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We'd all be better off if we were all richer

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A recurring topic in this column is the appropriate measurement of well-being. Typically when we want to compare the level of development of countries we look at per capita GDP - the market value of a nation's traded goods and services divided by the number of people. However this measure is not perfect.

We have pointed out in the past a number of flaws in per capita GDP as a measure of economic output. One deficiency frequently noted is that GDP doesn't measure leisure time. The US has higher per capita GDP than most European countries but Europeans have shorter and fewer weeks of work. Furthermore using a per capita measure hides differences between people. In household welfare measures economists always adjust for family size since children and people in larger families are presumed to get more benefit from consumption.

But in national welfare measures these differences are ignored. Thus Israel with much larger families than European countries has in effect of "more people per person" and the adjusted per capita measure brings us closer to richer countries.

The most jarring assumption however is that welfare is somehow a function of economic production. So there are attempts to measure happiness directly for example using the Gross National Happiness measure used in the kingdom of Bhutan.

A key question here is how much does it matter? If we throw all these things into the mix and discover that they add or subtract a couple of percent here and there then we're pretty justified in looking at GDP; if we discover profound changes in ranking then we have to think hard about what kind of welfare we are interested in measuring.

This question was taken up in earnest by the economics profession in the early 1970's. In that era two of the most esteemed economists in the world Nordhaus and Tobin made an ambitious study entitled "Is Growth Obsolete?" in which they answered their eponymous question in the negative: Growth is not obsolete it matters a lot. Nordhaus and Tobin found that economic growth doesn't measure welfare but it is highly correlated for the purpose of making comparisons whether between nations or between time periods.

Shortly afterwards Richard Easterlin introduced a new methodology and a new conclusion. The new methodology was measuring happiness by just asking people how happy they are. The new conclusion was that economic growth didn't contribute much to well-being which was mainly determined by relative income. If this is true then economic

growth is just a rat-race; everyone is trying to get ahead to improve his or her relative income but by doing so they lower the relative income of everyone else and we are all running in place. If this is true it has profound policy implications. For example the drag on well-being caused by high taxes is much less since such taxes don't impact relative incomes. Leveling incomes could improve well-being even if it had a high "cost" in terms of discouraging economic activity and growth. Crowding out growth would mean that everyone enjoys more leisure and spends less time on the treadmill. But what if leisure also is relative?

A related claim is that absolute incomes improve reported well-being but only up to a point; beyond a certain threshold income the "Easterlin effect" is dominant.

My own studies using the World Values Survey failed to confirm Easterlin's hypothesis. I found that absolute income remains a very important contributor to national levels of self-reported well-being even among wealthy countries. A new and influential study by Betsey Stevenson and Justin Wolfers at the Brookings Institution reaches the same conclusion: based on surveys conducted since Easterlin's study and based on a more careful examination of survey data that were available then they conclude that life satisfaction is highest among the wealthiest countries.

I would almost say the opposite of Easterlin. His claim was that absolute levels of income were relatively unimportant. Within countries relative income is the most important; between countries other factors are influential. Based on more recent studies it seems that both within and among countries more income means more satisfaction. The trick seems to be to get a high average level of economic well being which is advanced by increasing equality (think - progressive taxes) but also harmed by reducing growth (think - low and flat taxes). So in the 2000's we're right back where we were before our 1970 soul-searching: finding the golden mean between equity and efficiency.

So the rising tide is a better analogy than the treadmill. If all citizens share in economic growth they will all share in having improved life satisfaction.

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