Ec240: Markets, Motivation, & Welfare

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THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE


Economics for the Common Good
Jean Tirole
Economic Analysis, Moral Philosophy, and Public Policy
THIRD EDITION
MICHAEL SANDEL
WHAT MONEY CAN'T BUY
The Moral Limits of Markets
WHY SOME THINGS SHOULD NOT BE FOR SALE
THE MORAL LIMITS OF MARKETS
DEBRA SATZ
DANI RODRIK
ECONOMICS RULES
why economics works, when it fails, and how to tell the difference
'Charming, funny and inspiring — Fantastic stuff'
BBC RADIO 4 REITH LECTURER 2009
MICHAEL J. SANDEL
JUSTICE
WHAT'S THE RIGHT THING TO DO?

Motivation

- The narrow self-interest driven view of individuals in the economic domain has increasingly come under question.

- Recent work in economics has moved beyond stylized models of motivation based on a narrow view of *homo economicus* who cares about only money and leisure, and have embraced a wider perspective on motivation.

- In this research seminar, we will examine various aspects of this broad theme.

Topics

- The first lecture will look at how does motivation (whether due to moral values such as altruism and pro-sociality, reciprocity and fairness, social norms, reputational and identity concerns etc) interact with market forces – e.g., do market forces crowd out moral behaviour and should there be limits to markets?

- The second lecture will discuss the concept of altruistic capital as an asset that facilitates altruistic acts and that can be shaped by policies. This opens the possibility that an intervention that increases he returns to altruistic capital triggers a virtuous circle that leads to pro-social behaviour and the accumulation of more altruistic capital.

- The third lecture will discuss how pro-social motivation and incentive pay interact in the context of public service delivery.

- The fourth lecture will examine the issue of how motivation is formed (e.g., a worker's loyalty to a firm), the role of socialization and identity, social norms, & how do social norms and altruistic preferences evolve dynamically

- The fifth and final lecture will look at social entrepreneurship.
  - The traditional belief that markets are the most efficient way of producing private goods, while the government takes care of public goods and services while also correcting a range of market failures is no longer tenable.
  - There is an increasing importance of private social-sector organizations such as non-profits, NGOs, and social enterprises.
  - This lecture will examine how these organisations work, in what way they are different from standard (for-profit) firms, and how they survive in a market economy.

Schedule

- The course will include lectures given by researchers from inside and outside LSE. The lectures will expose the students to research on the frontier in topics such as public economics, political economy and decision making in the public domain.
- This research and background reading will then be discussed in seminars. The seminars will discuss the *previous* lecture as well as examining background reading related to the topic.
- Each term will consist of a series of biweekly lectures (5 x 90mins) and seminars (5 x 60mins).
- Lectures will be given by speakers on a specific topic, and will allow for the opportunity to interact and ask questions.

Speakers

All lectures except for the one by Nava Ashraf will take place at PAR.1.02 (Parish Hall on the LSE campus, room 1.02) from 18-19.30.

Lecture 1 - January 11

Maitreesh Ghatak, Department of Economics, and STICERD, LSE.

Title: "Does Money Crowd Out Motivation?"

Lecture 2 - January 15

Nava Ashraf, Department of Economics, STICERD, and The Marshall Institute, LSE

Title: "Altruistic Capital"

Please note different venue and time: due to scheduling constraints, this lecture would be held at this date as opposed to February 8 jointly with The Marshall Institute Lecture Series, and at a different venue - in the **Old Theatre**. The time is **18.45 – 20.15**. The classes corresponding to this lecture will be held on January 25.

Lecture 3 - January 25

Oriana Bandiera, Department of Economics, and STICERD, LSE

Title: "Pro-sociality and Incentives for Public Service Delivery"

Lecture 4 - February 22

Michael Muthukrishna, Department of Psychological and Behavioural Science, LSE & Zaki Wahhaj, School of Economics, University of Kent.

Title: (Provisional) "Endogenous Motivation and Social Norms"

Lecture 5 - March 1

Stephan Chambers, The Marshall Institute, LSE.

Title: "Profit and Purpose: An Introduction to Social Entrepreneurship"

Eligibility

- This course is compulsory on the BSc in Philosophy, Politics and Economics. This course is not available as an outside option nor to General Course students.
- This course is only available to second year students on the BSc in Philosophy, Politics and Economics.
- The course will run from the beginning of Lent Term in year 2 and will continue as EC340 through to the end of Lent Term in year 3.

Evaluation

- Students will be expected to produce 1 essay and 1 presentation in the LT.
- Students will write a 2,500 word essays in groups in the LT of year 2 and MT of year 3 to prepare them for the individual assessment of year 3.
- In addition, students will discuss and present current research.
- Feedback on these essays and the presentation will help prepare students for the final **individual** essay and presentation.

- Students will be assessed throughout the course, through essays, presentations and class participation. There will be one essay and one presentation per term in MT and LT of the third year of the PPE.

- The final summative grade will weigh together the presentations (20%), essays (70%) and class participation (10%) from all three terms (the essays will be weighted 15%, 15% and 40%, respectively

- For this term, the essay will be have weight 15% (10.5% of the overall grade)

- The overall grade the students will receive will be one of four: fail, pass, merit and distinction.

Administrative information

- My office is 3.08A in the third floor of 32LIF.
- My assistant is Rhoda Frith (r.m.frith@lse.ac.uk), Ext 6674, 32 Lincoln Inn Fields, 3rd Floor, office 3.06. My office hours are Tuesdays 4 -5PM.
- They are walk-in but booking a slot minimizes the likelihood of waiting. Please book a slot using the spreadsheet whose link is on my website:
- Please email Rhoda Frith (r.m.frith@lse.ac.uk) to book an appointment at a different time if the slot is full or you cannot make it for some reason.

Reading List

- For each lecture there will be a 2-3 readings that you are **required** to read.
- There will be a number of additional readings that are **optional**.
- In case you cannot get hold of the the Tirole or the Hausman et al book in the library, Rhoda will have a photocopy of the relevant chapter that you can borrow.

Introduction

- The narrow self-interest driven view of individuals in the economic domain has increasingly come under question

- Recent work in economics has moved beyond stylized models of motivation based on a narrow view of *homo economicus* who cares about only money and leisure, and have embraced a wider perspective on motivation.

- Broadly speaking, this has been focused on different approaches to pro-social motivation, such as:
  - commitment to a mission
  - the role of identity (being a "good" or "responsible" person, a good teacher or doctor or friend or parent)
  - commitment to "in-group" (e.g., family, community, tribe)
  - intrinsic motivation
  - reputational concerns & social norms
  - status rewards
  - pure altruism.

- Relatedly, another trend is questioning the division of economic activitiy between the markets and the government

- The traditional belief that markets are the most efficient way of producing private goods, while the government takes care of public goods and services while also correcting a range of market failures is no longer tenable

- Several reasons
  - First, a large body of evidence on market failure where private gains lead to social loss (e.g., bailout of banks during the financial crisis) beyond what was already known (e.g., environmental pollution, lobbying by private corporations)
  - Second, a large body of evidence has accumulated on government failure due, for example, to corruption, waste, absenteeism, and poor quality of service.
  - Third, an increasing importance of private social-sector organizations such as non-profits, NGOs, and social enterprises as well as hybrid organizational forms such as public-private partnerships, and contracting-out, make it too restrictive to equate the provision of public goods and services with provision through government agencies.

Part 1: Recent points of departure from standard economic models

The Original Dilemma of Economists?

> "It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages." Adam Smith (*The Wealth of Nations*, 1776)

"How selfish soever man may be supposed, there are evidently some principles in his nature, which interest him in the fortunes of others, and render their happiness necessary to him, though he derives nothing from it, except the pleasure of seeing it. Of this kind is pity or compassion, the emotion we feel for the misery of others, when we either see it, or are made to conceive it in a very lively manner. That we often derive sorrow from the sorrows of others, is a matter of fact too obvious to require any instances to prove it; for this sentiment, like all the other original passions of human nature, is by no means confined to the virtuous or the humane, though they perhaps may feel it with the most exquisite sensibility. The greatest ruffian, the most hardened violator of the laws of society, is not altogether without it."
Adam Smith (*The Theory of Moral Sentiments*, 1759)

The Two Mr. Smiths

Economists have adopted a simplifying strategy that goes back at least to John Stuart Mill (1867)

> "[Political economy] does not treat of the whole of man's nature . . . it is concerned with him solely as a being who desires to possess wealth, . . . it predicts only such . . . phenomena . . . as take place in consequence of the pursuit of wealth. It makes entire abstraction of every other human passion or motive."

The Three Separation Assumptions

I will argue that this strategy involves three separation assumptions

- Separation between markets and the government
- Separation between (consumer/donor) preferences & productive activity
- Separation between intrinsic and extrinsic motivation

A. Markets and the Government

- The invisible hand of the market, described in Adam Smith, harnesses consumers' and corporations' pursuit of self-interest to the pursuit of efficiency.

- The state corrects market failures whenever externalities stand in the way of efficiency, and redistributes income and wealth, as the income and wealth distribution generated by markets has no reason to fit society's moral standards.

- Markets are the most efficient way of producing private goods

- Not for Public goods (or bads) where appropriate tax/subsidy or direct provision by the government is warranted

- Also, tax and redistribution to tackle inequality

- Welfare Economics: separation between efficiency role of markets, and distributional concerns

- Assumes no externalities - this is where government's role is acknowledged (Pigou, Lindahl, Samuelson)

B. Consumption and Productive Activity

- Individuals maximize utility as investors, consumers or workers to decide how much to sell, buy, where to work, invest etc

- Firms maximize profits independent of the preferences of the people involved

- Otherwise, competitive markets will push them out

- Business is business, and that does not mix with pleasure or ideals

- You may be a bleeding altruist in your social life, but in your economic life you are ruthless maximizer

C. Intrinsic and Extrinsic Motivation

- Individuals have preferences over various occupations, effort levels (as workers), goods and services (as consumers), investment opportunities (as investors)

- For example, a worker may have a lower cost of effort when he is working in a task he likes - intrinsic motivation

- Money (wages, prices, returns) also affects the choice of individuals to work, buy, or invest

- These can be treated separately - if someone pays you to do something you like to do anyway, then you do it even more

Over the last few decades economists have been exploring relaxing these three sets of separation assumptions

1. Relaxing the Separation between Markets and the Government

- The traditional view equated public goods to government provision

- Benevolent government steps in, and uses
  - corrective taxes/subsidies
  - regulation
  - direct provision

- This view ignored
  - government failure (agency, political economy etc)
  - role of non-state non-market institutions such as voluntary organizations (non-profits, NGOs)
  - social enterprise

2. Relaxing the Separation between Consumption & Production

- Production efficiency not guaranteed if there are market frictions

- Agency problems, information and transactions costs

- Incentives matter, organizational form matters (non-profits, social enterprise, for-profits etc)

- Organizational form may reflect the preferences of workers, owners through self-selection or signalling or commitment to certain missions

- Motivation can be a substitute for incentive pay (Besley-Ghatak, 2005)

3. Relaxing the Separation between Intrinsic and Extrinsic Motivation

- Using monetary incentives may crowd out intrinsic motivation

- Richard Titmuss (1971) found that the US where blood-donors are paid had lower quality blood supplied than UK where it was based on voluntary donation

- Recent books by Michael Sandel, Debra Satz
  - What Money Cannot Buy
  - Why Some Things Should Not be For Sale

- Subsequent experiments (surveyed by Frey and Jergen, 2000 and Fehr and Gachter, 2001) provides evidence for crowding out of intrinsic motivation if monetary incentives are provided.

Today's Topic - Limits of Markets

- In most day-to-day commercial transactions that involve "willing" buyers and sellers, the state has little or no role to play.
- Three key assumptions
  - Individuals are rational and informed - they know what's good for them
  - There are legal institutions that make sure no one is robbed or cheated
  - There are no effects on third parties
- If consenting and informed adults engage in a transaction voluntarily and no one else is affected, what's the ground for preventing that?

- On the flip side are transactions where either the buyer or the seller is "unwilling".

- When one of them exerts pressure over the other or adopts dishonest means, it is naturally considered unlawful.

A Simple Schema

	Buyer Willing	Buyer Unwilling
Seller Willing	Most Market Transactions	Selling one's kidney
Seller Unwilling	Forcible Acquisition of Land	Robbery or fraud

- Academically economists are well aware of the limitations of the market due to
  - Absence of proper institutions of protection of property rights - can lead to coercion
  - Externalities on third parties - e.g., pollution, underprovision of public goods whose social returns exceed private returns
  - Asymmetric information and transactions costs - quality assurance & trust problem
  - Asymmetric bargaining power - can lead to exploitation
  - Paternalistic concerns - individuals may have self-control problems and other biases

- However, kidney sales or commercial surrogacy involve consenting adults who are voluntary participants in a transaction.

- Then what could be the arguments for banning it?

- One can well take the view that laws banning a specific market will be ineffective, or drive the activity underground, or make the problem worse

- Given the egregious failure of basic law enforcement at all levels in developing countries from child-trafficking to public safety, from mob violence to financial crimes, whether in preventing them or in bringing criminals to justice, no one can be faulted for having a pessimistic view about what can be accomplished by laws.

- However, it is instructive to think through arguments in favour of banning something from the point of view of **principle** as distinct from **practice**.

- What Sandel is putting on the table is “corruption” or “degradation”
  - Certain transactions are **repugnant**

- Consider the following examples
  - Kidney Sales
  - Commerical Surrogacy
  - Selling (as opposed to donating) blood

- He also refers to things such as friendship, honours, poems for wedding toasts and some people’s attempt to "buy" them

- That is indeed tacky, but clearly not a strong case for "banning" anything

- Other examples - eating horse & dog meat is illegal in California, dwarf-tossing (see Table 1 of Roth, 2007)

- Finally, he refers to the problem of markets crowding out community norms

Table 1

Markets In Which Some Transactions Are, or Were Once, Repugnant

Human remains
- Cadavers for anatomical study, organ donation, bone and tissue
- Live donor organs (kidneys, livers)

Labor
- Indentured servitude, slavery
- Volunteer army, mercenary soldiers
- Discrimination based on race, gender, handicap, marital status, etc.

Reproduction and sex
- Adoption
- Surrogate mothers, egg and sperm donation, abortion, birth control
- Prostitution, pornography
- Brideprice, dowry
- Polygamy, gay marriage, incest

Words, ideas, and art
- Obscenity, profanity, and blasphemy
- Cultural treasures, art, and antiquities

Risk
- Life insurance for adults, children, and strangers
- Gambling
- Prediction markets

Finance
- Short selling, currency speculation
- Interest on loans

Pollution markets
- Tradable emissions entitlements
- Dirty industries in less developed countries

"Price gouging"
- After natural disasters
- Ticket scalping

Religion/Sports
- Sale of indulgences and ecclesiastical offices ("simony")
- Endorsements/payments for amateur versus pro athletes
- Drugs and sports

Food, drink, and drugs
- Horse and dog meat
- Alcohol (Prohibition)
- Marijuana and narcotics

Vote selling and bribery

Dwarf-tossing

Alvin Roth (2007), "Repugnance as a Constraint on Markets", Journal of Economic Perspectives.

How To Draw Limits on Markets

- In economics, we evaluate everything in terms of three main criteria:
  - Efficiency
  - Equity
  - Individual freedom.

- Following Sandel we may add
  - Repugnance

- Advocates of the free market usually prioritise efficiency and individual freedom, while those leaning left emphasise equity.

- The underlying assumption is that there are institutional safeguards that prevent certain obvious premises of voluntary trade
  - Coercion (property rights respected, some alternative options available to both buyers & sellers)
  - Deception

- If the transacted commodity, be it agricultural land or one's kidney, is more valuable to the seller than to the buyer, then the transaction generates greater economic efficiency.

- But if poverty and deprivation are among the reasons for selling (as in the case of a poor farmer selling land, or his kidney), then, the efficiency argument notwithstanding, the transaction becomes problematic from the point of view of equity.

- The criterion of individual freedom dictates that no one can interfere in the decision to sell or not to sell things that are our own, such as our labour or our land, or, according to some, our kidneys.

- Coercive land acquisition by the government using eminent domain laws or human trafficking are clearly examples of activities that cannot be supported on any of these grounds.

- However, the problem with the equity argument is that there is no dearth of inequitable transactions around us (for example, child labour).

- Some market transactions make inequity more apparent and shocking — such as a poor person selling his kidney— than others, such as a poor farmer selling his land, which we have gotten used to.

- But this is clearly somewhat subjective.

- Also, it is not as though equity would be restored if all these markets were eliminated altogether.

- Would the desperate circumstances that might drive a poor person to sell his kidney on the black market be alleviated by a crackdown on organ trade?

- The only way to deal with the problem of inequity is poverty alleviation, and not shutting down markets arbitrarily.

- Besides equity, two other arguments are usually advanced to restrict voluntary transactions in the marketplace
  - Externalities
  - Paternalism

- Externalities
  - For kidney or blood sales, it is not clear that there is any indirect effect on third parties
  - There might be aesthetic or moral objections to any exchange (e.g., prostitution or gambling), but it is difficult to use them to legally forbid a transaction, because they are almost always subjective.

- Paternalism
  - Another case for regulating voluntary exchanges could be made when there are questions about the judgement of the seller or the buyer.
  - Is she/he equipped to weigh the pros and cons of his decision?
  - Does she/he possess complete information about the risks involved?
  - Reasonable concerns but apply to many other contexts (e.g., taking a loan, making a risky investment, gambling, smoking, drinking etc) - call for suitable regulations and information campaigns, it is hard to justify banning all such activity.

Coercive Transactions - Land Acquisition

- My first real world experience of the failure standard market logic was when I interviewed farmers in India on the issue of land acquisition.

- Eminent domain or land acquisition or compulsory purchase or resumption is the power of a state, provincial, or national government to take private property for public use.

- Some of the farmers I met said they were not ready to sell their land, whatever be the price offered.

- Other, more affluent farmers claimed that the returns from farming were small, and so they would not mind selling their land if they got a suitable price.

- On the face of it, land acquisition and legalisation of the trade in human kidneys seem to have little in common.

- But one can indeed draw a parallel between the two if one thinks in terms of the legal and ethical limits of economic transactions.

- Most day-to-day market transactions involve ‘willing’ buyers and sellers. Barring taxation and quality control, the state has little or no role to play in them.

- On the flip side are transactions where either the buyer or the seller is ‘unwilling’.

- When one of them exerts pressure over the other or adopts dishonest means, it is naturally considered unlawful.

- But the act of buying and selling human kidneys is unacceptable in the eyes of the law even when both the buyer and seller are willing.

Evaluating Different Transactions

	Kidney Sale	Land Sale (poor farmer)	Land Sale (rich farmer)	Land Acquisition
Efficiency	✓	✓	✓	✗
Equity	✗	✗	~	✓ or ✗
Liberty	✓	✓	✓	✗

Use of Prices and the Crowding out of Intrinsic Motivation

- In his seminal 1970 book, The Gift Relationship, Richard Titmuss argued that monetary compensation for donating blood might crowd out the supply of blood donors.

- Argued that the US where blood-donors are paid had lower quality blood supplied than UK where it was based on voluntary donation

- This is referred to as crowding out - presumably use of money crowds out the voluntary donors, leaving only who do it out of financial need

- Does money "contaminates" certain relationships and so the price mechanism fails?

- Arrow (1972) and Solow (1971) in their surveys of Titmuss thought that doing something for money simply expands the choice set - how can that hurt?

- If you derive intrinsic motivation, and get paid, just add them up

- Also, can donate the money back to your favorite charity

- Can we explain this using standard the economic framework?

- To test this claim Mellström and Johannesson (Journal of the European Economic Association, 2008) carried out a field experiment with three different treatments.
  - In the first treatment subjects were given the opportunity to become blood donors without any compensation.
  - In the second treatment subjects received a payment of SEK 50 (about \$7) for becoming blood donors
  - In the third treatment subjects could choose between a SEK 50 payment and donating SEK 50 to charity.
- For the overall sample the supply of blood donors decreases from 43% to 33% when a payment is introduced, consistent with a crowding-out effect, but the effect is not statistically significant.

- Therefore cannot reject the null hypothesis of zero crowding out at conventional significance levels.

- The introduction of a charity option increases the supply of blood donors from 33% to 44%, but also in this case they cannot statistically reject the null hypothesis of no effect.

- However, the results differ markedly between men and women.

- For men the supply of blood donors is not significantly different among the three experimental groups.

- For women there is a significant crowding-out effect - the supply of blood donors decreases by almost half when a monetary payment is introduced.

- There is also a significant effect of allowing individuals to donate the payment to charity, and this effect fully counteracts the crowding-out

- Titmuss's original conjecture was silent about the effect of gender, but our results suggest that his conjecture holds for women but not for men.

- According to the authors, in terms of the signaling model of crowding out of Bénabou and Tirole (2006), the difference between men and women can be interpreted as "..women being more concerned with social esteem than men"

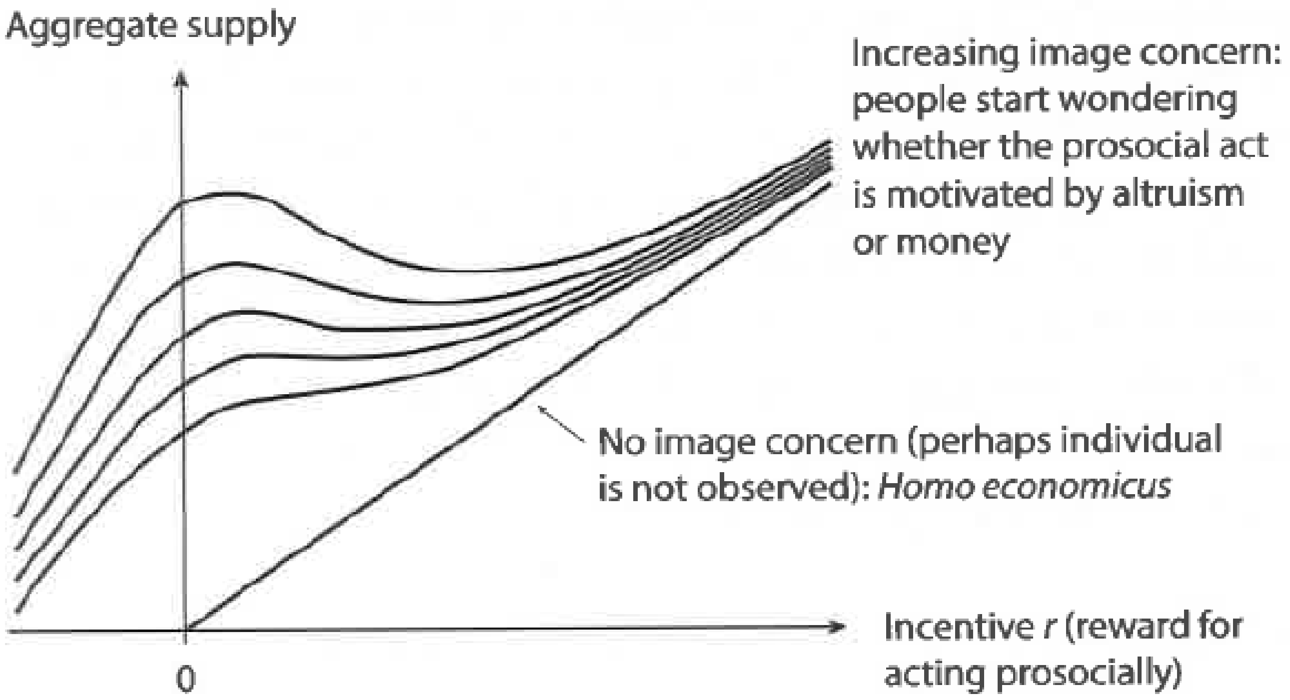

Figure 5.5. Intrinsic motivation and extrinsic motivation. Supply of public good in relation to a monetary incentive *r*; the different curves correspond to different levels of the individual's attachment to the image of himself that he projects (a higher curve corresponds to a greater importance accorded by the individual to his image). When the image becomes sufficiently important for the individual, an interval appears in which an increase in the reward has a counter-productive effect.

Jean Tirole (2017): "The Moral Limits of the Market", Chapter 5 in *Economics for the Common Good*

- There is a more recent paper on this by Lacetera, Macis, and Slonim (2012, American Economic Journal: Economic Policy): "Will There Be Blood? Incentives and Displacement Effects in Pro-social Behavior"

- Presents evidence from nearly 14,000 American Red Cross blood drives and from a natural field experiment showing that economic incentives have a positive effect on blood donations without increasing the fraction of donors who are ineligible to donate.

- The effect increases with the incentive's economic value.

- However, a substantial proportion of the increase in donations is explained by donors leaving neighboring drives without incentives to attend drives with incentives; this displacement also increases with the economic value of the incentive.

- They conclude that extrinsic incentives stimulate pro-social behavior, but unless displacement effects are considered, the effect may be overestimated.

- There have been similar studies of crowding out in other contexts

- In a field experiment on day-care centers in Israel, Gneezy and Rustichini (2000b) furthermore found that introducing a fine increased the number of late-coming parents.

- Consistent with this finding, several recent laboratory experiments suggest that the introduction of fines or minimum performance requirements can reduce performance (Fehr and Gâchter 2002; Fehr and Rockenbach 2003; Fehr and List 2004; Falk and Kosfeld 2006).

- Subsequent experiments (surveyed by Frey and Jergen, 2000 and Fehr and Gachter, 2001) that provides evidence for crowding out

Conclusion

- Where to draw the line as to which markets are considered repugnant?

- A very useful framework provided by Kanbur (2001)

- Depends on
  - Extremity of outcome (irreversible & potentially dangerous consequence)
  - Limited Agency (behavioural biases are likely to be large)
  - Inequality (desperation, not free choice)

Table 1

Each Obnoxious Market is Obnoxious in its Own Way

	Extremity	Agency	Inequality
Arms	+	+	_
Hard Drugs	+	+	_
Soft Drugs	_	_	_
Toxic Waste	+	+	+
Blood	_	_	+
Body Parts	+	+	+
Child Prostitution	+	+	+
International Debt	+	+	_
Speculative Capital	+	+	_

Note: A "+" denotes a relatively high score while a " – " denotes a relatively low score. A " – " does not indicate that there is no problem along this dimension.

Ravi Kanbur, "On Obnoxious Markets", Working Paper, Cornell University, 2001

- It seems most potent they are combined
  - Only extremity of outcome would rule out dangerous sports
  - Only limited agency would require regulating lots of activities including eating unhealthy food
  - Only inequality would pretty much shut down the labour market in developing countries given the shortage of jobs & the poor job term and conditions
- When all three are combined, one can clearly see the grounds for repugnance
- Selling one's hair or even blood seems ok, but kidney is harder to accept, & heart seems unacceptable

- Even if we agree a market if repugnant, banning or regulation is not costless

- There are implementation issues and could lead to worse outcomes

- In the end, it depends on

  - In principle, which factor we put most weight on - liberty, equality, efficiency, or minimizing repugnant transactions

  - In practice, implementation considerations given the institutional realities