

NAR then went back to single mechanic who both recommended and performed repairs, but replaced the incentive pay with a flat salary. Although this removed the incentive to do unnecessary repairs, it also removed the incentive to work hard, resulting in what economists call “shirking.” Since mechanics made the same amount of money regardless of whether they recommended and performed repairs, they ignored all but the most obvious problems.

Figuring out which solution is most profitable involves weighing the trade-offs associated with various solutions. For example, before implementing the two-division solution, NAR management should have asked whether the new decision maker had enough *information* to make good decisions, as well as the *incentive* to do so. The answer could have alerted NAR management to the potential for collusion between the recommending mechanic and the repairing mechanic. Similarly, this kind of analysis would have identified shirking by the mechanics as a cost of the flat-salary solution.

With the benefit of hindsight, I would have suggested a third potential solution: keep the original organizational design, but use an additional performance metric, based on reports provided by “secret shoppers” who bring good cars into the garage to test whether the mechanics order unnecessary repairs. If so, fire or penalize the mechanics who recommend unnecessary repairs. Secret shoppers are used successfully in other contexts, for example, in restaurants to measure service quality. By measuring and rewarding quality, restaurant chains are able to protect the value of a brand as a signal of quality. Similarly, using secret shoppers may have been able to protect the value of NAR’s brand as a signal of reliable service.

1.4 Ethics and Economics

Using the rational-actor paradigm in this way—to change behavior by changing incentives—makes some students uncomfortable because it seems to deny the altruism, affection, and personal ethics that motivate most people. These students resist learning the rational-actor paradigm because they think it implicitly endorses self-interested behavior, as if the primary purpose of economics were to teach students to behave rationally, optimally, and selfishly.

These students would probably agree with a *Washington Post* editorial, “When It Comes to Ethics, B-Schools Get an F,”¹ which blames business schools in general, and economists in particular, for the ethical lapses at FIFA, Goldman Sachs, and other organizations.

A subtle but damaging factor in this is the dominance of economists at business schools. Although there is no evidence that economists are personally less ethical than members of other disciplines, approaching the world through the dollar sign does make people more cynical.

What these students and the author, a former Harvard ethics professor, do not understand is that to control unethical behavior, we first have to understand why it occurs. When we analyze problems like the one at OVI, we’re *not* encouraging students to behave opportunistically. Rather, we’re teaching

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them to anticipate opportunistic behavior and to design organizations that are less susceptible to it. Remember, the rational-actor paradigm is only a tool for analyzing behavior, not advice on how to live your life.

It is also important to realize that these kinds of debates are often debates about value systems. *Deontologists* judge actions as good or ethical by whether they conform to a set of principles, like the Ten Commandments or the Golden Rule. *Consequentialists*, on the other hand, judge actions by their consequences. If the consequences of an action are good, then the action is deemed to be good or moral. We illustrate these contrasting value systems with a story about price gouging.²

When Notre Dame entered the 2006 season as one of the top-ranked football teams in the country, demand for local hotels during home games rose dramatically. In response, local hotels raised room rates. According to the *Wall Street Journal*, the Hampton Inn charged \$400 a night on football weekends for a room that cost only \$129 on non football days. Rates climbed even higher for games against top-ranked foes. For the game against the University of Michigan, the South Bend Marriott charged \$649 per night—\$500 more than its normal weekend rate of \$149.

On a campus founded by priests of the Congregation of Holy Cross, where many students dedicate a year after graduation to working with the underprivileged, these high prices caused alarm. The *Wall Street Journal* quotes Professor Joe Holt, a former priest who teaches ethics in the school's executive MBA program, "It is an 'act of moral abdication' for businesses to pretend they have no choice but to charge as much as they can based on supply and demand." The article further reports Mr. Holt's intention to use the example of rising hotel rates on football weekends for a case study in his class on the integration of business and values.

Deontologists like Professor Holt would object on principle to the practice of raising prices in times of shortage.³ We might label this the *Spider Man Principle*: with great power comes great responsibility. The laws of capitalism allow corporations to amass significant power; in turn, society should demand a high level of responsibility from corporations. In this case, while property rights give a hotel the *option* of increasing prices, possession of these rights does not relieve the hotel of its *obligation* to be concerned about the consequences of its choices. A simple beneficence argument might suggest that keeping prices low would be better for consumers.

Economics, on the other hand, gives us a *consequentialist* understanding of the practice by comparing high prices to the implied alternative. An economist would show that if prices do not rise, the *consequence* would be excess demand for hotel rooms. Would-be guests would find their rooms rationed, perhaps on a first-come, first-served basis. More likely, arbitrageurs would set up a black market, by making early reservations, and then "selling" their reservations to customers willing to pay the market-clearing price. Not only would consumers end up paying the same price, but these "arbs" would make money that would have otherwise gone to the hotel. Without the ability to earn additional profit during times of scarcity, hotels would have less incentive to build additional rooms, which would make the long-run problems even worse!

Versions of this debate—between those who criticize business on ethical grounds and those who are trying to make money—have been going on in this country since its founding. Although a full treatment of the ethical dimensions of business is beyond the scope of this book, many disagreements are really about whether morality should be defined by *deontology* or *consequentialism*. Once you realize that a debate is really a debate between value systems, it becomes much easier to understand opposing points of view, and to reach compromise with your adversaries. For example, if the government were considering price-gouging laws that made it illegal to raise prices on football weekends, a solution might involve donation of some of the profits earned on football weekends to a local charity. This might assuage the concerns of those who ascribe to the Spider Man principle.

As a footnote to this story, when someone offered our former priest \$1,500 for his apartment on home-game weekends, he took the offer and now spends his weekends in Chicago. Apparently, his principles became too costly for him.

1.5 Economics in Job Interviews

If this well-reasoned introduction doesn't motivate you to learn economics, read the following interview questions—all from real interviews of students. These questions should awaken interest in the material for those of you who think economics is merely an obstacle between you and a six-figure salary.

-----Original Message-----

From: "Student A"
Sent: Friday, January 2, 2009, 3:57 PM
Subject: Economics Interview Questions

I had an interview a few weeks ago where I was told that the position paid a very low base and was mostly incentive compensation. I responded that I understood he was simply "screening out" low productivity candidates

[NOTE: low productivity candidates would not earn very much under a system of incentive compensation, and so would be less likely to accept a job with strong incentive compensation].

I "signaled" back to him that this compensation structure was acceptable to me, as I was confident in my abilities to produce value for the company, and for me.

[Note: "Signaling" and "screening" are both solutions to the problem of adverse selection, the topic of Chapter 19.]