"AFTER THE HONEYMOON: ON THE ECONOMICS AND THE POLITICS OF ECONOMIC TRANSFORMATION"

by

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After the Honeymoon:
On the Economics and the Politics of Economic Transformation

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Summary

This paper focuses on the obvious: Pareto-improving programs may fail to improve everyone’s lot. Politically, it has been often interpreted as requiring that a majority benefits from the change. Events in Central and Eastern Europe suggest otherwise and cast doubt on the relevance of the median voter theorem. The addition of minority discontents may result in major political difficulties and this leads governments to avoid actions that generate strong minority objections. As a result the technically best-crafted plans may end up being politically rejected. In addition, reform programs which are ex ante politically acceptable may well become rejected ex post after they are implemented. One solution is to introduce a heavy dose of egalitarian income distribution, even if it runs against labor supply incentives.
1. Introduction

During the course of 1989, there was a widely shared feeling of enthusiasm as formerly planned economies in Europe - thereafter called Central and Eastern Europe or CEE - announced their determination to embrace the market system. Barring blatant policy mistakes, it was expected that the shift would take the shape of a J-curve. After an early, possibly deep and long-lasting, recession it was commonly expected that fast growth would set in and allow CEE, within a decade or two, to catch up with Western Europe. Indeed, a December 1991 agreement with the European Community formally states that it is expected that Czechoslovakia, Hungary and Poland will open discussions towards accession to the EC within ten years.¹

Three years later, a deep sense of disappointment, sometimes even failure, is developing among a number of observers. To varying degrees, measured output has fallen dramatically, unemployment is quickly rising above Western European levels, inflation which initially exploded is still not under control and budget deficits deepen. The rapid deterioration of economic conditions seems to be matched by the end of the early apparent consensus of the post-revolution honeymoon period. Yet even as political pressure to slow down reform is mounting, populations seem to be taking on hardships with extraordinary calm: both actual elections and public opinion polls show majorities in favor of a continuation of reform programs along with growing nostalgia for steadier times. Stiff opposition by minorities result in disorientation at all levels, from heads of state to simple citizens.

What initially appeared to be a technical challenge for economists - how to reform a formerly planned economy - has turned into a challenge for politicians. While the worsening of economic conditions was unavoidable, did political difficulties have to

² Representative of this early line of thought are Begg et al (1990) and Collins and Rodrik (1991).

There is no better illustration of the relevance of this point than the speed at which other ex-Soviet Republics have felt compelled to free prices once Russia had done so.

¹
rise to the point of jeopardizing economic reforms in several countries? Is it policy front-loading which has generated a political backlash, or would have resistance, or fatigue in the terminology of Bruno (1992), appeared anyway? Dewatripont and Roland (1992) introduce political issues in a model where policies are Pareto-improving but side-payments are impossible because of information asymmetries. Their conclusion, that gradualism provides the way to circumvent political opposition, is predicated by the absence of the public and national budget constraints so that the shadow price of transferring resources across time, the cost of gradualism, is nil. Actual reforms do face severe public and national budget constraints. In this paper, instead, I look at the political acceptability of a "big-bang" Pareto-improving reform process in a model with the relevant budget constraints. The next section presents a cursory overview of the economic situation. Section 3 motivates the link between economic and political conditions which is formally studied in Section 4. The simplest benchmark case is studied in Section 5, the following sections removing restrictive assumptions: foreign borrowing is introduced in Section 6 and domestic financial credit markets in Section 7, while Section 8 considers the case where different people are unemployed in turn during the transition period.

2. A combined demand and supply shock

As shown by Hughes and Hare (1992) and Senik-Leygonie and Hughes (1992), when evaluated at world prices, whole segments of industries in the formally planned economies are either not profitable or value-subtracting. Exposing such an economy to world prices

Here I disregard an alternative view, that there have been many serious policy mistakes, particularly that the "big bang" approach has been unrealistic and inevitably left aside key microeconomic preconditions (a representative statement is in Portes (1992), a balanced assessment in Bruno (1992)).

This model may provide an appealing interpretation of the gradual Hungarian reform process since 1968 which resulted in the highest debt per capita ratio in the world.

As economists, we know exactly how to stop the deficit in Italy or in the US, and maybe how to reduce bring unemployment in Belgium and France; what is harder is to make the measures politically acceptable.
markets is producing a massive supply side shock. The magnitude of the relative price changes that they face dwarfs many times over the oil-shocks of the seventies which delivered both unemployment and inflation. What is surprising, therefore, is that some have been surprised at the magnitude of the stagflation effects of a sudden shift to market pricing.

At about the same time, CMEA trade collapsed, producing a massive demand shock. To have an idea of the violence of that shock, it is instructive to consider in Table 1 the case of Finland, a country with strong ties to CMEA, particularly to the ex-Soviet Union. While less dependent on trade with the ex-Soviet Union than the other formally planned economies, the Finnish growth rate has swung from 5.4% in 1989 to -5.2% in 1991, and industrial production has fallen by more than 7%. This swing is of the same order of magnitude as what is observed in the former CMEA countries. The big difference concerns inflation. It shows that Finland did not have to undergo a supply shock at the same time. It also suggests that the supply shock has largely gone into inflation.7

Even if the downward-sloping portion of the J-curve is deep and drawn out over time by a succession of massive supply and demand shocks, it must eventually turn up. Views to the contrary are most likely informed by empirical models and intuition based on sharply different experiments. The prediction of an L-curve could only be justified by arguments explicitly based on hysteresis effects. However, except for emigration, none of the reasons associated with hysteresis effects (trade union membership, decay of job or firm specific human capital) apply to the present case.8

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7Rodrik (1992a) concludes that the CMEA shock explains most of the output fall in Hungary, a large portion in Czechoslovakia, less so in Poland which indeed underwent the most rapid transition and had to deal with hyperinflation. Bruno (1992) reports similar estimates from the IMF.
8Empirical evidence in favor of hysteresis is limited, so far. Another source of hysteresis is endogenous growth, for which
3. Sequencing: more about politics than about economics

The shocks are not entirely exogenous, however. Should policy measures have they been spread out over time? Both price and trade changes are eventually welfare-enhancing given the initial distortions. However they trigger supply responses which are inherently slow: it will take years, possibly decades, to accumulate the required physical and human capital. The ideal approach would be to trigger the process by unambiguously announcing the end point, while staggering the actual implementation of reforms to match the state of the economy. For example, oil prices could be raised in steps over several years as new energy-saving equipment and cars replace the older vintage. Such a view completely misses three crucial aspects.

First, the principle of second best means that partial price liberalization may make things worse than either full or no liberalization. Murphy, Schleifer and Vishny (1991) show how industries (or countries) may use partial liberalizations to engage in a welfare-reducing game. The two other points concern politics. The process under way is fundamentally revolutionary. On a large number of dimensions (social, political, economic, cultural, even family) the changes amount to a complete break from the past. That they were achieved almost peacefully is remarkable, to the point that their revolutionary nature sometimes gets overlooked. As in all revolutions, things happen truly exogenously, whether good or bad. In the present case, central planning had to come to a brutal halt, as was the case for the CMEA and the Soviet Union itself. The CMEA shock, and the refusal of former "satellite countries" to band together to soften the blow, were beyond control of any far-sighted political leader. The sudden dismembering of central planning left a vacuum which had to

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empirical evidence has yet to be produced.

There is no better illustration of the relevance of this point than the speed at which other ex-Soviet Republics have felt compelled to free prices once Russia had done so.
be filled instantaneously. Any comprehensive price fixing scheme was off-limit. The third aspect is in the realm of political economy: once the old regime has disappeared and democracy is introduced, politics matter as much as economics, exactly as elsewhere. Accordingly, long term commitments are never fully credible, and cannot be used as a device to unleash supply-side responses while actual reforms are being delayed. The best crafted reform policies may be dealt fatal blows by political forces banding together.

4. Economic efficiency and political acceptability

Economic reform is captured here by a J-curve. Because the program starts by a radical change in the price vector, output initially falls. There are N identical persons, all in the labor force. In period t=0, under central planning, each worker's (marginal and average) productivity is \( y \) and full employment is the rule so that national income is \( Y_0 = Ny \). In period t=1, given the existing capital stock it is impossible to raise individual workers productivity which remains \( y \). However, the combination of new prices, the end of subsidies and the imposition of hard budget constraints lead firms to eliminate overmanning. Thus employment in period 1 drops to \( N_1 < N \), \( U = (N - N_1) / N \) is the rate of unemployment, and national income is \( Y_1 = N_1y \). Since all workers are identical job losses are purely random, e.g. the outcome of a lottery. While the number of redundancies to be eliminated is known \( \text{ex ante} \), individual workers do not know who will be affected. In the long run, represented by period 2, each worker's productivity increases to \( \tilde{y} \) and full employment is restored. National income is then \( Y_2 = N\tilde{y} \).

Economic efficiency of the reform program is taken to mean that the present value of income rises:

As economists, we know exactly how to stop the deficit in Italy or in the US, and maybe how to reduce bring unemployment in Belgium and France; what is harder is to make the measures politically acceptable.
where \( R \) is the interest factor applied to the second (infinitely lasting) period. In the absence of a domestic financial markets, \( R \) is better evaluated at the world real rate of interest. An individual who happens to become unemployed in period 1 and receive no welfare transfer would lose from the reform:

\[
R \bar{y} < (1 + R)y
\]

(1) and (2) imply the following economic efficiency condition which is assumed to hold throughout:

\[
\frac{U + R}{R} < \frac{\bar{y}}{y} < \frac{1 + R}{R}
\]

This condition, which is assumed to hold throughout, does not guarantee that the program is welfare-enhancing. For a reform to be \textit{ex ante} politically acceptable it must be that the (homogeneous) workers expect their lot to improve, i.e. with time-separable utility:

\[
E[u(c_1) + \beta u(c_2)] \geq (1 + \beta) u(c)
\]

where \( \beta \) is the time-preference factor which needs not be equal to the world real interest factor \( R \), and \( c_1 \) is consumption in period 1 under reform, \( c \) being the no-reform level of consumption.

If some key markets - e.g. credit or insurance - are missing economic efficiency does not necessarily imply that welfare improves. This will be made apparent below. Condition (4) is the \textit{ex ante} political acceptability condition: when it is not satisfied all workers, who are identical, reject an economically efficient program. When (4) is satisfied, political difficulties emerge once the program is implemented because, \textit{ex post}, workers are not all alike: some keep their jobs and others are unemployed. There exist then \textit{ex post} political acceptability conditions which
may not be satisfied even when (4) is because one group is losing. In such a situation it is customary to resort to the median voter theorem and look for conditions under which government gets a majority support. This is not how governments actually operate, however. The median voter theorem is valid when politicians are judged on one dimension. Real life politicians are judged on many dimensions, with strong spillover effects (akin to increasing return to scale) from one dimension to the other. On some issues they are not able or willing to antagonize minority groups, and will seek to seek a sufficient degree of consensus on any particular issue. In the present case, it means that the government cares about income distribution between the losers who become unemployed during the transition and the winners who retain their jobs. Period 1 unemployment benefits \( b \) represent the natural symbol of income distribution in the present setup.

5. The benchmark case: no private and public borrowing

It is first assumed that individuals and the government are both unable to borrow against future income, either at home or abroad. Workers consume current income \( y_i \) and the government must finance the unemployment abroad benefits out of taxes \( \tau \) levied in period 1 on the employed who still each earn pre-reform \( y \). As a result all citizens are worse off in period 1, as compared to pre-reform. Ex ante popular political acceptability condition (4) requires that the future be bright enough:

\[
(5) \quad E[u(c_1)] + \beta u(\bar{y}) \geq (1+\beta) u(\bar{y})
\]

or equivalently:

\[
(5') \quad (1-U) u(y - \frac{1-U}{U}b) + U u(b) \geq (1+\beta) u(y) - \beta u(\bar{y})
\]

where account has been taken of the government budget constraint \( (N-N_1)b = N_1 \tau \).

Ex post, when job losses have occurred, workers are not anymore
all alike. There are now two political acceptability conditions, one for the losers:

(6) \[ u(b_1) \geq (1+\beta) u(y) - \beta u(\tilde{y}) \]

and one for the winners:

(7) \[ u(y - \frac{1-U_b}{U}) \geq (1+\beta) u(y) - \beta u(\tilde{y}) \]

The \textit{ex ante} condition (5') is a weighted average of the two \textit{ex post} conditions: if (6) and (7) are both satisfied (5') also is satisfied, but not the other way around. The range of acceptable income distributions is wider \textit{ex ante} than \textit{ex post} as seen in Figure 1 which displays the left-hand sides of the three conditions. This is one reason why the transition phase is difficult. The narrowing of the set of acceptable distributions means that unanimity is likely to fizzle during the transition, an evolution which may well generate enough political turmoil to call the program into question. For example, if point A was selected \textit{ex ante}, shifting mid-way to, say, point B would be seen as social-dumping.

\textit{Ex ante} a government enhances its chances by choosing an income distribution scheme (unemployment benefits) that maximize the left-hand side of (5'). This turns out to be what a benevolent utilitarian government would do and the solution is point C where \( b=y-\tau \) i.e. full \textit{ex post} income equality among \textit{ex ante} identical citizens. If under this scheme (5') is satisfied, then both (6) and (7) are also satisfied: if all citizens are treated equally, a reform that is welfare-increasing for society is welfare-increasing for each individual. This is the only time-consistent income distribution scheme, which means that it is politically robust. This robustness in front of considerable uncertainty, where the difference between being a winner or a loser is often a matter of luck - being in the right or the wrong industry - is probably a fairly general result. The obvious counter-argument, the moral hazard of unemployment insurance, is
probably not crucial early on in the reform process as the benefit from acquiring human capital on the job offsets the cost of giving up leisure.\footnote{Incentives may have been important in post-war Western Europe when opportunities were equally limited for all; in reforming economies fair treatment may be required for decisions to apply policies which hit some industries, not all.}

6. Foreign public borrowing

When governments are able to borrow abroad unemployment benefits paid out in period 1 may be repaid with taxes $\tau_1$ levied in both periods. The \textit{ex ante} political acceptability condition becomes:

\begin{equation}
(8) \quad (1-U) u(y-\tau_1) + U u(b_1) + \beta u(y-\tau_2) \geq (1+\beta) u(y)
\end{equation}

with obvious associated \textit{ex post} conditions. The intertemporal government budget constraint is $Ub_1 = (1-U)\tau_1 + R\tau_2$. While (8) is less demanding than (5), most results of the previous case apply: the economic efficiency condition (1) still does not necessarily imply \textit{ex ante} support, nor does \textit{ex ante} support guarantee \textit{ex post} acceptability. Political support (8) is maximized by a benevolent utilitarian government which smooths out income across both social groups and time. The familiar condition is:

\begin{equation}
(9) \quad u'(b_1) = u'(y-\tau_1) = (\beta/R) u'(y-\tau_2)
\end{equation}

With a CRRA utility function $u(y) = y^{\gamma}/\gamma$, (8) and (9) become:

\begin{equation}
(10) \quad \frac{y}{\gamma} \geq \frac{U+R(\beta/R)^{\sigma}}{\gamma}
\end{equation}

where $\sigma = (1-\gamma)^{-1}$ is the elasticity of intertemporal substitution. Given (3), a \textit{sufficient} condition for political acceptability is $R \geq \beta$, i.e. borrowing at an interest rate less than the rate of time preference. Then, with full insurance, \textit{ex post} acceptability is assured. This highlights the strategic importance of foreign
loans, the more so the more impatient is the population. If we interpret the risk of reform fatigue (Bruno(1992)) as a gradual increase in citizens' impatience, there is a case for stepping up foreign concessionary loans as reform progresses. In the opposite direction, a sufficient condition for (10) to be rejected, using (3), is \(1 + R \leq U + R(\beta/R)^\sigma\). Rejection is more likely with a high rate of unemployment in period 1 of course, but also with a combination of either high \((\beta/R)\) when \(\sigma\) is large or a low \((\beta/R)\) when \(\sigma\) is small: a high interest rate prevents enough intertemporal substitution or a limited willingness to substitute intertemporally prevents from taking advantage of low interest rates.

7. Private local borrowing

Now consider the case where citizens can \textit{ex ante} borrow and lend locally, but still not abroad. Consumption and income are dissociated as financial markets open after individuals know whether they are winners or losers and before goods markets open. In the absence of unemployment benefits (their role has been studied above) \(y_1\) can take the value 0 or \(\overline{y}\), while \(y_2=\overline{y}\) for everyone. Loan market equilibrium requires that all domestic claims cancel out. With a CRRA utility function, it can be shown that:

\[
(11) \quad R = \beta \left( \frac{Y_1}{Y_2} \right)^\sigma, \quad \text{so } R < \beta
\]

The real interest rate exceeds the rate of time of preference. Because all individual incomes increase in period 2, everyone wants to borrow during the transition. Those who need most to borrow, the losers, offer rates high enough to convince the winners who have a paid job to do the lending.

Given the concavity of the utility function, \(E[u(x)] \leq u[E(x)]\) so

\[12\text{-Foreign borrowing has been studied in the previous section: it does not matter whether it is done privately or publicly.}\]
the *ex ante* political acceptability condition (4) implies:

\[(12) \quad E[u(c_1) + \beta u(c_2)] \leq u((1-U)y) + \beta u(\tilde{y})] \]

*Ex ante* political acceptability of the reform program depends on two factors: 1) trivially, whether $\tilde{y}$ is large enough relative to $(1-U)y$ to make up for uncertainty and the loss of income during the transition; 2) the amount of uncertainty which is reflected in the spread in consumption levels of the winners ($c_1$) and of the losers ($c_2$) in both periods. With a CRRA utility function, we have:\(^{13}\)

\[(13) \quad c_1 - c_1 = \frac{Y}{1+K}, \quad c_2 - c_2 = \frac{K}{1+K} \frac{Y}{R} \]

where $K=\beta(Y_2/Y_1)\tilde{y}$. Both spreads rise with period 1 income $y$ which captures the extent of inequity, the income difference between the winners and the losers. Period 2 spread increases with the real interest rate (lower $R$) which reflects the unwillingness of the winners to lend to the losers. From (11), we know that the real interest rate increases with the magnitude of the post-reform swing $(Y_2/Y_1)$ from contraction to expansion. Thus, paradoxically, expectations of a very sharp improvement in living standards may make the reform politically unacceptable. This result seems to be related to the observation in Lucas (1992) that, when the unemployment risk cannot be diversified away, recurrent shocks in a pure credit economy lead to an ever more unequal distribution of income. Here, as the interest rate exceeds the rate of time preference, the losers who borrow end up poorer relatively to the winners.

8. Overlapping losers

The contrast between losers and winners may be too stark. This section differs from the benchmark case by allowing for various

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\(^{13}\)Initial individual wealth is assumed to be zero. There is no loss of generality as long as we assume that there is no difference in individual initial wealths.
individuals to become unemployed for a limited portion of the transition period. Let the transition period go from $t=1$ to $t=T$, the steady state lasting for ever after. If those who lose their jobs in $t=1$ remain unemployed until $t=T$, there is no difference with the previous case. At the other extreme each period is a new random drawing where each worker stands a probability $U$ of being unemployed irrespective of his current situation. Then the same situation reproduces itself $T$ times and it is fairly obvious that the longer the transition period the tighter is the \textit{ex ante} political acceptability condition\(^{14}\). On the other side the \textit{ex post} condition is not much tighter than the \textit{ex ante} condition because being unemployed today does not increase the probability of being unemployed again; the longer the transition the less costly it is to become unemployed once, but of course the more likely that it happens.

9. Conclusion

This paper focuses on the obvious: Pareto-improving programs may fail to improve everyone's lot. Politically, it has been often interpreted as requiring that a majority benefits from the change. Events in Central and Eastern Europe suggest otherwise and cast doubt on the relevance of the median voter theorem. The addition of minority discontents may result in major political difficulties and this leads governments to avoid actions that generate strong minority objections. These observations also concern the economists profession. As economists, we typically look at condition (1) to design or evaluate policy actions. The public worries \textit{ex ante} about condition (4) and \textit{ex post} about more demanding conditions. Thus the technically best-crafted plans may end up being rejected. There is need therefore to pay attention to such "details" as political acceptability. One solution is to

\[^{14}\text{The } \textit{ex ante} \text{ political acceptability condition (5') becomes:}\]

\[
(1-U)\ u(y - \frac{1-U}{U-b}) + U\ u(b) \geq \frac{u(y) - \beta^T u(\bar{y})}{1 - \beta^T}
\]

and the right hand-side is increasing with $T$.
introduce a heavy dose of egalitarian income distribution, even if it runs against labor supply incentives.
References


Table 1. The 1990-1991 Shock

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Notes: Growth is real GDP, except for Bulgaria, CSFR, Romania and the Soviet Union before 1991 where it is NMP. Inflation is measured with the CPI, except Finland for which the consumption deflator is used.

Source: OECD, Economic Outlook 50, June 1992
Figure 1