COMPENSATING VICTIMS

Robert S. Goldfarb

COMPENSATING THE "VICTIMS" of government policy changes for job or wage loss has gathered quite a head of steam in recent years. (I say victims because, whatever one's approach, and whether one wants to do something or nothing about it, some workers are in fact hurt by fundamental changes in government policy—by deregulation in particular—and the hurt is most commonly reflected in loss of jobs or wages.) The trade adjustment assistance program of 1962–1975, for example, compensated workers injured by lowered trade barriers. Other examples include labor protection provisions in CAB-approved airline mergers and comparable provisions for transit workers affected by urban mass transit grants, railroad workers hurt by the formation of Amtrak and Conrail, airline workers displaced by the 1978 Airline Deregulation Act, and loggers whose trees were absorbed into the Redwood National Park, also in 1978.

The growth in compensation programs has not been matched, however, by much systematic analysis of either rationales for or actual experience with such programs. How do they work? Do they in fact "work" at all? Do they fulfill the various promises held out for them? Here we seek some of the answers.

Professor Gordon Tullock of VPI argued in these pages two years ago that a policy of compensating the victims of government actions might have at least three advantages (see *Regulation*, November/December 1978). On the level of pure pragmatics, he suggested, compensation may lead to "political buy outs." That is, it may help secure passage of desirable legislation, such as regulatory reform, by disarming the opposition. Moreover, a compensation policy may be appealing on equity grounds, in that the "deserving" victims of government policy changes are helped to adjust. And a compensation policy may even promote increased efficiency in policy formulation by government agencies. If they are required to pay compensation, their estimates of costs and benefits may be more realistic—may even result in sounder policy choices. As far back as 1974, Harold Hochman of City University of New York provided a more elaborate equity rationale (see *Redistribution through Public Choice*, H. Hochman and G. Peterson, editors). He argued that fundamental considerations of fairness might *require* compensation. Dealing equitably with those who suffer windfall losses because of changes in rules or institutions, he suggested, may be a necessary precondition for preserving belief in the system's essential fairness. At the very least it may create a perception that the process of changing the rules is equitable.

Even at this early stage in the analysis, some reflections are in order (and here I draw heavily on work I have done in collaboration with my colleague Joseph Cordes). First and most obviously, policy choices about compensation rely on fundamental and varied value judgments. Hochman's fairness view has very

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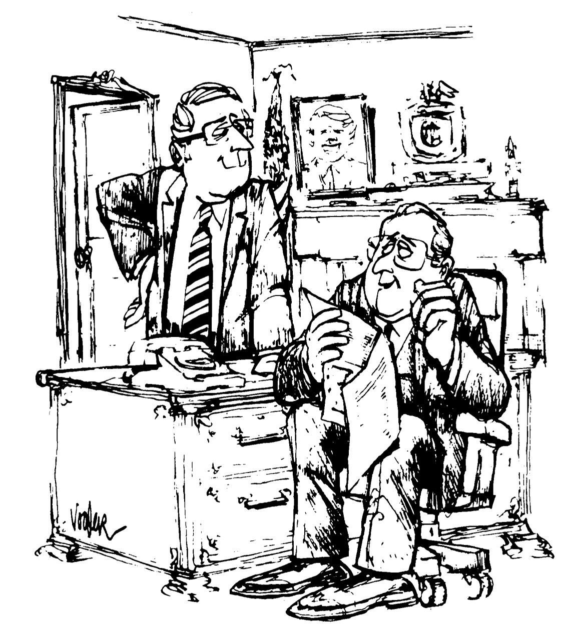
OF POLICY CHANGE



"Harebrain hypothesis, lousy documentation, meddlesome rules—you've got the makings of a great federal program, here, Winslow!"

different ethical premises than the political buy-out view, and both differ in turn from the position some have taken that compensation is *un*ethical and *un*fair if it provides reimbursement for the loss of "ill-gotten monopoly gains." Then, too, different views of compensation imply different levels of payment and even different recipients. The fairness view would seem to involve paying full or nearly full restitution to all those hurt by a government rules change, while the political buy-out view would lead to paying the minimum amounts to the fewest possible victims consistent with achieving the desired legislative result. All of which suggests that any notion that a compensation policy can readily achieve several desiderata at once—ranging from political buy outs to promoting fairness and better policy choices—may be wildly misleading. Or naive. Or a delusion. Or all of the above.

As if the theoretical underpinnings did not create enough problems, the implementation of compensation policy raises many more.

- The first is the difficulty of clearly delineating legitimate from illegitimate compensation situations. Does paying compensation in a specific case necessarily open a Pandora's box that leads inexorably to widespread and overwhelmingly expensive additional programs?
- A second problem arises from the claim that compensation programs enhance perceptions of the system's equity or fairness. Yet actual program experience suggests that this claim may be seriously wide of the mark.
- And, in the third place, a number of issues arise concerning the precise design of particular compensation schemes. These design issues play a large part in determining the efficiency and equity of any one scheme—and can strongly color one's views of the efficacy of compensation in general. Thus a legislator might believe that compensation is in principle a good idea but that design problems make any actual scheme so imperfect, so fraught with difficulties, as to be unworkable: what is de-

sirable in principle must therefore be abandoned in practice. Design problems include determination of the "boundaries" of payments (how far out do the waves of impact extend?), their incentive effects on job seeking or remaining unemployed, and the devising of target-efficient mechanisms for triggering compensation programs in the first place. (There is also, to be sure, a more positive aspect to these problems of design. For example, compensation can be paid by different mechanisms, some explicit—that is, actual payments—and some implicit—that is, limited postponement of a policy change. While this is itself a design "problem," it suggests that judicious choice of design may minimize other difficulties.) We will return to all of these problems in due course.

Opening Pandora's Box

The very act of paying compensation for job losses when it seems clearly justified might create political pressures to pay compensation when it is not so clearly justified (or not justified at all). Such a domino effect is certainly no stranger to public policy. In tax law, for example, percentage depletion for mineral A led to pressures for percentage depletions for minerals B through ZZ. Attempts to provide fair treatment of single persons by altering tax rates led to the claim (with some truth) that married persons were unfairly treated. While chain reactions always are a real danger, there may be ways of controlling them. Some of the rationales for compensation cover only the very limited set of job losses resulting from fundamental rules changes. Thus, insofar as actual compensation programs are proposed, defended, and passed with unequivocal reference to a limited-scope compensation rationale of wide appeal, this may provide a bulwark against attempts to widen the population of potential claimants.

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Consider how Hochman's fairness rationale might work to limit compensation claims. This rationale seems to endorse compensation for those harmed by government rules changes but generally not for those harmed by a range of other public actions, or by private market shifts. What then is "fair" when jobs are lost in an industry where they are known to be typically short-lived? A well-informed worker choosing between such a job and one that probably would last longer in another industry might well accept the short-lived job only at a large enough wage differential. In other words, those losing the "typically short-lived" jobs *already* have been compensated by higher wages—so that additional public compensation is inequitable as well as unwarranted! This no-compensation argument holds not only for pure private-sector job losses but also for those at defense contractors and for similar government-financed employment. It is surely true in defense industries that relative instability of employment is well-compensated by higher wages.

On the other hand—do not count on the power of an explicit rationale to limit compensation. Pressure groups are many and varied, and their claims are legion. As Robert Harris, executive vice-president of the Urban Institute, has emphasized,

> all sorts of groups will seek to develop claims on public funds using the argument that they have been hurt by public action, whether or not they have been so harmed. And some of the groups may be politically irresistible. . . . When public compensation for government-caused harm is accepted as an intellectually respectable basis for public expenditures, it can be used to cover almost anything.

Harris cites the black lung program as one example, and a very expensive one. Whereas its supposed rationale was to help coal miners whose lungs had been damaged by working in the mines, the program in fact benefits many individuals who have never suffered such damage. "At the time the program was enacted in its current form," Harris explains, "it was known by most involved actors that the program would 'overcompensate'—but it was politically irresistible." A second example involves veterans programs, which, according to Harris, compensate many people with no servicerelated injury. While these examples do not directly concern job-loss compensation, the general problem is clearly parallel.

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might well point out, for example, that trade adjustment assistance (TAA), which started out as a program for compensating workers hurt by lowered trade barriers, was expanded in the Trade Act of 1974 to cover workers whose job losses were not related to such changes. The skeptic might also note that if Chrysler were finally to shut down, intellectual rationales for not paying compensation in such a case—where the public already has made a substantial investment—would likely give way to strong political demands for still more aid. Of course, in the absence of a well-reasoned rationale of wide appeal, such a cancerous spread would be even more of a danger.

Equity in Action

We have noted that a major argument for compensation programs is that such payments make the system seem fairer and more equitable. But actual program experience suggests that paying compensation need *not* promote perceptions that the system is fair—may in fact produce exactly the opposite effect. Indeed, the connection between fairness and compensation may be tenuous at best.

Consider, for example, the compensation program for loggers adversely affected by the expansion of the Redwood National Park. In only the first eight months of the program, weekly benefits (of about $3.4 million) plus severance payments (of almost $4 million) averaged some $6,300 for each of 1,156 workers. And compensation per worker of this dimension outraged many observers. A CBS Evening News report on March 15, 1979, opened with a description of a former logger who was being paid $30.40 an hour "for doing absolutely nothing." The general tone of the report was that the program encouraged able-bodied workers not to work and generally smacked of a rip-off. Moreover, it was noted that claims of fraud were being investigated. Clearly, outside observers were not given the impression that this compensation program made the system more fair.

A second example is the trade adjustment assistance program of 1962–75, which was supposed to provide severance pay to those losing their jobs because of lowered trade barriers. For fully seven years, no TAA payments were authorized at all, and relatively few were authorized for several years thereafter. The Tariff Commission (now the International Trade Commission), which had to approve payment applications, used a case-by-case approach and very stringent criteria for determining eligibility—hewing more to statutory than to economic judgments. Labor groups, which had probably fought less strenuously for continued trade restrictions because of the presumed availability of TAA payments, were infuriated by this failure to approve compensation in what seemed to be highly justifiable circumstances. This compensation scheme certainly did not promote the view among organized labor that the system was fair. Interestingly, while both the Redwood and TAA cases illustrate the danger of any easy assumption that compensation promotes perceptions of fairness, the sources of disillusionment are polar opposites. In the Redwood case, the problem was that individual payments were too generous; in the TAA case, disillusionment stemmed from the fact that too few cases were compensated. Apparently, promoting a perception of fairness requires following a very narrow "flight path"; raising *or* lowering the "altitude" is likely to result in disaster.

There are several implications to be drawn from these experiences. Both cases show the sensitivity of perceptions of fairness to specific design features of the compensation schemes. In the pre-1975 TAA program, the trigger mechanism for getting compensation started was case-by-case examination by a commission—as it happened, by one that used statutory criteria interpreted in such a way that cases of economic merit were denied. Moreover, the case-by-case trigger, as would be expected, resulted in long delays and thus in a failure to provide transitional income support when it was most needed.

In the Redwood case, incentives built into the program tended strongly to promote continued unemployment even when attractive job opportunities were available. (While any severance pay program is likely to have some unemployment-increasing incentives, we will have occasion to note that they can be lessened by careful design.) Then, too, the size of the payments seems outlandishly large. The fact that they were so large may simply have reflected shrewd political maneuvering by the labor organizations involved, but a more subtle explanation is possible. The loggers received payments based on past wages, and those past wages doubtless reflected a substantial premium for the fact that logging is a dangerous business. But when someone is paid *not* to log, the payment necessary to restore real income should be smaller than the prior wage by at least the "danger premium": no more danger should equal no more premium. This suggests that, for dangerous or otherwise unpleasant occupations, the uncritical use of prior wages as the basis for payment results in *over*compensation.

A second implication about the ability of compensation payments to promote fairness goes back, of course, to fundamental views of what is fair. There are those who do not find any equity rationales convincing—on the grounds, for example, that risk is inherent in the market system, that the system depends on encouraging individuals to adjust to change, and that any compensation scheme slows down such "natural" adjustment. To such individuals, compensation programs are fundamentally undesirable—and fairness has nothing really to do with it.

Finally, there is the view—politically highly realistic—that compensation programs are most likely to be established when the victims have political clout. It is no accident, from this perspective, that union members are often in the group to be compensated. This "selective incidence of compensation programs" is itself likely to be viewed as unfair by many observers, the more so because political clout tends to correlate with wealth and not necessarily with "deserving victims." In short, the argument that compensation automatically promotes increased belief in the system's fairness is much too naive.

Design Problems

These are the problems that arise in trying to implement compensation programs in a manner consistent with chosen rationales, and with such other desiderata as minimizing transaction costs. In this sense, the failure of compensation programs to promote perceptions of fairness is just one example of a (particularly important) design problem. Three kinds of design problems are of particular interest—those involving trigger mechanisms, incentives for working or staying unemployed, and delineating a program's boundaries.

Trigger Mechanisms. Triggers are the devices that start compensation payments flowing. The TAA program was set up, as noted, with a case-by-case or discretionary trigger. The Airline Deregulation Act, on the other hand, provides that a 7½ percent decline in employment in a twelve-month period at any qualifying airline in existence prior to deregulation constitutes presumptive evidence that a compensation program should be "triggered on." While the legislation is ambiguous on whether the 7½ percent decline is sufficient by itself (without additional action by the CAB) to start compensation, our assumption will be that it is. So we have in these two programs the two extremes of trigger mechanisms.

One important criterion for any compensation scheme is promotion of "target efficiency"—that is, compensation should be paid to *all* deserving recipients and *only* to deserving recipients. Clearly, a deregulation compensation program that provides payments to many who are not hurt by deregulation while failing to compensate many who are hurt will be both cost-ineffective and unfair.

How then are deserving recipients to be identified? One technique is simply to pay compensation to everyone losing a job in the deregulated industry after deregulation. Period.

This technique has the advantage of minimizing the real cost of deciding who should receive compensation. But it would almost inevitably result in considerable target inefficiency: some of those being compensated would surely have lost their jobs anyway, deregulation or not. The case-by-case technique "solves" this difficulty. But again there is a flip side. Even apart from the decision-making expense involved in examining each case in detail and apart from the inevitable lags in payments to deserving recipients, there is, as the old TAA program indicates, the fundamental issue of the criteria on which decisions are based. If these criteria are not at least partially prespecified, a compensation program may function in a legislatively unintended, or even random, way. Indeed, the TAA process never impressed analysts with its subtle logical consistency. If all the criteria *are* effectively prespecified, on the other hand, case-by-case determination becomes all but an automatic trigger.

But then automatic triggers also have their difficulties. Some rule, some jumping off point must be chosen, and it is likely to be arbitrary to a degree. Even if a very elaborate rule were to be designed by a panel of economic savants, it would still exhibit some arbitrary features and produce some target inefficiency. This must be true because of the virtual impossibility of sorting out all job-losing individuals into the two categories of "caused by deregulation" and "for all other reasons." Moreover, actual trigger rules are unlikely to be elaborate structures designed by economic savants. Instead, they will usually be rules of thumb concocted by legislatures through political give and take. The trigger specified in the Airline Deregulation Act is a 7½ percent decrease in employment at a qualifying airline. But surely a decrease of that size is more likely in a recession than in the beginnings of a boom. So even if 7½ percent is right, on average, it is going to be too generous in a recession and too stringent in a boom. And why pick 7½ percent anyway? The original Senate bill proposed 15 percent, a number defended in a Senate report with the argument that 15 percent is large enough to subsume all "normal" cyclical patterns, which of course indicates the danger in terms of target efficiency of the 7½ percent rule. Indeed, the most intellectually palatable rule would give *different* percentages depending on the level of aggregate economic activity, relative input price changes, and other important factors. It is unlikely, however, that legislated compensation programs would ever mandate rules of such elegance.

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These triggering difficulties do not, of course, "prove" that compensation programs must be dismissed out of hand; any such conclusion requires careful consideration of a number of complex program benefits and costs —and our analysis has not yet run its course. We stress these difficulties for three reasons: (1) to sharpen our sense of the complexity of projecting the anticipated benefits and costs of compensation programs; (2) to indicate yet again the sensitivity of program attractiveness, as well as workability, to design features; and (3) to provide a potent illustration that alternative *forms* of compensation are differentially subject to such specific difficulties as target inefficiencies induced by the particular trigger that is chosen.

Our discussion of trigger mechanisms focused on one type of an *explicit* compensation program—one that involves severance pay. An alternative *implicit* form of compensation would involve postponement. If a reform is announced today, to take effect in N years, this N-year postponement provides implicit compensation to those who will be hurt by the reform. It does this by delaying the cost impact of the reform and therefore making it smaller in the present value sense. And because no explicit compensation is involved, no trigger mechanism is required. Moreover, the target-efficiency problem does not really arise *because all of those hurt by deregulation are automatically compensated!* Postponement *automatically* achieves a very high target-efficiency score. It helps only those who would have been hurt and does so "automatically" by delaying the hurt. So far, on the basis of the target-efficiency criterion at least, postponement of change looks like a good bet.

Minimizing Unemployment Effects. There is reasonably good empirical evidence that unemployment compensation generally increases the duration of unemployment. Because severance pay programs are similar to, but longer-lasting and even more generous than, ordinary unemployment compensation, their unemployment-increasing effects are likely to be greater. Rather than encouraging the displaced worker to find another job as fast as possible, the availability of severance pay may slow down this process, thereby raising the real social cost of the policy change that provoked the displacement. Moreover, as the Redwood example shows, the appearance of "induced idleness" can outrage observers and counteract whatever equity advantages a compensation program might embody.

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For any specific compensation scheme, attention will naturally focus on how large the unemployment effects are likely to be. Is it possible, through judicious program design, to hold down the unemployment-increasing incentives of compensation? Aside from the obvious point that the generosity of compensation will almost certainly affect the scale of induced unemployment, a number of other considerations enter into the equation. First of all, a severance pay scheme that does not condition payments on unemployment status is likely to have fewer unemployment-inducing effects than a system that is unemployment-conditioned. Consider, for example, a severance pay scheme that provides fixed monthly payments for a predetermined number of months, whether or not a new job is obtained; then compare this scheme with one that provides payments *only as long as the potential recipient is unemployed.* Suppose further that the anticipated total payment per recipient is the same under both schemes. The predetermined payments scheme is almost certain to promote a quicker return to work, because returning to work does not involve a loss of severance pay.

Chalk up one (it would appear) for predetermined payments schemes. Unfortunately, however, design issues are rarely as clear-cut as they appear. In this case, the predetermined payments scheme has the important *dis*advantage that "excess" payments go to individuals who find jobs right away and have no need for transitional support, whereas those who fail to find jobs by the time the payment period ends will not receive anything extra. In short, gains associated with better incentive features are offset by losses in target efficiency and equity. This kind of a trade-off is typical of the dilemmas besetting compensation policy.

Another point to be made about unemployment effects involves a comparison of a straight severance pay scheme with one that makes payments during unemployment *and also* makes up a portion of wage losses for some period after reemployment. Under the latter, if wages on the new job are less than the wages on the job from which the individual was displaced, a percentage of the shortfall is reimbursed. A wage reimbursement scheme should induce less unemployment than a straight severance pay scheme, because wage reimbursement lowers the cost—in terms of lost severance payments—of taking a job. The compensation scheme in the Airline Deregulation Act, for example, contains wage reimbursement features.

Or, again, compare the unemployment-inducing effects of severance pay with implicit postponement compensation. Suppose, for example, that compensation in the Redwood case had been "paid" not immediately—by implementing the policy change and therefore providing severance pay—but rather by postponing expansion of the park. By switching to compensation through postponement, the unemployment-inducing feature of severance pay is of course eliminated—simply because there is no severance pay. Moreover, by postponing the change, workers are given time (and an incentive) to look for other work *before* their jobs disappear. To the extent that workers believe the change will not be postponed indefinitely, this recourse may promote a less socially costly pattern of reemployment.

This example illustrates the attractiveness of postponement, but also suggests why postponement is no panacea. In the Redwood case, it might have resulted in an orgy of redwood cutting as logging companies tried to reap as many benefits as possible before the (postponed) date of the federal takeover. This, clearly, would have been a most undesirable outcome.

Finally, concern about unemployment effects has sometimes provoked unusual program design features aimed at least in part at minimizing these effects—features that themselves may create bizarre and certainly unintended outcomes. A prime example is the requirement in the Airline Deregulation Act that job openings be offered first to applicants laid off by other airlines. According to the Labor Department's proposed implementing regulation, this requirement applies even if an individual with sufficient seniority loses his job for reasons other than deregulation. While there is some question about the enforceability of the regulation, if enforced it might result (as the *Wall Street Journal* has claimed) in putting "the Labor Department in the position of running what industry and union leaders say amounts to a 'national hiring hall' in the airline industry" (December 7, 1979). The implications and possible precedents are mind-boggling.

Determining Payment Boundaries. When an industry is deregulated—say, the airlines—and a long-established firm in that industry goes bankrupt, an argument can be made for compensating the affected personnel. But suppose airline deregulation leads to a big increase in airline business and, as an indirect result, several intercity bus lines go bankrupt. Do the displaced bus drivers not have a similar claim to compensation? They too are victims of airline deregulation, after all. And if bus drivers are compensated, how about workers laid off from the firms that produce buses? And so on, more or less to infinity. Conceptually, how far removed does the injury have to be before it need *not* be compensated? While one can legitimately argue for narrow compensation boundaries because of measurement difficulties—it would, for example, be virtually impossible accurately to attribute job losses in bus employment to airline deregulation versus all other causes—this argument does not eliminate the *logical* inconsistency involved, and therefore does not resolve the equity issue. In point of fact, the Airline Deregulation Act does limit compensation to airline employees only.

If the airline-bus example seems a bit far-fetched, a case involving trade adjustment assistance may be more compelling. Suppose that piano imports rise because of a change in trade policy, and domestic production of pianos falls as a result. Then workers in domestic piano-producing firms should qualify for TAA. But it is quite plausible that, as domestic production of pianos falls, domestic production of specialized inputs to pianos ("piano parts") is also likely to fall—without any increase in imports of piano parts. Should displaced piano-parts workers qualify for TAA? And what about workers who produce special wires that are then sold exclusively to the piano-parts producers? In the actual case, the Tariff Commission ruled that piano-parts workers did not qualify for TAA, apparently because there was no associated rise in piano-part imports. This decision, which makes little *economic* sense, was no doubt based on strict statutory construction. The larger point, however, is that there is a serious measurement and conceptual equity problem in deciding how far afield to go.

As with trigger mechanisms and unemployment effects, so also with delineating boundaries: severance pay compensation raises boundary problems, while postponement compensation does not. Because postponement delays all bad effects automatically, it automatically delays them for bus drivers as well as airline workers, for piano-parts workers as well as piano producers. From the perspective of the boundary problem at least, postponement looks extremely attractive.

Is Postponement the Answer?

As answers to compensation dilemmas go, a postponement strategy does indeed look good. But it raises difficulties uniquely its own. Consider, for example, whether recipients of postponement compensation are likely to consider themselves compensated, and therefore fairly treated, to the same degree as if they had received severance pay. While an economist can appreciate the argument that postponement today provides compensation (reduced present value of loss) today, the typical recipient of postponement compensation might well find this subtlety cold comfort on the future day when his job really does disappear. Another serious problem with postponement is the lack of inevitability of the policy change. If there are compelling arguments and strong political pressures for postponing a deregulation today, is it not likely that the same arguments and pressures will reappear at the future date (now postponed) of the policy change? Indeed, opponents of deregulation or tariff reductions may be more than happy to defuse pressures for change by accepting postponement, knowing they can refight the fundamental decision as the new effective date approaches. Legislation to decontrol fuel prices "later" provides a useful example of the difficulties involved. And even if all these matters are set aside, it still is necessary to weigh costs and benefits. A major cost of postponement is the benefits lost precisely *because* the policy change is delayed. In particular cases, these costs may be very large, and they must in any case be calculated and compared to the costs of compensation.

First cousin to compensation-by-postponement is what might be called the "keep it vague" strategy. Clearly, different interests and therefore different legislators might and do support compensation legislation for very different and often conflicting reasons. Thus, in order to form the broadest possible coalition of support, the legislation is often left sufficiently vague that groups which favor compensation for quite different reasons can come together. This is precisely what happened with the Airline Deregulation Act. Such a crucial feature as the percentage of prior wages on which severance pay was to be based was not specified in the legislation—instead, it was left to be determined by the secretary of labor after the fact—so that groups wanting high compensation and groups wanting low compensation could all vote "yea." In fact, the proposed federal regulations were written with a rather tight cap on the monthly payments, and this must have given the pilots union an unpleasant shock: the cap provides a relatively low level of compensation to any senior pilot who gets displaced.

And legislative indeterminacy itself creates a dilemma for the advocates of compensation policy. Getting a preliminary agreement that compensation will be written into legislation is a first step only. It does not guarantee that the actual compensation features that result will fit any particular pattern. Advocates of compensation must face the awkward fact that, when they lobby or vote for compensation provisions, they really are buying a lottery ticket on which they and their compensation principles could just as easily end up losers as winners.

The moral of this long, somewhat unhappy tale can be succinctly stated. Whatever one's grand philosophical rationale for compensation, it is very difficult (probably impossible) to produce an actual scheme that is not seriously flawed—that may even contradict and negate the rationale itself. These flaws can arise from the inherent difficulty of program design, the need to form political coalitions, the very existence of differing philosophical views about compensation, or (as Robert Harris stresses) the political irresistibility of giving something to most everyone. All of our experience with the concept of compensation counsels the high probability that any specific compensation scheme will be ridden with seemingly intractable dilemmas. A hard lesson, indeed, about hard reality—but harder still if we refuse to learn it. ■

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