



The Long-Term Fiscal Living Standards Framework: Addressing Fairness

Rebecca Prebble

New Zealand Treasury

DRAFT PAPER FOR THE
LONG-TERM FISCAL EXTERNAL PANEL

OCTOBER 2012

**DRAFT PAPER FOR
LONG-TERM FISCAL
EXTERNAL PANEL**

The Long-term Fiscal Living Standards Framework: Addressing
Fairness

MONTH/YEAR

October 2012

AUTHOR

Rebecca Prebble
New Zealand Treasury
1 The Terrace
PO Box 3724
Wellington 6008
New Zealand

Email
Telephone
Fax

NZ TREASURY

New Zealand Treasury
PO Box 3724
Wellington 6008
NEW ZEALAND

Email information@treasury.govt.nz
Telephone 64-4-472 2733
Website www.treasury.govt.nz

DISCLAIMER

The views, opinions, findings, and conclusions or recommendations expressed in this draft paper are strictly those of the author. They do not necessarily reflect the views of the New Zealand Treasury or the New Zealand Government. The New Zealand Treasury and the New Zealand Government take no responsibility for any errors or omissions in, or for the correctness of, the information contained in these working papers. The paper is presented not as policy, but with a view to inform and stimulate wider debate.

Table of Contents

Purpose of this paper	1
Why is it important for the <i>Long-Term Fiscal Statement</i> to address fairness?	2
How have different people thought about fairness?	3
So how should the Treasury treat fairness in the <i>Long-Term Fiscal Statement</i>?	7

The Long-Term Fiscal Living Standards Framework: Addressing Fairness

Purpose of this paper

This paper is intended to support a discussion about fairness at the Long-Term Fiscal External Panel Session 2, on 26 September 2012. This note does not propose a Treasury view. Rather, it suggests a number of different approaches for the purpose of getting feedback from the External Panel about how best to treat ideas about fairness/equity in the 2013 *Long-Term Fiscal Statement*.

1. The Treasury's 2013 *Long-Term Fiscal Statement* will set out a number of possible options for addressing New Zealand's long-term fiscal issues. The Treasury will assess each of these options using its Living Standards Framework, suitably tweaked to apply more directly to the present context. This means that it will take into account:
 - **Fiscal sustainability:** Does the option make government services more affordable over the long term, either by reducing spending or raising revenue?
 - **Economic efficiency:** How does the option affect incentives for consumption, investment, working, and saving? Are resources directed towards their most efficient use?
 - **Equity/fairness:** Where do the benefits and burdens of this option fall, both across society and across time?
 - **Risk:** What effect does this option have on New Zealand's ability to withstand shocks or unexpected events? Is the option flexible enough to respond if the world changes in unpredictable ways?
 - **Social institutions:** How might this option affect the trust and connections between people, and between people and the government? What role does the state play in this option, and is it suitable in the New Zealand context?

2. This note takes a closer look at the “equity/fairness” dimension. It considers (1) why it is important for the *Long-Term Fiscal Statement* to address fairness (2) how different people have thought about fairness, and (3) how the *Long-term Fiscal Statement* should treat fairness.
3. This note highlights questions that we would particularly like the Panel to consider.
4. This note tends to use the word “fairness”, whereas in other published work the Treasury has used the word “equity” in the context of its Living Standards Framework. This choice of words is not intended to imply a difference in approach.

Why is it important for the *Long-Term Fiscal Statement* to address fairness?

5. Fairness concerns how benefits and burdens are distributed across society and across time. Although Treasury analysis generally considers distributional impacts of particular policies, the previous two *Long-Term Fiscal Statements* (in 2006 and 2009) did not focus on this aspect. However, it is intended that fairness will play a key role in the 2013 *Statement*.
6. The reason for the focus on fairness is that fairness is something that people care about. The perception of fairness – and unfairness – is a significant motivating force in democratic societies: many major changes in government policy been implemented in response to perceptions that the status quo is unfair. Perceived unfairness can lead people to support changes even when those changes operate to their personal detriment.¹
7. It has been suggested that New Zealanders have a particularly strong attachment to ideas of fairness.²
8. Political speech regularly evokes or appeals to notions about what is or isn’t fair. Some recent examples are:
 - **David Cameron:** “Fairness means giving people what they deserve – and what people deserve depends on how they behave.”³
 - **Barack Obama:** “Do we want to keep giving tax breaks to the wealthiest Americans like me, or Warren Buffett, or Bill Gates – people who don’t need them and never asked for them?”⁴
 - **Tony Blair:** “Ultimately, [proposed benefit reform] is about fairness - about fairness in helping people off benefit and into work and making sure that only those that should be on incapacity benefit are actually on the benefit.”⁵

¹ See Colin James’ discussion of the abolition of the slave trade and the 1832 Reform Act (UK) widening the franchise in “Making Big Decisions for the Future”, forthcoming.

² See David Hackett Fischer, *Fairness and Freedom: A History of Two Open Societies* (Oxford University Press, 2012), which contrasts New Zealand’s attachment to “fairness” with the United States’ attachment to “freedom”.

³ David Cameron, 2010 Conservative Party Conference Speech.

⁴ Barack Obama in relation to his proposed “Buffett Rule”, quoted in “The Buffett Rule’s Billionaire Backers”, Clare O’Conner, Forbes Magazine, 10 April 2012, available at <http://www.forbes.com/sites/clareoconnor/2012/04/10/the-buffett-rules-billionaire-backers-meet-the-super-rich-who-want-to-pay-more-taxes/>.

9. Experience appears to inform politicians that people connect with ideas about fairness. One of our aims with the 2013 *Long-Term Fiscal Statement* is to communicate better with New Zealanders and their representatives in Parliament. And that means addressing things that we know people care about.

Question for the Panel – We think that the Long-term Fiscal Statement needs to address fairness in some way if it is to be a useful communication tool. Do you agree?

How have different people thought about fairness?

10. There are many different definitions of fairness. It might even be true to say that each individual has their own. But there are certain themes that recur in discussions of fairness, both in academic writing and in casual conversation:
- **Addressing need:** the idea that fairness involves some sort of redistribution of resources towards society's least-advantaged people. The Barack Obama quote above appeals to this idea of fairness. Ideas that fairness is about promoting greater equality can be seen as an extension of this idea.
 - **Just deserts:** the idea that people should enjoy the benefits of their hard work and take responsibility for their mistakes. "Equality of opportunity" ideas also come into play here – if everyone has the same opportunities, there is a rational basis for allowing them to keep the fruits of their own labour. The David Cameron and Tony Blair quotes above appear to use the word "fairness" in this sense.
 - **Utilitarianism:** the idea that resources should be directed towards those who will enjoy them the most, or create the most good with them.⁶ This idea is closely tied to economic efficiency.
 - **Procedural fairness:** young children grasp this concept: fairness means making decisions impartially, taking only relevant factors into account. Notions of fairness as "playing by the rules" fall into this category.
 - **Intergenerational fairness:** the idea that we owe something to future generations and our actions should not disadvantage them unduly.
11. Most people would probably agree that these are all important dimensions of fairness. These dimensions are not alternatives – they are just different ways of looking at a situation. But there are, of course, situations where different ideas of fairness will conflict, forcing a decision about what is most important.

⁵ Tony Blair, quoted in BBC News "Benefit Shakeup 'About Fairness'", 23 January 2006, http://news.bbc.co.uk/2/hi/uk_news/politics/4639446.stm

⁶ These first three ideas of fairness are taken from James Konow (2003) "Which is the Fairest one of all? A Positive Analysis of Justice Theories" *Journal of Economic Literature*, Vol. XLI, December, 1188-1239, discussed in David Gruen, James Kelly, and Stephanie Gorecki (Australian Treasury) "Wellbeing, living standards, and their distribution" Treasury guest lecture, 9 September 2011, available at www.treasury.govt.nz.

Fairness reflected in constitutional foundations

12. Ideas about fairness exist in our founding constitutional documents. For example, Magna Carta reflects procedural fairness when it states:

No Freeman shall be taken or imprisoned, or be disseised of his Freehold, or Liberties, or free Customs, or be outlawed, or exiled, or any other wise destroyed; nor will We not pass upon him, nor condemn him, but by lawful judgment of his Peers, or by the Law of the land.

13. In a New Zealand-specific context, Article 3 of the Treaty of Waitangi reflects both procedural fairness and – possibly – ideas about substantive equality when it states that:

Her Majesty the Queen of England extends to the Natives of New Zealand her Royal protection and imparts to them all the Rights and Privileges of British Subjects.

Fairness as a term of our social contract

14. One way of thinking about fairness is as a term of our social contract. Social contract theory assumes that societies and governments exist because people accept an implied contract with each other to live a certain way. So when we ask “what is fairness?” we are really asking “on what terms have we agreed to live together as a society?”
15. For Thomas Hobbes, writing in the mid-1600s (and having experienced the English Civil War), a social contract was the alternative to the “solitary, poor, nasty, brutish and short” life we could otherwise expect.⁷ For John Locke, writing in the late 1600s, the social contract was a way for people to enforce natural rights (ie rights that existed irrespective of a social contract) and also a way to resolve situations where rights compete.⁸
16. Jean-Jacques Rousseau, writing in the 1700s, brought explicit ideas about equality into the social contract frame. For him, an ideal system of law was one which set very high targets in terms of reducing inequalities between citizens.⁹
17. In more recent times, American moral philosopher John Rawls wove the idea of fairness explicitly into his social contract theory. Rawls had a specific idea of what “fairness” meant: the difference principle. The difference principle holds that social and economic inequalities are permissible if they are to be to the greatest benefit of the least-advantaged members of society.¹⁰

⁷ Thomas Hobbes, *Leviathan*, (Indiana: The Liberal Arts Press, 1958. First Published 1651).

⁸ “R S Woolhouse “John Locke” in Ted Honderich (ed) *The Oxford Companion to Philosophy* (2ed, New York: Oxford University Press, 2005).

⁹ Jean-Jacques Rousseau, *The Social Contract*, translated by Maurice Cranston (Penguin Books, Middlesex, 1968), 96: “no citizen shall be rich enough to buy another and none so poor as to sell himself”.

¹⁰ John Rawls, *Justice as Fairness: A Restatement*, E. Kelly (ed), (Cambridge, MA: Harvard University Press, 2001) 42-43.

18. Rawls arrived at this principle by using the “veil of ignorance” as a thought experiment: if no one knew what characteristics they had – race, sex, birthplace, etc – what kind of society would they choose to live in? Rawls suggests that everyone would choose a society that helps its least-advantaged people. Rawls’ conception of fairness is therefore very much in the “addressing need” category.

Horizontal and vertical equity

19. For most economists, any discussion of fairness will start with horizontal and vertical equity. Horizontal equity holds that people who are in the same position should be treated in the same way. The principle is most often invoked in the tax context, holding that people of equal wealth should pay the same amount of tax, regardless of whether that wealth comes from self-employment, earning a salary, holding shares in a number of companies, or any other source. Horizontal equity is perhaps best thought of as an instance of procedural fairness: similar cases should be treated similarly.
20. Vertical equity provides that tax burdens faced by different people should be relative to their ability to pay.¹¹ The principle underpins tax systems where the marginal tax burden increases as incomes increase. Vertical equity is therefore a more Rawlsian, need-based principle, consistent with the idea that fairness involves improving the lot of those at the bottom of the heap.
21. Although most economists agree that horizontal and vertical equity are good things, opinions differ on how much equity is enough. For example, the Victoria University Tax Working Group identified that New Zealand’s different marginal tax rates for companies, trusts, and individuals eroded horizontal equity.¹² But opinions differ on whether this different treatment is a sufficiently serious problem that it must be addressed.¹³
22. Assessments also differ about how far vertical equity needs to go. For example, goods and services tax (GST) is set at a flat rate so is not a progressive tax. Even so, many people think GST is an important and appropriate part of a tax system due to its simplicity, the difficulty in avoiding it, and its relatively modest impact on investment and consumption decisions compared with alternative types of taxation.

Extending fairness ideas across time

23. The fairness concepts discussed in this note so far are generally expressed as applying at one point in time. But the *Long-Term Fiscal Statement’s* 40 year+ time horizon means that we must consider how resources are distributed across time, not just within one period.

¹¹ *The Report of the Victoria University of Wellington Tax Working Group* (Centre for Accounting, Governance and Taxation Research, Victoria University of Wellington, January 2010) contains a discussion of horizontal and vertical equity at page 15.

¹² *The Report of the Victoria University of Wellington Tax Working Group*, above, 29.

¹³ Following the *Report of the Tax Working Group* the Government did in fact address this issue to a degree, by aligning the top personal tax rate with the trust rate.

24. Rawls specifically addresses the rights of future people in his conception of fairness: his “just savings principle” holds that the main duty we owe to our successors is the saving of sufficient capital to maintain just institutions over time. The just savings principle is a constraint on the difference principle: favouring today’s least advantaged people is not permissible if it is at the expense of tomorrow’s least advantaged people.
25. Although it is helpful that Rawls addressed this point, the idea does not take us very far. It presupposes a particular idea of *intra*-generational fairness: the difference principle.¹⁴ If we are not quite ready to sign up to a particular idea of intra-generational fairness, however, thinking about fairness across time means asking questions, for example:
- Where do the benefits and burdens of a particular policy fall over time?
 - What is the respective “well off-ness” of different cohorts of people, and does that matter?
 - Are trade-offs between people born 50 years apart any different to trade-offs between people born on exactly the same day? In other words, can age (or birth year) ever be a relevant consideration in determining what people have a moral right to?¹⁵
26. These questions are hard, and fortunately we do not have to answer them definitively in the *Long-Term Fiscal Statement*. But we must address the role that distribution over time plays, alongside the fairness implications of that distribution.

A plurality of views

27. Faced with so many different views of fairness, it is hard to know where to take them. Amartya Sen helpfully provides a way through. Sen argues that we do not need to have a fully realised idea of fairness before we can evaluate whether certain things are fair. In a society where people have different views about what is fair, it will not always be obvious which view should prevail in any one situation, so it makes sense to think about more than one.¹⁶
28. Sen gives the example of three children, Anne, Bob, and Carla, fighting over who should get a flute.
- **Anne** argues that she plays the flute, so therefore should get it. Someone who equated fairness with utilitarian ideas of the greatest good might agree with her.
 - **Bob** argues that as he has grown up with no toys, he should get the flute. Someone who sympathises with Rawls and thinks that fairness means improving the position of the least fortunate would give Bob the flute.

¹⁴ That is probably reasonable, as this is in fact Rawls’ idea of fairness.

¹⁵ Martin Wilkinson’s paper “Intergenerational Ethics and Long-term Fiscal Planning”, also prepared for the 26 September External Panel session, covers this ground but with more breadth and depth.

¹⁶ Amartya Sen, *The Idea of Justice*, (2009, Penguin Books, London), 14.

- **Carla** argues that she made the flute and therefore should get it. Someone who thinks that fairness means rewarding people for their effort would agree with Carla.¹⁷

29. Sen's point is that all three children have what seem to be reasonable claims to the flute. All we can do is acknowledge these three claims, and try to make the best decision in the circumstances.

So how should the Treasury treat fairness in the *Long-Term Fiscal Statement*?

30. It is not Treasury's role to endorse any particular definition of fairness, or to say that any one dimension of fairness should prevail in a particular situation. But there are ways that the *Long-Term Fiscal Statement* can address fairness without necessarily arguing that any particular approach is "fair". This note suggests three options, which are not mutually exclusive.

Option 1: Clarity about benefits and burdens

31. At a minimum, the *Long-Term Fiscal Statement* should analyse where the benefits and burdens of different options fall, both within one time period and across time. It will not always be possible to put a dollar value on these benefits and burdens, but it will usually be possible to describe who gives and who receives. Readers will then be able to decide whether the distribution describes fits with their ideas of fairness.

Question for the Panel – Do you agree that it is sensible to take the approach of setting out the benefits and burdens of policies, leaving readers to decide on "fairness"?

Option 2: Demonstrate how different fairness ideas play out using examples

32. We would ideally like the high-level "fairness is different for everyone" message to come through in the *Long-Term Fiscal Statement*. One way of doing this would be to use examples to draw out different fairness ideas.

33. For example, consider the idea of reducing the rate of growth of New Zealand Super payments. We can look at this from different fairness perspectives:

- **Addressing need:** People with this conception of fairness might be concerned about how reducing the rate of growth in Super would affect those who have no supplementary source of income.
- **Just deserts:** People with this conception of fairness might be concerned about people who have been working and paying taxes all their lives, and therefore "deserve" to receive Super at current growth rates.

¹⁷ Sen, above, 12-13.

- **Utilitarian:** People concerned about the total amount of “good” created by this policy might consider the amount saved by reducing the growth rate of Super payments, and wonder about the benefits it would have created in the hands of superannuitants relative to the benefits from it being redeployed elsewhere.
- **Procedural fairness:** Procedural fairness prompts us to consider what kind of warning people need before such a policy change could happen.
- **Intergenerational fairness:** People concerned about intergenerational justice would wonder whether there is any rationale for treating different generations differently in terms of the conditions under which they receive Super.

34. We do not propose to go through these dimensions of fairness for each initiative examined in the *Long-Term Fiscal Statement*. But choosing one or two particularly suitable initiatives could be a useful way of communicating the various ideas people need to think about under the heading “fairness”.

Question for the Panel – Do you think that using examples to draw out different ideas of fairness is a useful approach?

Option 3: Theme “option packages” around different fairness definitions

35. The *Long-Term Fiscal Statement* will present a number of “packages” of options for closing the gap between expenses and revenue. There are many ways of doing this, involving different combinations of adjustments to spending and taxes. One possible approach would be to “theme” option packages around different dimensions of our Living Standards Framework. Within the fairness dimension, we could produce packages that might be consistent with the different takes on fairness discussed in this note.

36. For example, we could present packages that reflect these concepts:

- **Addressing need:** this option package could involve significant transfers from the richest to the poorest, and would likely include tax increases.
- **Just deserts:** this option could reward those who save for their own lifetime needs, for example by advocating the use of individual retirement savings accounts and private health insurance.
- **Utilitarianism:** This option might centre on policies that encourage people into the workforce, supporting economic growth (if “maximising good” is taken to mean “maximising growth”, which is obviously not the only possibility).
- **Intergenerational fairness:** the centrepiece of this package of options might be a save-as-you-go system for major spending areas, ensuring that intergenerational transfers do not take place.¹⁸

¹⁸ These are not necessarily the actual option packages we will be presenting – they are just examples to illustrate the concept.

37. Presenting options in this way would challenge people to think about what their values are, and confront what those values mean in practice.

Question for the Panel – Do you think there is merit in using different fairness concepts to demonstrate possible packages of options?