SUMMARY

FREAKONOMICS

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Summary of “Freakonomics” by Steven D. Levitt and Stephen J. Dubner

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The study of economics can be wilder than you think.

Introduction

What incentivized you as a kid? Although you probably didn't think of it in terms of economic principles, incentives were all around you in one form or another. Positive reinforcement, like getting a cookie for finishing your homework, might have been one powerful form of motivation. For others, however, only the threat of a truly unpleasant punishment was enough to compel us to do things we didn't want to do. In fact, these incentives continue throughout our lives; the only difference is that the variables change as we age. For example, instead of getting a cookie for finishing our homework, we might be tempted with the promise of a big bonus if we exceed our sales quota this quarter. Likewise, the knowledge that we would go to prison is enough to keep us from killing that person who drives us crazy. (Although hopefully, our sense of morality helps keep us in check too!)

As you can see from these examples, you have only to alter the variables as it suits your situation. Plug in one scenario or another and you can plainly see that most of our decisions are still motivated by incentives in one way or another. And economists like the authors know that incentives are actually so prevalent in our society that they can be put into three distinct categories: economic, social, and moral. As you can imagine, their prevalence and versatility gives incentives a unique form of power over our lives. And that's exactly why economists are interested in studying them. So, through the course of this summary, we're going to take a look at incentives-- along with a few other economic principles-- and unpack the role they play in our decision-making and society.

Incentives Can be Complicated

If you think about it in terms like those outlined in the introduction, it might seem like incentives are pretty straightforward; positive incentives motivate us to do more of a good thing while the threat of punishment gives us a reason to avoid doing bad things. But sometimes, incentives can get a little more complicated, producing results we didn't intend. How? Well, let's consider an example. Imagine for a moment that your office has a problem with people consistently missing deadlines and submitting their reports late.

So, in an effort to flatten that curve, the office institutes a new policy: every time you're a day late with your work, you have to put $5 in a donation box for charity. So, if we outline it in those terms, we now have a sequence that looks like this: an undesirable behavior (turning your work in late) an incentive which offers negative consequences for that behavior (being required to donate $5) and the intended result (that people will stop bringing their work in late). As a result, our expectation would be that people would stop turning in their work late because they're dissuaded by the negative consequences. But what if this incentive backfired? What if, instead, people were even later? How could that happen?

The authors explain that this is just part of how incentives work: they can produce unintended consequences. Fortunately, however, we can use the study of economics to unpack this dilemma and identify a few reasons why this strategy backfired. For starters, remember how, earlier in the chapter, we discussed the fact that incentives operate on three levels: economic, social, and moral? Well, each of those factors are at play in this example and each one offers us a critical insight into why this incentive backfired. For example, one reason this was ineffective was because it removed the element of social pressure. We all know the feeling of judging our performance in relation to others; we don't want our co-workers to think we're lazy or stupid or that we're the only one who didn't turn in our work.

The element of privacy allows each employee to think they might be the only one who's behind and ultimately, it might motivate them to scramble around and get their work together. But when it's made clear that everybody is doing this, people start to feel a little less embarrassed and they no longer have the pressure to save face in front of their co-workers. Now, if they're late, they're all late together and people might start to adopt a lax, "Oh well!" attitude when it comes to their deadlines. This is also true when it comes to the moral incentive because this is another big factor in our decision-making. Although everyone makes mistakes and it's true that there are some genuinely bad people out there, for the most part, people are basically good and they want to do the right thing.

Therefore, that sense of morality-- the desire to be a good person and do the right thing-- is a strong motivator in many of our lives. It's what drives us to turn in our work on time because we know that slacking on the job is wrong and we don't want to think of ourselves as people who do bad things. But when the secrecy and social pressure is removed-- and the incentive to give to charity is added-- people can relax a little more and start to rationalize their decisions by saying that everybody's doing it and even if they are late, they'll be donating to charity, which is a good thing! And lastly, considering the element of economic pressure, it's possible that the amount of $5 wasn't high enough to feel punitive; if it was an amount that people considered to be unfair or extortionate, they might have been motivated to change their behavior in order to avoid it. But in this case, instead of being incentivized to improve, people just grew more comfortable with breaking the policy.

And of course, once this incentive backfires, you can imagine that it would be pretty tough to work around it. Removing the new policy doesn't really help because then you're right back where you started. And after you've already tried and failed to set a new standard, it's unlikely that you'll be taken seriously when instituting another remedial policy. As a result, this example just goes to show that incentives aren't always as straightforward as we think and that economics can be used to explain a lot about human behavior.

Incentives Are Heavily Influenced by Context

Everybody's different. We know, for example, that one size doesn't really fit all, that different things work for different people, and that you can't expect everyone to respond the same way, as if we're all identical robots. But if we understand that, then why would we expect the same incentives to work for everybody? The authors observe that this is another important thing to consider when it comes to the study of economics and incentives. Because if we want to incentivize people to do something, we need to start by understanding that everyone doesn't share the same motivations and, as a result, incentives won't always produce identical results.

For example, you've probably never murdered anyone. Maybe it's because of the moral incentive; you understand that murder is wrong and you don't want to be a bad person or do bad things. Or maybe you resist temptation because social pressure acts as a disincentive; you don't want to hurt or embarrass your family or you don't want to worry about what people would think. Avoiding jail is probably a big motivator for all of us as well! But despite this, people still murder other people all the time, even though every single one of those disincentives remain relevant in their lives. Why? Well, put simply, it's because the same incentives don't work for everybody; an incentive's effectiveness is also heavily dependent on context. Let's say, for example, that someone you're very close to has betrayed you. It's the worst pain you've ever experienced so far and you're devastated. Not only do you never want to see them again, you want them to suffer like you have. Maybe you kind of wish they were dead. But you make the choice to refrain from violence because of the disincentives referenced above. Someone else, however, in a different position-- maybe someone who has suffered an extreme form of violence or abuse-- might look at those same disincentives and say that it's worth it. In that case, their incentive to get justice or to feel better might outweigh the negative consequences they would face.

So, put simply, this means that we can't establish blanket incentives and expect them to be foolproof. Neither can we expect them to consistently produce the same results. Because every person is different, every incentive depends on the context of an individual, their unique experience and worldview, and their emotional state. And, perhaps scarily enough, this truth applies to everything from the possibility of committing murder to whether or not you’re willing to return a wallet you found on the ground.

Experts Aren't Always the Good Guys

That might sound like a no-brainer, right? Chances are, we've all been cheated at one point or another, probably by a repairman who overcharged us or an expert who gave us bad advice. But why does this happen so often? One primary reason is that experts have an informational advantage over the average person. After all, if you knew how to fix your car yourself, you wouldn't need to take it to a mechanic. This puts experts in a unique position of power and raises an ethical question for them: are they going to use their expertise to give someone the help they need? Or would they rather extort you for their own personal gain?

While it's fortunate that, in most cases, the experts we encounter are honest and they do the right thing, this disparity in information creates a power imbalance that often leads to more subtle forms of extortion. For example, when we're buying a new car, the salesman might not necessarily charge us thousands more than he should. In fact, he might even sell us the car for a very fair price. But because of the intrinsic power imbalance-- you probably don't know a lot about cars and he does, which means you trust him to help you-- he stands to benefit from your ignorance. This means that he is in a unique position to take advantage of you.

And because he gets a commission off the final sale price, it's unlikely that his primary interest is helping you get the best deal. Instead, he's more likely to encourage you to take the deal which will give him the biggest commission. So, even if you're not necessarily being cheated in an overt or egregious way, it's still highly likely that your expert is taking advantage of you in one way or another. Why? Because he's been incentivized to help himself by appearing to help you.

This is just another example of the impact incentives can have on our lives. And because the scenario described in this example is all too common in real life, it might be helpful to keep this in mind the next time you're considering a major purchase!

Google is Your Friend

Fortunately, however, there is a way to reduce the power imbalance between yourself and experts and it starts with the internet. Although people sometimes regard the internet as a lazy, secondhand alternative to the more labor-intensive research practices of our ancestors, the truth is that knowing where to look for answers and being able to have them at your fingertips is a special skill all its own-- and one we should take advantage of. It's especially useful when it comes to protecting yourself because the internet offers you a unique opportunity to fight misinformation. Although it can't protect you from everything, it can definitely come in handy when you're making a major purchase that requires an expert's advice.

Now, thanks to the internet, you don't have to blindly take a real estate agent or car salesman's word for anything! Instead, you can listen to the information they give you and then plug that information into Google to learn for yourself if that's really a good deal. Likewise, thanks to the thousands of commercials that bombard us every day, you probably already know that you can also compare prices and learn if the real estate agency or dealership you're using is really giving you the best value for your money. You can even compare rates for flights, hotels, prescriptions, and pretty much everything else you could ever need to buy!

Put simply, the internet offers you the opportunity to reduce the information advantage your expert has over you. Now that you have the ability to fact-check what they tell you, it's less likely that they'll be able to take advantage of you and you have the opportunity to call them on misinformation or take your business elsewhere. However, this ability impacts more than just your personal decision-making. Because people all around the world have put their newfound skills into practice, reducing the advantage of experts, businesses have had no choice but to lower their prices in response. So, as you can see, when you fact-check the information that's given to you by experts, you're not just making a difference in your own life, you're helping to revolutionize the economy!

The Omission Effect

Are you on Tinder? If you use this or any other online dating service, then you know that the first thing you look for is someone's profile picture. Although we're all familiar with the risks of online dating and we know we can't trust every stranger on the internet, seeing someone's picture gives us a small feeling of security. Now that we know what they look like, we feel a little more trusting; we can see that they're a real person and we know that if we meet up in person, we can check their appearance against the picture they provided to confirm it's really them. It also helps us perform an early assessment of compatibility. Are they someone we find attractive? Do they look like somebody we would want to talk to? A nice profile picture can help answer all of these questions.

But what about when someone has a blank profile picture? This changes the whole equation, doesn't it? Not only are we not willing to talk to them, we become instantly suspicious. We might even block or report their messages if they try to reach out to us. Why? Because they've omitted a key piece of information (their profile picture) and as a result, our instinct is to mistrust them or assume they have something to hide. And if you find yourself wondering what this has to do with the study of economics, you might be surprised to realize that this distrust is actually part of a core economic principle! In fact, it's why items decrease in value when they're being resold.

So, how does that work? Well, let's imagine that you bought a new car yesterday. It's only a day old and the only person who's ever driven it is you. In fact, it hasn't even been driven that much; maybe you only drove it to your local coffee shop and back home. It might have less than 20 miles on it. But let's pretend that, in some weird turn of events, you've suddenly discovered that you don't need a car anymore. Maybe you're moving to an area where the public transportation is so efficient that a car is no longer necessary. But for whatever reason, after only a day of owning the car, you’ve now decided to sell it. Do you think you can then expect to sell it for its full value? The answer, in case you’re wondering, is, “Absolutely not.”

That’s because in this case-- as in the example with the Tinder profile picture-- it doesn’t really matter what the truth is. What matters is what other people perceive. And because you’re selling your car and the prospective buyers don’t personally know its full history (a case of omitted information), their default response is to assume that there’s something wrong with it. Even though your car may be in perfect condition and you haven’t deliberately mislead your prospective buyers at all, what ultimately matters is what your buyers don’t know. And because human beings are inherently afraid of the unknown, 9 times out of 10, we’re going to fill in the blanks with our worst assumptions. Which means that you, like the owner of the blank Tinder profile, will more or less be punished as a result, even if you’ve done nothing wrong. So, if you’re wondering what you can do to remedy this situation in the future, the first step in dating and in transactions is to consider what information the other person wants to know and what they expect you to provide. Staying on top of this and being honest can help you avoid unfortunate mistakes and undeserved penalties.

Final Summary

The study of economics might seem like something far removed from our everyday lives. But in fact, as Freakonomics demonstrates, economic principles govern almost every facet of our lives and decision-making processes whether we realize it or not! The good news is that we can use these principles to our advantage by learning more about them and allowing that knowledge to guide our choices.

By learning about the dangers of omitted information, developing our understanding of incentives and how they work, and using the internet to reduce the power imbalance between ourselves and experts, we can develop practical economic strategies to improve every aspect of our lives.