The Incentive Problem

*This is my own opinion and I don't provide any facts to support these thoughts. I may write other blogs deep diving into some of the open questions looking at empirical data.

Incentives can take two forms: compensation for high performers or punishment for under performers. If you don't compensate the people who are doing well, then nobody has motivation to work extremely hard. Therefore, incentive must come in another form, punishment for those who underachieve. Otherwise, productivity will diminish as people realize their life will be the same no matter how hard they work, so "why not just take it easy"? There are some interesting discussions to be had on why that is the case, tying into human psychology and ideas like The Tragedy of the Commons[1]. For this blog I want to focus on positive incentives and compensation in the form of money, as it is much more interesting and I have more to say about it. From here on when I refer to incentives, I'll be talking about incentives of this nature in the context of a business.

Most of the time incentive structures like this work great. If you compensate people who are performing well, then more people will perform well. This will result in higher productivity. Again, there is more to say here on why that is the case, but I'll leave it at this massive oversimplification for now. Incentives are also necessary for innovation and driving society forward through technological advancements. Founders will innovate in hopes of winning and being compensated for that innovation. Some founders say they are obsessed with problems first, and the compensation is secondary. I don't believe they would be saying this if there was no hope of a large reward in return for the long hours, stress, and risk they undergo.

Moral of the story, motivation through incentive is a prerequisite for productivity and innovation in a business. The interesting question is: how do you measure performance in order to distribute compensation? For most businesses this is very simple. If you make money for the business that will translate to a proportional compensation. I'm a software engineer - if I write a lot of high quality code, in theory that will translate to more money for the company, and I'll get paid proportionally. If a salesperson sells a ton of a product, they will generate more money for the company, and they will get paid proportionally. Therefore, I'm incentivized to write a lot of high quality code and the salesperson is incentivized to sell a ton of the product. Not only does this benefit me, but it also benefits the consumer of our product. This also applies on a more macro scale. Businesses are incentivized to create products that consumers want, because those consumers will pay them for those products.

However, what happens if a company's profits are not directly tied to the product they are selling? Let's consider a simple case, a weatherman. The product they are selling is reliable and accurate weather, but they are compensated based on how many viewers they get, which is directly proportional to the amount of money they are generating. In this case, they may be incentivized to predict more severe weather, so more people tune in and the news station gets more money. And herein lies what I call the incentive problem. Stated more formally: **if an**

[1] https://en.wikipedia.org/wiki/Tragedy_of_the_commons

actor's compensation is not directly tied to the product they are conveying to consumers, then they are motivated to act in a way that does not benefit those consumers.

I see this phenomenon everywhere, and I believe it contributes to a lot of problems we see in the U.S.. Media outlets - the product they are selling is truthful news, they make money based on how many views they get, incentivizing them to create click-baity far-fetched stories with strong bias. Regional Banks - the product they are selling is a safe place to responsibly borrow and deposit money (I know this is an overgeneralization). The execs at SVB were incentivized to drive up the stock price so they get more money, causing them to make risky bets and questionable loans, ultimately leading to the bank's collapse. AI companies - the product they are selling is a safe and useful tool, they stand to make more money if they don't dedicate significant resources to the ethics and safety of the products they are developing. This incentivizes them to skip these steps and take the path of least resistance to releasing a product. There are many more examples like this. In every one, the incentive problem causes actors to behave in a way that benefits them, but is harmful to consumers.

Is there a potential solution here? Possibly, and the key to that solution is transparency. If a business is transparent about what they are doing, then consumers can make informed decisions about whether they want to consume the product the business conveys it's selling. If the business says "Here is what I'm doing, and here's how that is aligned/misaligned from the product I'm selling you," that will go a long way. I have no problem with biased media outlets, risky banks, or crazy weathermen. What I do take issue with is a business pretending to provide a service that it's not, and then acting in a way to maximize profits and hurt the consumer. With a more transparent system, people can actually choose which products they want to consume and which they don't. Here's where the free market will do what it does best. The products that people actually want will thrive, and those that they don't will die. This is usually how it works, but not when the incentive problem is introduced.

But why would a business be incentivized to do this, especially if it results in them taking actions that reduce profits? One reason could be government regulation that requires them to do so - a punishment incentive. I hate that solution for many reasons that I won't get into. The other solution is consumers treating that transparency as an additional service the company is providing and subsidizing it. This could take two forms. The first is a company simply charging higher prices for their product, think a bank increasing fees to subsidize the opportunity cost of profits lost from forgone investments. The second is a platform where companies can create posts about how and why they are making certain decisions. Users pay to gain access and those funds are collected in a central pool. Then through some form of voting process (quadratic funding[2] proposals could be interesting here) those funds are distributed to the most honest companies. I could see the funding of independent journalists, with moderators voting and distributing funds, as a perfect use case for this system.

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[2] https://vitalik.ca/general/2019/12/07/quadratic.html

Incentives are a prerequisite for a productive and innovative economy. Capitalism does a great job of providing these incentives through monetary compensation, and in turn generating high productivity and innovation to benefit the consumer. However, when the product a business is conveying to sell to customers is not directly tied to its profits, the incentive problem rears its ugly head. Transparency is the key to eliminating this problem. With transparency around how and why a business is acting, consumers can make informed decisions, and the free market will do its thing. Namely, remove the bad actors who don't benefit consumers, and let the good actors shine. A potential solution is a paid platform that provides this service to the users, and then distributes those funds to the businesses on the platform. This will provide businesses the incentive to act in a more transparent way, and can make up for the difference for any loss in profits. There may be a secondary effect of consumers giving their business to these companies as they become more comfortable with them, leading to an increase in profits regardless.