

Michael J. Trebilcock

Dealing with Losers

The Political Economy
of Policy Transitions

OXFORD

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Introduction: The Places In-Between¹

I have spent much of my professional career researching, writing, and teaching about the policy reform process in a wide range of policy contexts. I have also, in many contexts, been an active participant in this process, in one capacity or another. I have repeatedly been struck in many, if not most of these contexts, by the realization that diagnosing the ills of the status quo, and imagining better policy alternatives, at least in their broad contours, are often not especially controversial. However, the real challenges, in many cases, relate to getting from “here” to “there.” Over time, existing policies develop their own encrustations of institutions, vested interests, adaptive preferences, and expectations that render the trajectory of getting from here to there a major part of the policy challenge. This book is about that challenge, which I attempt to illuminate both at a general level and through concrete illustrations developed in seven brief policy reform case studies.

As most parents of small children who have embarked on long vacation trips can attest, one of the most recurrent and frustrating questions is “are we there yet?,” to which the common, enigmatic, and no doubt equally annoying answer is typically “we’re getting closer.” This book is about the “here” and the “there,” but most particularly the importance of taking seriously, in political economy terms, “the places in between.”

The long fight to end slavery, led by William Wilberforce, among many others, culminated in Britain with the enactment of the *Slavery Abolition Act* in 1833. This act made provision for a payment of 20 million pounds (almost 40 percent of the British budget at the time) in compensation to plantation owners in many British colonies—about \$21 billion (US) in present day value. Moreover, only slaves below the age of six were initially freed while others were redesignated as “apprentices,” who were to be freed in two stages in 1838 and 1840.² Wilberforce and many other abolitionists accepted that compensation and phased implementation were required to ensure enactment of the legislation,³ particularly by the House of Lords where plantation owners were strongly represented among the aristocracy.⁴

Whenever governments change policies—whether tax, expenditure, or regulatory policies—even when the changes are on net socially beneficial, there will typically be losers. These losers will have made investments of one kind or another, physical, financial, or human, predicated on, or even deliberately induced by, the

pre-reform set of policies. Very few policy changes make somebody better off and nobody worse off according to their own subjective valuations (the economists' concept of Pareto efficiency). Rather, policy changes reallocate social benefits and costs in different ways.⁵ The issue of whether and when to mitigate the costs associated with policy changes, whether through explicit government compensation, grandfathering, phased or postponed implementation, is ubiquitous across the policy landscape.

A few selective, but far from exhaustive, examples serve to illustrate this point. First, take the case of land use regulations or controls. Sometimes relevant levels of government see fit to change these regulations. They may increase building setbacks from property lines or road allowances. They may impose height restrictions on buildings in residential or mixed-use neighborhoods. They may change zoning laws from mixed-use to residential. In most of these cases, existing property owners will be exempted from these requirements, and their existing uses treated as legal "non-conforming uses." In a similar vein, in tight residential housing markets, sometimes rent controls are imposed on existing rental properties, but the construction of future rental buildings is often exempted from these controls in order to incentivize new rental construction and alleviate supply constraints.

To take another example, environmental regulations are often subject to change, reflecting new scientific knowledge of environmental risks, or at least public perceptions thereof. Energy efficiency requirements for motor vehicles are but one example where regulations have become more stringent over time. Typically, these do not apply to the existing fleet of motor vehicles but to motor vehicles manufactured in the future, and often with a lead time in order to allow manufacturers to adapt to more stringent requirements. Similarly, in the case of climate change policies, often countries adopt relatively long time horizons for phasing in requirements for renewable energy generation, or carbon taxes, or cap-and-trade regimes on an implementation schedule designed to become more stringent over time, while avoiding disruptive and costly changes to existing forms of production or consumption.

Another example, particularly apt in a contemporary US policy context, relates to proposals to reform gun control laws. Even strong proponents of stricter gun control laws in proposing comprehensive background checks on all purchasers of guns or proposing the prohibition of assault rifles or magazines in excess of a certain capacity recognize that such restrictions can only feasibly apply to prospective purchases of weapons, and not existing owners of weapons, who would be effectively grandfathered under these reform proposals.

A yet further example relates to professional qualifications. In many professions, including law, medicine, and dentistry, entry requirements have become increasingly stringent over the past century. Yet, in applying these more stringent requirements, existing professionals are, in effect, grandfathered, subject perhaps to continuing professional education requirements.

Another, and quite different, international example is found in post-conflict nation-building exercises, where a major challenge is addressing what should be

done with respect to atrocities committed in the past by various antagonists in the conflicts that have afflicted a nation. Here, more or less judicious combinations of truth and reconciliation commissions, lustration policies designed to disqualify certain officials from previous repressive regimes from future public office, and residual classes of cases where the most egregious past atrocities are remitted to either domestic or international criminal tribunals for prosecution, are often adopted. Such combinations of policies are obviously designed to draw a qualified line in the sand between what has happened in the past and new rules of civic engagement and collective governance going forward.⁶

The seven brief case studies that I develop in this book are all designed to illustrate in greater detail, and in widely disparate policy contexts, the central importance of transition cost mitigation strategies, particularly those aimed at specific subgroups of populations, in advancing politically feasible reform options. Although these case studies are, to some extent, idiosyncratic in that (with the exception of mortgage interest deductibility) they reflect areas of public policy in which I have had a previous engagement either as a scholar or policy participant, they are also major contemporary (and in many cases contentious) areas of policy debate.

In the public pension context discussed in Chapter 3, where many countries have in the past adopted pay-as-you-go, self-sustaining public pension schemes, the sustainability of these schemes is or has been threatened, first by significant increases in life expectancy of pension beneficiaries (and hence the scale of their entitlements), and second by declining fertility rates, which have reduced the size of the working age population whose contributions finance current entitlements. Simply reducing entitlements across the board is likely to be perceived as widely unfair by current pensioners and imminent retirees, who have limited or no capacity to adjust to such a reduction in entitlements, while raising contribution rates substantially on existing workers to finance shortfalls in the system would be widely perceived as unfair to them and an implicit tax on new job creation. Raising the existing retirement age incrementally, along with modest benefit reductions and contribution increases, may yield the most politically feasible set of burden-sharing options.

Chapter 4 focuses on the reform or abolition of mortgage interest tax-deductibility in the United States. This policy is widely viewed, at least by economists, as inefficient in overstimulating demand for homeownership and encouraging over-leveraging by homeowners, as well as being inequitable in conferring disproportionate benefits on higher income taxpayers in higher marginal tax brackets, for whom the deduction is more valuable. However, abolishing or reforming this provision is likely to entail significant direct transition costs for homeowners, given that the value of the deduction has been largely impounded in house prices, as well as imposing indirect costs on the housing sector more generally. A gradual, back-ended phaseout of the deduction, accompanied by a much more finely targetted form of time-limited assistance to first-time home buyers with below-average household incomes may be the most politically feasible reform option. This case study illustrates a broader set of issues with many kinds of tax reforms. Although the starkest forms of retroactivity

would be widely rejected as unfair (e.g., raising tax rates on income that has been previously taxed), reforms that raise rates on future income (or capital gains) have a retroactive effect on investments made prior to the changes and are predicated, at least to some extent, on the existing tax rules.

Chapter 5 addresses the politics of negotiating new international trade liberalization commitments, multilaterally, bilaterally, or regionally. In this context, a significant focus of negotiations will typically be on demands by various of the negotiating parties for exclusions or dispensations for certain sectors or for gradual rates of reduction over time in prevailing levels of protection, such as tariffs or quotas. More generally, gradualism in implementing liberalization commitments over time, safeguard provisions to permit reinstatement of previous protections in the event of unforeseeably large import surges that cause serious injury to domestic industries or their workforces, and reciprocity where contraction of import-competing sectors is offset by expansion of export-oriented sectors that are facilitated by reciprocal liberalization commitments, are all designed to moderate the transition costs, both real and publicly perceived, associated with trade liberalization commitments.

Chapter 6 focuses on a particularly acute manifestation of the centrality of transition costs as an impediment to trade liberalization: agricultural protectionism. This case study focuses on a specific example of this phenomenon—dairy supply management in Canada—but many other countries also provide exceptional forms of protection to their agricultural sectors through trade restrictions and domestic and export subsidies. These forms of protection (like mortgage interest deductibility) tend to be impounded in land or quota values, so that dismantling these schemes is likely to entail very substantial losses for the current generation of farmers. The intractability of the transition cost problem in the agricultural sector largely explains the very limited progress that has been made in international trade negotiations in liberalizing trade in agricultural products. Progress is only likely to be made with credible political commitments to phase out these forms of protection very gradually over time, but in some cases accompanied by one-time explicit forms of (partial) compensation for losses incurred. The opaqueness and complexity of many of these schemes poses a major challenge for policy reformers in overcoming public ignorance, apathy, and possibly even antipathy, in underwriting such a strategy.

Chapter 7 focuses on liberalizing immigration policy in many industrialized countries, a policy option that shares some affinities with the liberalization of international trade: immigration involves cross-border movement of people, whereas international trade primarily involves cross-border movement of goods (and services). However, liberalizing immigration policy raises some distinctive challenges, including non-wage-related immigration where immigrants are induced to migrate not principally because of greater employment opportunities in the receiving countries, but because of more generous social welfare systems, whose sustainability may be threatened with an unconstrained influx of immigrants seeking to make claims on such programs. More open immigration policies also attract concerns

over labor market effects on domestic low-skilled workers, and over the erosion of important cultural, political, or community values in the receiving country as a result of larger influxes of immigrants who do not share these ideals.

Notwithstanding these concerns, over recent decades an increasingly fierce international competition for highly specialized talent has emerged in many sectors, and unduly restrictive immigration policies constrain the competitiveness and innovative potential of the sectors that are hampered by restrictive regulations in their ability to compete for this talent. Hence, progressive liberalization of entry restrictions on highly skilled foreign workers as either permanent residents or temporary workers with a clear path to permanent resident status and ultimately citizenship would seem the highest priority. In the case of less skilled or unskilled foreign workers who are able and willing to fill gaps in local labor markets, a more cautious process of liberalization would seem warranted so as to minimize the risks to less well-endowed domestic workers of wage erosion or job displacement. In the case of countries with large numbers of illegal or undocumented immigrants, such as the United States with an estimated 11 million such immigrants, deportation on a massive scale seems totally infeasible. In moral terms, this is because of the enormous human costs entailed in many cases for the immigrants in question. Politically, it is because of the enormous direct costs involved for government and its taxpayers in implementing such a program. And economically, such a policy would entail substantial upward pressure on wages due to the elimination of a large pool of low-wage workers. Thus, some form of conditional but realistically achievable amnesty seems unavoidable.

In Chapter 8, I turn to perhaps the most daunting regulatory challenge of our age: climate change policy. In the nature of the problem, concerted action by all countries, developed and developing, that are major emitters of greenhouse gases (principally CO₂) is required in order to ameliorate this problem, but to date a formal international agreement among such countries on appropriate abatement policies has proven elusive. Although unilateral policy reforms, such as increasingly stringent carbon taxes or cap-and-trade regimes, are often advocated and relatively more practicable to implement, concerns naturally arise that these will simply lead to carbon leakage or migration to other countries whose industries are not similarly regulated, or indeed relocation of businesses from countries adopting such unilateral policies to countries lacking such policies. In practice, unilateral action alone is likely to have little or no impact on the environmental problem that motivates it, and it may entail a loss of competitiveness, investment, and employment in countries invoking such policies.

These concerns have led to proposals that unilateral action on climate change, in the form of carbon taxes or cap-and-trade systems, should be accompanied by border tax measures (“carbon tariffs”) that impose similar burdens on imports, in effect “taxing” consumption of carbon-intensive products, wherever the carbon is produced, with a remission of such burdens where countries of origin adopt similar domestic measures themselves, with a view to the evolution over time of an

internationally harmonized carbon tax (or cap-and-trade equivalent). Although such proposals raise a number of difficult legal and geopolitical challenges, it is clear that mitigating various kinds of transition costs is absolutely critical to policy progress on the climate change problem.

My final case study (Chapter 9) focuses on institutional reform in developing countries. Over the past two decades or so, scholars, policymakers, and international aid agencies have tended to converge on a consensus that the quality of a country's institutions—political, bureaucratic, and legal—are a crucial determinant of that country's future development trajectory, a view captured in the mantra “institutions matter,” or “governance matters.” Unlike the previous six case studies, which were not predicated on fundamental reforms to a country's institutions, in this context institutional reform is viewed as a predicate to more effective policy formulation and implementation. However, despite the investment of vast resources by the international community in institutional reforms in developing countries, experience to date has been mixed to poor, as exemplified by the faltering efforts to institute democracy and the rule of law in countries such as Iraq and Afghanistan and similar efforts in various Middle Eastern countries (such as Egypt and Libya) following the so-called “Arab Spring.” It is now increasingly recognized that the contingencies of a country's history and culture—captured by the concept of “path dependence”—delineate both the feasible scope of institutional reform and its advisable contours. More specifically, various kinds of switching costs from the status quo are likely to impede reforms. In terms of political economy, switching costs may be high for those within and outside existing institutions (however socially dysfunctional) who benefit from the institutional status quo and hence will resist reforms. Switching costs may also reflect individual learning costs in adapting to a new regime and the loss of network effects and institutional complementarities that may have evolved around existing regimes. Switching costs may also reflect the scarcity of financial and specialized human resources required to implement new institutional regimes. Finally, switching costs may reflect deeply embedded cultural beliefs or practices—norms of appropriateness—that are highly resistant to change. Regardless of the salience of any particular factor in a specific context, strategies for mitigating switching costs are likely to be a precondition to major progress on institutional reform in developing countries.

As the foregoing examples and the case study synposes make evident, explicit compensation of losers from policy changes constitutes a tiny proportion of the larger universe of transition mitigation strategies employed or available. Nevertheless, much of the scholarly literature that addresses transition costs from policy change has focused on explicit compensation, largely influenced by the complex and sometimes incoherent case law emanating from the US Supreme Court in applying the Fifth Amendment of the US Constitution (the so-called “Takings Clause”), which provides that private property may only be taken by the state for public use and with just compensation. In legal jurisdictions that lack constitutionally entrenched expropriation procedures, statutory laws raise many of the same

legal issues, as do expropriation provisions in bilateral investment treaties (BITS) or regional trade agreements such as NAFTA with respect to the treatment of foreign investors. However, transition mitigation strategies other than explicit compensation are not directly engaged by any of these provisions. Moreover, in many respects, debates over the scope of these provisions are addressed to the question of appropriate constraints on government behavior, perhaps enforced by courts or similar arbitral bodies sanctioned by domestic constitutions or statutes or international treaties. A much less well-developed body of literature focuses not on the obligation to compensate as a legal or constitutional constraint on government action, but rather as a strategy for expanding the politically feasible scope for socially desirable policy changes by muting or mitigating the resistance of losers to these changes—the principal focus of this book. In the absence of effective transition mitigation strategies, the status quo becomes the default option, which for a broad cross section of the citizenry is likely to be less congenial than various reform proposals that include transition mitigation strategies. My intended audience for this book is politicians and their constituencies, not the judiciary.

In Chapter 2, I sketch the principal strands of both normative and positive theories of the political process as they bear on the full menu of transition cost mitigation strategies, including compensation, grandfathering, postponed implementation, or graduated implementation. Although voters and interest groups in the political process who perceive themselves as material losers from a proposed policy change are likely to invoke arguments from material self-interest, as discussed in the second part of Chapter 2, they are also likely to appeal to normative values (of the kind sketched in the first part of Chapter 2) in order to engage the support of other citizens or interest groups who share their values but not their interests. Hence, normative and positive theories of the political process exhibit significant interdependencies, which are important to illuminate early in this book with a view to exemplifying them in more detail in particular policy contexts in the case studies that follow.

Framing the Issues: Normative Discourses, Political Imperatives

The range of normative viewpoints reflected in the scholarly literature on the transition cost compensation or mitigation issue, even among scholars who share the same general disciplinary or theoretical orientation, is startling. I will describe and comment briefly on the leading normative perspectives in turn. By “normative” I mean perspectives or theories that purport to advise governments on what policies they should adopt in this context as a matter of efficiency, fairness, justice, or some other conception of right or wrong. In contrast, positive theories of government merely purport to explain or describe what factors move governments to adopt certain policies, whether right or wrong in a normative sense. I review such theories in the second part of this chapter, along with their implications for transition cost mitigation strategies.

I. Normative Theories of the Case for and Against Compensation or Mitigation of Transition Costs

A. EFFICIENCY THEORIES

An efficiency perspective emphasizes the importance of adopting public policies designed to maximize the total value of social resources, as reflected in the preferences or utility functions of all the members of the society in question. In other words, the guiding criterion is maximizing social welfare.¹ Given problems of accurate revelation of underlying preferences or utility functions, and aggregation of these into a coherent and stable social welfare function in applied policy contexts,² this typically entails a presumption in favor of voluntary market transactions, subject to a reasonably well-established list of caveats pertaining to various kinds of market failure, such as monopoly, externalities, information failures, and public goods. Thus, one version of an efficiency perspective on the compensation issue is to inquire whether private markets fail in all or some contexts in allocating the risk of policy changes.

The most prominent proponent of this perspective on compensation issues is Louis Kaplow, who contends that no law or policy should rationally be presumed

to be eternal and immutable.³ In his view, the uncertainty of government policy is broadly equivalent to more conventional instances of market uncertainty, such as the success or failure of a new product or the actions of one's competitors. Thus, for Kaplow government transitions warrant the same treatment as market transitions: no transition relief.

Kaplow focuses on the two primary economic consequences of changes in government policy: the effect on incentives to engage in the affected activities and the imposition of risk. An efficient level of investment is induced where investors bear all the costs and benefits of their decisions. Thus, the encouragement resulting from the assurance that compensation or some other form of mitigation will be provided in the event of policy change results in excessive prior investment in the affected activity by shifting part of the long-run costs of private investment to the public, thus distorting an otherwise efficient decision-making process. To the extent that investors are risk-averse, market mechanisms often provide efficient options for striking an optimal risk-incentive trade-off, for example, through discounting the value of assets acquired that may be subject to depreciation in value through future policy changes, or through buying explicit market insurance or through other risk diversification strategies.

Kaplow acknowledges that private insurance markets are subject to failures, such as (1) moral hazard (once insured, parties have incentives to increase their risky behavior); (2) adverse selection (only higher-risk parties are likely to buy private market insurance, which will lead to higher insurance premiums that price less risky parties out of the market); and (3) transaction and information costs (especially for low probability policy contingencies). Nevertheless, it is his contention that governments are unlikely to improve on how markets, including insurance markets, balance risk and incentives, and in many (probably most) cases are likely to strike a less socially efficient balance between risks and incentives. In his view, other transition mechanisms, such as grandfathering, delayed implementation, and phased-in implementation, raise many of the same problems as explicit compensation in distorting risk-incentive trade-offs, while at the same time attenuating the benefits of the policy change in question through exceptions or delays.

Kaplow emphasizes that his analysis assumes that government behaves optimally in undertaking policy reforms in terms of maximizing social welfare and is not influenced in its policy choices by the transition policy in force. In effect, he assumes that all policy changes will be socially optimal.⁴ He concedes that in a complete analysis one would relax these assumptions and consider when government policy is or is not likely to be optimal, how it deviates from optimality when it is not, and how transition policy may affect the choice of underlying substantive policies: "Such is the subject of an entire discipline, political science (or as some prefer, political economy or public choice) and is obviously beyond the scope of this investigation."⁵ He acknowledges that the analysis of private actors with regard to incentives and risk bearing is substantially more developed than is the analysis of government behavior, including how such behavior

is affected by transition policy. In the latter respect, he acknowledges that “most analysis—including by this author—has been fairly black box, and has not taken full advantage of recent decades of work by political scientists and other pertinent scholars.”⁶

In contrast to Kaplow, scholars adopting a more political economy-oriented perspective on the compensation issue argue that an expansive case for compensation for transition costs may be justified, precisely in order to ensure that policy changes that governments adopt are in fact social welfare-enhancing. For example, a Kaldor-Hicks conception of efficiency is satisfied when society is, on net, better off from a policy change when the winners from the change are in a position to compensate the losers such that the losers would be indifferent to the change after compensation, and the gainers, even after paying compensation to the losers, would still derive a benefit. However, typically under a Kaldor-Hicks conception of efficiency compensation is not in fact paid to the losers; rather, the scale of the benefits to the winners is compared to the scale of the losses to the losers, and if the former exceeds the latter the policy change should proceed.

Critics of this conception of efficiency argue that policymakers, in undertaking the cost-benefit analysis implicit in the Kaldor-Hicks conception of efficiency, face incentives to undervalue the costs of the policies they are promoting, given that they do not bear these costs, and perhaps to overvalue the benefits. Hence, the concern is that policymaking, in the absence of an actual compensation principle (ideally one that is consensually determined, albeit subject to the “holdout” or monopoly problem that some claimants may present), is likely to reflect a form of “fiscal illusion.” To combat this tendency, some scholars argue that governments should be required explicitly to compensate the losers—something closer to the Pareto conception of efficiency that requires that a policy change only proceed if it makes at least one individual better off without making anyone worse off—and face the political consequences of explicit budgetary outlays on this account. This, it is assumed, would discipline any tendency of policymakers to adopt policy changes that are not in fact social welfare-enhancing.⁷ These might be characterized as “Pareto reforms,” rather than “cost-benefit reforms.”⁸

However, as John Quinn and I have pointed out,⁹ and as Kaplow himself notes,¹⁰ policymakers, whether legislators, regulators, or bureaucrats, rarely capture directly most of the benefits of the policy changes they promote, nor are they likely to bear most of the costs. As such, it is not clear that an explicit government compensation requirement is likely to change government behavior. Conversely, it might actually increase rent-seeking behavior by special interest groups as they will be incentivized to promote socially undesirable policies, recognizing that they will be compensated in the event that these policies are subsequently withdrawn or modified.

A more subtle political economy argument for compensation policy argues that in a majoritarian political system, there may be contexts in which a majority of voters (or their representatives) will find it in their interests “to gang up on” or “single out” a small minority of their fellow citizens, who are not sufficiently numerous or

well-organized to be politically influential, to bear most of the costs of policies that the majority favor—a form of Tyranny of the Majority.¹¹ On the one hand, this might lead to the adoption of policies that are not socially optimal because they confer modest benefits on the majority at great expense to the minority. On the other hand, even where the policies are socially optimal (in a social welfare framework), a “singling out” policy that requires politically marginal interests to bear most of the costs of these policies is likely to strike many people as an abuse of government power. This is most evident in the classic eminent domain case: a local resident’s house is taken and the land used to build a public school. Even if the social benefits from this alternative land use exceed the costs to the existing resident, it will strike most people as unfair that the local resident should bear all the costs of this policy transition. Kaplow, drawing on Blume and Rubinfeld,¹² considers that this kind of case may justify government compensation on the grounds that private insurance may be unavailable for reasons related to moral hazard, adverse selection, or transaction costs.

However, it is not clear to me that these insurability problems are any more severe in this context than coverage for many other low probability, independent events such as fire or theft.¹³ Moreover, despite Kaplow’s objections to broader compensation commitments for policy change by way of analogy to the poor risk-incentive properties of government compensation for natural disasters,¹⁴ it seems obvious that private insurance coverage is less likely to be available, or at least to be prohibitively expensive, for highly correlated (and undiversifiable) risks that many regulatory changes (and natural disasters) entail.¹⁵ It is also argued that policy changes are often likely to be of a *sui generis* character, precluding pricing based on actuarial experience.¹⁶ Relatedly, Shavell argues that grandfathering may be efficient relative to other risk mitigation strategies if the costs of adapting investments made in compliance with a prior regulatory regime and ongoing compliance costs with a new regime exceed the social benefits (e.g., a municipality increasing the minimum distance a building must be set back from a street).¹⁷ Moreover, adverse selection problems may sometimes favor the mandatory pooling of risks to prevent risk pools from unraveling. Examples might include unemployment, disability, or healthcare insurance.

Thus, concerns over the cost and availability of market insurance appear to have a much broader application than eminent domain, while not directly addressing the issue of “singling-out” as an abuse of government power. Whether or not it is true that markets are relatively efficient in allocating risks of both market and policy uncertainty for either sharply focused or more dispersed losses, through contractual arrangements or explicit insurance, the fact remains that applying Kaplow’s “no compensation” presumption, private parties, one way or another, in the case of policy changes, are left bearing all the costs of policy changes (including where they are insurable or diversifiable), even if one assumes them to be on net socially desirable. Whether it is fair that they should do so moves the discussion into a quite different normative domain. As the economist William Fischel notes, “Why has economics not been especially helpful in resolving the ‘takings’ issue? Part of the answer is that the issue involves fairness as well as efficiency. . . To move from the conclusion that

just compensation promotes efficiency (or inefficiency) to the recommendation that it ought to be paid (or not paid) is to impose the culture of economics on the culture of society at large."¹⁸

B. UTILITARIANISM

Although utilitarian perspectives on the compensation issue share much in common with efficiency perspectives, they do not necessarily converge in this context. The most prominent proponent of a utilitarian perspective on compensation for transition costs is Professor Frank Michelman.¹⁹ Michelman's formula for compensation, while complex, revolves around three elements. First is the idea of Demoralization Costs (D). The costs are defined as the disutilities to uncompensated losers and their sympathizers beyond material losses, and the lost future production from impaired incentives or social unrest that would arise if no compensation were paid. He asserts that individuals who suffer harm as a result of state action experience a special kind of disappointment and anxiety when they have reason to suspect that they have been singled out as the victims of uncompensated losses. Thus, demoralization costs, for Michelman, include both uncertainty costs and disaffection costs. Second, Settlement Costs (S) are the costs, chiefly administrative, of operating a compensation program, that must be borne to avoid demoralization costs, which may in many cases be substantial in tracing out second, third, and fourth order effects of policy changes (much like determining the ultimate incidence of a tax). Third, Efficiency Gains (E) are the excess of the gains produced by government acts over the material losses inflicted by them, not including (D) or (S).

According to Michelman, government should compensate losses if demoralization costs exceed settlement costs; conversely, governments should not compensate losses if settlement costs exceed demoralization costs. Presumably, if demoralization costs exceed both efficiency gains and settlement costs, government should not proceed with the policy reform in question. As Fischel points out, Michelman's approach adopts an intermediate position between Pareto and Kaldor-Hicks conceptions of efficiency. It is more permissive than the Pareto conception in that it would approve some government actions without actual compensation if settlement costs exceed demoralization costs, while it is less permissive than the Kaldor-Hicks conception, which does not, in principle, require compensation at all.²⁰ It differs from Kaplow's perspective in that Michelman assigns significant weight to the private costs of policy changes, whether insurable or not, which Kaplow is prepared largely to ignore, or by assumption to treat as exceeded by the social benefits of the policy reform in question.

Although Michelman's decision rule has intuitive attractions, operationalizing it presents formidable challenges. Valuing each of the three key components in his formula in robust and defensible ways, and avoiding the political manipulation of these valuations so as to favor particular political constituencies or special interests, raise major institutional challenges.