forethought

A survey of ideas, trends, people, and practices on the business horizon

Aaron Leighton

GRIST

When Economic Incentives Backfire

by Samuel Bowles

Organizations and societies rely on fines and rewards to harness people's self-interest in the service of the common good. The threat of a ticket keeps drivers in line, and the promise of a bonus inspires high performance. But incentives can also backfire, diminishing the very behavior they're meant to encourage.

A generation ago, Richard Titmuss claimed that paying people to donate blood reduced the supply. Economists were skeptical, citing a lack of empirical evidence. But since then, new data and models have prompted a sea change in how economists think about incentives – showing, among other things, that Titmuss was right often enough that businesses should take note.

Experimental economists have found that offering to pay women for donating blood decreases the number willing to donate by almost half, and that letting them contribute the payment to charity reverses the effect. Consider another example: When six day care centers in Haifa, Israel, began fining parents for late pickups, the number of tardy parents doubled. The fine seems to have reduced their ethical obligation to avoid inconveniencing the teachers and led them to think of lateness as simply a commodity they could purchase.

Dozens of recent experiments show that rewarding self-interest with economic incentives can backfire when they undermine what Adam Smith called "the moral sentiments." The psychology here has eluded blackboard economists, but it will be no surprise to people in business: When we buy, sell, produce, consume, or save, we are not only trying to get stuff – we are also trying to be a certain kind of person. People desire to be esteemed by others and to be seen as ethical and dignified. And they don't want to be taken for suckers. Rewarding blood donations may backfire because it suggests that the donor is less interested in being altruistic than in making a buck. Incentives also run into trouble when they signal that the employer mistrusts the employee or is greedy. Close supervision of workers coupled with pay for performance is textbook economics – and a prescription for sullen employees.

Perhaps most important, incentives affect what our actions signal, whether we're being self-interested or civic-minded, manipulated or trusted, and they can imply – sometimes wrongly – what motivates us. Fines or public rebukes that appeal to our moral sentiments by signaling social disapproval (think of littering) can be highly effective. But incentives go wrong when they offend or diminish our ethical sensibilities.

This does not mean it's impossible to appeal to self-interested and ethical motivations at the same time – just that efforts to do so often fail. Ideally, policies support socially valued ends not only by harnessing self-interest but also by encouraging public-spiritedness. The small tax on plastic grocery bags enacted in Ireland in 2002 that resulted in their virtual elimination appears to have had such an effect. It punished offenders monetarily while conveying a moral message. Carrying a plastic bag joined wearing a fur coat in the gallery of antisocial anachronisms.

Understanding why Irish shoppers responded positively to the fine, unlike Haifa parents, is the next challenge. How to reliably design synergistic incentives will be a hot topic for behavioral economists in the coming years. Meanwhile, organizational and social policy makers would do well to examine their incentive systems to see whether they're unwittingly encouraging the opposite of the behavior they desire.

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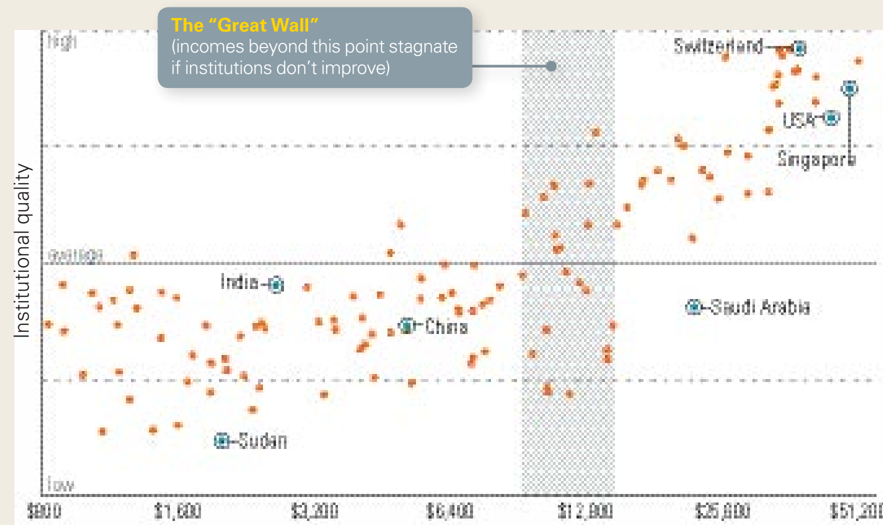
DATA POINT

Another Challenge to China's Growth

by Antonio Fatás and Ilian Mihov

How long can China's economy continue to grow? Not much longer, we suspect, unless the country engages in deep structural reforms that improve its institutions. It's well known that countries' economic performance is related to institutional quality, which is gauged by factors like political stability, government efficiency, and the prevalence of corruption. China has sustained high growth rates in recent years despite its poor institutions because institutional quality is relatively less important in developing economies. However, we find that as their incomes increase, such countries need good institutions in order to reach the income levels of advanced economies. This chart links institutional quality, measured as the average of six governance indicators produced by the World Bank, to income per capita in 2007. There is only a mild positive relationship between the two variables below $10,000 per capita. After that, the relationship becomes very strong. We call the barrier around $10,000 to $12,000 the Great Wall. Without reform, countries hit that wall and stagnate.

Consider the Soviet economies prior to the 1980s. They grew fast for a time, despite the absence of market-supporting institutions. But once incomes approached the Great Wall, economic problems emerged; indeed, the Soviet bloc collapsed as incomes reached approximately $12,000. To produce value above this threshold, economies need complex organization of production, which is possible only with good institutions.



Income per capita in $US for 2007

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