

The ABC of Economic Literacy: 'I' is for incentives

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Incentives are the little magnets that guide human activity. But that doesn't mean things always go according to plan.

Take the "cobra effect": an anecdote set in the time of British rule in colonial India. In order to decrease the number of venomous cobras, the British government offered a financial incentive to the public for every dead cobra. The problem is, the government underestimated the enterprising and creative nature of the Indians. People began purposely breeding cobras in order to receive the bounty.

The problem wasn't that the public had not responded to the incentive. It was that they had responded too enthusiastically.

Such is the nature of incentive schemes. Those who offer incentives must be aware of what motivates people, where their self-interest lies, and the unintended consequences of trying to direct human behaviour.

Incentives are the reason we wake up in the morning, go to bed at night, and do everything in between.

In their simplest form, incentives are costs or benefits that motivate consumer, business or individual decision-making. In economic terms, incentives are a market mechanism for producing mutually beneficial results.

The most common example of how incentives produce mutually beneficial results, is price. Sellers have an incentive to maximise their profits, it is in their self-interest to do so. However, buyers have an incentive to get value for their dollar, and maximise their utility. Basic trade economics stipulate that the buyer and seller will arrive at a mutually agreeable price when both respond to incentives and pursue self-interest.

Of course, this is only a simplistic account. In the real world, people may continue to buy certain goods even as the price rises exorbitantly. Petrol is one example.

However, incentives are not simply the decision to buy or not to buy. On an individual level, they can also encourage creativity and innovation. The rising price of petrol could provide the incentive to take fewer frivolous trips, drive more sensibly, plan journeys that cover multiple errands, or car pool.

On a business level too, rising prices provide incentives for competitors to enter the market, seek out alternative fuel sources, or for current petrol retailers to improve their service or reduce their prices in other areas.

Because of human creativity and innovation, predicting responses to incentives is never easy. As economics professor Glen Whitman argues, "What distinguishes good economic thinking from bad is recognition of the subtle, creative, and often unforeseen ways that people respond to incentives."

The New Zealand Initiative is a Wellington-based think tank formed by the merger of The New Zealand Business Roundtable and The New Zealand Institute. www.nzinitiative.org.nz. CEO Dr Hartwich is a regular speaker at PortfolioConstruction Forum programs.
