals have about the effect of the reform on them personally. In both cases, the key issue is not whether redistribution is politically credible or not, but rather on how the amount of information that is available affects voters' assessment of the effects of the reform, with or without redistribution. The wider point is that the limited attention in the literature on redistribution as a means of promoting reform has tended to focus on the credibility problems of redistributive promises. These examples are intended to illustrate that, even in the absence of credibility problems, the informational problems of identifying the affected parties and targeting redistribution accurately, are not insignificant, and can have a decisive impact on whether reforms are passed or not.

5 Retraining incentives

Suppose that prospective losers (or 'unknowns') can mitigate the effect of the reform by incurring costly retraining. In this section, we demonstrate that the provision of redistributive programs might distort incentives for individuals to undertake retraining. This insight is common to several fields - the provision of unemployment insurance, for example, might delay the

costly adjustments that laborers need to make. The new insight here, similar to the point made in example 2, is to show that this disincentive effect can be large enough to derail a reform package that, in the absence of any redistributive promises, would have passed anyway.

Our third example differs from the first two in that, here, distinguishing *ex post* between winners, or winners and losers, is not the issue. Rather, here, the tension is between the disincentive effects that redistributive programs have on retraining efforts, and the safety-net aspect of the redistributive program, which should work in favor of the passage of reform. In contrast to Dixit and Londregan (1995), the central issue here is not the credibility of government promises (or threats), but rather the incentive effects of those promises (or threats).

Consider a reform whose effect on a representative worker/voter is summarized in Table 1. If this citizen-worker undertakes retraining, then the probability of “success”, i.e., emerging a winner, is p , and the payoff is s . With probability $(1 - p)$, the retrained worker loses from the reform, an amount f . The cost of retraining is c . If no retraining is undertaken, then the corresponding probabilities of “success” and “failure” are q and $(1 - q)$, where $q < p$. If the reform is packaged with redistributive promises, then in addition to their payoff from the reform, workers also get an amount r if they lose, and pay v if they win.¹³

TABLE 1A. Reform with redistribution

Retrain	Winner	Loser	Not retrain	Winner	Loser
Probability	p	$1 - p$	Probability	q	$1 - q$
Payoff	s	$-f$	Payoff	s	$-f$
Retraining cost	$-c$	$-c$			
Tax/transfer	$-v$	$+r$	Tax/Transfer	$-v$	$+r$

TABLE 1B. Reform with no redistribution

¹³Of course, the precise sizes of r and v will depend on the number of workers who win and lose, the budget balance condition, and the *CCR*.

Retrain	Winner	Loser	Not retrain	Winner	Loser
Probability	p	$1 - p$	Probability	q	$1 - q$
Payoff	s	$-f$	Payoff	s	$-f$
Retraining cost	$-c$	$-c$			

Our task is to show that there may be circumstances in which, (1) in the reform-with-redistribution case (denoted by W), the net payoff to not retraining is more attractive than retraining, and is less than zero (so that reform fails), while (2) in the reform-with-no-redistribution case (denoted by N), the net payoff to retraining is higher than not retraining, and is positive (so that reform passes). The conditions for the first claim, having to do with the redistribution case, are that:

$$\begin{aligned}
W1 & \quad (p - q).(s + f) - (p - q).(r + v) < c \\
W2 & \quad q.(s - v) + (1 - q).(-f + r) < 0
\end{aligned}$$

In the case where redistribution is assured, $W1$ says that not retraining is preferable to retraining, and $W2$ ensures that even then, with no retraining, the expected value of reform is negative.

The conditions for the second claim, having to do with the no-redistribution case, are that:

$$\begin{aligned}
N1 & \quad (p - q).(s + f) > c \\
N2 & \quad p.(s - c) + (1 - p).(-f - c) > 0
\end{aligned}$$

In the no-redistribution case, $N1$ says that retraining is preferable to not retraining, and $N2$ ensures that then, with retraining, the expected value of reform is positive. Depending on the values of r and v (subject to the CCR), if r is small relative to v , and q is small relative to p , then $W2$ and $N2$ will be satisfied. And if $(r + v)$ is large enough, then $W1$ and $N1$ will be satisfied.¹⁴

¹⁴A numerical example might serve to clarify the idea. Suppose $p = \frac{1}{2}$, $q = \frac{1}{4}$, $s = 5$, $f = 2$, $c = \frac{3}{2}$, $v = 2$, and $r = \frac{3}{4}$. Then it is easy to check that all four conditions are satisfied (with $c = \frac{3}{2}$, $N2$ holds with equality. A value of c that is ϵ less than $\frac{3}{2}$ would make the inequalities hold in each of the four conditions).

The intuition behind the above example is that redistributive promises have two disincentive effects. One is a well-recognized moral hazard effect from labor economics: that workers promised redistribution conditional on an adverse outcome will have less incentive to take costly actions that would lessen the likelihood that they would face that adverse outcome. But a second, more subtle, effect is what might be dubbed a ‘redistributive burden’ effect: that if this redistribution is financed by taxing the winners, then that narrows the gap between winners and losers, and may even make the whole reform policy sufficiently less attractive as to lose support. Brander and Spencer (1994) and Davidson and Matusz (2002) discuss the effects of trade adjustment assistance on workers’ incentives, but their focus is on finding the form of assistance program that is least distortionary. Our interest here is in the effect that redistribution might have, in a voting model, on the prospects for passage of reform.

6 Extensions and discussion

In Jain and Mukand (2003d), we consider the implications of labor mobility for the design of compensation schemes for displaced workers. For the reasons discussed in this paper, the promise of compensation as a way to soften the blow, is often crucial in winning passage of a policy (e.g., trade integration, economic union, and so on) that creates losers as well as winners. For a discussion of the political necessity of creating such a compensation program, Trade Adjustment Assistance, and later the NAFTA Transitional Adjustment Assistance program, in the US, see Magee (2001), and Kletzer (1998). Here, we argue that the benefits of labor mobility may be over-rated, at least in the limited context of designing compensation mechanisms that will win political support.

Drawing on insights from the application of screening models in development economics, to the analysis of poverty alleviation programs (see Besley and Coate, 1992), and to credit markets (Jain, 1999), we show that, in markets such as the US, where labor mobility is high relative to the EU

and CEEC, both geographically and across occupations,¹⁵ the compensation mechanism for displaced workers would be more likely to be a targeted one. In the US case, workers who can demonstrate that they have been displaced by increased imports are entitled to unemployment compensation for a longer period, and to other benefits such as retraining and relocation allowances (Magee, 2001, and Kletzer, 1998). An important aspect of the program is that workers' claims to these benefits must be screened by the U.S. Labor department, which must certify that the workers in question were in fact laid off because of increased imports.

Further, since the magnitude of the upheaval in the EU and accession countries' labor markets is likely to be significantly greater than that caused by NAFTA in the US, the theory predicts that this should tilt the argument in favor of the more universal programs when the magnitude of displacement is higher. The intuition is that the screening benefits of the more particular programs come at a cost - in a first best world, these screening methods would not be necessary. And the necessity of bearing those screening costs is lower in environments where a large fraction of the pool of potential

¹⁵For a discussion of the mobility of US workers, vis-a-vis their relatively immobile EU and CEEC counterparts, see, for example, the widely-cited report by Boeri et al. (2002), and the various 'Joint Assessments of Employment Policy in the Candidate Countries', conducted jointly by the European Commission and the respective Labor Ministries of the candidate (accession) countries (European Commission, 2001). Reasons cited for the low mobility of European workers range from differences in culture/language (see, for example, the Estonia report), insufficient flexibility in the housing market (Czech republic, Poland), greater regulation of occupations (Slovenia, Poland), or deficiencies in the communication network (Poland). Almost without exception, each of the country assessments conclude that labor mobility is low, and recommend increased flexibility and the reduction of barriers to geographic mobility.

These concerns are echoed for the current EU member countries, in Boeri et al. (2002), and the final report of two European Commission teams analyzing the impact of the accession on employment and labour markets in the EU member states (European Commission, 2000). In addition to the above-mentioned reasons for the low mobility of labor, others cited include, for example, the apprenticeship-based training and industry-level wage bargaining in Germany, and the lack of harmonization across member countries' taxation rules for retirement savings (Boeri et al., 2002, pp. 7-8).

applicants for the benefits program are in fact the ‘desired’ beneficiaries. In other words, it only makes sense to ‘separate’ the applicants by having a particular program, rather than pooling them all in a universal program, if the fraction of the non-target population is relatively high. Thus, consistent with the theory, one finds that the market with more mobile workers, and more limited displacement, adopts compensation schemes that are more targeted, or particular, than in the EU and the CEEC.

The negative aspects of the relatively low labor mobility of European workers are well-understood. Further, as Boeri et al. (2002) argue, this low mobility means that the role for government intervention in labor markets is greater than in the relatively more flexible U.S. labor markets. We make a slightly different point: that the *form* of the government intervention also differs, depending on the mobility of workers. In particular, a positive aspect of the relatively immobility of European workers is that it reduces the necessity of screening or certifying displaced workers so as to identify those who have been adversely affected by a particular market integration policy. Instead, the more general benefits available under the European Social Fund can continue to be employed, without creating a new program to be administered.¹⁶

7 Conclusion

In this paper, we have tried to examine by means of simple stylized examples, the effect that asymmetric information and incentives might have on the prospect for passage of economic reform when the credibility of the redistributive promises that accompany the reform proposal are not at issue. By way of extension, in a more general model, one might try to endogenize the choice of policy, whether redistributive or not. Here, we have limited

¹⁶As mentioned earlier, the use of the NAFTA Transitional Adjustment Assistance program has been criticized by some observers, who argue that the Labor department in the Clinton administration used the program to favor its supporters by ‘too easily’ certifying workers as being displaced by NAFTA, so as to make them eligible for the special benefits of the program (see, for example, Richards (1997)).

ourselves simply to contrasting outcomes under redistribution and no redistribution. In an environment where an existing union is set to undergo a large expansion, with the accession of several countries that are economically very different from the existing members, with all the attendant upheaval that is anticipated, we would argue that these issues are sufficiently important to be considered in greater depth.

These stylized insights are of more than just theoretical interest. An issue of abiding interest to both political scientists and economists, in international economics especially, but also in other fields, has been the determination of circumstances under which large-scale economic policy changes are politically feasible. As Rodrik (1996) points out, in a related context, the implementation of economic reforms is almost always accompanied by pronouncements of political resolve to ‘push through’ reforms (involving ‘fiscal austerity’, ‘belt-tightening’ and so on) that are politically unpopular. But: “What is the point of loudly proclaiming reforms if these are not aimed at improving the well-being of a large majority of the population? And if that is their goal, why should reforms be unpopular?” (Rodrik (1996), p. 9). A large part of the answer to this puzzle has to do with the asymmetric impact of these economic policies - the distributional consequences are not neutral, but winners and losers are created. The key, dating back to Kaldor (1939) and Hicks (1939), is the feasibility of compensating losers. The Kaldor-Hicks ‘compensation criterion’ suggests that if the winners could in principle compensate the losers, and still have a net gain, then an improvement in social welfare would result.

But why is ‘Kaldor-Hicks compensation’ so hard to implement in practice? Our research agenda can be viewed essentially as an attempt to answer this question. While Kaldor and Hicks were content to define welfare evaluations in terms of the economic feasibility of implementing a system of Pareto-improving transfers, our approach, consistent with developments in modern political economy, is to evaluate the political feasibility of these transfers. What (political) constraints do societies face in developing mechanisms to implement (economically) efficient policies, in spite of the ability

to redress the asymmetry of outcomes by means of redistributive compensation? A better understanding of these constraints is of interest not just to academics and researchers in economics and political science, but also to policy makers contemplating economic reforms.

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