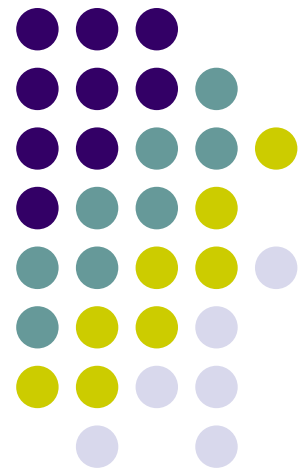


Introduction to Economics of Development

Incentives, Human Behavior
& Economic Development





Incentives and Freakonomics

- What do schoolteachers and Sumo wrestlers have in common?
 - Why did schoolteachers in Chicago cheat?
 - What did Sumo wrestlers in Japan cheat?
 - Everybody could “cheat” if stakes are “right”



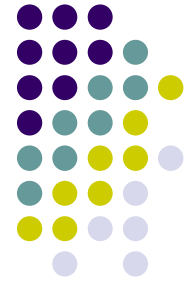
Each wrestler has fifteen bouts per tournament. If he finishes the tournament with a winning record (eight victories or better), his ranking will rise. If he has a losing record, his ranking falls. If it falls far enough, he is booted from the elite rank entirely. The eighth victory in any tournament is therefore critical. So a wrestler entering the final day of a tournament on the bubble, with a 7–7 record, has far more to gain from a victory than an opponent with a record of 8–6 has to lose.



Incentives: what are they?

“An incentive is simply a means of urging people to do more of a good thing and less of a bad thing.”

- Economic incentives
 - \$3-per-pack cigarettes tax
 - IRS and 7 million children in America suddenly disappeared in one night
- Moral incentives
 - Israeli day-care center
 - Wrong incentive backfired: \$3 fine
 - Moral incentive was substituted by wrong economic incentive. Parents buy the guilt and feel entitled to be late.
- Social incentives
 - Blood donators
 - Drop in blood donations if monetary compensation is used.
 - What if blood donators were given \$5,000?



Incentives and economic development

- *Why development aid is not working?*
 - Money is given to poor people in hopes that they will use it to invest in better farming technology, children's education, etc.
 - In reality, most people spent the money right away. Why?
 - Are poor people short-sighted?
 - Incentives for immediate spending, instead of saving and investing for the future:
 - The future prospect is not so great, maybe too much uncertainties, e.g. civil wars.
 - Inflation is high, and no sign of coming down
 - Using similar reasoning, do you think the current fiscal stimulus package will work?



A gentle reminder to Bono



Incentives and economic development

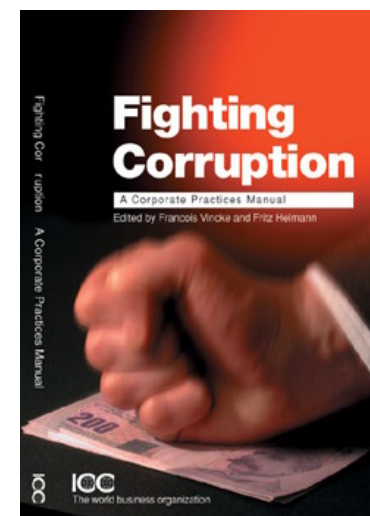
- *Why did socialism fail miserably?*
 - Socialism advocates for equal society, especially equal distributions.
 - But in a society, people are all different:
 - Some are hard working, some are not
 - Some are more talented, some are not
 - Some with higher education, some are not
 - Some with better skills, some are not
 - Equal distribution or tendency to do so distorts one's incentives to work up to his potential → unproductive workers → stagnant economy





Incentives and economic development

- *Why corruptions persist in developing countries?*
 - Corruption is often thought to be connected to one's morality: less noble men more likely to be corrupt.
 - Economists tend to think everyone has potential to be corrupt, again when the incentive is right.
 - Thus, the policy alternative to reduce corruption does not hinge so much on better education, but on how to design a mechanism to channel people's incentives not to become corrupt.





Incentives and Mechanism Design

At Penn State University, there were four sophomores taking chemistry and all of them had an "A" so far. These four friends were so confident that, the weekend before finals, they decided to visit some friends and have a big party. They had a great time but, after all the hearty partying, they slept all day Sunday and didn't make it back to Penn State until early Monday morning.

Rather than taking the final then, they decided that after the final they would explain to their professor why they missed it. They said that they visited friends but on the way back they had a flat tire. As a result, they missed the final. The professor agreed they could make up the final the next day. The guys were excited and relieved. They studied that night for the exam.



Incentives and Mechanism Design

The next day the Professor placed them in separate rooms and gave them a test booklet. They quickly answered the first problem worth 5 points. Cool, they thought! Each one in separate rooms, thinking this was going to be easy.... then they turned the page. On the second page was written....

For 95 points: Which tire? _____

Incentives and Mechanism Design

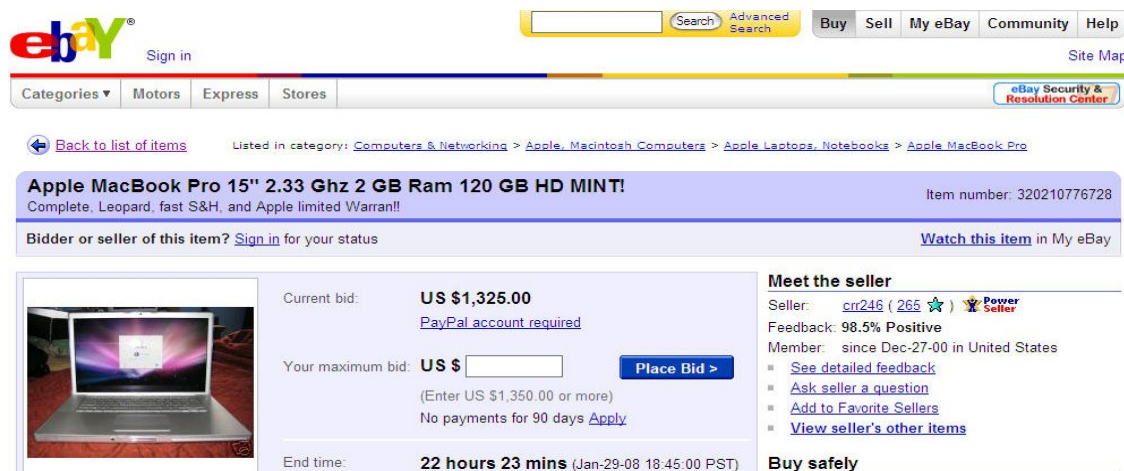


Mechanism Design at work: congestion Pricing

- To relieve city's traffic nightmare during rush hours, governments are experimenting to charge different rates on different routes: busiest routes are often charged the highest rate during rush hour.
- This mechanism uses pricing mechanism to channel people's incentives and alter their driving behavior, thus helps to divert non-work traffic to less busy routes.



Incentives and Mechanism Design

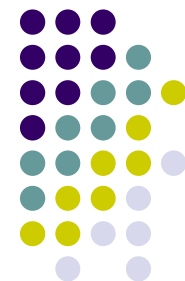


Mechanism Design at work: Ebay's seller feedback system

- Buyers feel safer to buy from the seller with higher feedback scores. This is especially true for big-ticket items.
- In essence, the feedback system provides a mechanism of alleviating the information asymmetry problem, where buyers treat the score as a proxy for seller's reputation, thus less likely the fraud will happen.
- What's the implication for international trade? How is it related?



The Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel 2007



The design of economic institutions

Adam Smith's classical metaphor of the invisible hand refers to how the market, under ideal conditions, ensures an efficient allocation of scarce resources. But in practice conditions are usually not ideal; for example, competition is not completely free, consumers are not perfectly informed and privately desirable production and consumption may generate social costs and benefits. Furthermore, many transactions do not take place in open markets but within firms, in bargaining between individuals or interest groups and under a host of other institutional arrangements. How well do different such institutions, or allocation mechanisms, perform? What is the optimal mechanism to reach a certain goal, such as social welfare or private profit? Is government regulation called for, and if so, how is it best designed?

These questions are difficult, particularly since information about individual preferences and available production technologies is usually dispersed among many actors who may use their private information to further their own interests. Mechanism design theory, initiated by **Leonid Hurwicz** and further developed by **Eric Maskin** and **Roger Myerson**, has greatly enhanced our understanding of the properties of optimal allocation mechanisms in such situations, accounting for individuals' incentives and private information. The theory allows us to distinguish situations in which markets work well from those in which they do not. It has helped economists identify efficient trading mechanisms, regulation schemes and voting procedures. Today, mechanism design theory plays a central role in many areas of economics and parts of political science.



Incentives and Mechanism Design

- Some questions to think about:
 - How to design a mechanism or institution to make “lazy” people work harder?
 - What incentives to give to women in Western countries with declining fertility to have more children?
 - How would you design a mechanism or policy to make Americans less dependent on oil?
 - What mechanism would encourage firms to engage more in pollution reduction?