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The Case for Happiness-Based Economics

By Kentaro Toyama

We're familiar with the American trinity of life, liberty and the pursuit happiness. Washington typically passes laws to protect the first two. Should we start paying more attention to the third?

When typical measurements make your economy look like a failure, politicians tend to look for alternate report cards.

Last year, British Prime Minister David Cameron called for his government to start measuring psychological and environment well-being.* Two years ago, French President Nicholas Sarkozy commissioned prominent economists to come up with alternatives to GDP that better mirrored national well-being. A young king of Bhutan started it all in 1972, when he proposed that his country seek Gross National Happiness rather than Gross National Product.

Money doesn't buy happiness -- beyond a point. Economist Richard Easterlin reached that well-known conclusion as early as 1971. He found that among rich countries, people living in countries with the highest per-capita GDPs didn't report greater happiness. He also didn't find evidence that GDP growth among rich countries made people happier. Above some level of income required to meet basic needs, the absolute level of wealth didn't seem to matter. Easterlin did find on the other hand, that within a single country, richer people were happier than poorer people. The apparent contradiction came to be known as the Easterlin Paradox.

For a while, the evidence supported it. Europe, the United States, and Japan all appeared to flatline in happiness even as their economies grew. Some poorer countries seemed just as happy as richer ones.

The only disagreement seemed to be the critical threshold. Estimates ranged as low as $10,000 per year, and last September, economist Angus Deaton and psychologist Daniel Kahneman found $75,000 annual income as the point beyond which more money failed to "buy" more happiness. Whatever the case, it seemed that above a threshold, happiness stopped growing with increasing income.

The paradox was resolved through evidence from psychology, which found that, like so many things, happiness was all relative. Happiness relative not only to the wealth of our neighbors, but also to the level of our aspirations. And both tend to increase as we get richer. As a result, we end up on a "hedonic treadmill," where more income is continually required to stay at the same level of happiness.

Then, in 2008, economists Betsey Stevenson and Justin Wolfers upended that view just as it was becoming accepted. They painstakingly converted incomes to purchase price parity, normalized different scales for happiness, and even re-interpreted survey questions in other languages. They then reexamined Easterlin's claims and found that they didn't hold up. Their conclusion: Absolute income matters. Life satisfaction continues to increase with greater income, after all.

Neoliberal economists cheered. Angus Deaton said wryly, "As an economist I tend to think money is good for you, and am pleased to find some evidence for that." Stevenson and Wolfers wrote triumphantly that their findings "put to rest the earlier claim that economic development does not raise subjective well-being," and all but broke out the green pom-poms to cheer for GDP.

Their research, however, also emphasizes something that most economists are less eager to discuss. Central to Stevenson and Wolfers's analysis is the use of a logarithmic scale to relate happiness to income. What correlates with a fixed increment of happiness is not a dollar increase in absolute income (e.g., an additional $1000), but a *percentage* increment (e.g., an additional 100%). So, going from a $5000 annual income to $50,000 links with as much additional happiness as going from $50K to $500K, or from $500K to $5 million, or even from $5 million to $50 million.

To put it another way, as income rises, every additional dollar represents a smaller increment of happiness. At one level, this is perfectly obvious. The first increase of $45K -- from $5K to $50K -- would take a family from hunger and homelessness to being well-fed in an apartment, probably with a TV to boot. An additional $45K of income to $95K might allow for a few luxuries, but certainly nothing close to the difference between starvation and the middle class!

Economists know this at some level, but they largely neglect it in their models. Introductory textbooks highlight the field's concern with "utility" -- mainstream economics' clinical term for happiness -- and often include student exercises that equate utility with the logarithm of income. The idea rarely makes it out of textbooks, however, probably because it makes the math more complex. For one thing, your $1000 is no longer worth the same as my $1000. National accounts would be a nightmare if in tallying each purchase, it was necessary to know the income of the buyer.

Still, if policy makers were serious about utility, they could take the logarithm of personal wealth and sum over all citizens for an estimate of national welfare. Though this would overlook other components of well-being, it would immediately focus more attention on income inequality: Ten people each earning $100,000 would have much greater total happiness than nine people earning $10,000 and one person with $910,000, even though each group earns the same $1 million.

This suggests that a more even distribution of income would correlate with greater total happiness than an unequal distribution. That would mean seeing unemployment as an even worse scourge than it already is. That would mean increasing marginal tax rates on the richest and maybe even plowing the extra dollars to the poor. Most importantly, that would mean greater investments in education for the underprivileged.

Building a public policy on the foundation of happiness research would be controversial, to say the least. Critics, especially on the right, might accuse Washington of using wishy-washy assumptions about money and happiness to guide our tax and welfare policy. To be sure, causal relationships between income and happiness are still not established, and we care about values beyond income equality. But, focusing on the logarithm of income might make us pay a little more attention to that third pursuit Thomas Jefferson hailed in the Declaration of Independence.

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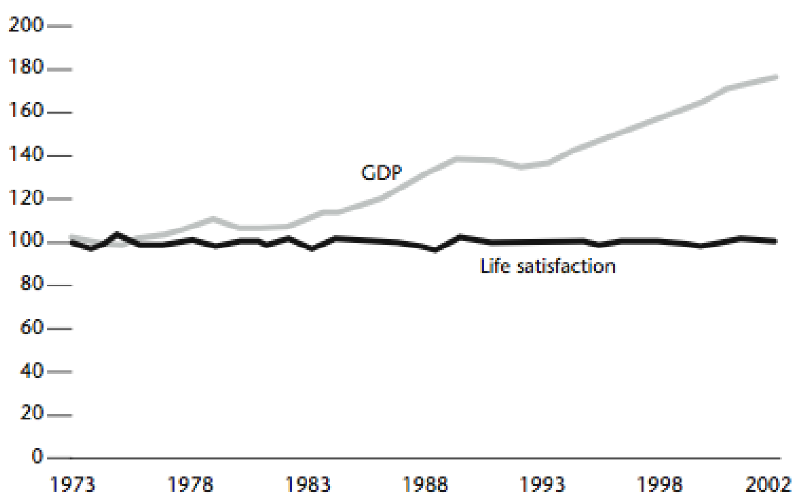
*The UK's GDP has grown steadily, year by year, decade by decade. But publicly reported happiness across the country is flat. Great Britain's experience, by the way, is typical of rich, developed countries.

Figure 1 **UK life satisfaction and GDP, 1973–2002**
1973 = 100



Source: NEF (2004)

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