

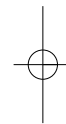


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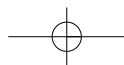
# *Identity Economics*

HOW OUR IDENTITIES SHAPE OUR  
WORK, WAGES, AND WELL-BEING

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ONE

## Introduction

ANN HOPKINS WAS HIRED in Price Waterhouse's Office of Government Services in 1978. By all accounts, she was hard-working and diligent. She retrieved from the discard pile a State Department request for proposals and masterminded it into a contract worth approximately \$25 million.<sup>1</sup> It was the largest consulting contract Price Waterhouse had ever secured, and her clients at the State Department raved about her work. In 1982 she was put up for partner, the lone woman among eighty-eight candidates.<sup>2</sup> But the promotion did not go through.

What was deemed wrong with her performance? Colleagues complained about her deportment and the way she treated her staff. In their written comments on her promotion, the senior partners observed: "Needs a course in charm school," "macho," and "overcompensated for being a woman." Her boss, who supported her, told her that if she wanted to make partner she should "walk more femininely, talk more femininely, dress more femininely, wear makeup and jewelry, and have her hair styled."<sup>3</sup>

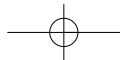


Hopkins sued, on the grounds of sex discrimination under Title VII of the Civil Rights Act. After a series of appeals, the case reached the U.S. Supreme Court in 1988. There, the majority held that the firm had applied a double standard. The court wrote that “an employer who objects to aggressiveness in women but whose positions require this trait places women in an intolerable and impermissible catch 22: out of a job if they behave aggressively, and out of a job if they do not.”<sup>4</sup>

*Price Waterhouse v. Hopkins* is an illustration of identity economics at work. The partners were applying contemporary norms for behavior: *men* were supposed to behave one way, *women* another. We could interpret these views as reflecting basic tastes or preferences—they just liked working with women who talked and walked “more femininely.” But these are not basic tastes such as “I like bananas” and “You like oranges,” which are the foundations of the economic theory of trade. Rather, these tastes depend on the social setting and who is interacting with whom. The tastes derive from *norms*, which we define as the social rules regarding how people *should* behave in different situations. These rules are sometimes explicit, sometimes implicit, largely internalized, and often deeply held. And the “preferences” or “tastes” that derive from these norms are frequently the subject of dispute, so much so that—as in *Hopkins*—they may even be adjudicated in court.

This book introduces identity and related norms into economics. The discipline of economics no longer confines itself to questions about consumption and income: economists today also consider a wide variety of noneconomic motives. But identity economics brings in something new. In every social context, people have a notion of who they are, which is associated with beliefs about how they and others are supposed to behave. These notions, as we will see, play important roles in how economies work.

We begin with the *Hopkins* case because the type of identity involved—that of gender—is so obvious. Even as toddlers, children learn that boys and girls should act differently. But gender, and equally obviously race, are just the clearest manifestations



of identity and norms. In this book we study norms in many different contexts—in workplaces, homes, and schools.

To see the salience of identity in economic life, let's take another example from a source where it might be least expected. On Wall Street, reputedly, the name of the game is making money. Charles Ellis's history of Goldman Sachs shows that, paradoxically, the partnership's success in making money comes from subordinating that goal, at least in the short run.<sup>5</sup> Rather, the company's financial success has stemmed from an ideal remarkably like that of the U.S. Air Force: "Service before Self." Employees believed, above all, that they were to serve the firm. Goldman Sachs's *Business Principles*, fourteen of them, were composed in the 1970s by the firm's co-chairman, John Whitehead, who feared that the firm might lose its core values as it grew. The first Principle is "Our clients' interests always come first. Our experience shows that if we serve our clients well, our own success will follow." The principles also mandate dedication to teamwork, innovation, and strict adherence to rules and standards. The final principle is "Integrity and honesty are at the heart of our business. We expect our people to maintain high ethical standards in everything they do, both in their work for the firm and in their personal lives."<sup>6</sup> Like the military and other civilian companies we examine later in the book, Goldman Sachs is an example of identity economics in action. The employees do not act according to basic tastes: by accepting Whitehead's principles, they identify with the firm and uphold its ideals in both their professional and their personal lives. The creed is: "Absolute loyalty to the firm and to the partnership."<sup>7</sup>

### *Origins of Identity Economics*

Our work on identity and economics began in 1995, when we were both, by coincidence, based in Washington, DC. We had been together at Berkeley—George as a professor, Rachel as a graduate student. George then went to the Brookings Institution while his wife was serving on the Federal Reserve Board. Rachel was at the University of Maryland.

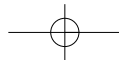
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*Identity Economics* began with a letter from Rachel to George telling him that his most recent paper was wrong.<sup>8</sup> He had ignored identity, she wrote, and this concept was also critically missing from economics more generally. We decided to meet. Quite possibly, we thought, identity was already captured in the economics of the time; perhaps it was already included in what we call *tastes*.

We talked for months. We discussed the research of sociologists, anthropologists, psychologists, political scientists, historians, and literary critics. We discussed the focus on identity: how people think they and others should behave; how society teaches them how to behave; and how people are motivated by these views, sometimes to the point of being willing to die for them. We worked to distill many ideas and nuances, to develop a basic definition of identity that could be easily incorporated into economics. And we saw that including identity would have implications for fields as disparate as macroeconomics and the economics of education.<sup>9</sup>

This book builds an economics where tastes vary with social context. Identity and norms bring something new to the representation of tastes. Garden-variety tastes for oranges and bananas—to continue with the earlier example—are commonly viewed as being characteristic of the individual. In contrast, identities and norms derive from the social setting. The incorporation of identity and norms then yields a theory of decision making where social context matters.

This vision of tastes is important because norms are powerful sources of motivation. Norms affect fine-grain decisions of the moment—decisions as trivial as which T-shirt we wear to go jogging. Norms drive life-changing decisions as well: on matters as important as whether to quit school, whether and whom to marry, whether to work, save, invest, retire and fight wars. We will see throughout the book that identities and norms are easy to observe. Anthropologists and sociologists are professional observers of norms. But norms and identities are also easy to see in day-to-day life. We have already seen two examples: Goldman Sachs, with its fourteen principles, and Price Waterhouse, with the partners' descriptions of Hopkins. People express their



views in the ways they describe themselves and others. As the Supreme Court put it in the *Hopkins* decision, “It takes no special training to discern sex stereotyping in a description of an aggressive female employee as requiring ‘a course at charm school.’ Nor does it require expertise in psychology to know that, if an employee’s flawed ‘interpersonal skills’ can be corrected by a soft-hued suit or a new shade of lipstick, perhaps it is the employee’s sex, and not her interpersonal skills, that has drawn the criticism.”<sup>10</sup>

Until now, economists have had neither the language nor the analytical apparatus to use such evidence or to describe such norms and motivations. Of course, many economists have suggested related nonmonetary reasons for people’s actions, such as morality, altruism, and concern for status. This book provides both a vocabulary and a unifying analytical framework to study such motives.

### *Ideas Have Consequences*

Economics—for better or for worse—pervades how policy makers, the public, and the press talk and think. Modern economics follows Adam Smith’s attempt in the eighteenth century to turn moral philosophy into a social science designed to create a good society. Smith enlisted all human passions and social institutions in this effort. 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. As economics evolved into the twentieth century, the models grew more sophisticated, but *Homo economicus* lagged behind. This began to change when Gary Becker developed ways to represent a variety of realistic tastes, such as for discrimination, children, and altruism.<sup>11</sup> Fairly recently, behavioral economics has introduced cognitive bias and other psychological findings. *Identity Economics*, in its turn, brings in social context—with a new economic man and woman who resemble real people in real situations.<sup>12</sup>

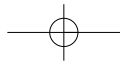
What does this increased humanity buy us? We get a more reliable model, which makes economics a more useful tool for im-

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CHAPTER ONE

proving institutions and society. This richer, socially framed conception of individual decision making should help economists working at various levels to construct sturdier accounts of the economy. Social scientists in other disciplines should find identity economics useful because it connects economic models with their own work, enabling the development of richer accounts of social processes. And policy analysts and business strategists will benefit from identity economics because it offers ways of more accurately predicting the consequences of public policies and business practices.

“Ideas have consequences” was a theme at Milton Friedman’s ninetieth birthday celebration at the White House in 2002.<sup>13</sup> As John Maynard Keynes wrote two generations earlier: “Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back.”<sup>14</sup> Identity economics restores human passions and social institutions into economics. Whether economics includes or excludes identity, then, also has its consequences.





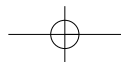
TWO

## Identity Economics

THIS CHAPTER INTRODUCES THE framework of identity economics. It shows the fault line between economics with and without identity and norms.

### *Identity, Norms, and Utility Functions*

Economists have a way of describing motivation: we describe an individual as having a “utility function.” This is a mathematical expression that characterizes what people care about. For example, a person may care about today’s consumption and about future consumption. That person then makes decisions that maximize her utility function. For example, she will choose how much to borrow and how much to save. This mathematics may seem like a roundabout way of describing motivation, but it turns out to be useful. Utility functions and what goes into them give economists a formal way to classify motivation. In principle, a utility function can express any sort of motivation.





Most economic analysis concentrates on pecuniary motivations, such as desires for consumption and income. But economics today is not just about money, and many economists believe that we should study nonpecuniary motives as well. Utility functions have been developed to express a wide array of nonpecuniary tastes and preferences, such as the desire for children, the concern for status, and the desire for fairness and retribution.

But in this welter of activity, with rare exception, economists have maintained the basic presumption that such tastes and preferences are individual characteristics independent of social context. Some individuals simply care more about children, others less. Some people care more about status, others less. And so on. This presumption ignores the fact that what people care about, and how much they care about it, depends in part on their identity.

We illustrate with the example of “fairness.” Leading economists, including John Nash, Hal Varian, Matthew Rabin, and Ernst Fehr, have brought fairness into our purview.<sup>1</sup> They argue that people care about being fair and being treated fairly. The utility function then should take account of such concerns. Fairness thus conceived can explain many results from experiments where subjects—usually students at a university laboratory—participate in scenarios that mimic economic transactions. Instead of maximizing their own monetary reward, subjects tend to choose outcomes that look “fair.”<sup>2</sup>

But in the real world, individuals’ conceptions of fairness depend on the social context. In many places it is seen as fair and perhaps natural to treat other people in ways that elsewhere are considered unfair and even cruel. This observation is as important as it is obvious. In India, upper castes do not treat lower castes equally. In Rwanda, Tutsis and Hutus do not treat each other equally. In America, whites have not treated blacks equally. We also see unfairness in daily interactions. We see it on the playground. We see it in hospital surgery rooms, in the interaction between doctors and scrub nurses. In many countries, even today, women and girls are physically assaulted; they are not permitted to go to school or leave their homes, let alone vote, own property, or own a bank account.

These examples have one thing in common: they all involve people's identities. The norms of how to behave depend on people's positions within their social context. Thus, people's tastes for fairness depend on who is interacting with whom and in what social setting. And indeed, in experiments that explicitly match people with different social identities, the subjects treat others differently. We review such experimental evidence in Chapter 4.

### *Social Categories, Ideals, and Observation*

How do people know the norms that apply to their situation, prescribing what they and others should or should not do? We learn a great deal from watching others. An obvious example occurs in the acquisition of language, where children—effortlessly, it seems—learn to speak by copying others. Not only do they learn words and grammar; but, remarkably, they also mimic exact pronunciations. Furthermore, they make subtle distinctions when learning language.<sup>3</sup> Immigrant children adopt the accents of their peers, not those of their parents. Children as young as six understand that there are different styles of speech that are appropriate for talking to some people, but inappropriate for talking to others. Thus, for example, Lisa Delpit tells of the black first-grader who asked her teacher, “How come you talkin’ like a white person, . . . like my momma talk when she get on the phone?”<sup>4</sup>

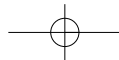
In the formal language of the social sciences, people divide themselves and others into *social categories*. And social categories and norms are automatically tied together: people in different social categories *should* behave differently. The norms also specify how people of different types—different social categories, in our new vocabulary—should treat each other.

Identity, norms, and categories may appear to be abstract concepts, but their reality is both powerful and easy to see. Norms are particularly clear when people hold an *ideal* of who they should be and how they should act. (By *ideal* we mean the exemplary characteristics and behavior associated with a social category.) This ideal may be embodied by a real or imagined

person. Religions offer obvious and powerful examples. The founder of a religion and its leading prophets or saints are often exemplars. For Christians, the life of Jesus Christ, as described by the Gospels, gives an ideal of how they should behave. For Muslims, it is the life of Muhammad and the Sunnah. We also observe categories, norms, and ideals in how people talk about their lives. Many people can readily describe how they think they should behave and how others should behave. Transgressions are the stuff of gossip. The outside observer—for example, the visiting anthropologist—need only learn the stories and listen to the gossip to infer the norms.

A small slice of everyday life in America, as observed by Erving Goffman, gives an elementary example of identity and norms in action.<sup>5</sup> Goffman described children at a merry-go-round. Children are very aware of their age. They state their precise ages proudly, not only in years, but often in months, and sometimes even in days. Children understand norms for age-specific behavior well: they know that big kids should act differently from little kids. Children at the merry-go-round thus yield a natural experiment that shows the role of norms. We can observe how children of different ages react to the merry-go-round. Toddlers ride on their parents' laps. Four- and five-year-olds ride alone. Proud of their accomplishment, they smile and wave at their parents, who are standing on the side. Older children try to hide their excitement—they ride a funny animal, like a frog or a tiger, or they stand up while the carousel is in motion. You can see in their faces that they like the merry-go-round, but they are also embarrassed. They will act like a thirteen-year-old boy we ourselves saw last summer. He first fidgeted on a horse; then he switched to an ostrich; and then he changed animals yet again. Before the end of the ride, he had gotten off entirely.

Why do older children act this way? It is not because they dislike the merry-go-round, at least in the conventional way economists describe tastes. On the contrary, older children seem—like the younger children—to be entranced by the rotation and the music. The older children are ambivalent because they like the carousel, but they also know they should be too old for it.



Such interplay of tastes and norms lies at the heart of this book. The merry-go-round illustrates a general point. When people are doing what they think they should be doing, they are happy, like the four- and five-year-olds. But those who are not living up to the norms that they (and others) have set for themselves, like the older children, are unhappy. They then change their decisions to meet their standards.

### *Putting It All Together*

This book incorporates *identity*, *norms*, and *social categories* into economics. We also use the word *identity* as shorthand to bundle together these three terms. The term *identity* has been used in many different ways in academic research and in popular usage. Many economists would say it is a fuzzy concept. We give it a precise definition in the context of our analysis. People's identity defines who they are—their social category. Their identity will influence their decisions, because different norms for behavior are associated with different social categories. Goffman's carousel is an elementary example. First, there are social categories: the different age groups of the children. Second, there are norms for how someone in those social categories should or should not behave. Third, norms affect behavior. The thirteen year-old cannot enjoy the merry-go-round; so he makes his way off.

### *Identity Economics and Supply and Demand*

Our discussion of identity and utility has ranged from merry-go-rounds to genocide. And indeed a major point of our book is that the concepts of identity and norms, and their dependence on social category, have great versatility. Identity may describe the interactions of an instant, a day, a few years, a lifetime, or generations. For example, over the course of a day, a woman may see herself as a mother at home and a professional at work. The social category then refers to how she sees herself at the time. And over a lifetime, people can dramatically change their understanding of their lives.

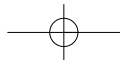
Thus identity has the same kind of versatility as our tried-and-true notion of supply and demand. On the one hand, supply and demand may refer respectively to the supply and demand for a given stock or bond for just a few seconds. But it may also refer to supply and demand in the aggregate economy over long periods. In each case we refer to supply and demand in the relevant context.

We use the concept of identity similarly. In the relevant context, analysis of demand and supply leads us first to identify individuals as buyers or sellers. Second, we specify the prevailing technology and the market structure. And third, we look for individual gains and losses from particular actions such as choice of prices or purchases. Analogously, with identity, we first associate individuals with particular social categories. Second, we specify the prevailing norms for these categories. And third, we 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 then determine what people do.

### *Outline of Book*

Part 1 of the book builds the framework of identity economics. In it, we explain how we formally bring identity and norms into economic analysis and discuss where these concepts fit into today's economics.

Parts 2 and 3 apply our framework to four substantive areas of economics. We study organizations, education, gender in the labor market and in the home, and race and poverty. In each case our approach leads to new and different conclusions. For example, it offers a new understanding of organizations. About forty years ago economists began to build a theory of work incentives, emphasizing the role of wages and bonuses. A good company, according to the theory, gets those incentives right. But a more subtle view draws a near-opposite conclusion. If employees care only about wages and bonuses, they will game the system. They will do what it takes to earn the bonus, but not necessarily what is good for the clients or for the firm. If mone-



tary incentives alone do not work, what does? Identity economics suggests that a firm operates well when employees identify with it and when their norms advance its goals. Because firms and other organizations are the backbone of all economies, this new description transforms our understanding of what makes economies work or fail.

Looking inside schools, we also have a new understanding of education. Again about forty years ago, economists developed a theory of education, emphasizing its monetary costs and benefits. Economists have elaborated on these costs and benefits, including such possibilities as incorrect information about the benefits of education, the effect of peer groups on learning, and students' impatience. Identity economics puts more meat on these old bones. The lion's share of the costs of staying in school, and also of working hard at it, come from norms. How much schooling students get—what is called “the demand for education”—is largely determined by who they think they are and whether they should be in school. Good schools—schools with low dropout rates and high academic achievement—transform students' identities and norms. We thus address the two fundamental questions in the economics of education: who is enrolled in school and why, and what makes schools succeed or fail.

The final part of the book looks ahead. We discuss how identity economics makes use of new evidence and why economists, like scientists, should be receptive to data from close observation. We also discuss how identity expands economic inquiry. For example, identity widens the scope of choices that economists should study. People often have some choice over their identity. Parents choose schools for their children. Women may choose to pursue a career or stay at home. Immigrants choose whether to assimilate. Men and women choose whether to be single or to marry. In this way, people's motives, or tastes, are partly of their own making. Choice of identity, then, may be the most important “economic” decision a person ever makes. Second, identity points us to a new reason why preferences can change. Third parties may have incentives to change who people think they are, as well as their norms. Advertisers, politi-

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CHAPTER TWO

cians, and employers all manipulate social categories and norms. Finally, identity gives us 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.