Common Sense Economics

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The Power of Incentives
By Dwight Lee
Audio (8:19 minutes)
Common Sense Economics, Part 1, Element 1

Question for thought: As you listen, think about what incentives are and why they matter.

The surest way to get people to behave in desirable ways is to reward them for doing so—in other words provide them with incentives. This is so obvious that you might think it hardly deserves mention. But it does.

You might say that people shouldn’t have to be rewarded (or bribed) to do desirable things. Even when you acknowledge that incentives are necessary, it is not obvious how to establish the ones that motivate desirable action.

I recently encountered the emotional resistance some people have to using incentives to accomplish good things. I was pointing out that the elephant populations in Zimbabwe and South Africa were expanding because policies there allow people to profit from maintaining elephant herds. A student who had stressed his environmental sensitivity responded that he would rather not see the elephant saved if the only way to do so was by relying on people’s greed. In other words, he was willing to stand on principle as long as only the elephants suffered the consequences. His principle, one that I suspect was shared by others “with similar convictions”, was that good things should be motivated by compassion and concern, not self-interest. I couldn’t resist telling him that I would be impressed with his moral stance if, when he required delicate surgery to save his life, he refused to go to a surgeon and let his mother perform the operation instead.

Convincing people that incentives are appropriate is not nearly as difficult as determining the appropriate incentives. Of course, we want incentives that motivate people to behave in desirable ways, but what is desirable? In some situations, the answer is rather obvious. But not always.

Every time you do a good thing, you necessarily reduce your ability to do something else good. This is an unavoidable implication of scarcity and is captured in the concept of opportunity cost. There are always tradeoffs, and we often need information from many sources to know the best course of action. So the two important functions of incentives are: (1) to communicate information on the best things to do and (2) to motivate people to do them.

Incentives and the Treatment of Prisoners

In some cases the desirable course of action is clear, and these cases let us concentrate on the power of incentives to motivate people. The British government's practice of contracting with ship captains to transport prisoners to Australia in the 1860s provides a good example. The survival rate of the prisoners shipped to Australia was only 40 percent, which everyone knew was much too low. Humanitarian groups, the church, and governmental agencies appealed to the captains on moral grounds to improve the survival rate with more decent treatment. Despite these appeals, the survival rate remained at 40 percent.

Finally, an economist named Edwin Chadwick recommended a change in incentives. Instead of paying the captains a fee for each prisoner who walked onto the ship in England, Chadwick suggested paying them for each prisoner who walked off the ship in Australia. The improvement was immediate and dramatic. The survival rate increased to over 98 percent, as the captains now faced a strong incentive to protect the health of prisoners by reducing the number crowded into each ship and providing them with better food and hygiene in passage.[1]

Creating Incentives Directly and Indirectly

Desirable incentives can sometimes be created directly, as in the case of shipping prisoners. You know what you want done, so you create a reward (say, a cash payment) for doing it. Unfortunately, in most cases the type of behavior we desire requires subtly balancing competing objectives. In such cases, creating a direct incentive to do one thing can be *too* effective because it causes people to ignore other things.

The former Soviet Union was full of the perversities that can result from the direct application of incentives. Managers responded to incentives to increase the production of shoes, for example, by making only a few sizes, hardly caring which sizes best fit consumers. Such incentives affected people's behavior, but they failed to promote the social cooperation necessary for a productive economy.

When the objective is to motivate people to cooperate, desirable results can rarely be realized by directly establishing incentives. Instead, incentives have to be established indirectly through a set of general rules that allow them to emerge from social interaction.

Traffic demonstrates the importance of general rules in motivating cooperation. As aggravating as rush-hour traffic is, traffic flows reflect an amazing amount of spontaneous social cooperation. Without that cooperation, tens of thousands of commuters in every large city would get caught in a hopeless tangle of traffic. The basic rules that allow motorists to so effectively cooperate with one another are simple: (1) drive on the right side of the road; (2) go on green, either speed up or prepare to stop on yellow, and stop on red; (3) don't exceed the posted speed limit by more than ten miles per hour; and (4) don't touch. These rules convert our incentive to get to our destinations safely and conveniently into a pattern of accommodating behavior that serves the interests of all.[2]

The market economy is the ultimate example of how a set of rules can create a setting in which private incentives motivate social cooperation.

Market economies do not create incentives directly. Indeed, in a literal sense, markets don't create incentives at all. The most important incentives come from the subjective desires of individuals: the incentive to find love, to earn respect, to make the world a better place, to provide for their families. Markets are the rules of conduct that harmonize these various incentives by making it possible for people to communicate their desires to others. The prices, profits, and losses commonly referred to as market incentives, are created by people's interacting with one another. These incentives, which can be communicated only through markets, contain information that promotes social cooperation.

Concluding questions: Now, can you explain why private incentives are able to promote social cooperation through markets? Do you think private incentives make the world a better place? Why or why not?"

Reference:

Lee, D. R. (2003, June 1). *The power of incentives.* Foundation for Economic Education. **https://fee.org/articles/the-power-of-incentives/**

[1] For more on this example, see Robert B. Ekelund, Jr., and Richard Ault, *Intermediate Microeconomics: Theory and Applications* (Lexington, Mass.: D.C. Heath and Company, 1995), pp. 21–22.

[2] 2. The example of traffic flow comes from Paul Heyne, *The Economic Way of Thinking*, 8th ed. (Upper Saddle River, N.J.: Prentice-Hall, Inc.), chapter 1.