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THE VIRTUES OF GRADUALISM AND LEGITIMACY IN THE TRANSITION TO A MARKET ECONOMY

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THE VIRTUES OF GRADUALISM AND LEGITIMACY IN THE TRANSITION TO A MARKET ECONOMY

Mathias Dewatripont and Gérard Roland

ABSTRACT

The Virtues of Gradualism and Legitimacy in the Transition to a Market Economy*

This paper presents a simplified model of sectoral restructuring in Eastern Europe. A move towards allocative efficiency is desired by the reform-minded government, but the shift to higher productivity which such efficiency requires would lead to massive layoffs and labour reallocation in the transition period. We look at the impact of political constraints (unanimity and/or majority worker approval) on reform proposals when the government faces a heterogeneous workforce, holding private information on relative outside opportunities. When the budgetary consequences of exit compensations are so important as to make partial reforms preferable to full reforms, *gradualism* emerges as the optimum in a dynamic context without government commitment. It is also shown that under democratic majority rule, a government in control of the agenda of reforms can win majority approval for plans which end up hurting majority interests intertemporally by threatening to switch majorities in future reform proposals.

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NON-TECHNICAL SUMMARY

This paper addresses two policy issues relevant to the transition from plan to market in Eastern Europe. First, to what extent does the establishment of democratic regimes prior to radical economic reform create an obstacle to reforms which may hurt a majority of the population? The existence of such political constraints may appear as a puzzle to economists. The gains brought about by a shift to more efficient institutions should, it is often argued, be large enough to compensate the potential losers. If so, institutional change supported by the appropriate compensation schemes would be Pareto-improving, and any resistance towards change can not be explained as the behaviour of rational agents. The required compensation payments might, however, prove much more costly to the government if it cannot observe the potential losses suffered by different categories of workers, especially in the case of hidden rents. They might still prove more costly if, moreover, workers believe that the government cannot commit to preannounced intertemporal compensation schemes. Second, are there any virtues to gradualist strategies in the transition process? These questions are addressed in the context of sectoral restructuring, implying massive layoffs and labour redeployment inside the economy.

The framework in which these questions are treated is a simplified model of restructuring where a reform-minded government faces a heterogeneous workforce characterized by three different levels of relative opportunities outside their current job ('good', 'average' and 'bad'). These are however private information known only to the individual worker. The initial situation, before restructuring, is characterized by a low level of productivity and full employment. We assume that the move towards allocative efficiency implies a shift to higher productivity and requires two thirds of the workforce to be reallocated in the transition period. As the government can not distinguish the outside opportunities of individual workers its reform proposals must thus be incentive compatible: the government can induce the workers with the best relative outside opportunities to leave by offering wages, productivity level and exit bonuses. This clearly implies a cost since the government cannot discriminate between worker types when setting a wage or an exit bonus. Reform plans are proposed by the government, which therefore controls the agenda, but these plans are subject to political constraints. In this context, we assume that the approval of a majority of the workers is necessary to have a reform plan accepted. This implies potential wage and exit compensations that might be very costly for the state budget. A trade-off can thus appear between allocative efficiency and the budgetary costs of reform. *Full reforms* achieve allocative efficiency immediately, since both the 'average' and the 'good' workers leave the sector. The political acceptance of *full reforms*, which would entail massive and immediate redundancies, would

require very costly compensation. *Partial reforms*, which entail laying off only those workers with the best relative outside opportunities, will generally cost less.

When budget considerations are so important as to make partial reforms preferable to full reforms, we show that *gradualism* emerges as the optimum in a dynamic context without government commitment. Indeed, once a partial reform has been implemented and workers with the best relative opportunities have left, it becomes optimal for the government to offer a new plan where workers with 'average' outside opportunities also leave. Allocative efficiency is thus reached gradually, at a budgetary cost which is lower than that with the *full* or *'big bang'* reform.

Concerning the role of *democracy* as an obstacle to reform, we show that a government in control of the agenda of reforms can win majority approval for plans which hurt majority interests intertemporally. The general idea is that the government can, through the credible threat of future reforms, extract today concessions from the group which will be in the minority tomorrow, and use their votes to hurt another group of individuals today. We show that this 'divide and conquer' strategy can be profitable in the cases of both gradualist and 'big bang' reforms. Our analysis thus suggests that a democratic government with the legitimacy required to be in full control of the agenda of reforms can largely circumvent the political constraints that might otherwise plague the implementation of efficiency-enhancing reforms, and thus secure acceptance of transitional measures which may be painful for a majority of the population.

1. INTRODUCTION.

This paper adresses two policy issues relevant to the transition from plan to market in Central and Eastern Europe. First, are there any virtues to gradualist strategies as opposed to "big bang" strategies, in the transition process ? Second, to what extent is the establishment of democratic regimes prior to radical economic reform an obstacle to the latter, when transition measures may hurt a majority of the population in the short run ? These questions are adressed in the context of sectoral restructuring, implying massive layoffs and labor redeployment inside the economy. The key to our approach consists in integrating the effects of political constraints on optimal reform proposals. Political constraints are generally thought to appear because proposals for change towards more efficient economic institutions make some groups of agents worse off. In the case of Eastern Europe, the transition to a market economy hurts the interests of bureaucrats but also of vast groups of the population and this opposition reflects in the political decision-making. One-party communist rule clearly gives more weight to conservative bureaucratic interests, but within the newly emerging democratic institutions in Eastern Europe, opposition of various interest groups to economic reform undoubtedly starts to find forms of political representation.

The very existence of political constraints to economic reforms may however appear as a puzzle to economists. One may indeed argue that the efficiency gain entailed by a shift to more efficient institutions is often big enough to compensate the potential losers, even after taking into account transition costs and the potential distorsionary effects of compensation schemes. So, if this is the case, institutional change supported by the appropriate compensation schemes would be Pareto-improving, and any resistance towards change would remain unexplained, at least if we assume that the agents are rational. The required compensation payments might however prove much more costly to the government if it cannot observe the potential losses suffered by different categories of workers, especially in the case of hidden rents. They might still prove more costly if,

moreover, workers believe that the government cannot commit to preannounced intertemporal compensation schemes.

In this paper, we try to capture and analyze these problems in a simplified model of restructuring where a reform-minded government faces a workforce which is heterogenous in terms of relative opportunities outside their current jobs. These are however private information held by individual workers. The initial situation before restructuring is characterized by a low productivity level and full employment. The move towards allocative efficiency implies a major shift to higher productivity and massive layoffs and labor reallocation in the transition period. As individual agents are undistinguishable for the government, it can only achieve this outcome through the choice of an exit bonus and a wage increase, inducing workers with the best outside opportunities to leave. Reform plans are proposed by the government who is assumed to be in control of the agenda of reforms proposals, but these proposals are however subject to political constraints. In this context, it means that a majority (or even unanimity) of worker approval is necessary to have a reform plan accepted. This implies potential compensations that might be very costly for the state budget. A tradeoff thus appears between allocative efficiency and the budgetary costs of reform. The political acceptance of full reforms, implying massive immediate redundancies, can be very costly in terms of exit compensation. Partial reforms, implying only laying off those workers with the highest relative outside opportunities, will generally cost less, even though it will be worse in terms of allocative efficiency.

This is the basis for our first result, concerning the virtue of gradualism. Gradualism is advantageous when the political acceptance of full and immediate reforms implies excessively costly compensations. In our model, gradual reform consists in a plan inducing one group of workers to leave in the first period and the other group to leave in the second period. Allocative efficiency is thus only reached in the second period. If the government could precommit to its reform plans, there are cases where partial reforms are preferable to full reforms because the economy on compensation payments is greater than the allocative loss it implies. If the government cannot precommit in advance to its own

reform plans, then maintained partial reform is not time consistent : once a partial reform has been implemented and workers with the best relative outside opportunities have left, it becomes optimal for the government to offer a new plan where workers with "next-to-best relative" outside opportunities also leave. Allocative efficiency is thus reached gradually, at a budgetary cost which is lower than *full* or "*big bang*" reform.

Concerning the role of *democracy* as an obstacle to reform, we show that a government in control of the agenda of reforms can win majority approval for plans which end up hurting majority interests intertemporally. This is the second basic result of this paper. The general idea is that the government can, through the credible threat of future reforms, extract today concessions from the group which will be in the minority tomorrow, and use their votes to hurt another group of individuals today. Our analysis thus suggest that a democratic government which has the necessary legitimacy to be in full control of the agenda of reforms can in large part circumvent the political constraints that could plague the implementation of efficiency-enhancing reforms, and win acceptance of transition measures which reveal painful for a majority of the population.

In our view, political constraints are bound to play a crucial role in the whole transition process in Eastern Europe. While this paper focuses on the political economy of the restructuring phase, political constraints could also be investigated in other phases of transition (whose economic aspects have already been the object of extensive research[1]).

In section two, we briefly present the model and the conditions for allocative efficiency. In section three, we present the case for gradualism. In section four, we present the result on democracy. Section 5 concludes with some policy implications.

2. THE MODEL.

There are initially three groups of workers inside the sector. We assume each group to be of unit mass, and each with a continuum of infinitesimally small individuals. Each group is characterized by individual unit disutilities of effort $\bar{x}$, x and $\underline{x}$ respectively, with

$$\bar{x} \geq x \geq \underline{x} \geq 0 \qquad (1)$$

Productivity is assumed common to all workers in the sector. It thus depends solely on the organization of production in general. Two modes are possible : e = 1 means a low productivity for all and e = 2 represents a high productivity for all. When workers leave the sector, e = 0 is chosen as normalization. Group output q(e) depends on productivity, with q(2) > q(1). Worker utility is defined as the monetary payments received minus e times the disutility of effort.

The economic situation before reform is assumed to be one where all three groups work inside the sector at e = 1 and for a wage w > $\bar{x}$. By normalization, every worker's outside opportunity is zero. Nobody has thus an incentive to exit voluntarily before reform. The vector of worker utilities under the status quo, that is, without reform is thus

$$U\,(S.Q) = \begin{pmatrix} w & - & \underline{x} \\ w & - & x \\ w & - & \bar{x} \end{pmatrix}$$

Before reform, rents are thus negatively correlated with the relative disutilities of effort inside the sector. Define the vector of gains and losses from reform R as :

$$U^*(R) = U(R) - U(S.Q.)$$

The government acts as the agenda-setter[2], that is, it has the initiative in terms of offering reform proposals. It is assumed to maximize net allocative surplus minus the distortionary cost of monetary payments (implicitly financed by taxation). Call λ the distorsionary cost per unit of revenue. In order to define allocative efficiency, we assume the following conditions :

$$(1 + \lambda) \, x \geq q(1) \geq q(2) - q(1) \geq (1 + \lambda) \, \underline{x} \qquad (2)$$

Under (2), only the $\underline{x}$ group should remain in the sector, at $e = 2$. Indeed, compensating the x group for the disutility of working at $e = 1$ or a fortiori at $e = 2$ is more costly than its group output thus, as the first two inequalities on the left show us. Keeping the $\bar{x}$ group working is of course even more costly. On the contrary, inequality on the right shows us that the allocative gain from increasing productivity for the $\underline{x}$ group is higher than the cost of compensating them for their higher total disutility of effort.

We assume informational asymmetry in the sense that the government cannot directly observe individual effort disutilities. It only knows the values $\underline{x}$, x and $\bar{x}$ and their proportions in the population. Reform proposals must thus be incentive compatible : the government can offer wages, productivity level and exit bonuses in such a way as to induce the desired exit behaviour from workers. This clearly implies a cost since the government cannot discriminate between worker types when setting a wage or an exit bonus.

In period 1, a reform proposal by the government is thus denoted $(w_1, e_1, b_1, w_2, e_2, b_2)$, i.e. a wage level, a productivity level and an exit bonus in periods 1 and 2. We assume no government commitment. This means that in period 2, the government is free to propose another reform (w_2', e_2', b_2') different from the one voted in period 1.

In order to be able to implement its reform proposals, the governement must satisfy "political contraints". We will look at two possible cases, unanimity and majority of worker approval. In the following section, we will derive the case for gradualism on the basis of a unanimity assumption[3], whereas the result of Section 4 will rely on a majority assumption.

3. GRADUALISM

To understand the rationale for gradualism, compare first two reforms in a one-period framework : "a full reform" and "a partial reform".

Under a full reform, (noted F), allocative efficiency is reached immediately, with the x and $\underset{\sim}{x}$ group exiting. Under unanimity rule, monetary payments must however leave individuals of each group at least as well off as under the status quo. Individuals of the $\underset{\sim}{x}$ group must be compensated for the higher productivity and the exit bonus must be high enough to keep the x group as happy as in the status quo, thus conceding a rent to the $\bar{x}$ group. We thus have as least costly incentive - compatible (IC) full reform :

$$F \qquad \begin{aligned} w_1 &= w + \underset{\sim}{x} \\ e_1 &= 2 \\ b_1 &= w - x \end{aligned} \qquad\qquad U^*\,(F) = \begin{pmatrix} 0 \\ 0 \\ \bar{x}-x \end{pmatrix}$$

The cost of a full reform is thus to concede extra rents to the $\bar{x}$ group, who benefit from the exit of the x group. The value of the government's objective function is

$$V\,(F) = [q(2) - 2\underset{\sim}{x}] - \lambda\,(3w + \underset{\sim}{x} - 2x)$$

Instead, in partial reform, (noted P), only a moderate move towards allocative efficiency is made, as productivity remains low and only the $\bar{x}$ groups exits[4]. In such a case, the wage can remain unchanged, and the bonus only has to keep the $\bar{x}$ group as happy as in the status quo. We thus have as least costly partial reform :

$$P \qquad \begin{aligned} w_1 &= w \\ e_1 &= 1 \\ b_1 &= w - \bar{x} \end{aligned} \qquad\qquad U^*\,(P) = \begin{pmatrix} 0 \\ 0 \\ 0 \end{pmatrix}$$

The advantage of a partial reform is thus not to concede extra rents to any groups of workers in comparison to the status quo, because the $\bar{x}$ group cannot benefit from the exit of the x group. The value of the government's objective function is in this case :

$$V (P) = [2q(1) - x - \underset{\sim}{x}] - \lambda (3w - \bar{x})$$

The government will prefer partial reform to full reform iff V (P) > V(F), i.e. iff

$$x < \frac{1}{2} (\underset{\sim}{x} + \bar{x} - \frac{1}{2\lambda} (q(2) - 2q(1) + (x - \underset{\sim}{x}))) \qquad (3)$$

Intuitively, for x and $\bar{x}$ given, when x is near $\underset{\sim}{x}$, the allocative loss from keeping the x group working becomes small in comparison to the rent extraction motive. Indeed, full reform gives a rent of $(\bar{x} - x)$ to the $\bar{x}$ group and this rent becomes higher the nearer x is to $\underset{\sim}{x}$. When there is a trade off between allocative efficiency and the budgetary cost of reform, due to incentive and political constraints, partial reform can thus be preferable.

Let us assume condition (3) is satisfied, that is, partial reform is preferable to full reform and let us now look at the two-period problem in the absence of government commitment. One realizes quickly that partial reform cannot be maintained over the two periods, because it is not time consistent. Indeed, once it has been implemented and the $\bar{x}$ group has left period 1 with their two-period exit bonus $2(w - \bar{x})$, it becomes optimal for the government to offer another reform in period 2 $(w_2'; e_2', b_2') = (w + \underset{\sim}{x}, 2, w -x)$. This induces the x group to leave, is acceptable to the x and $\underset{\sim}{x}$ group and increases the governments' objective function by $[q(2) - q(1) - (1 + \lambda) \underset{\sim}{x}] + [(1 + \lambda) x - q(1)] > 0$. But if economic agents know that partial reform is time inconsistent, it cannot be implemented in the first period. Indeed, an $\bar{x}$ worker could gain from not exiting in the first period and from receiving a bonus $w - x$ when leaving in the second period, thus inflicting an allocative loss to the Government. The following gradual reform (G) is however time consistent and incentive compatible :

$$w_1 = w \qquad e_1 = 1 \qquad b_1 = (w - \bar{x}) + (w-x)$$

G $\qquad\qquad w_2 = w + \underline{x} \qquad e_2 = 2 \qquad b_2 = w - x$

$$U^*(G) = \begin{pmatrix} 0 \\ 0 \\ \bar{x} - x \end{pmatrix}$$

$$V(G) = (2q(1) - (\underline{x} + x) + q(2) - 2\underline{x}) - \lambda(6w + \underline{x} - 2x - \bar{x})$$

Gradual reform is here preferable to full reform. Indeed, one can see that V (G) is exactly the average of V (P) and V (F) when partial and full reform are each maintained over two periods. This means that the government would prefer partial reform to gradual reform if it could credibly precommit itself. Indeed, an amount $(\bar{x} - x)$ of extra rents has to be granted to the $\bar{x}$ group for <u>each</u> period for which the x group works no longer in the sector (because these have to receive a per-period bonus of (w-x) to keep them happy). Under condition (3), these extra rents more than compensate the allocative cost of keeping the x group inside the sector and keeping productivity low. Ideally, the government would like to maintain the partial reform over the entire horizon. Lack of commitment however makes the gradual reform the best (time-consistent) option. Its advantage over a full reform is that, by delaying the exit of the $\underline{x}$ group, it can reduce the level of extra rents received by the $\bar{x}$ group. Intuitively, by inducing first the exit of only those workers whose relative outside opportunities are highest, the first-period bonus can be lower than in a full reform where workers with lower relative outside opportunities have to be also compensated[5].

To summarize, gradualism can be an optimal policy for a reform-minded government, in the presence of informational asymmetry, lack of precommitment and political constraints. Gradualism allows the authorities to compensate the loss of allocative efficiency in comparison to a full reform or "big bang" strategy by lower monetary compensations while satisfying the political constraints.

4. DEMOCRACY AND CHANGING MAJORITIES

We now look at reforms under majority rule. Contrary to unanimity rule, minorities can now be hurt by a reform proposal, (of course, IC constraints must still be respected). Our goal in this Section is to show that the government can in principle seek a variety of majorities and also, in a dynamic framework, credibly threaten to switch majorities to extract more rents from workers. To show how the government can gain from such a "divide and rule" threat of shift in majorities, we will limit ourselves to the comparison of two full reform proposals, $F_{\underline{x}}$ hurting the $\underline{x}$ group and $F\bar{x}$ hurting the $\bar{x}$ group.

In a one-period framework, minimizing total payments subject to IC and political constraints yields :

$$F_{\underline{x}} \qquad \begin{aligned} w_1 &= w - \bar{x} + 2\underline{x} \\ e_1 &= 2 \\ b_1 &= w - \bar{x} \end{aligned} \qquad U^*(F_{\underline{x}}) = \begin{pmatrix} -(\bar{x} - \underline{x}) \\ 0 \\ \bar{x} - \underline{x} \end{pmatrix}$$

$$F\bar{x} \qquad \begin{aligned} w_1 &= w + \underline{x} \\ e_1 &= 2 \\ b_1 &= w - \bar{x} \end{aligned} \qquad U^*(F\bar{x}) = \begin{pmatrix} 0 \\ -(\bar{x} - \underline{x}) \\ 0 \end{pmatrix}$$

$F\bar{x}$ gives the $\underline{x}$ group a wage just low enough to keep them at work, whereas $F\bar{x}$ sets the bonus just high enough not to hurt the $\bar{x}$ group. Note that $F\bar{x}$ and $F\underline{x}$ imply the same allocative surplus, and differ only in terms of total payments to workers. $F\underline{x}$ sets b_1 to protect all workers who exit and puts the $\underline{x}$ group in the minority through $w_1 < w + \underline{x}$. Instead, $F\underline{x}$ implies a lower bonus, protecting only the $\bar{x}$ group in comparison to the status quo, while also protecting the $\underline{x}$ group through $w_1 = w + \underline{x}$[6]. As a whole, $F\underline{x}$ is costly in terms of w_1, but is less expensive than $F\bar{x}$ for the two groups who leave. Computation of total payments shows that $F\underline{x}$ is more attractive than $F\bar{x}$ for the

government iff $3x \leq 2\bar{x} + \underline{x}$. Moreover, one can show that these two reforms are the only optimal ones wherever $2x \geq \underline{x} + \bar{x}$[7].

The above example provides some intuition about optimal majorities a government might seek to minimize the budget cost of reform (see Lewis et al. (1990) for a general analysis of this problem in the context of agricultural reform). It can also be extended to a two-period setting where the first proposal is offerred under the threat of a second-period proposal in the case of rejection. Consider for example the case $2x \geq \underline{x} + \bar{x}$ and $3x \leq \underline{x} + 2\bar{x}$, that is, Fx is the one-period optimum. In such a case, worker will vote in favor or against a two-period proposal in period 1 after having compared with the status quo followed by Fx (since, after rejection, they can expect Fx to be implemented). One possibility for the government is then to offer in period 1 the reform Fx replicated twice (i.e. $b_1 = 2(w - \bar{x})$ and $w_1 + w_2 = 2(w + \underline{x})$). This is politically acceptable to a majority, since it multiplies gains and losses by two in comparison to Fx.

A greater variety of reform proposals is however possible. The following is a reform we will call F$\underline{x}$x.

$$\mathbf{F\underline{x}x} \quad \begin{array}{ll} w_1 = b_1 + 2\underline{x} & w_2 = 2\underline{x} \\ e_1 = 2 & e_1 = 2 \\ b_1 = (w - \bar{x}) + (w - x) & b_2 = 0 \end{array} \quad U^* F(\underline{x}\, x) = \begin{pmatrix} -(\bar{x} + x - 2\underline{x}) \\ -(\bar{x} - x) \\ \bar{x} - x \end{pmatrix}$$

As one can see, in comparison to the status quo, this reform hurts the x group through a bonus lower than $2(w-x)$ and it also hurts the $\underline{x}$ group who receive a wage just high enough to keep them inside the sector. A majority is thus hurt by this reform in comparison to the status quo. Could a majority vote however for such a proposal ?

The answer is yes ! Imagine that this reform is rejected in the first period. Then, no reform takes place in period 1 and the government can offer a new reform in period two, and it will be Fx under our assumptions. In such a case, the x group would lose $(\bar{x} - x)$ in comparison to the status quo, so that they would be ready to vote for any proposal that leaves them intertemporally weakly better off than that. This is exactly what happens with

reform F̲xx (which moreover gives extra rents to the x̄ group in comparison to the status quo followed by Fx).

Under F̲xx, the government thus uses the threat of having the x̲ and x̄ groups vote Fx in period 2 in case of rejection in order to induce the x group to vote F̲xx together with the x̄ group, with the x̲ group now in the minority. The credible threat of changing majorities thus enables the government to obtain a majority vote for a reform that overall ends up hurting a majority in comparison to the status quo. This "divide and rule" strategy can also be optimal in the case where a gradual reform is the one-period optimum, using the threat of a partial reform hurting one group in period 2 to improve a reform leaving two groups less well off than under the status quo. (See Dewatripont-Roland (1990)).

F̲xx increases the government's payoff compared to Fxx, the replicated optimal one-period reform, since it implies less monetary payments, as one can easily verify. It can be shown (see Dewatripont-Roland (1990)) that F̲xx is the optimal two-period reform when Fx is one-period optimum. One can however also show that reforms hurting two groups are not systematically preferable for the government to reforms hurting just one group in comparison to the status quo. For example, one can show that, when $3 x > 2 \bar{x} + \underline{x}$, F̲x̲x is the optimal two-period reform, that is, one cannot do better than replicating the static optimum.

5. SOME POLICY IMPLICATIONS

We conclude briefly by indicating some policy implications of the results deduced :

1. Gradualism can be better than full immediate reform when the budgetary cost of compensations to respect the existing political constraints are very high compared to the allocative gain of immediate restructuring. Gradualism is less costly for the budget because it allows for rent extraction from some worker groups. This result has relevant policy implications for the transition in Eastern Europe. In the case of the former GDR, a policy of rapid restructuring has been chosen, inter alia to avoid massive emigration to the

West. But the cost of this rapid restructuring will be very high, 1.000 billion DM at least according to Treuhandanstalt estimates[8]. The dilemma between fast but costly restructuring on one hand, and slow but less expensive restructuring was at the heart of the political debate in the Federal Republic of Germany, Chancellor Kohl and his government choosing the former, and the Social Democratic opposition headed by Oskar Lafontaine being in favor of the latter.

In the case of the other Central and Eastern European countries where restructuring is still ahead, this dilemma will also be at the center of the policy choices. Contrary to the former GDR, there is less of a threat of immediate massive emigration, and thus less of a need for quick restructuring. Moreover, it is doubtful whether the West is willing to pay for the high cost of rapid restructuring. Countries that would opt for the latter choice would thus have to face a heavy fiscal burden. Without the necessary fiscal instruments, the probable outcome would be inflation. Rapid restructuring and successful macroeconomic stabilization might prove contradictory, and gradual restructuring may appear as a likely policy choice.

2. Democracy is not necessarily an obstacle to transition in the sense that the majority rule would not allow to impose measures that might hurt a majority of the population. Indeed, as we have shown, the government can use the threat of future reforms hurting one group to extract approval for a reform that hurts a majority. This result also has implications for the transition in Eastern Europe as, in contrast to China for example, political change precedes economic change. There is a general consensus among economists that the power monopoly of the nomenklatura must be toppled in order to fully make the step to a market economy. Fears are however expressed that the newly created democratic institutions might jeopardize the transition process. According to our result, democracy is not necessarily the problem, it might be legitimacy. Indeed, the agenda-setter assumption used throughout this paper assumes a degree of legitimacy sufficient to allow governments to have full contrase over the agenda, i.e. the nature and sequence of proposals put to vote. In some Eastern European countries where the move

towards democracy is not yet credible or solid enough, this minimum of legitimacy might still be lacking.

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[1] See for example Lipton and Sachs (1990) and Portes (1991) on stabilization, or Grosfeld (1990) and Tirole (1991) on privatization. For more general analyses of the economics of transition, see Blanchard et al. (1990), CEPR Annual Report (1990), Kornai (1990), Newbery (1991) or Roland (1990).

[2] For the agenda-setter framework, see e.g. Romer and Rosenthal (1979) and Rosenthal (1989).

[3] This is done just for the sake of simplicity of exposition because a similar result will hold under majority rule.

[4] One could also have a partial reform with a high productivity and a wage compensation for the x. One may verify that if $q(2) - q(1) < \lambda x + \frac{1}{2} (\underline{x} + x)$, then this reform is dominated by the partial reform described above. We will make this assumption in order to keep the comparison between one full and one partial reform.

[5] This result is very similar to the standard durable - good monopoly problem (see Gul et al. (1986)).

[6] IC is clearly satisfied in Fx. Concerning Fx, the $\underline{x}$ group prefers not to exit, while the $\bar{x}$ group is happy to take b_1 and leave. The same is true for the x group if $w + \underline{x} - 2x \leq w - \bar{x}$, i.e. if $2 x > \underline{x} + \bar{x}$, a simplifying assumption we make here. See Dewatripont-Roland (1990) for the other case (where b_1 has to be higher).

[7] See Dewatripont-Roland (1990). For $2 x \leq \underline{x} + \bar{x}$, partial reforms may become optimal, hurting either the x group or the $\bar{x}$ group. For full reforms, note that it is impossible to hurt the $\bar{x}$ group (through $b_1 < w - \bar{x}$) without hurting the x group, i.e. violating majority rule.

[8] Estimate given by André Leysen, board member of Trenhandanstalt, at the Conference "Privatization in Central Europe : the European Horizon" (Leuven Institute for Central and East European Studies, 08/02/1991).