CASE STUDY – VI

CONSUMER PREFERENCES & CHOICE

Does Money Buy Happiness?

Philosophers have long pondered this question. Economists have now gotten involved in trying to answer this age-old question. They calculated the "mean happiness rating" (based on a score of "very happy" = 4, "pretty happy" = 2, and "not too happy" = 0) for individuals at different levels of personal income at a given point in time and for different nations over time. What they found was that up to an income per capita of about $20,000, higher incomes in the United States were positively correlated with happiness responses, but that after that, higher incomes had little, if any, effect on observed happiness. Furthermore, average individual happiness in the United States remained remarkably flat since the 1950s in the face of a considerable increase in average income. Similar results were found for other advanced nations, such as the United Kingdom, France, Germany, and Japan. These results seem to go counter to the basic economic assumption that higher personal income leads to higher utility.

Two explanations are given for these remarkable and puzzling results:

1) Happiness is based on relative rather than absolute income, and
2) Happiness quickly adapts to changes in the level of income

Specifically, higher incomes make individuals happier for a while, but their effect fades very quickly as individuals adjust to the higher income and soon take it for granted. For example, a generation ago, central heating was regarded as a luxury, while today it is viewed as essential. Furthermore, as individuals become richer, they become happier, but when society as a whole grows richer, nobody seems happier. In other words, people are often more concerned about their income relative to others' than about their absolute income. Pleasure at your own pay rise can vanish when you learn that a colleague has been given a similar pay increase.

The implication of all of this is that people's effort to work more in order to earn and spend more in advanced (rich) societies does not make people any happier because others do the same. (In poor countries, higher incomes do make people happier). Lower taxes in the US encourage people to work more and the nation to grow faster than in Europe, but this does not necessarily make Americans happier than Europeans. The consensus among happiness researchers is that after earning enough to satisfy basic wants (a per capita income of about $20,000), family, friends, and community tend to be the most important things in life.

Sources: R. A. Easterlin, "Income and Happiness," *Economic Journal,* July 2000; B. S. Frey and A. Stutzer, "What Can Economists Learn from Happiness Research?," *Journal of Economic Literature,* June 2002; R. Layard, *Happiness: Lessons from a New Science* (London: Penguin, 2005); R. Di Tella and R. MacCulloch, "Some Uses of Happiness Data, *Journal of Economic Perspectives,*Winter 2006, pp. 25–46; and A. E. Clark, P. Frijters, and M. A. Shields, "Relative Income, Happiness, and Utility: An Explanation for the Easterlin Paradox and Other Puzzles," Journal of Economic Literature, March 2008, pp. 95–144.