

The W effect of incentives

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Abstract: Economic theory prescribes that people invest more effort the larger the incentives they get. In contrast, a large body of empirical evidence shows that introducing monetary rewards might crowd-out intrinsic motivation and result in a reduction in the behavior rewarded. Other findings show that sanctioning an activity might be counterproductive. I show that economic theory and the empirical findings can be reconciled. In a proposer-responder game using rewards and fines, I find support for the crowding out phenomenon for small, but not for large incentives. When “employees” are simply asked to invest work effort with no consequence for them, they invest more than when the “employer” can either reward or punish them. However, this is true only for small incentives; when the retaliation option is large enough, work effort exceeds the no consequence condition, and hence the result is in line with the economic reasoning. A plot with incentives as the horizontal axis (such that fines are on the negative side and rewards on the positive), and work effort on the vertical axis, results in a W shaped graph.