Identity Economics

*How Our Identities Shape Our Work, Wages, and Well-Being*

George A. Akerlof and Rachel E. Kranton

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**Key Concepts**

*Identity*, or the identity, norms, and social categories that define who people are, expands economic inquiry in three ways:

1. It widens the scope of personal choices that economists can study. Choices based on one’s identity are among the most important “economic” decisions people make. Parents choose schools for their children, women may choose to pursue a career or stay at home, immigrants choose whether or not to assimilate, and men and women choose whether to be single or to marry. These choices and the motivation for making them inform economic analysis.

2. It has a direct impact on personal preferences. Third parties may have incentives to change who people think they are, as well as their norms. Advertisers, politicians, and employers all manipulate social categories and norms.

3. It gives people a new window on inequality. Norms can call for behavior that leads to underperformance and unemployment. Boundaries of race, ethnicity, and class also limit who people can be. Because identity is fundamental to behavior, such limits may be the most important determinant of economic position and well-being.

**Introduction**

*Identity Economics* by George Akerlof and Rachel Kranton discusses a new way to understand people’s decisions—at work, at school, and at home. The book brings identity and related norms to economics. People’s notions of what is proper or forbidden are fundamental to how hard they work, and how they learn, spend, and save. By viewing economics with human passions and social institutions in mind, *Identity Economics* offers a way of more accurately predicting the consequences of public policies and business practices.

**Economics and Identity**

Most people think of economics as the branch of knowledge that deals with the production and dis-
tribution of wealth in theory or practice. The study began in the eighteenth century with Adam Smith's attempt to turn moral philosophy into a social science designed to create a good society.

In the nineteenth century, economists began to build mathematical models of how the economy worked, using a stick figure of a rationally optimizing human with only economic motivations. In the twentieth century, the models grew more sophisticated, but the study of human behavior in the models did not. Economists maintained that individuals had a “utility function,” a mathematical expression that described what people cared about. What went into utility functions gave economists a way to classify motivation. Much of economic analysis focused on financial motivations, dealing with consumption and income.

Economics today, however, is not just about money. Many believe that it should include nonpecuniary motives as well. But economists also agree that tastes, such as the desire to have children, the concern for status, and the wish for fairness, are preferences that are independent of social context. This presumption ignores the fact that what and how much people care about something depends in part on their identities.

In reality, the idea of fairness involves social context. What is seen as fair in some parts of the world may be considered unfair elsewhere. Examples include:

- India, where upper castes do not treat lower castes equally.
- Rwanda, where Tutsis and Hutus do not treat each other equally.
- The United States, where whites do not always treat blacks equally.
- In some countries women and girls are physically assaulted with no repercussions and not allowed to go to school.

Identity, norms, and social categories may seem like abstract concepts, but they are actually easy to understand. Norms are clear when people hold an ideal of who they should be and how they should act. Akerlof and Kranton bundle identity, norms, and social categories in one word: identity. People’s identities define who they are and determine their social categories, which influences their decisions.

While economists often describe identity as a fuzzy concept, identity has the same kind of versatility as the tried-and-true notion of supply and demand. Supply-and-demand analysis leads economists to:

1. Identify individuals as buyers or sellers.
2. Specify prevailing technology and the market structure.
3. Look for individual gains and losses from particular actions, such as choice of prices or purchases.

With identity included, economists would:

1. Associate individuals with particular social categories.
2. Specify the prevailing norms for these categories.
3. Posit individual gains and losses from different decisions, given identities and corresponding norms.

These gains and losses combined with the standard concerns of economic analysis will determine what people do.

IDENTITY AND NORMS IN UTILITY

All economic studies begin with a description of people’s motivations. By building a new, augmented...
utility function that includes identity, norms, and categories, economists can bring “identity” into economic analysis. With categories, norms and ideals, and identity utility, economists can capture how motivations vary with social context. The model includes two parts:

1. Analysts specify the standard components of utility: a person’s tastes for goods, services, or other economic outcomes.

2. Analysts identify elements for the relevant social context, including the social categories and each individual category assignment, or identity; the norms and ideals for each category; and the identity utility, which is the gain when actions conform to norms and ideals, and the loss when they do not.

The last ingredient contains possible externalities that occur when an individual’s action hurts or benefits others. One example of this is air pollution from a factory. In the case of identity, people’s utility may increase or decrease, not only as the result of their own choices but also because of other people’s choices. People choose actions to maximize their utility—their gains—given their identity, norms, and social categories. They balance their Part 1 standard utility and their Part 2 identity utility.

While people’s decisions are described as maximizing their individual utility functions, it does not mean to imply that choices are always conscious. Some decisions are unconscious. Individuals’ decisions may not be driven by personal tastes but by internalized social norms. Similarly, people may or may not be able to choose their own identities. Choice can also be limited by race, family background, and ethnicity, making it impossible for an individual to adopt a new identity.

In a society where social categories are defined by race, family background, and ethnicity . . . it may be virtually impossible for an individual to adopt a new identity.

Where We Fit into Today’s Economics

In the last 50 years, economics has had many transformations, for example:

- Fifty years ago, economic theory mostly considered two market structures: perfect competition and monopoly. But many industries—including the automobile, airline, and oil industries—did not fit either mold, so economists started using the game theory to study major parts of economies. This involved specifying who the actors are, what they know, the timing of their decisions, and their choice of strategies.

- Economic studies at the time assumed all participants in a market had the same information. Nothing was hidden from the buyer or the seller. Today, that information is asymmetric, and studies specify who knows what and when they know it.

- More recently, economists commonly discuss psychological terms such as present bias, habit formation, and loss aversion in their findings.

- Gary Becker’s groundbreaking 1957 book The Economics of Discrimination prompted other economists to study social problems. Discrimination, dysfunctional families, and crime have all called for a new approach.

These transformations have helped bring theory closer to observation, emphasizing the individual in the social setting.

About the Authors

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Since the mid-1950s, experiments in social psychology and now increasingly in economics, show that individuals’ behaviors depend on who people think they are. Experiments have isolated groups to see how members functioned and reacted to suggestions. In addition to these experiments, similar research is being done on the norms in economics. To date, economists have mostly seen norms as sustained by external forces: people follow a norm because if they do not, they could be punished.

The military’s stress on “service before self” and its deemphasis of pecuniary rewards suggest—as in our model—that military identity can substitute for incentive pay.

In identity economics, however, people seem to follow and adhere to norms because they want to. One suggestion is that people need norms to adapt psychologically to disadvantageous environments. Another suggests that norms may evolve to maintain a sense of belonging.

IDENTITY AND THE ECONOMICS OF ORGANIZATIONS

Observation in the workplace is difficult, as is determining monetary incentives and measuring their impact on success. Business owners do not actually observe a worker’s performance, even though they are able to observe the results of that performance. In a factory, owners can test the product at random and record failure rates. In retail sales, owners can count the sales at the end of the day. The worker can be paid more when the failure rate is low or the sales numbers are high. Workers can be given incentives based on their success. But research indicates that in order for an organization to function well, it should not rely solely on monetary incentives.

Identity economics argues that identity is central to what makes organizations successful. For example, workers who feel as though they are “insiders” require lower bonuses to induce high effort compared with those workers on the outside who are motivated purely by financial gain. A company should consider investing in resources to change workers’ identities and make them insiders. However, changing a worker’s identity can be costly. It can involve expenditures on training, sign-on bonuses, and benefits. Since profits will increase when companies do not have to motivate workers with more pay, a firm is more likely to invest if:

- Instilling identity is cheap.
- There is much underlying economic uncertainty.
- Workers’ effort is hard to observe.
- Revenues or output depend on special exertion at peak times.
- Workers especially dislike risk.
- High effort is critical to the organization’s output.

In the military, it is relatively cheap to impart identity to soldiers and officers because:

- As volunteers they tend to be inherently sympathetic to its goals.
- Military personnel are especially susceptible to indoctrination because of their isolation from civilian life.
- It is very costly to quit.

The military makes investments to turn outsiders into insiders. Initiation rites, short haircuts, boot camp, uniforms, and oaths of office are among the means of creating a common identity. In addition, military personnel are turned from outsiders into insiders as a by-product of normal operations. They live and work in separation from civilians.

The model applies to the civilian as well as military workplace. Current studies show that management that encourages workers to be insiders is more effective. “Management by objective” gives employees a role in setting their own goals. Similarly, total quality management (TQM) aims to encourage workers to take pride in their work and thereby identify with their organizations and their missions.

IDENTITY AND THE ECONOMICS OF EDUCATION

The current economic theories of education characterize students as rational decision makers. Students are able to weigh the economic costs and benefits of staying in school. Schools are like factories where textbooks, labs, the building, the teachers, and student talent are all inputs. The outputs are, more or less, productive workers.
What is often missed however is how students feel about their status in the school and how they fit in with peers. Applying the authors’ model, shows that a student weighs the economic costs and benefits of education. The costs to the student include the effort on schoolwork, as well as delayed wages and other expenses. The benefits are higher future wages. Armed with this information combined with the defined norms and ideals of the various social categories and gains and losses in identity utility, students will be able to identify themselves.

There are two categories of students in the representative study—jocks and burnouts, or insiders and outsiders. Because jocks have a higher social status, it should follow that students will try to look like jocks and put in effort in school in order to gain higher future wages. While there is some choice between being a jock or a burnout, many students never fit in because they are not physically or socially able to conform. When students cannot attain the jock ideal, they tend to become burnouts, exerting too little effort to attain the rewards of an education, or try to be a jock and suffer the identity losses that come with trying to fit in.

Administrators may be able to influence the insider ideal and promote athletic programs or other activities that promote the jock ideal. Some schools have been successful in making academic achievement the ideal. Accounts suggest that success lies in students’ and teachers’ identification with the school and its academic ideals. Teachers can also be important in the effort to help push their students to identify with the school. Some teachers may be more effective running their classrooms so that students identify with them and the school.

**Gender and Work**

In the United States, individual workers may like certain kinds of work, be particularly skillful at a task, or have a particular talent in a specific field. But some jobs seem to be proper for women and others for men. These are known as occupational norms. As late as the 1970s, some of the jobs that are stipulated for either men or women include:

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Women have been thought to be “nurturing and patient,” qualities that suit them for positions like elementary school teacher or nurse. In contrast, qualities in men make them more suitable to positions as administrators, doctors, and pilots.

Even today, studies indicate that people continue to view some jobs as appropriate for men and others for women, and those who violate the norms can be subject to harassment and even violence.

**By and large, men and women in the United States work in different occupations. Occupational segregation is one of the most stubborn features of the American labor market.**

By adding gender norms, identity economics leads to new theories concerning discrimination and occupational segregation. Some of them include:

* The firm owners have a personal “distaste” for employing women, or the employer has no distaste, but male workers do. The firm must then pay men higher wages for working with women, which increases the firm’s costs.
* Women have “a lower attachment” to the labor force and invest less in education and skills. Women therefore end up in jobs where less investment is required.
* When women are presumed—correctly so within the model—to have lower skills, employers hire fewer women and at lower wages.

In conclusion, adding identity to the economics model shows people why it took a social movement and government intervention rather than a competitive marketplace to erode discrimination.

**Race and Minority Poverty**

Two of the most prominent and respected economists, Gary Becker in 1957 and Kenneth Arrow in 1972, stud-
ied race discrimination in economics and presented two versions of race discrimination that are similar to those of gender discrimination:

1. **Taste-based discrimination.** In this theory, white employers dislike hiring black workers, and white workers similarly dislike working with blacks. The same holds true in reverse.

2. **Statistical discrimination.** In this theory, white employers discriminate against black employees because they think blacks, on average, have low skills.

Both theories have the same results: black workers will receive less pay and will work in different jobs than whites. The application of the identity model is the same as the model for male and female workers. Black workers have three choices:

1. To be an insider.
2. To be an outsider who works.
3. To be an outsider who does not work.

Blacks who try to be insiders will suffer from lack of acceptance and respect by whites. Outsiders who choose not to work maintain self-respect, but blacks who choose to remain outsiders but work lose self-respect for going against their ideals. There are three ways to prevent black workers from dropping out of the labor force:

1. Eliminate the distinction between black and white workers in the insider ideal. If all blacks chose to be insiders, disparities between white and black workers would disappear.
2. Change what it means to be black. The oppositional identity does not imply self-destructive behavior. Rather, it is the norms associated with such an identity that may be self-destructive.
3. Limit the feedback effects. If government policies can break the chain in which the adoption of an outsider identity leads others to choose it, black poverty can be lowered.

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**IDENTITY ECONOMICS AND ECONOMIC METHODOLOGY**

By incorporating identity into economics, Akerlof and Kranton modify and broaden economic analysis. The concept is powerful, and is an extension of the addition of psychological aberrations that has occurred over the last half century.

In his 1953 essay, “The Methodology of Positive Economics,” Milton Friedman outlined how economists should conduct research:

- Choose a model or theory.
- Test the model against observations.
- Reject it if it does not fit.
- There should also be back-and-forth between observations and theory, as each informs the other.

Identity economics seems to fit in with Friedman’s definition. Many economists also believe that a good model, besides passing all the tests, should yield surprising conclusions. While the criticism that the identity model often leads to obvious conclusions, the assumptions may be new and thus may give rise to new insights. Two examples are:

1. If tasks are tagged as male or female, men and women will work in different occupations, and women will have lower wages.
2. If identity matters to workers, they will require less incentive pay when they think of themselves as insiders to the organizations.

Neither of these propositions follows from standard theory. What is new in each are the assumptions.

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**CONCLUSION, AND FIVE WAYS IDENTITY CHANGES ECONOMICS**

Looking toward the future, there are five reasons that identity should be used to enrich economic analysis:

1. **Individual actions.** Identity affects individual behavior directly. This impact is most apparent in things people do that yield no economic benefit—often in activities that are costly, uncomfortable, and even
injurious. Identity economics allows economists a simple representation of what could be labeled as self-destructive behavior and actions that seem to make little economic sense.

2. Externalities. People’s actions often affect others’ well-being. Economists and policy makers make a great deal of these externalities, which can be positive or negative. Reactions to others’ actions fit well in the framework of identity economics to analyze things like crime and the corresponding policies that aim to reduce it.

3. Creating categories and norms. The authors have taken the social categories, norms, and ideals of the situations presented in the book as given. But many people and organizations manipulate categories, norms, and ideals for their own advantage. Therefore, identity as a factor in revolutions and political battles could be used to influence constituents’ ideals and even change their norms.

4. Identity and regret. Identity economics greatly expands the study of “time inconsistency” where people have different selves at different points in their lives, making decisions at one point in life that they regret at another time.

5. Choice of identity. Economics is sometimes called the science of choice. The influence of identity on choices of action has been discussed, but identity itself can be a choice. To a degree, people can choose who they want to be.

Features of the Book

Estimated Reading Time: 5–7 hours, 192 pages

Identity Economics will be of interest to business managers, economists, policy makers, social scientists, and school administrators—anyone who is concerned about what motivates people to make decisions. An unusual dichotomy of psychology and economics, George Akerlof and Rachel Kranton present their concept of identity economics as a framework for studying the nonmonetary motivations for people’s actions. They provide comprehensive references, notes, and an index, as well as a glossary of sorts in the Postscript to Chapter 3 to help readers who may not be familiar with the jargon of economics understand their intended use of certain terms. People who are familiar with economics parlance can skip this chapter; otherwise the book should be read from cover to cover as each chapter builds on ideas presented previously.

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A Note to Our Readers

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