Describing Compensation

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1 Introduction

Recent work in political science and economics has demonstrated a causal relationship between exposure to international competition in Western countries and support for far-right populism there (e.g., Scheiring et al. 2024). This relationship has increased scholarly attention to compensation, which economic theory suggests may mitigate said relationship. However, there has been a lack of consensus on how to measure compensation and little systematic work detailing how compensation has varied in countries exhibiting the above relationship.

In this article, I aim to fill this gap by describing changes in commonly used measures of compensation and proposing an index that may capture the theoretical concept of compensation more accurately. In particular, I collect data on active labor market policy (ALMP) spending, trade adjustment assistance (TAA), the European Globalization Fund (EGF), and government interventions in the distribution of income via taxes and transfers. After describing changes in these measures over time and space, I propose building an index that incorporates all of these forms since all can provide compensation in theory.

The paper is laid out as follows. In the next section I define compensation as a theoretical concept before detailing how compensation has been variously measured previously in section 3. In section 4 I introduce my proposed index. I close with suggested opportunities for future work.

2 Compensation as a Theoretical Concept

In this section I detail compensation as a theoretical concept in welfare economics.[1] To fix ideas, suppose that there are two households in an economy, $H \in \{1, 2\}$. The utility each household attains in the current state of the economy, A, can be written as $U_{1,2}(A) = (u_{1A}, u_{2A})$. Now suppose that a policy is proposed such that the state of the economy would become B (e.g., from autarky in state A to free trade in state B). The households' utilities over state A and B are graphed in Figure 1.

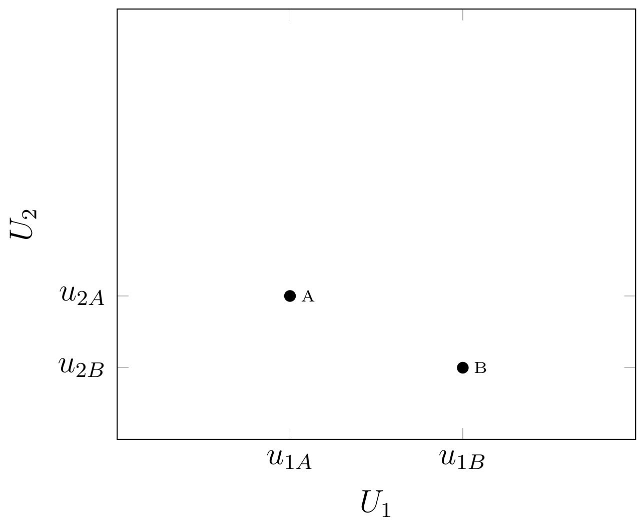

Figure 1: States A and B

The policy is said to satisfy the (strict) Pareto criterion and be a Pareto improvement if moving from state A to state B increases the utility of at least one household while no household loses utility. As can be seen in Figure 1, this is not the case since $U_2(B) < U_2(A)$. Household 1 gains utility (by $u_{1B} - u_{1A}$ utils) but household 2 loses utility (by $u_{2A} - u_{2B}$ utils).

However, if household 1's income gain from the policy can hypothetically be redistributed to household 2 such that state C is attainable (Figure 2), for example, then the policy is said to satisfy the compensation principle.

[1]This section is heavily based on Johansson (1991) and Moore (2007)

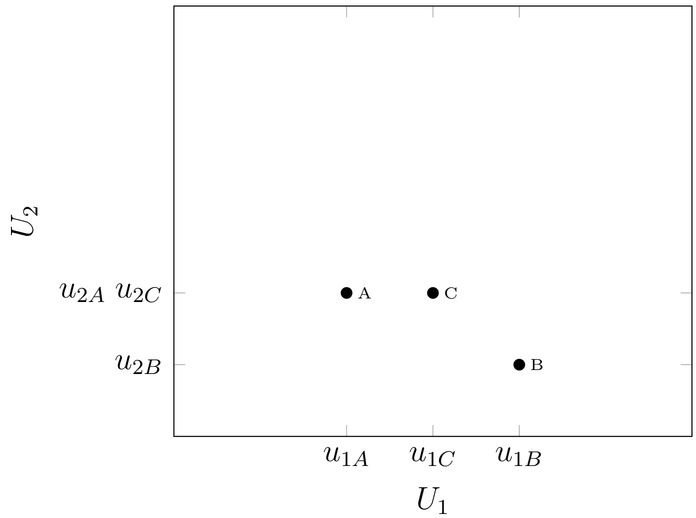

Figure 2: States A, B, and C

The compensation principle states that a policy is desirable if a hypothetical redistribution of income after the policy change can result in at least one household increasing its utility while no households lose utility. Thus, compensation is the income needed to be redistributed from the gainers of a policy to the losers such that the latter do not experience a loss in utility. Note that if compensation is made actual, the policy satisfies the (strict) Pareto criterion and represents a Pareto improvement.

Implicit in this discussion is the assumption that households get utility from their income and only their own income. It is also necessary to state that compensation must account for possible price changes induced from a redistribution of income (although commodity and factor markets are ignored here). Further, it should be mentioned that the compensation principle cannot be used to compare between states that are both Pareto improvements. It is generally impossible to compare the gains in utility for different households. See Moore (2007) for greater detail.

3 Measurements of Compensation

Political scientists and economists have sought to test hypotheses about compensation to the losers of free trade by measuring compensation in various ways. For example, studies on the U.S. have typically relied on trade adjustment assistance (TAA) while comparative studies have mainly used active labor market policy (ALMP) spending or other social spending. In this section, I define and describe each.

Bibliography

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