

On Fairness

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Executive Summary

Fairness is a central defining political concept of our current government and a key issue of political debate across the spectrum, from the unfairness of leaving debts to our children, to the unfairness of private equity managers paying less tax than their cleaners, to the unfairness of a child's life chances being largely set by the time she reaches school. However, though invoked all the time, what politicians and journalists mean by the term "fairness" is unfortunately vague, and the UK debate, to this point, has run the unfortunate risk of making the term "fairness" into a vacuous, Humpty-Dumpty-esque "fairness is whatever I believe in".¹

In this paper, by contrast, we offer a concrete, simple and intuitive notion: that being fair is a special kind of being proportionate, with particular application in respect of equality, proportionality, and desert. This concept is related to justice, but not the same as it, for while justice is a *moral* concept and an ethical/normative *obligation* (one always ought to be just), fairness is a *technical* concept and an ethical *consideration*.

We explore three important cases in which it is undesirable to be fair: promises/contracts, familial obligation, and private property. Once I make a promise (or contract – a contract is a special kind of promise), the promise-holder is not to be treated equally or in proportion to desert with others – the promise "trumps" the obligation to be fair. Similarly, it is not that I give my own children Christmas presents and not the children of strangers because my own children *deserve* presents more. Nor am I obliged to buy my chocolate bars equally from each corner shop, or from the most deserving one.

One might conclude that this meant there was a natural role for government action to "correct" for the unfairness automatically generated by promises/contracts, familial obligation and private property. But since these are the three classical foundations of human society, an alternative implication is that any society must (and ought to) contain a certain level of unfairness upon which policy should be reluctant to encroach.

¹ "When I use a word," Humpty Dumpty said, in a rather a scornful tone, 'it means just what I choose it to mean—neither more nor less.'"

Even if society ought not always to be fair, fairness is nonetheless of great policy significance in many ways. We explore how our fairness concept is already applied in many current policy debates, and has been embedded in policy-making for hundreds of years. We first explore equality. We argue that equality in distribution is a “residual” notion of justice — if we have no good reason not to allocate fairly, then we ought to allocate fairly; to do otherwise is to be “arbitrary”. Modern game theoretic analysis suggests that this deep ethical instinct reflects fundamental structural features of human interaction, and that the presence of “inequity aversion” is important in sustaining non-exploitative social equilibria in many (but not all) settings.

We explore the problem of dividing up a cake, and reflect upon the fact that procedures have been established, mathematically, by which any number of individuals can divide up a cake of any size amongst themselves in ways that they all consider fair (and in particular more fair than any division imposed by any agreed central arbitrator). We suggest that this might mean that in promoting fairness government would typically do better as a facilitator of people choosing allocations for themselves than as a central arbitrator.

We explore policy debates in which equality concepts of fairness are central, such as redistribution, equality before the law, equalities legislation in the labour market, and equality of treatment by those with market power. We argue that intervention can sometimes be justified to promote fairness, even when impinging upon contract and private property, in order to move from a less desirable to a more desirable social equilibrium. However, we caution that one should not be tempted into believing that the purpose is to impose fairness on contracting or the use of private property, and one should also recognise that other social mechanisms (such as markets) will often promote more rapid transition to tomorrow’s desirable social equilibrium than any government intervention.

We consider fairness as proportionality, noting the significance of this concept in European policy-making rules and in the long-established English legal concept of “equity”. We consider proportionality in taxation, and explore the difficulties involved in interpreting “progressivity” in taxation as fair (proportionate) without having a principle of proportionality to ability to pay (which might naturally imply lower tax rates for those with children). We think also about proportionality to talent or worth, and that an important basis for investment returns being “fair” is if they are proportional to risk.

We explore proportionality to action (desert). We note that fair rewards are not necessarily the same as just rewards — for example, justice sometimes requires mercy, and it can be just to punish unequally with respect to action when one case requires more deterrence than another. We explore issues regarding fairness of reward to work versus out-of-work benefits, and fair rewards for sacrifice to try to better oneself or one’s family. We note that there can be a clash of fairnesses here (even regarding desert). For the child that is not helped by her parents may not deserve to do any less well than the child that is so helped. So that which is fair from the perspective of the parents — that their sacrifice produces the result it deserves, in respect of her children doing better than others — may be unfair from

the perspective of the other child – that she has not done anything to merit doing less well or being helped less than the other child.

We think about punishment for mistakes, and circumstances in which it might not be unfair to punish even “honest mistakes” (judgement calls that were right at the time, based on the information available, but later turned out to be errors). We consider “golden parachute” schemes for executives, criticised as “rewards for failure” and see why apparently unfair contracts might be economically useful. We consider the case of fair pay differentials, and the function of bonuses — in particular why the very point of bonuses is often to decouple an individual’s reward from the performance of an enterprise as a whole.

We finish by setting out a series of challenges for think tanks, academics, and journalists: to explore intergenerational fairness, fairness in welfare reform, and fairness in pay and pricing.

One need not always be fair. But usually one should, and it is important (vital) that we do! But when? The answer to *that* is, of course, at the heart of the political debate.

Introduction

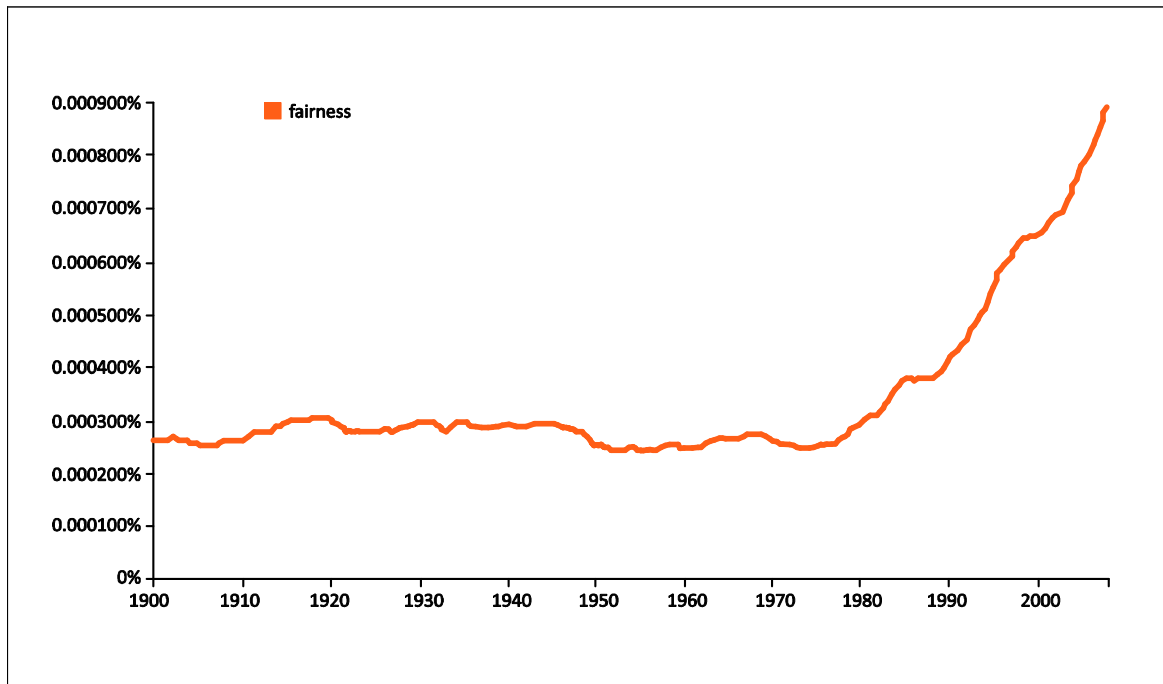
Much recent political discussion has revolved around whether some policy or other is “fair”. This discussion has often been clouded by the fact that all parties agree that to be “fair” is a Good Thing, but disagree on what being “fair” is.

We could define “fair” in such a way that it is simply a synonym for “just” and as such as always right — to be unjust is always wrong. But that would make the concept of “fairness” very politically loaded. If “fairness” simply means “whatever I believe is right” then whenever we disagree about what is best, we will disagree about whether it is “fair”, and that statement says little more than simply: “We disagree”.

To avoid that problem, in this Research Note we shall attempt to offer a narrower, more politically-neutral concept of fairness, defined in such a way that there will be some occasions on which it is *not* good to be fair. Our purpose is to set up a concept and explore how to use it — we aren’t, in the main, aiming to decide whether this or that policy or situation is, in fact, fair or, if not, whether anything should be done about it. Fairness, as we shall understand it, is one factor that might guide policymaking, but it is perfectly conceivable that the best policy will *not* be the one that is most fair.

How “fairness” has grown in importance recently

The following chart, from Google Ngrams, tracks the term “fairness” as a proportion of words in British English books since 1900.



We can see that up until the late 1970s, the term “fairness” was still employed about as regularly as it had been in 1900. But since then, its use has exploded.²

A few policy debates in which “fairness” features

It will be useful to list a few of the many recent debates in which the term “fairness” has been central. We shall not enter into these debates here (we don’t even claim that the issues are specified properly) — we simply list them to note the use of the term “fairness” in them.

- Is it fair to leave debts to our children? (e.g. in the context of the budget deficit)
- Is it fair to cause environmental damage today and then expect our children to clean it up? (e.g. in the context of global warming)
- Is it fair that a private equity fund manager pays less tax than his cleaner? (e.g. in the debates about non-doms and capital gains tax)
- Is it fair that the poor pay higher taxes and have their benefits cut so that governments can afford to bail out the banks? (e.g. in Ireland)
- Is it fair that MPs that personally benefitted from funded higher education now vote to impose tuition fees on tomorrow’s students?

² By contrast, use of the term “football” has risen consistently since 1900; the term “god” peaked in the 1920s since when its use has declined by about two thirds (and is now about equal with “football”, having been at around ten times the level in 1900); whilst “liberty” peaked in the late 1940s but is now about equal to its 1900 level.

- Is it fair that someone with children pays the same tax as someone without, despite having a lesser ability to pay?
- Is it fair that companies can choose to favour women over men in employment conditions, but not men over women? (e.g. regarding equalities legislation)
- Will it be fair if people that have made national insurance contributions all their lives now only receive the same pension as people that do not have a complete contribution record? (cf. recent proposals for pensions reform)
- Is it fair that people are arrested for defacing the Koran when defacing the Bible is regarded as “art”? (cf. recent arrests for Koran-burning)
- Is it fair that a child’s life-chances are largely set by the time she enters school?

A provisional definition

Fairness can have a number of meanings. So before proceeding any further, we shall focus upon the approximate space in which the concept of fairness in which we are interested sits. That involves three closely interleaved notions — always bearing in mind that, as we shall see, in this sense it is not always desirable that things should be fair:

- 1) Fairness is about equality — a fair division of a cake is an equal division.
- 2) Fairness is about proportionality — a fair allocation (say, of tax obligation) is a proportionate allocation (say, proportionate to ability to pay).
- 3) Fairness is about proportionality to action (desert) — a fair allocation is one in which people receive in proportion to what they have done (punishment to bad action; reward to good action, effort, length of work, contribution to success of an enterprise, etc.).

Since equality and desert are both forms of proportionality, being fair is a special kind of being proportionate, with particular application in respect of equality, proportionality, and desert.

We shall see in what follows that this concept is already deeply embedded in policymaking, and has been for hundreds of years, and explore some options concerning in what respect things are to be measured to see if they are proportionate.

Fairness, Justice and Social Justice

The term “fairness” can be employed as simply a synonym for “justice”. We are avoiding that meaning of “fairness”, since, although the debate about what constitutes “justice” is fundamental, important, and interesting, it has also been raging since at least the time of Socrates and (though we are ambitious)

we do not aspire to finally resolve it here. We are not attempting to define fairness in terms of justice.

One way to think about our distinction between fairness and justice is that whilst justice is a moral concept and an ethical/normative obligation (one always ought to be just), fairness (as we define it) is a technical concept (in principle able to be *measured*) and an ethical consideration (one ought to take account of fairness but one is not always obliged to be fair).³

However, we should not pass on before noting a slightly different connection between justice and fairness. Even when fairness is conceived of in the sort of terms we favour — as related to equality, proportionality and proportionality to action (desert) — there is a famous philosophical tradition within which justice was defined in terms of fairness, namely that of John Rawls.

Rawls used the phrase “Justice as Fairness” to refer to his theory of “distributive” or “social” justice, set out in his *A Theory of Justice*. There are two central principles of this theory:

1. Each person should have an equal right to the most extensive basic liberty compatible with similar liberty for others. (The “equal liberty” principle.)
2. Insofar as social and economic inequalities are to be permitted, they should be attached to positions and offices open to all under conditions of fair equality of opportunity, and be to the greatest benefit of the least advantaged members of society.

Rawls believes that these two principles are those that would be chosen in an “original position” — a thought experiment in which we choose among principles of justice to order the basic structure of society from behind a “veil of ignorance” in which we do not know where in society we ourselves would be placed.

The concept of “social justice” originated in Catholic social theory in the early nineteenth century, particularly in the writings of the Jesuit Luigi Taparelli. Social justice was, in this sense, the proper “good” which a society exists to promote. (It is the proper objective of secular authorities, as opposed to the spiritual objectives of religious authorities.) According to Catholic social theory, the moral test of any society is “how it treats its most vulnerable members. The poor have the most urgent moral claim on the conscience of the nation. People are called to look at public policy decisions in terms of how they affect the poor.”⁴

The concept of “social justice” as a good that society exists to promote was famously denounced by Hayek:

³ A relevant related distinction is that made in jurisprudence between law and “equity”, discussed in more detail below.

⁴ *Option for the Poor, Major themes from Catholic Social Teaching*, Office for Social Justice, Archdiocese of St. Paul

“There can be no test by which we can discover what is 'socially unjust' because there is no subject by which such an injustice can be committed, and there are no rules of individual conduct the observance of which in the market order would secure to the individuals and groups the position which as such (as distinguished from the procedure by which it is determined) would appear just to us. [Social justice] does not belong to the category of error but to that of nonsense, like the term 'a moral stone'.”⁵

Whether “social justice” is a well-formed concept and, if so, how to operationalise it and whether it is the proper goal of society are interesting and important questions. But our focus will not be on how to define a concept of justice in terms of fairness. It will be on how to define a concept of fairness itself.

Being Fair is not Always Right

Through most of what follows, we shall try to apply our understanding of fairness to a number of important policy debates, but we must next understand that being fair — as we are defining it — is not always right. As we shall see, understanding when being fair is not right will be very important to the constructive application of our concept of fairness.⁶

Important but straightforward cases in which being fair is not appropriate are those in which the costs of creating or enforcing fairness are greater than the gains from the increased fairness. That might include cases in which the administrative cost is too high (e.g. perhaps it would be possible to improve the fairness of benefits through more extensive and detailed assessments, but the added detail would be overly costly in terms of added resources used and in terms of the encroachment of privacy involved or perhaps the humiliation of those attempting to claim). It might also include cases in which acting too fairly would create incentives to exploit the system (encourage others to act *unfairly*).⁷

However, though these cases are of great policy relevance, they are instances of unfairness being tolerated because although it would be desirable to be fair, it is not feasible to be fair without creating more harm than one removes. Of more interest to us in this section are cases in which it is not merely a matter of *tolerating* unfairness; rather, fairness is positively *undesirable*.

⁵ Hayek, F.A., *Law, legislation, and liberty, Volume 3, The Mirage of Social Justice*, Routledge, 1973

⁶ It is also a general methodological principle when defining any concept, rule or theory that much of its significance/content is to be found in what it *excludes*. (cf. the famous discussions on this point of Wittgenstein and Popper.)

⁷ One case of these effects working together might be one in which being fair makes everyone worse off in a material sense, say because the damage to incentives were so great. (The technical terms for such an outcome is that it is “(strictly) Pareto inferior”.) If we thought the cost of unfairness (e.g. people being miserable at being treated unfairly) were high enough relative to the material loss for even the worst off, then some people might believe that even a material loss for all would be justified by achieving fairness. But a more common reaction would be that if being fair makes everyone worse off, then it isn’t worth being fair — for example, how many people would really think it better for everyone to be paid the same if the consequence were that all incentives to innovate or train or work hard were so badly damaged that everyone ended up paid less than they are now?

As children and parents, we are all familiar with the little boy or girl crying "It's not fair!" And as we mature, we realise that being fair is not always desirable. In later sections we shall explore familiar cases in which equality and proportionality are held undesirable. Slightly more subtle, though, is to understand that few (if any) of any of us really believe that we should always receive in proportion to our actions. There is a classic and famous Biblical parable that illustrates why not.⁸

The Parable of the Workers in the Vineyard — Matthew 20:1-16 (Revised Standard Version)

¹"For the kingdom of heaven is like a householder who went out early in the morning to hire laborers for his vineyard. ²After agreeing with the laborers for a denarius a day, he sent them into his vineyard.

³And going out about the third hour he saw others standing idle in the market place; ⁴and to them he said, 'You go into the vineyard too, and whatever is right I will give you.' So they went. ⁵Going out again about the sixth hour and the ninth hour, he did the same.

⁶And about the eleventh hour he went out and found others standing; and he said to them, 'Why do you stand here idle all day?' ⁷They said to him, 'Because no one has hired us.' He said to them, 'You go into the vineyard too.'

⁸And when evening came, the owner of the vineyard said to his steward, 'Call the laborers and pay them their wages, beginning with the last, up to the first.' ⁹And when those hired about the eleventh hour came, each of them received a denarius.

¹⁰Now when the first came, they thought they would receive more; but each of them also received a denarius. ¹¹And on receiving it they grumbled at the householder, ¹²saying, 'These last worked only one hour, and you have made them equal to us who have borne the burden of the day and the scorching heat.'

¹³But he replied to one of them, 'Friend, I am doing you no wrong; did you not agree with me for a denarius? ¹⁴Take what belongs to you, and go; I choose to give to this last as I give to you. ¹⁵Am I not allowed to do what I choose with what belongs to me? Or do you begrudge my generosity?'

¹⁶So the last will be first, and the first last."

⁸ We shall discuss the version of this parable attributed to Jesus in the New Testament — there is a similar parable attributed to Mohammed in the Hadith:

The Prophet said: "Your example and the example of the people of the two Scriptures is like the example of a man who employed some laborers and asked them, 'Who will work for me from morning till midday for one silver coin?' The Jews accepted and carried out the work. He then asked, 'Who will work for me from midday up to the afternoon prayer for one silver coin?' The Christians accepted and fulfilled the work. He then said, 'Who will work for me from the afternoon till sunset for two silver coins?' You, Muslims have accepted the offer. The Jews and the Christians got angry and said, 'Why should we work more and get lesser wages?' Allah said, 'Have I withheld part of your right?' They replied in the negative. He said, 'It is My Blessing, I bestow upon whomever I wish.'

Why the unfair landowner is in the right

Obviously the treatment of the five categories of workers is significantly out of proportion to the effort involved. Those hired in the morning work the whole day for the same total wages paid to those hired at the eleventh hour — one twelfth of the hourly rate for the same work (indeed, perhaps harder work as they point out that they have borne the heat of the day)!

And yet, though this is clearly unfair, the landowner is clearly in the right. He entered into a contract with those he hired first thing in the morning to work that day for a denarius. The workers honoured their side of the bargain: working all day; and the landowner honoured his: he paid them one denarius. Similarly, he entered into a different contract with those hired at the eleventh hour, and paid them what he had promised: one denarius. All parties were free participants — there was nothing to stop those that agreed to work with him in the first hour from gambling that he would hire them later in the day if they waited. They accepted the deal.

This illustrates an important point: fairness can be trumped, morally, by normatively significant acts such as making promises. For example, if I enter into an exchange of promises with a woman such that she becomes my wife, it ceases to be right for me to treat her equally with other people.

Another key point is that made by the landowner himself: “Don't I have the right to do what I want with my own money?” The presence of true private property removes the obligation to be fair in its distribution. For example, if I choose to give money to charity, I am under no obligation to give to the charity that is most deserving — it is my money to give as I choose. I am, likewise, not obliged to buy a chocolate bar from the most deserving corner shop. As a first iteration, and subject to a number of crucial caveats that we shall explore below, the presence of private property removes any obligation to act fairly or equally in its commercial use.

Aside from familial ties created by promises (such as marriages, adoptions, or bound-brother-ships — perhaps even oathman-ships⁹), other familial ties also morally trump fairness. There is a famous moral conundrum concerning a burning building from which one might rescue only one person — who should it be? It is indisputably “unfair” for me to prioritise rescuing my own children over rescuing other people that might be closer to me and in more imminent danger — indeed, some of them might be much more morally worthy people than my children, people that have done great things and have great things left to do, that certainly would not deserve to perish in a fire just because I decided to seek out my children first, even though they might have been in no significant danger. But though it is unfair for me to prioritise saving my own children, virtually no-one would dispute that to do so is right, my duty as

⁹ Bound brothers (of which the best-known type of example are “blood brothers”) are typically friends that establish a special oath committing themselves to each other. Blood brother rituals were common in ancient Greece, the Balkans, Asia Minor, amongst Mongols and the ancient Chinese and were even known in Norman Britain. An oathman swore fealty, sometimes to a Lord or King, but often as simply a retainer of a knight or warrior. Oathman-ships were common in Saxon and then Norman England.

a parent. No-one would admire my commitment to fairness had I rescued, say, that man that was close to curing cancer at the expense of leaving my own son to burn.

Lessons learned

So, we can understand that there will be situations in which being fair is not right. If we have entered into a contract, we are obliged to honour the contract even if the consequences are unfair. Part of property actually *being* private is that one is entitled to dispose of it as one chooses — including unfairly, if one wants. Familial obligations unfairly, but rightly, lead to our prioritising our own families ahead of others. These are deeply important points. For familial obligation, private property and promise exchanges are amongst the basic foundations of society.¹⁰

An interesting implication might be that the presence of some unfairness is a fundamental element of a functioning society. One might conclude that this meant there was a natural role for government action to “correct” for the unfairness automatically generated by the familial, property-holding and promise-keeping building blocks of society — the analogy of government intervention “correcting” for market failures in the economic sphere comes naturally to mind. But an alternative lesson might be that government intervention to correct for unfairness needs to recognise the risk of impinging upon the fundamental “basis” unfairness that is entirely right and proper, reflecting the presence of promises, private property and familial obligations. Put bluntly: it is impossible to have a society that is fair; and if it were possible, it would be wrong.

But, even so, fairness still matters!

Just because society cannot be, and should not aspire to be, totally fair, it does not follow that fairness does not matter. It does. It matters profoundly, in many ways we shall now explore, and indeed (as we shall see) the promotion of fairness can even properly circumscribe freedom of promise-exchange, familial obligation and private property.

Fairness as Equality

In the next three sections we shall explore our three inter-related concepts of fairness, and see how they are applied and nuanced in a number of important policy debates. Our goal will not typically be to resolve these debates — rather, we seek to illustrate how our concept(s) of fairness can be used and to hone/nuance our understanding in the light of practical application. We shall also see that the concept of fairness that we propose is already deeply embedded in policy-making, and has been for hundreds of years.

¹⁰ For example, in his *A Treatise of Human Nature* (B3.2.11), Hume quotes the stability of possessions, their transfer by consent, and the keeping of promises as the “three fundamental rules of justice” that make human society possible. Locke and Burke claim that the single most important reason societies exist is the protection of property. Others (e.g. Filmer) contend that society should be understood as a form of extended family.

Our first, and most straightforward notion of fairness is *equality*. A fair distribution is an even (an *equal*) distribution. In this sense, fairness constitutes what we might term a “residual” notion of justice: that is to say, if we have no other basis for allocating justly — such as allocating on the basis of contracts or desert or by favouring those to whom we have particular obligations — then what is left (the residual) is for us to allocate evenly.¹¹ If we did *not* allocate evenly, in the absence of some good reason for allocating unevenly, we could properly be accused of being “arbitrary” — simply allocating randomly, for example, is not good enough.

This is a powerful idea, and connects both with much traditional moral thinking and also with deep human instincts. One interesting area of research in game theory¹² concerns what is called “inequity aversion”.¹³ Inequity aversion can be defined as the willingness to sacrifice potential gain to block another individual from receiving a superior reward.¹⁴ Inequity aversion is a standard interpretation of results of two important classes of economic experiment:¹⁵

1. The Dictator game: In the Dictator game, there are two players. One chooses how to divide a reward between herself and the other player. We call the player that decides upon the division the “dictator” (“her”) and the other player the “partner” (“him”). If the dictator were interested only in how much of the reward she received herself, she would choose a split of everything for herself and nothing for the partner.¹⁶ Now this is indeed the most common choice. But in experiments, many dictators choose not to take everything for themselves, and the second most common option chosen is a 50:50 split.

2. The Ultimatum game: The Ultimatum game begins like the Dictator game, but after the split is announced, the partner can choose to reject the whole deal. If all people cared only about how much of the reward they received themselves (and if the game were credibly played only once), then to guarantee acceptance of a split, the dictator would need only to provide a tiny portion to the partner

¹¹ An interesting implication of this line of thought might be that if broader morality were to wither — if promises came to seem unimportant, family duty weak, and other moral obligation ill-founded — it might be natural to imagine that “fairness” as a concept would rise in importance. Fairness is what is left once we lose confidence in all more specific (and perhaps contentious) moral norms.

¹² “Game theory” is the analysis of situations of strategic interaction, in which the best actions for one decision-maker (called a “player”) depend on what other players are doing. Game theory dominates modern microeconomic theory and evolutionary biology, whilst also being important in macroeconomic theory, moral philosophy, and even applied to quantum physics.

¹³ The current paradigm for the analysis of inequity aversion appears in Fehr, E. & Schmidt, K.M. (1999). “A theory of fairness, competition, and cooperation”, *The Quarterly Journal of Economics*, 114, pp. 817–868.

¹⁴ More technically, one might believe that utility functions are intertwined, such that my utility depends not only on how much I receive but also on (say) whether you receive more than me without having done anything to merit it.

¹⁵ In an economic experiment, one obtains volunteers to participate in a set-piece interaction (a “game”) and observes what they do.

¹⁶ Sometimes one reads this point described more along the following lines: “If the dictator were *self-interested*, she would choose a split of everything for herself and nothing the partner.” But that is incorrect. The point here is not acting against one’s self-interest. The dictator that splits 50:50, as far as we know, *prefers* this to a split of 100:0, so it is in her interest to choose it.

(e.g. if the total reward were £100, a split of £99.99 to the dictator/£0.01 to the partner should be enough to induce the partner to accept). However, in experiments what is found is that partners very often reject splits when low offers are made. That is to say, people consistently prefer receiving nothing, whilst punishing the dictator for her unfair division, to agreeing to receive only a small share.

A key implication of the results of these games is that an instinctive concern for fairness reduces the opportunity for exploitation. In other words, precisely because I do not care only about myself — precisely because my objectives are not purely selfish — but also care about what happens to others *relative* to myself (including both, as it were, “positive” caring — preferring outcomes in which others do better if that makes them more like me; and “negative” caring — disliking outcomes in which others do better if that makes them more *unlike* me) the power to exploit is reduced. Those with the power of offer will be less likely to offer unfair divisions if unfair divisions are more likely to be rejected.

When we are more self-absorbed, we become more vulnerable. Classic instances of those more focused upon their own interests are children (who know no better) and those living close to subsistence (who have little option). So if society contains many inter-relationships analogous to the Ultimatum game in which children or those close to subsistence are partners, or the Dictator game in which children or those close to subsistence are the dictator, then enhanced freedom of choice could result in greater exploitation. But if we are socially-minded, then that itself protects us in these situations, even without intervention by the state.

That does not mean that the pursuit of self-interest is always the enemy of fairness. There are many categories of game in which the vigorous pursuit of self-interest is crucial to the achieving of a fair outcome. Consider, for example, the game of dividing up the gains from trade between two producers and a consumer. We shall call this the “Bertrand” game, after the mathematician that first explored it. Let us assume that the producers can each produce either one or two items of a good, and the consumer wants two items, that it costs each producer the same, and the same as each other, to produce each item of the good, and that if the consumer faces the same prices she will purchase one item of the good from each producer. If each player pursues her self-interest, then the two producers will each sell one item of the good to the consumer at their cost of production. The outcome will be fair in that each producer sells the same and in that the amount paid by consumers is equal with the amount it cost to produce the goods.

But now suppose that one of the producers is more interested in fairness than in self-interest. She will cease to try to sell at the lowest price, but may instead (say) prefer that in the final outcome she makes only as much from the business as her rival. Let us assume that her rival (we shall refer to the second player as “him”) is self-interested. Then he can set the price at the highest the market will bear (the “monopoly price”) and because his rival seeks equality with him she will raise her price to match his, rather than under-cut him and take his business. The consequence is that the consumer ends up paying more for the good than it costs the producers to make it — which is unfair. Unlike the Ultimatum and

Dictator games, in which the desire for fairness reduced exploitation and the pursuit of self-interest facilitates it, in the Bertrand game the pursuit of fairness increases exploitation and the pursuit of self-interest prevents it.

It is thus important, in devising policies with an eye to fairness, that we understand what forms of social interaction are involved — what are the “mechanisms”. The desire for fairness is a deep human instinct and a key protection from exploitation, but in some settings the ill-advised pursuit of fairness can result in fundamentally unfair outcomes.

Envy-free division of a cake

One question of particular interest is whether it is possible to divide a given set of goods, services, resources or other kind of “cake” in such a way that the participants all believe the outcome to be fair. It is tempting to believe that this could be achieved by appointing an arbiter (indeed, with a large number of people that appointing an independent arbiter would be the *only* fair way to proceed). But that is not so clear. Even a well-intentioned arbiter might easily make errors. If there are two of you, and you ask me to divide a cake between you, I might try to divide it evenly but what might seem even to me might not seem even to the recipients. So who gets first pick?

This problem — the “cake-cutting problem” — has long been known, and most of us also know the solution when there are two players involved: one player cuts and the other picks first. (We could think of this as a variant of the Ultimatum game in which the first player proposes a split, and the second player chooses which portion he receives.) The only function of any arbiter is to ensure that the rules are adhered to — the players happily divide the cake between themselves; the first player considers her division even and the second gets first pick; so there is no sense of unfairness (if the first player is aware of having divided the cake unevenly, she has no-one else to blame). Such a division is said to be “envy-free”.

A natural conclusion might be that a key role of the state is in enforcing mechanisms of fair division, leaving people to divide up society’s “cakes” for themselves in ways they will all consider fair, rather than imposing some division from above. But this is a little swift, for it is by no means obvious that the elegant two-player cake-cutting solution is applicable in more complicated contexts. Even just considering three players, how would it work? If one player cuts the cake in three then which of the other two players gets first pick and how can we ensure that the player picking second does not resent not picking first?

A more general question is whether a cake, of arbitrary size and infinitely divisible, can be divided between arbitrarily many players in such a way that none resents the division? This was for many years one of the great problems of mathematics, known as the “cake-cutting problem”. It was proved in the

1940s that a solution to this problem must indeed exist,¹⁷ but it was only in the 1990s that a specific solution was actually produced.¹⁸

Let us spell out what is being said here: provided that all adhere to an appropriate mechanism, large numbers of people themselves, without central direction, can divide goods up in ways that all consider fair. This is an extraordinary and profound finding. A more natural first idea would be that it is hopeless to imagine that large numbers of people could possibly agree on a fair division, and that the only ways forward would be to choose between giving up on any hope that matters are fair or turning over the allocation of goods to a central agency. But the implication of the cake-cutting problem's solution is that this is not so. An agency might be required to devise and enforce the mechanism, but people themselves can produce fair outcomes. Indeed, an envy-free division chosen via such a mechanism will be perceived by the parties involved as *more* fair than any division that could be devised by a central arbiter.

That said, we should bear in mind four qualifications:

- The mechanism could be costly to implement if it is very complex. In principle even those that would get lesser “unfair” portions without the mechanism might be better off without it if those “unfair” portions are larger, in absolute terms, than the fair portions they receive once the costs of the mechanism are included.
- There could be a fundamental issue of ownership of the pie. It's all very well producing a mechanism by which large numbers of people can divide a cake equally or fairly, but if it is *my* cake to begin with, I am unlikely to be content. This could be a particular issue if, for example, the “cake” in question were the proceeds of taxes levied on the rich.
- There will be a problem if people do not desire fairness, especially if they prefer others to have more than themselves. For example, consider two people dividing a cake, when each wants the other to have more than half. The first player might cut the cake two thirds: one third, hoping the other player would choose the larger piece, but then the other player chooses the smaller piece because *he* wants the first player to have the larger share.
- More generally, as ever, a fair outcome might not be desirable for reasons spelt out earlier.

Equality as a policy goal

Let us consider four well-known policy debates concerning equality as a policy goal.

¹⁷ Steinhaus, H. (1948), “The problem of fair division”, *Econometrica* 16, pp. 101–104

¹⁸ Brams, S. J. & Taylor, A.D., *Fair division: From cake-cutting to dispute resolution*, Cambridge University Press, Cambridge, 1995.

Equality of outcome, equality of opportunity, and redistribution

Probably the best-known debate in this area is that between equality of outcome (say, wealth or income) and equality of opportunity.¹⁹ This is not the place to enter into that debate in any detail, except to note the irony that, although the discussion is heated and long-standing, few people actually believe in equality in any of these respects. In particular, whilst a few communists, anarchists and other such rejecters of private property might believe in true equality of wealth or income (everyone possesses zero), virtually *no-one* actually believes in literal equality of opportunity if understood as a system in which each of us must succeed or fail purely on the basis of her own biological merits and no-one is allowed to help anyone to do any better, relative to others, than her biological merits imply.²⁰

It is sometimes suggested that, although virtually no-one seeks *literal* equality, it is reasonable to want *more* equality, and that when people argue for equality of outcome or opportunity, they are really merely arguing for *greater* equality, not *absolute* equality. That may be plausible in respect of those arguing for equality of outcome as a policy goal (say, through redistribution). It is less plausible in respect of those arguing for “equality of opportunity”. Almost certainly, what the latter are actually arguing for is “greater opportunity”, but achieving increased opportunity is, of course, no more a matter of increasing *equality* of opportunity than achieving increased wealth is a matter of increasing *equality* of wealth.

Let us briefly consider redistribution. Many discussions of pay revolve around whether particular groups such as footballers or chief executives “deserve” their salaries, with those on the left often arguing that they do not and those on the right arguing that they do.²¹ Then there are discussions about whether it is something that could be changed, anyway, without negative economic consequences, or whether in a democracy we should feel we can choose to share out the country's wealth however we believe best.

Central to one's attitude to these debates is one's view of the status/nature of property. In particular, is property a (metaphysical) consequence of the existence of enforceable property rights intrinsically created by governments — the view classically associated with Hobbes²² — or is property *prior* to society (could we own private property even absent a government) — the view classically associated with Locke?²³

¹⁹ Proponents of this debate are typically interested in issues such as those explored in footnote 7 concerning whether increased equality of outcome might so undermine incentives that it comes at the expense of a large drop in the overall size of the cake.

²⁰ For a fuller elaboration of this point, see Lilico, A., *Measuring child poverty and targeting its elimination*, Bow Group, 2006

²¹ ...unless the high-paid people in question are public sector workers...

²² Hobbes held that in the state of nature all property would be common. I can only truly possess anything if there is one dominant power, and that power acknowledges and enforces my possessing of it.

²³ Locke held that I own myself and my labour, and that by admixing my labour with natural resources then (subject to two “provisos” — in particular that I do not extract so much from nature that I do not

Let's begin with the view that property is *essentially* a societal construct — that I only possess property because the government creates property rights. In that case there would seem to be a straightforward argument that the government would have a natural basis for charging those granted property rights for some of the costs of enforcing them (defence, police, courts, and other mechanisms of maintaining social order, perhaps including benefits and education). And if governments *create* property, there would seem a natural question as to whether governments had allocated those property rights *fairly*.

Indeed, since, as we have argued above, one needs a good reason *not* to allocate goods evenly (otherwise one is "arbitrary"), and since governments are likely to face limited, if any, familial obligation and only be bound by contract or promise to a small extent, if there is no *truly* private property (i.e. if property is only ever a consequence of government) then there would appear to be a prima facie obligation upon governments to allocate property rights evenly.

Perhaps there could be some argument that pre-existing property right allocations should be honoured, to some extent, but there would appear to be a strong case that the obligation of fairness in respect of allocation would imply re-distribution, over time (especially if some historic allocation had arisen unjustly, e.g. through unjust conquest).

Consider now, instead, the idea that property is conceptually prior to state-established property rights. Any infant crying "mine" is aware of the notion of property. What a state-established property right does is to agree to the collective *protection* of property — I have a property right if the state has agreed to defend my property. But I could *possess* property even in a stateless wilderness.²⁴

Consequently, salaries are not "ours" to do with as "we" see fit. Property is not purely collective. People own things themselves. They have their own salaries — they are theirs, not ours. So the question of whether they deserve their salaries or whether they are fair in other ways is neither here nor there. The question of significance is whether they have acquired their property innocently (e.g. by working for it, or receiving it as a gift), as opposed to acquiring it improperly — say through theft or

leave enough for others) I create property. Other concepts of private property existing prior to society include the "first possession" theory according to which I would own, say, a stick if I were the first to take it. Most first possession theories would be variants of Locke's theory, since Locke's concept of "work" is very broad and would include, for example, picking a piece of fruit from a tree or picking up a stick.

²⁴ It is not clear that a Lockean must believe that this is true of *all* property. For example, I might believe that I could own a spear that I had carved or a cloak that I had sown, even outwith a state. But could anyone really own some part of the radio spectrum in a stateless wilderness? A Lockean that thought that spears were truly private property but radio spectrum is not might think that the state's duties in respect of imposing fairness on exercise of the two kinds of property were different — that the state had more of a role in ensuring that I use radio spectrum (and perhaps also the fruits of radio spectrum, such as salaries earned) fairly than that I used truly private property fairly. If that point were conceded, then it might be of interest to ask whether money (and money-related activity, such as banking) is something more like radio spectrum — i.e. that private ownership of money depends intrinsically and metaphysically upon the existence of a state — or whether it is more like (e.g. because standing in the place of) a spear or cloak.

fraud. Policymakers then would not need a reason to "allow" me to keep my property, such as that I deserve it; rather, they need a good reason to take it away from me.²⁵

Equality before the law

One classic area in which fairness as equality has been debated concerns equality before the law. Most states, historically, applied different laws to different categories of people. For example in eighteenth century France, aristocrats were subject to a significantly different set of laws from the wider population (e.g. they were exempt from many taxes paid by others).²⁶ Indeed such distinctions still apply in many countries today — e.g. in Nigeria today Muslims are subject to Sharia law whilst non-Muslims are not.

But from Magna Carta onwards,²⁷ English law came gradually to develop a concept of equality before the law.²⁸ Related to this is the concept that the law should not single out individuals for special treatment — e.g. by introducing an Act of Attainder. Acts of Attainder, singling out specific persons to be declared guilty of some crime without trial or to confiscate their property were used between 1321 and 1798. The most recent well-known proposal for an Act of Attainder was Harriet Harman's suggestion, in March 2009, that special particular legislation should be introduced to confiscate or circumscribe Sir Fred Goodwin's pension.

²⁵ Related to this would be the contention that it is never a proper goal of policy that anyone should be poorer. The government must spend money on guns or police or hospitals or benefits, so it must tax. But it does not tax in order to make those taxed poorer — otherwise it could be legitimate, in principle, for it to take my money simply in order to throw it away. And of course governments will act in ways that might have the consequence of making certain people poorer — drug dealers, thieves, monopolists, and so on. But the goal of that policy is not to impoverish the drug dealer (say) — if he can make more money doing something that is not illegal, then good luck to him! Anti-drugs policy isn't trying to prevent drug dealers from making money — it's merely trying to prevent them from making money by dealing drugs. So levelled-down equality, in which the rich are made poorer so that matters are more equal, would not (on this conception of property) ever be legitimate.

²⁶ Brissaud, Jean. (2001). *A History of French Public Law*. 1st Edition, Washington, D.C.: Beard, pp. 364-6.

²⁷ Magna Carta establishes the principle that the King is subject to the law. This principle originally appeared in the limited sense that the King could only arrest people insofar as they were under sentence of law: *"No freeman shall be arrested or imprisoned or disseised or outlawed or exiled or in any other way harmed. Nor will we [the King] proceed against him, or send others to do so, except according to the lawful sentence of his peers and according to the Common Law"*. (Section 39)

²⁸ The very closely related concept of "equal justice" is usually sourced back to the funeral oration of Pericles: *"Our form of government does not enter into rivalry with the institutions of others. We do not copy our neighbours, but are an example to them. It is true that we are called a democracy, for the administration is in the hands of the many and not of the few. But while the law secures equal justice to all alike in their private disputes, the claim of excellence is also recognised; and when a citizen is in any way distinguished, he is preferred to the public service, not as a matter of privilege, but as the reward of merit. Neither is poverty a bar, but a man may benefit his country whatever be the obscurity of his condition."* (Jowett, B. *Thucydides, translated into English, to which is prefixed an essay on inscriptions and a note on the geography of Thucydides*, 2nd edition, Oxford, Clarendon Press, 1900)

Equality in the labour market

Many countries employ extensive “equalities” legislation dealing with the relative treatments of men and women, different races, those of different ages, of different sexual orientations, parents versus the childless, those with different religions, those with disabilities, and so on.

It is beyond the scope of this paper to debate the precise balance in this area in any detail. However, within our framework it is of particular interest to note that, insofar as such legislation applies to private sector companies (as opposed to, say, being a code of conduct for public sector employment), it impinges upon the free employment of private property. We note that, for example, this distinction was precisely that urged by the Conservative Party in the late 1960s to argue against the introduction of equalities legislation. The contention was that the application of equalities principles in the public sector was a straightforward application of the principle of equality before the law (and hence entirely proper) but that to apply such legislation to the private sector was to impinge upon freedom of contract and the liberty to make use of one’s private property.²⁹

Few would now contend that there cannot be a valuable role for equalities legislation under at least some circumstances. For example, in his 2008 Oakeshott Lecture,³⁰ David Willetts pointed out that there are many games subject to “multiple equilibria” and contended that equalities legislation had a key role in moving society from a “bad” equilibrium to a better one. To understand what is meant by “multiple equilibria” in this context, consider the Driving Game. Imagine a society with no rule of the road, and consider how people might react if, driving cars, they encountered another car coming in the opposite direction. There are at least three broad strategies available:

- a) Veer left
- b) Veer right
- c) Randomise, veering left half the time and right half the time

For the two cars, there will be three “equilibria” (three strategies which, if each player is adopting them it will not be to the benefit of the other player to change): Both veer left; Both veer right; Both

²⁹ There is a passage in Enoch Powell’s notorious “Rivers of Blood” speech in which he discusses the Conservative Party’s policy at the time on precisely this issue: *“The third element of the Conservative Party’s policy is that all who are in this country as citizens should be equal before the law and that there shall be no discrimination or difference made between them by public authority. As Mr. Heath has put it, we will have no ‘first-class citizens’ and ‘second-class citizens’. This does not mean that the immigrant and his descendants should be elevated into a privileged or special class or that the citizen should be denied his right to discriminate in the management of his own affairs between one fellow citizen and another or that he should be subjected to inquisition as to his reasons and motives for behaving in one lawful manner rather than another.”*

³⁰ http://www2.lse.ac.uk/PublicEvents/pdf/20080220_Willetts.pdf

randomise.³¹ Since the “Both randomise” equilibrium involves collisions between cars half of the time, this is obviously a less socially attractive outcome than either of the veering left or veering right equilibria.

Willetts’ claim is that society has switched equilibrium since the 1960s, from an unattractive social equilibrium in which there was widespread discrimination and relatively fixed expectations of the roles in society of women and members of ethnic minorities to a much more attractive social equilibrium of changed social norms today.³² He believes that equalities legislation has played an important role in that process: *“The Equal Pay Act and successive race relations acts helped by creating a framework to enforce these norms, and so encouraged progress.”*

Setting aside the detailed discussion of what further equalities legislation might be appropriate today (or whether certain legislation should even be reversed), if we accept Willetts’ central contention that (at least some part of) equalities legislation has enabled society to move between less attractive and more attractive social equilibria, then it would appear that we have identified a nuance to our earlier discussion about the appropriate unfairness associated with the exercise of private property (as we signalled at the time). For although there may be no *individual* obligation to behave fairly in respect of private property (as we have argued, the lack of any such obligation is an intrinsic and fundamental implication of its being truly *private* and truly *property*), and although equalities legislation *does* indeed impinge upon the exercise of private property, there could (at least arguably) be a broader social policy interest in promoting fairness over private property in certain, carefully circumscribed, cases.

³¹ Let’s spell this out slightly more. If one player is veering left, then the other player can choose between veering left, veering right, and randomising. Veering left means there are zero collisions; veering right means there is a collision every time, and randomising means a collision half the time. So if the first player is veering left it is clearly in the interests of the second player to veer left. Similarly, by parallel reasoning, if the first player is veering right it is clearly in the interests of the second player to veer right. Now consider the case in which the first player is randomising. Then there will be collisions half the time if the second player randomises. But if he veers left there will still be collisions half the time, and if he veers right the same. So he does no better by switching, and both players randomising is thus an equilibrium.

³² There are at least three kinds of changed social equilibrium that could be envisaged here. In one, society tends naturally to exclude “out” groups (not understanding them as well as “in” groups), as a consequence of which immigrant communities find it difficult to break into society and so remain “out”. But after a generation of equalities legislation, people understand immigrant groups better (they become “in”). In another, those from less affluent backgrounds naturally find it more difficult to achieve social acceptance, immigrant groups are initially less affluent, so the children of immigrants find it difficult to achieve sufficient social status to make the most of their skills. But after a generation of equalities legislation, the children of immigrants can break in and the negative equilibrium is escaped. In a third, consumers have racist views based on ignorance and limited contact with those of other races, and, because their consumers are racist, employers that hire members of ethnic minorities will not attract as many consumers and so not be as profitable, so will not hire members of ethnic minorities and consumers will never escape their ignorance. But equalities legislation means that all contact with members of ethnic minorities becomes frequent and so consumer ignorance (and hence racism) is reduced.

However, we should be clear in our minds what is being said here. It is not that equalities legislation is justified on the grounds that, in its absence, people would behave unfairly. The unfairness in question is not, in itself, socially bad — it is a proper reflection of the exercise of private property. The proper function of equalities legislation is that (if it does) it breaks us out of negative social equilibria into new, superior social equilibria.

To take a more concrete case, the justification for constraining someone from behaving unfairly in the use of her property is not that what she is doing is *wrong*. Under the classical conception of a tolerant liberal society individuals ought to be able to conduct themselves in accord with their own different moral norms (including in particular acting in ways that would be considered wrong by majority social norms). If all that some such equalities-oriented constraint is doing is enforcing a centrally-determined or majoritarian notion of morality, then by standard (Lockean) conceptions of a tolerant liberal society it would be indefensible.³³ Rather, the equalities legislation will find its justification (if it has one) in the fact that, absent such legislation, society would find it difficult to break out from an “unfair conduct” equilibrium into a “fairer” one.

It is important to note that we are not, here, contending that the new equilibrium generated by the introduction of equalities legislation is what economists and political theorists term “Pareto superior” (in a Pareto equilibrium no-one can be made better off without someone being made worse off; in a Pareto superior equilibrium at least one person is better off and no-one is worse off). It is all-but inevitable that there will be someone whose loss from the impingement of the exercise of her property is not compensated for by gains in the new, better equilibrium.

A further point to note is that our discussion employs a classical notion of personal property, in which if it is really and unrestrictedly mine then property is mine in all exercises — in particular, it is my property (it is private property) whether I am using it in my home or in my workplace. Much equalities legislation employs a different conception of property, in which its use is unrestricted (subject to broader laws — e.g. I could not use my crowbar to steal just because it is mine) when used in a “private” space (such as a home) but becomes restricted when used in a “public” space such as a commercial setting. Such a distinction would clearly beg the question for our discussion here, since the issue we have discussed would simply overlap with the consideration of whether and when property can be said to be in a public space.

In principle, similar reasoning to that we have offered to provide an in-principle defence of the impingements on private property implied by equalities legislation could be employed to justify the banning of private education or private healthcare or many other such impingements upon the exercise of private property. However, it should be noted that the conclusion would depend upon being able to demonstrate that (as with equalities legislation):

³³ It might be more defensible on a utilitarian conception of liberalism as *itself* a social welfare objective.

- a) One can identify a superior social equilibrium to that at present
- b) That superior social equilibrium would be delivered (or at least materially advanced towards) by curtailing the exercise of private property through banning private education or private healthcare
- c) That superior social equilibrium would not be delivered *without* curtailing the exercise of private property through banning private education or private healthcare
- d) The social gains from that new social equilibrium, relative to the current one, are greater than the social losses from the impingement of private property involved in the restriction.
- e) The dynamic losses from the impingement on private property do not outweigh the gains above. (The point here is that the free exercise of private property might tend to promote movement to superior social equilibria in the future, so there might be dynamic losses from restricting it.)

Of particular interest here are steps (c) and (e). It is, for example, commonly argued by advocates of free markets that processes of competition will tend to weed out ill-founded prejudice and other features of undesirable equilibria, so that equalities legislation will tend to be both unnecessary (in trying to address a problem that markets can better address themselves) and counter-productive (in undermining the functioning of markets, which depend for their efficiency (inter alia) on the free exercise of private property).

Equality of treatment by those with market power

An important concept in competition policy and regulation is that, when a company is determined to have significant market power, it has an obligation to ensure that the terms for customers to access its services are “fair, reasonable and non-discriminatory” (FRND).³⁴ Similarly, EU competition law prohibits the abuse of a dominant position, and an example of such abuse is the charging of unfair prices.³⁵

³⁴ See, for example, <http://stakeholders.ofcom.org.uk/consultations/tpsguidelines/statement/>

³⁵ See Article 102 of the TFEU. As an example, the European Court of Justice ruled in the *United Brands* (1978) case (Case C-27/67, *United Brands Co. & United Brands Cont’l BV v. Comm’n*, 1978 E.C.R 207) that a price is abusive if (i) the price-cost margin is excessive and (ii) the price is unfair compared to other prices. (There were related findings in *Hoffmann-La Roche* (1979), and *Michelin* (1983).) The table on page 22 sets out various practices by dominant entities that would be considered unfair.

Pricing is not automatically unfair, in these settings, when it differs, but differences must be based on some objective justification. For example, if a provider of a television platform (e.g. a satellite service) is deemed to have significant market power, it is obliged to allow other companies (including companies owned by alternative platforms, such as a cable network) to offer their programming content on that platform at a fair price. (So, to spell that out, if Sky has significant market power, it is obliged to offer Virgin the opportunity to broadcast Virgin television programmes on Sky’s satellite system, at a fair price.) But that does not mean that the price for access to the platform must be the same for all providers. A niche educational channel or a channel directed at a particular minority language group might provide much lower revenue opportunities than, say, a channel offering live football or new mass appeal reality TV shows. That difference could justify the live football channel being charged a higher price for access than the educational channel. (The concept of fairness here is thus closer to proportionality — which we shall discuss in the next section — than equality.)

One could imagine similar principles applying to equalities or industrial relations laws. It might be, for example, that certain categories of equalities laws would not be useful when there is a competitive market, because either workers would have adequate choice to work elsewhere (and hence would not suffer from any unfairness of treatment) or market processes would tend to drive out unfairness more effectively than would equalities legislation. But if a firm were the sole employer in a region (if it had “monopsony” power in the labour market) and did not face threat of entry by other firms (if the market were not “contestable”) then workers treated unfairly could experience detriment and market

Practice	Harmful (“unfair”) economic effect	Legal Qualification
Excessively high prices – “charging a price which is excessive because it has no reasonable relation to the economic value of the product supplied”	“Unfair” decrease in consumer welfare	Exploitative conduct: Excessive pricing – TFEU Article 102 2(a) e.g. <i>Deutsche Post II (2001)</i>
Excessively low prices – “limiting production, markets or technical development to the prejudice of consumers”	Competitor exclusion (“unfair” market competition)	Expulsionary conduct: Predatory pricing and abusive rebates – TFEU Article 102 2(b) e.g. <i>AKZO (1991)</i>
Excessively high wholesale prices and low retail prices – “limiting production, markets or technical development to the prejudice of consumers”	Downstream competitor exclusion (“unfair” market competition)	Expulsionary conduct: Abusive margin squeeze – TFEU Article 102 2(b) e.g. <i>Wanadoo Interactive (2005)</i>
Differentiated prices – “applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage”	Customer exclusion (“unfair” decrease in consumer welfare)	Exploitative conduct: Price discrimination – TFEU Article 102 2(c) e.g. <i>General Motors (1975)</i>

processes might be ineffective at driving out such unfairness. In such a case it might be natural, following a determination by a competition or regulatory authority that if a firm did indeed have monopsony power in respect of employment, that stronger equalities obligations be applied to such a firm than would apply in a competitive market. Similarly, one could imagine that if a firm were deemed to be a monopsony purchaser of labour, it would face additional equity obligations in respect of industrial relations.³⁶

Fairness as Proportionality

Equality and proportionality are clearly closely related concepts — indeed, equality can be thought of as a special case of proportionality. But in a number of settings it seems intuitive that what it is to be fair is not to be “equal” per se (unless perhaps in the slightly strained sense of being “equal in proportion”) and it is more natural to unpack the concept of being fair in terms of the broader concept³⁷ of being “proportionate”. Conversely, acting “disproportionately” or suffering impacts that are “disproportionate” would be typically regarded as “unfair”.

The principle of proportionality in policymaking

An important principle in regulation is that measures introduced should be “proportionate”; that none of those affected should suffer disproportionate negative impacts; and in many areas that application or interpretation of rules should be proportional. Many UK and European Union regulatory frameworks include this principle — for example:

- The European Commission produces annual reports on the application of the principles of subsidiarity and proportionality,³⁸ as set out in Article 5 of the Treaty, of which Clause 4 reads: *“Under the principle of proportionality, the content and form of Union action shall not exceed what is necessary to achieve the objectives of the Treaties. The institutions of the Union shall apply the principle of proportionality as laid down in the Protocol on the application of the principles of subsidiarity and proportionality.”*
- In the Solvency II Framework the principle applies *“where it would be disproportionate to the nature, scale and complexity of undertakings’ business to apply the general rules (quantitative and qualitative) without relief. The individual risk profile should be the primary guide in assessing the need to apply the proportionality principle ... Proportionality works two-ways: it justifies simpler and less burdensome ways of meeting requirements for low risk-profile*

³⁶ For more on this point, see Holmes, E., Lilico, A. & Flanagan, T., *Modernising Industrial Relations*, Policy Exchange, September 2010.

http://www.policyexchange.org.uk/images/publications/pdfs/Modernising_industrial_rel.pdf

³⁷ i.e. broader than “equality”, and not always implying equality

³⁸ e.g. http://ec.europa.eu/governance/better_regulation/reports_en.htm

*portfolios, but also increases the likelihood that undertakings in fulfilling requirements will need to apply more sophisticated methods and techniques for more complex risk portfolios.*³⁹

- Under the Swedish “Proportionalitetsprincip”, “[in] applying the European Convention on Human Rights a proportionality principle is upheld in case-law whereby encroachment on the rights enshrined in the Convention is permitted provided it is necessary in order to protect certain important interests, but only if the extent of the encroachment is in reasonable proportion to the seriousness of the interest being protected.”⁴⁰

An iconic example of a debate about proportionality in policymaking in the UK concerned the ban on the private ownership of handguns introduced in the UK in 1997 in the light of the infamous 1996 Dunblane massacre.⁴¹ This resulted in the near-complete ending of recreational and competitive target shooting in the UK — a popular sport in which Britain had a strong Olympic tradition. Given that there were 57,000 handguns privately owned in the UK at the time, there was a vigorous debate as to whether it would be proportionate to ban all handguns — for example, the Home Affairs Select Committee concluded in 1996 that a ban on handguns would be “panic legislation”, and there was a broad national discussion as to whether it would be fair to ban the sport of peaceful target shooters because of the actions of one disturbed individual. In the end it was decided that a ban on handguns was a proportionate response to Dunblane — and banned they were.

The English legal concept of equity

There is a distinction made in English jurisprudence between law and “equity”. From the mediaeval period until the 1870s (though the distinction of principles persists even today), English law had a tradition of “equity courts” distinct from the “courts of law”. The courts of law oversaw the development of the body of law (the “common” law) that grew out of the legal reforms of Henry II. Law courts judged cases in the name of the monarch, but if judgements were too slow or regarded as unfair (e.g. because although correctly reflecting the common law, they were disproportionate in their effects upon a particular party), litigants could still directly petition the monarch (“throwing themselves upon the king’s conscience”) who, as the font of justice was held responsible for the just treatment of his subjects.

Responsibility for resolving such petitions eventually fell to the Chancellor, who was typically a cleric or particularly pious noble that took the role of confessor to the king and keeper of his conscience, and the Chancery came to be known as the “Court of Chancery”.

Equity can be understood as a set of concepts that allows courts to use their discretion and act fairly in accordance with “natural law”, mitigating what would otherwise be some of the disproportionately

³⁹ http://ec.europa.eu/internal_market/company/docs/shareholders/study/final_report_en.pdf

⁴⁰ <http://www.eurofound.europa.eu/emire/SWEDEN/ANCHOR-PROPORTIONALITETSPRINCIP-SE.htm>

⁴¹ The Firearms (Amendment) Act (1997) and the Firearms (Amendment No. 2) Act 1997

harsh consequences of rigid application of common law. A key principle is that when there is conflict between equity and common law, equity prevails.

Proportionality in taxation

The most straightforward application of this notion is probably in the tax system in countries that use universal value added taxes such as New Zealand's Goods and Services Tax (GST).⁴² In New Zealand one pays 15% in tax, (virtually⁴³) regardless of what one buys or how much one spends.

More subtlety arises when we consider income taxation or, more broadly, the proportions of income paid in tax by the rich relative to the poor. Most tax systems aspire to be "progressive" — that is to say, it is thought to be good if the rich don't merely pay *more* tax than the poor, but in fact pay a higher *proportion* of their incomes as tax. It is typically felt that there are limits to how much higher a proportion should be paid — otherwise incentives to earn high incomes would be undermined (and in at least some sectors high incomes are often thought to reflect some combination of creativity, entrepreneurship and effort and as such to be socially benign). But the idea remains that, to the extent that appropriate incentives for high earning can be retained, the rich should pay higher proportions.

It is not immediately obvious that this is in any sense fair. After all, the rich, under a progressive system, are not being taxed either equally with others, or in equal proportion to income. And yet believing in "progressivity" has become virtually a touchstone for those aspiring to fairness in taxation. Why?

The ability to pay

One thought might be that progressivity is not intended to be fair in the sense of being proportional to income but, rather, fair in relation to *ability to pay*. The idea would then be that there is a certain amount of spending necessary for all of us and that it is out of the income above that necessary minimum level that we should be paying tax. Since the minimum necessary level is conceptually excluded here, the consequence will be that applying a proportional tax rate on the income in excess of the necessary minimum will (mathematically) imply an increasing proportion of *overall* income being paid in tax.

There are two important weaknesses in this story. The first is that most tax systems do not simply involve an allowance for necessities and a single rate to be paid on income in excess of that. Typically there are a number of increments in tax rates. For example, in the UK, on a naïve reading of income tax rates (i.e. setting aside complexities arising from national insurance and from the withdrawals of various allowances as income rises) there are four rates: the zero rate (which could be conceived of with

⁴² Note that the UK's VAT is not a good example, since it is applied at full rate only to only about 55% of goods and services.

⁴³ Unlike the UK's VAT, New Zealand's GST has very few exemptions — for example all types of food are taxed at the same rate. Exemptions include rent and charitable donations.

reference to the allowance for necessities, though it is rather low for that); the “basic rate” (20p); the “higher rate” (40p); and the “additional rate” (50p).

Perhaps one could just about conceive of a multi-rate system within an amplified version of the story about necessities in which instead of two classes of goods/services — the “necessities” and the rest — there are a number of classes — perhaps the “necessities”, the ordinary goods/services, the luxuries and the super-luxuries. As expenditure ascends the luxury hierarchy it becomes less and less needed and so those spending higher proportions on the luxury and super-luxury goods have disproportionately higher ability to pay. Put less abstractly, once you are spending money on super-luxuries a rise of £100 in your income increases your ability to pay by more than a rise of £100 in the income of someone that can afford only ordinary goods.

Obviously there are quite strong value judgements about consumption involved here, on which those in different parts of the political spectrum might differ (and that is before we start worrying about issues such as whether the super-rich might be important investors as well as consumers, or whether they might leave the country or otherwise avoid paying tax rates that they consider unfairly high). But this line of argument leads us to the second weakness with the ability-to-pay defence of progressivity, for it involves very heavy dependence on a broad concept of the “ability to pay”. But the tax system in the UK appears not to focus on any broad concept of the “ability to pay” that goes beyond income.

In particular, a broad concept of the ability to pay manifestly depends on one’s (allowable) obligations in terms of costs. For example, a single childless person on £40,000 a year would be better able to pay £15,000 in tax than a lone parent of two children on that same £40,000. But this concept of ability to pay has virtually no role in our tax system. The tax system has come to regard having a child as a consumption decision. Recent reports suggest that having a child now costs more than £200,000.⁴⁴ From the tax system’s point of view, you could choose to spend £200,000 on a second-hand Ferrari, or a yacht, or a child — it’s all the same, as far as the taxman is concerned.

This was not always so. A famous paper by Patricia Morgan detailed how, over the 1960s, 1970s and 1980s the balance of taxation changed dramatically, with taxes on families rising rapidly throughout the period and taxes on single childless people rising much less through the 1960s and 1970s then falling through the 1980s.⁴⁵

That happened partly because there was the explicit removal of tax reliefs to the benefit of couples (e.g. the Married Couples Allowance), partly because the incidence of many “anomalous” reliefs (e.g. MIRAS) removed in periods when chancellors sought to raise tax had actually had an incidence skewed sharply towards couples with children. But the single most important change was the initial downgrading of the child tax allowance during the 1960s and early 1970s, its conversion into a flat payment mis-baptised

⁴⁴ <http://www.guardian.co.uk/money/2010/feb/23/child-cost-inflation>

⁴⁵ http://www.cps.org.uk/cps_catalog/CPS_assets/168_ProductPreviewFile.pdf

“child benefit”⁴⁶ in the late 1970s, and then the freezing of that tax allowance/“benefit” during the 1980s. (This was in stark contrast to the treatment of child tax allowances in the 1920s and 1930s, when they rose continually even when much else was cut.)

Now some readers will doubtless be inclined to respond: “Why should I pay for others to have high benefits to pay for children they can’t afford?” But I am not discussing benefits here. It isn’t a question of the state paying anyone to have children. The question is how much tax people should have to pay. And the thought is that if you have dependents, your ability to pay taxes is less, so you should pay less tax. And note that this point is independent of precisely how much income you have — someone on £100,000 that has two children is less able to pay £40,000 in tax than is a childless person on £100,000.

The last element of the tax system that acknowledged this issue in any way was the mis-baptised “child benefit”. But the recent proposal to remove child benefit for higher rate tax payers, finally converting child benefit from a residual flat-rate tax allowance into a welfare benefit (and hence something not to be paid to the wealthy), removes even this vestigial in-principle acknowledgement.

So: is a child a consumption choice, like a Ferrari; or is it a dependent person that increases the costs and reduces the ability to pay tax of whoever is supporting it?⁴⁷ Views on this point differ, and on it turns a key point of fairness. If someone believe that a child *is* a consumption choice, she is liable to think it would be unfair if that consumption choice had a tax break attached to it that other consumption choices did not. But if she believes that a child is a dependent person that reduces the ability to pay, she is liable to consider it unfair if those with children, and hence with lesser ability to pay, are taxed just as much as the childless.

Proportionality to talent or worth

It is not usually considered unfair that one footballer earns more than another if the difference reflects the fact that the better-paid footballer is more talented. It is not considered unfair that one student goes to a better university than another if the student going to the better university is more talented. (Indeed, some people would consider it unfair if those differing in talent were treated *equally*.)

Though not *usually* (or *automatically*) considered unfair, these differentials might (at least by some people) be considered unfair if the difference in talent between (say) the two students were not a result of any greater biological skill in the one than the other but, rather, just that the better student went to a better school or had more attentive parents in early life. However, why one accident of birth — one’s

⁴⁶ It was long an amusing irony of the British tax system that the tax allowance for children was called “child benefit” whilst the income-related benefits given in respect of children were called “child tax credits”.

⁴⁷ Observe, in passing, that this is nothing to do with deficit reduction or other fiscal matters per se. It is simply and solely a question of the balance of taxation to be paid between the childless and those with children.

biology — should be considered any more fair a basis for such differentials than another accident of birth — one’s attentive parents — is unclear.

Note that we are restricting our discussion to proportionality to *talent* at this stage — proportionality to *effort* or other forms of desert in respect of action are discussed in the next section.⁴⁸ One oft-noted feature of market-oriented systems is that they provide high rewards to talent that are not necessarily related to effort, and are thus in that sense unfair. Similarly, the moral worth of a nurse might be much greater than that of a pop singer, yet the pop singer is much better paid. (Opinions are somewhat inconsistent on this point, however. Although capitalism is often criticised as “unfair” for offering low rewards to “important” activities such as saving lives, whilst offering high rewards to “unimportant” matters such as pop music, as soon as people do make large amounts of money saving lives (e.g. big pharmaceuticals companies) they are condemned as “profiteering from death”!)

Proportionality to risk

Accounting the “fair value” of an asset takes into account factors such as operational costs and the supply-demand balance in the sector, along with measures of risk and the cost of capital.

Let us draw a distinction between two different notions of a “fair return” in business:

- a fair return to hard work/effort. Loosely, we might term this a “fair return on entrepreneurship” (though entrepreneurship will typically involve an element of skill and creativity, and hence include a notion of proportionality to talent).
- a fair return for risk borne — this is best understood in terms of proportionality. Loosely, we might term this a “fair return on *investment*” (though as well as bearing risk, investors often engage in skilled assessment of opportunities for above-market return, and hence there is often an element of proportionality to talent).

Indeed, in the standard “Capital Asset Price Model” (CAPM) of Sharpe and Lintner, investment returns (in excess of the “risk-free” return) are literally and *linearly* proportional to risk borne.⁴⁹

⁴⁸ The distinction could be challenged, however. For example, some differences between people in respect of what is termed “effort” surely reflect different native biological abilities — for example in the length of time one can concentrate, or one’s fitness to work long hours.

⁴⁹ According to CAPM, the return, R , on an asset, i , is given by $R_i = R_f + \beta_i \times \text{MRP}$, where R_f is the return on a risk-free asset, MRP is the “market risk premium” (the excess return, over the risk-free rate, that would be delivered by a perfectly-diversified portfolio of assets), and β_i is the correlation between movements in the price of asset i and movements in the average prices of all assets (more strictly, $\beta_i = \text{Cov}(R_i, R_m) / \text{Var}(R_m)$, where R_m is the total return on a perfectly-diversified portfolio of assets).

Fairness as Proportionality to Action (Desert)

Like equality, desert (as we are understanding it here) is a special case of proportionality — specifically, proportionality to action. A fair allocation is one in which people receive in proportion to what they have done.

Again, we shall attempt to contain the discussion mainly to *fair* desert, as opposed to *just* desert. One interesting thing about fair desert is that (unlike just desert) it is typically *relative* as opposed to absolute. That is to say, it seems unfair if someone receives more for having performed an act than someone else performing exactly the same act; or it would seem unfair if two people received the same reward when one had acted well and the other badly.

But there is an absolutist notion of fairness. A fair punishment is one that is proportionate, that “fits the crime”. If a punishment is disproportionate, it is “unfair”. That is widely acknowledged both in respect of disproportionately low punishments, and disproportionately high ones. Similarly, it is fair to be rewarded proportionately for Doing the Right Thing.

Of course, it is not always *just* to be *fair* — sometimes the just punishment will not be proportionate to the deed. A classic well-known set of cases are those relating to *mercy*: sometimes, a just judge will be merciful, even when doing so is not fair.⁵⁰

Doing the Right Thing vs Doing the Wrong Thing

Work vs out-of-work benefits

A classic area of fair-desert-related policy concern is in the area of rewards for work vs out-of-work benefits. It does not seem fair that, after taking account of travel costs, taxes and benefits withdrawn, people can be less well-off if they do not work than if they do. We feel that someone that works has done what the system expected of them – went and found a job – and is now punished for that by having a lower income.

⁵⁰ Fairness considerations may interact with justice here in a manner it is worth dwelling upon briefly. In his famous essay *The Humanitarian Theory of Punishment* C.S. Lewis argues that proportionate desert is a crucial, ineliminable element of justice. Not the only component, of course. He contends that it can be legitimate, for example, to make an example of someone punished, but only to the extent that his actions merited the punishment imposed. Without the concept of desert, he claims, punishments intended to reform might be greatly in excess of what was merited by the crime committed (if we decide that someone is sick and the goal of punishment is to cure before release, then someone difficult to treat might be subject to curative punishment long after retribution was achieved); and punishments intended to deter need not even be inflicted upon the guilty. One might reflect upon the latter line of thought in considering certain changes to criminal justice procedures that had the stated goal of increasing conviction rates — presumably policymakers in such cases should be wary of the temptation to believe that achieving some conviction rate is important in order for the system to provide a credible deterrent, when the cost of that might be more innocent people convicted?

Now, of course, that position sets aside a number of the benefits of working, such as integrity (we obtain benefits on the basis of promises to do our best to obtain work; by finding a job we secure our part of that particular bargain); the “option value” of a lower-paid first job in equipping us to take later, higher-paid jobs; greater self-reliance (though we may still depend upon in-work income support benefits); and social benefits to being in work, such as the opportunity to meet new friends. But the calculus of proportionality to action typically ignores these factors. People do not typically feel that these factors should be offset against the gap in income so as to compensate for the fundamental unfairness that the person that does the Right Thing ends up paid less than the person that does not.

Trying to better oneself or one’s family’s circumstances

A classic tragic movie or book narrative plays upon our sense of unfairness in relation to desert. We have someone struggling in difficult circumstances – poverty, an abusive family environment, criminal surroundings. She refuses to surrender to circumstance, instead engaging in great sacrifices to better herself or to improve the circumstances of her family (perhaps by facilitating her children’s education). We admire her energy, her resolution, her self-discipline. But then, despite what she has done, cruel circumstance crushes all that she has achieved.

“Unfair!”, we cry, and we hope to see a happy ending (though one is not always granted to us). We feel that the system should protect and support those that do the Right Thing to try to improve themselves and their family circumstances. We feel it is *unfair* if their efforts are thwarted by some petty regulation, or prejudice, or crime, or because they are not protected from abusive relatives, or by some small-minded, unimaginative bureaucrat or lender that applies his rules and criteria too rigidly.

The philosopher William Galston’s well-known formulation is that the three key routes out of poverty are education, work, and family. These speak particularly strongly to our instincts of fair desert. If a system does not allow for the flourishing of those that strive in their education, are disciplined in their work, and loyal and self-sacrificial to their families, relative to those that those that do not do these things, the sense of unfairness is particularly acute.

This is an area of interesting clash between the proportionate desert and equality concepts of fairness. For there to be proportionate desert, there must be inequality. More than that, for flourishing to be the proper, fair fruit of action, there must be those that do *not* flourish. If my sacrifice for my children is to have its proportionate result, it must be that my children do better than they would without my sacrifices; they must do better than do other children without parents that sacrifice for them. Love must issue in effect; equality of opportunity cannot be permitted. Love and desert are incompatible with equality.

This is a hard doctrine, precisely because of the clash of fairnesses here. Indeed, there is even a clash of deserts. For the child that is not helped by her parents may not deserve to do any less well than the child that is so helped. Even if she behaves badly, much of that might be attributable to her difficult

personal circumstances (e.g. poor upbringing). So that which is fair from the perspective of the parents – that their sacrifice produces the result it deserves, in respect of her children doing better than others – may be unfair from the perspective of the other child – that she has not done anything to merit doing less well or being helped less than the other child.

Punishment for mistakes

We all make mistakes — in our work, in our personal lives, in our public statements. It is widely understood as fair that there should be consequences for mistakes. Negative consequences for getting things wrong provide us with incentives not to make the mistakes in the first place.

However, a tricky and interesting set of cases are those in which someone faces a situation of uncertainty and makes a judgement call based on the information available at the time, with matters then turning out badly. That is to say, with the benefit of hindsight one can see that a different call would have turned out better, but the judgement call originally made, based on the available information at the time, might still have been the best call to have made. The question then is: is it fair to punish a “mistake” that is visible only with hindsight?

Viewed in the abstract, and put as straightforwardly as here expressed, probably most people would say not. But in practice, if you hire a stock broker to invest some of your money, and the stock broker assesses the market and chooses some investment that then goes bad and you lose your money, few people will dispute that it is reasonable for you to fire your stockbroker. Similarly, many a politician has come under pressure to resign after a judgement call went bad, even in cases where informed opinion has concluded that the original call was balanced and sensible based on the information available at the time.

Though arguably unfair, our instincts probably reflect the fact that there is a contract here (explicit in respect of the stockbroker; implicit with the politician) and we understand that if the agent (the stockbroker, say) doesn't deliver on her task (say, making you money) and so gets fired, and the contract trumps fairness.

Indeed, the lack of fairness is vital to the efficacy of the contract. For, in these situations, the person making the judgement call acts as an agent for others, and does so on the basis of information that others cannot fully observe or understand. Furthermore, we cannot observe how diligently the agent analysed the data and came to her judgement — it would probably be impossible even to lay out all the factors in the overall call. So it will always be possible for the agent to declare that her judgement wasn't flawed; she was merely unlucky — and how, really, are the rest of us supposed to tell whether she is correct? The only way we can provide incentives for her to make an appropriate degree of effort to make a good judgement call is if there are consequences to failure. Of course, one consequence is the lost gains from the good judgement call — positive incentives (e.g. praise for getting it right if things

go well). But in many situations, as well as positive incentives to success, we may need negative incentives for failure, even when failure is not the result of poor action *ex ante*.

Thus, though it may be unfair to punish honest mistakes, it is necessary that such punishment can be contracted for. It would usually be thought fair that people should understand at least the potential for being punished for an honest mistake before accepting the position of judge. If someone thought she would only be punished for negligence or incompetence, but then finds herself punished for an honest error that wasn't even an "error", *ex ante*, that would widely be perceived as unfair.

Golden parachutes

A "golden parachute" is the popular name given to the elements of an executive's remuneration package that determine the payments he receives in the event of his leaving the company — at least in cases where such compensation is perceived as "generous". Of particular interest are notice periods, severance payments, and pension entitlements.

On May 19th, 2003 the pharmaceutical giant GlaxoSmithKline suffered an unprecedented defeat at its annual general meeting when shareholders voted against the group's remuneration report, the biggest shareholder revolt of its kind in UK corporate history. The main focus of shareholder discontent was a controversial "golden parachute" element in the pay package for Chief Executive Jean-Pierre Garnier.⁵¹ The issue returned with a vengeance during the financial crisis, regarding various payouts to former senior staff at failed banks, such as the pension for Sir Fred Goodwin.

Golden parachute schemes potentially perform a number of useful functions, such as:

- Increasing security for executives joining companies that might otherwise dismiss them arbitrarily.
- Enhancing the bargaining position of executives seeking significant reforms of companies.
- Incentivising the choice of certain business strategies when ordinary basic pay schemes would lead to other strategies being chosen.
- Incentivising staying with a firm when directors might otherwise be attracted by headhunters

In general, golden parachutes might insulate executives from the consequences of failure so as to secure their *participation* and to *empower* them to do what is needed (e.g. take the risks involved in significant restructuring).

⁵¹ At around the same time there were also significant shareholder revolts at Royal and Sun Alliance, HSBC, and Tesco, and a consultative document on remuneration schemes produced by the Department of Trade and Industry. Archie Norman, then a Conservative MP, proposed a Bill in December 2002 which would have required compensation paid to a director in respect of loss of office to be "fair and reasonable" in terms of that director's performance, irrespective of what is stated in the contract of employment.

On the other hand, golden parachute schemes, as with other forms of executive remuneration, may involve a number of potential drawbacks:

- The particular circumstances of a firm may not make a golden parachute appropriate.
- The size of the golden parachute may be wrong.
- Such schemes may undermine executive incentives or create perverse incentives.
- Golden parachutes may reflect insufficient accountability of boards to shareholders.

It is also worth considering whether (and if so in what circumstances) it will be appropriate for executives to have relatively more generous severance packages than other company employees. Would it be more (or less) fair if it were easier (or harder) to fire an executive than an assembly-line worker?

Reward to contribution to success of an enterprise

There are many questions about fairness in respect of contribution to success of an enterprise. For example:

- How large a differential between the highest-paid and lower-paid staff can possibly be fair?
- Is it fair if bonuses are paid to some staff even when the company as a whole is in trouble?

Pay differentials

The issue of whether there are any general constraints upon appropriate differentials between the highest and lower-paid individuals in companies is addressed in a long-standing research programme in economics. Indeed, the joint first winner of the Nobel Prize for Economics (Jan Tinbergen, 1969) was best known for the “Tinbergen norm”, the principle that the maximum potentially efficient differential between the highest- and lowest-paid workers in a company is 5:1.

A recent paper⁵² has argued that if salaries were proportionate to their varying contributions to company success, one would expect the salary distribution to be approximately log-normal, and that this is true of the bottom 90-95% of the US distribution, but that at the very top of the distribution there is significant upwards skew relative to this norm.⁵³ For the US⁵⁴ the “ideal ratio” (in the sense of that

⁵² Venkatasubramanian, V. (2009), “What is Fair Pay for Executives? An Information Theoretic Analysis of Wage Distributions”, Entropy 2009, 11, pp766-781, <http://www.mdpi.com/1099-4300/11/4/766/pdf>

⁵³ The approach assumes that the relative contribution of employees can be captured in the question: “What is the least biased distribution of M dollars among N employees given the constraints $E[\ln S] = \mu$ and $E[(\ln S)^2] = \sigma^2$?” It then employs an information-theoretic principle, the Principle of Maximum Entropy (PME), according to which, “given some partial information about a random variate S , of all the distributions that are consistent with the given information, the least biased distribution is the one that has the maximum entropy associated with it. Thus, the maximum entropy distribution does not make

ratio conforming to the lognormal norm) of highest- to lowest-paid employee is 8.2 (remarkably close to the Tinbergen norm, given the methodology), whilst the actual ratio cited in the paper is 1,057:1. This contrasted with actual ratios of 11:1 in Japan, 15:1 in France, 20:1 in Canada, and 22:1 in Britain.^{55,56} Other sources have cited compatible ratios between the average US CEO compensation and average employee compensation (a different definition of the concept) at 531:1 in 2000, up from 42:1 in 1980.⁵⁷

Bonuses

A key economic function of bonuses is that they improve alignment between the worker's pay and her efforts. Take a sales setting, for example. It is not practical or efficient to have a manager watching over everything a salesman does, to check that she puts in high effort and does all the research recommended to maximise her chances of making a good sale. So if she were simply paid a flat fee – the same, regardless of how many she sold – then in a large organisation in which her own sales were irrelevant to the company's performance as a whole, she would have little incentive to work hard.

What a bonus does in this setting is to separate the individual's pay from the performance of the company as a whole. That is its central purpose, its economic function. Indeed, commissions and other incentive-related pay are often subject to specific contracts (I get paid X% of the fees I generate, or Y% for each sale I make, or Z% of the returns on the assets I personally manage).

any unwarranted assumptions or biases about individual values that are not explicitly specified a priori as constraints." The result is thus an implication of the constraints identified. But it is quite plausible that the key constraint identified in the paper (that perceived value can be modelled as the natural log of wages) reasonably approximately an underlying economic mechanism applicable for most of the workforce, but does not capture the economic function of senior staff. Put in terms of PME, there could be a missing constraint that does not bind evenly across the wage distribution, but, rather, only binds significantly on the top 5-10% of workers.

⁵⁴ Based on the company salary distributions of those 35 of the top 50 highest-paid chief executives for which such distributions were available to the authors.

⁵⁵ Research by the Heritage Institute cites comparable figures for Japan (10:1), France (11:1), Canada (21:1) and the UK (25:1) in 2000. See <http://www.heritageinstitute.com/governance/compensation.htm> for details. However, the ratio of average compensation for a CEO of a FTSE 100 to an average employee is cited to be between 76:1 and 128:1. See http://www.theworkfoundation.com/assets/docs/publications/146_The%20risk%20myth.pdf, http://www.ourfutureplanet.org/newsletters/resources/A_Bit_Rich.pdf and http://www.tuc.org.uk/the_tuc/tuc-18610-f0.cfm.

⁵⁶ The paper notes that this huge differential between US and European/Japanese ratios is a relatively recent phenomenon: "*In recent years, there has been great concern over the high pay packages awarded to the Chief Executive Officers (CEOs) of U.S. corporations. The ratio of CEO salary (i.e., total compensation including bonuses and stock options) to that of an average employee has gone up from about 25–40 in the 1970s to as high as 344 in recent years in the U.S ... Compared with minimum wage, the ratio has risen from about 50 in 1965 to about 866 in 2007 ... However, the ratio has remained around 20–40 in Europe and 10–15 in Japan...*"

⁵⁷ The data is based on the Mercer Survey of 350 large industrial and service firms conducted for the Wall Street Journal. See <http://www.heritageinstitute.com/governance/compensation.htm> for details. A similar ratio for the S&P 500 is given as 525:1 in 2000. See <http://www.afcio.org/corporatewatch/paywatch/pay/> for further details.

Now suppose that a company has two departments: A and B. And suppose that I manage department B and my contract states that I receive X% of the profits of department B. But then suppose that department A makes large losses so that the company as a whole is in difficulty. Should I still receive my payment in respect of department B even when shareholders are wiped out and creditors are defaulted upon?

Contractually and legally, my situation might be the same as that of other employees. That is to say, my salary might be automatically calculated from my performance, like a commission, and such salaries be preferred creditors in the event of company default (salaries get paid before anything else). So, whether or not it is *fair* that I receive my (commission-based) salary, it is *right* that I do so because that was the contract. (Remember, promises/contracts trump fairness.)

Now consider a slightly different case. Suppose that, as the manager of department B, I am assessed each year according to the performance of department B and granted a bonus on the basis of that performance, but the amount of the bonus is not specified. Then if the company gets into financial difficulty, my bonus might not rank above payments to creditors. We might very well ask whether that is fair – my performance, my contribution to the success of the enterprise, might be just as positive and significant as if I had had a specific contract setting out a formula for my bonus, but because I didn't I receive nothing. Is that fair? Probably not, but the company had a contract with its creditors that trumps its obligation to be fair to me.

A Challenge for Think Tanks

In this paper we have set out a concept of *fairness as being proportionate*: in some cases that implies equality, in others proportionality, and in others more specifically proportionality to desert. We have urged that it is not always desirable to be fair. Quite apart from cases in which pursuit of too perfect a fairness is too costly, there is an important set of cases where other values trump fairness, specifically promises/contracts, familial obligation, and private property.

In exploring how fairness, interpreted in the way we urge, is already deeply embedded in policymaking (and has been for hundreds of years – for example through the “equity” courts), we have honed our understanding. We have seen that different concepts of property create very different notions of what fairness implies in respect of redistribution, and that the trumping of fairness by property and contract is not unrestricted. There can be legitimate policy grounds for impinging upon property and contract to pursue changes in social equilibria from less fair to fairer ones, but we must be careful to understand longer-term dynamic effects, that society itself has mechanisms for promoting fairness – indeed, society acting in a decentralized way can produce outcomes that everyone will agree are fairer than anything that could be imposed centrally by the state – and that impingements upon contract, familial obligation and property should not be based upon unfairness in specific cases (because, to repeat, these three fundamental bases of society ethically trump fairness).

Though equality is an important dimension of fairness, that is because it is a specific application of the broader fairness requirement of proportionality, and so in many cases it will be fairer not to be equal. We recognize that equality is less desirable than proportionality to talent, to risk-taking, to effort, to self-sacrifice. Fair desert is a particularly evocative form of fairness, and we can become outraged when good action does not produce a good reward, when bad action is not punished proportionately. But these matters are complicated, and there can be other considerations than fairness. Justice may sometimes require *mercy* instead of proportionate punishment, and one person might be punished more than another because of the importance of deterrence. In a commercial setting, some good performance might require particularly high rewards (perhaps unfairly high) to create useful incentives, whilst poor performance might sometimes be insulated from punishment in order to secure participation.

We have learnt something, perhaps. But much remains left to do. Think tanks, academics, journalists, and policymakers might reflect usefully upon the following topics.

Intergenerational fairness

Five key political debates revolve around intergenerational concepts of fairness:

- Government debt control programmes
- Inheritance taxes
- Environmental damage
- Third age issues of pensions and healthcare
- Issues of educational opportunity

Is it fair to leave debts to our children? What are they supposed to have done to deserve inheriting debts? And yet, our children will be much richer than us, inheriting the fruits of our innovation and capital build-up, as well as benefitting from our sacrifices in looking after them and in defending our national security. Would it be fair for them to benefit from these gifts we endow them with without sharing in the costs through repaying debts?

Is it any less fair to inherit wealth than to inherit beauty or intelligence? If so, does that mean that taxes on inheritance are fair (they might nonetheless not be *good* — e.g. if they produced poor incentives — but we would be focused upon the question of whether they were *fair*)? Are inheritance taxes merely an *unfair* tax on poor planning or ill fortune (dying unexpectedly early, before one had the chance to pass on wealth to one's children well in advance of death, or before one had created tax-protected trusts)? If it is no less fair to inherit wealth, might the answer be special taxes on those that inherit beauty or intelligence? Would a tax that were *actually* upon the inheriting of wealth, as opposed to the

UK's "inheritance" tax that is really a tax on bequests, be fairer? Is it fair for bequests to be taxed but not gifts?

Is it any more or less fair to impose a burden of cleaning up the environment upon our children than other debts? Whilst there are risks associated with debts, in respect of environmental damage there is a high degree of so-called "Knightian" uncertainty (better known now as "unknown unknowns"). This applies both to Knightian uncertainty in respect of environmental damage and to Knightian uncertainty in respect of the long-term opportunity cost of environmental protection measures in terms of growth and innovations foregone. Does the presence of Knightian uncertainty change the intergenerational fairness ledger?

What is a fair treatment of the elderly in respect of pensions and healthcare? Are pay-as-you-go pensions and healthcare systems, in which each generation pays for its own elderly rather than the elderly saving earlier in life to pay for themselves, fair? As we have emphasized many times, fairness is not the only legitimate consideration, and there could be powerful reasons for insisting that unfair pensions and healthcare systems are better, but it would be relevant to understand what the concept of intergenerational fairness had to offer to these debates.

Many discussions of grammar schools and of tuition fees for higher education include concepts of intergenerational fairness, and in particular the metaphor of the ladder of opportunity being drawn up behind a particular generation. Many affluent forty-somethings that went to university in an era of full grants feel it would be unfair not to subsidize today's university applicants, much as an older generation of grammar school beneficiaries worried (rightly or wrongly) that later school systems offered less opportunity for advancement. How should one think about inter-generational issues in education?

Fairness in welfare reform

Much of the recent welfare policy debate has revolved around notions of 'fairness'. This has ranged from Prime Minister David Cameron stating it is "unfair" for housing benefit claimants to live in areas many taxpayers could not afford to the Leader of the Opposition declaring the move to restrict Child Benefit to households without a higher rate taxpayer as "unfair and unworkable". More recently, the Archbishop of Canterbury has commented of the proposal to create sanctions for benefits claimants who refuse to do unpaid community work: "I don't immediately think it's fair."

What is a "fair" welfare reform? What is the proper balance between fairness

- to those that, through no fault of their own, have fallen on hard times;
- to those that try hard to escape from difficult circumstances, as opposed to those that give up or try to exploit the system;

- to those that are genuine claimants, but who end up waiting to be dealt with because of a need to process less worthy claimants;
- to those that would benefit from a prod and other pressure to escape from their circumstances, as opposed to being given up upon, versus those liable to be demoralised further by disapproval and criticism;
- to those that have genuinely difficult personal circumstances but lack the personal resources to explain themselves clearly;
- to social security decision-makers and others such as doctors that must make difficult judgement calls about when to accept and when to reject someone's claim that they are unable to carry out or find work;
- to the taxpayer?

As argued above, it is not always desirable to be fair. When is unfairness in the welfare system appropriate — e.g.

- providing benefits to those that do not merit them because the alternative would be a breakdown in order;
- providing benefits to those that do not merit them because otherwise their children would suffer;
- providing benefits without checking that recipients properly merit them because the administrative costs of proper testing are disproportionate;
- imposing rough justice on those that might merit assistance but do not receive it because the negative incentive effects of providing assistance in these cases are too serious;
- imposing rough justice in a spending cuts programme because, even though some aspect is exposed as undesirable, once cuts are backed down upon a wider spending cuts programme (going well beyond welfare) might unravel;
- it is more important to maintain implicit or explicit government contractual obligations (e.g. in respect of contributory benefits) than to introduce a fairer system in the short term?

Fairness in pay and pricing

What does “fair pay” or a “fair price” mean in the modern context? Mediaeval scholars reflected upon “just wages” and “just prices” but how (if at all) are these concepts relevant to a modern market economy? European competition law has evolved a concept of “excessive pricing” and there are many requirements for fair and reasonable treatment, particularly by monopolists. But are these debates

anything more than a replay of the old clash between market-based allocation concepts and the mediaeval “just price” allocation system?

High pay and bonus pay are hot political topics, especially concerning pay in the financial sector and pay of top executives of FTSE 100 firms. Many commentators allege that structural errors in pay schemes have been a significant factor in the financial crisis of recent years — that, for example, remuneration schemes encouraged excessive risk-taking or excessive short-termism in financial sector companies, or for Chief Executives encouraged over-merging and an over-focus on profitability or share prices at the expense of the underlying robustness of the business. Others contend that although there are weaknesses in pay schemes – perhaps including pay levels being excessive or encouraging excessive risk-taking – these weaknesses are symptoms of problems elsewhere in the system, such as weak corporate governance structures, overly-low interest rates, or implicit bailouts for bondholders, not problems to be treated in and of themselves. And there are also those that deny, outright, that there are any problems with remuneration levels at all, arguing that high levels of remuneration are required to attract top talent to the UK.

Much political discussion about high pay – especially in Continental Europe – focuses on the question of whether it can ever be *fair* for certain people to be paid as much as they are. What is the interplay between these other, technical questions, and the ethical considerations involved in fairness?

As diverse as the analyses of the issue are the solutions proposed, which range from remuneration caps (e.g. proposed for the financial sector in the European Parliament), to bonus taxes, to bonus bans to increased rates of taxation on the wealthy to corrections of corporate governance regimes, to mechanisms for exposing bondholders, to additional risk. Perhaps some of these solutions might increase perceived social fairness, in respect of relative wages across society. But are these solutions *fair* to the individuals affected by them?

Conclusion

Fairness is a concept upon which moralists, political philosophers, game theorists, and policymakers have reflected for hundreds of years. The UK debate, to this point, has run the unfortunate risk of reducing this rich and well-explored concept to a vacuous, Humpty-Dumpty-esque “fairness is whatever I believe in”.

We, by contrast have offered a simple and intuitive notion: that being fair is a special kind of being proportionate, with particular application in respect of equality, proportionality, and desert. This concept is related to justice, but not the same as it, for while justice is a *moral* concept and an ethical/normative *obligation* (one always ought to be just), fairness is a *technical* concept and an ethical *consideration*.

One need not always be fair. But usually one should, and it is important (vital) that we do! But when?
The answer to *that* is, of course, at the heart of the political debate.

About the Author

Dr Andrew Lilico is the former Chief Economist of Policy Exchange. He is now Director and Principal of Europe Economics, having previously worked there as Managing Director. He has also worked as an economist for the Institute for Fiscal Studies and the Institute of Directors, as a business analyst for two plastics multinationals, as a mathematical chemist for ICI, and as an opera singer for Opera New Zealand.

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The work of the Economics Unit at Policy Exchange

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