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Regulation by Incentives, Regulation of the Incentives in Urban Policies

Tommaso Vitale[*]

Abstract: The Institutional Analysis and Development (IAD) Framework developed at the University of Indiana is very promising for advancing comparative urban studies. Ostrom's "Grammar of Institutions" is useful for addressing urban allocative conflicts. Such conflicts are valuable entry points to better grasp urban politics, especially in comparative research. This paper introduces a theoretical and conceptual framework to analyse the role of monetary and non-monetary incentive schemes in the field of urban policies. The incentives to consider in urban policies can be divided into four categories: (1) direct financial incentives; (2) indirect financial incentives; (3) non-financial incentives; (4) broader social incentives. Direct and indirect financial incentives are well studied by public choices theorists in urban economics; non-financial incentives are considered in some forms of planning theory, while broader social incentives are especially stressed by urban sociologists. This paper stresses the relevance for urban theory of configurations that articulate the four kinds of incentives conjointly, from both a bottom-up perspective and a top-down perspective. Taking into account of incentives, and not only of single incentives (one by one), it is a promising advancement. It is hypothesized that this could sustain relevant development in comparative urban research.

Key words: urban policy; Institutional Analysis and Development Framework; urban commons; collective incentives; social norms

1. Introduction

The Institutional Analysis and Development (IAD) Framework developed at the University of Indiana is very promising for advancing comparative urban studies. Understanding Institutional Diversity (Ostrom, 2005) specifies a "Grammar of Institutions" (Crawford and Ostrom, 1995; Ostrom, 2005), which is quite useful for coping with urban allocative conflicts. Conflicts around the allocation of urban commons and collective goods are absolutely relevant not only per se, but also as entry points to better grasp urban

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politics, especially in comparative research. IAD researchers focus on (1) the type of relationship between disputants; (2) the nature of a dispute– i.e. the type of good under dispute (public, private, toll goods, common-pool resource); (3) the arena of interaction (among operational choice arena, collective choice arena, and constitutional choice arena); (4) the cost-benefit configuration of different options of dispute resolution mechanisms (because each mechanism has an expected value to each party and outside options are always available); and consequently, (5) the incentives facing disputants to cheat, shirk, mislead, or exploit at each stage of the dispute process.

In this analytical configuration, the way of looking at incentives within contentious action situations is particularly innovative, and must also be discussed by scholars in urban studies. In this paper, I introduce a theoretical and conceptual framework to analyse the role of monetary and non-monetary incentive schemes in the field of urban policies. The incentives to consider in urban policies can be divided into four categories: (1) direct financial incentives; (2) indirect financial incentives; (3) non-financial incentives; (4) broader social incentives. Direct and indirect financial incentives are well studied by public choices theorists in urban economics; non-financial incentives are considered in some forms of planning theory, while broader social incentives are especially stressed by urban sociologists. In this article, I stress the relevance for urban theory of configurations that articulate the four kinds of incentive conjointly, from both a bottom-up perspective and a top-down perspective. Taking into account configuration of incentives, and not only single incentives (one by one) it is a promising advancement, and my hypothesis is that it could sustain relevant development in comparative urban research.

2. Main debates about regulation by incentives

It is interesting to note that the word “incentive” is never quoted in the monumental history of economic thought written by Schumpeter (1954). This may seem strange, especially in terms of the current economics debate in which incentives play a central role. Schumpeter’s omission is easily explained when one considers his statement that the main concern of economic theorists was the theory of value in large economies. It can easily be argued that incentive theories emerge from the issue of division of labour and trade, and partly from distribution of work within the family (Laffont, Martimort, 2002:1). The division of labour introduces the problem of delegation, hence the consideration of incentives, which can already be found in Adam Smith’s (1776) famous thoughts about “sharecropping contracts” in agriculture. Sidgwick also dealt implicitly with the issue of incentives in 1883, examining the problems of redistribution. In firm theory, and in management in particular, Chester Barnard in 1938 was the first to have a broad view of both monetary and non-monetary incentives.

In practice, however, the study of incentives developed explicitly and systematically from the second half of the 1950s. The initial concept was simple, and assumed a high degree of automatism. The institution

sets the framework for incentives, and actors adapt their strategies to the institution's objectives. This can be defined as a narrow view of regulation by incentives. The "narrow" view of regulation by incentives assumes rational actors that are able to choose between alternative courses of action based on calculation. Therefore, it only considers pay incentives, without acknowledging even the potential role of non-pay incentives. Consequently, this narrow view considers one type with only three classes: (1) Financial Incentives; (2) Tax Incentives; and (3) Real Incentives. Jorgenson was the economist who formalised this model using a well-known equation. This is a model that provides incentives for social investments. It was conceived in 1963 within a neoclassical framework. The expression shows the cost of using capital, whereby it would be advantageous for a company to invest until the increase in revenue equals the cost of additional investment.

Recently, the Agency Theory, or Principal/Agent Theory, has profoundly renewed the way in which regulation by incentives is considered. The Agency Theory is one of the most important theories in the current debate in economics. It has profoundly renewed microeconomics by placing information, and its role in the operation of a market economy, at the centre of its analytical framework, and in particular the interests of financial agents (Laffont, 2003). Solutions proposed by the Agency Theory vary based on two different types of opportunism: the first is pre-contractual opportunism (adverse selection), and the second is post-contractual opportunism (moral risk). Therefore, the problem with the Agency Theory is balancing the benefits of incentives and the costs of the risk (Barbera, 2005). However, the aim is always to have the principal's interests coincide with those of the agent by means of an appropriate incentive plan, taking advange of the agent's interest.

Therefore, many significant criticisms of the Agency Theory, principally by sociologists (Trigilia, 2002), do not relate solely to its assumptions (e.g. selfish and rational actors, Pavlovian actors, little consideration of the contradictory nature of the many incentives that are present in the situation, etc.), but also to its scope conditions. The Agency Theory may work where private assets are involved, but it is not very promising where public assets are concerned.

Does this mean that incentives have no part to play in the regulation of the urban policy sector? Given the criticisms of the Agency Theory, some believe that it is not possible to conceive a regulatory model based on incentives for the production of public goods (Barbera, 2000). The reasons for a lack of confidence in regulation by means of incentives are based on the significant "perverse" effects that are triggered by incentives. The main perverse effects identified by Carlo Trigilia (2002) are:

- The waste effect, which indicates that the same assumption would have been made without assistance.

- The replacement effect, whereby the incentivized assumption replaces a non-incentivized assumption in another company.
- The habit effect, whereby assumptions are made only on the basis of incentives.
- The selective effect (or "cream skimming effect"), whereby only the most competitive people are employed.

Following Barbera (2000; 2005), it is possible to add a fifth criticism:

- The automatic nature of incentives, as they are often implemented in urban policies, which according to many commentators (and analysts), has prevented the nature of selective and targeted interventions (see also Barbera, Negri 2008).

However, from our point of view, the criticisms described above should not be generalized to apply to all regulation by means of incentives, but rather to the way in which it is implemented. In other words, regulation by means of incentives, as it is often used–particularly in the urban policies– does not affect the institutional context. It is only concerned with reducing costs and does not increase the actors' ability to cooperate. In this case, introducing incentives in urban policies would only satisfy short-term political requirements.

3. Steps to an institutional approach

Using a slogan, I could say that if incentives are not sufficient to regulate economic actions, then an additional regulation of incentives is required instead (Barbera, 2001). In other terms, incentives can only work with appropriate institutional conditions, including trust, social capital, interpersonal relations, rules, and regulatory and cognitive resources. Barbera (2002) showed two variations: the first states that incentives work well with given institutional conditions. Here, institutions take on a role regulating individual interest and define– but do not replace– the structure of constraints and resources with which actors interact (e.g. the relationship between institutions and economic development in North, 1990). The second version is more radical, and states that institutions replace incentives in the actors' plan of action. Here, institutions play a constituent role in individual interests (Streeck, 1992): incentives only work with appropriate institutional constraints.

The requirement to pay particular attention to the ways in which incentives are actually implemented emerges for studying local and urban development (Vitale, 2001). In order to do this, a conceptual tool kit is required to support the analysis of incentive plan implementation processes. Thus, the incentive system within a complex context, such as a large metropolis, is a secondary problem (the appropriateness of opportunism) compared to the ways in which regulations are established within the collective of actors

implied in an urban policy. This results in an analytical problem: establishing the relevant classes of regulations to analyse the impact of incentives on groups.

4. Incentives in urban policies

A significant part of the criticism expressed towards regulation by incentives is linked to the fact that such incentives are offered without regard to the specific context in which they would be given. In direct response to these criticisms, approaches to the problems of incentives have been specifically developed to take each context closely into account. The choice of an approach which accounts for the conditions in which incentive schemes are implemented locally is, nevertheless, fully coherent with the more general challenges faced by comparative urban research. As held by Hicks and Adams (2000:12): "Incentives seldom exist in isolation, and the policy context in which they exist may be as important as the incentive itself in affecting behaviour".

The framework developed by the Workshop in Political Theory and Policy Analysis under the direction of Elinor and Vincent Ostrom, i.e. the Institutional Analysis and Development framework (IAD), allows the simultaneous consideration of the configuration of incentives and the context within with they are stated. In the IAD, collective action is central to the problem of incentive regulation. In institutional analysis, the term "incentive" refer to rewards and punishments that are perceived by individuals to be related to their actions and those of others: "the payments people receive or costs they have to pay, the respect they earn from others, the acquisition of new skills or knowledge are all external stimuli that may induce more of some kinds of behaviour and less of other kinds" (Ostrom E. et al., 2002: 6). The incentive structure that impacts a group is filtered by the set of regulations adopted by each group. The types of regulations are universal and their specification is infinitely varied, whereby it is only possible to study the differences between groups relationally.

The IAD was developed reflecting on two very different research programs: (1) common-pool resources, e.g. management of groundwater, irrigation systems, forestry resources and fisheries, typically by local groups (McGinnis 1999b); and (2) local public economies and public services (McGinnis 1999a).

The research programs conducted by Workshop-affiliated scholars must be seen in the context of other studies of institutions as crucial links between political and economic phenomena. Institutional analysis initially began as a variant of public choice. In early works, public choice was the preferred term used by the founders of the Workshop (e.g., Ostrom and Ostrom, 1971). Mitchell (1988) argues that the IAD framework differs from the other public choice tradition in its reliance on inductive empirical research rather than the development of formal models per se. Another major difference is that Herbert Simon's work on public administration and on the cognitive limitations of human rationality had a major influence on institutional analysis. Human beings are defined as "fallible learners" (Ostrom and Ostrom, 2004; see

also Vitale, 2010a). The following three points summarize aspects of institutional analysis that differentiate it from these other approaches to the study of institutions (McGinnis, 1999c).

1. No one institution or set of actors can be totally understood in isolation. Institutional analysts must consider the ways in which actor preferences are shaped by their institutional roles, which in turn result from processes in other arenas of choice. In this sense, all institutionalized interactions are instances of polycentric games (McGinnis, 2000). The essential defining characteristic of a polycentric policy system is one where "many officials and decision structures are assigned limited and relatively autonomous prerogatives to determine, enforce, and alter legal relationships" (Ostrom V., 1999: 55). This implies the absence in a polycentric system of any simple one-to-one correspondence between categories of goods, property rights, and owner-bodies-organizational entities.

2. All successful organizations require effective procedures for monitoring and sanctioning. "This holds true even for small, homogeneous groups. Even groups with a strong sense of a shared community of understanding cannot neglect questions of monitoring the behaviour of individuals (both members and agents) and the sanctioning of rule violators" (McGinnis, 1999c: 5).

3. Co-production involves direct participation in the production of a collective good by those who will benefit from its production. This term denotes an alternative to the standard conceptualization of production and consumption as totally separate activities. In co-production, the quality of a good can be enhanced if consumers are directly involved in the production of that good. In regular production consumers and producers engage in simple exchange. This concept was originally developed in the study of neighbourhood security and other local public goods (Parks et al., 1981; McGinnis, 1999b). It has subsequently been applied to sustainable development (Ostrom E., 1996; McGinnis, 1999a) and it has important implication for urban regeneration (Vitale, 2010b).

The implications of institutions for individual behaviour and policy outcomes can best be understood by careful examination of particular empirical contexts, but such detailed analyses are most effective if they are informed by an overarching framework of analysis. The IAD framework provides a common set of concepts and analytical categories that can be applied to a broad array of empirical contexts. Thus, the IAD framework has cumulated an extensive body of political, social, and economic theory that focuses on the impact of diverse rules on the incentives, behaviour, and likely outcomes within different settings. It permits the undertaking of an analysis of how combinations of rules, the structure of the goods and technology involved, and culture interact to affect the incentives facing individuals and resulting patterns of interactions adopted by individuals. As Elinor Ostrom et al. (2002: xiii) say: "a successful approach to the problem of development must focus on how to generate appropriate incentives so that the time, skill,

knowledge, and genuine effort of multiple individuals are channeled in ways that produce jointly valued outcomes".

While in IAD these "individuals" are fallible learners (Ostrom V., 1987), they can, and often do, make mistakes. "Whether incentives encourage people to learn from these mistakes, or to continue to make the same mistakes forever, depends on the particular institutional settings. In addition, whether incentives encourage the adoption of a reputation for being reliable and trustworthy or the seeking out of short-term benefits without taking into account the effect on longer-term patterns of interaction, also depends largely on the rules structuring particular situations" (Ostrom et al., 2002: 279).

5. Configurations of incentives

The IAD considers relational, organizational, and process interdependence of great importance, but it does not identify any process variables. Each local situation can be analyzed using the process variables that a researcher chooses to select from the social theory that s/he considers appropriate. There are no general process variables. Otherwise, the approach would become one big structural/functionalist theory. The IAD is an analytical framework and not an explanatory one. It provides direction on how to observe the impact of incentives on action situations by the configuration of classes of rules. In other words, it basically says that there is no correlation between a rule and collective performance. There are only very local configurations (that is to say, it is a hyper-local approach). It is the configuration of each group's rules that allows the group to perceive incentives in a different way.

The essential point is that incentives do not align atomized and Pavlovian actors in a banal way. They work in directions that are similar (but never coincident) to those of the principal when they impact a collective where there is trust and reciprocity, and if the collective is able to intervene actively in its constituent rules. In addition, the incentives do not destroy the capacity for collective action, but rather they reinforce and support cooperation. Incentives will only produce results when all of these conditions have been met.

It is therefore possible to provide incentives using this approach, as long as there is a thorough understanding of the combination of rules being used in each specific context. One of the main messages of this approach is that it is not enough for urban authorities to shower money on an action situation. It is important to redistribute powers and to re-define the ownership of the projects to implement (Gibson, et al. 2005).

6. Trust, cooperation, and non-pay incentives

The approach I have described seems particularly useful and productive to analyze the regulation through incentives in urban policies that usually have a contradictory and paradoxical character. The IAD framework highlights how the cognitive method through which actors apply the incentive structure in a specific city has a normative basis, that is, a specific configuration of rules that govern the life of the group of actors implied. The implementation of an incentive plan in an urban policy is perceived in different ways according to the configuration of rules that characterize the local context. Before designing and implementing incentive plans from the city government, the IAD framework reminds us that the regulations must be analyzed accurately, as individual incentives are not important in themselves, for their content, but rather for their configuration in relation to the structure of rules in the action situation that they will impact, i.e. in each different neighbourhood. In addition, the incentives of actors are shaped by institutional arrangements, and it is not always the case that the actors incorporate these incentives into their goal structure in exactly the manner that the original designers intended. "Instead, individuals respond creatively to their changed circumstances, creating consequences that may not have been foreseen by those involved in the design process" (McGinnis, 2003: 2).

In this sense, it is not possible to design incentive plans that are universally valid for all parts of a large metropolis, as each neighborhood is a specific situation that reacts to incentives based on its specific structure of internal rules. This very local approach, far from discouraging investment in regulation through incentives, actually leads to attention being focused on the implementation process. At the same time, the connection between rules and incentives shows how it is not only financial incentives that allow the objectives of urban policies to be directed.

In my judgment, this is really a major analytical result. It allows better understanding of if and how incentives could change urban policy outcomes. The structural connection between the normative aspect of urban policy and regulation by incentives helps us to analyse feasible changes in urban agencies. It is obviously rather difficult for change to come about, especially in critical situations where obstacles and habitual inertia make the problems impossible to solve and exacerbate the already chronic effects. In this sense, the desire for change is not enough: in fact, the framework I have chosen strongly reminds us that the intention of a single actor is not enough, nor is his or her rationality or capability. Just as change cannot come about by means of a pre-designed plan, well-defined objectives together with an appropriate calculation of the relationship between means and ends are not enough. As the IAD framework emphasizes above all else, it is necessary to be aware of the different sets of rules which characterise the life of each urban context.

Resistance to change, linked to the rules that characterise the particular city government (or other authority insisting on an urban space), needs to be fully explored on a different scale. Such resistance to change forms is a fundamental part of collected and shared ways of understanding and of working in

urban policy. Moreover, these practices indeed enjoy a strong normative power: what is thought and done matches what must in fact be thought and done. This situation, which rests on a long-settled body of rules, often seems to be the only possible option, whereby resources always appear to be dramatically scarce, and one finds himself thinking only in terms of what lacks and not in terms of potential actions to bring change, improvement and learning (Hirschman, 1971). In this sense, change in urban policy is only possible where the situation and the common feeling with respect to the situation, rules, and preferences are successfully turned around.

From the IAD framework, I understand that it is important to investigate if and how incentives are able to direct the inertia, which characterises and oppresses the urban policies in a different manner. So we could test the hypothesis that directing inertia can only be made possible through this joint work on the normative and cognitive structure of each single organized urban setting. Strategic reasoning and intention is thus far from enough (Boltanski, 2002), and it is very necessary to give weight to the capacity to reflect and learn throughout policy tools (De Leonardis, 2002). To achieve this objective, again there are no recipes, but the preferences of the actors involved and their changes could be used as a means to spur the work. Integrating, relocating, and creating a plurality of contrasting experiences and viewpoints would also be extremely useful, without losing track of the need to produce tangible, visible results which can be shared by all, and which can provoke a change in perspective (both the situation and the way it is seen) by virtue of their very existence.

As urban scholars, the IAD framework directs our attention not only to the contents of an incentive scheme for urban policies (e.g., financial or non-financial motives), and not generically to the context in which such a scheme must be implemented. The tools of the IAD framework focus the analysis "on the institutional change that will be required to allow beneficiaries to overcome their collective-action problems and realize their own developmental potential" (Ostrom E. et al., 2002: 250).

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