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• Fast 50 — Event: Wednesday, Sept. 22, High Point University.

For more information or to register for events, contact Grace Johnston at (336) 370-2905 or gjohnston@bi journals.com.

Opinion

BUSINESS PULSE SURVEY
Should the 14th Amendment, granting citizenship to anyone born in the United States, be repealed or changed?

Next week’s question: In hindsight, should the government have bailed out the financial institutions (Citibank, AIG, et al.)?

Go to http://triadbizjournals.com and click on Business Pulse Survey to participate.

Based on 476 responses. Numbers may not total 100 due to rounding.

The complexity of incentives

In the popular mind, economics is about taxes and government spending and Gross Domestic Product. Those are the economic topics that make the news. But at root, economics is about individuals and businesses and the way they respond to incentives.

The framework is applicable to a multitude of scenarios, from rising food prices to changing physician reimbursement rates. The economic model makes predictions, and in contrast to the poor performance of macroeconomic forecasts, the model does quite well in these smaller settings.

But incentives can be more complicated than they seem at first blush. A recent news report described a study that looked at the use of betting as a way to lose weight. The study used data from the London betting house, William Hill. Even though bookmakers rarely accept bets in which the bettor can influence the outcome, William Hill invited people to bet on their own weight loss.

William Hill gave odds of up to 50/1, and some winning bets were worth more than $7,000. But the study found that in spite of the obvious monetary incentive to lose the weight and thereby win the bet, 80 percent of the bettors couldn’t do it. In this case, incentives didn’t work. I wouldn’t say this discribes the theory of incentives, but it does show how psychology comes into play. The average duration of the weight-loss bets was eight months, and bettors were left entirely to their own devices during that time. Perhaps it’s not surprising that so many bettors lost their bets.

But most of us have learned to divide big challenges into smaller tasks. It turns out that this works for weight-loss bets as well. Other studies have shown that when the bettor is required to check in regularly with a counselor, the success rate shoots up. In other words, monetary incentives can be a powerful tool depending on how the bet is structured.

The complexity of incentives is reflected in many current policy questions. For example, do lower marginal tax rates encourage enterprise? Do unemployment benefits discourage unemployed workers from seeking work?

For the above, economic theory seems to answer yes. The lower the tax on each successive dollar earned, the greater the incentive to work, making work more attractive. Similarly, job-seekers are no doubt motivated by the threat of no income.

However, a falling tax rate changes a taxpayer’s incentives in two ways. One effect is the one noted above. Keeping more of one’s additional earnings is nice. But the other effect, which economists call the income effect, leads the taxpayer to feel richer and hence work less. Which effect wins? It depends on many factors, including the size of the change and the level of the tax rate before the change. Small changes are unlikely to have any effect, one way or the other. And that’s especially true for the corollary issue of whether lower tax rates actually raise government revenues.

As for unemployment benefits, studies do show that they discourage job seeking. But the effect is small, and it gets even smaller when the economy has significant slack, as it does right now. In other words, our 9.5 percent unemployment isn’t the result of our paying unemployment benefits.

In addition, there’s a kind of income effect here as well. The Congressional Budget Office says that unemployment benefits are among the most cost-effective forms of economic stimulus when the economy is weak. Unemployed people spend that money.

So yes, incentives drive behavior. But it’s not always simple.

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