
By Jane Katz

# issues in economics

## Higher inflation? Rising unemployment? So, how does that make you feel?

ECONOMISTS DON'T SPEND a lot of their time asking people about their feelings. They track wages and productivity, investigate spending and saving, even try to assess the causes and consequences of behavior that has not always been viewed as "economic," such as getting married and having children.

But economists have not focused much on measuring how ordinary people actually feel. In economic theory, the concept of "utility"—which refers not to usefulness but to a person's subjective valuation of the goods and services he or she consumes—comes closest to capturing what most people mean when they want to know whether an economic policy will improve human happiness. But in practice, economists have rarely tried to directly measure a policy's impact on utility or happiness, in large part because it's a difficult job. There are no obvious units that allow us to add up and compare how much happier a person will be in different situations; nor is there an obvious way to say whether one person is happier than another.

So, economists have often tried to sidestep the problem. Policy has typically been evaluated by factors assumed to be associated with happiness, such as income, productivity, or another measure of the capacity of the economy as a whole—or the individuals in it—to consume market goods and services. Certainly, economists didn't often ask anyone how they felt. Those questions were strictly for psychologists and the other "soft" social sciences.

But in economics, as in the rest of life, it's hard to keep feelings out of the picture. In *The General Theory*, John Maynard Keynes used the phrase "animal spirits" in an effort to explain the volatile (and he thought unreliable) spending behavior of entrepreneurs and other businessmen on investment goods—behavior that in Keynes's view was a major culprit causing economic downturns. And "consumer confidence," regularly measured by the Conference Board, is an attempt to capture economic fundamentals as well as how the public "feels."

Moreover, it makes sense to choose and evaluate macroeconomic policies by how happy they make us. After all, the object of reducing inflation and unemployment is not simply increased income or wealth in and of itself—or even the better health and longer life expectancy they might bring—although these clearly do matter. We care about how we feel. Are we happy? Would a different policy make us happier? So, macroeconomists are beginning to show their softer side. They care about how you feel. And they may even ask you about it.

ILLUSTRATION BY JULIETTE BORDA

## ALL THAT IS SOLID

Everyone agrees that unemployment and inflation make people unhappy, and that policies to reduce them make people happier. What is not so clear is by how much. Are the gains to reducing inflation and unemployment large or small? Do they depend on whether current rates are at high or low levels? And, if there are short-run tradeoffs—for example, if lower unemployment means higher inflation—how do people feel about making this tradeoff?

In the past, economists have attempted to measure the unhappiness created by unemployment by looking at proxies for happiness such as lost wages, the loss of skills and other human capital, and even the reduced health outcomes that might result from being unemployed.

Measuring the cost of inflation was a little trickier, in part because economists define inflation as a sustained rise in the general level of prices—not as the rise in the price of only a few goods and services. In the textbook case, the price of everything you buy (food, housing, clothes, computers, movies, healthcare) rises by the same percentage as everything you sell—primarily labor (that is, wages), but also products you produce and sell, and interest on money you lend, rents, etc.), leaving your long-run real income essentially unchanged.

This suggests that inflation won't have a big impact on happiness because, by itself, it doesn't really affect anyone's long-run standard of living. The negative impact results mainly from a loss in wealth to anyone holding cash, since the value of the cash in your pocket does not increase along with the price of the goods and services you buy and sell. (In the real world, of course, contracts and other institutional arrangements such as tax rates are not always indexed to price changes and prices do not all rise exactly in tandem. But more on that later.)

Until recently, most calculations of the textbook cost of inflation have come from economic models. For example, Nobel Laureate Robert Lucas figures the gains to permanently reducing inflation from 14 percent to 3 percent to be slightly less than 1 percent of GDP each year in perpetuity. He argues that this gain is much larger than the potential gain from improving policies to smooth the fluctuations in income that come with the business cycle. While many economists think that unemployment must rise temporarily in order to reduce inflation, Lucas doesn't estimate or include this cost.

It's also worth pointing out that an inflation rate of 14 percent is very high by U.S. standards, and that a reduction of 11 percentage points is far larger than that which typically occurs over the U.S. business cycle. That is, the benefits to reducing inflation from 3 percent to zero would presumably be much smaller. And none of these results come from actually asking people how they feel.

## IF YOU WANT TO KNOW, ASK

Yet, one need only look at the newspaper to see that people seem to care quite a lot about both inflation and unemployment. In order to learn more about public attitudes, Yale University economist Robert Shiller decided to actually ask people questions, such as: Do you have worries that if inflation rises too high, then something really bad might happen? Do you think that controlling inflation should be a high priority for the U.S. government and its agencies? Shiller surveyed a group of ordinary people and also a sample of professional economists, motivated in part by the apparent differences between what economists think and what the public feels. "Studying public attitudes," he remarks, may help policymakers "better understand the reasons that they should (or should not) be very concerned with controlling inflation."

What did Shiller learn? Almost everybody (about 90 percent of U.S. respondents) thinks inflation is an important policy issue, although without specifying what is meant by "a high priority" such answers may tell us less than might appear. The notion that the general public sees more harm than do professional economists is also confirmed. When asked, "Do you agree that preventing high inflation is an important national priority, as important as preventing drug abuse or preventing deterioration in the quality of our schools?," the fraction of U.S. respondents who agreed (84 percent) was substantially higher than the fraction of economists who agreed (46 percent)—although Shiller's questions don't define how high "high" is. More than one-third of the public agreed that keeping inflation low is important enough that they would not approve of a policy that caused the rate to double even if it were also certain to double the economy's growth rate (corrected for that inflation). Only 7 percent of economists would not favor the policy.

People dislike inflation in part because they believe it hurts their standard of living

The public and economists show more consensus on recession. About 80 percent of the general public (and 75 percent of economists) agreed that preventing recession is as important as preventing drug abuse or bad schools. And more than 80 percent of both groups would favor policies that reduced recessions even if the policies were to equally reduce booms.

Shiller also inquires directly about the tradeoff between unemployment and inflation. He asks respondents to choose between an inflation rate of 2 percent and an unemployment rate of 9 percent (12 million people) and an inflation rate of 10 percent and an unemployment rate of 3 percent (4 million people). Although the alternatives are extreme and presented without historical context, people's choices are still striking. About 75 percent chose lower inflation at a cost of much higher unemployment.

Why do people seem to care this much about inflation when textbooks suggest that the long-run impact may be relatively small? Some mention concerns that high inflation might precipitate a financial collapse, lead to business failures, or inhibit economic growth. Others worry that high inflation affects the gap between rich and poor, although respondents are not always clear—or in agreement—on exactly how each of these various harms occurs.

But the biggest reason is: People appear to believe that inflation will hurt their standard of living. When asked to imagine how things

## Further reading

"Macroeconomic Priorities," by Robert E. Lucas, Jr., Presidential Address delivered at the American Economic Association meetings, *American Economic Review,* January 2003.

"Why Do People Dislike Inflation?" by Robert Shiller, in *Reducing Inflation: Motivation and Strategy*, edited by Christina D. Romer and David H. Romer, University of Chicago Press, 1997.

"Is Business Cycle Volatility Costly? Evidence from Surveys of Subjective Well-being," by Justin Wolfers, National Bureau of Economic Research Working Paper 9619, April 2003.

would have been different if the United States had experienced higher inflation over the past five years, only about a third of respondents thought that their (nominal) dollar income would have been higher. That is, people tend to overlook the impact of higher inflation on their wages on other sources of income and assume that inflation will reduce the purchasing power.

The public's apparent belief that inflation means lower living standards may reflect the fact that in the real world (as opposed to textbooks), prices never rise by exactly the same amount. For example, in the 1970s, the most recent inflationary period in the United States, oil prices rose much faster than other prices, and oil companies benefited at the expense of most average people trying to heat their homes or put fuel in their cars. Shiller's results suggest the people may recall and associate inflation with the effects of the particular 1970s inflation that they remember.

It may also reflect the fact that unexpected price increases may hurt lenders (and other sellers using long-term contracts), while benefiting borrowers (and other buyers), if contracts do not index the dollar payments to inflation. Similarly, there may be gains to the government if tax rates are not indexed to inflation. Almost half of those surveyed reported being angry at someone when they see prices rise—the government, manufacturers, store owners, Congress, and greedy people were all mentioned. Almost three-quarters of ordinary respondents (and half of economists) agreed that the confusion caused by price changes allowed their boss, the government, or others to play tricks on them by "forgetting" to raise wages or change tax rates. However, no one answering the survey questions seemed to think they personally benefited from inflation.

Also striking is the extent to which public concern about inflation seems to extend beyond its immediate economic ramifications. A large fraction of the public believes that a high inflation rate causes society to lose "its cohesion and the feeling for the common good" (65 percent) or "lead to economic and political chaos" (91 percent) or "lose international prestige" (82 percent). This suggests that people dislike high inflation in part because it often reflects larger problems in the way a country is being run or governed. But one can also interpret this, particularly the concern for the "common good," as a response to a change in relative prices—and to the potentially disparate impact it has on the well-being of particular individuals—as much as to unhappiness over the general rise in prices by itself.

### PUTTING THEIR MOUTHS WHERE THEIR MONEY IS

A third study by Stanford Business School economist Justin Wolfers, in his words, "treads a path between the approaches of Shiller and Lucas." Wolfers makes use of regular surveys that ask people in a number of countries how satisfied or happy they are with their lives. By comparing and correlating the survey results with contemporaneous macroeconomic conditions, Wolfers can infer how changes in inflation and unemployment affect how happy people report being.

Wolfers results tend to show people placing greater weight on reducing recession and unemployment relative to inflation than either Lucas or Shiller. He estimates that an increase in the inflation rate of 10 percentage points lowers the share of the population that is "very satisfied" with their lives from 28 percent to 26 percent, while a similar increase in the unemployment rate decreases the "very satisfied" group by a whopping 12 percentage points.

Wolfers also finds that increasing levels of unemployment do "increasing harm to well-being." That is, when the unemployment rate is 15 percent, the increase in happiness to reducing the rate is quadruple that when unemployment is 5 percent, while reducing inflation by 1 percent is pretty much the same, regardless of the level of inflation. In his words, "The public appears to be extremely averse to unemployment."

Finally, Wolfers calculates a "happiness tradeoff." By this calculation, reducing unemployment by 1 percentage point improves happiness by the same amount as reducing inflation by 5 percentage points. What does this mean for the short-run tradeoff between the two policy goals? Consider a central bank trying to permanently reduce inflation by 1 percentage point. According to Wolfers, if the cost of such a policy is a temporary increase in the unemployment rate of about 2 percentage points for a year (as research suggests), the public would be slightly happier with the 1 percent reduction in inflation. But if the increase in unemployment were to persist for a longer period or the drop in inflation were not permanent, then happiness would decline.

### WHAT DOES THE PUBLIC WANT?

These studies suggest that asking the public what it wants can yield insights not easily derived from models—and that further work might help reconcile some of the apparently conflicting findings of Shiller, Wolfers, and others.

At the same time, studies like these also raise interesting and thorny issues about how one would best incorporate public preferences into macroeconomic policy decisions. If, for example, some of the public's dislike for inflation is a result of shifts in the relative prices of various goods and services that come along with inflation, what does this mean for central bank policy—which can affect the overall price level but not relative prices? And what if how people feel (and how they answer questions about how they feel) depends on when and under what conditions and in what context they are asked, as much research suggests is true? This means that preferences about policy may not be stable over time but may shift around in ways that do not make taking account of them straightforward.

Yet, finding answers and improving policy will likely require supplementing economic models with a serious attempt to figure out what the public wants. And if you want to know what makes someone happy, it is usually a good idea to ask.※