

# Perspectives on 'fairness'

George Yarrow

RPI Westminster Conference

3 May 2017

## The energy policy cycle, based on an analogy with thermodynamics (Rumelt: *Good strategy/bad strategy*)

1. Disruptive event (privatization and regulatory reform) -> development of new institutional order. Driven by 'thoughtfulness' (metaphorically a form of intellectual energy), institutional order increases ('entropy' declines). Internal (to the regulator) energy is supplemented by external energy in an open system.
2. Internal energy dissipates and external energy sources decline as the system becomes less open. Entropy/disorder increases.
3. Further disruptive events occur (climate change, digital revolution) but energy in the system is depleted. There is an acceleration toward disorder (higher entropy).

# Thoughtfulness on issues involving 'fairness'

- Fairness is widely referenced in public policymaking and enforcement.
- No settled meaning -> incoherent application across contexts (disorder).
- There is a tendency toward use of the concept to justify decisions driven by other considerations, helping sustain politicians' logic (something must be done; this is something; therefore we will do this). 'Fairness' can be used a response to the potential question *precisely why must something be done?* Answer: because the current state of affairs is 'unfair'.
- This is a rhetorical device, spin not substance.
- But issues of fairness are substantive: they call for serious thinking.

# Different contexts, different meanings

- Coherence in policy does not entail a single meaning of fairness.
- Network regulators are required to determine *outcomes* (set price or revenue caps) and reliance on notions of *distributive justice/fairness* are unavoidable, see the 'just and reasonable' price criterion of US utility regulation.
- In competitive markets, other meanings more closely related to notions of *procedural justice/fairness* may be more relevant.
- What is required is a stable mapping from context to usage, so that economic agents can observe the context and form reasonable expectations as to what will be considered fair or unfair. This is sufficient for purposes of regulatory certainty.
- It is instability/unpredictability in the mappings that cause problems, not an absence of one, common meaning.

# Convenient meanings of 'fairness' vs discovery

- Interest groups (political, bureaucratic, business, academic, etc.) tend to adopt whatever meaning is convenient.
- Scholars tend to argue about abstract notions of fairness -- see the literature from Plato and Aristotle to Rawls (*Justice as Fairness*).
- Take a different tack:
  - If consumers are interested in fairness, authorities with delegated responsibilities to consumers should look first to consumers' *own* views of 'fairness'.
  - The task is to *discover* the relevant norms, not to assume and impose.
- This is the approach taken in the first great work in English on political economy, Adam Smith's *Theory of Moral Sentiments*. We have a methodology and template to build on, perhaps obscured by Smith's economical use of the word 'fair' (precisely because he deals with things at a more fundamental level).

# Homo Economicus

- The conceptual frameworks of regulation and competition law tend to be dominated by a view of economic agents, *homo economicus* (HE), whose falsity has been re-emphasised by modern behavioural psychology and economics.
- There is an intellectual failure here. HE is a fiction invented to analyse the behaviour of economic *systems*, not to assess the preferences or the behaviours of individual types or sub-sets of *actual* economic agents.
- Analogy: the kinetic theory of gases. The macro properties of a system can, for many (but not all) purposes, be analysed effectively on the basis of an assumption about the properties of atoms that no physicist believes to be adequate.
- However, when the context is one in which the theory is inadequate to explain the observed phenomena, physical scientists switch to a different theory: they don't claim either a 'system failure' (the equivalent of 'market failure') or blame atoms for not behaving like little bouncy balls.

# Questions in energy policy

- In 2008 DECC/Ofgem decided that it was 'unfair' that that electricity suppliers discounted retail prices in geographic areas in which their share of business was relatively low. Was this sentiment widely shared by consumers? Did any actual consumer complain about it to DECC/Ofgem?
- More recently, is there a widespread sense of unfairness about a situation in which those who shop around can achieve significantly lower retail energy prices than those who don't. Is this because consumers consider the price differentials (the *outcomes*) unfair, or might it be that any issue is more to do with a sense that 'loyalty' is inadequately recognised by suppliers (a concern with *conduct* – businesses behaving badly)?
- Actual consumers do, of course, tend to become agitated by sharp price hikes for commodities that are important budget items, but that is a different matter and is not specific to regulated sectors.

# Switch of perspective/question: when is conduct improper, meriting disapprobation?

- Take as given that what is and is not considered acceptable behaviour in a social or economic context is heavily influenced by social norms. The norms influence an individual's own conduct directly and provide criteria for judging the conduct of others.
- Ask: does this conduct meet with 'approbation'/approval/favour or 'disapprobation'/disapproval/disfavour?
- Proposition: in their conduct people tend to be strongly motivated to seek approbation and avoid disapprobation.
- Subject to a general health warning about the artificiality and contextual narrowness of 'laboratory experiments', this is a proposition that can be partially tested against the evidence that such experiments yield.
- NB: the evidence to be discussed is usually interpreted in terms of notions of 'fairness' rooted in notions of distributive justice (the concern of today's theorists). Here the focus is on a Smithian approach.

# The Dictator Game (DG)

- Give person A a sum of money, let A keep what he/she wants and leave the rest to another person in the experiment B under double blind conditions (A and B are anonymous to each other and both are anonymous to the researcher, R: all that A, B and R can see are the outcomes).
- *Homo Economicus* would take the lot. Most do – around two thirds is a typical outcome – but many don't and there is local modal point in the distribution of outcomes at 50/50. Some, albeit relatively weak, internalisation of a social norm (e.g. 'share good fortune with others') is indicated. (NB in the experiments, the pot to be divided is a windfall.)
- Absent double blind conditions – i.e. A and B are not anonymous to R – there is a substantial shift toward more 'sharing'.
- Proposition: the approbation effect appears to be a strong one. There is no strong, previous social bond between the As and R, but many As appear to care about how their conduct will appear to R.
- Potentially good news for regulators/competition authorities. Just being there as 'spectators' can have significant effects, provided that the presence is recognised.

# The Ultimatum Game (UG)

- Same as the Dictator Game, but, if B declines to take the residual available (the 'offer'), neither party gets any of the money.
- Requires A to give consideration to what B might do, since B can now influence the payoffs of the A, and also to pay attention to how B views things, since this will influence what B will do.
- Perfect Nash Equilibrium with HE assumption is for A to leave only a pittance on the table, which it is then 'rational' for B to accept.
- In practice, the median offer is around 60/40 and up to about 20% of asymmetric (not 50/50) splits are rejected by the Bs.
- The most interesting results are the rejections. What do they signify?
- "You have failed to give *due* consideration to my interests and power of veto: I do not approve of your conduct, and would not approve of my own conduct if I endorsed and benefited from it by accepting the offer."

# A real context: Percy Jackson's twenty rules of conduct

**In all conduct the aim should be *due consideration* for others.** (A meta-rule or standard of conduct.)

...

**Do not run in the corridors.**

...

*Notes and observations:*

The call for consideration is of *others affected by the conduct*.

The simultaneous creation of an expectation – a student can *expect* due consideration from other students.

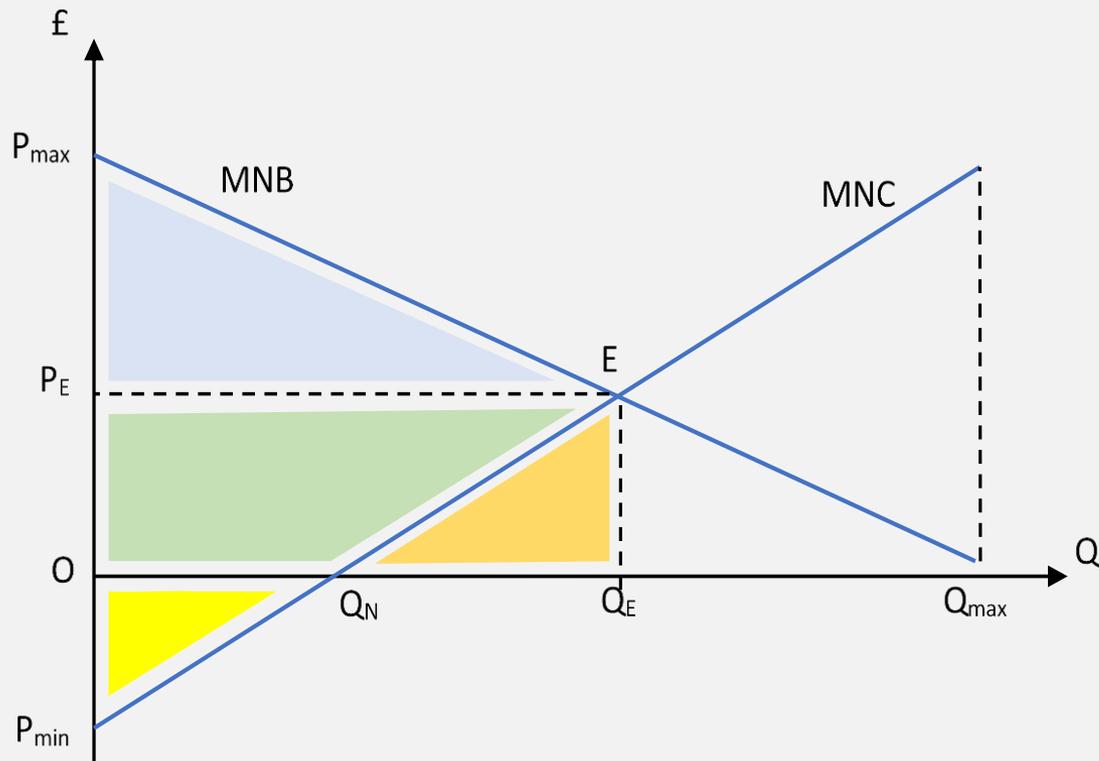
Failure to give due consideration is a breach of the shared rules (not 'fair play').

The call for judgment in the little word 'due'. Saintliness not required.

# The Israeli nursery school

- Concern that late arrivals (a violation of the informal norms/rules: lack of due consideration for others) were causing disruption to classes.
- Decision to impose financial penalties for late arrivals (failure to meet the requisite standard of conduct, i.e. people were 'breaking the rules').
- The incidence of late arrivals *increased*. Why?
- Late arrivals broke the prevailing rules => the disapproval of teachers and other parents: not 'fair play'.
- Arriving late and paying a fine conformed to the adjusted rules. Could now be interpreted as 'fair play'. Weakening of the informal incentive structure.
- The appropriate inference is not that financial penalties are *necessarily* ineffective, rather that, when applied, thought needs to be given to whether they *complement* or *substitute* for informal norms. See the *Political Economy of Markets* for more on this point.

# Immigration policy and the ultimatum game 1



# Immigration and the ultimatum game 2

- The UG suggests that a highly asymmetric distribution of benefits will be widely interpreted as lack of due consideration for the interests and residual power of the Bs, and might be vetoed (even if it makes the Bs worse off).
- Alternative accounts of the Leave vote:
  - Irrational/stupid in the face of self-harm (the ‘project fear’ approach).
  - Voters behaving normally: approval withheld on account of lack of due consideration (a violation of the standard expected of government).
- Indicators of lack of due consideration:
  - Economic assessments of effects of immigration failed to distinguish between marginal and average effects – not a something that conforms to any normal standard of conduct for economists.
  - The asymmetry could be alleviated by, for example, pricing residency rights, but there is no indication that this is possibility that has been given serious consideration.

# Parallels with procedural justice/fairness

- An everyday concern with having one's interests 'duly considered' (a thought *process*) is more closely aligned with procedural views of justice/fairness than with approaches rooted in concerns about particular outcomes (distributive justice/fairness).
- The expectation of due consideration induced in B arises when A's conduct has material effects on A. This tends to occur in schools, but also in markets and in policymaking contexts. The most egregious offence is to give no consideration at all.
- Compare all this with the preoccupation with distributive justice in the intellectual underpinnings of regulation and competition law. Maybe a double standard here: in practice, the theorists and authorities can be almost obsessively concerned with how they themselves are viewed.

# Further developments and issues to consider

- Trade-offs: in the UG game, there might be a shared norm, behaviour, but someone starving might take a low offer, whereas a wealthy B would not.
- Approbation/disapprobation tends to come in degrees. One B may consider an 80/20 split egregiously improper, another may consider it only mildly improper. These judgments may be influenced by hormones, alcohol and other substances.
- The 'rules', inclusive of social norms, differ across institutions. Percy Jackson's rules obviously differ from the rules of retail markets in regulated sectors. The common factor lies in the responses to violations, whatever they are.
- There may be multiple spectators capable of influencing a regulator, each with roots in a different institution and different normative structures. A regulator seeking the approbation of politicians or the media will likely behave differently to one guided by the everyday norms of consumers.

# Final thoughts

- The types of matters discussed, which were much more central in classical political economy than in contemporary discourse, have recently attracted new interest, from regulators among others. There is a sense, however, of going around in circles in thinking about them.
- A methodology and conceptual framework for developing standards of conduct via an inductive discovery process was set down in 1759, but it has not been built upon and it is difficult to detect significant progress since that period. Instead there are un-coordinated bursts of energy, which then quickly dissipates.
- It could be otherwise, even with the constraints, pressures and distractions that face today's authorities.