Incentives (from *Freakonomics*, D.Levitt and Stephen J. Dubner, 2005)

Imagine for a moment that you are the manager of a day-care center. You have a clearly stated policy that children are supposed to be picked up by 4 p.m. But very often parents are late. The result: at day's end, you have some anxious children and at least one teacher who must wait around for the parents to arrive. What to do?

A pair of economists who heard of this dilemma—it turned out to be a rather common one—offered a solution: fine the tardy parents. Why, after all, should the day-care center take care of these kids for free?

The economists decided to test their solution by conducting a study of day-care centers in Haifa, Israel. The study lasted twenty weeks, but the fine was not introduced immediately. For the first four weeks, the economists simply kept track of the number of parents who came late; there were, on average, eight late pickups per week per day-care center. In the fifth week, the fine was enacted. It was announced that any parent arriving more than ten minutes late would pay $3 per child for each incident. The fee would be added to the parents' monthly bill, which was roughly $380.

After the fine was enacted, the number of late pickups promptly went... up. Before long there were twenty late pickups per week, more than double the original average. The incentive had plainly backfired.

Economics is, at root, the study of incentives: how people get what they want, or need, especially when other people want or need the same thing. Economists love incentives. They love to dream them up and enact them, study them and tinker with them. The typical economist believes the world has not yet invented a problem that he cannot fix if given a free hand to design the proper incentive scheme. His solution may not always be pretty—it may involve coercion or exorbitant penalties or the violation of civil liberties—but the original problem, rest assured, will be fixed. An incentive is a bullet, a lever, a key: an often tiny object with astonishing power to change a situation.

We all learn to respond to incentives, negative and positive, from the outset of life. If you toddle over to the hot stove and touch it, you burn a finger. But if you bring home straight As from school, you get a new bike. If you are spotted picking your nose in class, you get ridiculed. But if you make the basketball team, you move up the social ladder. If you break curfew, you get grounded. But if you ace your SATs, you get to go to a good college. If you flunk out of law school, you have to go to work at your father's insurance company. But if you perform so well that a rival company comes calling, you become a vice president and no longer have to work for your father. If you become so excited about your new vice president job that you drive home at eighty mph, you get pulled over by the police and fined $100. But if you hit your sales projections and collect a year-end bonus, you not only aren't worried about the $100 ticket but can also afford to buy that Viking range you've always wanted—and on which your toddler can now burn her own finger.

An incentive is simply a means of urging people to do more of a good thing and less of a bad thing. But most incentives don't come about by themselves. Someone—an economist or a politician or a parent—has to invent them. Your three-year-old eats all her vegetables for a week? She wins a trip to the toy store. A big steelmaker belches too much smoke into the air? The company is fined for each cubic foot of pollutants over the legal limit. Too many Americans aren't paying their share of income tax? It was the economist Milton Friedman who helped come up with a solution to this one: automatic tax withholding from employees' paychecks.

There are three basic flavors of incentive: economic, social, and moral. Very often a single incentive scheme will include all three varieties. Think about the anti-smoking campaign of recent years. The addition of a $3-per-pack "sin tax" is a strong economic incentive against buying cigarettes. The banning of cigarettes in restaurants and bars is a powerful social incentive. And when the U.S. government asserts that terrorists raise money by selling black-market cigarettes, that acts as a rather jarring moral incentive.

Some of the most compelling incentives yet invented have been put in place to deter crime. Considering this fact, it might be worthwhile to take a familiar question—why is there so much crime in modern society?—and stand it on its head: why isn't there a lot more crime?

After all, every one of us regularly passes up opportunities to maim, steal, and defraud. The chance of going to jail—thereby losing your job, your house, and your freedom, all of which are essentially economic penalties—is certainly a strong incentive. But when it comes to crime, people also respond to moral incentives (they don't want to do something they consider wrong) and social incentives (they don't want to be seen by others as doing something wrong). For certain types of misbehavior, social incentives are terribly powerful. In an echo of Hester Prynne's scarlet letter, many American cities now fight prostitution with a "shaming" offensive, posting pictures of convicted Johns (and prostitutes) on websites or on local-access television. Which is a more horrifying deterrent: a $500 fine for soliciting a prostitute, or the thought of your friends and family ogling you on www.HookersAndJohns.com.

So through a complicated, haphazard, and constantly readjusted web of economic, social, and moral incentives, modern society does its best to reduce crime. Some people would argue that we don't do a very good job. But taking the long view, that is clearly not true. Consider the historical trend in homicide (not including wars), which is both the most reliably measured crime and the best barometer of a society's overall crime rate. These statistics, compiled by the criminologist Manuel Eisner, track the historical homicide levels in five European regions.

Homicides (per 100,000 people)					
	England	Netherlands & Belgium	Scandinavia	Germany & Switzerland	Italy
13th and 14th cent	23.0	47.0	n.a.	37.0	56.0
15th century	n.a.	45.0	46.0	16.0	73.0
16th century.	7.0	25.0	21.0	11.0	47.0
17th century	5.0	7.5	18.0	7.0	32.0
18th century	1.5	5.5	1.9	7.5	10.5
19th century	1.7	1.6	1.1	2.8	12.6
1900-1949	0.8	1.5	0.7	1.7	3.2
1950-1994	0.9	0.9	0.9	1.0	1.5

The steep decline of these numbers over the centuries suggests that, for one of the gravest human concerns—getting murdered—the incentives that we collectively cook up are working better and better.

So what was wrong with the incentive at the Israeli day-care centers? You have probably already guessed that the $3 fine was simply too small. For that price, a parent with one child could afford to be late every day and only pay an extra $60 each month—just one-sixth of the base fee. As babysitting goes, that's pretty cheap. What if the fine had been set at $100 instead of $3? That would have likely put an end to the late pickups, though it would have also engendered plenty of ill will. (Any incentive is inherently a trade-off; the trick is to balance the extremes.)

But there was another problem with the day-care center fine. It substituted an economic incentive (the $3 penalty) for a moral incentive (the guilt that parents were supposed to feel when they came late). For just a few dollars each day, parents could buy off their guilt. Furthermore, the small size of the fine sent a signal to the parents that late pickups weren't such a big problem. If the day-care center suffers only $3 worth of pain for each late pickup, why bother to cut short the tennis game? Indeed, when the economists eliminated the $3 fine in the seventeenth week of their study the number of late-arriving parents didn't change. Now they could arrive late, pay no fine, and feel no guilt.

In the 1970s, researchers conducted a study that, like the Israeli day-care study, pitted a moral incentive against an economic incentive. In this case, they wanted to learn about the motivation behind blood donations. Their discovery: when people are given a small stipend for donating blood rather than simply being praised for their altruism, they tend to donate less blood. The stipend turned a noble act of charity into a painful way to make a few dollars, and it wasn't worth it.

What if the blood donors had been offered an incentive of $50, or $500, or $5,000? Surely the number of donors would have changed dramatically.

But something else would have changed dramatically as well, for every incentive has its dark side. If a pint of blood were suddenly worth $5,000, you can be sure that plenty of people would take note. They might literally steal blood at knifepoint. They might pass off pig blood as their own. They might circumvent donation limits by using fake IDs.

Answer the following questions in detail <u>on a separate sheet of paper</u>:

1. Why does the writer think that incentives are at the heart of economics?
2. What's the point the writer is trying to make with all of the examples of incentives in the 6th paragraph?
3. Which incentives do you think have been most effective at reducing teen smoking? Why do you think they have worked?
4. Do you think jail or moral incentives (including feeling guilty) are more effective at deterring crime? Why?
5. The chart shows that murders have gone down a lot over time. Do you think human nature has changed over the last 800 years or that societies are better at coming up with incentives against crime? Why do you think so?
6. What does the writer mean when he says "Any incentive is inherently a trade-off; the trick is to balance the extremes"?
7. What does the writer mean when he says the Israeli daycare center "substituted an economic incentive for a moral incentive"?
8. What would be the best incentive to get you to donate blood?