Mitchell's Musings 9-28-15: Look for Earlier Problems

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When I taught labor markets and got into incentives, there was always the issue of incentives which led to perverse behaviors that eventually harm the organization. A simple example is a piece rate system that emphasizes quantity over quality and leads to defective, hasty production. Usually, there is some awareness of the potential pitfalls of incentive programs and additional arrangements may be put in place to prevent perverseness. In the piece rate example, you can hire inspectors who watch for defects. But such supplementary efforts cost money and attaining 100% perfection may not be the optimal decision. Some level of defects may be acceptable. And no incentive system perfectly aligns worker interests with employer interests, despite claims and hypes.

The idea of incentives should not be limited to explicit formulas that link pay to output (such as piece rates, sales commissions, etc.). In organizations, there are inevitably ways employees discover to get ahead. Certain behaviors are rewarded, perhaps by promotions, plum assignments, and the like. The notion that organizations have "cultures" – for better or for worse - is closely related to the idea of built-in incentives. Employees figure out what gets them rewards. The actual culture may have little resemblance to grand platitudes in organization mission statements. It's the substance of numerous "Dilbert" cartoon strips.

What I used to say in class is that if you observe a perverse outcome, it could just be a one-time fluke or a mistake. But if the perversity repeats, there is probably something in the organization that incents such behavior.

The recent Volkswagen scandal suggests a corollary to me. In the Volkswagen case, certain diesel engine cars had computer programming built in to allow detection of government emission tests. The engines operated differently during such testing than they did when run in actual driving conditions. In some cases, car buyers may have received government rebates based on the supposedly low emissions. As revelations of the fraud became public, the CEO of Volkswagen resigned hastily saying he was "not aware" of having done anything wrong. He said he was "stunned that misconduct on such a scale was possible in the Volkswagen Group."[1]

If you think about this episode, you can see that the risks of the fraud becoming known over time had to be large. The programming was in the cars waiting to be detected by authorities that became suspicious.

[1] http://www.latimes.com/business/la-fi-vw-ceo-resign-20150923-story.html

There is always some disgruntled employee or some righteous whistleblower somewhere in the system to leak out the information. And the gain to Volkswagen of having somewhat lower emissions really wasn't all that great, especially when compared with the cost of the eventual revelation.

So, is it possible that the emissions fraud was a one-off event, due to the action of some "bad apple" in the corporate barrel? Should the CEO really have been "stunned"? Maybe. But it seems very unlikely that – even if this incident was a one-off event – that only one bad apple could have pulled it off. There had to be a lot of folks at some level in the firm aware of what was being done, even if the CEO did not know of - or did not officially authorize - the plan.

My corollary suggests that a really big fraud of the VW type is unlikely to be a one-off event. The corollary is instead that if there is a really big perverse event, look for earlier – perhaps less risky – frauds that have not yet been uncovered. If there were such frauds, and if those employees who perpetrated them were met with rewards, you can see how a perverse-incentive culture could form that eventually led to the emissions scandal. My suggestion to the authorities who will be probing the VW emissions fraud is to find out what preceded it.