

The Irrationality of Rationality in Market Economics: A Paradox of Incentives Perspective

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Abstract

Current incentive structures are more favorably aligned with the world's problems than with their solutions. We conceptualize this as the paradox of incentives to argue the need for new thinking and restructuring of incentives to break the paradox during the COVID-19 pandemic and beyond, and create new opportunities for societal transformation.

Keywords

COVID-19 pandemic, incentives, inequality, justice, paradox, peace, rationality

Why are house prices increasing dramatically in many developed countries such as the United States and the United Kingdom even when policymakers are introducing new measures to tackle housing problems? Why are some government leaders keen to initiate war despite the suffering it brings to people? Why is COVID-19 likely to persist for a long time? The key to understanding these and other such issues is the *paradox of incentives*, which arises when actors in charge of correcting a problem (or have the power to do so) do not have incentives to *correct* the problem but, rather, *have* incentives to

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perpetuate the problem for personal, organizational, and/or institutional gain. Thus, it characterizes situations wherein private interest leads to the continuation of a problem, although public interest requires its resolution.

Problematization of the Existing Incentives Structures

As market economics is rooted in rational choice theory, the paradox of incentives problematizes what is considered as rational/irrational in a given situation. Rational choice theory suggests that rational actors' net utility/profit maximization determines their decisions. However, such rational decision-making often leads to suboptimal outcomes for the wider society. The paradox of incentives that we introduce explains these market imperfections and failures. For example, a government may want its citizens to stop smoking in the drive to improve public health and lower health costs, but if everyone stops smoking, it can lose more in tax revenues from the tobacco industry. Hence, a government may not have incentives to impose a ban on smoking although scientific evidence strongly suggests that smoking is not good for public health. Furthermore, ideological incentives may inhibit a government from interfering in personal lifestyles and exacerbating the adverse social and health outcomes.

The paradox of incentives also explains conditions under which negative consequences or externalities recur. For instance, wars ultimately help weapon manufacturers and associated industries to flourish, irrespective of whether they supply arms to an aggressor or to a defender of peace. Furthermore, if policymakers increase their popularity by appealing to nationalist sentiments in a war-like environment or realize personal gains because they have interests in firms that benefit from a war (e.g., Rosenbaum, 2004), they may have the incentives to engage in warmongering.

The implications arising from the paradox of incentives explain some of the many other compelling challenges facing societies worldwide. For example, if policymakers hold large property portfolios and stand to lose by reining in house prices (e.g., Davies et al., 2018), they have fewer incentives to pass laws that ameliorate the housing problem. In the case of the United Kingdom, several policies to address the housing problems in recent times including the Help to Buy scheme and stamp duty waivers for buyers are acknowledged to have had the opposite effect of *increasing* the house prices, as they increased the demand for housing instead of addressing the supply side constraints in housing. Thus, the paradox of incentives explains a wide-ranging of counterintuitive phenomena observed across the world. In the following, we illustrate the specific case of the COVID-19 pandemic and offer solutions to break the paradox.

Addressing the *Paradox of Incentives* During the Pandemic

The pharmaceutical industry (Big Pharma) has reaped windfall gains during the COVID-19 pandemic, but these profits will stop once the pandemic ends. Consequentially, firms in the pharmaceutical industry have limited reasons to find an enduring solution to the pandemic. In this case, at least from the pharmaceutical industry's stance, the economic incentives are more favorably aligned for the pandemic's continuation than elimination. Unsurprisingly, then, it is extremely lucrative for this industry to have a regular and repeat booster campaign (e.g., annual vaccination program) and sale of complementary products to treat patients (e.g., oral tablets for symptomatic patients). Products promising to protect patients (e.g., PPE products and subcontracting of PPE through tender bids) can bring additional profits to it and to associated industries.

We propose four mechanisms as illustrations to break the paradox of incentives in the context of the pandemic:

1. Limiting the incentives to CEOs and top management who receive exceptional salaries/bonuses directly tied to firms' profits, particularly in the Big Pharma, health care, and associated industries. Such incentives make leaders take decisions that generate greater profits for their firms rather than advancing public interest. We propose two resolutions to this:
 - a. *Adding counterbalancing incentives*: Offering subsidies and incentives to the industry based on societal health indicators to create incentives for firms to promote societal health and well-being. Here, the World Trade Organization (WTO) and/or the World Health Organization (WHO) can play a central role to distribute these subsidies and measure the benefits of such investments to manage incentive structures. However, to ensure objectivity, profit/expenses ratio caps similar to CEO/worker salary ratio caps can be developed and publicized widely so that stakeholder groups can scrutinize these for both the private and public actors.
 - b. *Removing incentives that lead to negative externalities*: This extends to tracking, listing, and controlling exploitative behavior in all sectors that benefit from the pandemic. For instance, this can be done using measurements such as those proposed above where relevant stakeholder groups can examine publicly available data on exploitative behavior of actors and/or by using advances in technology (e.g., Artificial Intelligence).

2. Making public the complexities surrounding how governments subsidize research that leads to new medical compounds, vaccines, and associated complementary products, and making the knowledge created through such subsidies accessible. In this way, unrestricted and universal access to such subsidized products and processes is established. In the past, in agreement with pharmaceutical firms, the WTO set differential pricing so that developing countries could afford HIV/AIDS medications at subsidized prices for poor patients. Such a pricing strategy came into effect after a successful movement mobilized by the Treatment Action Campaign (TAC) in South Africa (Chowdhury, 2021). One of TAC's arguments was that an early compound of HIV/AIDS medicines was discovered by an institute funded by an American government's subsidy which helped Burroughs Wellcome to patent and manufacture the first HIV/AIDS medicine—namely AZT.
3. Permanently liberating patent rights for producing the vaccines and related medical products so that developing country firms do not need to fight for this right on a case-by-case basis and are able to manufacture these products at significantly lower costs through a transparent differential pricing strategy.
4. A worldwide binding agreement to offer significant rewards to firms in the pharmaceutical industry that fast-track innovations for enduring solutions to this current global crisis. While this is a tough task, recent agreements by world governments to limit tax evasion by corporates suggest that this is achievable if the political will is present (OECD, 2021).

Going Beyond the Irrationality of Rationality: Market Economics That Matters to All Not a Few

Incentives lie at the heart of economics and getting them right can drive the world toward recovery from global challenges. For every unresolved challenge facing the world, there are actors who have incentives to maintain the status quo. We emphasize that behind climate change, wars, the pandemic, and multiple challenges arising from market economics, hidden incentive structures perpetuate these problems. There is a compelling need to identify the underlying incentive structures in these cases to determine how such structures must be aligned with the solutions rather than with the perpetuation of the challenges themselves to resolve the paradox of incentives. This can limit the exploitation of the paradox of incentives while enabling public actors and

corporations to realize their responsibilities. Our ability to make the planet sustainable and peaceful for future generations depends on the ability to contest these untenable incentives and restructure them to break the paradox of incentives and create new opportunities for societal transformation.

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