



INCENTIVES

UNIT II: 5 PRINCIPLES OF ECONOMICS



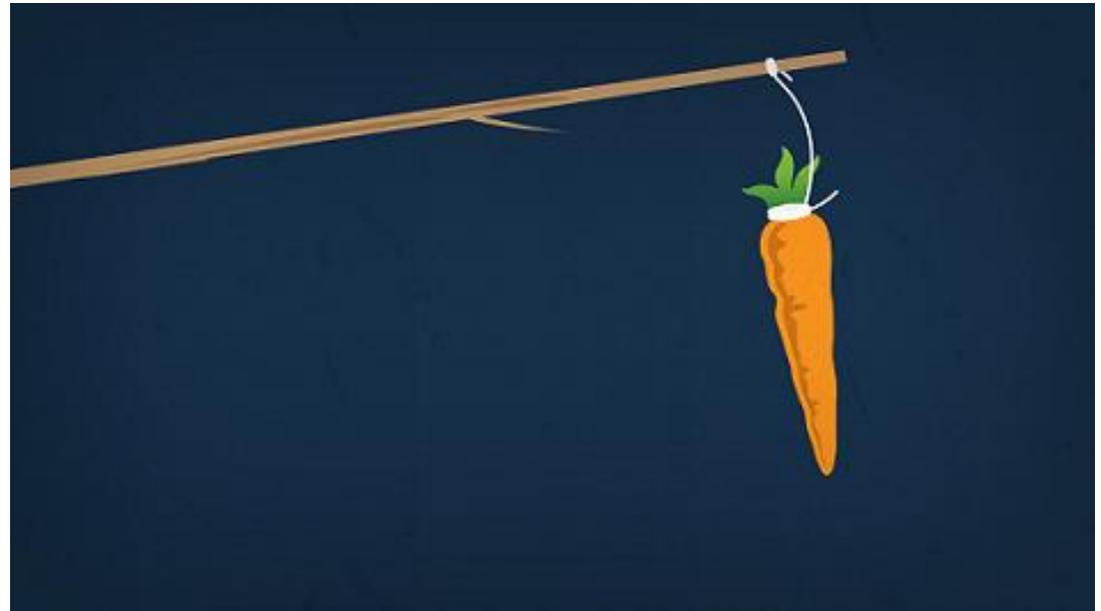
INCENTIVES

- The concept of incentives is the backbone of economics
- **Incentives** are factors that motivate a person to act or exert effort
- There are FIVE key foundations to economics
 - Incentives
 - Trade-offs
 - Opportunity Cost
 - Marginal Thinking
 - Trade Creates Value



POSITIVE AND NEGATIVE INCENTIVES

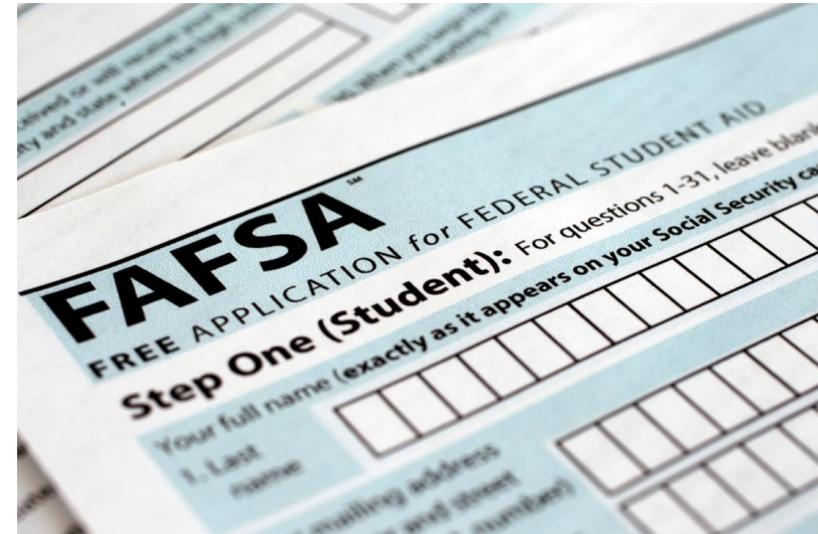
- There are **positive** and **negative** incentives
 - **Positive** incentives encourage action
 - Performance bonuses at work (work harder)
 - High fives for a good play (try harder)
 - **Negative** incentives deter action
 - Suspension from school for fighting (don't fight)
 - Lung cancer from smoking (stop smoking)



Incentives may be positive or negative depending on the preferences of the individual. Going to the beach may sound great to some, but not someone who is easily sunburnt!

DIRECT AND INDIRECT INCENTIVES

- Incentives are **direct** and **indirect**
- **Direct Incentives** are more easy to recognize
 - **Compensation** such as a paycheck for doing work
- **Indirect Incentives** may take a couple of steps to have a noticeable affect
 - **Welfare** *may* be an indirect incentive
 - Fewer lower income families leads to lower crime rates and your neighborhood may become safer.



Paying taxes into the government to support student loans for college may not sound fun but a more educated society leads to a better country. Who knows – someone who needed the loans may find discover the cure to cancer!

UNINTENDED CONSEQUENCES

- Definition: Actions or outcomes that are unanticipated or were not designed to happen.
- Policymakers *should* consider possible incentives and outcomes when determining actions.
- Examples:
 - What may occur when Common Core is implemented?
 - *Teachers may appear ineffective when transitioning*
 - What will happen if college becomes free?
 - *Students may stop trying hard in high school*
 - What might happen if minimum wage is raised?
 - *Taxes may be lowered as people become self-sustained*

“There is only one difference between a bad economist and a good one: the bad economist confines himself to the visible effect; the good economist takes into account both the effect that can be seen and those effects that must be foreseen.”

-Frederic Bastiat

THE SEATBELT THEORY

Sam Peltzman's Study:

- Public policy often has unintended consequences
- It would be hard to argue against seatbelts!
- Peltzman's 1975 suggested consumers felt safer and therefore committed more risky behavior
- More accidents due to speeding occurred
- Fewer driver/passenger deaths occurred
- However, more pedestrian deaths occurred



INCENTIVES: APPLICATIONS FOR REAL LIFE

Economists may study Black Friday to determine what prices maximize profit by determining what discounts lead to the most shoppers willing to wait, brave the cold, and stay up late in order to increase revenues!

At what prices have *you* gone out on Black Friday?

What incentives caused you to react *or* prevented you from going?

The image displays a collection of Target Black Friday advertisements. On the left, an iPad is advertised for \$499.99 with a 'FREE 100' incentive when buying any iPad. Next to it, a set of colorful folders is on sale for \$34.99. Below that, an iPhone is priced at \$195 with a 'FREE 100' incentive. A large red banner at the bottom left offers '5% OFF OUR EVERYDAY LOW PRICES WITH REDcard'. To the right, a Beats headphone set is featured as a 'DOORBUSTER' for \$179.99, with a 'SAVE \$20' incentive. Other items include a portable DVD player for \$75 and a portable DVD player for \$149. A large green banner on the far right reads 'START SAVING 9 PM TONIGHT!'. Various other products like a navigation device and a smartphone are also shown with their respective sale prices and incentives.

INCENTIVES: APPLICATIONS FOR REAL LIFE

The risk of foreclosure on a home forces people to make mortgage payments

At the same time, foreclosures also cause some people to just walk away from their investment and file bankruptcy to avoid paying for their living expense

It is important to try to foresee and explore *all* possible outcomes



INCENTIVES: APPLICATIONS FOR REAL LIFE

