

## *Research Article*

# Incentives: The Scaffolding that Keeps Economic Orthodoxy from Teetering into Oblivion?

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**Abstract:** Incentives are commonly perceived to be one of the primary motivational forces that drive a capitalistic economy. By in large, they are seen within the orthodox economic disciplinary field as the counterpart to self-interest and rational choice theory. They are described as not merely wanted but needed. The aim of this paper is to invalidate the myth that incentives are necessary for the regeneration of society. Instead, it is put forward that the two fundamental components required are human instincts and habits (which encompass norms, mores and values). In this light, the explanation of incentives as a driving mechanism for economic renewal becomes diminished.

## **Introduction**

The word incentive is thrown around willy-nilly these days. Its pervasiveness leaves one to wonder if humans are left with any natural instincts at all. The argument for incentives would seem to suggest that left to our own devices we would rot away while watching reality TV. Incentives then are presumed to be needed, not merely wanted. This argument is also adopted to partially explain our capitalistic economic system. Human behavior, it is argued, responds to incentives. This position would imply that incentives drop from the sky like manna from heaven and put people to work. Given the „proper“ incentives and a few other assumptions regarding human behavior (self-interest and rationality), individuals will be made to be productive and in so doing generate enough goods and services to create equilibrium within the socioeconomic system.<sup>xxxviii</sup> But this argument is absurdly narrow in the way that it defines human behavior and moreover it entirely neglects the problem of origination. It is an argument largely proposed by neoclassical or orthodox economics. If however we perceive humans as complex and heavily influenced by institutional social factors—which is clearly closer to the reality of the world—incentives begin to lose their weight and validity with respect to the argument.

Incentives in this light are not isolated forces but are determined by our organizational and institutional structure (capitalism) as well our overarching belief system, methodological individualism. In other words, what type of incentives our society generates will be dependent upon what types of institutions it possesses which in turn is itself dependent upon our society’s belief system. Given our current state of affairs regarding these two, most individuals would advocate, whether economist or not, that „proper“ incentives are not only beneficial for society but necessary. The aim of this paper is to invalidate this myth by

making use of the Institutionalist approach. Incentives, it will be argued, are not necessarily needed to regenerate society. This is not to say that all incentives are valueless but that our uses of them are misplaced. For instance, we use incentives as a justification or rationalization of individual behavior when in fact the behavior was not an individual problem at all but a social one. Instead of arguing for incentives as the *modus operandi* of economic forces, it will be argued that the essential attributes needed for regeneration are human instincts and culturally formed habits and norms. It is only because economic orthodox theory has held supremacy over the past five to six decades that the belief in the critical role of incentives has flourished. The organization of this paper is as follows: section two will address the pundit's perception of incentives, section three will define self-interest and incentives, section four will briefly discuss orthodox and Institutional economics theories on this topic, section five will discuss the role of incentives in capitalism and section six will contain the conclusion.

### **Conventional Wisdom**

After the most recent capitalist crisis in the United States (the 2008 financial/housing crisis), explanations surrounding its collapse abounded. But a consensus began to form around one explanation in particular—the problem of incentives. The system, it was argued, must have a proper incentive structure. When it fails to do so, the result is an inevitable crisis. Though this argument could be seen in the endless loop of the 24 hour news cycle, it also appeared in blogs and newspapers. Thus, following this logic, a new incentive structure is needed to keep a capitalistic economy stable. It is an argument that neither addresses how the present incentive structure came to be, how we would change it nor the problem surrounding

positive and negative incentives. The implicit implication is that incentives must carry positive externalities, i.e. incentives that will not crash the system. But who defines what „proper“ incentives are? Who benefits from these incentives once put into place? Why are they so critical to the inner workings of a capitalist system? And where do incentives, positive and negative alike, come from? These questions will be addressed in the following sections by analyzing the theoretical frameworks of both orthodox and heterodox economic theory. However it is necessary to first address the issue of defining incentives. The concept of self-interest will also be assessed do to its conflation with incentives as well as its essential role in both theories.

### **Incentives and Self-Interest: What Are They?**

Generally speaking, the prevailing tendency surrounding the view of incentives and self-interest in a booming capitalistic system is one of conflation, as if they were both drawn from the same well, but they are most definitely not the same nor do they share the same source. The conflation of the two is more common when society’s socioeconomic institutions are experiencing an upswing. It follows from this line of reasoning that incentives and self-interest are aligned; or, that incentives generated by the structural socioeconomic system stem from each individual’s self-interest. The supporting belief- system of this perception is methodological individualism and self-regulating market forces. When institutions are running smoothly and generating growth, the invisible hand works its magic and aligns self-interest with a functional and proper incentive structure. However, when the system begins to experiences a downturn the distinctions between the two are underscored. It is imperative then that we have a distinct understanding of the two. According to *Webster’s Online Dictionary*,

incentive is defined as “something that incites or has a tendency to incite to determination or action”, while self-interest is defined as “a concern for one’s own advantage and well-being”. While not explicit in the definition, incentives almost always carry rewards or punishments. Two obvious distinctions can be drawn from this. One, whereas incentives are exogenous, self-interest is endogenous, and two, only incentives carry outside rewards or punishments. One implication in respect to the motivation of self-interest is that actions undertaken by individuals come from within and do not require outside stimuli as a force to action. This is not to say that outside forces do not influence and internally direct what the individual motivators are (society is always doing this) but that humans have a set of instinctual behaviors. The internal forces within human individuals incorporate an entire range of motivations from base economic needs to philosophical self-actualization. Moreover, it is self-interest not incentives that become aligned with the social norms of society. Incentives do not have this characteristic, for if they did they would cease to be an incentive by definition.

Self-interest is yet another way of saying that humans have intrinsic motivators. Much of the scholarly work done in modern psychology supports this perspective. Intrinsically motivated behaviors are those whose motivation is based in the inherent satisfactions of the behaviors per se, rather than in contingencies or reinforcements that are operationally separable from those activities (Deci and Ryan 10). Underlying this concept of self-interest is the theory that humans have an innate propensity towards growth and unity. This is of course in direct contrast to operant behaviorists who theorize that the regulation of behavior along with one’s personality is determined by current contingencies. The concept of self-interest as intrinsic motivator is not a denial of environmental conditioning but a starting point of development. In other words, humans have tendencies to originate interconnections within

their own consciousness along with other individuals and/or in groups—we have, as it were, both autonomy and homonymy (ibid 5). Self-interest is markedly different then from incentives in that they are provided to the individual from outside the self. The difference is a question of the starting point. When considering the nature of incentives, one should begin at the level of institutions, but when considering the nature of self-interest one should begin at the level of the individual. Incentives are directed outward from societal institutions and onto individuals. Self-interest begins inward and is directed outward onto society. This is not, however, a never the twain shall meet condition—it is a generalization on originating forces.

### **Self-interest and Incentives in Economics**

Adam Smith is almost entirely without question the father of modern economic theory on self-interest. The interpretation of Smith's self-interest though has been widely split in economics. In brief, orthodoxy defines self-interest as a motivating principle for the attainment of the material aspects of life (food, clothing, housing etc). This allows for a decentralized decision-making process. It also defines individuals as atomistic and rational. Together with competitive markets, these characteristics will achieve maximum utility for the individual and Pareto-efficiency for society. This theory of human behavior makes no room for social relations, institutions or for that matter evolution. It is a narrow interpretation and pulls directly from Smith's famous quote of the lack of benevolence on the part of the butcher, brewer and baker. From Edgeworth's (1881) declaration, „the first principle of economics is that every agent is actuated only by self-interest (16), to modern day standard economic textbooks, self-interest with its corollary rational choice theory (RTC), has been the predominant explanation for human economic behavior.xli Humans, under the guise of

orthodoxy have been christened homo economicus.

Not surprisingly, this is but only one of several other interpretations and theories on self-interest. Heterodox economic theory views self-interest through the prism of society and its institutions. Humans are not seen as automatons singularly maximizing utility, but rather as complex beings. To this extent, Smith's famous quote of the invisible hand is put back into context and considered alongside his *Theory of Moral Sentiments*. From this perspective individuals do not act in isolation but within the social world. Therefore, humans by the evolutionary forces of nature must live amongst each other and not in a vacuum. "It is thus that man, who can subsist only in society, was fitted by nature to that situation for which he was made" (Smith 124). This obvious recognition, that the human experience never lacks a social dimension, though profound in a general way is yet only a surface-level observation. Smith understood this well and went on to define several different forms of human instincts. In conjunction with self-interest (the instinct for self-preservation and personal well-being) he also identified two others, the instinct of affection/generosity and the instinct of hatred/resentment (Wight 99). He astutely acknowledged the multidimensionality of humans in terms of individuality and in terms of social relations. Consider a passage in *The Theory of Moral Sentiments*:

Concern for our own happiness recommends to us the virtue of prudence; concern for that of other people, the virtues of justice and beneficence—of which the one restrains us from hurting, the other prompts us to promote that happiness. Independent of any regard either to what are or to what ought to be, or to what upon a certain condition would be the sentiments of other people, the first of those three virtues is originally recommended to us by our selfish, the

other two by our benevolent affections. Regard to the sentiments of other people, however, comes afterwards both to enforce and to direct the practice of all those virtues (Smith 385).

Smith is specifically addressing characteristics of human behavior and instincts within a social setting. And not only are social institutions addressed but they are said to exist as a guiding mechanism, as a necessity in the renewal of virtues. In this way, they behave as forces for the betterment of humanity. This is just another way of saying that all cultures exhibit norms, values and mores that are necessarily formed through collective social interaction.

Although the heterodox theories to emerge out of Smith's conception of human behavior and instincts were many, for instance, Marxism, the German Historical School, Institutionalism, Keynesianism and Post-Keynesianism, it is argued here that it is Institutionalism that more fully incorporates this conception. Thorstein Veblen, in particular, emphasized, expanded and integrated them into a comprehensive theory of social economics. Veblen, like Smith, considered instincts as one of two explanations for human behavior. Unlike Smith, Veblen identified the instinct of workmanship and to some degree the instinct of parental bent as the contributing factors for societal regeneration; social habits would constitute the remaining explanation for human behavior. Though these two motivational forces (human instincts and habits) sometimes worked together and sometimes at cross-purposes, it was quite clear that there existed a demarcation between them. Instincts were innate to individuals, whereas habits were the propensities individuals formed through the process of institutional molding (Hodgson 164). Suffice to say, instincts and habits for Veblen, though a complicated lattice-work, underlined much of the behavior patterns of humans and became a fundamental object of study:

The instincts, all and several, though perhaps in varying degrees, are so intimately engaged in a play of give and take that the work of any one has its consequences for all the rest, though presumably not for all equally. It is this endless complication and contamination of instinctive elements in human conduct, taken in conjunction with the pervading and cumulative effects of habit in this domain, that makes most of the difficulty and much of this interest attaching to this line of inquiry (Veblen 316).

Instincts and habits are therefore the fundamental forces impelling humans to action and reaction—instincts providing the intrinsic motivations, habits the extrinsic motivations. In this context it is not necessary to have a specified incentive structure; through our natural proclivities and our institutions, we are more than capable of regenerating society.

### **Incentives**

Where and how do incentives enter into heterodox and orthodox theories? As just mentioned, Institutionalism has little if any need for them. And this is why, by and large, that they are conspicuously absent from the theory. Polanyi (1968) has argued that the motivations and incentives that our belief system or what he calls our “practical philosophy” promulgates (that incentives of everyday life spring from material motives) are obsolete in our present form of capitalistic organization (60-61). What then compels a person living in the modern world towards work? Heilbroner (1988), Galbraith (1967) and Mills (2000) submit alternative explanations respectively in lieu of our modern day obsolete belief system:

Work has become the avenue to enjoyments that were previously the prerogative only of those who did not work. Although work may be

minuscule compared with those that accrue to property, the kinds of pleasures they afford are measured in the same coin of self-esteem and the approval of the world. The capitalist relationship of free contractual engagement opens the possibility of social advancement to ordinary men, and ordinary men come crowding in to seize the opportunity (Heilbroner 94).

The individual, on becoming associated with the group, may conclude that its goals are superior to his own. Humans, in contrast to machines, evaluate their own positions in relation to the value of others and come to accept others' goals as their own. Such an exchange is not compelled. Neither is it purchased, although it is not inconsistent with compensation, this motivating influence may be called identification (Galbraith 131).

Status follows the big hierarchies. Status follows the big money, even if it has a touch of the gangster about it. Status follows power, even if it be without background. Below, in the mass society, old moral and traditional barriers to status break down and Americans look for standards of excellence among the circles above them, in terms of which to model themselves and judge their self-esteem (Mills 357-358).

In other words, the motivations surrounding work is the hope for an advancement in social status. Clearly, incentives play but a very limited role if any in this account. As Veblen would also argue, and can be found throughout his *Theory of the Leisure Class*, institutions in society are essential in directing individuals and groups and the desire for acceptance and prestige

within it, is a habitual constant.

For orthodoxy, on the other hand, incentives play a vital role in its theory. This is because it has no theory of social relations, no theory of institutions and no 'real' theory of value. They are needed to explain a wide range of economic actions that cannot be explained by its narrow definition of self-interest. Here is Professor Mankiw, in Principles of Microeconomics:

An incentive is something (such as the prospect of a punishment or a reward) that induces a person to act. Because rational people make decisions by comparing costs and benefits, they respond to incentives. You will see that incentives play a central role in the study of economics. One economist went so far as to suggest that the entire field could be simply summarized: People respond to incentives. The rest is commentary (7).

It is evident from this passage that for incentives to work properly individuals must be rational and capable of weighing costs and benefits. If this were not the case, incentives would fail to be effective and be of no use. For example, an irrational person may or may not respond to an incentive. Their choice would then become random. This would also be true if one was incapable of weighing costs and benefits. To properly understand the orthodox concept of incentive, it must be regarded in conjunction with the premise of rationality. Without the parameters of self-interest and rationality, incentives are without meaning in this theory. What is more, implicit implications can also be found within the passage. Specifically that incentives have positive attributes for the economy. For orthodox theory, they are effective and valuable. But as discussed in section two, not any old incentive structure will be adequate. It must be one that generates positive externalities.

What would happen if they failed to be effective? A serious problem arises within the orthodox theory when incentives exhibit negative characteristics. For instance, the 2008 financial crisis has been partially accredited to a perverse incentive structure. How would orthodoxy explain the development and proliferation of these perverse incentives? Usually by branding those individuals as bad apples, as aberrations. Of course this assumption implies that the socioeconomic system (capitalism and its belief system) normally generates a positive incentive structure, but, and this is a crucial point, this generation is done through individual actions alone. There is no collective institutional force involved. But how is it possible that the aggregated behavior of rational, atomistic agents acting in competitive markets could generate negative or positive externalities as a whole? Leaving aside the issue of rationality, this could only be possible if incentives were endogenous to the self, but clearly, as we have seen, they are not. Individuals do not generate incentives independently of other individuals. In times of optimism and increasing growth, the conflation of self-interest and incentives is a moot point. It is convenient simply to pile incentives on to the theory of self-interest. But it is all that more difficult to explain during waves of pessimism, rising unemployment and crises because it becomes clear that the two are in effect quite disparate. Unquestionably, incentive structures do not develop from individuals maximizing their utilities.

However, orthodoxy does offer a remedy for perverse incentive structures. The solution is to simply put in the proper incentives (i.e. a fixed set) and capitalism can go about its merry Pareto-efficient way. Though there have been many criticisms of this theory, the most glaring among them is clearly the lack of any theory or explanation regarding the origins of incentives themselves. They have no theory to what generates incentives, whether good

or bad. They are taken as given, as if appearing out of thin air.

### **Capitalism's Reliance Upon Incentives**

Thus far, it has been argued that economic orthodoxy relies on incentives as an explanation for human behavior and one of the primary motivational forces driving the economy. But as we have seen, incentives, in general, are not a good measure for this especially when they are taken merely as given, i.e., without any institutional grounding. Incentives are a product of social, cultural and institutional shaping. From the vantage point of Institutionalism, incentives spring from institutions themselves. They, much like habits, norms, mores and values, arise out the socialization process. And as also argued, although incentives can play beneficial roles in society, they are not necessarily needed for its regeneration. With this in mind, why then do we find incentives so prevalent in our society? Historically, societies have not relied heavily upon the role of incentives as motivating forces, so why have they become so ubiquitous in ours?

The overarching *raison d'être* for the pervasiveness of incentives is that capitalism relies upon them as a proxy to get individuals to not only keep supplying labor but to keep them contented with their work. It is true, as discussed in section 4.2 that the strong desire for acceptance and status seeking impels individuals to work and it is true that individuals have an instinctual proclivity towards work. But it is also true that under the capitalistic socioeconomic structure, the majority of laborers are submitted daily to exploitation, or submission. In large part the incentives generated are pecuniary but these alone are not enough to keep the idea of the denigration of work from continually forming. An entire industry (the Motivational Industry) has risen in the U.S. to fulfill the role of mind

manipulation. In the hands of employers, positive thinking has been transformed into something its nineteenth-century proponents probably never imagined—not an exhortation to get up and get going but a means of social control in the workplace, a goad to perform at ever-higher levels (Ehrenreich 100,116).

Part of the need for this incentive-driven motivation is because capitalism is structured in hierarchical form and carried out in military-like fashion (Heilbroner, 1998; Veblen, [1904] 1996). Is there any wonder why banks (financial and investment) and mortgage brokers created incentives that would benefit themselves while simultaneously destroying the wealth of their clients? Capitalism's mantra since its inchoate beginnings has been methodological individualism, competition, pecuniary gain at any cost and persistent growth. Capitalism's structure is a military formed hierarchy. The perverse incentives that brought down the financial and housing markets as well as the rest of the economy in 2008 were simply the everyday enactment of its belief system. It was simply an outgrowth of business culture—the norms, mores and habits of the business enterprise. The perverse incentives were a product of capitalism's structure and belief system not a maker of it. Explicating, 'people respond to incentives' really tells us nothing about how capitalism's socioeconomic system works. Rather we must look at the institutions, their structures and the belief system they disseminate to get an understanding of where, who and how incentive structures come into and out of being.

For orthodoxy to recognize this simple fact would require it to accept the pivotal role of institutions on the interconnectedness of the social world, the natural instinctual behaviors of humans as individuals and a diminishment of the power of incentives—in short the embeddedness of the economy. The orthodox argument then for

incentives is thus of utmost importance, for they are the struts in its shell of a theory. It is therefore necessary in our current belief system or, in Polanyi's terms our practical philosophy that we insist upon incentives as motivators to economic production.

## **Conclusion**

Orthodox economics is alone in the social sciences as describing the individual as atomistic, self-interested and rational. With humans so narrowly defined the theory requires additional scaffolding for support. Employing incentives achieves this end. However, as we have seen, humans are much more complex, have intrinsic or natural instincts to productivity and are always found in a social environment dominated by social institutions. It is not necessary then to allocate such a large role to incentives in economic production, or in anything else for that matter. Unfortunately, as Polanyi, along with many others, have made evident, our belief system still propagates and disseminates the market mentality. This mentality emanates from orthodox theory itself, where self-interest, material motivation and methodological individualism reign supreme. The vested interests will persevere and do their best to continue the dissemination of such a mentality despite all the evidence to the contrary. In attempting to overcome such an omnipresent and enshrouded belief system, we must engage on a philosophical normative level not solely on an empirical scientific one. This is an outright battle, but it is a battle over minds.

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