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

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 in- spires high performance. But incentives can also backfire, diminishing the very behaviors they’re meant to encourage.

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—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 elimina- tion 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 reli- ably 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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experimentation next challenge to China’s Growth

by Antonio Fatas 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, de- spite 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.

Comparing the United States to China, we notice a similar threshold. As incomes reach approximately $10,000, the U.S. growth rate slows, and with incomes approximately $12,000, it levels off. The U.S. Great Wall, as it were, is lower than China’s, but it is the same phenomenon: institutional quality is required to get past the barrier, and with it, the economy can grow at a high rate.

China has achieved impressive growth for decades, but its institutions have remained poor. Therefore, we believe this is the Achilles heel of its growth. Once China begins to improve its institutions, we think its economic trajectory will resemble the U.S. One theory is that institutional quality is the key to China’s growth, a phenomenon known as the Great Wall Effect.

We think institutional quality is a hot topic for behavioral economists and for public policy makers. We find that institutional quality is a public good, in the sense that it is non-excludable: the Chinese government can’t exclud- e its citizens from enjoying better institutions. Likewise, the Chinese government can’t exclude foreign investors and firms from gaining access to a better institution.

In the past, China’s institutions have kept out foreign investors and firms, but as its economy continues to grow, they will begin to demand better institutions, which is the rationale of this paper. We believe that once China reaches a critical level of institutional quality, its economic growth will be self-sustainable. China will become a superpower in its own right, one that can afford to buy and sell in the world market, not just with its own citizens. We think this is the case for no other country except China. For this reason, we think China’s growth is not sustainable, and we believe that it will be unable to sustain a high growth rate for a very long time.

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