

Rules & Incentives Matter

Rules influence incentives, and incentives influence choices.

Rules help to establish a sense of order in society and they make it easier for people to work together. In successful economies, many people work together on specialized tasks to produce and distribute goods and services. Rules (both formal and informal) foster these relationships. Rules help to create social systems in which strangers may work independently in an interdependent relationship. Specialization and interdependence are obviously important. Most people, after all, do not sew the clothes they wear, grow the food they eat, or build the homes they live in. Instead, one person's work and output are exchanged for another person's work and output. Rules can help make interaction of this sort regular and predictable. Ultimately, rules influence the incentives that people have to act in certain ways.



For better or worse, incentives modify people's behavior. When we are paid on commission, we work harder; if the price of gasoline goes up, we drive less. Incentives matter. This was one of Adam Smith's insights in *The Wealth of Nations*: "It is not from the benevolence of the butcher, the brewster, or the baker that we expect our dinner, but from their regard to their own interest." Self-interest makes the world go around – a point that may seem obvious, but one that is routinely ignored. Keep in mind, though, that human beings are complex creatures who are going to do whatever it takes to make themselves as well off as possible. Sometimes it's easy to predict how that will unfold; sometimes it is enormously complex. Nevertheless, incentives influence choices.

The greater the benefits people expect to receive from an alternative, the more people are likely to choose that option. The greater the costs expected from an alternative, the less people are likely to select it. If we understand what makes human beings tick, we can make general predictions as to how individuals or groups of individuals will respond to changes in their economic situation – in particular, how they will respond to new incentives.



Rules influence incentives, and incentives influence choices.

Rules & Incentives Matter

Activity

All countries establish rules for their economies, and these rules influence behavior. Some rules encourage people to use resources and exchange goods and services. Some rules discourage people from using resources and exchanging goods and services.

(Note: Some examples in this activity involve important religious beliefs or cultural norms. This activity implies no moral judgment of those beliefs or norms; it focuses only on whether the rules in question would be likely to encourage or discourage economic activity.)

Decide whether the rules described below would encourage or discourage economic activity. Then EXPLAIN your reasoning.

- A. In Afghanistan, under Taliban rule, women could not go to school, hold jobs, or move around in public without an escort.

- B. In Russia when it was part of the former Soviet Union, managers of nail factories were rewarded for producing large numbers of nails. No reward was given for making nails in several different sizes.

- C. In the United States, if the water in a river provides the habitat for an endangered species, the water cannot be used to irrigate crops, create electricity, or water livestock.

- D. In many parts of India, cows are considered sacred, and people are not allowed to use beef as a food.

- E. In Argentina, beef is considered an important food source, and Argentine cows are sold to people around the world.