Incentive

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June 4, 2026

RECOMMENDED CITATION

mohammad looti (2026). *Incentive*. PSYCHOLOGICAL SCALES. Retrieved from https://scales.arabpsychology.com/?p=38448

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In economics and sociology, an incentive is any factor (financial or non-financial) that enables or motivates a particular course of action, or counts as a reason for preferring one choice to the alternatives. It is an expectation that encourages people to behave in a certain way. Since human beings are purposeful creatures, the study of incentive structures is central to the study of all economic activity (both in terms of individual decision-making and in terms of co-operation and competition within a larger institutional structure). Economic analysis, then, of the differences between societies (and between different organizations within a society) largely amounts to characterizing the differences in incentive structures faced by individuals involved in these collective efforts. Ultimately, incentives aim to provide value for money and contribute to organizational success.

Categories

Incentives can be classified according to the different ways in which they motivate agents to take a particular course of action. One common and useful taxonomy divides incentives into four broad classes:

Remunerative incentives (or financial incentives) are said to exist where an agent can expect some form of material reward -- especially money -- in exchange for acting in a particular way.
Moral incentives are said to exist where a particular choice is widely regarded as the right thing to do, or as particularly admirable, or where the failure to act in a certain way is condemned as indecent. A person acting on a moral incentive can expect a sense of self-esteem, and approval or even admiration from his community; a person acting against a moral incentive can expect a sense of guilt, and condemnation or even ostracism from the community.
Coercive incentives are said to exist where a person can expect that the failure to act in a particular way will result in physical force being used against them (or their loved ones) by others in the community -- for example, by inflicting pain in punishment, or by imprisonment, or by confiscating or destroying their possessions.
Natural Incentives such as curiosity, imagination, mental or physical exercise, admiration, fear, anger, pain, joy, or the pursuit of truth, or the control over things in the world or people or oneself.

(There is another common usage in which incentive is contrasted with coercion, as when economic moralists contrast incentive-driven work--such as entrepreneurship, employment, or volunteering motivated by remunerative, moral, or personal incentives--with coerced work--such as slavery or serfdom, where work is motivated by the threat or use of violence. In this usage, the category of "coercive incentives" is excluded. For the purposes of this article, however, "incentive" is used in the broader sense defined above.)

Other forms

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These categories do not, by any means, exhaust every possible form of incentive that an individual person may have. In particular, they do not encompass the many other forms of incentive--which may be roughly grouped together under the heading of personal incentives--which motivate an individual person through their tastes, desires, sense of duty, pride, personal drives to artistic creation or to achieve remarkable feats, and so on. The reason for setting these sorts of incentives to one side is not that they are less important to understanding human action--after all, social incentive structures can only exist in virtue of the effect that social arrangements have on the motives and actions of individual people. Rather, personal incentives are set apart from these other forms of incentive because the distinction above was made for the purpose of understanding and contrasting the social incentive structures established by different forms of social interaction. Personal incentives are essential to understanding why a specific person acts the way they do, but social analysis has to take into account the situation faced by any individual in a given position within a given society--which means mainly examining the practices, rules, and norms established at a social, rather than a personal, level.

Social pressure

It's also worth noting that these categories are not necessarily exclusive; one and the same situation may, in its different aspects, carry incentives that come under any or all of these categories. In modern American society, for example, economic prosperity and social esteem are often closely intertwined; and when the people in a culture tend to admire those who are economically successful, or to view those who are not with a certain amount of contempt (see also: classism, Protestant work ethic), the prospect of (for example) getting or losing a job carries not only the obvious remunerative incentives (in terms of the effect on the pocketbook) but also substantial moral incentives (such as honor and respect from others for those who hold down steady work, and disapproval or even humiliation for those who don't or can't).

Types of Incentives

Straight piece rate: In the straight piece rate system, a worker is paid straight for the number of pieces he produces per day. In this plan, quality may suffer.

Straight piece rate with a guaranteed base wage: A worker is paid straight for output set by management even if worker produces less than the target level output. If worker exceeds this target output, he is given wage in direct proportion to the number of pieces produced by him at the straight piece rate.
Halsey Plan: W = R.T + (P/100) (S-T).R where W: wage of worker, R : wage rate, T : actual time taken to complete job, P : percentage of profit shared with worker, S : std. time allowed. Output standards are based upon previous production records available. Here management also shares a

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percentage of bonus.
Rowan Plan: W=R.T + ((S-T)/S).R.T Unlike Halsey Plan gives bonus on (S-T)/S , thus it can be employed even if the output standard is not very accurate.

Incentive in economics

The study of economics in modern societies is mostly concerned with remunerative incentives rather than moral or coercive incentives -- not because the latter two are unimportant, but rather because remunerative incentives are the main form of incentives employed in the world of business, whereas moral and coercive incentives are more characteristic of the sorts of decisions studied by political science and sociology. A classic example of the economic analysis of incentive structures is the famous Walrasian chart of supply and demand curves: economic theory predicts that the market will tend to move towards the equilibrium price because everyone in the market has a remunerative incentive to do so: by lowering a price formerly set above the equilibrium a firm can attract more customers and make more money; by raising a price formerly set below the equilibrium a customer is more able to obtain the good or service that she wants in the quantity she desires.

A strong incentive is one that accomplishes the stated goal. If the goal is to maximize production, then a strong incentive will be one that encourages workers to produce goods at full capacity. A weak incentive is any incentive below this level.

Incentives help people to make the right decision, or the one one would like them to make. To accomplish things you want done in economics you must give the consumer or the producer incentives, with out them they would have no reason to do what you ask.

Example: Incentive Regulation in the Utility Sector

Incentive-based regulation can be defined as the conscious use of rewards and penalties to encourage good performance in the utility sector. Incentives can be used in several contexts. For example, policymakers in the United States used a quid pro quo incentive when some of the U.S. incumbent local telephone companies were allowed to enter long distance markets only if they first cooperated in opening their local markets to competition. Incentive regulation is often used to regulate the overall price level of utilities. There are four primary approaches to regulating the overall price level: rate of return (or cost of service) regulation, price cap regulation, revenue cap regulation, and benchmarking (or yardstick) regulation. With benchmarking, for example, the operator's performance is compared to other operators' performance and penalties or awards are assessed based on the operator's relative performance. For instance, the regulator might identify a number of comparable operators and compare their cost efficiency. The most efficient operators would be rewarded with extra profits and the least efficient operators would be penalized. Because

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the operators are actually in different markets, it is important to make sure that the operators' situations are similar so that the comparison is valid, and to use statistical techniques to adjust for any quantifiable differences the operators have no control over. Generally regulators use a combination of these basic forms of regulation. Combining forms of regulation is called hybrid regulation. For example, U.K. regulators (e.g. Ofgem) combine elements of rate of return regulation and price cap regulation to create their form of RPI - X regulation.

Incentive problems

Incentive structures, however, are notoriously more tricky than they might appear to people who set them up. Human beings are both finite and creative; that means that the people offering incentives are often unable to predict all of the ways that people will respond to them. Thus, imperfect knowledge and unintended consequences can often make incentives much more complex than the people offering them originally expected, and can lead either to unexpected windfalls or to disasters produced by unintentionally perverse incentives.

For example, decision-makers in for-profit firms often must decide what incentives they will offer to employees and managers to encourage them to act in ways beneficial to the firm. But many corporate policies -- especially of the "extreme incentive" variant popular during the 1990s -- that aimed to encourage productivity have, in some cases, led to spectacular failures as a result of unintended consequences. For example, stock options were intended to boost CEO productivity by offering a remunerative incentive (profits from soaring stock prices) for CEOs to improve company performance. But CEOs could get profits from soaring stock prices either (1) by making sound decisions and reaping the rewards of a long-term price increase, or (2) by fudging or fabricating accounting information to give the illusion of economic success, and reaping profits from the short-term price increase by selling before the truth came out and prices tanked. The perverse incentives created by the availability of option (2) have been blamed for many of the falsified earnings reports and public statements in the late 1990s and early 2000s.

Incentives in Recession Times

Though bonuses make an integral component of free market practices, continuing to pay them to executives by companies benefiting from US Government financial help as planned and as contracted is facing great criticism and opposition from politicians and media. The case of American Insurance Group is an obvious example of how refused normal bonus incentives have become after the capital market meltdown.

A possible solution against the criticism of overpaying executives in boom times and underpaying them in recession times is by linking bonus targets to an Operating Index. By doing so external effects (economic cycles) can be excluded from performance measurement. This makes incentive

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pay more fair as bonuses are based on performance relative to other companies in the peer universe.

While the notion of a fair system seems to be an equal deal, those who are outperforming by a large margin will feel slighted by this approach; Thus, a system based on individual company performance has been the standard.

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